MAY A SHAREHOLDER WHO OBJECTS TO A PROPOSED SETTLEMENT OF A DERIVATIVE ACTION APPEAL AN ADVERSE DECISION? A REPORT ON *CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM v. FELZEN*

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I. INTRODUCTION

In 1996, agricultural products giant Archer Daniels Midland (ADM) pleaded guilty to criminal antitrust charges and received a $100 million fine,[1] at that time one of the largest fines ever imposed.[2] The corporation also paid $90,000,000 to settle civil antitrust suits by its competitors.[3] Three executives, including Michael Andreas (the vice-president and son of ADM's autocratic chief executive officer), were ultimately convicted of illegal price fixing.[4]

ADM had long been "critic[ized] for its internal corporate management policies," as the Andreas family supported "stacking the ADM board with relatives."[5] "In the aftermath of the supported ADM criminal antitrust investigation, lawyers filed shareholder derivative suits against ADM's directors," charging them with gross mismanagement and seeking to recover the $190 million that ADM had paid in fines and settlements.[6] Two federal suits, brought by shareholder Paul Felzen and Sandra Esner, were consolidated in the Central District of Illinois in May 1996 and are the subject of this article.[7]

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[1]Linda Mullenix, *The Art of Intervening*, NAT'L L.J., Jan. 18, 1999, at B17.

[2]Richard A. Melcher & Greg Burns, *Oh, Mr. Andreas. Time is Just About Up*, BUS. WK., Oct. 28, 1996, at 52.

[3]*See* Mullenix, *supra* note 1.

[4]Brief for Petitioners at 3, California Pub. Employees' Retirement Sys. v. Felzen, 525 U.S. 315 (1999) (No. 97-1732) (per curiam), *aff'g* Felzen v. Andreas, 134 F.3d 873 (7th Cir. 1998).

[5]Mullenix, *supra* note 1.

[6]*Id.*

[7]*See* Mullenix, *supra* note 1. Fourteen state suits were filed and consolidated in the Delaware state court. These cases were stayed pending the decision in the federal cases, *see* Brief for Respondents the Directors of Archer Daniels Midland Company at 3, *Felzen*, 525 U.S. 315 (1999) (No. 97-1732), and will not be discussed here.

In 1997, after five months of negotiations, the plaintiffs' lawyers and ADM's insurance company agreed to a settlement.[8] The insurance company would pay $8 million: $3.92 million, or approximately forty-nine percent of the total, would cover the fees of the attorneys who brought the suit; and the remainder would pay future legal fees incurred in implementing reforms to ADM's corporate governance.[9] In return, the attorneys agreed to release any causes of action against ADM and its directors, except for claims against those prosecuted by the federal government.[10] The corporation itself would not receive any proceeds from the settlement.[11]

Two of ADM's largest shareholders, the California Public Employees' Retirement System (CalPERS) and the Florida State Board of Administration (FSBA), opposed the proposed settlement.[12] They believed that it "provided little or no benefit to the corporation," as the cash benefit would go solely to the lawyers, and that the lawyers' fee was excessive.[13] CalPERS and FSBA believed that the corporate governance reforms "provided no material benefit to shareholders and were the same measures ADM adopted a year [before.]"[14] In spite of the shareholders' objections, the district court approved the $8 million settlement, and awarded the $3.92 million requested by the plaintiffs' attorneys.[15] The plaintiffs' attorneys were also eligible to earn fees from the remainder of the fund for services rendered in implementing corporate governance reforms.[16]

At this point, "CalPERS and FSBA sought to appeal."[17] Felzen and Esner moved to dismiss, arguing that because CalPERS and FSBA had not intervened as parties in the original action, they had no right to appeal.[18] In *Felzen v. Andreas*,[19] decided January 21, 1998, the United States Court of Appeals for the Seventh Circuit agreed with the defendants.[20] This decision

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[8]*See* Mullenix, *supra* note 1.

[9]*See id.*

[10]*See id.*

[11]*See id.*

[12]*See* Mullenix, *supra* note 1.

[13]*Id.*

[14]*Id.*

[15]*See id.*

[16]*See* Petitioners' Brief at 6 & n.7, *Felsen* (No. 97-1732).

[17]*See* Mullenix, *supra* note 1.

[18]*See id.*

[19]134 F.3d 873 (7th Cir. 1998), *aff'd sub nom.*, California Pub. Employees' Retirement Sys. v. Felzen, 525 U.S. 315 (1999) (per curiam) (4-4 decision).

[20]*See id.* at 877-78.

explicitly overruled previous decisions in the Seventh Circuit[21] and conflicted with decisions in other circuits, most notably the Third Circuit.[22] On January 20, 1999, in *California Public Employees' Retirement System v. Felzen*,[23] an equally divided United States Supreme Court affirmed the ruling with no additional comment.[24]

At least one observer regretted the absence of clear guidance in this outcome.[25] The question presented was significant in helping to define the role of objectors in class actions and shareholder derivative suits. In addition, this was the first time that the Supreme Court had considered the role of an institutional investor that sought to appeal a settlement without intervening in the suit below.[26] CalPERS, FSBA, and numerous *amici* including the United States Securities and Exchange Commission, the Council of Institutional Investors, and Public Citizen argued that requiring objectors to intervene formally in order to preserve their right to appeal, simply deters valuable oversight of potentially collusive settlements.[27] Felzen and ADM, on the other hand, argued that the requirement serves to "weed out" frivolous or obstructionist objections and fosters greater efficiency in the courts.[28]

This article will discuss the effect the *CalPERS v. Felzen* decision might have on shareholders who object to a proposed settlement of a derivative action, and whether they can appeal an adverse decision. Part II will provide background to the debate, describing some of the problems of class action litigation and examining proposed solutions. Part III continues with a discussion of some of the federal rules of civil and appellate procedure, including Federal Rules of Civil Procedure 23, 23.1, and 24, that were applied in *Felzen*. Part IV analyzes some of the cases that relate, directly or indirectly, to the decision in *Felzen*. Finally, this article

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[21]*See id.* at 875-76 (overruling Armstrong v. Board of School Directors, 616 F.2d 305 (7th Cir. 1980); Patterson v. Stovall, 528 F.2d 108 (7th Cir. 1976); Tryforos v. Icarian Dev. Co., 518 F.2d 1258 (7th Cir. 1975); and Research Corp. v. Asgrow Seed Co., 425 F.2d 1059 (7th Cir. 1970), to the extent they permitted nonparties to appeal from any decision in a class action).

[22]*See id.* at 876 (disagreeing with Bell Atlantic Corp. v. Bolger, 2 F.3d 1304 (3d Cir. 1993)).

[23]525 U.S. 315 (1999) (per curiam).

[24]*See id.* Justice O'Connor took no part in the consideration or decision of the case. *Id.*

[25]Tony Mauro, *Frustrating Fight for High Court Protesters*, FULTON CO. DAILY REP., Feb. 9, 1999, at 7 (citing comments by Alan Morrison of Public Citizen Litigation Group).

[26]*High Court's Decision Bars Pension Funds' Appeal of Settlement Approval*, ANDREWS DEL. CORP. LITIG. REP., Feb. 1, 1999, at 8, 8.

[27]*See, e.g.*, Brief for Barclays Global Investors, N.A., State of Wisconsin Investment Board, and Certain Other Institutional Investors as *Amici Curiae* Supporting Petitioners at 17-18, *Felzen* (No. 97-1732) ("Sometimes justice prevails only because a non-intervening objector was able to challenge a settlement on appeal.").

[28]Mullenix, *supra* note 1.

concludes by discussing some of the policy issues that were left unresolved by the Supreme Court's split decision.

