Conflicting Ideologies of Group Litigation: Who May Challenge Settlements in Class Actions and Derivative Suits?

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It has often been suggested that derivative suits are a species of class actions. This suggestion, first found in judicial opinions and treatises, has crept into the Federal ... Rules of Civil Procedure. To the careful student of the law this raises the question: what are the logical bases for treating the shareholders' derivative suit as a class action? To the careful practitioner of the law it raises the question: if it is so treated, what results can be expected to follow?¹

I. INTRODUCTION

Class actions and shareholder derivative suits share a number of similar characteristics. Historically, both forms of litigation began as equitable remedies.² Rule 23.1 of the Federal Rules of Civil Procedure, which currently governs shareholder derivative suits in federal court, was originally carved out of Rule 23 of the Federal Rules of Civil Procedure, which governs class actions.³ Class actions and derivative suits are both often

². See 13 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5940 (perm. ed. rev. vol. 1995) ("The derivative proceeding developed as an equitable device to enable shareholders to enforce a corporate right against faithless officers and directors, or abusive majority shareholders, that the corporation had either failed or refused to assert on its own behalf."); 7A CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 1751 (2d ed. 1986) ("The class action was an invention of equity ... mothered by the practical necessity of providing a procedural device so that mere numbers would not disable large groups of individuals, united in interest, from enforcing their equitable rights nor grant them immunity from their equitable wrongs." (quoting Montgomery Ward & Co. v. Langer, 168 F.2d 182, 187 (8th Cir. 1948)). For further discussion of the historical development of class actions and derivative suits, see infra Parts II.A, III.A.
³. Prior to a substantial revision of the Federal Rules of Civil Procedure in 1966, derivative suits in federal court had been treated like class actions under subdivision (b) of Rule 23. See Benjamin Kaplan, Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I), 81 HARV. L. REV. 356, 356-58 (1967). As part of that revision, the provisions for derivative suits and class actions were completely rewritten and augmented. The amended Rule 23 significantly altered provisions for the
referred to as “representative” actions. Class action plaintiffs represent not only themselves but also all other members of the class who share a common interest. Derivative suits allow shareholders to represent the corporation in corporate claims against directors, controlling shareholders, and third persons, when the corporation itself has failed to take appropriate action. As representative actions, class actions and derivative suits by definition necessarily determine the rights and duties of absent parties. Thus, unnamed class members must rely heavily on class representatives to protect their interests, and unnamed shareholders enforcing the right of the corporation must rely on the derivative plaintiff to protect their interests. This is particularly true when the named representative in a class action or derivative suit decides to settle the case prior to a judgment on the merits. In such instances, the Federal Rules of Civil Procedure prohibit the settlement of a class action or derivative suit without court approval and notice of the proposed settlement to all class members (in class actions) or current shareholders (in derivative suits).

One issue that has divided the courts for years in the class action context is whether absent parties who are dissatisfied with the class action settlement may subsequently appeal the court’s approval of the settlement. Some of the federal circuits that have tackled this question have held that unnamed

conduct of class actions; a new Rule 23.1 was adopted to deal with derivative suits by shareholders, and a new Rule 23.2 was added to cover actions relating to unincorporated associations. See generally 7A, 7C WRIGHT ET AL., supra note 2, §§ 1753, 1821; Sherman L. Cohn, The New Federal Rules of Civil Procedure, 54 GEO. L.J. 1204, 1213-28 (1966). For the full text of Rules 23 and 23.1, see infra notes 36-40, 108.

4. See 13 FLETCHER, supra note 2, § 5941.10 (“The shareholder brings suit on behalf of the corporation as a kind of volunteer representative.”); HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 1038 (3d ed. 1983) (“In [some] sense, a derivative action is both a representative action and a class action.”); 1 HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 1.01 (2d ed. 1985) (“Class actions are representative suits on behalf of groups of persons similarly situated.”); Note, supra note 1, at 570.

5. Class actions may not be maintained unless the claims of the class representative are typical of the claims of the class and the class representative will fairly and adequately protect the interests of the class. See FED. R. CIV. P. 23(a); see also 7A WRIGHT ET AL., supra note 2, § 1759.

6. 4 NEWBERG, supra note 4, § 22.81; see also FED. R. CIV. P. 23.1 (stating that “a derivative [suit] may not be [brought] if . . . the plaintiff does not fairly and adequately represent the interests of the shareholders . . . similarly situated in enforcing the right of the corporation”); 7C WRIGHT ET AL., supra note 2, § 1821; Mary E. Matthews, Derivative Suits and the Similarly Situated Shareholder Requirement, 8 DEPAUL BUS. L.J. 1, 6-9 (1995).

7. See FED. R. CIV. P. 23(e) and 23.1. See generally 5 JAMES WM. MOORE, MOORE’S FEDERAL PRACTICE §§ 23.83, 23.85 (3d ed. 1998) (discussing notice and court approval requirements for class action settlements); William E. Haudek, The Settlement and Dismissal of Stockholders’ Actions—Part II: The Settlement, 23 SW. L.J. 765 (1969) (discussing prerequisites to formal settlement of derivative actions including notice to shareholders, settlement hearing, and court approval of settlement).
class members may not appeal orders approving class settlements unless such members have formally intervened as parties to the litigation prior to the settlement.\textsuperscript{8} Other federal circuits have disagreed with this approach. Rather than burdening unnamed class members with the requirement of formal intervention, these courts permit such members to appeal the order approving the class settlement so long as they voiced their objections to the proposed settlement prior to its approval.\textsuperscript{9}

Very few courts have actually addressed this issue in the context of derivative suits. The Third Circuit, in \textit{Bell Atlantic Corp. v. Bolger},\textsuperscript{10} was faced with this question when an unnamed shareholder in a derivative suit appealed the settlement of the derivative suit. Although the shareholder had not formally intervened as a party to the litigation in the lower court, he had raised his objections to the settlement at the settlement hearing. The Third Circuit duly noted the split in the federal circuits with respect to the same issue in the class action context. After comparing some of the similarities and differences between class actions and derivative suits, the Third Circuit held that the unnamed shareholder did have standing to appeal the order approving the settlement of the derivative suit, despite his failure to intervene prior to the settlement.\textsuperscript{11} The court pointed out that large-scale, small-claim representative actions\textsuperscript{12} often involve “collective action problems”\textsuperscript{13} and “agency costs.”\textsuperscript{14} In such situations, named representatives

\begin{enumerate}
\item See cases discussed infra Part II.B.2.
\item See cases discussed infra Part II.B.1.
\item 2 F.3d 1304 (3d Cir. 1993). For a detailed discussion of \textit{Bell Atlantic}, see infra Part III.C.1.
\item \textit{Bell Atlantic}, 2 F.3d at 1310.
\item Frequently in class or derivative litigation, the number of clients is large and the individual injuries are small. In these cases, the overall liability of the defendant may be enormous, but the individual interests of the plaintiff class members or corporate shareholders are mininal. See Jonathan R. Macey & Geoffrey P. Miller, \textit{Auctioning Class Action and Derivative Suits: A Rejoinder}, 87 NW. U. L. REV. 458, 459 n.4 (1993).
\item \textit{Bell Atlantic}, 2 F.3d at 1309. The term “collective action” comes from the public choice literature and is used to refer to “any [group] situation where all [group members] are better off if they all cooperate than if they all defect, but where it is not necessarily in each [member’s] individual interest to cooperate.” IAIN MCLEAN, PUBLIC CHOICE 195 (1987). See also Jonathan R. Macey & Geoffrey P. Miller, \textit{The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform}, 58 U. CHI. L. REV. 1, 8 n.6 (1991). See generally JAMES S. COLEMAN, INDIVIDUAL INTERESTS AND COLLECTIVE ACTION 15-62 (1986); Randall S. Thomas & Robert G. Hansen, \textit{Auctioning Class Action and Derivative Lawsuits: A Critical Analysis}, 87 NW. U. L. REV. 423, 427 (1993) (stating that “collective action problems [are] inherent in any effort to organize a large group of individuals into one common project”). See infra notes 303-06 and accompanying text.
\item \textit{Bell Atlantic}, 2 F.3d at 1309. The term “agency costs” refers to the costs that must be incurred by the principal to insure that an agent is acting in the principal’s best interests and to the losses that result from the agent’s failure to act in such interests. John
in class actions and derivative suits serve as "mere figurehead[s]" in the litigation; they lack incentives to monitor closely their lawyers and the settlement negotiations because the costs of such monitoring outweigh any pro rata benefits to the named representatives. As a result, there is a risk of collusion between the attorney for the derivative plaintiff and the defendant: the plaintiffs' attorney and the defendant may settle the case in a manner that harms the plaintiffs by agreeing to a minimal settlement recovery in exchange for high attorney fees. The Third Circuit was persuaded that "[s]uch a risk cautions against creating obstacles to challenging derivative suit settlement agreements."

Faced with the identical issue, the Seventh Circuit recently disagreed with the approach taken by the Third Circuit in Bell Atlantic. In Felzen v. Andreas, the Seventh Circuit sharply criticized the reasoning and the result in Bell Atlantic. Distinguishing the nature of derivative suits from that of class actions for purposes of appeal, the Seventh Circuit held that unnamed shareholders who fail to intervene formally as parties in the lower court may not subsequently appeal the order approving the settlement of a derivative suit. The court reasoned that shareholders in derivative suits, unlike class members in class actions, are not the real injured parties; rather, the corporation is the true injured party. Thus, shareholders who wish to appeal the settlement of the corporation's right to recovery must intervene

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C. Coffee, Jr., Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669, 680 n.30 (1986). In the context of litigation, clients are principals that use attorneys as their agents to represent their interests in important litigation decisions. Some commentators have noted, however, that in class actions and derivative suits, "[p]laintiffs' ... attorneys do not [always] fit this mold [because] ... [t]hey are subject to only minimal monitoring by their ostensible 'clients' ... ." Macey & Miller, supra note 13, at 3. Because the agent's interests may differ considerably from the interests of the principal in representative actions, resources may need to be expended to overcome these agency costs. Id. at 13. See also infra notes 249-52, 302 and accompanying text.


16. Bell Atlantic, 2 F.3d at 1310; see also John C. Coffee, Jr., The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation, 48 No. 3 Law & Contemp. Probs. 5, 23-25 (1985) (discussing problems of collusion in the settlement of derivative suits); infra Part V.C.

17. Bell Atlantic, 2 F.3d at 1310.


19. Id. at 875. For a detailed discussion of Felzen, see infra Part III.C.2.
as parties. Applying this reasoning, the Seventh Circuit acknowledged that its decision creates "a conflict among the circuits."\(^{20}\)

This article presents a proposed resolution of this complex issue. The complexity arises in large part from the failure to understand the key differences and similarities between class actions and derivative suits for purposes of appeal. Part II begins with a summary of the historical development of the class action device and a discussion of its underlying purposes. Particular emphasis will then be given to the current split in the federal circuits over whether unnamed class members have standing to appeal orders approving class action settlements.

Mirroring this format in the derivative suit context, Part III will briefly summarize the historical development of the derivative suit device and discuss the policies that drive derivative litigation. A closer look will be taken at the conflicting approaches of the Third and Seventh Circuits with respect to unnamed shareholders’ standing to appeal orders approving derivative suit settlements. Part IV contains a critical analysis of the Seventh Circuit's reasoning in *Felzen v. Andreas* and concludes that the court has relied too heavily on legal fictions. *Felzen* fails to account for the reality of injury in derivative litigation. Although shareholders' injury is derivative, or secondary, to that of the corporation, the interests (and injury) of the shareholders cannot be ignored.

Part V addresses the collective action and agency cost problems inherent in class actions and derivative suits. Such concerns must be considered if one is to resolve the question of who possesses the right to appeal orders approving settlements in representative actions. Part VI examines the rule of formal intervention adopted by the Seventh Circuit and explores in detail how intervention would be implemented in the context of derivative suits. Requiring intervention to gain appellate rights would do little to ensure that settlements contain merit. This article thus recommends that the intervention rule be replaced with a more flexible approach.

Part VII suggests that the two different approaches adopted by the Third and Seventh Circuits with respect to appellate standing reflect two conflicting ideologies concerning derivative litigation and the costs associated with it. The rule of intervention and the rule recommended by this article represent two mutually exclusive methods for remedying the dual evils of agency costs and collective action problems. The adoption of one rule over the other constitutes a deliberate decision to remedy one set of problems while potentially increasing another set of costs. Part VIII concludes that it would be fundamental error to attempt to force derivative suits into a standard model of litigation. Overly technical procedural rules that bar appellate court access in the context of derivative suits should be discouraged because such rules threaten to harm the very interests of those absent parties who require the most protection.

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20. *Bell Atlantic*, 134 F.3d at 878.
II. THE CLASS ACTION SETTING

A. Historical Background

The origins of the class action device date back to seventeenth century England. "The Bill of Peace, created by the English [Court of] Chancery . . . , was the predecessor of the class action suit."21 This "invention of equity"22 enabled the court to adjudicate claims brought "by . . . a representative[] of a group if [the] plaintiff could [show] that the number of [individuals] involved was [sufficiently] large as to make joinder . . . impracticable."23 The "rigid common law . . . rules [applicable at the time] did not permit joinder of parties unless the joined parties were joint obligors [or] obligees."24 Thus, if a plaintiff had a claim against many persons who were not joint obligors, the common law system required the plaintiff to bring individual suits against each person despite the presence of common issues of law and fact. The bill of peace solved this problem by giving the equity court jurisdiction over all the parties in the entire matter, regardless of their status as joint obligors or obligees.25 The equity courts, however, had strict compulsory joinder rules which required that all "materially interested" persons be joined as parties to the action before they could be bound by any court judgment.26 Actions that potentially involved hundreds of parties would result in difficult problems of administration for the court.27 The bill of peace, therefore, became a "creation of necessity—to avoid the strict rule requiring joinder of all interested persons, where such joinder would be impracticable or impossible."28 Once the court allowed the representative action to proceed, the resulting judgment bound all members of the group, whether or not they were present in the action. "Bills of Peace


23. 7A WRIGHT ET AL., supra note 2, § 1751.


25. See Weiner & Szyndrowski, supra note 21, at 937.

26. 1 NEWBERG, supra note 4, § 1.10.

27. Id.

28. Note, supra note 1, at 569.
were [permitted largely] as a rule of convenience."\textsuperscript{29} Bringing a suit in equity was much more convenient and economical than adjudicating the dispute "in piecemeal fashion by multiple actions at law."\textsuperscript{30} With the merger of law and equity in England in 1873, class actions for damages became available along with class actions for equitable remedies such as accountings, declarations, and injunctions.\textsuperscript{31}

Because the English bill of peace served as the precursor to the class action, it is not surprising that class actions in the United States were initially permitted only in equity.\textsuperscript{32} It was not until 1938, when the first Federal Rules of Civil Procedure were adopted, "that law and equity were merged and class [actions] for damages . . . became available."\textsuperscript{33} Original Rule 23 of the Federal Rules of Civil Procedure, which governed class actions, had serious defects.\textsuperscript{34} Consequently, courts had difficulty administering the class action device until the rule was dramatically amended in 1966.\textsuperscript{35}

Amended Rule 23 describes in more practical terms the occasions for maintaining class actions, and it provides considerably more guidance on the measures that courts may take in managing class actions. Subsection (a) sets forth the four prerequisites to maintaining a class action: (1) numerosity of parties; (2) common questions of law or fact; (3) claims typical of the members; and (4) adequacy of representation.\textsuperscript{36} Subsection (b) describes the

\textsuperscript{29} I NEWBERG, supra note 4, § 1.10; see also 7A WRIGHT ET AL., supra note 2, § 1751.

