

Dismissal of Derivative Action—Effect on Non-Party Shareholders (Papilsky v. Berndt)

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The instant case is representative of the willingness of the courts to grant class status in doubtful situations rather than foreclose the plaintiff from possible relief.¹³⁰ This judicial policy outweighed the imperfect constitution of the class which the district court thought was the controlling consideration in the granting of class action status.¹³¹ In *Korn*, the Second Circuit has reaffirmed the equitable basis of the representative suit.¹³²

DISMISSAL OF DERIVATIVE ACTION — EFFECT ON NON-PARTY
SHAREHOLDERS

Papilsky v. Berndt

The doctrine of *res judicata*, which accords finality to judgments where the parties have had their day in court, is perhaps one of the most firmly established principles of law. In the context of stockholder derivative actions and other forms of representative suits, unique problems arise when the strictures of *res judicata* are applied. The Second Circuit, in *Papilsky v. Berndt*,¹³³ has carved out a significant exception in favor of non-party stockholders, to relieve such potential plaintiffs from the sometimes harsh effects of the *res judicata* doctrine.

In *Papilsky*, a stockholder of Affiliated Fund, Inc. brought an action on behalf of Affiliated,¹³⁴ alleging that the defendant officers, directors

¹³⁰ See *Esplin v. Hirschi*, 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969). The court felt that the "interests of justice" require that, in cases of using the class action remedy, it is preferable that the court err on the side of allowing the class action. Class action procedure allows for modification of the preliminary ruling. *Id.* at 101.

¹³¹ See note 96 *supra*.

¹³² See Z. CHAFEE, *SOME PROBLEMS OF EQUITY* (1950) at 292:

However, being much less familiar with class suits, judges do not yet know quite how to go about it. They are inclined to treat the representative suit as an ordinary adversary proceeding and to forget the unnamed persons, leaving them to the tender mercies of the parties in court. Instead the judge ought to think of these outsiders as somewhat like wards of the court, at least until he is sure that the representatives are stout fellows who are fighting vigorously for the entire class.

¹³³ 466 F.2d 251 (2d Cir. 1972).

¹³⁴ The nature of a shareholder's derivative action is such that he is allowed to enforce the corporation's claim against the directors or officers who have been guilty of mismanagement. He has no right to sue and recover damages on his own behalf. He does benefit indirectly, however, as any recovery becomes part of the corporate assets in which he, of course, shares.

See *Ross v. Bernhard*, 396 U.S. 531 (1970) where the Court said, in dictum, that no action existed at common law by which a stockholder could make a corporate director account for his wrongs. Equity made available a remedy in the form of a derivative suit "to enforce a corporate cause of action against officers, directors, and third parties. . . . [O]ne precondition for the suit was a valid claim on which the corporation could have sued; another was that the corporation itself had refused to proceed after suitable demand. . . . Thus the dual nature of the stockholder's action: first, the plaintiff's right to sue on behalf of the corporation and, second, the merits of the corporation's claim itself." *Id.* at 534-35. In *Kauffman v. Dreyfus Fund, Inc.*, 434 F.2d 727 (3d Cir. 1970),

and investment advisors of Affiliated failed to recapture brokerage commissions paid on portfolio transactions, resulting in higher management fees being paid to the defendant in violation of the federal securities laws.¹³⁵

The defendants contended that the present cause of action was identical to the one asserted in a previous suit, *White and Bernstein v. Driscoll*,¹³⁶ which was dismissed because of the plaintiff's failure to answer interrogatories.¹³⁷ Since the *White* judgment ordering a dismissal was not stated to be "without prejudice", defendants urged that it was an adjudication on the merits of the claim and thereby precluded the derivative action brought by Papilsky.

The lower court in *Papilsky* held that "the dismissal of the *White* action was not an adjudication on the merits."¹³⁸ While denying the

a shareholder in four mutual funds brought an action against those and other mutual funds for violations of antitrust and securities laws. Plaintiff claimed standing to sue in his own behalf and derivatively; as a shareholder in four of the funds, as a class representative of all similarly situated shareholders, and as a class representative of all similarly situated funds. The court held that "[a] stockholder of a corporation does not acquire standing to maintain an action in his own right, as a shareholder, when the alleged injury is inflicted upon the corporation and the only injury to the shareholder is the indirect harm which consists in the diminution in value of his corporate shares resulting from the impairment of corporate assets." *Id.* at 732. Plaintiff's standing to sue as class representative of other funds or their shareholders was also rejected. The court affirmed, however, the stockholder's standing to sue derivatively, on behalf of the funds in which he holds shares. "[T]here is no doubt that the appellee may litigate derivative actions in behalf of the . . . funds in which he holds shares." *Id.* at 734.

