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. 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. In *Korn*, the Second Circuit has reaffirmed the equitable basis of the representative suit.

**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*, 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, alleging that the defendant officers, directors...
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.\textsuperscript{135}

The defendants contended that the present cause of action was identical to the one asserted in a previous suit, \textit{White and Bernstein v. Driscoll},\textsuperscript{138} which was dismissed because of the plaintiff's failure to answer interrogatories.\textsuperscript{137} Since the \textit{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 \textit{Papilsky} held that "the dismissal of the \textit{White} action was not an adjudication on the merits."\textsuperscript{138} While denying the

\begin{itemize}
\item 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 sue 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." \textit{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." \textit{Id.} at 734.
\item \textit{137} \textit{White}, the derivative suits of two shareholders were combined in August of 1968. In January of 1969, the plaintiffs were ordered to file answers 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 \textit{FED. R. CIV. P. 37(b)(2)} (1970) which provides:
\begin{quote}
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:
\item An order . . . dismissing the action or proceeding or any part thereof, or rendering a judgment by default against the disobedient party;
\end{quote}

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." \textit{466 F.2d} at 254.
\item \textit{137} "It is undisputed that the claims in the \textit{White} action are the same as those now asserted in the case at bar." \textit{Papilsky v. Berndt}, \textit{333 F. Supp.} 1084, 1085 (S.D.N.Y. 1971).
\item \textit{138} \textit{Id.} at 1086. Judge Wyatt noted that no "notice of the proposed dismissal" was given to shareholders pursuant to Rule 23.1 of the \textit{Federal Rules of Civil Procedure}. \textit{Id.}
defendants' motion for summary judgment, the district court granted certification for appeal.\textsuperscript{138}

Recognizing the unique character of a stockholder's derivative action,\textsuperscript{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."\textsuperscript{141}

The court recognized that the effect of this holding was to carve out an exception to Rule 41(b),\textsuperscript{142} which as previously interpreted, would demand an opposite result.\textsuperscript{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. \textit{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. \textit{See note 134 supra.}

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{141} 466 F.2d at 256.

\textsuperscript{142} Id. at 256 n.5. \textit{Fam. 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.

\textsuperscript{143} 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." \textit{Id.}

The leading case in this area is Costello v. United States, 355 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." \textit{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 \textit{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, 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, such a dismissal is also an adjudication upon the merits, as determined by Rule 41(b).

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.” 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.

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. This rule man-
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.161 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.162 In addition, this provision serves to protect non-party stockholders in situations where the plaintiff must discontinue his suit for financial or personal reasons.163 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-

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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, 481 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. Additional support for this argument may be found in the principles set forth in *Costello v. United States*.

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. 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. 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*.

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. 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. 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.

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. 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. In light of the

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156 466 F.2d at 259 n.9.
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 . . . ." While there are few cases interpreting this sentence such an argument is buttressed by the Special Master's finding in White that the plaintiffs "were not serious in prosecuting the action . . . ." 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. 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," 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 259-57.

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 399.
168 333 F.2d at 1086.
169 466 F.2d at 259-60.
170 466 F.2d at 259.