\textsuperscript{30} 7A WRIGHT ET AL., supra note 2, § 1751; see also CHAFFEE, supra note 21, at 201; Marcin supra note 24, at 519.

\textsuperscript{31} I NEWBERG, supra note 4, § 1.10.

\textsuperscript{32} 7A WRIGHT ET AL., supra note 2, § 1751; Weiner & Szyndrowski, supra note 21, at 955. For a discussion of early group litigation in America, see generally Stephen C. Yezell, From Group Litigation to Class Action—Part II: Interest, Class, and Representation, 27 UCLA L. REV. 1067 (1980).


\textsuperscript{34} See Weiner & Szyndrowski, supra note 21, at 979-80 ("The rule as adopted was beset with difficulties: (1) obscure and uncertain definitions of categories; (2) the inadequacy of the rule in dealing with the binding effect of judgments; and (3) the failure of the rule to address measures assuring procedural fairness.") (citations omitted). For further discussion of the primary deficiencies in the original rule, see 7A WRIGHT ET AL., supra note 2, § 1752.

\textsuperscript{35} The Federal Rules of Civil Procedure were significantly revised in 1966. For a discussion of the revision process by the Advisory Committee on Civil Rules of the Judicial Conference of the United States and the subsequent adoption of the amendments to the Rules by the Supreme Court, see Kaplan, supra note 3, at 357-58.

\textsuperscript{36} FED. R. CIV. P. 23(a). Rule 23(a) provides:
three situations that justify the use of the class action device. Subsection (c) deals with various procedural aspects of the class action proceeding.

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

37. Fed. R. Civ. P. 23(b). Rule 23(b) provides:

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

38. Fed. R. Civ. P. 23(c). Rule 23(c) provides:

(c) Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Conducted Partially as Class Actions.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude the member from the class if the member so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if the member desires, enter an appearance through counsel.
A list of the court orders that may be issued in the course of the class action is contained in subsection (d). Finally, subsection (e) requires court approval and notice to all class members before a class action may be dismissed or compromised. Rule 23 has remained substantially unchanged since its amendment in 1966 and currently governs all class action proceedings in federal court.

Many commentators have argued about the pros and cons of class actions, but there is no doubt that class actions play a significant role in litigation in the United States. Class actions serve many useful purposes.

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

39. FED. R. CIV. P. 23(d). Rule 23(d) provides:
(d) Orders in Conduct of Actions. In the conduct of actions to which this rule applies, the court may make appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

40. FED. R. CIV. P. 23(e). Rule 23(e) provides:
(e) Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

41. Rule 23 was amended in 1987 to makes its terms gender neutral. No substantive change was made. FED. R. CIV. P. 23 advisory committee's note; 7A WRIGHT ET AL., supra note 2, at 1 (Supp. 1998). On April 24, 1998, the Supreme Court prescribed a new subsection (f) to Rule 23. Subsection (f) would create an opportunity for interlocutory appeal from an order granting or denying class action certification. Absent contrary Congressional action, this amendment to Rule 23 will become effective December 1, 1998. FED. R. CIV. P. 23; 7A WRIGHT ET AL., supra note 2, at 37 (Supp. 1998).

42. See, e.g., John C. Coffee, Jr., The Corruption of the Class Action: The New
One of the underlying objectives of class actions is "to promote judicial . . .

efficiency by [eliminating] . . . multiple adjudications of the same issues." 43

Class actions reserve the "resources of both the courts and the parties by

permitting an issue potentially affecting every [class member] to be litigated

in an economical fashion under Rule 23." 44 By spreading litigation costs

among groups of individuals, class actions also afford greater access to the

courts for litigants who have small claims and who would not otherwise

have the economic means to seek recovery through individual suits. 45 In

addition, class actions protect the interests of absentee class members. 46

Because these unnamed parties will be bound by the outcome of the

litigation, Rule 23 requires that their interests be "fairly and adequately"

represented by the class representative 47 and that they be given notice of any

proposal to dismiss or settle their claims. 48 Class action settlements must

be supervised and approved by the court in order to ensure that unnamed

class members' rights will not be compromised in favor of the interests of

43. 5 MOORE, supra note 7, § 23.02.
Yamasaki, 442 U.S. 682, 701 (1979) (alteration in original)); see also Allison v. Citgo
Petroleum Corp., 151 F.3d 402 (5th Cir. 1998). But see John C. Coffee, Jr. & Donald E.
Reform, 81 COLUM. L. REV. 261, 305 n.241 (1981) (suggesting that "[r]epresentative actions
place special burdens on the [judicial system] because of the [inclusion] of multiple
parties and, rather than promote judicial economy, actually appear to contribute
disproportionately to judicial congestion"); Kenneth W. Dam, Class Actions: Efficiency
Compensation, Deterrence and Conflict of Interest, 4 J. LEGAL STUD. 47, 49-52 (1975).
45. 5 MOORE, supra note 7, § 23.02; see also Deposit Guar. Nat'l Bank v. Roper, 445
U.S. 326, 339 (1980) ("Where it is not economically feasible to obtain relief within the
traditional framework of a multiplicity of small individual suits for damages, aggrieved
persons may be without any effective redress unless they may employ the class action
device."); 1 NEWBERG, supra note 4, § 1.05.
46. "Class actions constitute an exception to the [general] rule that litigation is
conducted by and on behalf of the named parties only." 5 MOORE, supra note 7, § 23.02;
General Tel. Co., 457 U.S. at 155 (citing Califano v. Yamasaki, 442 U.S. 682, 700-01
(1979)). See generally 1 NEWBERG, supra note 4, §§ 1.07, 1.08, 16.01-.29 (discussing
particular rights and party status of absent class members).
47. FED. R. CIV. P. 23(a).
48. FED. R. CIV. P. 23(e).
the named representatives.\textsuperscript{49} When a settlement has been reached by the parties and finally approved by the court, the named representative certainly has standing to appeal the approval of the class action settlement. The question that has divided the federal courts of appeals for years, however, is whether a dissatisfied, unnamed class member may appeal that same settlement.

B. Split in Federal Circuits Over Standing to Appeal Class Action Settlements

The federal courts have developed two conflicting approaches to resolve the issue of whether absentee class members may subsequently appeal a court order approving a class action settlement. Some circuits have held that unnamed class members who object to the settlement proposal in the district court have standing later to appeal the approval of the class settlement. Rejecting that flexible approach to appellate access, other circuits have held that standing to appeal extends only to parties who have formally intervened in the case. In these circuits, failure to intervene is fatal to any unnamed class member's attempt to appeal the approved compromise.

1. Alternative One: Appeal Permissible With Objections

The Sixth Circuit was the first court to examine the specific question whether an unnamed class member has standing to appeal an order

\textsuperscript{49} FED. R. CIV. P. 23(e). Note that in non-representative actions, settlement agreements lie entirely in the parties' hands. If the plaintiff and the defendant choose to settle their dispute, the trial court need not get involved. Rule 41 of the Federal Rules of Civil Procedure permits the court to dismiss any suit, other than a representative one such as a class action or a derivative suit, at any time if all the parties consent. FED. R. CIV. P. 41. The settlement does not require the court's approval. Compare FED. R. CIV. P. 41 with FED. R. CIV. P. 23(e). In the class action context, the trial court must evaluate the settlement and determine whether it is "fair, adequate and reasonable." 5 MOORE, supra note 7, § 23.85[1]; see also Marshall v. Holiday Magic, Inc., 550 F.2d 1173, 1178 (9th Cir. 1977) ("A court must find a class action settlement fair and adequate to all persons before approving it."); 7B WRIGHT ET AL., supra note 2, § 1791; Thomas M. Mengler, Consent Decree Paradigms: Models Without Meaning, 29 B.C. L. REV. 291, 291 (1988). The purpose of this requirement is clearly to "protect the interests of the absent classmembers who will be bound by the settlement." Mengler, supra, at 291. In a recent article discussing group decision-making about litigation, Professor Rubenstein highlights and addresses one interesting question that deals with the very essence of litigation in the group context: "Why is any individual group member able to step forward in the litigation arena unilaterally claim to represent, and indeed bind, all similarly situated group members to a particular legal position?" William B. Rubenstein, Divided We Litigate: Addressing Disputes Among Group Members and Lawyers in Civil Rights Campaigns, 106 Yale L.J. 1623, 1624 (1997).
approving a class settlement. In *Cohen v. Young*, an unnamed class member received notice from the court of a proposed settlement, appeared at the settlement hearing to object to the settlement, and filed to intervene in the action as a plaintiff. The district court denied the class member’s petition to intervene and issued a decree approving the settlement. Curiously, the class member did not appeal the denial of his petition to intervene; rather, he appealed the order approving the settlement. The Sixth Circuit held that the class member was “entitled as of right to prosecute the appeal.” The court noted that the unnamed class member had appeared at the settlement hearing in response to the district court’s notice, and therefore, he was analogous to “a defendant who is summoned by process of court and after an adverse ruling has the right to appeal.” For many years, the Sixth Circuit used this approach to resolve questions involving the appellate standing of unnamed class members.

The Third Circuit, in *Ace Heating & Plumbing Co. v. Crane Co.*, held that unnamed class members could appeal from the district court’s final approval of a settlement, even though such members had been informed of the proposed settlement and were given the option to exclude themselves from participating in it. In the notice of the proposed settlement, the class members were told that they could either opt out of the settlement or accept

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50. 127 F.2d 721 (6th Cir. 1942).
51. *Id.* at 722.
52. *Id.* at 723-24.
53. *Id.* at 724.
55. *See, e.g.*, Sertic v. Cuyahoga, Lake, Geauga & Ashtabula Counties Carpenters Dist. Council, 459 F.2d 579 (6th Cir. 1972). In *Sertic*, class members were not provided with notice of a compromise in a class action until after the compromise had been approved by the district court. Two unnamed class members then appealed the compromise. The appellees contended that these members had no standing to appeal the court order approving the compromise because they were not parties to the proceedings. *Id.* at 581. Rejecting their argument, the Sixth Circuit found that the case fell almost squarely within its prior decision in *Cohen* and that, therefore, the unnamed class members were not precluded from appealing the final judgment. *Id.* at 582. The court noted that the “only relevant distinction between . . . [Sertic] and *Cohen* lies in the omission of the District Court . . . [in Sertic] to notify the members of the class of the proposed orders . . . ” *Id.* at 581.

There is some indication that the Sixth Circuit may be retreating from the rule it first set forth in *Cohen*. *See Shults v. Champion Int’l Corp.*, 35 F.3d 1056, 1059-61 (6th Cir. 1994) (distinguishing *Cohen* and holding that the mere “interest of unnamed, non-intervening class members in the outcome of the class litigation is insufficient to confer standing [to appeal] upon them, even if they voluntarily make their interests known, through objections, to the district court”).
56. 453 F.2d 30 (3d Cir. 1971).
57. *Id.* at 33.
it and then waive any subsequent right to object to it. The Third Circuit found that, in situations where a group of plaintiffs, each with individually small claims, might not benefit at all from the proposed settlement, this type of option is "in reality no option at all." According to the court, "Rule 23 recognizes the fact that many small claimants frequently have no litigable claims unless aggregated." The court therefore concluded that a right to appellate review was required to guard against unfair settlements and to protect the interests of unnamed class members.

The Ninth Circuit, in *Marshall v. Holiday Magic, Inc.*, relied on the rule of *Ace Heating* and held that, because settlements of class actions affect the legal rights of unnamed class members, such members have standing to appeal. The Ninth Circuit has indicated in subsequent cases that, so long as a class member appears in response to a notice of hearing for the proposed settlement and voices his objections, he can appeal the entry of the final judgment.

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58. *Id.* at 32.
59. *Id.* at 33.
60. *Id.* The court was concerned that, if such class members were stripped of their rights to court approval of settlements and subsequent standing to challenge these settlements, these class members would be required to choose between "equally unpalatable alternatives—accept either nothing at all or a possibly unfair settlement." *Id.*
61. *Id.* The Third Circuit in recent years has reaffirmed the rule of *Ace Heating*. *See, e.g.*, Carlough v. Amchem Products, Inc., 5 F.3d 707, 714 (3d Cir. 1993) (holding that unnamed class members "will be able to appeal from the district court's final approval of any [class action] settlement"); Greenfield v. Villager Indus., Inc., 483 F.2d 824, 829 (3d Cir. 1973) (allowing appeal by unnamed class members who asserted a wrongful denial of the opportunity to participate in the class action because of improper notice). Appellants in *Carlough* and *Greenfield* had objected to the settlement in the lower court. Although the Third Circuit in both cases relied on the *Ace Heating* rule, the *Ace Heating* appellants had not formally objected to the proposed settlement. Therefore, it is not altogether clear whether unnamed class members must make an objection to the settlement in order to preserve their right to appeal any subsequent approval of the settlement. *Carlough, Greenfield, and Bell Atlantic* seem to suggest that such objections are necessary. In any event, the Third Circuit clearly does not require that unnamed class members formally intervene as parties before they will be afforded standing to appeal an order approving a settlement.
62. 550 F.2d 1173 (9th Cir. 1977).
63. *Id.* at 1176; *accord* Equity Funding Corp. v. Confino, 603 F.2d 1353, 1361 (9th Cir. 1979).
64. *See, e.g.*, *In re Cement Antitrust Litig.*, 688 F.2d 1297, 1309 (9th Cir. 1982) (stating that a "class member may appeal from an order approving a settlement to which the member objects"); Dosier v. Miami Valley Broad. Corp., 656 F.2d 1295, 1299 (9th Cir. 1981) (stating that dissatisfied class member who attended the settlement hearing and stated his objections could challenge the settlement by direct appeal). *Cf.* Silber v. Mabon, 957 F.2d 697, 700 (9th Cir. 1992) (stating that an appellant who did not receive notice of pendency of class action until after opt-out deadline had standing to appeal constitutionality
Initially, the rule of the Seventh Circuit was similar. In Research Corp. v. Asgrow Seed Co., the court held that a class member who appears in response to a notice of a proposed dismissal or compromise and objects to it has the right to appeal from an order approving the compromise. However, the Seventh Circuit began to back away from that approach over time. Recently, in Felzen v. Andreas, the Seventh Circuit overruled its decision in Asgrow Seed and aligned itself with those circuits that require unnamed class members to intervene formally as parties in order to have standing to appeal.

2. Alternative Two: No Appeal Without Formal Intervention

Several federal courts of appeals have adopted an alternative approach. The Eleventh Circuit, in Guthrie v. Evans, held that an unnamed class member, who was a pro se prison inmate dissatisfied with the resolution of claims challenging the conditions of his confinement, had no standing to appeal the final class action judgment. The court reasoned that unnamed
class members who are unhappy with the manner in which the litigation is being conducted can always resort to one of three other avenues of relief: (1) intervention as of right under Federal Rule of Civil Procedure 24; (2) collateral attack of the judgment on the grounds of inadequate representation; or (3) opting out of the class. The court also feared that allowing unnamed class members to bring individual appeals would render the litigation "unwieldy" and thereby "defeat the very purpose of [the] class action [device]," i.e., judicial economy.