¹³⁵ 466 F.2d at 253. It should be noted that the present plaintiffs had a good cause of action. Three days prior to the filing of the *Papilsky* action, the First Circuit, in *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied, 404 U.S. 994 (1971), ruled that claims similar to those asserted here did constitute violations of the Investment Company Act of 1940, 15 U.S.C. §§ 80(a)-1 *et seq.* (1970).

¹³⁶ 67 Civ. 98 (S.D.N.Y. 1971). In *White*, the derivative suits of two shareholders were combined in August of 1968. In January of 1969, the plaintiffs were ordered to file answers to interrogatories within one month. These answers were not filed, however, until fourteen months later, at which time they were returned by defendants as inadequate.

The plaintiffs delayed the filing of answers for nearly nine more months, and again the defendants found the answers to be unresponsive to the interrogatories. Shortly thereafter, defendants moved to dismiss the action pursuant to Fed. R. Civ. P. 37(b)(2) (1970) which provides:

If a party or an officer, director, or managing agent of a party . . . fails to obey an order to provide or permit discovery . . . the court in which the action is pending may make such orders in regard to the failure as are just, and among others the following:

(C) An order . . . dismissing the action or proceeding or any part thereof, or rendering a judgment by default against the disobedient party;

Defendants' motion for dismissal was granted upon the recommendation of a Special Master that the answers to the interrogatories were extremely inadequate and that the delay in sending them indicated that "plaintiffs are not serious in prosecuting this action." 466 F.2d at 254.

¹³⁷ "It is undisputed that the claims in the *White* action are the same as those now asserted in the case at bar." *Papilsky v. Berndt*, 333 F. Supp. 1084, 1085 (S.D.N.Y. 1971).

¹³⁸ *Id.* at 1086. Judge Wyatt noted that no "notice of the proposed dismissal" was given to shareholders pursuant to Rule 23.1 of the Federal Rules of Civil Procedure. *Id.*

defendants' motion for summary judgment, the district court granted certification for appeal.¹³⁹

Recognizing the unique character of a stockholder's derivative action,¹⁴⁰ the Second Circuit held that "when notice of a proposed dismissal of a stockholder's derivative suit for failure to answer interrogatories is not given to nonparty stockholders, the judgment of dismissal does not bar an identical cause of action asserted by a different stockholder in a subsequent derivative suit."¹⁴¹

The court recognized that the effect of this holding was to carve out an exception to Rule 41(b),¹⁴² which as previously interpreted, would demand an opposite result.¹⁴³ A dismissal of a plaintiff's cause of

While stating that he was "inclined to believe that notice to shareholders was required . . .", *id.*, Judge Wyatt based his decision to deny defendants' motion for summary judgment on other grounds. He explained that "the derivative suit contains two claims: (1) a claim by the corporation in which plaintiff is a stockholder, and (2) a claim by the stockholder against his corporation for its failure to enforce the claim belonging to it ((1) above)." *Id.* at 1087. He then concluded that the *White* action had the effect of barring the claim of *White* against the corporation but not the corporation's claim against *Berndt*. *Id.*

While the Second Circuit agreed with the district court that the present plaintiffs' action was not barred because of the *White* action, it rejected the Court's analysis of stockholder derivative actions. The court opined that there is only one claim — the corporate claim against the defendants. 466 F.2d at 255-56. See note 134 *supra*.

¹³⁹ In so doing, Judge Wyatt relied on 28 U.S.C. § 1292(b) (1970), which states in pertinent part:

(b) When a district judge in making in a civil action an order not otherwise appealable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he shall so state in writing in such order.

¹⁴⁰ The special character of a derivative action can be seen by the fact that the plaintiff stockholder is pursuing a claim which is, at most, tangentially personal to him. He is, however, substantially affecting the interests of the corporation and all stockholders of the corporation.

¹⁴¹ 466 F.2d at 256.

¹⁴² *Id.* at 256 n.5. Fed. R. Civ. P. 41 (b) (1970) provides in pertinent part as follows:

For failure of the plaintiff to prosecute or to comply with these rules or any order of court, a defendant may move for dismissal of an action or of any claim against him. . . . Unless the court in its order for dismissal otherwise specifies, a dismissal under this subdivision and any dismissal not provided for in this rule, other than a dismissal for lack of jurisdiction, for improper venue, or for failure to join a party under Rule 19, operates as an adjudication upon the merits.

