Res Judicata in the Derivative Action: Adequacy of Representation and the Inadequate Plaintiff

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Litigation Commons, and the Securities Law Commons

Recommended Citation
Available at: https://repository.law.umich.edu/mlr/vol71/iss5/4

This Note is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.
NOTES

Res Judicata in the Derivative Action: Adequacy of Representation and the Inadequate Plaintiff

I. INTRODUCTION

A shareholder whose interest in the corporation has been injured may seek redress through one of three forms of action. Selection of the proper vehicle is not a matter of discretion but is dictated by the nature of the interest violated: if the injury directly affects a shareholder, the proper avenue is a personal action for damages; when that same injury is inflicted on a larger group of shareholders, a class action may be the appropriate remedy; however, if only the corporation is directly injured, the proper recourse is a derivative suit—an equitable action brought by a shareholder on a cause of action belonging to but unenforced by, the corporation. The scope of the

1. A shareholder's "interest" in a corporation relates to the assets and profit potential of the enterprise. While there are various supplemental rights attendant upon ownership, see generally 13 W. Fletcher, Private Corporations, the primary concern of this Note is with acts by corporate directors or others who, through mismanagement, embezzlement, fraud, or violation of regulatory statutes, diminish the corporate assets or create a potential for such diminution.


5. Hawes v. Oakland, 104 U.S. 450 (1881). The Court reasoned that derivative actions were of such unusual nature as to require the extraordinary remedies provided by a court of equity, and held equity to be the proper court for all cases arising out of injuries inflicted on the corporation itself. Earlier, in Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855), plaintiff sought to enjoin the payment of taxes assessed against the State Bank of Ohio in violation of the bank's charter. The Court held equity jurisdiction proper insofar as an injunction was sought.

Equity jurisdiction of derivative suits had traditionally resulted in a denial of trial by jury, even though had the corporation brought the action in its own behalf at law a jury would have been proper on demand. Fed. R. Civ. P. 38(b). In Ross v. Bernhard, 396 U.S. 531 (1969), the Supreme Court eliminated this anomaly by authorizing jury trials in derivative actions.

6. See N. Lattin, Corporations 349-50 (1929). Since a corporation is a separate entity capable of suing and being sued in its own behalf, an injury done to it is properly redressed by the entity. It is irrelevant that the plaintiff is the sole shareholder of the corporation. Erlich v. Glassner, 418 F.2d 226 (9th Cir. 1969). The fact that the injury was sustained by the corporation denies plaintiff personal standing to bring the action.

7. E.g., Hawes v. Oakland, 104 U.S. 450, 454 (1881); Ogden v. Gilt Edge Consol. Mines Co., 225 F. 725, 728 (8th Cir. 1915).
derivative action is broader than either a personal suit or a class action. The derivative plaintiff represents not only the corporation in its suit against the wrongdoer, but also the interests of all shareholders in vindicating the corporation's legal rights. Since the derivative suit enforces corporate claims, damages generally inure directly to the corporation, not to the shareholders. By permitting shareholders to institute legal action upon default of the corporation's management, the availability of the derivative suit serves as a check on the activities of corporate directors.

The early history of the shareholder suit reveals that its deterrent potential was diminished as parties agreed to private settlements in which the defendant bought the plaintiff's consent to the entry of an adverse judgment. As the sum demanded for the plaintiff's acquiescence was often less than the cost of defense, corporate directors were likely to accede to such demands and thereby inadvertently encourage suits on even the most specious of derivative claims. Because such agreements carried res judicata effect and were often injurious to both the corporation and nonparty shareholders, various statutes and rules were adopted to regulate the conduct of the action. Thus, before the suit may begin, the plaintiff is commonly required to demonstrate shareholder status at the time of the suit and at the time of the alleged wrongdoing, and to guarantee de-


There are also several practical reasons for awarding derivative damages to the corporation. Among these are creditors' claims to recover on debts which the corporation could not pay prior to the judgment award, see N. LATIN, supra, at 378-80, and the need to satisfy the tax liability assessed against so much of the recovery as was not previously included in the corporation's gross income. See Liken v. Shaffer, 64 F. Supp. 432 (D. Iowa 1946). Cf. General American Investors v. Commissioner, 348 U.S. 434 (1954); Arcadia Ref. Co. v. Commissioner, 118 F.2d 1010 (5th Cir. 1941).


12. See, e.g., Wood Report, supra note 11, at 21-25, McLaughlin, supra note 11, at 435.


14. E.g., Fed. R. Civ. P. 23.1; DEL. CHAN. CT. R. 23.1; MICH. GEN. CT. R. 208.4. Such
a requirement precludes the possibility that stock will be purchased solely to initiate the action. An exception to this general rule accords standing to a current shareholder who purchased stock without notice after the occurrence of an action that creates a continuing and current wrong. Palmer v. Morris, 316 F.2d 649 (5th Cir. 1963); Winkelman v. General Motors Corp., 44 F. Supp. 960 (S.D.N.Y. 1942). The “contemporaneous ownership” rule has generally been regarded as a procedural requirement. Thus, a derivative suit brought in federal court by a noncomplying shareholder will be dismissed though the governing state substantive law had no comparable provision. 13 W. Fletcher, supra note 1, § 5931.

An interesting problem was presented in Bateson v. Magna Oil Corp., 414 F.2d 128 (5th Cir. 1969), cert. denied, 397 U.S. 911 (1970). Plaintiff had planned to initiate a derivative suit but had “accidentally” sold all his stock before the action had begun. Later, stock was reacquired and the suit brought on the continuing wrong theory. The court granted standing and held that a shareholder knowing of corporate wrongdoing who “by mistake” sells all of his stock can later reacquire shares and bring the action despite the fact that that purchaser had notice of the wrongdoing. Thus, the point in time of ownership test seeks to bar champertous plaintiffs, see Bateson v. Magna Oil Corp., 414 F.2d 123, 131 (5th Cir. 1969), cert. denied, 397 U.S. 911 (1970); Vann v. Industrial Processes Co., 247 F. Supp. 14, 18-19 (D.D.C. 1965); Sayles v. White, 18 Misc. 155, 158, 41 N.Y.S. 1063, 1064 (Sup. Ct.), revd. on other grounds, 18 App. Div. 396, 46 N.Y.S. 194 (1896); Wood Report, supra note 11, at 116, or parties seeking improperly to confer jurisdiction, see Amar v. Garnier Enterprises, Inc., 41 F.R.D. 211, 215 (D.C. Cal. 1966); H. Ballentine, Corporations § 190a (1927).