The Fifth Circuit reached the same conclusion in *Walker v. City of Mesquite* one year later. In that case, the court held that unnamed class members lacked standing to appeal a settlement when they failed to intervene in the district court. Relying on the Eleventh Circuit's reasoning in *Guthrie*, the court emphasized that unnamed class members can best protect their interests by filing a motion to intervene. Denials of such motions to intervene are final orders from which class members can directly appeal, thus preserving their interests. The Fifth Circuit also referred to the Supreme Court's decision in *Marino v. Ortiz* and noted that its holding was consistent with *Marino*. In *Marino*, the Supreme Court held that only parties to a lawsuit, or those who properly become parties, may appeal an adverse judgment. The Fifth Circuit was largely concerned with the same fear that preoccupied the *Guthrie* court, namely that class actions would become unmanageable if each class member were given the individual right to appeal the settlement.

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71. *Id.* at 628-29.
72. *Id.* at 629. See also supra text accompanying notes 43-44. In contrast to the court's holding in *Guthrie*, the Eleventh Circuit has indicated in at least one case that intervention is not required to have appellate standing. *See In re Dennis Greenman Sec. Litig.*, 829 F.2d 1539, 1542-43 (11th Cir. 1987) (relying on the Seventh Circuit's decision in *Asgrow Seed* and holding that "[i]n order to preserve an appeal from a class settlement, a class member must, during the course of proceedings, object to either the terms of the settlement, or to the nature of the class certification") (citation omitted).
73. 858 F.2d 1071 (5th Cir. 1988).
74. *Id.* at 1074.
75. *Id.* at 1073-74.
76. 484 U.S. 301 (1988).
77. 858 F.2d at 1074.
78. 484 U.S. at 304. For further discussion of *Marino*, see infra notes 183-89 and accompanying text.
A few years later, the Eighth Circuit followed the lead of the *Guthrie* and *Walker* courts. In *Croyden Associates v. Alleco, Inc.*, the court held that an unnamed class member who objected to a settlement agreement entered into by named class members, but who failed to intervene as a party, could not appeal from the district court’s approval of the settlement. The Eighth Circuit explicitly discussed the conflicting approaches taken by the various circuit courts and concluded that the reasoning in *Guthrie* and *Walker* was the most persuasive. The court noted that the effect of requiring intervention as a condition of appeal would be to “channel into one line of litigation all issues of the class action settlement.” Once again, the judicial economy and efficiency objectives of class action litigation proved to be of primary importance.

Finally, in *Gottlieb v. Q.T. Wiles*, the Tenth Circuit, agreeing with and relying upon the conclusions of the Fifth, Eighth, and Eleventh Circuits in *Walker, Croyden,* and *Guthrie,* respectively, held that formal intervention is a prerequisite to an unnamed class member’s standing to appeal a settlement. The court believed that a contrary rule would undermine the purposes of the class action device. According to the court, “[i]f individual appeals without formal intervention were . . . permitted, the class action would break down under the burden of unpredictable and unlimited individual actions. Such a result would directly conflict with the goals of Rule 23 and would eviscerate the utility of the class action suit.” Moreover, the court was concerned that, if unnamed class members were allowed to appeal a settlement that had been approved by the named class representatives, the unnamed members would effectively usurp the role of the certified class representatives. The court concluded that “[s]uch a [result] would [further] undermine class action[s] because it would allow . . . unnamed class members to relitigate the suit without any indication that the named [representatives] were improperly certified.”

80. 969 F.2d 675 (8th Cir. 1992).
81. *Id.* at 680.
82. *Id.* at 678-80.
83. *Id.* at 680. The court added that this effect would “avoid the bifurcation that would result from dismissal of the appeal on a standing basis, followed by an independent action by the challenging class member.” *Id.*
84. The Eighth Circuit has subsequently allowed non-intervening class members to have standing to appeal in certain circumstances. See, e.g., *In re Piper Funds, Inc.*, 71 F.3d 298, 300-01 (8th Cir. 1995) (distinguishing *Croyden* and holding that intervention is not required for unnamed class member to have standing to appeal order enjoining arbitration).
85. 11 F.3d 1004 (10th Cir. 1993).
86. *Id.* at 1006.
87. *Id.* at 1009.
88. *Id.* at 1008. Before an action may be certified by the court as a class action, there must be a showing that “the claims or defenses of the [class] representative . . . are typical [of those] . . . of the class” and that “the [class] representative . . . will fairly and
Interestingly enough, in analyzing the appellate standing issue in *Gottlieb* with respect to *class actions*, the court actually took into account cases discussing the same issue in the context of *derivative suits*. The court ultimately found those derivative suit cases inapplicable, noting that the "protective mechanisms" offered by Rule 23 for class actions were unlike those offered by Rule 23.1 for derivative suits. Whether the two types of representative actions are sufficiently distinct to warrant different treatment of the appellate standing issue is an important question that has also elicited conflicting opinions from the federal courts. In order to address this question more effectively, it is necessary to take a closer look at the counterpart to the class action device: the derivative suit.

III. THE DERIVATIVE SUIT DEBATE

Shareholder derivative suits have been called everything from "fascinating," "extraordinary," and "ingenious" to "controversial," "anoma-
ous, and "uniquely complicated." The "derivative suit is [an] . . . equitable remedy in which a shareholder asserts on behalf of a corporation a claim [that belongs] not to the shareholder, but to the corporation." The right of the shareholder to bring the suit is therefore "derivative" or "secondary" in nature, and any judgment ultimately recovered by the shareholder belongs to the corporation.

A. Historical Background

The origins of the derivative suit date back to early nineteenth century England when equity courts began to recognize jurisdiction for shareholder actions. During the Industrial Revolution, the ownership of stock corporations became much more widely held, and judicial recognition of the derivative suit was needed to deal with the increasing conflicts between shareholders and managers.

By 1855, American courts had also recognized the importance of affording shareholders the right to sue on behalf of the corporation. Such suits,

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94. Swanson, supra note 93, at 1340, n.1 (citing ROBERT C. CLARK, CORPORATE LAW § 15.1 (1986) (stating that the derivative suit is "one of the most interesting and ingenious of accountability mechanisms for large formal organizations").

95. Glenn G. Morris, Shareholder Derivative Suits: Louisiana Law, 56 LA. L. REV. 583, 585 (1996) ("In the context of large, publicly-traded corporations, derivative suits are controversial."); Swanson, supra note 93, at 1340 ("The litigation's controversial nature results from the competing tensions underlying such unusual relief.").

96. RALPH C. FERRARA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 1.02 (Law Journal Seminars—Press 1998) ("Even among lawyers, the 'derivative' suit is considered a relatively anomalous legal vehicle.").

97. Swanson, supra note 93, at 1340 n.2 (citing DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 1.01 (1987) ("Derivative litigation is a uniquely complicated form of civil litigation, in part simply because the real party in interest in the litigation, the corporation, is not the plaintiff.").


99. See Ross v. Bernhard, 396 U.S. 531, 538 (1970) ("The proceeds of the [derivative] action belong to the corporation and it is bound by the result of the suit."); see also Matthews, supra note 6, at 1-2 ("The cause of action in [a shareholder derivative] suit belongs to the corporation."); Note, supra note 1, at 568-69 ("The right of the plaintiff to bring suit is derivative or secondary rather than original or primary, and any judgment recovered by the shareholder belongs to the corporation.").

100. Swanson, supra note 93, at 1343.

101. Id. at 1344 n.26.

102. See Coffee & Schwartz, supra note 44, at 261 n.2. The derivative suit became a recognized form of litigation by the Supreme Court for the first time in Dodge v. Woolsey,
however, were subject to potential abuse. Under the basic corporate law paradigm, shareholders, as owners of the corporation, elect directors to manage the corporation on the shareholders' behalf and to make decisions affecting the corporation, including the decision to initiate litigation. Shareholders who use unconstrained derivative proceedings to usurp the management authority of directors violate these basic principles of corporate governance. "To avoid [such] potential abuses [of derivative litigation], the United States Supreme Court established certain preconditions that a shareholder plaintiff would have to satisfy in order to [bring the derivative suit] in federal court[]." These requirements were later codified in successive Equity Rules and then adopted as subsection (b) of the original Federal Rule of Civil Procedure 23 in 1937. Original Rule 23 governed both class actions and derivative suits. When the 1966 revision of the rule was undertaken, subsection (b) was carved out and adopted as new Rule 23.1 for derivative actions. Rule 23.1 has remained substantially

59 U.S. (18 How.) 331 (1855). Id. See generally HENN & ALEXANDER, supra note 4, § 358; Bert S. Prunty, Jr., The Shareholders' Derivative Suit: Notes on Its Derivation, 32 N.Y.U. L. REV. 980 (1957) (tracing historical development of derivative suits). "The story of the derivative suit in its infancy and adolescence is that of the lawmakers' response to recognized misuse of economic organizations viewed against popularly accepted standards of business conduct." Prunty, supra, at 980. 103. See HENN & ALEXANDER, supra note 4, §§ 188, 207. 104. 13 FLETCHER, supra note 2, at § 5940. 105. Id.; see also HENN & ALEXANDER, supra note 4, § 359. See generally Hawes v. City of Oakland, 104 U.S. 450 (1882). 106. Matthews, supra note 6, at 9. Equity Rule 94, adopted by the Supreme Court in 1882, required that there be (1) a verification of the bill; (2) an allegation of contemporaneous ownership; (3) a disavowal of any collusion to establish jurisdiction; and (4) a showing of demand on the directors. Id. In 1912, Equity Rule 94 was replaced by Equity Rule 27 with only minor modifications. 7C WRIGHT ET AL., supra note 2, § 1821. The Rule finally evolved into original Federal Rule 23(b) with the adoption of the Federal Rules of Civil Procedure in 1938. Id. 107. Matthews, supra note 6, at 6 n.17. 108. Id. at 5-6, 10; see also supra note 3 and accompanying text. Federal Rule of Civil Procedure 23.1 provides:

Rule 23.1. Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the
unchanged since its adoption in 1966 and currently governs all derivative suit proceedings in federal court. Rule 23.1 contains a number of prerequisites that must be met before a derivative suit will be allowed to proceed. In interpreting Rule 23.1, courts have developed various requirements that govern derivative suit proceedings. The shareholder who brings the suit must have held shares in the corporation at the time of the alleged wrong. Before a derivative suit can be brought, the shareholder must first formally demand that the board of directors bring the action on behalf of the corporation. The demand requirement will be excused if it can be shown that making such a demand would be futile. The shareholder plaintiff must also fairly and adequately represent the interests of similarly situated shareholders of the corporation.

109. In 1987, the text of Rule 23.1 was amended to make its terms gender neutral. The amendment did not involve any changes to the substance of the rule. 7C Wright et al., supra note 2, at 1 n.1 (Supp. 1998); see also Fed. R. Civ. P. 23.1 advisory committee notes.

110. Fed. R. Civ. P. 23.1. This requirement is commonly referred to as the "contemporaneous share ownership" requirement. Henn & Alexander, supra note 4, § 362 at 1058. The purpose of the requirement is to prevent outside speculators from purchasing a derivative lawsuit. Id. at 1061; see also 7C Wright et al., supra note 2, § 1828; Paul P. Harbrecht, The Contemporaneous Ownership Rule in Shareholders' Derivative Suits, 25 UCLA L. Rev. 1041 (1978).

111. Fed. R. Civ. P. 23.1; 5 Moore, supra note 7, § 23.1.08[1].

112. See Fed. R. Civ. P. 23.1. This requirement is commonly referred to as the "demand-on-the-board" or the "demand" requirement. 5 Moore, supra note 7, § 23.1.08. If the directors comply with the shareholder plaintiff's demand, a derivative action is unnecessary. Swanson, supra note 93, at 1351. If, on the other hand, it is clear that the directors would refuse to bring the action because they themselves are the alleged wrongdoers, the demand is considered futile and is therefore excused. See 5 Moore, supra note 7, § 23.1.08; Swanson, supra note 93, at 1349-55 (discussing demand requirement and futility exception). See generally Tamar Frankel & Wayne M. Barsky, The Power Struggle Between Shareholders and Directors: The Demand Requirement in Derivative Suits, 12 Hofstra L. Rev. 39 (1983); Comment, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. Chi. L. Rev. 168 (1976).

113. Fed. R. Civ. P. 23.1. This requirement is commonly referred to as the "adequate representation" requirement. To be a fair and adequate representative, the shareholder plaintiff must be able to vigorously and conscientiously litigate the action and must not have interests that are in conflict with those of the other shareholders who are being represented. 7C Wright et al., supra note 2, § 1833; see also Matthews, supra note 6, at 6-9 (discussing
These requirements all serve to ensure that the derivative proceeding is in the corporation's best interests.

B. Nature of Derivative Suits

The derivative suit is essentially two causes of action combined into one: the first is a suit brought by the shareholders to require that the corporation pursue its right of action, and the second is a suit brought by the corporation against wrongdoers who are liable to it.\(^\text{114}\) The corporation therefore plays two different roles in the derivative suit. Because the corporation, through its board of directors, refuses "to sue in its own name . . ., it is brought into the action as a nominal party defendant."\(^\text{115}\) However, the derivative nature of the suit does not change the true ownership of the claim. The corporation remains the owner of the cause of action and, therefore, is the real party in interest.\(^\text{116}\)

1. Direct vs. Derivative Claims

Derivative suits are to be distinguished from direct actions. Shareholders who suffer injury to their own personal interests may bring their own individual direct actions. It is only when shareholders allege that they have suffered injury to their interests as a result of injury to the corporation, or derivative injury, that they may bring a derivative action.\(^\text{117}\) Distinguishing derivative claims from direct ones can be difficult and can prove to be an exercise in "circular reasoning."\(^\text{118}\)

Courts use a variety of approaches to determine whether a particular action is derivative or direct. The most common test focuses on the nature of the injury as described above.\(^\text{119}\) The claim is considered derivative if the corporation's interests have been injured; the claim is considered direct if it is the interests of the shareholder, rather than the corporation, that have been

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\(^\text{114}\) Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); 13 Fletcher, supra note 2, § 5941.10.

\(^\text{115}\) Henn & Alexander, supra note 4, § 358.

\(^\text{116}\) Id. The substantive claim belongs to the corporation, and the shareholder who brings the suit on the corporation's behalf serves as the "nominal plaintiff." 13 Fletcher, supra note 2, § 5941.10. In pursuing the action, the named shareholder plaintiff is treated as the corporation's representative and essentially assumes the role of the board of directors, which normally serves as the decision-maker for the corporation. Matthews, supra note 6, at 2; see Morris, supra note 95, at 584.

\(^\text{117}\) Morris, supra note 95, at 587-88.