¹⁴³ 466 F.2d at 254-55. The Second Circuit admitted that "[a] strict application of Rule 41(b) would seem to require a holding that the dismissal of the *White* action operated as an adjudication upon the merits and hence as a bar to the present derivative suit." *Id.*

The leading case in this area is *Costello v. United States*, 365 U.S. 265 (1961). Wherein the Supreme Court stated that "[a]ll of the dismissals enumerated in Rule 41(b) which operate as adjudications on the merits — failure of the plaintiff to prosecute, or to comply with the Rules of Civil Procedure, or to comply with an order of the Court . . . should, unless the Court otherwise specifies, bar a subsequent action." *Id.* at 286.

Later, in *Nasser v. Isthmian Lines*, 331 F.2d 124 (2d Cir. 1964), the Second Circuit, following the guidelines enumerated by the Supreme Court in *Costello*, held that the dismissal of the plaintiff's suit for failure to answer interrogatories was an adjudication on the merits where the order of dismissal did not provide that it was without prejudice.

action pursuant to Rule 41(b) unless otherwise specified,¹⁴⁴ is an adjudication upon the merits and hence *res judicata* as to subsequent suits based upon the same cause of action. Consequently, where a dismissal is made pursuant to Rule 37 of the Federal Rules of Civil Procedure,¹⁴⁵ such a dismissal is also an adjudication upon the merits, as determined by Rule 41(b).¹⁴⁶

In spite of previous case law which seemed contrary to its decision in *Papilsky*, the court agreed with the plaintiff that a different result is mandated in a stockholder's derivative action: "Courts traditionally have exhibited understandable caution in according *res judicata* effect to a prior derivative action in which the present plaintiff-stockholder did not participate."¹⁴⁷ Such caution stems from the fact that derivative actions, like class actions, are exceptions to the rule that where an individual is not before the court he cannot be bound by an *in personam* judgment.¹⁴⁸

In order to ensure that the courthouse doors are not closed to legitimate derivative claims a legislative remedy has been provided in Rule 23.1 of the Federal Rules of Civil Procedure.¹⁴⁹ This rule man-

dictum in *Saylor v. Lindsley*, 391 F.2d 965 (2d Cir. 1968), also indicates that failure to prosecute would result in a dismissal on the merits and hence bar a subsequent action by a plaintiff on the same claim. *Id.* at 969.

¹⁴⁴ See *Costello v. United States*, 365 U.S. 265, 286 (1961); *Nasser v. Isthmian Lines*, 331 F.2d 124, 127 (2d Cir. 1964).

Even where the dismissal is silent as to whether it is granted with or without prejudice it is deemed to be with prejudice. See *Stebbins v. State Farm Mut. Auto. Ins. Co.*, 413 F.2d 1100, 1102 (D.C. Cir.), *cert. denied*, 396 U.S. 895 (1969); *Kuzma v. Bessemer & L.E.R.R. Co.*, 259 F.2d 456, 457 (3d Cir. 1958); *Ma Chuck Moon v. Dulles*, 237 F.2d 241, 242, (9th Cir. 1956), *cert. denied*, 352 U.S. 1002 (1957); *Daley v. Sears, Roebuck & Co.*, 90 F. Supp. 562, 563 (N.D. Ohio 1950).

¹⁴⁵ See note 136 *supra*.

¹⁴⁶ *Stebbins v. State Farm Mut. Auto. Ins. Co.*, 413 F.2d 1100, 1102 (D.C. Cir.), *cert. denied*, 396 U.S. 895 (1969); *Nasser v. Isthmian Lines*, 331 F.2d 124, 127 (2d Cir. 1964).

¹⁴⁷ 466 F.2d at 257. For example, in *Saylor v. Lindsley*, 391 F.2d 965, 968 (2d Cir. 1968), a dismissal "with prejudice" of a stockholder's derivative suit for failure to post a security bond was held not to be *res judicata* as to any non-party stockholders. The court justified this holding by a finding that defendants had not been put to the inconvenience of preparing a defense (the threshold requirement established in *Costello* for dismissals which are adjudications on the merits). Nevertheless, the holding in *Saylor* marked a departure from the strict interpretation of Rule 41(b) in the case of derivative action by a stockholder. It is also interesting to note that the plaintiffs here argued that the prior dismissal should not be given *res judicata* effect to those stockholders who had not received notice of the proposed dismissal. *Id.* at 967. The Second Circuit, however, did not find it necessary to pass upon this contention.