16. N.Y. Gen. Corp. Law §§ 60-61b (McKinney Supp. 1972). Section 61(b) (Security for Expenses) requires that the derivative plaintiff post a security bond, but only if that plaintiff holds less than five per cent of the outstanding stock or the value of the shares held is less than 50,000 dollars. The restriction was not intended to foreclose any right but to protect the corporation from suit by a shareholder with only a minimal interest. See Governor’s Memorandum on Approving L. 1944 c. 668, in N.Y. Gen. Corp. Law § 61b (McKinney Supp. 1972). For a criticism of the New York rule, see Horstein, New Aspects of Stockholders’ Derivative Suits, 47 Colum. L. Rev. 1 (1947).

17. A shareholder may also be precluded from pursuing the corporate cause of action if he fails to exhaust intra-corporate remedies by demanding that the corporation seek redress on its own behalf. E.g., Fed. R. Civ. P. 23.1; Del. Chan. Ct. R. 23.1; Cal. Corp. Code § 834(a)(2) (West 1955); N.Y. Bus. Corp. Law § 623 (McKinney 1963). Presumably, such a requirement is based on the notion that the cause at issue is an asset of the corporation and is most properly vindicated by the officers of that entity. See note 6 supra. When the directors are also the alleged wrongdoers, however, such a demand would be patently futile and is not required. Delaware & Hudson Co. v. Albany & S.R.R., 213 U.S. 435, 451-53 (1909); deHas v. Empire Petroleum Co., 435 F.2d 1223, 1228 (10th Cir. 1970). See also In re Penn-Central Sec. Litigation, 355 F. Supp. 1026, 1039 (E.D. Pa. 1971); Sachs v. American Fletcher Natl. Bank & Trust Co., — Ind. —, 279 N.E.2d 807, 811 (1972) (demand on trustees of a bankrupt corporation).

Assuming that the shareholder satisfies requirements of his own qualifications to litigate the action, it is further required that the corporation be joined as a party. Davenport v. Dows, 85 U.S. (18 Wall.) 626 (1873); Philipbar v. Darby, 85 F.2d 27 (2d Cir. 1936); Marcus v. Textile Banking Co., 88 F.R.D. 185 (S.D.N.Y. 1965). If the court is unable to assert jurisdiction over the corporation or if the plaintiff fails to join the corporation, the suit is dismissed for failure to join an indispensable party. Lucking v. Welbilt Corp., 283 Mich. 373, 91 N.W.2d 846 (1958). Generally, the shareholder may refile his complaint in a jurisdiction able to assert its power over the corporation, as-
furthered the adequacy of the derivative suit by barring the cham­
pertous plaintiff and the spurious cause of action.

Even assuming that all preconditions are satisfied, however, it is
important that the derivative plaintiff be an adequate representative
if the corporate cause is to be fully litigated before the entry of a
final judgment. Because traditional res judicata principles prohibit
the splitting of a single cause of action between several successive
suits, the corporate claims are either barred or merged after a judg­
ment on the merits as to all issues which were litigated or which
might have been litigated in the initial action. 18 In defining a "cause
of action" 19 within the context of the derivative action, or any other
action, the courts have looked beyond the theory on which the
plaintiff has based his claim for relief to the facts comprising the
alleged offense. 20 A substantial identity of operative facts between
the two actions will generally result in the application of res judicata
to bar the second suit.

Thus, the derivative plaintiff is able to foreclose all future litiga­
tion by other shareholders 21 or the corporation's directors, 22 by ob­
taining a judgment on the merits 23 of the corporate cause. Despite

F.2d 435 (1st Cir.), cert. denied, 314 U.S. 659 (1941). See generally 1B J. Moore,
FEDERAL PRACTICE ¶ 4.091 (2d ed. 1965).

19. See 1B J. Moore, supra note 18, ¶ 4.401[1]; 2 id. ¶ 2.06[6] (2d ed. 1970); Clark,

20. E.g., McCarthy v. Noren, 370 F.2d 845 (9th Cir. 1967); Williamson v. Columbia
Gas & Elec. Corp., 185 F.2d 464 (2d Cir. 1950), cert. denied, 341 U.S. 921 (1951); Wolcott
Supp. 397 (S.D.N.Y. 1958), affd. per curiam, 266 F.2d 320 (2d Cir. 1959).


22. Alleghany Corp. v. Kirby, 333 F.2d 327 (2d Cir. 1964), cert. dismissed, 384 U.S.
28 (1966).

23. It should be noted that involuntary dismissals predicated on certain procedural
defaults peculiar to the derivative plaintiff, such as failure to satisfy a precondition of
the suit, see notes 13-17 supra, are not judgments on the merits. Thus, a dismissal
predicated upon failure to join the corporation as a party, see Notes of Advisory Com­
mittee on 1963 Amendment to Rules, FED. R. CIV. P. 41, or failure to establish the
court's jurisdiction, see Marcus v. Textile Banking Co., 38 F.R.D. 185 (S.D.N.Y. 1965),
does not carry res judicata effect. The principle is illustrated in Saylor v. Lindsley, 391
F.2d 965 (2d Cir. 1968). At issue was the loss to the corporation of a mine fraudulently
the effect of a derivative judgment on nonparticipating shareholders, foreclosure of the cause carries the same degree of finality afforded to a more limited, private action\textsuperscript{24} and no larger grounds for collateral attack are permitted. Thus, in the absence of fraud or collusion, even an inadequate derivative judgment, arrived at because of the plaintiff's negligence or economic inability to more vigorously prosecute the action, serves to bar relitigation of the action.\textsuperscript{25}

It is the purpose of this Note to examine the adequacy of representation in a derivative suit and to consider the appropriateness of applying res judicata to foreclose the corporate cause of action. Discussion will focus on the following areas: (1) the problem of the inadequate plaintiff; (2) the efficacy of judicially created devices designed to ensure the adequacy of representation; and, (3) the feasibility of partially exempting the derivative cause of action from the operation of res judicata.