\(^\text{118}\) See id. at 586-88.

directly damaged. 120 Although there are cases where it is easy to determine where the injury falls, there are situations where it is very difficult to make that determination. 121 In those cases, classifying the injury as belonging either to the shareholder or the corporation is "tantamount to resolving the ultimate issue of whether the suit [may be brought] derivatively or [directly]." 122 This circular reasoning has prompted at least one commentator to conclude that the injury criterion test is illogical. 123

A second method takes a "categorical approach" to classifying derivative and direct claims. 124 This approach "essentially . . . relies on stare decisis" and identifies "kind[s] of actions" that fit into each of the two categories. 125 The problem with this method is that it produces inconsistent results. How a given action is categorized will vary from jurisdiction to jurisdiction depending on the precedents that have been established in that particular jurisdiction. 126

A third test focuses on the nature of the right that is being enforced rather than the economic impact of the injury. To the extent the shareholder has individually retained certain rights, the shareholder is entitled to enforce those rights directly. 127 Where the right of the corporation must be asserted, the action should be brought derivatively. 128

Whichever approach is used, it is clear that the line of demarcation between direct and derivative actions can be blurred in many situations. In fact, a shareholder can, by clever pleading, convince a court that the claim alleges direct, rather than derivative injury, and thereby can avoid altogether many of the burdensome procedural requirements that are imposed on derivative suits. 129

120. Id.
121. See, e.g., id. at 155 n.42 ("[W]hen a minority shareholder alleges a breach of the duty of loyalty by a controlling shareholder, it is not at all clear whether the injury to the minority shareholder is direct or indirect.").
122. Id. at 155.
123. Id. at 155-56.
124. Id. at 157.
125. Id. The "types" of actions that, by definition, have been characterized as derivative are actions for corporate mismanagement, misappropriation of corporate property by directors, and damages to corporate-owned property. Id. Actions that have been categorized as direct are suits to vindicate voting rights or rights to receive a dividend, to enjoin ultra vires acts, or to recover for fraud in connection with the purchase or sale of stock. Id. at 157-58; see also Morris, supra note 95, at 587-88; Note, supra note 1, at 568-70.
126. See Welch, supra note 119, at 158-59.
127. Id. at 160.
128. Id. at 160-65.
2. Pros and Cons of Derivative Suits

Derivative suits serve a number of important purposes. Two principal goals are deterrence and compensation.\textsuperscript{130} Although the corporate cause of action can be asserted against third parties for harms done to the corporation, the reality is that derivative suits are more often used to redress harm to the corporation that is caused by the corporation's very own officers and directors.\textsuperscript{131} In situations such as these, the officers and directors are not likely to redress the wrongs themselves.\textsuperscript{132} The Supreme Court has acknowledged that the "purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'"\textsuperscript{133} In such cases, the directors are the real defendants. Derivative suits in this capacity serve to deter managerial misconduct. These suits establish and enforce corporate codes of conduct by punishing corporate fiduciaries for self-dealing transactions and other forms of behavior that injure the corporation.\textsuperscript{134}

derivative claims in terms of direct actions and thereby escape the procedural rules of derivative suits).

\textsuperscript{130} See Coffee & Schwartz, supra note 44, at 302-09 (discussing deterrence and compensation rationales of derivative suits); Swanson, supra note 93, at 1345-49 (discussing deterrence and compensation rationales of derivative suits); cf. Dam, supra note 44, at 49-56 (discussing deterrence and compensation rationales in the context of class actions). See generally James D. Cox, Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures, 52 GEO. WASH. L. REV. 745 (1984) (discussing the purposes of derivative suits).

\textsuperscript{131} See Morris, supra note 95, at 584 (explaining that, "in practice, [derivative] suits are used almost exclusively as a means of suing corporate officers and directors for alleged breaches of the fiduciary duties that are owed by the officers and directors themselves to the corporation").

\textsuperscript{132} See Meyer v. Fleming, 327 U.S. 161, 167 (1946) (referring to the derivative suit as "one of the remedies which equity designed for those situations where the management through fraud, neglect of duty or other cause declines to take the proper and necessary steps to assert the rights which the corporation has").


\textsuperscript{134} Some commentators have noted that, because corporate managers often own only a small percentage of the corporation's shares, see Donald E. Schwartz, In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley, 71 CORNELL L. REV. 322, 324 (1986), there are incentives for managers to maximize their own interests at the expense of other shareholders, Cox, supra note 130, at 746. See generally Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 312-13 (1976) (discussing corporate managers' natural drive to misbehave as their portion of the equity in the corporation decreases). Managers with a small ownership stake in the corporation receive only a small percentage of any wealth their business decisions create; thus, they may lack
Another purpose of derivative suits is to compensate the injured corporation and shareholders for specific past wrongs. Derivative suits can make the injured party whole by restoring what the corporation has lost. "[I]ndividual shareholders would have no access to compensation for injuries directly inflicted on their corporation" if the derivative suit were not available as a means for regaining those damages. 135

In spite of these laudatory rationales for the derivative suit, the prevalent use of the derivative suit is not without controversy. Those who are critical of derivative suits maintain that such suits "merely foster a form of legalized extortion in which the corporation and its insurers are forced to pay huge fees to plaintiff lawyers to settle expensive but meritless cases." 136 These "strike suits" 137 do little good for investors 138 and have sparked both sufficient incentives to maximize shareholder profit. See Macey & Miller, supra note 13, at 10. "[M]anagers [may also be] motivated as much, if not more, by desires for personal power and prestige, as they are by the goal of profit maximization." Jeffrey Michael Smith, Note, The Role of the Attorney in Protecting (and Impairing) Shareholder Interests: Incentives and Disincentives to Maximize Corporate Wealth, 47 DUKE L.J. 161, 164-65 (1997). Derivative suits are useful in "controlling these conflicts between managers and shareholders." Macey & Miller, supra note 13, at 10. Managers who are tempted to divert corporate resources for their own personal gain will be deterred from such misbehavior by the specter of the shareholder derivative suit. Thomas & Hansen, supra note 13, at 427.

135. Swanson, supra note 93, at 1345. Whether the compensation rationale for derivative suits is superior to the deterrence rationale is an open question. See, e.g., Coffee & Schwartz, supra note 44, at 305 ("[T]he great achievement of . . . derivative actions is not that they yield meaningful compensation, but that . . . they produce a great enough sanction to create real deterrence."); James D. Cox, Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, 1982 DUKE L.J. 959, 990 (1982) ("[I]n the question whether the primary purpose of the derivative suit is deterrence or compensation . . . the goal of compensation has prevailed."); Schwartz, supra note 134, at 331 ("Deterrence is the major reason for and principal effect of derivative suits."); Note, When Should Courts Allow the Settlement of Duty-of-Loyalty Derivative Suits?, 109 HARV. L. REV. 1084, 1090 (1996) ("[C]ompensation alone does not drive the derivative suit.").

136. Morris, supra note 95, at 585.

137. "The term 'strike suit' . . . refers to a derivative [suit] whose nuisance value gives it a settlement value independent of its merits." Brandi, supra note 129, at 357 n.1. In more specific terms, the Supreme Court has characterized strike suits as claims brought by individuals who are only seeking to "get[] quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them." Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966). See generally Coffee, supra note 16, at 17-26 (discussing four explanations for the possible prevalence of strike suits).

138. Empirical studies of the change in market price of the stock in corporations involved in derivative litigation show variations so small as to be statistically insignificant. See Daniel R. Fischel & Michael Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 CORNELL L. REV. 261,
judicial and legislative responses. From the corporation’s perspective, derivative suits carry the potential to do more harm than good. The existence of a pending suit may involve an extensive disruption of normal business activity as top-level members of corporate management divert their time and energy to the litigation. Thus, some critics have argued that “shareholder litigation is a weak, if not ineffective, instrument of corporate governance.”

Proponents of derivative litigation argue that these criticisms are unjustified and that the “strike suit” is merely a fictional monster. Regardless of whether derivative suits are societally and economically beneficial, the issue that has recently been brought to the fore must be addressed: when such suits are finally settled, who, if anyone, has the right to complain about the settlement?

277-82 (1986). This may lead one to the conclusion that derivative suits benefit attorneys only and do not provide economically significant benefits to shareholders. Morris, supra note 95, at 600 & nn.77-78.

139. See, e.g., Burks v. Lasker, 441 U.S. 471 (1979) (accepting the special litigation committee as a means for quickly terminating derivative suits with only minimal judicial review). See generally Charles W. Murdock, Corporate Governance—The Role of Special Litigation Committees, 68 WASH. L. REV. 79 (1993) (discussing origins and nature of special litigation committees).

140. A number of states have enacted security for expense statutes which require the plaintiff at the beginning of a derivative suit to furnish a bond out of which the corporation may be reimbursed for the reasonable fees and expenses it may incur in defending the suit. Cox, supra note 135, at 965. See, e.g., Cal. Corp. Code § 800(c)-(e) (West 1990); N.Y. BUS. CORP. LAW § 627 (McKinney 1986). The purpose of these statutes is to deter the filing of frivolous derivative suits. See Cox, supra note 135, at 965. Security for expense statutes are not applied in derivative suits brought in federal court for violations of federal law. See id.

141. Franklin A. Gevurtz, Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits, 46 U. PITT. L. REV. 265, 290 (1985). The Supreme Court has acknowledged that a meritless unresolved lawsuit may have settlement value merely “because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event . . . .” Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742-43 (1975).


143. See, e.g., Brandi, supra note 129, at 357 n.6 (“One [advocate of the derivative suit] has put his position into the following terms: ‘The strike suit . . . may very well be no more than an over-the-hill dragon, puffed into life to frighten the courts away from deciding substantive issues.’” (quoting WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 931 (6th ed. 1988))); Macey & Miller, supra note 13, at 78 (“Although a theoretical model exists in which suits are brought solely for their nuisance settlement value, the frequency of strike suits in derivative and class litigation remains an open question. Most observers agree that strike suit litigation is relatively uncommon.”).
C. Split in Federal Circuits Over Standing to Appeal Derivative Suit Settlements

In order to prevent potential abuses of the derivative suit device, Rule 23.1 requires that any settlement of the action be approved by the court and that notice of the proposed settlement be given to all shareholders.144 This requirement is virtually identical to the settlement provision in Rule 23(e) for class actions.145 As in the class action context, it is clear that, once a settlement has been reached by the parties and approved by the court, the named shareholder as the plaintiff representative has standing to appeal the approval of the settlement. It is far from clear, however, whether an unnamed shareholder who is unhappy with the settlement may appeal the court’s approval of the settlement. Two federal circuits have confronted this issue and rendered opinions that are diametrically opposed.

1. Third Circuit Approach: Bell Atlantic Corp. v. Bolger

In Bell Atlantic Corp. v. Bolger,146 the Third Circuit held that an unnamed shareholder in a derivative suit who attended the settlement hearing and objected to the proposed settlement of the suit had standing to appeal the court’s approval of the settlement.147

The lawsuit arose out of a consumer fraud prosecution brought by the Pennsylvania Attorney General against one of the subsidiaries of Bell Atlantic Corporation (“Bell”).148 Bell settled the prosecution for $40 million. In response to the settlement, two groups of shareholders filed derivative suits against Bell and “certain of its officers and inside directors . . . [for] mismanagement and breach of fiduciary duty.”149 One group, represented by shareholder Lazar, filed a derivative suit in state court; the other group, represented by shareholder Taub, filed a derivative suit in federal court along with other federal claims. Shortly before trial in the federal suit, the parties agreed to a settlement that would release all claims arising out of the original consumer fraud litigation.150 The agreement thereby “jettisoned the Lazar state court claim.”151 It also included a provision for the payment of a maximum of $450,000 for Taub’s attorneys’ fees and expenses. Prior to the settlement hearing, Lazar, and twenty-four other shareholders objected to the terms of the proposed settlement, and Lazar’s counsel objected to the

144. See Fed. R. Civ. P. 23.1
146. 2 F.3d 1304 (3d Cir. 1993).
147. Id. at 1310.
148. Id. at 1306.
149. Id.
150. Id. at 1306-07.
151. Id. at 1307.
settlement at the hearing. The district court nonetheless approved the settlement and awarded approximately $421,500 in fees and expenses to plaintiffs’ counsel. Lazar appealed the court’s approval of the settlement, contending that the settlement conferred no benefit on Bell and benefitted only the individual defendant directors and plaintiffs’ counsel.

The plaintiffs argued that “Lazar lack[ed] standing to appeal the . . . [settlement] because [he was] not a named party and [he] failed to intervene under Fed. R. Civ. P. 24.” That failure, they contended, constituted an admission that the named plaintiffs served as adequate representatives of Lazar’s interests. The plaintiffs urged the court to approve a “‘no-intervention, no-standing’ rule for appeals by unnamed members of . . . derivative actions who object to settlement agreements.”

The Third Circuit began its analysis by quoting Marino v. Ortiz, a Supreme Court decision that held “only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment.” Turning to the class action context for guidance, the Third Circuit then discussed the different approaches taken by the various circuit courts with respect to the issue whether an unnamed class member has standing to appeal an order approving a settlement of a class action. The court reiterated its own position in Ace Heating that aggrieved class members may appeal class action settlements even though they have the right to exclude themselves from the class.

Extending the analysis to the derivative suit context, the court referred to the “agency costs” inherent in “large-scale, small-claim” class and derivative litigation where the client, as principal, has little incentive to strictly monitor the actions of the attorney, his agent. As far as derivative suits are concerned, “[s]hareholders with well-diversified portfolios or small holdings” know that “the costs of policing [settlements] . . . outweigh any pro rata benefits to the shareholder.” Therefore, it makes the most

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152. Id.
153. Id.
154. Id.
156. Id. at 304. See also infra text accompanying notes 183-89 (discussing Marino).
157. Bell Atlantic, 2 F.3d at 1307-08. The court acknowledged the conflicting approaches taken by the Fifth, Eighth, and Eleventh Circuits on the one hand, and the Ninth, Sixth, and Seventh Circuits on the other. Id.; see also supra Part II.B (discussing split in federal circuits over standing to appeal class action settlements). Curiously, the court was careful to note that it was “not decid[ing] whether different rules apply to objector appellate standing in class [actions versus] . . . derivative suits.” Bell Atlantic, 2 F.3d at 1307 n.4.
158. Bell Atlantic, 2 F.3d at 1308-09. See also supra text accompanying notes 56-61 (discussing Ace Heating).
159. Bell Atlantic, 2 F.3d at 1309. See also supra note 14; infra notes 249-52, 302 and accompanying text.
160. Bell Atlantic, 2 F.3d at 1309. See also infra notes 255-56 and accompanying text.
economic sense for any one shareholder to avoid expending resources to monitor settlement negotiations. In the event shareholders wish to monitor settlements, they will find it difficult to do so because most shareholders do not even become aware of the derivative suit until after they have received notice of the proposed settlement.\textsuperscript{161}

The court noted that the risk of this lack of shareholder monitoring in derivative litigation is that counsel for the plaintiffs and the defendant directors and officers will collude to reach a settlement that involves high plaintiffs’ attorneys’ fees and relatively minimal recovery for the corporation.\textsuperscript{162} Objecting shareholders play an important role in the entire process by giving judges who must approve settlements access to otherwise potentially hidden information about the settlement’s merits.\textsuperscript{163} Because of the risks of collusion between the plaintiffs’ attorneys and defendants, the court believed that “creating obstacles to challenging derivative action settlement agreements” should be avoided.\textsuperscript{164}

Given the nature of derivative proceedings, the court concluded that Lazar should have standing to appeal the district court’s approval of the settlement even though Lazar had failed to intervene as a party. According to the court, “[a]ssuring fair and adequate settlements outweighs concerns that non-intervening objectors will render the litigation ‘unwieldy.’”\textsuperscript{165}

Therefore, in the Third Circuit, so long as unnamed shareholders who oppose proposed settlements of derivative suits appear at the settlement hearing and air their objections, they will subsequently have standing to appeal any settlement approved by the district court.

2. Seventh Circuit Approach: \textit{Felzen v. Andreas}

In \textit{Felzen v. Andreas},\textsuperscript{166} the Seventh Circuit recently addressed the identical issue faced in \textit{Bell Atlantic} and reached an entirely different result. In doing so, the court explicitly had to overrule several of its prior opinions.\textsuperscript{167}

The “derivative suit arose out of claims that managers of Archer Daniels Midland Co. conspired with rival sellers [in a price-fixing arrangement] and thus exposed the [company] to criminal and treble-damages liability for
conspiracy in restraint of trade." Although an unnamed shareholder vigorously opposed the proposed settlement of the suit, the district court approved the settlement, which provided concessions on corporate governance to the shareholders and $4 million in fees to the attorneys. The objecting shareholder then appealed the district court's approval of the settlement.