II. BACKGROUND

In recent years, there has been a great deal of controversy over class actions — particularly securities class actions.[29] Some observers emphasize the social utility of these suits. Private securities actions, these commentators say, are crucial in promoting investor confidence in the financial markets' integrity.[30] Private actions are a necessary supplement to the efforts of the Securities and Exchange Commission and help deter violations of the securities laws;[31] resulting in plaintiffs acting as "private attorneys general."[32]

Other observers focus on widespread abuse seen in class actions. Securities class actions are viewed as "lawyers' vehicles,"[33] since the typical named plaintiff exercises no "meaningful" control over the litigation.[34] These plaintiffs are often "individuals who owned only small interests in many different companies and were willing to lend their names to the securities class actions in exchange for an extra payment upon settlement."[35] The "usual pattern is for a lawyer who specializes in representing plaintiffs" to carefully monitor stock prices and other financial data.[36] If a significant negative change occurs, the attorney may recruit one or more representative plaintiffs and file a class action complaint, "often within days of the financial disclosure at issue."[37]

In addition to initiating a securities class action, the attorneys are often willing to "bear [much] of the litigation risk" because they have more to gain from the action than the typical named plaintiff.[38] Fees awarded by the court can be substantial, often amounting to between twenty and thirty percent of

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[29]Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2054 (1995).

[30]*See id.* at 2058.

[31]*See id.*

[32]*Id.* at 2059 (footnote omitted).

[33]Weiss & Beckerman, *supra* note 29, at 2059 (quoting Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1349 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991)).

[34]Eugene Zelensky, Note, *New Bully on the Class Action Block — Analysis of Restrictions on Securities Class Actions Imposed by the Private Securities Litigation Reform Act of 1995*, 73 NOTRE DAME L. REV. 1135, 1136 (1998) (quoting S. REP. NO. 104-98, at 6 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 685).

[35]*Id.* at 1135 n.1.

[36]Weiss & Beckerman, *supra* note 29, at 2060.

[37]*See id.*

[38]*See id.* at 2059-60.

any fund created.[39] This is true whether the case is settled or the plaintiff wins on the merits.[40] While the attorneys have some incentive to maximize fees by going after a large judgment, there is also a strong incentive to settle and avoid the risk of losing at trial.[41]

If a defendant in this situation cannot obtain a motion for dismissal or for summary judgment, he may also have a strong incentive to settle.[42] This type of suit can be extremely "disrupt[ive] of normal business activities," as discovery procedures can be costly and time-consuming.[43] Among other incentives to settle, a defendant faces the possibility of significant liability if it loses at trial.[44] Corporate decision-makers as individuals are often risk-averse, and the existence of insurance coverage and indemnification provisions for officers and directors makes it relatively easy for them to settle a lawsuit using "other people's money."[45] The company's insurers may also prefer to settle, because they may be held liable for amounts in excess of policy limits if they refuse a reasonable settlement offer.[46] All of these factors can inflate the potential settlement value of a securities class action.[47] In practice, very few class actions actually go to trial; "virtually all class actions not dismissed . . . are settled."[48]

An individual attorney-recruited plaintiff, with only a nominal interest in the class action, has little incentive to monitor the attorney effectively.[49] For example, such a plaintiff is not likely to bargain with the attorney over the attorney's fees.[50] This individual is also not likely to press for a larger settlement; besides, even if the representative plaintiff wanted to do so, he lacks leverage because his consent is not needed for the settlement to be approved.[51] Although attorneys are subject to rules of professional ethics,

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[39]*See id.* at 2059.

[40]*See* Weiss & Beckerman, *supra* note 29, at 2059.

[41]*See id.* at 2064 (citing John 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, 716-18 (1986)).

[42]*See id.*

[43]*See id.* at 2063 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742-43 (1975)).

[44]*See* Weiss & Beckerman, *supra* note 29, at 2064 n.53 (citing Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 528-34, 548-68 (1991)).

[45]Id. (quoting Alexander, *supra* note 44, at 566).

[46]*See id.*

[47]*See id.* at 2063-64.

[48]*See* Weiss & Beckerman, *supra* note 29, at 2064.

[49]*Id.* at 2064.

[50]*See id.* at 2065.

[51]*See id.*

which require that the client's interests control,[52] in reality, Rule 23 may provide the only significant constraint on the attorneys' behavior.[53]

Under Rule 23, the court must approve any proposed settlement of a class action.[54] In addition, the court must "determine what constitutes a reasonable fee for the attorney's efforts."[55] In theory, these provisions should protect class members; critics charge, these procedures are often subverted by settlement hearings that are not genuinely adversarial.[56] In the words of Judge Henry Friendly: "Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork . . . ."[57] In fact, one much-quoted study suggests that settlement amounts typically have little to do with the perceived merits of the cases.[58]

Trial judges are rarely able to critically evaluate the parties' joint presentation because it is unlikely they have examined the evidence in any detail.[59] While attorneys' fees may receive more critical attention from a court,[60] judges generally have very little information on the actual amount of work done by the attorneys.[61] Moreover, judges often have a strong interest in approving settlements and will often taken an active role in promoting settlements to help clear their dockets.[62] As a result, courts have historically approved almost all class action settlements.[63]

The potential for abuse is most egregious in the context of a shareholder derivative suit, where there is no direct recovery by shareholders.[64] Often, settlements provide no more for the plaintiff class than a commitment by the corporation to implement "largely cosmetic, 'corrective'" measures, while awarding substantial fees to the plaintiffs'

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[52]*See* Weiss & Beckerman, *supra* note 29, at 2065 (citing MODEL RULES OF PROFESSIONAL CONDUCT 1.2(a), 1.7(b), 2.1 (1989); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 5-101(A) (1981)).

[53]*See id.*

[54]*See id.*; FED. R. CIV. P. 23(e).

[55]Weiss & Beckerman, *supra* note 29, at 2065.

[56]*See id.* at 2066.

[57]*Id.* (quoting Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting)).

[58]*See id.* at 2080 (citing Alexander, *supra* note 44, at 566-68).

[59]*See* Weiss & Beckerman, *supra* note 29, at 2066.

[60]*See id.* at 2071.

[61]*Id.* at 2066.

[62]*See id.* at 2067.

[63]*See* Weiss & Beckerman, *supra* note 29, at 2067.

[64]*See id.* at 2067 n.73.

attorneys.[65] In addition, the corporation and its insurers, rather than the actual wrongdoers, typically pay all of the settlement expenses or damages; thus, any deterrent effect is minimal, at best.[66]

Many critics of the class action process believe that these agency problems are "unavoidable because no class member has a stake in the litigation large to justify [the cost of] monitoring the attorneys."[67] Even if a potential recovery is very large, economic decisions are distorted by the "free-rider" problem: if anyone steps forward to bear a cost, he or she will not get the full benefit, but instead must share any gains with the "free-riders" who make up the rest of the class.[68]

In 1995, Professors Elliot Weiss and John Beckerman published an "influential article"[69] arguing that the holdings of institutional shareholders,[70] and the potential gains from litigation, might be large enough to make it worth their while to bear the costs of monitoring the litigation.[71] At that time, institutional investors as a group owned more than fifty percent of the thousand largest public corporations in the United States.[72] Other measures of the institutions' participation in the securities markets showed similarly dominant positions.[73] Surveying a number of sources, Weiss and Beckerman noted that large institutional investors also accounted for a large proportion

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[65]*See id.* (citing John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 24-25).

[66]Keith L. Johnson, *Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors*, 60 LAW & CONTEMP. PROBS., Autumn 1997, at 155, 164.

[67]*See* Weiss & Beckerman, *supra* note 29, at 2088 (citing John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 894-95 (1987); Coffee, *supra* note 41, at 677-78).