II. Adequacy of Representation in the Derivative Suit

Unlike the more limited personal action, a judgment foreclosing a derivative cause of action is relevant to the interests of a large transferred to a second corporation in which the defendant directors held large personal interests. The first suit on this cause was dismissed "with prejudice" for failure of the plaintiff to post bond guaranteeing defendants' litigation expenses; the dismissal was upheld on appeal. Hawkins v. Lindsley, 327 F.2d 356 (2d Cir. 1964). The Hawkins judgment was then pled by the defendants as a bar to Saylor's action. The district court agreed and held that the earlier dismissal "with prejudice" had foreclosed the action. Saylor v. Lindsley, 274 F. Supp. 253 (S.D.N.Y. 1967). The Second Circuit reversed and held that the Hawkins plaintiff had merely failed to satisfy a requirement necessary to commence the action. The defendants had therefore not been required to defend on the merits of the action and had not been placed in danger of an adverse judgment. The court concluded that to bar Saylor on the basis of Hawkins' default would work too harsh a result for another's failure to satisfy a rule of procedure. 391 F.2d at 969.

A related problem arises with regard to involuntary dismissals for failure to prosecute or to comply with procedural requirements during the course of the litigation. Unless specifically designated as being "without prejudice," FED. R. CIV. P. 41(b) provides that such dismissals are "upon the merits." The Supreme Court has stated in dictum that FED. R. CIV. P. 41(b) is to have res judicata effect. Costello v. United States, 365 U.S. 265, 286 (1961). In a recent case, however, the Second Circuit created an exception to the general operation of that rule:

We hold that, when notice of a proposed dismissal of a stockholder's derivative suit for failure to answer interrogatories is not given to nonparty stockholders, the judgment of dismissal does not bar an identical cause of action asserted by a different stockholder in a subsequent derivative suit.


\textsuperscript{25} The frequency with which a corporate claim is inadequately represented is, by the nature of the problem, unascertainable. There are many instances, however, in which shareholders have sought to upset a derivative judgment on the basis of the original plaintiff's alleged ineptitude. See, e.g., Papilsky v. Berndt, 466 F.2d 251 (2d Cir.), cert. denied, 409 U.S. 1077 (1972); Saylor v. Lindsley, 391 F.2d 965 (2d Cir. 1968); Phillips v. Bradford, 228 F. Supp. 397 (S.D.N.Y. 1964); Ratner v. Paramount Pictures, Inc., 6 F.R.D. 618 (S.D.N.Y. 1942).
class of persons. The consequences of foreclosing the corporate claim, likewise spread among that same group, become harsher in direct proportion to the number of interests inadequately represented. Yet, despite the wide scope of the action, standard rules of res judicata apply since the corporation, in the form of a plaintiff-shareholder, has had an opportunity to litigate the merits of the claim. Given the complexity of the derivative action, however, it is clear that all plaintiff-shareholders are not equally able or willing to adequately prosecute the action. This section will discuss some specific problems related to inadequate representation and will examine devices created to counter the effects of such deficiencies. In addition, supplemental proposals to further ensure the adequacy of plaintiff's representation will be considered.

A. The Problem of the Inadequate Plaintiff

In the absence of collusion, the adequacy of plaintiff's representation involves two separate factors. The first may be equated with the plaintiff's inherent qualifications. Some persons are more vigorous, more knowledgeable and better able to bear the financial burdens attendant upon such an action. The second relates to the plaintiff's use of those qualifications through the discovery and presentation of evidence. To the extent that the derivative plaintiff is deficient in either respect, his representation is inadequate and the corporate cause may be extinguished without an adequate adjudication. For example, failure to discover facts concerning the nature of defendant's wrongdoing and the extent of the injuries sustained by the corporation may lead to an unwarranted judgment for the defendants or an insufficient award for the plaintiff. 26

Failure to adequately discover is not always a consequence of negligence or lack of interest. Discovery, inevitably, is a function of economics and its effectiveness is often limited by the plaintiff's inability to pay the attendant expenses. Apart from economics, complex derivative actions present a particular potential for abuse of the discovery process. A recalcitrant defendant may conceal some relevant materials from the plaintiff or deliver a mass of quasi-relevant but misleading documents. 27 Despite his ability to compel discovery, even a knowledgeable plaintiff is unlikely to be cognizant of all relevant documents. 28 Correlatively, invocation of the enforce-

26. In determining the adequacy of a voluntary settlement, the courts place primary emphasis on whether the settlement figure appears adequate on the basis of the evidence actually presented, not that which might have been presented. See, e.g., Masterson v. Pergament, 303 F.2d 315, 333 (6th Cir., cert. denied, 346 U.S. 832 (1953); Phillips v. Bradford, 228 F. Supp. 897, 401 (S.D.N.Y. 1964).


ment devices\textsuperscript{29} incorporated into the discovery rules may be expensive, time consuming, and frustrating. Under such circumstances, it is clear that the derivative cause cannot be adequately adjudicated by an inept or negligent plaintiff. The fact that courts recognize the importance of discovery in the derivative context, does not necessarily mean that they will take the initiative in forcing its completion prior to the entry of a judgment.\textsuperscript{30}

Even when the plaintiff is aware of all relevant facts, it is not certain that he will be able to properly utilize such information. Again, the problem is one of vigor, economics and sufficient expertise to formulate the most appropriate theory of action. Depending on the particular circumstances, a derivative plaintiff may choose to predicate his action, for example, on debt, breach of fiduciary duty, waste, fraud, or violation of any applicable regulatory statute. To the extent that one form of action more adequately encompasses the nature of the derivative cause than another, the plaintiff-shareholder pursuing that alternative may be the most adequate representative of the corporate interests.\textsuperscript{31} As a general proposition, however, foreclosure of a cause of action is not avoided by reference to new theories of enforcement.\textsuperscript{32}

The problem of the inadequate plaintiff is especially acute if concurrent suits are brought on the same derivative cause. Not uncommonly, a single breach of fiduciary duty will result in the initiation of several derivative actions in different jurisdictions.\textsuperscript{33} As a general proposition, any judgment rendered on the merits of a corporate cause operates as a bar to all other derivative actions, whether those competing claims were brought before,\textsuperscript{34} or during\textsuperscript{35}

\textsuperscript{29}E.g., \textit{FED. R. Civ. P. 37}.