¹⁴⁸ 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE & PROCEDURE: CIVIL § 1840 (1972) [hereinafter WRIGHT].

¹⁴⁹ FED. R. CIV. P. 23.1 provides in pertinent part as follows:

The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders . . . in enforcing the right of the corporation or association. The 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 shareholders or members in such manner as the court directs.

dates that a derivative action may not be "dismissed or compromised without the approval of the court and notice of the proposed dismissal or compromise shall be given to the shareholders or members" ¹⁵⁰ However, courts have interpreted this notice requirement as necessary only when dismissals are voluntary. ¹⁵¹ There are a number of strong policy considerations requiring that notice be given for such voluntary discontinuances.

Requiring notice prevents collusive settlements which would be adverse to the interests of the corporation and absent stockholders. ¹⁵² In addition, this provision serves to protect non-party stockholders in situations where the plaintiff must discontinue his suit for financial or personal reasons. ¹⁵³ Finally, the rule protects the corporate claim from prejudice which may result "from discontinuance of a derivative suit after the plaintiff-stockholder has already secured an advantage or when the statute of limitations precludes the institution of a new suit." ¹⁵⁴

Conversely, the requirement of notice has no application where the dismissal follows litigation on the merits. ¹⁵⁵ In such a case the opportunity for collusion or fraud is negated by the fact that the corporate claim has been dismissed by the court following a diligent presentation of the issues.

Hence, the problem faced in *Papilsky* was whether in a shareholder's derivative action, a dismissal for failure to answer interrogatories should be treated as a voluntary dismissal or as a dismissal following litigation on the merits. The Second Circuit recognized that the dismissal here in controversy contained elements of both voluntary and involuntary dismissals. For example, it is arguable that the dismissal was involuntary because it was adversary in nature, *i.e.*, plaintiffs op-

¹⁵⁰ *Id.*

¹⁵¹ See *Saylor v. Lindsley*, 391 F.2d 965, 968 (2d Cir. 1968); *Pittston Co. v. Reeves*, 263 F.2d 328, 329 (7th Cir. 1959); *Mullins v. De Soto Sec. Co.*, 45 F. Supp. 871, 886 (W.D. La. 1942), *aff'd in part, rev'd in part on other grounds*, 136 F.2d 55 (5th Cir. 1943). "Voluntary dismissals" have also been interpreted to include situations where the plaintiff consents to entry of summary judgment against him. See *Certain-Teed Prods. Corp. v. Topping*, 171 F.2d 241, 243 (2d Cir. 1948); *Brendle v. Smith*, 7 F.R.D. 119 (S.D.N.Y. 1946).

¹⁵² 466 F.2d at 258. See, *e.g.*, *Norman v. McKee*, 431 F.2d 769 (9th Cir. 1970), *cert. denied*, 401 U.S. 912 (1971). In this case, the settlement of a claim that the directors and officers of a security fund violated the Investment Company Act was disapproved by the district court. On appeal, the Ninth Circuit affirmed the decision.

The district judge properly understood that his responsibility was to act as guardian of the absent parties and the corporate fund as a whole. As such, he was entitled to consider that the prayer for relief was reasonable and that the settlement, when compared to the relief sought, was inadequate.

Id. at 774.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 258. See *WRIGHT*, note 148 *supra*, § 1839.

¹⁵⁵ 466 F.2d at 258; see *Pelelas v. Caterpillar Tractor Co.*, 113 F.2d 629, 633 (7th Cir. 1940) *Daugherty v. Ball*, 43 F.R.D. 329, 335 (C.D. Cal. 1967).

posed the granting of such a motion.¹⁵⁶ Additional support for this argument may be found in the principles set forth in *Costello v. United States*.¹⁵⁷ There the Supreme Court held that "a *sua sponte* dismissal by the court for failure of the plaintiff to comply with an order of the Court . . ." should be treated as an adjudication upon the merits unless the court specifically states otherwise.¹⁵⁸ In deciding whether a dismissal comes within the purview of Rule 41(b), the controlling factor is whether the defendants have been put to the inconvenience of preparing a defense because there is no bar to reaching the merits.¹⁵⁹ Defendants claimed that substantial work had been done in preparing to meet the plaintiff's claims in the *White* action and that therefore they fit literally within the confines of *Costello*.¹⁶⁰