[68]*Id.* at 2088 n.188 (quoting Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 20 (1991)).

[69]Julia C. Kou, Note, *Closing the Loophole in the Private Securities Litigation Reform Act of 1995*, 73 N.Y.U. L. REV. 253, 257 n.18 (1998).

[70]"Institutional investors" include:

> public pension funds, corporate pension funds, union pension funds, retail mutual funds, banks and thrifts, insurance and annuity companies, and private foundations.... The most activist institutional investors include the California Public Employees' Retirement System (CalPERS), the New York State Common Retirement Fund, the State of Wisconsin Investment Board (SWIB), and the Florida Board of Administration.

Id. at 255 n.11 (citations omitted).

[71]*See* Weiss & Beckerman, *supra* note 29, at 2089.

[72]Stuart M. Grant, *Appointment of Lead Plaintiff Under the Private Securities Litigation Reform Act*, 1070 P.L.I./CORP. 547, 550 (1998).

[73]*See* Weiss & Beckerman, *supra* note 29, at 2056 (footnotes omitted).

of the dollar value of the claims in class action suits.[74] Moreover, there were often very large differences between the actual recoveries and the losses claimed and allowed.[75] Recoveries might be increased if the institutional investors increased their participation in the litigation process.[76]

Theoretically, institutional investors could also benefit in ways other than direct monetary recovery for themselves or the corporations.[77] Institutional investors are large shareholders with diversified portfolios, and often continue to own shares in the corporations that are the subject of the litigation.[78] This widespread and ongoing presence in the market means that institutional investors stand to gain from any deterrent effect on corporate boards and management that may result from shareholder derivative suits.[79] As a result, institutional investors are more likely than an individual shareholder to insist that recovery be obtained from the individual parties who actually committed the wrongs.[80]

The ability to benefit significantly from the deterrent effects may also lead institutional investors to refuse inadequate settlements and pursue better claims at trial.[81] In addition to providing deterrence, the knowledge that meritorious claims will be vigorously prosecuted may result in higher settlement values for future claims.[82] Institutional investors also have an incentive to work towards inclusion of corporate governance reforms as a part of a settlement.[83]

Through the corporations they own, and because they suffer as investors from inefficiencies in the market, institutional investors bear much of the cost of class actions[84] and have strong incentive to eliminate wasteful and abusive suits.[85] In one case, four institutional investors (including CalPERS) acted together to help prevent a suit they thought was without merit.[86] A well-researched letter, explaining the institutions' position, was

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[74]*See id.* (footnote omitted) (noting that when there were recoveries, institutional investors often received significant dollar amounts).

[75]*See id.*

[76]*See id.*

[77]*See* Johnson, *supra* note 66, at 158.

[78]*See id.*

[79]*See id.*

[80]*See id.* at 165.

[81]*See* Johnson, *supra* note 66, at 164.

[82]*Id.*

[83]*See id.* at 156.

[84]*See* Weiss & Beckerman, *supra* note 29, at 2095.

[85]*See* Johnson, *supra* note 66, at 158.

[86]Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559, 582-83 (1996).

sent to both plaintiff and defense counsel.[87] One plaintiff voluntarily dismissed the action one day before receiving the letter; the second decided to dismiss within ninety minutes of receiving the letter.[88]

In 1995, to control what it saw as a growing number of frivolous and costly lawsuits,[89] Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA or the Act).[90] This was the "first substantial reform of the federal securities laws since the . . . New Deal,"[91] imposing a new "layer of restrictions" in addition to the requirements of the Federal Rules of Civil Procedure.[92] These changes have had a significant effect on the entire field of federal securities class actions.[93]

In addition to preventing frivolous lawsuits, the reforms were designed to cut back on attorneys' ability to rely on "professional plaintiffs."[94] As one judge explained, the PSLRA "'appears to reflect a congressional intent to transfer power . . . to those shareholders who possess a sufficient financial interest in the outcome to maintain some supervisory responsibility over both the litigation and their counsel.'"[95] Controlling the attorneys was a major goal; some foresaw potential benefits from having lawyers compete for the institutional investors' business. Competition would encourage reputable law firms to focus on "skillful representation of investors' interests,"[96] and enable representative plaintiffs to negotiate reasonable fees with their attorneys.[97]

Congress believed that institutional investors were well suited to take on the task of monitoring shareholder derivative suits because they already have, or can acquire, the expertise needed.[98] Pension funds, like CalPERS and FSBA, were viewed by some as particularly appropriate representatives because they are "obligated as fiduciaries to act in the best interests of their

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[87]*See id.* at 562.

[88]*See id.*

[89]Zelensky, *supra* note 34, at 1135.

[90]*See id.* at 1135 (citing Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in different sections of 15 U.S.C.)).

[91]*Id.* at 1136.

[92]*See id.* at 1135.

[93]*See* Zelensky, *supra* note 34, at 1135.

[94]*Id.* at 1135 (footnote omitted).

[95]Kevin P. Roddy, *"Another Fine Mess You've Gotten Us Into": Appointment of Lead Plaintiffs and Lead Counsel Under the Private Securities Litigation Reform Act of 1995*, SD 11 A.L.I.-A.B.A. 981, 986 (1998) (quoting *In re* Horizon/CMS Healthcare Corp. Sec. Litig., 3 F. Supp. 2d 1208, 1212 (D.N.M. 1998) (citations omitted)).

[96]Weiss & Beckerman, *supra* note 29, at 2096 n.218.

[97]*See id.* at 2105.

[98]*See id.* at 2095.

participants, the average American working person."[99] Of the total assets held by institutional investors in 1995, almost one-half were owned by pension funds.[100]

Under the PSLRA, when a court appoints a lead plaintiff, it may presume that the class member with "the largest financial interest in the outcome" is "the most adequate plaintiff."[101] The ability of a party to serve as lead plaintiff is limited to five class actions brought within any three-year period; institutional investors, however, are specifically exempt from this limitation.[102] Other provisions also attempt to encourage institutions to take an active role.[103]

Several years after the passage of the PSLRA, it is unclear whether it is achieving its goals.[104] The initial reaction to the imposition of stringent new federal standards was, not surprisingly, to drive many securities cases into the state courts.[105] To counter this, Congress passed legislation preempting the field, eliminating parallel state causes of action for certain securities violations.[106]

Given the slow pace of securities litigation, it may be too early to judge the PSLRA. It seems to have succeeded, at least temporarily, in reducing the overall number of federal cases.[107] Less clear is whether institutional investors have actually been willing, as Congress had hoped, to take a more active role. Some commentators state flatly that the institutions are not stepping forward;[108] others point out that in recent years, the number

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[99]Grant, *supra* note 72, at 551 n.5 (quoting Keith Johnson, *Deployment of Institutions in the Securities Class Action Wars*, 38 ARIZ. L. REV. 627, 628 (1996)).

[100]*See id.* at 551 (citations omitted).

[101]Zelensky, *supra* note 34, at 1144 (quoting 15 U.S.C.A. §§ 77z-1(a)(3)(B)(iii)(I), 78u-4(a)(3)(B)(iii)(I) (1997)). Before passage of the Act, lead plaintiff status most often went to the person who filed the first action. *See* Weiss & Beckerman, *supra* note 29, at 2062 (citations omitted).

[102]*See* Zelensky, *supra* note 34, at 1146-47 (citing 15 U.S.C. §§ 77z-1(a)(3)(B)(vi), 78u-4(a)(3)(B)(vi); H.R. CONF. REP. NO. 104-369, at 35 (1995)).

[103]*See* Grant, *supra* note 72, at 550.