The Seventh Circuit held that, because the unnamed shareholder failed to formally intervene as a party to the derivative suit, no right of appeal existed and the court had no jurisdiction to consider the appeal. The court began its analysis, as the Third Circuit did in Bell Atlantic, with a reference to the rule articulated by the Supreme Court in Marino v. Ortiz that "only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment . . . ." With respect to the issue whether an unnamed class member has standing to appeal an order approving a class action settlement, the court noted its own prior position in Research Corp. v. Asgrow Seed: class members who object to the settlement in the district court may later appeal orders approving class action settlements, even though they have not intervened below. The court found that, in light of Marino, the Asgrow Seed rule was "no longer authoritative."

Comparing class actions under Rule 23 with derivative suits under Rule 23.1, the court determined that the differences between class actions and derivative suits do not support the position of the unnamed shareholders. According to the court, all class members have an equal right to litigate because all have been injured. In derivative suits, however, "the individual investor is not an injured party and is not entitled to litigate." The court noted that a shareholder brings a derivative suit on the corporation's behalf (not the shareholder's) to recover for alleged harms to the corporation, and

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168. Id. at 876.
169. See 7th Circuit Won't Allow Pact Appeal from Non-Intervening Shareholder, 13 No. 8 Andrews Corp. Officers & Directors Liability Litig. Rep., at 16 (Feb. 23, 1998). These facts are not included in the Seventh Circuit's opinion in Felzen. The objecting shareholder was the nation's largest government pension fund, California Public Employees Retirement System (CalPERS). CalPERS had called the pact "a classic case of lawyer greed." See id.
170. Felzen, 134 F.3d at 875-76.
171. Id. at 874 (quoting Marino v. Ortiz, 484 U.S. 301, 304 (1988)).
172. Id.; see also supra text accompanying notes 65-68 (discussing Asgrow Seed).
173. Felzen, 134 F.3d at 874. According to the court, if a derivative suit settlement required a "corporation to fire its CEO, or to curtail its purchases of fax machines, or to choose a different law firm, [ ] the affected employees, vendors, and lawyers could not appeal just because they believed the settlement improvident . . . ." Id. The Marino rule states that only parties may appeal. Id. This applies similarly to shareholders who, according to the court, "have no more right to speak for the [corporation] or control its litigation decisions than bondholders or banks or landlords, all of whom have contractual interests that may be affected by litigation." Id.
174. Id. at 875.
it is the corporation that collects the damages. Shareholders who are unhappy with the conduct of the board of directors may elect new directors, but they do not have the right to displace the board in litigation. Thus, according to the court, "[s]hareholders have no more the attributes of parties when managers settle derivative litigation than when managers settle antitrust litigation."77

Turning its attention to the holding of the Third Circuit in *Bell Atlantic*, the court rejected the Third Circuit’s manner of phrasing the issue as one of appellate standing. According to the court, "[s]tanding means injury in fact, and a reduction in the market price of one’s stock is injury... Equating injury with party status is exactly the approach disapproved by *Marino.*"78 The court disagreed with the Third Circuit’s approach of treating shareholders in derivative suits like class members in class actions and permitting them both to appeal. According to the court, "shareholders have the weaker claim."79

Thus, the Seventh Circuit held that unnamed shareholders in derivative suits, who oppose proposed settlements but fail to intervene as parties, have no right to subsequently appeal any settlement approved by the district court. The court expressly overruled its prior decisions that suggested otherwise, and the court acknowledged that its opinion "create[d] a conflict among the circuits."80

IV. CRITICAL ANALYSIS OF FELZEN

The Seventh Circuit’s conclusion in *Felzen* is somewhat problematic. Its heavy reliance on the Supreme Court’s decision in *Marino v. Ortiz*81 seems to be misplaced. The court’s failure to consider in depth the distinguishing features of derivative suits produces a result that disregards the interests of the shareholders. Although the focus of any derivative litigation necessarily must be on the injury to the corporation, the injury and interests of the owners of the corporation must not be ignored altogether.

175. *Id.*
176. *Id.*
177. *Id.* at 875-76. The court notes that unnamed shareholders “are not treated as parties [at all] in derivative [suits].” *Id.* at 875. Even their citizenship is disregarded for diversity purposes in federal court. *Id.*
178. *Id.* at 876.
179. *Id.*
180. *Id.* at 878.
A. Reliance on Marino v. Ortiz

In *Felzen*, the Seventh Circuit begins and ends its analysis with the rule articulated by the Supreme Court in *Marino v. Ortiz*. However, *Marino*, which addresses the status of nonparties in a class action setting, is not dispositive of the issue whether unnamed shareholders may appeal orders approving settlements in derivative suits.

In *Marino*, black and Hispanic police officers alleging employment discrimination with respect to a police sergeant's examination brought a Title VII lawsuit against the City of New York. The defendants included the police department, a group representing white officers who were eligible for promotion and who had been granted provisional promotions as sergeants, and a group representing white officers who were eligible for but had not been granted provisional promotions. "The parties reached [a] settlement, which was first approved by the District Court on an interim basis, and finally, after a [settlement] hearing, by consent decree." The settlement provided for a policy that would allow minority candidates to be promoted in proportionately representative numbers. A separate group of white police officers ("the petitioners"), "who claim[ed] that they were not placed on the [promotion] eligib[lility] list even though they had scored at least as high on the examination as the lowest scoring minority officer promoted under the interim [approval] order," objected to the policy at the settlement hearing. They did not, however, intervene in the action pursuant to Rule 24 but instead, appealed the final order approving the settlement. "[T]he [c]ourt of [a]ppeals dismissed the appeal because [the] petitioners were not parties to the litigation giving rise to the [settlement]."

The Supreme Court affirmed the dismissal, holding that "because [the] petitioners were not parties to the underlying lawsuit, and because they failed to intervene for purposes of appeal, they [could] not appeal from the consent decree approving that lawsuit's settlement . . . ." The Court recited the "well settled" rule that "only parties to a lawsuit, or those that

182. See *Felzen*, 134 F.3d at 874, 876 (discussing Marino v. Ortiz, 484 U.S. 301 (1998)).
186. *Id.* at 304.
187. *Id.*
properly become parties, may appeal an adverse judgment ... "188.
According to the Court, "when the nonparty has an interest that [may be]
affected by [a] trial court's judgment" in a lawsuit, "the better practice is
for such a nonparty to seek intervention for purposes of appeal ... "189.
The Court thus held that the nonparty petitioners were not entitled to appeal
the approval of the settlement.

The Seventh Circuit interpreted the language in Marino to say that a
person who is adversely affected by a class action settlement may appeal
from the approval of the settlement only if the person has intervened as a
party.190 However, the Supreme Court's brief statement that intervention is
the better practice should not be taken to establish an intervention require-
ment, in light of the facts of Marino. The impact of the settlement on the
Marino petitioners was very slight.191 There was little indication that any of
the petitioners would have received promotions based on their examination
scores in any event.192 As one commentator has suggested, although the
result of Marino was clearly right, the Court's brief comment that the better
practice involves intervention must not be interpreted to establish a formal
intervention requirement applicable in all circumstances.193

The facts of Marino, which involved a class action lawsuit with outside
nonparties seeking to appeal a settlement, are certainly distinguishable from
those of Felzen, which involved a derivative suit with actual owners of the
corporation seeking to appeal the settlement. As the Third Circuit in Bell
Atlantic noted in its discussion of the Marino rule: "Unlike this case, the
nonparty appellants in Marino were not members of the class or derivative
action."194 It is not unreasonable to require intervention from outside
nonparties whose interests are directly adverse to the named plaintiffs.
Under the intervention rules, had the Marino petitioners moved to intervene,
the motion most likely would have been granted.195 In the context of
derivative suits, however, intervention requests from unnamed shareholders
are much more problematic because presumably the named shareholders
adequately represent the interests of the unnamed shareholders and the
corporation.196 Thus, the "reasons for intervention [become much] less

188. Id. The Court also cited Federal Rule of Appellate Procedure 3(c), which states
that "a notice of appeal shall specify the party or parties taking the appeal."
189. Id. The Court made clear that denials of motions to intervene are appealable.
190. Id. (citing United Airlines, Inc. v. McDonald, 432 U.S. 385 (1977)).
191. Id.
192. 15A CHARLES A. WRIGHT ET AL., FEDERAL PRACTICE & PROCEDURE § 3902.1
at 130 n.52 (2d ed. 1992).
193. Id.
194. Id.
195. See infra notes 270-86 and accompanying text (discussing intervention rules).
196. Paolini, supra note 79, at 1738.
apparent to a court."\textsuperscript{197} Marino, therefore, does not appear to be very helpful to the analysis of the issue at hand concerning derivative suits. As discussed below, at least some consideration needs to be given to the status of those who seek to appeal settlements in derivative suits.

\textbf{B. Corporate or Shareholder Injury?}

Under basic corporate law, the corporation is "technically \ldots an artificial person composed of natural persons" and has corporate interests that are "more or less distinguishable from the individual interests of its individual members."\textsuperscript{198} This fundamental "corporate law paradigm that shareholders are the owners of a corporation who elect directors to manage the corporation on the shareholders' behalf is an old-fashioned legal fiction [that] has a powerful hold on the legal imagination \ldots ".\textsuperscript{199} Under the strictures of this paradigm, the Seventh Circuit in \textit{Felzen} stated that, when it comes to derivative suits, individual shareholders are not the injured parties; rather, it is the corporation and the corporation alone that suffers injury and collects the damages.\textsuperscript{200} The court emphasized that shareholders have the right to "replace the board [of directors] if [they are] dissatisfied with its performance, but they may not \textit{displace} the board in litigation."\textsuperscript{201}

The proposition that an injury to the corporation is not an injury to its shareholders is dubious, "since every injury to a corporation [necessarily has] an impact, however slight, on the shareholders as well."\textsuperscript{202} To focus solely on the corporation itself as the "injured party" is to accept "the baldest of legal fictions."\textsuperscript{203} As previously discussed, attempts to distinguish derivative claims from direct ones, by classifying the injury as belonging either only to the corporation or to the shareholders, can be difficult and at times illogical.\textsuperscript{204} Although derivative suits must necessarily concentrate on

\textsuperscript{197} \textit{Id.; see also infra} notes 279-83 and accompanying text.
\textsuperscript{198} HENN & ALEXANDER, supra note 4, § 78, at 145.
\textsuperscript{200} See \textit{Felzen v. Andreas}, 134 F.3d 873, 875 (7th Cir. 1998).
\textsuperscript{201} \textit{Id.}
\textsuperscript{202} \textit{William L. Cary & Melvin Aron Eisenberg, Cases and Materials on Corporations} 1014 (7th ed. 1995).
\textsuperscript{203} Coffee & Schwartz, supra note 44, at 303. "To some degree, the anthropomorphic fallacy inherent in viewing the corporation, rather than its shareholders, as the victim is probably a necessary fiction accepted by courts in order to avoid the potentially enormous problems involved in identifying the true victims." \textit{Id.}
\textsuperscript{204} See \textit{supra} Part III.B.1. Some commentators have noted that the injury to the shareholders, due to the events underlying a derivative suit, can theoretically at times be greater economically than the injury to the corporation. See, e.g., Coffee & Schwartz, supra note 44, at 304 (discussing the plausibility that the "[share]holders’ aggregate loss [can] exceed that of the corporation" when a fiduciary breach is perceived by the marketplace as
the injury to the corporation as a whole, it must at least be understood that
"[share]holders are inextricably attached, through their [ownership of the
stock of the corporation], to the costs and benefits of [a derivative] suit."205
The Seventh Circuit in *Felzen* recognized as much when it acknowledged
that shareholders do suffer some injury when the market price of their stock
decreases.206

Placing legal fictions aside, the reality of derivative suit litigation is that
"these suits are used almost exclusively as a means of suing corporate
officers and directors for alleged breaches of [their] fiduciary duties . . . ."207
Derivative suits are intended to be a tool for "protecting shareholders of
corporations from the designing schemes and wiles of insiders who are
willing to betray their company’s interests in order to enrich themselves."208
Thus, the members of the corporation’s management often are the real
defendants. Their objectivity in pursuing the derivative claim or negotiating
a settlement is questionable because the derivative suit exists only as a result
of the directors’ refusal to institute the suit. In this capacity, the derivative
suit acts as the “last and only resort of shareholders seeking to redress
corporate wrongs.”209

The suggestion in *Felzen* that shareholders who are displeased with the
board may simply elect new directors offers little comfort.210 As a practical

creating a risk of repetition). "[F]or legal purposes, the corporation’s loss is a historical
concept, measured by accounting conventions and limited to injuries that have actually
occurred; in contrast, the shareholder’s loss may be greater, because in a securities market
that discounts future possibilities, predictions of future loss are immediately converted into
a present decline in share values." *Id.* But cf. *Fischel & Bradley, supra* note 138, at 277-82
(describing minuscule changes in the stock prices of corporations involved in derivative
litigation).


206. *Felzen*, 134 F.3d at 876. Although the court initially insists that individual
investors are not injured parties and that it is only the corporation that suffers injury, *see id.*
at 875, the court later admits that shareholders are injured persons, *see id.* at 876. However,
according to the court, "[p]arties are [only] a subset of injured persons," and it would be
improper to elevate all injured persons to the status of parties. *Id.*

207. Morris, *supra* note 95, at 584.


209. Swanson, *supra* note 93, at 1385. In certain instances, the damages recovered
in the derivative suit will be awarded directly to the shareholders rather than to the
corporation. *See* Matthews, *supra* note 6, at 1 n.1 ("[R]ecovery [to shareholders] has been
awarded 1) where the derivative suit is against insiders in order to prevent their control over
the fund; 2) where shareholders can be differentiated as ‘innocent’ or ‘guilty’; and 3) where
the corporation is no longer functioning.").

210. In fact, the statement proves too much. If shareholders may at any time merely
elect a new board when they are displeased with its conduct, why should there ever be a
need for bringing derivative actions? Rule 23.1 would be entirely superfluous in that event.
Any interpretation of Rule 23.1 would be flawed if it began with the premise that Rule 23.1
is unnecessary.
matter, the interests represented by the shareholder plaintiff in a derivative suit are generally those of the minority shareholders. A derivative suit would be unnecessary if the majority shareholders wished to assert a corporate cause of action because the majority shareholders, by virtue of their control of the board of directors, could have the corporation pursue the action directly. Minority shareholders who are dissatisfied with the board of directors do not have the ability to appoint new directors. Significantly, Rule 23.1 requires that the shareholder plaintiff in a derivative suit "fairly and adequately represent the interests of," not the corporation, but those shareholders . . . similarly situated in enforcing the right of the corporation," i.e., the minority shareholders. The derivative suit thus provides the minority shareholders with a mechanism for asserting, on behalf of the corporation, a right to recovery that might not otherwise be pursued.

The court in Felzen emphasized that unnamed shareholders should not be considered parties to the litigation, and if they wish to be heard on appeal, they must intervene as parties. Felzen states that "[s]hareholders have no more the attributes of parties when [corporate] managers settle derivative litigation than when managers settle antitrust litigation," for example. The analogy is weak, however, because the incentives involved are completely different in both situations. For instance, in antitrust investigations and litigation that involve the corporation, managers defend the corporation; in derivative suits that involve alleged breaches of their fiduciary duties, managers defend themselves. A derivative suit will be available only when the directors cannot or will not bring the suit. "The directors will thus, as a rule, be hostile to the suit and cannot be effective champions of the corporation's interests in [settling a derivative suit]," at least when it involves allegations of managerial misconduct. To suggest that shareholders should not be treated as parties in such situations silences the voice of those who represent the interests of the corporation.