\textsuperscript{30}One court, for example, after permitting a shareholder to initiate a suit in federal court largely because of the superiority of available discovery devices, \textit{Ratner v. Paramount Pictures, Inc.}, 46 F. Supp. 339, 340 (S.D.N.Y. 1942), held that same suit barred by a judgment in state court dismissing a concurrent suit on the same cause of action. \textit{Ratner v. Paramount Pictures, Inc.}, 6 F.R.D. 618 (S.D.N.Y. 1942).


\textsuperscript{32}See text accompanying note 20 \textit{supra}.


\textsuperscript{34}Masterson v. Pergament, 203 F.2d 515 (6th Cir.), \textit{cert. denied, 346 U.S. 832 (1953)}.

the suit on which the judgment was secured. Thus, when the defendant achieves a judgment in one jurisdiction, he may assert, in all other actions then in progress, that the corporate cause has been extinguished. In an ideal world, such foreclosure would work little hardship since the merits of each derivative suit on the same corporate cause are substantially identical. As a practical matter, however, some plaintiffs are more vigorous, resourceful or in a better economic position to adequately pursue the cause. Corporate defendants may therefore seek to delay all but the least harmful derivative suit and litigate the issues, or reach a voluntary settlement, in the most favorable context. While some authority indicates that a concurrent derivative suit will not be forceclosed by a settlement purposely entered to frustrate a more competent plaintiff, it is unlikely that less blatant examples of "plaintiff-shopping" would warrant similar treatment. Further, it is equally unlikely that such a practice would constitute fraud sufficient to upset a judgment on collateral attack.

While the courts have expressed concern that the derivative cause not be too easily extinguished, such an attitude is not a viable substitute for adequate representation. Thus, the inadequate plaintiff's capacity to foreclose the derivative cause is largely unabated. The problem, however, cannot be fully understood without a consideration and appraisal of the judicial and statutory devices that are designed to safeguard adequacy of representation.


37. See Breswick & Co. v. Briggs, 135 F. Supp. 397 (S.D.N.Y. 1955). Plaintiffs in Breswick had filed a derivative suit in federal court concerning various transactions of the Alleghany Corporation. Similar litigation had been filed by other plaintiffs in the New York state courts, consolidated as Zenn v. Anzalone, 17 Misc. 2d 897, 191 N.Y.S.2d 840 (Sup. Ct. 1959), appeal dismissed, 11 App. Div. 2d 938, 210 N.Y.S.2d 748 (1960) (approving final settlement). The Breswick plaintiffs, however, "were the first and only litigants to develop the contention that during the period in question Alleghany was subject to the Investment Company Act" of 1940, as amended, 15 U.S.C. §§ 80a-1 to -52 (1970). 135 F. Supp. at 406. This contention had been upheld and an injunction issued in a related action by the same plaintiffs, Breswick & Co. v. United States, 134 F. Supp. 132 (S.D.N.Y. 1955). Four days after that injunction was issued, the parties to the Zenn litigation, from which the Breswick plaintiffs had been excluded, announced a stipulation of settlement to terminate Zenn. The federal court, however, noting that the Breswick plaintiffs "perhaps had been the most vigorous and most successful in the litigation," reversed the Zenn defendants' conduct inequitable and enjoined them from using the proposed settlement to assert res judicata in Breswick. See Note, "Enjoining" Res Judicata: The Federal-State Relationship and Conclusiveness of Settlements in Stockholders' Derivative Suits, 65 YALE L.J. 543 (1956).

38. See Alleghany Corp. v. Kirby, 325 F.2d 327, 334 (2d Cir. 1964), cert. dismissed, 384 U.S. 1077 (1966). See also FED. R. CIV. P. 65(b)(3). See generally Comment, supra note 27.

B. Current Devices and Suggested Improvements To Ensure Adequacy of Representation

It would be unfair to conclude that the courts have been completely oblivious to the problems created by inadequate representation. The courts have formulated a series of measures designed to protect the corporate cause from undue extinction. Because those safeguards are generally ineffective, further measures appear necessary to ensure adequacy of representation in the derivative suit.

1. The “Adequate Representation” Standard

As a prerequisite to bringing a derivative action, Federal Rule of Civil Procedure 23.1 requires that a plaintiff “fairly and adequately represent the interests of the shareholders.”40 While there are few cases interpreting that standard, it would seem reasonable to expect that factors regulating the class action representative would also apply to the derivative plaintiff.41 At a minimum, an adequate class representative must have the same interests as the class at large and have no conflicting interests.42 By requiring that a derivative plaintiff demonstrate shareholder status, Federal Rule of Civil Procedure 23.1 and similar state statutes43 go far toward ensuring this basic level of adequacy.44 Similarly, these technical requirements imposed

---

40. Compare the language of Fed. R. Civ. P. 23(a)(4), permitting a class action only if “the representative parties will fairly and adequately protect the interests of the class.” Prior to the 1966 amendments to the Rules, shareholders’ derivative suits were included as class actions under Rule 23. The single standard applicable to both required plaintiff to “fairly insure the adequate representation of all” members of the class.


43. See note 14 supra.

44. In some cases, however, the plaintiff’s technical compliance with the shareholder requirement may be so insubstantial in fact that he does not meet the required standard of adequacy. In Amar v. Garnier Enterprises, Inc., 41 F.R.D. 211 (C.D. Cal. 1966), plaintiff had become a shareholder by purchasing from his cousin an interest barely sufficient to meet federal jurisdictional requirements, while other shareholders of longer standing were parties to a concurrent action for dissolution in the state court. The court found that “[m]ost of the transactions of which Amar complains in his pleading in this action occurred before he became a shareholder, and his ability to prosecute with respect to such matters is at least doubtful . . . .” 41 F.R.D. at 217. The court accordingly determined that the plaintiff lacked representative capacity. These same
by the various rules and statutes as preconditions to the derivative action also help to ensure plaintiff's interest in the litigation. In addition to measuring the representative's objective relation to his class, the courts have also cited the plaintiff's honesty, vigor, conscientiousness, skill, and competence of counsel as relevant components of adequate representation.