[104]Richard M. Phillips & Robyn J. Lipton, *Impact of the Reform Act on Federal Securities Class Actions*, SC88 A.L.I.-A.B.A. 351, 355 (1998).

[105]*See* Kou, *supra* note 69, at 256.

[106]*See* Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 2-3 (1998) (citing the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.)).

[107]*See* Phillips & Lipton, *supra* note 104, at 355.

[108]Peter M. Saparoff et al., *The Role of the Institutional Investors in Class Actions Under the PSLRA — Are They Walking on a Slippery Slope? One Year Later*, C73 A.L.I.-A.B.A. 657, 659 (1998). "The PSLRA has also failed to achieve the stated Congressional objective of reducing the control of traditional plaintiffs' counsel over securities class actions." *Id.* at 659 n.1.

of institutional investors who are "lead plaintiffs" has been slowly but steadily increasing.[109]

In spite of Congress' clear desire to favor institutional investors as lead plaintiffs,[110] many factors continue to discourage them from seeking that status.[111] Some of the same factors also deter institutions from intervening, as required by the court in *Felzen*, and many of the policy issues are the same. One deterrent to the involvement of institutional investors is the threat of extensive discovery, which may be applied by a defendant seeking to prove that the proposed plaintiff will not adequately represent the class.[112] In addition, the institution may have concerns over disclosure of proprietary information.[113]

Another deterrent may be the uncertainty associated with a new law, as many details remain to be interpreted by the courts. For example, the courts have had to define what, exactly, factors into the calculation of "the largest financial interest."[114] Is it the largest number of shares? At what point in time? Is it the largest loss? Although courts have chosen these factors,[115] their application remains uncertain.[116]

Another element of uncertainty involves whose financial interest to measure. May a heterogeneous group gain lead plaintiff status?[117] In some cases, plaintiffs' attorneys have unsuccessfully assembled groups of smaller shareholders in opposition to an institutional investor.[118] In other cases, institutional investors have been forced to share the lead plaintiff status;[119]

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[109]Robin Glenn, *Oxford Gets an Education*, PLAN SPONSOR, June 1998, at 46, 47.

[110]*See* Grant, *supra* note 72, at 550.

[111]*See, e.g.*, Saparoff et al., *supra* note 108, at 659 ("[I]nstitutional investors have identified the costs associated with fighting off other plaintiffs during the lead plaintiff appointment process as a substantial disincentive for seeking such an appointment." (citations omitted)).

[112]*See* Weiss & Beckerman, *supra* note 29, at 2103 ("The cost of producing all documents concerning an institution's investment philosophy and trading over several years would be substantial.").

[113]*See id.*

[114]Grant, *supra* note 72, at 564 (noting that the PSLRA "does not define how to calculate the largest financial interest").

[115]*See id.* (quoting *In re* Olsten Corp. Sec. Litig., 3 F. Supp. 2d 286, 295 (E.D.N.Y. 1998) (citation omitted)).

[116]*Id.*

[117]*See id.* at 560 (noting that whether the group is in competition for the lead plaintiff position or consists of unopposed individual plaintiffs may play an important part in a court's decision) (citations omitted).

[118]*See* Grant, *supra* note 72, at 561-62 (citing Gluck v. Cellstar Corp., 976 F. Supp. 542, 549 (N.D. Tex. 1997) (rejecting the shareholder group's bid for co-lead plaintiff status because it would delegate more control to the lawyers, reduce the influence of the institutional investor, and increase the time and expense spent on the case)).

[119]*See id.* at 562 (citing *In re* Oxford Health Plans, Inc. Sec. Litig., 182 F.R.D. 42 (S.D.N.Y. 1998) (mem.)).

since control of the litigation is so important, this can be a powerful disincentive to get involved. Although the Act requires, and courts have imposed, a high threshold before discovery will be allowed by challengers for the position of lead plaintiff,[120] there is still a threat of extensive discovery. At this time, there is some anecdotal evidence that class actions are proceeding more slowly than ever, at least in part because of conflicts over who will represent the class.[121]

A court's view of policy considerations may be more important when an institutional investor seeks to intervene, than when one seeks lead plaintiff status. Congress has not spoken on intervention, and policy is entirely in the hands of the courts. The petitioners in *Felzen* believed that intervention is often denied in shareholder derivative cases.[122] One reason is that allowing intervention requires a court to reverse its own judgment; a judgment made when the class was originally certified that the named plaintiffs "adequately represent the interests" of the other class members.[123] The defendants in *Felzen*, on the other hand, point out that CalPERS itself had successfully intervened in recent cases.[124] In New York, CalPERS argued persuasively that "intervention is to be liberally allowed" and that the federal cases are in accord.[125]

In the next few years, judgments made in the context of the PSLRA and in cases like *Felzen* will be closely monitored. In recent years, federal courts have seemed extremely hostile to class actions generally, and to securities class actions especially. If the courts share Congress' goal of involving institutional investors, their decisions should reflect this policy. If not, and judicial decisions seem to emphasize an overall desire to simply reduce class actions in any way possible, institutional investors will avoid the courts and find other ways to achieve their goals.

III. THE RULES

California Public Employees' Retirement System v. Felzen[126] is only one example of a larger debate over how to protect the rights of persons who are not actively involved in a lawsuit, but may have their interests

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[120]*See id.* at 554 (citing Blaich v. Employee Solutions, Inc., No. 97-545-PHX-RGS, 1997 WL 842417, at *2 (D. Ariz. Nov. 21, 1997) (discussing 15 U.S.C. § 77z-1(a)(3)(B)(iv)).

[121]*See* Roddy, *supra* note 95, at 992-93.

[122]Brief of *Amicus Curiae* Council of Institutional Investors in Support of Petitioners at 23, California Pub. Employees' Retirement Sys. v. Felzen, 525 U.S. 315 (1999) (No. 97-1732).

[123]*Id.* (quoting FED. R. CIV. P. 23.1).

[124]Respondents' Brief at 17, *Felzen* (No. 97-1732) (footnote omitted).

[125]*Id.* at 20 (citations omitted).

[126]525 U.S. 315 (1999).

significantly affected by it. In the case of a class action, Rule 23 of the Federal Rules of Civil Procedure provides some procedural protections for class members, whether or not they have participated in the suit. The most fundamental procedural protection is notice. Rule 23(c)(2) provides that for certain types of actions:

> 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.[127]

Rule 23.1, that specifically governs shareholder derivative actions,[128] does not include any parallel language about notice of the binding effect of a judgment, the possibility of opting out, or the possibility of entering an appearance.

In the context of a dismissal or a negotiated settlement, however, the two sections include almost identical provisions. Rule 23(e) provides: "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."[129] Rule 23.1, governing shareholder derivative suits, uses very similar language: "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."[130]

One clear difference between class actions under Rule 23 and shareholder derivative actions under Rule 23.1 deals with the standing of the actors. In a class action, all members of a class theoretically have a personal right to litigate[131] because the relevant claims or defenses apply to each of them. In contrast, shareholders bring an action not for themselves but on

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[127]FED. R. CIV. P. 23(c)(2).

[128]*See id.* at 23.1.

[129]*Id.* at 23(e).

[130]*Id.* at 23.1.