While the Second Circuit admitted both of these propositions, it felt that a dismissal for failure to answer interrogatories was more analogous to a voluntary dismissal.¹⁶¹ Indeed, the court found that the same policy considerations which required that notice be given to non-party stockholders in voluntary dismissals were also present here.¹⁶² Therefore, the court concluded, notice to non-party stockholders is an indispensable predicate to barring such stockholders from maintaining subsequent derivative actions grounded on the same claim.¹⁶³

While an adequate remedy was created for such stockholders by carving out an exception to Rule 41(b), a question may be raised as to whether the same result could not have been achieved by using Rule 60(b) of the Federal Rules of Civil Procedure.¹⁶⁴ By invoking this provision, the plaintiff could have requested that, although the dismissal may be *res judicata*, it should be vacated for "excusable neglect." Papilsky's failure to timely intervene and prevent dismissal of the *White* action should be excused because she or other non-party shareholders had not received notice of the impending dismissal.¹⁶⁵ In light of the

¹⁵⁶ 466 F.2d at 259 n.9.

¹⁵⁷ 365 U.S. 265 (1965).

¹⁵⁸ *Id.* at 286-87.

¹⁵⁹ *Id.* at 286.

¹⁶⁰ 333 F. Supp. at 1087.

¹⁶¹ 466 F.2d at 259.

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ 28 U.S.C. Rule 60(b) (1970). In part this rule provides:

On motion and upon such terms as are just, the court may relieve a party or his legal representative from a final judgment, order or proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect . . . The motion shall be made within a reasonable time, and . . . not more than one year after the judgment, order or proceeding was entered or taken.

¹⁶⁵ In *Pittston Co. v. Reeves*, 263 F.2d 328 (7th Cir. 1959), the court held that notice

court's liberal attitude against barring legitimate corporate claims advanced by non-party stockholders such an argument might have been persuasive.

Alternatively, the plaintiff might have argued that the representation provided by the *White* plaintiffs inadequately represented his interest, thereby activating Rule 23.1. In addition to requiring notice, Rule 23.1 also provides that a derivation action "may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the stockholders" ¹⁶⁶ While there are few cases interpreting this sentence ¹⁶⁷ such an argument is buttressed by the Special Master's finding in *White* that the plaintiffs "were not serious in prosecuting the action" ¹⁶⁸ Such a literal interpretation of 'adequately represented' seems consistent with the legislative intent of Rule 23.1.

Even without the aid of Rule 23.1 considerable doubt was raised by the court itself as to whether the representation provided by the *White* plaintiff met the standards of due process. ¹⁶⁹ While the Second Circuit found it unnecessary to decide this issue, such a finding would have obviated the necessity of creating an exception to the rule.

In conclusion, the *Papilsky* decision has provided a substantial remedy to non-party stockholders. While the exception to Rule 41(b) was limited by the court to "dismissals for failure to answer interrogatories," ¹⁷⁰ a logical extension of this exception in derivative actions will be its future application to other pre-trial dismissals granted under Rule 37.

of a proposed voluntary dismissal must be given to stockholders and if such notice is not given a motion to vacate judgment under Rule 60(b) must be granted.

Alternatively, the plaintiff could have argued that neglect or lack of diligence by White's attorney constituted grounds for vacating the judgment because of "excusable neglect." There is some support for a contrary position. In *Geigel v. Sea Land Service, Inc.*, 44 F.R.D. 1 (D.C. Puerto Rico 1968), the Court found that the plaintiffs were not entitled to have the dismissal for failure to answer interrogatories vacated. The court rejected plaintiff's argument that his attorney's unexcused or negligent conduct demanded a dismissal under Rule 60(b).

However, it should be noted that *Geigel* did not involve a stockholder's derivative action, the distinction which the Second Circuit used to distinguish *Papilsky* from *Costello* and *Nasser*. 466 F.2d at 256-57.

While the negligence of White's attorney is imputable to White, it should not be imputed to *Papilsky*, a nonparty shareholder.

¹⁶⁶ See note 149 *supra*.

¹⁶⁷ See WRIGHT, note 148 *supra* at 393.

¹⁶⁸ 333 F.2d at 1086.

¹⁶⁹ 466 F.2d at 259-60.

¹⁷⁰ 466 F.2d at 259.