1975

Federal Civil Procedure: Case Notes

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http://hdl.handle.net/1811/69597

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The recent decision of Greenspun v. Bogan illustrates the need for district courts to set forth their findings of fact and conclusions of law in judgments approving settlements of shareholder derivative actions. The district court's judgment approving the settlement in Greenspun stated only that the settlement was found to be "fair, reasonable, and proper," without explaining the basis for that decision. Although rule 23.1 of the Federal Rules of Civil Procedure requires the approval of the district court for the settlement and dismissal of shareholder derivative actions in order to safeguard the interests of the absent shareholders, the failure of rule 52 to require the district court to set forth its findings of fact and conclusions of law in approving that settlement substantially reduces the protections, and thereby defeats the purpose of that portion of rule 23.1. A revision of rule 52 to include the approval of settlements proposed in shareholder derivative actions among those actions requiring the district court to state its findings of fact and conclusions of law would provide reviewing courts with a basis for determining whether the district court adequately protected the interests of the absent shareholders.

The special character of a shareholder's derivative action was recognized in the 1966 revision of the Federal Rules of Civil Procedure when rule 23.1 was abstracted from the general provisions of rule 23 pertaining to class actions. One of the general provisions of rule 23 made specific in rule 23.1 is the requirement that the district court approve any proposed settlements of shareholder derivative actions:

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 the shareholders or members in such manner as the court directs.

The derivative action is a special type of class action in which a

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1 492 F.2d 375 (1st Cir. 1974).
3 Advisory Committee Comment to FED. R. CIV. P. 23.1 (1966): A derivative action by a shareholder of a corporation or by a member of an unincorporated association has distinctive aspects which require the special provisions set forth in the new rule.
4 FED. R. CIV. P. 23.1.
shareholder may bring suit to enforce a right that is owned by the corporation, because the corporation either cannot or will not enforce that right. The right sued upon and any recovery obtained belong to the corporation on whose behalf the action is brought, and will only indirectly benefit the plaintiff or other similarly situated shareholders. Thus, the plaintiff shareholder's interest in the action may be somewhat less than when the plaintiff owns the right sued upon and stands to benefit directly from a favorable judgment. Prior to the promulgation of the Federal Rules, and the requirement of court approval of settlements in derivative actions, the plaintiff's position was sometimes an encouragement to come to a private settlement with the defendants, whereby the plaintiff would benefit directly to the detriment of the other shareholders. Even where the plaintiff is not in collusion with the defendants to gain personal benefit, the time and expense of maintaining the action may be a strong inducement for the plaintiff to agree to an unfair settlement.

Moreover, the settlement and dismissal of an action where the plaintiff owns the right sued upon will ordinarily bind only the parties directly involved in the action. The settlement and dismissal of a derivative action, however, binds all the shareholders as well as the parties of record. The effect of a judgment approving a settlement is even greater in derivative actions than in other types of class actions, since shareholders cannot exclude themselves from the action, an alternative usually available under rule 23(b)(3).

The peculiar position of the plaintiff and the effect of a settlement in a derivative action account for the provisions of rule 23.1 requiring that notice of the proposed settlement be given to the shareholders and that the court approve the settlement. These requirements were intended to protect the absent shareholders from strike suits and private settlements that do not represent their interests. It has been said that the court becomes another party to the action with the duty of safeguarding the interests of the absent shareholders from unfair settlements.

As the court points out in *Greenspun*, the purpose of requiring

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1 Pittston Co. v. Reeves, 263 F.2d 328 (7th Cir. 1959); Haudek, *The Settlement and Dismissal of Stockholders' Actions — Part I*, 22 Sw. L.J. 767, 768 (1968).
2 Haudek, supra note 5, at 768.
7 492 F.2d at 378.
court approval of proposed settlements would be defeated if the court merely rubber stamped any settlement proposed by the parties. The court must, in order to safeguard the interests of all the shareholders, exercise a sufficiently independent and objective judgment as to the fairness of the settlement. An independent evaluation of the propriety of the settlement commonly requires that the court hold a hearing on the settlement and consider in detail the evidence produced by discovery, exhibits, testimony and documents, as well as the memoranda filed with the court. This investigation should have some limits in depth and scope, however, since the purpose of a settlement is to avoid the expense and delay of a full litigation of the issues at a trial. The court, then, must do more than put a rubber stamp of approval on the proposed settlement, yet it must not try the case when considering a motion to approve the settlement and to dismiss the action.

The approval of proposed settlements is often said to be discretionary with the district court unless the settlement is clearly shown to be unfair and against the best interest of those who will be affected by it. In Cohen v. Young, a frequently cited case setting out the procedure for the approval of settlements in derivative actions, the court adopted the definition of discretion set out by the Supreme Court in Styria v. Morgan: "[d]iscretion means the equitable decision of what is just and proper under the circumstances." There is, then, no special interpretation given to discretion in the approval of derivative actions. The discretionary power of the court is not arbitrary; the decision to approve a settlement must be a "reasoned judgment."