[131]Felzen v. Andreas, 134 F.3d 873, 875 (7th Cir. 1998), *aff'd sub nom.* California Pub. Employees' Retirement Sys. v. Felzen, 525 U.S. 315 (1999) (per curiam).

behalf of the corporation.[132] In *Felzen*, this difference was among the factors used to determine who may be considered a "party" to an action.[133] If one is not a party, and wishes to become one, it is necessary to intervene under Rule 24.[134] In some circumstances, covered in Rule 24(a), the intervention may be "of right," meaning that the person is entitled to intervene because:

> the applicant claims an interest relating to the property or transaction which is the subject of the action and the applicant is so situated that the disposition of the action may as a practical matter impair or impede the applicant's ability to protect that interest, unless the applicant's interest is adequately represented by existing parties.[135]

Rule 24(b) provides for permissive intervention, which may be allowed, in the court's discretion, "when an applicant's claim or defense and the main action have a question of law or fact in common."[136] While it is not clear in *Felzen* whether the shareholders must intervene as of right or permissively, it is very clear that they must intervene successfully if they wish to appeal.[137] This conclusion is based on another rule invoked in *Felzen*, Federal Rule of Appellate Procedure 3.[138]

Rule 3 details the steps for taking an appeal from a district court to a court of appeals. Rule 3 begins by describing the person taking the appeal as the "appellant,"[139] but in section (c) the language changes. Section (c) provides that the notice of appeal must "specify the party or parties taking the appeal by naming each one in the caption or body of the notice."[140] Thus, according to the court, if one is not a party to the original action, or has not properly become a party, no appeal is possible.[141]

Others read Rule 3(c) as being purely procedural, concerned only with the formal contents of the notice and not with the limits of appellate court jurisdiction.[142] Indeed, Federal Rule of Appellate Procedure 1(b) states

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[132] *Id.*
[133] *Id.*
[134] FED. R. CIV. P. 24.
[135] *Id.* at 24(a).
[136] *Id.* at 24(b).
[137] *See Felzen*, 134 F.3d at 876.
[138] FED. R. APP. P. 3.
[139] *Id.* at 3(a)(2).
[140] *Id.* at 3(c)(1)(A).
[141] *See Felzen*, 134 F.3d at 874-75.
[142] *See* Petitioners' Brief at 12, *Felzen* (No. 97-1732).

explicitly: "These rules do not extend or limit the jurisdiction of the courts of appeals."[143]

IV. THE CASES

As formulated by Judge Easterbrook, the actual question before the court in *Felzen* was "whether shareholders who are not parties to a Rule 23.1 action nonetheless may appeal."[144] Judge Easterbrook's analysis, however, is much more general than his question; the judge's analysis involves the status of both class members under Rule 23 and shareholders in a derivative suit under Rule 23.1.

The court answers its question with a quote from *Marino v. Ortiz*,[145] a Supreme Court case dismissing an appeal from a settlement agreement:

> The rule that only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment, is well settled. The Court of Appeals suggested that there may be exceptions to this general rule, primarily "when the nonparty has an interest that is affected by the trial court's judgment." We think the better practice is for such a nonparty to seek intervention for purposes of appeal; denials of such motions are, of course, appealable.[146]

The *Felzen* court explained:

> With these words the Supreme Court held that a person adversely affected by the settlement of a class action may appeal from the consent decree based on that settlement only if he has intervened as a party. . . . Following *Marino* we held that a class member in an action under Fed. R. Civ. P. 23 who has not become a party may not appeal from an order granting summary judgment to the defendant.[147]

In some ways, this interpretation seems a bit odd. First, the language, "we think the better practice is,"[148] can be — and has been — interpreted as

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[143]FED. R. APP. P. 1(b). *See also* 28 U.S.C. § 1291 (1994) (describing jurisdiction of courts of appeals).

[144]*Felzen*, 134 F.3d at 874.

[145]484 U.S. 301 (1988) (per curiam).

[146]*Id.* at 304 (citations omitted).

[147]*Felzen*, 134 F.3d at 874 (citations omitted).

[148]*Marino*, 484 U.S. at 304.

permissive, rather than mandatory.[149] In the Ninth Circuit, for example, a line of cases after *Marino* consistently held that "non-parties may appeal where 'they participated in the district court proceedings,' and 'the equities weigh in favor of hearing the appeal.'"[150] In a subsequent case in the Second Circuit, where *Marino* itself was decided, the Court of Appeals ignored the Supreme Court's criticism and, quoting its pre-*Marino* decision,[151] held that "a nonparty may appeal 'when the nonparty has an interest that is affected by the trial court's judgment.'"[152]

Second, the decision in *Felzen* applied *Marino* to a situation that was not entirely analogous. Most significantly, the petitioners in *Marino* were nonparties from the very beginning; they were not class members of any kind, named or otherwise, in the original action.[153] In *Felzen*,[154] *Brand Name Prescription Drugs*,[155] and the decisions addressed in *Felzen*, the appellants were absent or unnamed class members under Rule 23, or non-named shareholders under Rule 23.1.

In fact, all the cases relied upon for the decision in *Felzen* can be distinguished from the situation before the court. Various courts and commentators have focused on different aspects of each fact pattern to reach a wide range of results, but the major distinctions can be grouped into a few categories. The first distinction, already mentioned,[156] is between a person who is involved, formally or otherwise, in the original action, and someone who is not. The second set of distinctions relates to the degree of participation the person had at various stages of the litigation.[157] For example, did he or she appear at a hearing to object, or attempt to intervene? A related question is what caused the participation: Was it notice from the

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[149]Timothy A. Duffy, Comment, *The Appealability of Class Action Settlements by Unnamed Parties*, 60 U. CHI. L. REV. 933, 946 n.79 (1993) (citing Hal Roach Studios, Inc. v. Richard Feiner & Co., 896 F.2d 1542, 1546-47 (9th Cir. 1990); EEOC v. Pan American World Airways, Inc., 897 F.2d 1499, 1504 (9th Cir. 1990); Class Plaintiffs v. City of Seattle, 955 F.2d 1268, 1277-78 (9th Cir. 1992)).

[150]*Id.* at 945 & n.75 (quoting SEC v. Wencke, 783 F.2d 829, 834 (9th Cir. 1986)) (citations omitted).

[151]Hispanic Soc'y v. New York City Police Dep't, 806 F.2d 1147 (2d Cir. 1986), *aff'd sub nom.* Marino v. Ortiz, 484 U.S. 301 (1988).

[152]United States v. International Bhd. of Teamsters, 931 F.2d 177, 183-84 (2d Cir. 1991) (quoting *Hispanic Soc'y*, 806 F.2d at 1152).

[153]*See Hispanic Society*, 806 F.2d at 1152-53. The petitioners were white police officers who tried to appeal a settlement reached in a Title VII lawsuit between the New York City Police Department and a plaintiff class composed of black and Hispanic officers. *See id.* at 1151-52.

[154]*See Felzen*, 134 F.3d at 874.

[155]*See In re* Brand Name Prescription Drugs Antitrust Litig., 115 F.3d 456, 457 (7th Cir. 1997).

[156]*See supra* notes 156-58 and accompanying text.

[157]*See infra* notes 164-82 and accompanying text.

court under Rule 23, or some other trigger?[158] The third category of distinctions involves the disposition of the case at issue:[159] Is the attempted appeal from a court approval of a settlement agreement, or is it from a final judgment that may have been more fully litigated? Finally, there is the distinction between members of a class under Rule 23 and shareholders in a derivative suit under Rule 23.1.[160]

Many cases have focused on the type of participation that occurred in the courts below. Citing a 1993 comment by Timothy A. Duffy,[161] the court in *Felzen* stated: "Courts have disagreed for several decades about whether class members (and shareholders, their counterparts in derivative actions under Rule 23.1) must intervene as parties in order to appeal from adverse decisions."[162] According to Duffy, there is one line of thought arguing the "simple but powerful 'general proposition'" that any class member may appeal an order approving a settlement; even if she has taken no previous action at all, she may appeal because her rights are being adjudicated.[163] In *Ace Heating & Plumbing Co. v. Crane Co.*,[164] the Third Circuit found that unnamed class members had standing to appeal even though they had not objected below.[165] The court stated that "[o]rdinarily, aggrieved class members may appeal any final order of a district court in proceedings held pursuant to Rule 23."[166] In *Marshall v. Holiday Magic, Inc.*,[167] the Ninth Circuit agreed, holding that unnamed class members have standing to appeal an order simply because "their legal rights are affected by the settlement."[168]

In the dominant line of cases, an unnamed class member, or shareholder, has taken action in the court below.[169] In *Cohen v. Young*,[170] one of the earliest cases in this line, an unnamed shareholder received notice to show cause if he objected to a proposed settlement of a derivative suit.

