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Derivative Actions And Notice Of Compromise

Law360, New York (September 03, 2009) -- Rule 23.1(c) of the Federal Rules of Civil Procedure governs the settlement of shareholder derivative litigation.

The rule requires court approval of any settlement, voluntary dismissal or compromise in all derivative actions. The rule also requires that notice "must be given to shareholders or members in the manner that the court orders."

"Notice" issues are important because courts perceive derivative action settlements to be "particularly favored" due to the litigation of such actions being "notoriously difficult and unpredictable." In re Xcel Energy Inc., 364 F. Supp. 2d 980, 1002 (D. Minn. 2005).

All too often, the unique corporate governance issues implicated by derivative actions are outside the expertise and comfort levels of many judges.

This article focuses on the notice requirement of FRCP 23.1(c) and how courts have exercised their discretion in requiring notice of settlements and voluntary dismissals in shareholder derivative litigation.

History of Rule 23.1(c)

The modern Rule 23.1 has its roots in the 1966 amendments to the Federal Rules of Civil Procedure.

Specifically as to the notice requirement, the text of the original Rule 23.1 stated that "[t]he 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."

The Advisory Committee notes to the original Rule 23.1 provided that because a court "has inherent power to provide for the conduct of the proceedings in a derivative action,"

a court "has the power to ... require that any appropriate notice be given to shareholders or members."

Rule 23.1 was amended in 1987, but no changes were made to the rule's notice provisions. The rule took its present form by way of the 2007 amendments. The Advisory Committee notes state that the "changes are intended to be stylistic only."

Rule 23.1(c)'s court-approval and notice requirements govern over the more general dictates of Rule 41(a), which allows plaintiffs to dismiss actions without court order upon the filing of a notice (before the defendant answers) or upon a stipulation of dismissal signed by all parties.

See Fed. R. Civ. Pro. 41(a) ("Subject to Rule[] 23.1(c) ... the plaintiff may dismiss an action without court approval by filing ...").

Although the current rule now makes this clear, courts interpreting Rule 23.1 before 2007 correctly concluded that notice need not be provided of involuntary dismissals. Nathan v. Rowan, 651 F.2d 1223, 1228 (6th Cir. 1981) ("[I]n derivative actions nonparty shareholders are not entitled to notice of dismissal following a hearing on the merits.").

Rationale for Requiring Notice

Courts have explained that requiring notice of settlements and voluntary dismissals of derivative actions fulfills several goals.

The interrelated rationales of (a) ferreting out private or collusive settlements between an individual plaintiff and the defendant and (b) providing reasonable, timely notice of a proposed settlement to possible objectors are the primary rationales for Rule 23.1(c)'s notice requirement. Bell Atlantic Corp. v. Bolger, 2 F.3d 1304 (3d Cir. 1993); Maher v. Zapata Corp., 714 F.2d 436, 450 (5th Cir. 1983).

The notice requirement is especially important where the proposed settlement or voluntary dismissal will have preclusive effects or where a subsequent action would be barred on statute of limitations grounds. Saylor v. Bastedo, 623 F.2d 230, 237 (2d Cir. 1980); Grimia v. Applied Devices Corp., 78 F.R.D. 431, 432 (E.D.N.Y. 1978).

And, of course, requiring notice to be sent to all shareholders helps to protect the corporation from unfair settlements. Burks v. Lasker, 441 U.S. 471 (1979); Felzen v. Andreas, 134 F.3d 873, 876 (7th Cir. 1998) ("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").

Content of Notice in General

Courts have not fashioned a uniform, bright-line test for determining the adequacy of the notice of settlement or dismissal. Rather, the required content of the notice must be fashioned and reviewed on a case-by-case basis.

At a minimum, though, the notice must be "reasonable" and should provide the shareholders with information sufficient to allow them decide whether or not to object to the proposed settlement. In re Fleet/Norstar Securities Litigation, 935 F. Supp. 99, 105 (D.R.I. 1996); Maher, 714 F.2d at 451.

Regardless of the complexity of the litigation, the notice should (a) explain the nature of the claims and defenses at issue, (b) set forth the terms of the proposed settlement or dismissal, (c) identify the time and place of the settlement hearing, and (d) inform the shareholder of their right to appear and object. Maher, 714 F.2d 450-53.

The specifics of each case and the precise issues in dispute will determine whether or not a proposed notice is sufficient for Rule 23.1 purposes.

Form of Notice — Individual, Publication or Internet

In general, "the best notice practicable under the circumstances" should be given to the shareholders. In re Critical Path Inc., 2003 WL 22947672, at *2 (N.D. Cal. Dec. 9, 2003).

Because the mailing of individual notices to every shareholder of a large, public corporation can run in the hundreds of thousands of dollars, the use of publication by notice in newspapers or other print media, issuance of press releases and postings of notice on the internet have also been embraced by the courts.

See, e.g., Cohn v. Nelson, 375 F. Supp. 2d 844, 850-51 (E.D. Mo. 2005) (holding summary of notice of proposed settlement was sufficient via publication in the Wall Street Journal and publication via Business Wire); Brendle v. Smith, 7 F.R.D. 119, 120 (S.D.N.Y. 1946) (holding notice requirement satisfied by "a single publication of a ten day notice in the New York Law Journal").

In the appropriate circumstances, notice via publication on the court's electronic docket, which is available to the public, may suffice for notice under Rule 23.1(c).

Is Notice Mandatory?

Because Rule 23.1 vests notice-related decisions within the discretion of the court, it seems clear that the requirement of providing notice is not mandatory and can be excused in the appropriate circumstances.

Larkin Gen. Hosp. Ltd. v. AT&T Co., 93 F.R.D. 497, 502 (E.D. Pa. 1982) (interpreting language of comparable federal rule and stating that the language is "sufficiently flexible to permit the court to approve a dismissal, but to determine that no notice at all is

required, where the dismissal will not result in any prejudice"); see also Plaskow v. Peabody Int'l Corp., 95 F.R.D. 297, 299 (S.D.N.Y. 1982) (determining that notice could be waived where costs associated with notice would substantially deplete any possible recovery).

The touchstone for determining that notice of a voluntary dismissal or settlement need not be issued is fundamental fairness to the nonparty shareholders.

For instance, where a derivative action is voluntarily dismissed, but the action would have no preclusive effect on other shareholders and there would be ample time to file another action before the running of the statute of limitations, a court could rightfully conclude that notice could be excused.

See Ball v. Field, 1992 WL 57187, at *10-11 (N.D. Ill. Mar. 19, 1992) (holding notice not required where plaintiff "voluntarily dismissed" derivative actions by amending complaint and basing decision on finding that there was no statute of limitations concern and that amendment was plaintiffs' strategic decision and not the result of a private agreement).

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