The court in Felzen was careful to classify unnamed shareholders as nonparties who must intervene as parties in order to be heard. Focusing on

211. See Matthews, supra note 6, at 12-13.
212. Id.; see also 7C WRIGHT ET AL., supra note 2, § 1833, at 137.
213. FED. R. CIV. P. 23.1; see also 7C WRIGHT ET AL., supra note 2, § 1833, at 138; Matthews, supra note 6, at 13.
214. "It is the very essence of a derivative suit that the opposition of a majority cannot prevent or annul the maintenance of that suit, else very few such suits would ever be brought and minority members would have no effective remedy." 7C WRIGHT ET AL., supra note 2, § 1833, at 138 (quoting Shulman v. Ritzenberg, 47 F.R.D. 202, 211 (D.D.C. 1969)). Under certain circumstances, particularly when the defendants hold a substantial majority of the shares of the corporation, the recovery obtained from the derivative suit will be paid to the minority shareholders directly. Haudek, supra note 7, at 776-77.
216. Id. at 875-76.
217. Haudek, supra note 7, at 770.
"party" versus "nonparty" status, however, is not helpful. To refer to an unnamed shareholder as a "nonparty" simply constitutes a conclusion, rather than a part of any reasoned analysis. Unnamed shareholders are "parties" to the litigation for certain purposes but not for others. The court would agree that absent shareholders are parties at least for the purposes of being bound by the judgment in the litigation, but they are not parties for purposes of filing motions or participating directly in the trial. In the class action context,

[v]arious courts and commentators have addressed whether a particular litigation requirement, procedure, or rule applies to an absent class member by analyzing whether absent members are parties for purposes of the [particular] requirement, procedure, or rule involved. This focus . . . [on the "party" or "nonparty"] status of absent class members is only of limited value, because it begs the underlying issue concerning whether the procedure or rule applies to persons who are not physically before the court . . . .

The same is true in the derivative suit context. Courts must concentrate on substantive solutions and the real parties in interest, rather than on the technicalities of how a suit is classified and who is named as the nominal party on the pleadings.

C. Unavailability of Opt-Out Option

One important difference between class actions and derivative suits is that class members have the right to exclude themselves from certain class actions. Shareholders in derivative suits do not have the option of "opting out" of the litigation as class members do in typical class action lawsuits. Under Rule 23, class actions that fall under subsection (b)(3) require the court to give notice to all class members, informing them of their right to opt out of the class action. Any class members who choose to opt out will not be bound by any judgment or settlement that is reached in the case. Opt-out rights serve important protective functions. For instance, they supply a type "of market test of . . . [the] fairness and adequacy" of a

218. 1 NEWBERG, supra note 4, § 1.08, at 14.
220. FED. R. CIV. P. 23(b)(3).
221. See FED. R. CIV. P. 23(c)(2). See generally 5 MOORE supra note 7, §§ 23.43[6], 23.45[2] (discussing notice to class members and opportunities to opt-out under 23(b)(2) and 23(b)(3)); 3 NEWBERG, supra note 4, §§ 16.14-16.17, 16.20 (discussing rights of exclusion and res judicata in class actions); 7B WRIGHT ET AL., supra note 2, §§ 1787, 1789 (discussing notice and the effect of the judgment in class actions).
settlement.\textsuperscript{222} This market check has the effect of "limit[ing] the opportunities for class counsel to 'sell out' the class for a significant fee award."\textsuperscript{223}

In contrast to Rule 23, the provisions of Rule 23.1 do not give shareholders the option of opting out of derivative suits.\textsuperscript{224} Rule 23.1, therefore, does not afford shareholders the same variety of protective mechanisms that Rule 23 supplies to class action members.\textsuperscript{225} Settlements in derivative suits often involve changes in corporate practices that would be impossible to implement if opt-outs were permitted. Thus, all shareholders are bound by the outcome of a derivative suit whether they desire to be or not. While unnamed class members have the advantage of opting out of the class in order to protect themselves from a mismanaged class action, unnamed shareholders cannot avoid inclusion in a derivative suit unless they terminate their interests in the corporation.\textsuperscript{226} For some investors, "this may be too high a price to pay."\textsuperscript{227}

The necessarily inclusive nature of the derivative suit can, in certain circumstances, cause even more harm to the corporation’s interests, especially if the court follows the rule in \textit{Felzen}. For example, an unnamed shareholder may object to a settlement on the grounds that it is the result of a collusive arrangement between the defendant directors and the shareholder plaintiff’s attorney. In this situation, the inability to opt out of the suit or to appeal an order approving the settlement will result in large fees for the plaintiff’s attorney, release of liability for the directors, and no substantive recovery for the corporation. In situations where unnamed shareholders object to the settlement on the grounds that it is truly not in the best interests of the corporation, there should be some mechanism for meaningful appellate review of that settlement. The following discussion addresses this issue and the unique problems that arise in the context of settling representative actions.

\textsuperscript{222} See Peter H. Schuck, \textit{Mass Torts: An Institutional Evolutionist Perspective}, 80 CORNELL L. REV. 941, 964 (1995); see also David Rosenberg, \textit{Of End Games and Openings in Mass Tort Cases: Lessons from a Special Master}, 69 B.U. L. REV. 695, 705 (1989) ("In class actions generally, the opt-out procedure provides a check on whether the efficiencies of the collective process can be and have been translated into adequate compensation for [class members].").


\textsuperscript{224} FED. R. CIV. P. 23.1; Rosenbaum v. MacAllister, 64 F.3d 1439, 1443 (10th Cir. 1995).

\textsuperscript{225} Gottlieb v. Wiles, 11 F.3d 1004, 1011 (10th Cir. 1993).

\textsuperscript{226} Cox, supra note 135, at 960 n.6.

\textsuperscript{227} Id.
V. PROBLEMS INHERENT IN THE SETTLEMENT OF REPRESENTATIVE ACTIONS

A. Incentives to Settle

Class actions and derivative suits tend to be complex, drawn out proceedings that are not easy to resolve through adjudication. The majority of such actions are settled by the parties and never actually go to trial.\textsuperscript{228} Theoretically, the settlement of any dispute "represents a more efficient resolution of the . . . [matter] relative to the net costs of adjudication by the court."\textsuperscript{229} The pervasive view that settlements are the preferred means of disposing of lawsuits has led to the familiar axiom that a bad settlement will almost always be better than a good trial.\textsuperscript{230}

In the context of derivative suits in particular, both parties have strong incentives to settle the suit rather than adjudicate it. In contrast to the general American rule that requires each side to pay its own legal fees, the corporation in a derivative suit may be compelled to reimburse the expenses of the shareholder plaintiff if the suit benefits the corporation.\textsuperscript{231} This benefit can be in the form of a settlement recovery and need not be the result of a final adjudication after a trial.\textsuperscript{232} Similarly, corporate directors and officers who are named as defendants can look to the corporation to indemnify them for the legal expenses they incur in defending the action.\textsuperscript{233}


\textsuperscript{230} \textit{See} Haudek, \textit{supra} note 7, at 793 ("The bird in hand is to be preferred to the flock in the bush and a poor settlement to a good litigation.").

\textsuperscript{231} \textit{Henn & Alexander, supra} note 4, § 377, at 1112.

\textsuperscript{232} \textit{Id.} at 1108-11. Of course, if the suit goes to trial and the plaintiff is unsuccessful, the corporation will not be liable for the plaintiff's fees.

\textsuperscript{233} Some state statutes authorize corporations to provide such indemnification of
Such indemnification is not available to the defendants, however, if they are adjudged to be liable to the corporation for a breach of their fiduciary duties. These fee-shifting measures result in a peculiar situation whereby both sides may be reimbursed for their legal expenses in the event of a settlement but not in the event of a final adverse judgment. Thus, all parties have some interest in seeing the derivative suit settle rather than proceed to trial.

In addition to the parties, courts may also find themselves encouraging the settlement of derivative suits. With crowded dockets, courts may look unfavorably upon the specter of a complicated, time-consuming trial involving derivative claims. The settlement of the suit means one less


235. See Coffee, supra note 16, at 23-24 (discussing the possibility of joint fee shifting in derivative suits). Defendants may possess additional motives for advocating settlements in derivative suits. As individuals, they may be concerned about the injury to their reputation that will result from a highly publicized trial in which they are accused of fraud. Those who are risk-averse will prefer the certainty of a settlement that precludes any adjudication of wrongdoing. Moreover, the size of the recovery that is sought in some derivative suits may be so large that an adverse judgment may put the corporation out of business altogether. In such cases, the defendants may be more prone to settle the suit than to risk terminating the continued existence of the corporation. See Alexander, supra note 228, at 529-34 (discussing possible incentives of defendants to settle securities class actions).

236. Macey & Miller, supra note 13, at 46. “Federal judges, by their [own] accounts, have too much to do.” Lauren K. Robel, Caseload and Judging: Judicial Adaptations to Caseload, 1990 B.Y.U. L. REV. 3, 3 (“Judges in overwhelming numbers report that caseload pressures have a significant negative effect on their satisfaction with their work and their ability to decide cases in accordance with what they believe constitute appropriate standards.”). In response to burgeoning caseloads, many federal trial judges have become increasingly more involved in the period between case filing and trial. This pretrial activism is commonly known as “case management.” Id. at 12. “The belief that judges should encourage case settlements is the cornerstone of case management.” Id. at 16.
case, a potentially large one at that, for the court to administer. Moreover, the court may find it difficult to attempt to compel parties to litigate their case when what they really wish to do is settle it. 237

With all parties and the court having a stake in the speedy settlement of the derivative suit, the litigation may be resolved in a manner that does not truly reflect the worth of the claims before the court. As discussed below, there are risks that derivative suits will produce settlements that result from collusive arrangements between the parties’ attorneys, thereby compromising the interests of the corporation and the unnamed shareholders.

B. Named Shareholder as Plaintiff Representative

Rule 23.1 requires that the named plaintiff in a derivative suit adequately represent all “similarly situated” shareholders. 238 The unnamed shareholders rely on the named shareholder to represent their interests vigorously and prudently in enforcing the corporation’s right to recovery. The named shareholder is not elected or appointed by the other shareholders; rather, this derivative plaintiff steps in as a volunteer. 239

One of the risks associated with both class actions and derivative suits is that the named plaintiff may not really be “the best representative of the class’s interest.” 240 “Because the named plaintiff’s interest in the litigation . . . [may be relatively small in relation to] that of the class as a whole, . . . [the interests of the] named plaintiff and [the] class or corporation” may not always be aligned. 241 Simply requiring that the named plaintiff “adequately” represent the class is an ineffective means of protecting absent class members.

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237. See Coffee, supra note 16, at 27. As a matter of policy, the goal of settlement is encouraged in the federal courts. The federal rules make “facilitating the settlement of the case” an objective of pre-trial conferences before the court. Fed. R. Civ. P. 16(a)(5).

238. Fed. R. Civ. P. 23.1; see also supra note 113 (discussing adequate representation requirement).

239. Matthews, supra note 6, at 14 (discussing fiduciary nature of the relationship between derivative plaintiff and remaining shareholders); see also Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549 (1949) (stating that the named shareholder is a “self-chosen representative and a volunteer champion”). In the context of class actions, the named plaintiff has a similar role. Dam, supra note 44, at 56 (“Not only is the named plaintiff a representative, but he is also a volunteer. He chose himself.”).

240. Macey & Miller, supra note 13, at 42.

241. Id. For example, “[t]he named plaintiff [might] have a personal [stake] in the litigation” that can result from feelings of malice, vengeance, or a desire to gain a disproportionate piece of the proverbial settlement pie. Id. (discussing the faulty assumption that the named plaintiff is the best representative for the class in representative actions and enumerating factors that may place the named plaintiff’s interests at odds with those of the class being represented).
In the derivative suit context, the reality is that there may be up to four parties with potentially conflicting interests: the named shareholder, the remaining shareholders, the defendant directors and officers, and the corporation. All the parties claim to have the best interests of the corporation in mind. When a proposed settlement is reached by the named shareholder and the defendants, there is a risk that the interests of the corporation and the shareholders will be compromised. Rule 23.1 therefore requires that the settlement be judicially approved and that notice of the settlement be sent to all shareholders. Courts supervise settlements precisely because of the danger that the interests of the corporation and the unnamed shareholders will be compromised in favor of the interests of the named plaintiff or the named plaintiff’s attorney. Thus, in evaluating the fairness of the settlement, the court must act as “the guardian of the absent class members.” This may prove to be a difficult task for the court because, as discussed previously, the court may have just as much incentive as the parties before it to have the suit settle. Moreover, the court may lack the information needed to protect the unnamed shareholders and the corporation from a damaging settlement.

C. Risks of Collusion

Even in those situations where the named shareholder’s interests coincide with those of the unnamed shareholders and the corporation, there is still one more person whose interests may have a strong influence on the conduct of the litigation: the named shareholder’s attorney. In fact, in many derivative suits, it is not the named shareholder who controls the conduct of the litigation. Rather, the named shareholder’s attorney is the one who exercises significant control over the suit from the time of the initial filing to the negotiations for the suit’s settlement.

The named shareholder’s interests may not always be shared by the shareholder’s attorney. The lawyer’s economic interest in the litigation is


243. The court in Felzen recognized the existence of this danger: “Rule 23.1 provides for notice to shareholders only in the event of dismissal or settlement, so that other investors may contest the faithfulness or honesty of the self-appointed plaintiffs . . . .” Felzen v. Andreas, 134 F.3d 873, 876 (7th Cir. 1998).

244. Haudek, supra note 7, at 792.

245. See infra Part V.D.

246. Thomas & Hansen, supra note 13, at 433. The named plaintiff’s attorney has often been referred to as “the engine that drives the derivative action.” Coffee & Schwartz, supra note 44, at 316. Plaintiffs’ attorneys play the role of “entrepreneurs who bear a substantial amount of the litigation risk and exercise nearly plenary control over all important decisions in the lawsuit.” Macey & Miller, supra note 13, at 3. See generally John C. Coffee, Jr., The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action, 54 U. Chi. L. Rev. 877 (1987); Dam, supra note 44, at 56-61.
the expected fee, which is not the same interest maintained by the shareholders. The shareholders’ interest lies in the net recovery to the corporation. Plaintiffs’ attorneys usually work on a contingency fee basis and are motivated by the financial goal of obtaining their fees from the settlement fund. The financial costs of the derivative suit can be so high that the named plaintiff’s attorney may have to make large cash advances to move the case forward. After months or years of preparing the case for trial, the attorney has so much time and money already invested in the litigation that the attorney’s objectivity during settlement negotiations will be extremely difficult to maintain.

The potential conflict of interest between named plaintiffs and their attorneys raises the risk of collusion between the plaintiffs’ attorneys and the defendants. This risk contributes to the “agency costs” that are associated with representative actions. The lawyer, as the agent of the client,

247. Alexander, supra note 228, at 535-36; Gevurtz, supra note 141, at 288. Similar concerns are raised in the class action context. See Dam, supra note 44, at 56-57 (stating that one “conflict of interest” that arises in class actions is “that faced by the lawyer for the class. His personal interest may be different from that of either the representative plaintiff or the class as a whole. His interest is in his fee. If he does not obtain either a settlement or a judgment for the class, he will not receive any compensation.”).