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[158]*See infra* notes 172-82 and accompanying text.

[159]*See infra* notes 183-218 and accompanying text.

[160]*See infra* notes 219-46 and accompanying text.

[161]*See* Duffy, *supra* note 149.

[162]*Felzen*, 134 F.3d at 874.

[163]Duffy, *supra* note 149, at 936.

[164]453 F.2d 30 (3d Cir. 1971).

[165]*See* Duffy, *supra* note 149, at 935 (discussing Ace Heating & Plumbing Co. v. Crane Co., 453 F.2d 30 (3d Cir. 1971)).

[166]*Ace Heating & Plumbing Co.*, 453 F.2d at 32.

[167]550 F.2d 1173 (9th Cir. 1977).

[168]*Id.* at 1176 (citing *Ace Heating & Plumbing Co.*, 453 F.2d at 32-33). *See also* Duffy, *supra* note 149, at 935-36 (discussing Marshall v. Holiday Magic, Inc., 550 F.2d 1173 (9th Cir. 1977)).

[169]*See* Duffy, *supra* note 149, at 936 (reviewing a line of caes where unnamed class members appealed after objecting in a lower court).

[170]127 F.2d 721 (6th Cir. 1942).

The shareholder appeared at a hearing to object and move to intervene, but was denied.[171] Analogizing the shareholder's position to that of a defendant "who is summoned by process of court and after an adverse ruling has the right to appeal,"[172] the Sixth Circuit held that "a class member who had objected to a proposed settlement was 'entitled as of right' to . . . appeal."[173]

Before being expressly overruled by *Felzen*, the lead case in the Seventh Circuit was *Research Corp. v. Asgrow Seed Co.*[174] In that case, an appeal by unnamed defendants in an antitrust suit was dismissed because the defendants had neither objected nor intervened in the proceedings below.[175] The court held that "[i]f a class member intervenes or even appears in response to a notice pursuant to [FRCP] 23(e) and objects . . . he has a right to appeal from an adverse final judgment. . . . However, . . . a person in disagreement . . . must take, at least, these minimal steps to preserve his right to appeal."[176] According to Duffy, "the principle that an unnamed class member who has objected in the court below has standing to appeal an order approving a settlement has . . . become the most widely accepted solution to the question at hand."[177] Until *Felzen*, this was the practice in the Seventh Circuit for class members under Rule 23 (following *Asgrow*) and stockholders under Rule 23.1 (following *Tryforos v. Icarian Development Co.*[178]) alike.[179]

There is a line of cases with a different approach, at least with respect to class members under Rule 23. These cases held that intervention is necessary before an unnamed class member may appeal. Indeed, *Asgrow* itself contained a footnote, which seemed to contradict the main holding, stating that "the failure of appellants to formally intervene . . . forecloses their right to appeal."[180] In an influential case in the Eleventh Circuit,

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[171]*See* Duffy, *supra* note 149, at 936-37 (discussing *Cohen*, 127 F.2d at 723-24).

[172]*Cohen*, 127 F.2d at 724 (citations omitted).

[173]Duffy, *supra* note 149, at 936-37 (quoting *Cohen*, 127 F.2d at 724).

[174]425 F.2d 1059 (7th Cir. 1970), *overruled by* Felzen v. Andreas, 134 F.2d 873 (7th Cir. 1998).

[175]*See* Duffy, *supra* note 149, at 937 (discussing *Asgrow*, 425 F.2d at 1060-61).

[176]*Id.* (quoting *Asgrow*, 425 F.2d at 1060-61) (second, fourth, and fifth alterations in original).

[177]Duffy *supra* note 149, at 938 & n.37 (citing nine cases and three treatises in support of this point).

[178]518 F.2d 1258 (7th Cir. 1975), *overruled by* Felzen v. Andreas, 134 F.3d 873 (7th Cir. 1998).

[179]*See Felzen*, 134 F.3d at 874.

[180]*Asgrow*, 425 F.2d at 1060 n.2. *See also* Croyden Assocs. v. Alleco, Inc., 969 F.2d 675, 679 (8th Cir. 1992) (discussing *Asgrow* and noting that subsequent cases "have ignored this footnote and have relied on the text" instead).

Guthrie v. Evans,[181] a prisoner appealing pro se was unable to challenge a final judgment — not a settlement — handed down in a class action.

The *Guthrie* court gave three reasons for its decision. "First, unnamed class members cannot represent the class absent the procedures set forth in Rule 23 for the certification of class representatives."[182] This is meant to assure that the class representative is "typical" of the class and will "fairly and adequately represent the interests of the class members."[183] Second, the court explained that dissatisfied class members have other avenues of relief.[184] These may include intervention as of right under Rule 24, if it can be shown that "the current representation is inadequate."[185] A denial of such intervention may be appealed.[186] Another avenue is a collateral attack on the adequacy of the class representation.[187] If an action is certified under Rule 23(b)(3), the members will be entitled to notice and may opt out of the class.[188] The court's third reason was the general policy behind class actions, to "unify and render manageable litigation" involving large numbers of potential actors.[189] The court reasoned that allowing individual appeals could defeat the very purpose of class actions.[190] *Guthrie* "appears to be the progenitor of the modern trend in the federal courts in this unsettled area of the law."[191] Its reasoning has been widely followed, and it has been applied to ever-widening sets of facts. Since *Guthrie*, a number of decisions have been handed down denying petitioners the right to appeal the dispositions of their cases.

The first of these class action cases was *Walker v. City of Mesquite*.[192] In *Walker*, a class action suit, the court applied the reasoning of *Guthrie*, which involved a *final judgment* to an appeal from a *settlement agreement*.[193] *Walker* cited the recently decided *Marino* for support,[194] broadening

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[181]815 F.2d 626 (11th Cir. 1987).

[182]Gottlieb v. Wiles, 11 F.3d 1004, 1008 (10th Cir. 1993) (citing *Guthrie*, 815 F.2d at 628).

[183]*Id. See also Guthrie*, 815 F.2d at 628 ("Named plaintiffs and counsel cannot represent a class in federal litigation until the district court makes certain findings, including that they will fairly and adequately protect the interest of the class.").

[184]*See Gottlieb*, 11 F.3d at 1008.

[185]*Id.*

[186]*See id.*

[187]See *id.*

[188]*See Gottlieb*, 11 F.3d at 1009.

[189]*Id.*

[190]*See id.* (citing *Guthrie*, 815 F.2d at 629).

[191]Shults v. Champion Int'l Corp., 35 F.3d 1056, 1059 (6th Cir. 1994).

[192]858 F.2d 1071 (5th Cir. 1988).

[193]*See* Duffy, *supra* note 149, at 939 (discussing Walker v. City of Mesquite, 858 F.2d 1071 (5th Cir. 1988)).

[194]*See Walker*, 858 F.2d at 1074 (citing Marino v. Ortiz, 484 U.S. 301 (1988)).