While such considerations would assist in protecting the derivative cause, they are difficult to measure as a threshold matter, and require the court to make a subjective determination without an adequate basis for evaluation. The best solution would be for the court to grant conditional representative status to a derivative plaintiff, subject to revocation. If the plaintiff's representation later appears inadequate, the court should consider augmenting the action by requiring notice to other shareholders of plaintiff's inadequacy and permitting intervention, or dismissing the action without prejudice to the corporate cause. Thus, the court could minimize the possibility that an inadequate plaintiff would foreclose the derivative cause.

2. Appointment of Independent Counsel

In a further attempt to protect the derivative cause, some courts, having found a conflict of interest when counsel represents both the corporation and the alleged wrongdoers, require the appointment of an independent attorney to represent the corporation. How-factors, of course, also established that the action was "a collusive one to confer jurisdiction" in contravention of Fed. R. Civ. P. 23.1, the alternative basis for the court's dismissal. 41 F.R.D. at 216-17.

45. See notes 15-17 supra.


48. Such a rule is currently incorporated into Fed. R. Civ. P. 23(d)(2). See also text accompanying notes 66-74 infra.

49. Fn. R. Civ. P. 23(d) permits the court, upon finding that the plaintiff is an inadequate class representative, to limit the class to those adequately represented, order the representative group to be augmented, or permit the suit to continue as a private action. See 7 C. WRIGHT & A. MILLER, supra note 41, § 1765. While the nature of the derivative suit precludes reformation into a private action, the other remedial measures for class actions seem equally appropriate for derivative suits.

50. See, e.g., Murphy v. Washington American League Baseball Club, Inc., 324
ever, those courts have not always outlined procedures sufficient to
guarantee that the "independent" attorney would in fact be free of
the defendant directors' influence.

Basically, the problem involves the method of selection. One
court, for example, while granting plaintiff's motion for the appoint­
ment of an independent attorney to represent the corporation, also
concluded that "[t]he fact that the selection of such independent
counsel will necessarily be made by officers and directors who are
defendants does not . . . present any insuperable difficulty."51 However,
any such selection by derivative defendants would inevitably
be tainted with elements of self-interest. Alternatively, to permit the
plaintiff to make the selection would constitute a pretrial judicial
determination that the derivative plaintiff is the best judge of the
corporation's interests. A procedure requiring the judge alone to
make such a selection would constitute judicial involvement in in­
ternal corporate affairs, prior to a showing that such interference is
justified. Further, a procedure which involves both defendant and
plaintiff would not prove satisfactory if the parties are unable to
agree on a mutually acceptable choice. While there appears to be
no simple solution, perhaps the optimal procedure would involve
a two-stage process in which the parties, with judicial supervision,
could attempt to make a mutually acceptable selection. Failing
agreement, the court could appoint such a representative and justify
its interference on the ground that the actions of the parties clearly
indicate an impasse requiring judicial intervention for the limited
purposes of selecting an independent corporate representative.

3. Alignment of the Corporation

Another problem concerning the role of the corporation in the
derivative suit is that of the alignment of parties. As a general rule,
the corporation, an indispensable party to the derivative action,52 is
joined as a defendant. While disregarding the corporation's theoreti­
cal identity of interest with the plaintiff, such alignment follows from
the danger that the corporation, which has refused to bring the
action in its own behalf and which is often under the control of the
defendant directors, will be antagonistic to the derivative cause.53

F.2d 394 (D.C. Cir. 1963); International Bhd. of Teamsters v. Hoffa, 242 F. Supp. 246
R.R., 57 F. Supp. 680 (E.D. Pa. 1944) (actual showing of conflict required before in­
dependent attorney need be appointed). See also Burnham, The Attorney-Client Privi­
leges in the Corporate Arena, 24 Bus. Law. 991 (1969); Osborn, Developments in Cor­

52. See note 17 supra.
Thus, the plaintiff-shareholder is protected from interference from hostile parties. On motion, the corporation may, in some cases, be made a plaintiff. As a prerequisite to such realignment, the court must be satisfied that the corporation recognizes that its interests lie with the plaintiff; that the persons currently in control of the entity did not share in the alleged wrongdoing, and that the court's jurisdiction will not thereby be destroyed. Consequently, realignment is seldom granted, and plaintiff's control of the action is not diluted by the presence of a potentially hostile party. While the rules regarding alignment of the parties tend to preserve the integrity of the action, they are, at best, a negative safeguard and do nothing to ensure that the plaintiff-shareholder's representation will be adequate even in the absence of interference.

4. Intervention of Shareholders

Intervention into a derivative suit will be granted as a matter of right to an otherwise qualified shareholder only when the interests of the intervenor are not being "adequately represented" by the plaintiff-shareholder who initiated the derivative action. When representation is adequate, permissive intervention may be granted, but the courts will consider whether the intervenor's participation will delay the proceedings or prejudice the rights of the original parties.

While the intervention of additional shareholders may ensure a more adequate representation of the derivative cause and minimize

56. E.g., In re Penn-Central Sec. Litigation, 335 F. Supp. 1026 (E.D. Pa. 1971) (petitioners were court appointed trustees for the bankrupt defendant railroad).
58. See supra note 18, § 23.1.21[1].
59. FED. R. CIV. P. 24(a)(2).
60. "The rule is that representation is adequate if no collusion is shown between the representative and an opposing party, if the representative does not have or represent an interest adverse to the proposed intervenor and if the representative does not fail in the fulfillment of his duty." Martin v. Kalvar Corp., 411 F.2d 552, 553 (9th Cir. 1969). See also Twentieth Century-Fox Film Corp. v. Jenkins, 7 F.R.D. 197 (S.D.N.Y. 1947) (intervention granted when corporation reluctant to prosecute suit begun at shareholder's behest); Duncan v. National Tea Co., 14 Ill. App. 2d 290, 144 N.E.2d 711 (1957) (original plaintiff no longer willing to prosecute).
61. See, e.g., Nuesse v. Camp, 385 F.2d 694 (D.C. Cir. 1967); Degge v. City of Boulder, 336 F.2d 220 (10th Cir. 1964); Janousek v. Wells, 303 F.2d 118 (8th Cir. 1962).
62. That attitude was expressed within the context of shareholder intervention into a suit begun by a corporation at the shareholder's behest. Twentieth Century-Fox Film
opportunities for collusion between a single plaintiff and the derivative defendants, such participation is expensive and, in some circumstances, nonproductive.\textsuperscript{63} Unless the motion was granted because of the plaintiff's inability or unwillingness to protect the cause, at least partial control of the action will remain with the original party.\textsuperscript{64} Thus, a recalcitrant derivative plaintiff might seek to impair the intervenor's effective participation by denying him access to relevant materials.\textsuperscript{65}