248. Courts are not unaware of this potential problem. The Second Circuit has observed:

There can be no blinking at the fact that the interests of the plaintiff in a stockholder’s derivative suit and of his attorney are by no means congruent. While, in a general sense, both are interested in maximizing the recovery this is only a half-truth. . . . The plaintiff’s financial interest is in his share of the total recovery less what may be awarded to counsel, simpliciter, counsel’s financial interest is in the amount of the award to him less the time and effort needed to produce it. A relatively small settlement may well produce an allowance bearing a higher ratio to the cost of the work than a much larger recovery obtained only after extensive discovery, a long trial and an appeal. The risks in proceeding to trial vary even more essentially. For the plaintiff, a defendant’s judgment may mean simply the defeat of an expectation, often of relatively small amount; for his lawyer, it can mean the loss of years of costly effort by himself and his staff.

Saylor v. Lindsey, 456 F.2d 896, 900-01 (2d Cir. 1972).

249. See supra note 14 (describing agency costs). The concept of agency costs was originally developed by Michael C. Jensen and William H. Meckling in 1976. See Jensen & Meckling, supra note 134, at 308-10 (explaining that when the interests of an agent in a business setting are not perfectly aligned with those of the principal, certain agency costs are incurred by both the agent and the principal due to the divergence of their respective interests). The agency cost model has since been applied in a number of different settings. See, e.g., Linz Audain, The Economics of Law-Related Labor V: Judicial Careers, Judicial Selection, and an Agency Cost Model of the Judicial Function, 42 Am. U. L. Rev. 115 (1992) (applying agency cost model to judicial function); Kenneth G. Dau-Schmidt, An Agency Cost Analysis of the Sentencing Reform Act: Recalling the Virtues of Delegating Complex Decisions, 25 U.C. Davis L. Rev. 659 (1992) (applying agency cost model to
theoretically represents the client’s interests alone. However, when the interests of the agent begin to deviate from those of the principal, there is an increasing danger that the agent will behave opportunistically.250 Thus, plaintiffs’ attorneys may be tempted to agree to a premature and inadequate settlement, or they may be inclined to reject a perfectly adequate settlement, depending on how much of the settlement offer covers attorneys’ fees. There is always the possibility that plaintiffs’ attorneys will conspire with the defendants to exchange a small settlement for a large award of attorneys’ fees. In fact, derivative suits are unique in that the parties’ attorneys are often able to structure nonpecuniary settlements that (1) absolve the defendant directors and officers of any liability for breaches of their fiduciary duties; (2) “require [the] defendants to commit to largely cosmetic,” therapeutic changes in the way the corporation is run;251 (3) result in little or no monetary relief for the shareholders; and (4) provide for payment of a substantial fee to the plaintiffs’ attorneys. As discussed above, defendants have very powerful incentives to settle derivative suits, not the least of which is the enormous disruption in normal business activity that derivative litigation can cause. These concerns, when coupled with the incentives of the named shareholder’s lawyer, make collusive settlement arrangements more than merely a theoretical danger.252

federal sentencing regime); Dayna Bowen Matthew, Controlling the Reverse Agency Costs of Employment-Based Health Insurance: Of Markets, Courts, and a Regulatory Quagmire, 31 Wake Forest L. Rev. 1037 (1996) (using a reverse agency model to explore the role of health insurance in the employer-employee relationship and identifying potential conflicts of interests among the parties). In the context of derivative suits, agency costs involve “the divergence of attorneys’ incentives from shareholder interests.” Romano, supra note 228, at 69.

250. See Coffee, supra note 14, at 680 n.29 (referring to circumstances in which “agents [do] not abide by the terms of their contractual relationships with their principals, but [instead] . . . covertly pursue their own interests at their principals’ expense”); Coffee, supra note 16, at 62-63 (discussing increasing “misalignment between . . . interests of attorney and client” when attorneys finance the litigation). As “agency costs” become increasingly more pronounced, attorneys must be viewed as independent actors and not truly loyal agents of their clients. Coffee, supra note 14, at 680 n.30.

251. Weiss & Beckerman, supra note 15, at 2067 n.73. These “therapeutic” reforms can include such activities as revising audit procedures, providing for “corrective disclosures,” or changing the management style of the board. Coffee, supra note 16, at 24.

252. See, e.g., Susan P. Konik & George M. Cohen, Under Cloak of Settlement, 82 Va. L. Rev. 1051, 1087-89 (1996) (discussing Durkin v. Shea & Gould, 92 F.3d 1510 (9th Cir. 1996), as an “example of the kind of abuse that may well be widespread in the settlement of class and derivative actions” whereby plaintiffs’ lawyers and company lawyers arrange “a settlement that short-changes the company and its shareholders but serves the interests of directors by releasing them from liability at no cost to those directors”). The authors note that “the fairness hearing process does not appear adequate to prevent this [type of] abuse.” Id. at 1089.
One way to remedy conflict of interest problems such as these is to have clients more closely monitor their lawyer’s activities during the course of the litigation. It is well understood, however, that plaintiffs in the derivative suit context are often completely incapable of monitoring their attorneys. The Third Circuit in Bell Atlantic recognized that the plaintiff in a derivative suit is “neither well-situated nor adequately motivated to closely monitor and control the attorney, his agent.”253 This is because no single shareholder wishes to incur the opportunity costs or to devote the time and attention that is necessary to monitor the derivative suit’s progress and the lawyer’s conduct.254 The “free-rider” effects are powerful: no rational shareholder would assume the task of monitoring the litigation255 because “the costs of [doing so would far] exceed the pro rata benefit to [that] single shareholder . . . .”256 Even if a shareholder wanted to take on the role of “litigation monitor,” the shareholder would encounter some difficulty. Many shareholders remain unaware of the litigation until after they have received notice that a settlement has been reached.257 They are not likely to learn of the litigation from the corporate defendants who are generally averse to publicizing litigation that involves the corporation or, more specifically, litigation that involves allegations of managers’ breaches of fiduciary duties to the corporation.258 Thus, it is very difficult for individual plaintiffs to control effectively the agency costs associated with the attorney-client relationship in these cases.

D. The Court’s Lack of Information

One may argue that the court’s involvement and supervision pursuant to Rule 23.1 will serve as a proxy for effective client monitoring in derivative suits. Judicial evaluation of the fairness and adequacy of a settlement should work to filter out inappropriate settlements that are the result of collusion between the parties. However, the court’s ability to perform such a policing function is questionable. As previously discussed, courts themselves have an interest in approving the settlement of a potentially

254. Alexander, supra note 228, at 535.
255. Macey & Miller, supra note 13, at 19-20.
256. Bell Atlantic, 2 F.3d at 1309 n.9. “Free-rider effects” occur when a person “can obtain a benefit (or avoid a cost) without paying for it.” Macey & Miller, supra note 13, at 8 n.5. Shareholders in derivative suits have every incentive to “let someone else” do the monitoring for them and obtain the benefits of such monitoring for free.
257. Bell Atlantic, 2 F.3d at 1309 n.9; Macey & Miller, supra note 13, at 20.
258. Cf. Weiss & Beckerman, supra note 15, at 2100 (stating that in the class action context, “[a] corporation has no obligation to issue a press release disclosing that it has been sued unless the suit is likely to have a material effect on the corporation’s financial condition. Moreover, corporations generally are averse to publicizing class actions, perhaps fearing that doing so will stimulate the filing of additional claims.”).
large, protracted case that would otherwise consume the judiciary’s limited time and resources.\textsuperscript{269} Judges have taken affirmative steps to facilitate settlement in light of the policy that favors alternatives to trial for the resolution of disputes.\textsuperscript{270} Courts may have just as much incentive as the parties to have the case simply “go away.”

Moreover, once a settlement agreement is reached, the court is faced with little if any substantive opposition to the proposed settlement by the parties.\textsuperscript{261} On the contrary, at the settlement hearing, “the plaintiff[s] and defendant[s] naturally will join hands in supporting their agreement,”\textsuperscript{262} and the hearing turns into a “pep rall[yl] jointly orchestrated by plaintiffs’ counsel and defense counsel.”\textsuperscript{263} Because both parties argue in favor of the settlement, the court has little other information before it to conclude that the settlement is improper.\textsuperscript{264} When the parties as former adversaries appear before the court as fellow cheerleaders for the amicable disposal of their dispute, the circumstances are hardly conducive to scrutinizing judicial review.

In addition, a court may not be able to undertake a thoughtful consideration of a settlement’s merits simply because the court lacks information about the dispute. At the point of the settlement hearing, the judge has not yet had the opportunity to review much evidence in the case. Often the only information at the judge’s disposal will be in the pleadings, the initial briefs and the preliminary motions; such documents are not likely to provide

\textsuperscript{259} Alexander, supra note 228, at 566; see supra notes 236-37 and accompanying text.

\textsuperscript{260} See Alexander, supra note 228, at 566. Various methods of alternative dispute resolution, including settlement, negotiation, and mediation, have become increasingly popular in recent decades. See Robel, supra note 236, at 23-24 (“Trial courts are now employing a variety of alternative dispute resolution (“ADR”) procedures hoping to encourage parties to settle their disputes without resort to adjudication.”); see also Carrie Menkel-Meadow, Whose Dispute Is It Anyway?: A Philosophical and Democratic Defense of Settlement (In Some Cases), 83 GEO. L.J. 2663, 2663-82, 2687-93 (1995) (discussing some advantages of settlement and other ADR mechanisms over adjudication). Not everyone, however, favors settlement as a means of resolving disputes. Many scholars have expressed their concerns about utilizing settlements as a substitute for adjudicated resolutions. See, e.g., Owen M. Fiss, Against Settlement, 93 YALE L.J. 1073, 1075 (1984) (stating that “settlement is a capitulation to the conditions of mass society and should be neither encouraged nor praised”).

\textsuperscript{261} Gevurtz, supra note 141, at 310.

\textsuperscript{262} Id.

\textsuperscript{263} Macey & Miller, supra note 13, at 46. In Bell Atlantic, the court noted that “[i]n assessing settlements of representative actions, judges no longer have the full benefit of the adversarial process” because both parties join together “to spotlight the proposal’s strengths and slight its defects.” 2 F.3d 1304, 1310.

\textsuperscript{264} One commentator has suggested that “judges are ill-equipped to do much other than nod when the litigants join together and seek court approval.” Judith Resnik, Judging Consent, 1987 U. CHI. LEGAL. F. 43, 101.
the judge with sufficient evidence to determine independently whether the settlement is a fair representation of the value of the case.\textsuperscript{265} For these reasons, the court in \textit{Bell Atlantic} emphasized the important role that objecting shareholders play in the settlement evaluation process. According to the court, "objectors \ldots giv[e] courts access to information on the settlement's merits."\textsuperscript{266} They also provide the court with information concerning how diligently and effectively the plaintiffs' attorney has pursued the action.

In light of the foregoing factors that influence courts in evaluating settlements, it is not surprising that a "majority of \ldots settlements are judicially approved and rejections [of settlements] on the ground of inadequacy are comparatively rare."\textsuperscript{267} Given the parties' incentives, the various conflicting interests, the agency costs, and the information problems that are inherent in the settlement of derivative suits, the potential exists for settlements that lack merit to nonetheless gain judicial approval. This approval is obtained after evading all the protective statutory and judicial barriers designed to weed out such settlements. The goal of the court approval requirement in Rule 23.1 is to protect against unfair and inadequate settlements. A mechanism that provides for meaningful appellate review of such settlements would go a long way toward achieving that goal.

\section*{VI. ANALYSIS OF INTERVENTION SOLUTION AND RECOMMENDATIONS}

The Seventh Circuit in \textit{Felzen} was not blind to the agency costs and monitoring problems inherent in derivative suits, nor was the court doubtful that appellate review of court-approved settlements would be justified in some cases.\textsuperscript{268} The court, however, insisted that shareholders who have objections to the settlement must intervene as parties in order to appeal the approval of the settlement.\textsuperscript{269} There is no attempt in the opinion to discuss the intervention requirement or to explore in any detail how it would be

\begin{footnotesize}
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\item \textsuperscript{265} Macey & Miller, supra note 13, at 46; see also Weiss & Beckerman, \textit{supra} note 15, at 2066. Determining whether a settlement adequately reflects the merits of the case is a "highly subjective and imprecise" art. Macey & Miller, \textit{supra} note 13, at 46. Even if the court had greater information to assist the court in its evaluation, it would still be difficult to reliably estimate the settlement value of a case. \textit{Id.}
\item \textsuperscript{266} 2 F.3d 1304, 1310.
\item \textsuperscript{267} Haudek, \textit{supra} note 7, at 793; see Macey & Miller, \textit{supra} note 13, at 47.
\item \textsuperscript{268} The court noted that the notice and court approval requirements in Rule 23.1 exist "so that other investors may contest the faithfulness or honesty of the self-appointed plaintiffs; we do not doubt that this monitoring is often useful and that intervention to facilitate an appeal could be justified." \textit{Felzen}, 134 F.3d at 876. The court cited several scholarly articles, including a few that have been cited in this article, that discuss the problems associated with the settlement of class actions and derivative suits. \textit{Id.} (citing Alexander, \textit{supra} note 228; Fischel & Bradley, \textit{supra} note 138; Romano, \textit{supra} note 228).
\item \textsuperscript{269} \textit{Id.}
\end{itemize}
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implemented in the context of derivative suits. The following analysis of
the intervention rule examines this question of implementation and suggests
that the intervention requirement endorsed in *Felzen* is inappropriate as
applied to derivative suits.

"Intervention [is] a procedure by which an outsider with an interest in
a lawsuit may come in as a party though the outsider has not been named
as a party by the existing litigants . . . ." 270 Under Rule 24 of the Federal
Rules of Civil Procedure, such an outsider may intervene in one of two
ways: "intervention of right" under subsection (a)271 or "permissive
intervention" under subsection (b).272 Applicants may intervene as of right
when an action may "impair or impede [their] ability to protect [their]
interest[s]," and their interests are not "adequately represented by existing
parties."273 Permissive intervention is appropriate "when [the] applicant's
claim or defense and the main action have a question of law or fact in
common."274

Both types of intervention require that the application to intervene be
"timely."275 The meaning of "timeliness" in the derivative suit context is
far from clear.276 A strict construction of this provision may pose serious

270. 7C WRIGHT ET AL., *supra* note 2, § 1901. Unlike compulsory joinder,
intervention governs those situations where the absentees of their own accord wish to be
included in the litigation and petition the court to allow them to do so. *Id.*; cf. FED. R. CIV.
P. 19 (stating that compulsory joinder governs circumstances when the interests of the
absentees may be so affected by the litigation that it cannot be permitted to proceed without
them).

271.  FED. R. CIV. P. 24(a).

272.  FED. R. CIV. P. 24(b).

273.  FED. R. CIV. P. 24(a).

274.  FED. R. CIV. P. 24(b). "Persons granted intervention in the trial court become
parties [to the action], and ordinarily have standing to appeal according to the rules that

275.  See FED. R. CIV. P. 24(a) ("Upon timely application anyone shall be permitted
to intervene . . . ." (emphasis added)); FED. R. CIV. P. 24(b) ("Upon timely application
anyone may be permitted to intervene . . . ." (emphasis added)).