Marino's application from people who had never been parties at all, to unnamed class members.[195]

Croyden Associates v. Alleco, Inc.[196] was another case that cited the *Guthrie* rationale in great detail.[197] In denying an appeal in this securities class action, the court found the *Guthrie* reasoning "persuasive" and approved of the *Walker* rationale.[198] These cases — *Guthrie*, *Walker* and *Croyden* — are often cited together,[199] for the similar policy reasons in their holdings. Rule 23 class actions, they hold, could "break down under the burden of unpredictable and unlimited individual actions" if appeals were allowed without formal intervention.[200]

In addition to relying on *Marino*, the *Felzen* court relied on *In re VMS Limited Partnership Securities Litigation*[201] and *In re Brand Name Prescription Drugs Antitrust Litigation*[202] to hold that "*Asgrow Seed* is no longer authoritative."[203] Both of those cases relied on *Guthrie* and *Marino*, and, like *Guthrie*, both involved dispositions other than proposed settlement orders. *VMS* involved an appeal from a post-settlement order implementing a settlement decree,[204] and *Brand Name*, that relied on *VMS*, involved an attempt to appeal from an order granting summary judgment.[205]

As described earlier,[206] many observers feel that settlements pose greater risks for class members and shareholders than other dispositions of class actions and derivative suits. According to the court in *Felzen*, however:

> the distinction is inconsequential for purposes of Rule 3(c), the rationale of *Marino*, and the rationale of *Brand Name Prescription Drugs*: that the court should not "fragment the control of the class action" . . . . Lest doubt linger, we now formally overrule *Asgrow Seed* and any other case in this

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[195]*See* Duffy, *supra* note 149, at 942-43.

[196]969 F.2d 675 (8th Cir. 1992).

[197]*See id.* at 678-79.

[198]*Id.* at 680.

[199]*See, e.g.*, Shults v. Champion Int'l Corp., 35 F.3d 1056, 1059 (6th Cir. 1994); Gottlieb v. Wiles, 11 F.3d 1004, 1009 (10th Cir. 1993); Carlough v. Amchem Prods., Inc., 5 F.3d 707, 713-14 (3d Cir. 1993); *In re* VMS Ltd. Partnership Sec. Litig., 976 F.2d 362, 367-68 (7th Cir. 1992).

[200]*Gottlieb*, 11 F.3d at 1009.

[201]976 F.2d 362 (7th Cir. 1992).

[202]115 F.3d 456 (7th Cir. 1997).

[203]*Felzen*, 134 F.3d at 874 (citing *Brand Name Prescription Drugs*, 115 F.3d at 458).

[204]*See VMS*, 976 F.2d at 362-63.

[205]*See Brand Name Prescription Drugs*, 115 F.3d at 457.

[206]*See supra* text accompanying notes 50-69.

> circuit that permits non-parties to appeal from a decision of any kind in a class action.[207]

Another pair of cases cited in *Felzen*, *Shults v. Champion International Corp.*[208] and *Gottlieb v. Wiles*,[209] did involve proposed settlement orders, but each can be distinguished from *Felzen* on other grounds.

In *Shults*, a settlement was negotiated after a five-week jury trial ended in a mistrial.[210] The danger of collusion due to lack of adversary process seems less here than in the usual settlement context. More importantly, the *Shults* court refused to overturn its controlling precedent, primarily *Cohen v. Young*,[211] and found that whether a person had intervened in the court below was not dispositive.[212] Rather, it held that the critical factor was the court order Cohen had received to show he was "haled into court, 'like a defendant who is summoned by process of court'"; thus, earning the right to appeal.[213] *Shults* also pointed out that *Marino* could not overrule *Cohen* because *Marino* involved "non-parties" and not "non-representative members of a class or derivative suit."[214]

A final distinction between *Felzen* and every other case cited by the court for support is that *Felzen* is the only case that involves a shareholder derivative suit under Rule 23.1. The importance of this distinction is highlighted in *Gottlieb*, which presents an excellent analysis of why its decision to deny an appeal for a class member under Rule 23 is "inapposite" in shareholder derivative suits under Rule 23.1.[215] The problem, as stated by the *Gottlieb* court, is that "Rule 23.1 does not offer [a shareholder] the same protective mechanisms offered [to a class member] by Rule 23."[216] First, under Rule 23.1 there is no requirement of a "preliminary affirmative determination that the named [parties] will fairly and adequately represent the interests of the other class members."[217] Second, there is no opt-out provision for a shareholder in a derivative suit, so "all shareholders are

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[207] *Felzen*, 134 F.3d. at 875 (quoting *Brand Name Prescription Drugs*, 115 F.3d at 457) (citations omitted).

[208] 35 F.3d 1056 (6th Cir. 1994).

[209] 11 F.3d 1004 (10th Cir. 1993).

[210] *See Shults*, 35 F.3d at 1058.

[211] 127 F.2d 721 (6th Cir. 1942).

[212] *See Shults*, 35 F.3d at 1060.

[213] *Id.* (quoting *Cohen*, 127 F.2d at 724).

[214] *Id.* at 1061.

[215] *Gottlieb*, 11 F.3d at 1010-11.

[216] *Id.* at 1011.

[217] *Id.*

bound by the outcome regardless of their objections."[218] Finally, *Gottlieb* acknowledges the distinctive risks faced by shareholders in a derivative suit, where plaintiff's attorneys and defendants may exchange "a low settlement for high fees."[219]

In fact, by focusing on the protections offered by Rule 23, *Gottlieb* may actually be aligned with the traditional approach of *Carlough v. Amchem Products, Inc.*[220] and *Bell Atlantic Corp. v. Bolger*,[221] two Third Circuit decisions that are pointedly criticized in *Felzen*.[222] According to *Gottlieb*, *Carlough* (like *Ace Heating* on which it relies) involved a class action settlement that was negotiated before certification of the plaintiffs under Rule 23.[223] Thus, the protective mechanisms of Rule 23 were missing, and appeal was properly granted.[224] Of all the cases cited in *Felzen*, *Bell Atlantic*'s facts most closely resemble *Felzen*'s. Like *Felzen*, the case involved a settlement agreement, and unnamed shareholders had attended a hearing in the lower court to object to the approval of that agreement.[225] It is also the only case which, like *Felzen*, involved a derivative suit under Rule 23.1.[226]

The court in *Felzen* asked whether a shareholder derivative action under Rule 23.1 differs from a class action under Rule 23 "in a way that permits appeal by non-parties," and found that the differences "cut against" CalPERS' position.[227] Among other things, the court pointed out that in a shareholder derivative suit, "the individual investor is not an injured party and is not entitled to litigate."[228] In fact, a derivative suit is permitted

> [o]nly when the corporation's board defaults in its duty to protect the interests of the investors . . . and even then many

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[218] *Id.*

[219] *Gottlieb*, 11 F.3d at 1011 (quoting Bell Atlantic Corp. v. Bolger, 2 F.3d 1304, 1310 (3d Cir. 1993)).

[220] 5 F.3d 707 (3d Cir. 1993).

[221] 2 F.3d 1304 (3d Cir. 1993).

[222] *See Felzen*, 134 F.3d at 876.

[223] *See Gottlieb*, 11 F.3d at 1010 n.5.

[224] *See id. Gottlieb* resolved the discrepancy between the body of *Asgrow Seed* and its footnote by explaining that the case involved two groups of plaintiffs. *See id.* at 1011. One group was certified under Rule 23(b)(1) and 23(b)(2), and the body of the case gave them the right to appeal. *See id.* (citing *Asgrow*, 425 F.2d at 1060). The footnote, however, referred to the second group, which was certified under Rule 23(b)(3). *See id.* (citing *Asgrow*, 425 F.2d at 1060 n.2). Because the second group had the right to opt out, its members could not appeal without having intervened in the case below. *See id.*

[225] *See* Bell Atlantic Corp. v. Bolger, 2 F.3d 1304, 1306-07 (3d Cir. 1993).