The utility of intervention as a safeguard is further limited by the fact that potential intervenors are not certain to be aware of the pendency of a derivative suit. Generally, notice is not required to be given to all shareholders unless and until a voluntary settlement has been proposed.\textsuperscript{66} Thus, through entry of an involuntary judgment on the merits, for example, a derivative suit may be dismissed and the cause foreclosed without any notice to potential intervenors.\textsuperscript{67} In considering a motion for dismissal on the merits, the plaintiff's opposition to the motion might suggest that there is no further need to safeguard the derivative cause.\textsuperscript{68} While such a determination is presumably based on the notion that the plaintiff, having invested a great deal of time and effort into prosecuting the action, is not likely to easily relinquish his derivative claims, it fails to consider

\textsuperscript{63} For purposes of recovering legal expenses, it is unlikely that an intervenor will be afforded larger rights than those given the original derivative plaintiff: the intervenor must recover something of value for the corporation. \textit{See, e.g.,} Bosch v. Meeker Cooperative Light & Power Assn., 257 Minn. 362, 101 N.W.2d 423 (1960). The problem then is determining the meaning of a benefit to the corporation. The probable result is that the intervenor must recover, by virtue of his objections, an amount beyond what the parties would have accepted or that the intervenor must have contributed to the quality of the prosecution leading to a settlement. In either case, the measure is difficult and uncertain.


\textsuperscript{65} In such a situation, the intervening party may resort to discovery by invoking \textit{FED. R. CIV. P. 26}, which permits any party to take the testimony of any person or party upon oral or written interrogatories. The scope of permissible matter included "any matter not privileged, ... whether it relates to the claim of defense of any other party, including the existence, description, nature, custody, condition and location of any books, documents or other tangible things and the identity and location of persons having knowledge of relevant facts." \textit{FED. R. CIV. P. 26(b)}.

\textsuperscript{66} \textit{See, e.g.,} \textit{FED. R. CIV. P. 23.1}; 3B J. \textsc{Moore}, \textit{supra} note 18, \textit{\S} 23.1.24[2]. \textit{But see} Papilsky v. Berndt, 466 F.2d 251 (2d Cir.), \textit{cert. denied}, 409 U.S. 1077 (1972), requiring that notice be given of a dismissal pursuant to \textit{FED. R. CIV. P. 41(b)} if res judicata is to attach.


\textsuperscript{68} 7A C. \textsc{Wright} & A. \textsc{Miller}, \textit{supra} note 41, \textit{\S} 1839 at 436. \textit{Cf.} Daugherty v. Ball, 43 F.R.D. 329, 335 (C.D. Cal. 1967).
that the plaintiff may be inept or, alternatively, may be feigning opposition to protect a collusive agreement through entry of a binding judgment. Lacking notice, nonparty shareholders, not otherwise aware of the derivative action, are denied an opportunity to intervene and remedy a representative's deficiencies. Correlatively, absent notice, a more vigorous plaintiff engaged in a concurrent derivative suit on the same cause of action will not be alerted to possible foreclosure through judgment or provided an opportunity to intervene into or consolidate the respective actions.69

Clearly, then, if intervention is to be an adequate safeguard, notice should be given of the filing of a derivative suit. While the form that notice should take is best determined by the court in light of relevant circumstances, at a minimum it should contain a statement of the nature of the allegations, provide the identity of the representative, and be communicated to a reasonable number of shareholders.70 Because the expense of such notice may deter an otherwise vigorous representative, the court should be flexible in taxing that cost. The costs of the notice required in some class action suits,71 while generally assessed against the plaintiff as the invoking party,72 have, on occasion, been charged to the defendant.73 Those courts have considered as relevant factors "the apparent merit or lack of merit in the claim . . . the number of named plaintiffs and their financial responsibility . . . the ability of plaintiffs to make the initial outlay required, and, of course, the cost of notice."74

5. Settlement

The most familiar method of concluding a derivative suit is an agreement among the parties to voluntarily settle the action. Because of the potential for abuse inherent in such a resolution, many


70. The most analogous situation is that notice required to be given on the initiation of a class action. See, e.g., Booth v. General Dynamics Corp., 264 F. Supp. 465 (N.D. Ill. 1967) (publication sufficient notice when class consisted of several hundred thousand taxpayers); Eisen v. Carlisle & Jacquelin, 52 F.R.D. 253 (E.D.N.Y. 1971) (publication and random mailed notices sufficient when class consisted of 2,000,000 persons). In the derivative context, notices of a voluntary dismissal have also been tailored according to relevant circumstances. See, e.g., Birdbaum v. Birrell, 17 F.R.D. 409 (S.D.N.Y. 1955) (settlement notice to 7500 widely scattered shareholders sufficient when published in newspaper and local law journal).


authorizing statutes and rules require judicial supervision of settlements. Following such an agreement, shareholders must be notified of the proposed settlement and afforded an opportunity to object to its terms. At the conclusion of the settlement hearing, if all offered objections are insufficient, judgment will be entered terminating the action. Clearly, the res judicata effect accorded such a judgment is justifiable only insofar as the hearing presents an adequate forum for dissent. The crucial question in this context is whether objectors to the settlement have an opportunity to present their opposition.