276.  The test by which courts determine timeliness for intervention usually requires
the consideration of various factors including prejudice to the parties. *See, e.g.*, Alaska v.
Suburban Propane Gas Corp., 123 F.3d 1317, 1319 (9th Cir. 1997) ("[T]he test by which we
determine timeliness . . . . requires the consideration of three factors: (1) the stage of the
proceedings at which intervention is sought; (2) the prejudice that would be suffered by other
parties if intervention were granted; and (3) the reason for and length of the delay in seeking
intervention."); People Who Care v. Rockford Bd. of Educ., 68 F.3d 172, 175 (7th Cir. 1995)
("The timeliness factor is essentially a reasonableness inquiry, requiring potential intervenors
to be reasonably diligent in learning of a suit that might affect their rights, and upon learning
of such a suit, to act to intervene reasonably promptly. . . . [F]our factors to be considered
in determining if a motion to intervene is timely . . . . are 1) the length of time the intervenor
knew or should have known of his interest in the case, 2) the prejudice to the original party
caused by the delay, 3) the resulting prejudice to the intervenor if the motion is denied, and
problems for the unnamed shareholder. Lack of notice that a derivative suit
is pending and of information about the progress of the case make it
difficult for shareholders to determine whether intervention is necessary to
protect the interests of the corporation. Shareholders often are not aware
that derivative litigation is pending until they receive notice of the
settlement. Thus, even if they were to request intervention immediately
after learning of the litigation or learning of possible collusion between the
named parties, the court might very well find their request to be "untimely."

Even if the unnamed shareholder's motion to intervene were timely, it
is unlikely that the court would allow the intervention. Unlike the case in
Marino where the Supreme Court held that nonparties who had interests
directly opposed to those of the class were required to intervene before
having a right to appeal, unnamed shareholders in derivative suits appear
on the surface to have the same interests as the named plaintiffs. The
grounds for intervention would be much less apparent to the court in the
derivative suit context. Unnamed shareholders seeking to intervene as of
right under Rule 24(a), must convince the court that their interests, or more
specifically, the interests of the corporation, are not "adequately represented"
by the existing named shareholder. The court, however, pursuant to Rule
23.1, has already determined that the named plaintiff does "adequately
represent the interests of the shareholders . . . similarly situated in enforcing
the right of the corporation . . . ." The very existence of the derivative
suit presupposes that the adequate representation requirement has been met.
In order to grant the intervention request, the court essentially has to reverse
itself and find that the named plaintiff is not an adequate representative.
This type of reversal is not likely to occur very often.

4) any unusual circumstances." (citations omitted)).

277. One would hope that counsel for the plaintiffs would make every effort to inform
absent shareholders of the existence of the derivative litigation and the importance of
intervening if necessary to preserve their right of appeal. John R. Knight, Appellate Rights
for Unnamed Class Members in Federal Class Action Litigation, 44 FED. L.W. 16, 17
(1997). Experience in the class action context, however, reveals that this does not happen.
Id. In fact, in jurisdictions that require intervention to preserve appellate rights, "class
counsel have an incentive not to provide such notice . . . in order to [eliminate] the
[possibility] of a successful appellate challenge to a settlement." Id.

278. See supra notes 257-58 and accompanying text.
279. See supra Part IV.A (discussing Marino).
280. See FED. R. CIV. P. 24(a).
281. FED. R. CIV. P. 23.1.
283. Id.; see, e.g., Fielding v. Allen, 9 F.R.D. 106, 107 (S.D.N.Y. 1949) (denying
application to intervene as a matter of right in derivative suit where stockholders failed to
show that representation by existing plaintiff would be inadequate). Even the Supreme Court
has recognized the paradoxical application of the intervention rules in the class action
context: "[T]he judgment in a class action will bind only those members of the class whose
Unnamed shareholders are not any more likely to be successful if they request permissive intervention. Under Rule 24(b), it is under the court’s discretion whether to allow an absentee to intervene. The court’s primary concern is whether the intervention will “unduly delay or prejudice the adjudication of the rights of the original parties.” In light of the policy favoring settlement over adjudication, courts may be inclined to find that intervention will derail or hinder settlement negotiations, and thus find reasons for denying the motion to intervene.

Thus, intervention holds very little promise as a device for preserving the appellate rights of unnamed shareholders in derivative suits. District courts are not likely to grant motions to intervene. Although the denial of motions to intervene are appealable, the appellate court reviews such denials only for an abuse of discretion. With such a limited standard of review, district court decisions on intervention motions are likely to stand.

It is important to keep in mind that intervention under Rule 24 is technically designed to allow interested nonparties, rather than unnamed parties, the opportunity to represent their own interests in lawsuits that will directly affect them. As previously discussed, focusing on the “party” versus “nonparty” status of unnamed shareholders is not very useful. To the extent that a court endorses the rule of Felzen, a shareholder who for all intents and purposes is considered a “party” to the derivative suit and is

interests have been adequately represented by existing parties to the litigation; yet intervention as of right presupposes that an intervenor’s interests are or may not be so represented.” Sam Fox Pub’g Co. v. United States, 366 U.S. 683, 691 (1961) (citation omitted).


285. Id.

286. Weiss & Beckerman, supra note 15, at 2104; see, e.g., United States v. Mid-State Disposal, Inc., 131 F.R.D. 573, 576 (W.D. Wis. 1990) (denying motion to intervene on grounds that allowing intervention “would render the negotiations between the original parties a waste of time and stall the implementation of the [settlement]”); see also Note, Shareholder Intervention in Corporate Litigation, 63 Harv. L. Rev. 1426, 1429 (1950) (“Little use seems to have been made of [Rule] 24(b) in granting intervention to shareholders, either because it may have been construed not to cover derivative interests or because permissive intervention under [Rule] 24(b) probably would be precluded by a decision under [Rule] 24(a)(2) that representation was adequate . . . .”).


289. See supra text accompanying note 218.
undeniably bound by the decisions of the court with respect to the suit, will be required to “employ a [procedural] device not designed for such use.”

Therefore, this article recommends that the intervention rule of *Felzen* be rejected in favor of a more flexible approach: unnamed shareholders who appear before the court to object to a proposed settlement in a derivative suit should be granted the right to subsequently appeal an order approving that settlement, whether or not they have formally intervened. This rule is based on an understanding of the unique characteristics of derivative suits and the reality of shareholders’ roles and interests in these suits.

Class actions and derivative suits are both riddled with agency costs and information problems. Corporate litigation is unique, however, in creating powerful incentives for both sides to settle in order to have their attorneys’ fees reimbursed from the corporate treasury. In derivative suits involving allegations of fiduciary breaches by defendant officers and directors, the risk of collusion between named shareholders’ attorneys and the defendants is high. Unnamed shareholders in derivative suits, unlike class members in typical class actions, have no option of “opting out” of the litigation. The court’s own incentives and lack of information render the court particularly ill-equipped to protect the interests of unnamed shareholders and the corporation. As previously discussed, the adversarial character of settlement hearings is greatly diminished, and the court is deprived of helpful guidance. This is where objectors play a critical role. Objecting shareholders who appear before the court to offer evidence of the settlement’s real value, or lack thereof, provide the court with information that is useful in its determination of whether to approve the settlement agreement.

It is clear that “the roles of the objector and his counsel are not enviable.” It is no surprise that there is often very little or no opposition to most settlements. Unnamed shareholders who do appear before the


292. This approach is taken by the court in *Bell Atlantic*, although the court phrased its holding in terms of “standing” to appeal. See *Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304, 1310 (3d Cir. 1993).

293. See *supra* text accompanying notes 231-35.

294. See *supra* Part V.C.

295. See *supra* Part IV.C.

296. See *supra* text accompanying notes 236-37; *supra* Part V.D.


298. *Id.* Haudek insightfully explains the “unenviable” role of the objector’s attorney:
court to object to proposed settlements are persons who have overcome the strong free-rider effects and incentives not to expend time or resources to monitor the derivative litigation. Such objectors ought not be further saddled with the formalistic requirement of intervening in order to preserve their rights of appeal. By the time the objector has appeared in the suit, the additional intervention requirement results in little more than unduly burdening the objector and the courts without conferring a substantial benefit. Form should not be preferred over substance. It appears to be an exercise in circularity “to require objecting [shareholders] to intervene [formally] before they may appeal, [when] the . . . [primary] practical effect of intervention” would be to grant objecting shareholders the right to appeal.

This article thus proposes that an unnamed shareholder’s appearance in court to object to the approval of a settlement should be regarded as a necessary and sufficient condition to appeal an order approving that settlement at a later date. For the reasons discussed above, requiring intervention in order to preserve appellate rights is unduly burdensome and provides illusory relief since courts are not likely to grant motions to intervene in any case.

VII. Choice Between Two Conflicting Ideologies

It is important to recognize that the two different approaches to appellate standing that have been discussed in this article represent two mutually exclusive methods for remedying two different evils, namely agency costs and collective action problems. This article recommends that unnamed shareholders who raise objections to the settlement of a derivative suit be allowed subsequently to appeal a court order approving the settlement.

The adoption of such a rule helps resolve the problem of agency costs

“There compensation of the objector’s lawyer [depends] on his success and . . . ability to improve the terms of the [settlement].” Id. On the one hand, if “the settlement is approved . . . [over his objections,] he receives nothing” because he has not “conferred a benefit on the . . . corporation.” Id. On the other hand, if he successfully convinces the court to reject the proposed settlement, he still receives nothing. “[T]o earn [his] fee he would have to join in the [suit] and produce a recovery greater than the [rejected] settlement . . . .” Id. Thus, there are few incentives for the objector and the objector’s lawyer to oppose the settlement, no matter how “critical they may be of the settlement.” Id. “His prospects of a reward for opposing the settlement are thus meager,” “battling the united front of the proponents, and struggling with the court’s natural tendency to favor the compromise.” Id.

299. For purposes of judicial economy, requiring unnamed shareholders to intervene will not necessarily save the courts from work, especially if one assumes that the motion will be denied and then subsequently appealed. Duffy, supra note 229, at 949.
300. Id. at 954.
301. See supra Part VI.
inherent in representative actions. When plaintiffs' attorneys know that unnamed shareholders need only object to the settlement, rather than formally intervene in the action, in order to preserve their appellate rights, attorneys will recognize that the risks of appeal may be increased because access to appeal has been made easier. As appeals become less difficult to bring, these attorneys will be less inclined to enter into unmeritorious settlements that can easily be upset on appeal by objecting shareholders. In order to avoid shareholder objections to the settlement, attorneys have incentives to create valid settlements that reflect the true value of the suit. Thus, agency costs are minimized as attorneys' interests become aligned with those of the client.

The downside of this rule, however, is that the reduction of agency costs intensifies the collective action problems that are associated with any type of group litigation. Collective action refers to activities that require the coordination of efforts by two or more individuals. "[C]ollective action problems . . . arise when [the] group [participants may know that they will] benefit from cooperation, but lack the individual incentives to act collectively." Once "individual member's interests diverge from that of the collective, . . . member[s] [have] an incentive to cheat or defect," and there may then be problems securing compliance with collective decisions. If

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302. See supra notes 249-52 and accompanying text; see also John C. Coffee, Jr., Rethinking the Class Action: A Policy Primer on Reform, 62 Ind. L.J. 625, 628-34 (1987) (discussing agency costs in the context of class actions). One commentator has suggested that "[n]o opening generalization about the modern class action is sounder than the assertion that it has long been a context in which opportunistic behavior has been common and high agency costs have prevailed." John C. Coffee, Jr., Class Wars: The Dilemma of the Mass Tort Class Action, 95 Colum. L. Rev. 1343, 1347 (1995). Because the client as the principal is often "not in a good position to monitor the attorney's actions in advance, the client's formal power to accept or reject settlement offers may not [always] be a sufficient safeguard against attorney opportunism." Geoffrey P. Miller, Some Agency Problems in Settlement, 16 J. Leg. Stud. 189, 211 (1987). It is to the attorney's advantage to persuade the client to settle for much less than the true expected value of the suit. See Douglas E. Rosenthal, Lawyer and Client: Who's in Charge? 110 (1974) ("When faced with an economic interest that competes with the client's, most attorneys employ the device of preparing the client to accept less than he anticipates and persuading him that it is in his best interest to do so . . . .").

303. See supra note 13 (describing concept of collective action).

304. See Todd Sandler, Collective Action: Theory and Applications 1 (1992). These efforts are often intended to further the interests of the group. Id. The interdependence among the group participants causes the contributions or efforts of any one individual to influence unavoidably the contributions or efforts of other individuals. Id.


306. Id. at 1262. One of the most influential scholarly works describing the collective action concept was produced by Mancur Olson. See Mancur Olson, Jr., The Logic of Collective Action (1965). Olson transformed much of the thinking about group behavior
individual shareholders in derivative suits know that they can each gain the right to appeal so long as they appear at the settlement hearing and object, they may be tempted to do so and thus "defect" from the group settlement at a rate much higher than would have been the case without such a rule. As a result, the removal of barriers to appeal makes settlements more costly and increases the likelihood that settlements will be more difficult to finalize.

The adoption of a rule that requires intervention to preserve appellate rights, however, produces the opposite result. Because fewer shareholders will be inclined to take on the burden of formally intervening in the lawsuit, proposed settlements will be much less likely to meet with opposition. This reduces the costs of finalizing a settlement and contributes to a quick and efficient resolution of the action. The incentives that are created by such a rule, however, intensify the agency costs that are attached to the representation. Attorneys who know that fewer settlements will be the subject of an appeal have the incentive to structure settlements that may benefit the attorney more than the client.

Thus, the two conflicting rules articulated by the Third and Seventh Circuits reflect each one's choice of the lesser of two evils to some extent. The rule of objection and the rule of intervention represent different ideologies concerning derivative litigation and the costs associated with it. Resolving one set of costs may involve the heightening of another set of costs. Attempts to resolve all the problems inherent in representative actions require that a balance be struck and a choice be made. This article suggests that, although there is a price for adopting a rule that requires only objections to preserve appellate rights in derivative suits, the corresponding benefits of reducing agency costs, decreasing the risk of collusive arrangements, and ensuring fair and adequate settlements make the price worth paying.

VIII. Conclusion

As Professor Rubenstein has artfully expressed, "Groups are messy."307 They are composed of many different individuals who each have their own

307. Rubenstein, supra note 49, at 1623. It is with these three words that Professor Rubenstein begins his insightful article discussing group decision making in the context of litigation.
goals and styles of achieving them. Corporations are even messier. They are "persons" composed of natural persons (shareholders), but they act through other natural persons (directors and officers). Each person in the corporate equation has individual interests in addition to the overall interests of the corporation. Thus, the task of determining who speaks on behalf of the corporation can be difficult at times. In the context of derivative litigation, this task can approach the realm of the impossible. To rely on legal fictions does not provide much assistance in the search for the corporation's voice. A recognition of the real nature of derivative litigation, at least when it involves allegations of managers' fiduciary breaches, is more helpful in this search.

The derivative suit long ago was crowned the "chief regulator of corporate management." This term reflects the reality of derivative litigation: the derivative suit constitutes a method by which shareholders may keep potentially wayward directors and officers in check. However, it is also a reality that, in certain situations, the "chief regulator of corporate management" can easily become the tool of the "chief co-conspirator of corporate management." The derivative suit, with its attendant agency costs and risks of collusion, can be settled for a song by the named parties. In such cases, the derivative suit does more harm to the corporation than good.

Rules governing derivative suits must, therefore, be fashioned to take these realities into account. The Seventh Circuit's rule in Felzen fails to do that. Requiring intervention from unnamed shareholders in order to preserve their right to appeal an approval of a settlement elevates form over substance. It is an attempt to force derivative suits into the standard model of litigation wherein it is clear who the "parties" and "nonparties" are. That is an uncomfortable fit. This article recommends that such an approach be abandoned for one that focuses less on procedural niceties and more on the substance of the litigation.

308. Id.