[226] *See id.*

[227] *Felzen*, 134 F.3d at 875.

[228] *Id.*

> states permit the board to regain control of the litigation . . . . [S]tockholders other than the named plaintiffs are not treated as parties in derivative litigation—their citizenship is ignored when determining diversity, and they are not allowed to opt out. Corporate management may affect the interests of stockholders without notifying them or obtaining their consent; by investing in stock, they placed their funds at the management's disposal and obtained, in exchange, the right to choose future managers. Shareholders have no more the attributes of parties when managers settle derivative litigation than when managers settle antitrust litigation.[229]

In other words, said the court, "shareholders . . . have no more right to speak for the firm or control its litigation decisions than bondholders or banks or landlords, all of whom have contractual interests that may be affected."[230]

Petitioners and several *amici*, including the United States Securities and Exchange Commission (SEC) and two professors from Delaware, argued that in this sweeping statement the *Felzen* court underestimated the shareholders' interest in the derivative action under both federal and state substantive law.[231] Shareholders, the Delaware *amici* insisted, are not like other constituencies.[232] Shareholders can, in fact, displace the board of directors in litigation, which is the fundamental characteristic of a derivative action.[233] Here, the fact that the suit was not dismissed for failure to make a demand implies that the shareholders have authority to pursue the action without approval of the board.[234] The most important point in *Felzen*, however, is the notice requirement under Rule 23.1,[235] which is not required for members of other corporate constituencies that might be affected by the settlement of a derivative suit.[236]

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[229] *Id.* at 875-76 (citations omitted).

[230] *Id.* at 874.

[231] Brief of Professors Lawrence A. Hamermesh and Mary Brigid McManamon as *Amici Curiae* Supporting Petitioners at 1-2, *Felzen* (No. 97-1732) (*amici*'s interest was ensuring that the Court was apprised of "the substantive law and practice of Delaware in relation to stockholder derivative actions" and "the historical practice under [FED. R. CIV. P.] 23.1, with particular emphasis on the federalism concerns raised by the Seventh Circuit's creation of new federal common law"); Brief for the United States and the Securities and Exchange Commission as *Amici Curiae* Supporting Petitioners, *Felzen* (No. 97-1732).

[232] *See* Hamermesh & McManamon Brief at 16, *Felzen* (No. 97-1732).

[233] *See id.*

[234] *See id.* at 17.

[235] *See* SEC Brief at 14, *Felzen* (No. 97-1732).

[236] *See* Hamermesh & McManamon Brief at 19. Delaware's Chancery Court Rule 23.1 parallels the federal requirement. *See* DEL. CH. CT. R. 23.1.

The purpose of the notice requirement is to allow shareholders to object.[237] Unlike members of the other constituencies listed in *Felzen*, shareholders will be bound individually by the results of the litigation and precluded from asserting their own claims on settled issues.[238] Because of the need for fundamental fairness, state and federal courts have, by long-standing practice, allowed some form of "'meaningful participation at a settlement hearing,' including 'certain rights to discovery and cross-examination.'"[239] This does not contradict the rule that non-parties may not appeal, but rather complements the rule because shareholders "[a]s the owners of the corporation . . . are not strangers to the action."[240] The SEC points to a long history of treating objecting members of a class as a type of "quasi part[y]."[241] The Delaware *amici* explain that their state's law "treats objecting shareholders in a Rule 23.1 action to all intents and purposes as parties."[242]

This brings the argument full circle. Because the United States Supreme Court was equally divided in this case,[243] there is currently no answer to the unarticulated but ongoing question that runs through *Felzen*: What exactly is the shareholder's position in a derivative suit? In a post-*Felzen* decision, the Delaware Court of Chancery acknowledged the problem, stating: "I understand that there are differences of approach regarding whether a person who objects to a class action or derivative settlement in accordance with court procedures must thereafter intervene formally in order to appeal a judgment."[244] For policy reasons, it is likely that the Seventh Circuit will continue down the restrictive path it has chosen. The court made this clear in *Felzen*, where it cited an extensive list of scholarly publications for the following proposition: "Many thoughtful students of the subject conclude, with empirical support, that derivative actions do little to promote sound management and often hurt the firm by diverting the managers' time from running the business while diverting the firm's resources to the plaintiffs' lawyers without providing a corresponding

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[237]*See* SEC Brief at 14, *Felzen* (No. 97-1732).

[238]*See id.*; Hamermesh & McManamon Brief at 20.

[239]*See* SEC Brief at 14 (quoting 5 MOORE'S FEDERAL PRACTICE ¶ 23.1.10[1][c] (D. Coquillette et al. eds., 3d ed. 1997)); Hamermesh & McManamon Brief at 20.

[240]SEC Brief at 12 (footnote omitted).

[241]*Id.* at 4.

[242]Hamermesh & McManamon Brief at 13.

[243]*See* California Pub. Employees' Retirement Sys. v. Felzen, 525 U.S. 315 (1999) (per curiam) (4-4 decision).

[244]*In re* U.S. Robotics Corp. Shareholders Litig., No. 15,580, 1999 Del. Ch. LEXIS 46, at *29 (Del. Ch. Mar. 15, 1999) (citations omitted).

benefit."[245] For any shareholder who must decide whether to take on the burden of intervening in a derivative action or forever lose the right to appeal, significant uncertainty remains.

V. CONCLUSION

The events at ADM provide an outstanding example of genuine misbehavior by corporate managers and directors. Unfortunately, the resulting lawsuits, and their ultimate resolution in *Felzen* and *CalPERS*, provide a corresponding example of how poorly our current legal system often handles these matters.

The suits brought by shareholders against ADM and its directors could not have been viewed as frivolous — certain officers and directors had committed federal crimes, which cost the company $190 million.[246] When the plaintiffs' lawyers agreed to settle for the minimal sum of $8 million, and to pocket almost half that amount in fees,[247] the peculiar dangers of shareholder derivative suits came into very sharp focus.

In objecting to the settlement, and then attempting to appeal, CalPERS and FSBA fell into the crack between two strong trends in public policy. On one hand is a growing hostility in Congress and the courts towards class actions generally. Many of the provisions of the PSLRA were aimed at reducing the overall number of certain kinds of suits, and many court decisions in recent years have been motivated by a similar desire to cut off the flow of litigation. To accomplish this goal, substantive and procedural barriers have been erected wherever possible. On the other hand, Congress and the public seem to want someone — anyone — to exert control over the lawyers. Many provisions of the PSLRA are designed to persuade institutional investors like CalPERS and FSBA to volunteer for the job.

Unfortunately, in the words of one astute observer, "life gets complicated."[248] A decision like *Felzen* can successfully eliminate many abusive lawsuits, but it will bar the meritorious ones as well. For policy purposes, the important question is how this decision affects potential plaintiffs. Will *Felzen* be seen as a rebuff to institutional investors, telling them that their suits are as distasteful as any and should be limited by any means the court can find? Or is the court, in light of the PSLRA, trying to

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[245] *Felzen*, 134 F.3d at 876 (citations omitted).

[246] *See* Mullenix, *supra* note 1, at B17.

[247] *See id.*

[248] Interview with Professor Marjorie Fine Knowles, Georgia State University School of Law, Atlanta, Ga. (Jan. 1999) (quoting THE STATLER BROTHERS, *Class of '57*, *or* THE BEST OF THE STATLER BROTHERS, VOL. 1 (Mercury Records 1975)).

push the institutions to get involved earlier and more significantly in ongoing litigation? Time will tell . . . .