Initially, the objecting shareholder may be confronted by hostility from both the plaintiff and defendant. Once the original parties have invested a great deal of time and effort in arriving at a settlement, it is not likely that they will be anxious to continue the expensive proceedings in order to satisfy a belated objector. Given the amount of time invested in the litigation, the court also has an interest in protecting the agreed-upon resolution, and the prospect of continuing the action cannot be expected to excite a great deal of judicial sympathy. Consequently, a shareholder is likely to have less influence on the court as an objector than he would have had as a party to the action. In practice, then, a heavy burden is placed on such an objector to rebut the presumption that the offered settlement is a fair resolution.

The problem becomes more acute, however, should no objection be made or should the objecting shareholders not appreciate serious deficiencies in the settlement. While it is arguable that the legislative intent to protect the action is exhausted by providing an opportunity to object, it would be difficult to justify judicial tolerance of an offensive but unchallenged settlement.

Some courts have begun to formulate criteria against which to measure the adequacy of an offered settlement. One approach has

75. See, e.g., FED. R. CIV. P. 23.1; DEL. CHAN. CT. R. 23.1; MICH. GEN. CT. R. 208.4; N.Y. BUS. CORP. LAW § 626(d) (McKinney 1963); PA. CT. R. 2230(b).
78. See Comment, supra note 27, at 1190.
80. For a discussion of the role of the objector, see Haudeck, supra note 77, at 803.
81. On a more practical level, an objecting shareholder may have little opportunity to prepare a meaningful presentation or may feel deterred by the fact that he will likely receive no reimbursement for incumbent legal expenses should his objections fail to enlarge the settlement award. See Haudeck, supra note 77, at 803-06.
been for the court to request the advice of masters or appropriate governmental regulatory agencies. Recently, one court has presumed a settlement inadequate which results in an award far less than that originally demanded. While such approaches safeguard the derivative cause in some circumstances, they do not adequately respond to the problem of the inept plaintiff. However, any greater judicial involvement would raise serious questions as to the ambit of the court's review. Were the court to measure the adequacy of the offered resolution against facts discovered by the plaintiff, the danger of inadequate discovery would remain. Yet, given the crowded condition of court dockets and the limited number of court personnel available for such an investigation, an independent fact-finding process designed to complement plaintiff's discovery efforts represents a commitment in terms of time and effort that most courts cannot make. Clearly, then, it is difficult to imagine that judicial initiative in the settlement hearing will be more than superficially helpful.

6. Conclusion on Current Safeguards

It is apparent, then, that the current statutory and judicial devices created to safeguard the interests of all parties to the derivative action are inadequate for that purpose. The interests of the corporation are too easily defeated by the negligence or lethargy of the derivative representative. If the adequacy of plaintiff's representation was carefully examined as a threshold matter and carefully re-evaluated throughout the proceedings, the problem of the inadequate plaintiff might be partially solved. Certainly, a requirement of notice to all shareholders on the filing of a derivative suit would be an improvement. But to the extent that the safeguards remain unsatisfactory responses to the representation problem, alternatives to the current operation of res judicata should be examined.

III. TOWARD AN "ADEQUATE PLAINTIFF" TEST

Despite the danger of inadequate representation, it would be difficult to contend seriously that the derivative suit should be totally


84. The conditions of the federal dockets were described by Chief Justice Burger in remarks entitled Has the Time Come?, 55 F.R.D. 119 (1972). See also Hooper, Calendar and Docket Control in Single Judge Systems, 50 F.R.D. 353 (1970).
exempted from the operation of res judicata. Res judicata represents a determination that the importance of protecting defendants and conserving court energies outweighs the danger that an occasional party will be denied justice by operation of the rule.\textsuperscript{85} Specifically, the rule is designed to protect the defendant from vexatious lawsuits, to prevent multiple recovery of damages, to promote the stability of judgment and to conserve judicial resources.\textsuperscript{86}

Beyond such traditional concerns linger more practical considerations peculiarly applicable to the derivative action. To permit an unlimited number of suits on the derivative cause would create serious financial hardships for the corporate defendant. Successive derivative suits are certain to adversely affect corporate morale and cause a loss of reputation and goodwill among the business community.\textsuperscript{87} Directors and officers who are defendants or witnesses in continuous lawsuits are unlikely to be able to discharge their duties at any level approaching efficiency.\textsuperscript{88} Endless probes into corporate affairs and the concurrent inconveniences presented by records being unavailable would constitute an unjustifiable disruption of corporate affairs. The resulting loss of corporate efficiency may disrupt the flow of goods or services and increase production costs.

It is clear, then, that to completely free the derivative action from res judicata is a deceptively simple, but unjustifiable, resolution. Any advantages wrought thereby would be undermined by resultant costs, inefficiencies, and abuses. Alternatively, current rule operation permits foreclosure of the derivative cause before the corporate claim is fully litigated. The optimal compromise would be for the court to measure the adequacy of plaintiff's representation both before and during the derivative suit.\textsuperscript{89} Given the complexity of the derivative suit, however, a representative's inadequacies are not certain to become apparent during the course of the proceedings.

Because an inadequate derivative plaintiff threatens the interests

\textsuperscript{85}Thus, through plaintiff's failure to demand complete relief, "Defendant may continue to sleep in Plaintiff's bed though not under Plaintiff's bed-quilts. Defendant may continue to occupy Plaintiff's real estate though Plaintiff has a judgment awarding him possession." Cleary, Res Judicata Reexamined, 57 YALE L.J. 339 (1948).

\textsuperscript{86}See 1B J. Moore, supra note 18, ¶ 0.405[f]; Cleary supra note 85, at 344-49.

Despite courts' concern that judicial resources not be expended in unnecessary re-litigation of actions, res judicata is an affirmative defense which must be invoked by the defendants. See DAC Uranium Co. v. Benton, 149 F. Supp. 667 (D. Colo. 1956). While the pleading requirement prevents the defendant from objecting to a second suit after that judgment has been proven less advantageous than the first, as a practical matter, defendants will rarely fail to plead the defense.

\textsuperscript{87}See Note, Control Over Settlements of Shareholders' Suits, 54 HARV. L. REV. 833, 834 (1940). While the arguments presented therein pertain to settlement before trial, they apply with equal force to multiple suit situations.

\textsuperscript{88}See Masterson v. Pergament, 203 F.2d 315, 330 (6th Cir.), cert. denied, 346 U.S. 832 (1953).

\textsuperscript{89}See text accompanying notes 40-49 supra.
of all shareholders, the courts should consider partially exempting the derivative action from the operation of res judicata. Thus, a second shareholder would be permitted to relitigate the claim by demonstrating the inadequacy of the initial corporate representative and by satisfying the court that the derivative cause was inadequately adjudicated. While any standard employed to measure the adequacy of a plaintiff's representation would inevitably require some refinement, the court should consider plaintiff's vigor, knowledge, use of evidence and discovery, the experience of counsel, and the disparity between the settlement award and the amount originally demanded. Because relitigation of the derivative claims would pose serious threats to court efficiency, the petitioning shareholder should be required to rebut a heavy presumption that the initial plaintiff was an adequate representative. Thus, for example, he could be required to demonstrate that plaintiff failed to discover relevant evidence which a reasonable inquiry would have disclosed. Should the presumption of adequacy be rebutted, the derivative judgment would be opened and both parties allowed to relitigate the derivative claim.

To partially exempt the derivative cause of action from operation of res judicata clearly would mark a departure from the general foreclosing effects of a judgment. However, such an exception is not

90. While they are similar in many respects, there are sufficient differences between class actions and derivative suits to warrant affording shareholders the opportunity to relitigate the corporate action while denying that privilege to class representatives. Initially, it should be noted that the derivative plaintiff enforces a secondary claim belonging to the corporation while the class action plaintiff represents a large number of personal claims. Thus, the real parties in interest in a class action, the members of the class, may personally object to the adequacy of a voluntary settlement. In the derivative context, however, the corporation, often controlled by the defendants, must rely on others to object to the adequacy of plaintiff's representation. Further, neither the derivative plaintiff nor potential objectors or intervenors have a direct pecuniary interest in the litigation and benefit only insofar as the award effects the value of their interests. While the plaintiff may conspire to split legal fees with the attorney, judicial supervision of such fees tends to minimize the problem. See, e.g., Green v. Transtron Electronic Corp., 326 F.2d 492 (1st Cir. 1964); Angoff v. Goldfine, 270 F.2d 185 (1st Cir. 1959). In contrast, the class action representative has a direct personal interest in the outcome of the litigation and is, to that extent, likely to vigorously protect that interest. Finally, it should be noted that the class actions authorized pursuant to FED. R. CV. P. 23(b)(3) allow class members to exclude themselves from the class and bring a private action on the same cause. Because only the corporation has a claim in the derivative suit, no such option is available to shareholders wishing to preserve their right to sue on that claim at a later date.

91. Presumably, the initial plaintiff would be barred by the previous judgment. Clearly, a plaintiff should not be allowed to relitigate by denigrating the quality of his own representation.

92. The defendants, then, should be entitled to "set-off" the damages recovered in the first suit or to recover the difference, if any, by which the first award exceeded the second. Given the fact that the second plaintiff must offer tangible evidence that the amount recovered in the initial action was less than actual damages sustained by the corporation, however, the defendant's right to relitigate is not likely to result in damages lower than those awarded in the first suit.
without precedent. For example, res judicata has, on occasion, been held not to foreclose a second action when a judgment produced an absurd result or caused an unreasonable hardship to the complaining party. Suspensions of the rule, however, are permitted only when the court is satisfied that such relief will not result in the relitigation of a large number of suits. While this latter consideration would bar relief to nonparties seeking to upset a class action judgment and relitigate the issues as a personal suit, it would not affect the derivative action. Because the derivative suit is based on a single claim, not a collection of claims as in the class action, suspension of res judicata would result in the relitigation of but one cause of action. Further, such relitigation would be permitted only after a finding by the court that the initial plaintiff was an inadequate representative.

To partially exempt the derivative suit from res judicata is not inconsistent with expanding judicial concern that the derivative suit should not be too easily extinguished. For example, plaintiff's failure to satisfy rules of procedure or preconditions to the action have been considered an insufficient basis upon which to predicate a foreclosing judgment. Similarly, in Papilsky v. Berndt, the Second Circuit Court of Appeals specifically exempted the derivative cause from the normal operation of Federal Rule of Civil Procedure 41(b). The court noted that such a dismissal, without notice to all shareholders, would allow collusive parties to terminate the action without judicial supervision. Further, the court suggested that such foreclosure would raise a significant question of due process. While Papilsky is limited in scope, the tenor of the court's remarks indicates recognition of the need for more adequate measures to safeguard the derivative cause.

One problem is the possibility that the parties to the first action will respond to the threat of relitigation by prolonging the action in order to build a record of adequate representation. Such a tactic is unlikely to be productive, however, as mere delay will do nothing more than illustrate the quality of plaintiff's representation. If

97. See, e.g., Saylor v. Lindsley, 391 F.2d 965 (2d Cir. 1968); Philipar v. Derby, 85 F.2d 27 (2d Cir. 1936).
98. 466 F.2d 251 (2d Cir.), cert. denied, 409 U.S. 1077 (1972).
99. 466 F.2d at 259.
100. 466 F.2d at 259-60.
the defendant seeks to assist the plaintiff in order to create the appearance of adequacy, any resulting judgment would, of course, be subject to attack as fraudulent. To the extent that such delay results in a more complete adjudication of the corporation's claim, however, the problem of inadequate representation will be avoided without resort to a second derivative suit.

While partially exempting the derivative action from full foreclosure would create some problems in terms of judicial economy, the extent of such additional effort is uncertain. Clearly, if all derivative suits are relitigated, the burden on the courts would be prohibitive. Because the petitioning shareholder must rebut a heavy presumption favoring the adequacy of the initial action, however, not all derivative judgments will be set aside. Moreover, the courts already expend some effort in rebuffing shareholders seeking to begin or continue derivative suits based on a cause of action foreclosed through current operation of res judicata.\footnote{101}{See note 25 \textit{supra}.} In a situation in which a shareholder can demonstrate the inadequacy of the initial action, however, the additional burden required to repair the injury done to the corporation by the defendants and to the corporate cause by the original plaintiff would seem justified.