Although the district court's decision can be reviewed for errors of law or procedure, the appellate review of the fairness of the settlement is limited to whether or not the district court abused its discretion in approving the settlement. Appellate courts are reluctant to intervene in the district court's determination of the fairness of a

16 127 F.2d 721 (6th Cir. 1942).
17 186 U.S. 1, 9 (1902).
19 See, e.g., Ashback v. Kirtley, 289 F.2d 159 (8th Cir. 1961); Upson v. Otis, 155 F.2d 606 (2d Cir. 1946).
settlement where there is not a clear showing of an abuse of discretion. It would be an abuse of discretion, however, if the district court ruled on the proposed settlement with less than a "reasoned judgment."

The original action in Greenspun was filed by a shareholder of Continental Mortgage Investors (CMI) on its behalf against Continental Advisors (CA), acting as investment advisors to CMI. The complaint alleged that CA had diverted a corporate opportunity from CMI, and that CA was receiving excessive fees from CMI for its services. Under the investment management contract, CA's fee was a percentage based on the total investment assets of CMI. The settlement agreement approved by the district court provided that the responsibility of finding borrowers for CMI be shifted from CA to the Conco Mortgage Company (Conco), and that there would be a reduction in the advisory fee paid to CA by CMI. Conco was owned and controlled, in part, by those trustees of CMI affiliated with CA. Conco did not receive compensation directly from CMI; instead, Conco charged the borrowers that it found a "finder's fee" for its services.

Since a judgment approving a settlement and dismissing the action terminates the action, it is a final decision and may be appealed. The appeal in Greenspun was taken by two objectors (one individual and one corporate) to the settlement approved by the district court. The appellants claimed that the district court abused its discretion by failing to conduct an independent evaluation of the settlement and that the approval of the settlement was an abuse of discretion since the terms of the settlement were grossly unfair. The appellants supported the first contention with the fact that the district court had only limited information available to it prior to the settlement hearing. Although two volumes of exhibits and documents were given to the court at the hearing, the court approved the settlement on the day following the hearing. The appellants contended that the

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21 492 F.2d at 377.
22 The fee reduction follows a schedule based on Conco's profits and CMI's investment assets. 492 F.2d at 380.
23 CMI's charter permits CMI to enter into advisory contracts with a limited number of its own trustees, if the contract is approved annually by a majority of the unaffiliated trustees. 492 F.2d at 380.
24 Partial settlements are beyond the scope of this case note.
26 492 F.2d at 377.
settlement was grossly unfair and a sham because the "finder's fee" charged by Conco would necessitate a lower interest rate that the borrowers would be willing to pay for CMI's loans. Thus, even with the reduced advisory fee, the settlement would result in no real benefit to CMI.

In order to appreciate the significance of the district court's failure to set forth its findings of fact and conclusions of law in a judgment approving a settlement at the appellate level, it is first necessary to briefly examine the factors that the district court considers when ruling on the settlement.

The burden of showing the fairness of the settlement proposal at the settlement hearing falls on the proponents of the settlement. The proponents are generally aided by the fact that the law favors settlements. In *Feder v. Harrington*, the court put the burden on the proponents merely to show that the settlement agreement was non-collusive. This proven, the burden shifted to the opponents to prove that the settlement was not fair. In other cases the proponents have had a burden to show some degree of fairness in addition to non-collusion, but the fact that the law favors settlements and the prospects of avoiding what are often long, complex, and expensive trials generally aid the proponents.

The opinion of the counsel of the parties of record is often considered, but will not alone support the approval of a settlement since the interests of the counsel and their clients are not necessarily representative of the interests of the absent shareholders. Another consideration is the position taken on the settlement by the current board of directors. The value of this consideration varies greatly. Since the corporation owns the right sued upon, there can be no settlement if the corporation, acting through its directors, opposes the settlement proposal. The endorsement of the settlement by the corporation's directors will not aid the court appreciably if the suit was directed at the conduct of these individuals. It is of greater value where the conduct of the directors is not the subject of the action. Thus, the position of the parties recommending approval of the settlement is an important consideration for the district court. In a case

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30 Haudek *Part II*, supra note 7, at 799.
like Greenspun the position taken by the unaffiliated trustees is more important than the position of the affiliated trustees.\(^{34}\)

There is conflicting authority on the extent to which the district court should exercise its own judgment in considering the fairness of the settlement. Some courts consider this to be a part of an independent evaluation and objective judgment,\(^{35}\) while other courts restrict their consideration to the fairness of the settlement terms on their face without substituting the court's own judgment.\(^{36}\) The court should not, in any case, attempt to renegotiate the settlement at the hearing, but should limit itself to ruling on the settlement agreement negotiated and proposed by the parties.\(^{37}\)

In City of Detroit v. Grinnell Corp.,\(^{38}\) the court stated that "'[T]he most important factor is the strength of the case for the plaintiffs on the merits, balanced against the amount offered in the settlement.'"\(^{39}\) Since the settlement is proposed in lieu of a trial on the merits, it is appropriate to judge the fairness of the settlement terms by comparing them with the best possible recovery at a trial, and with the likely outcome of a trial. The court need not, and should not, decide all of the questions in the case or deal with the intricacies of the action in detail, but it should hear sufficient evidence to estimate the degree of success or failure that the important aspects of the case would likely have at a trial.\(^{40}\)

A general notion of fairness is reflected in all of these factors. There are no fixed standards that a settlement proposal must meet, since each settlement is negotiated to deal with different controversies set in specific circumstances. Comparison to other settlements in similar situations may be helpful but is not a determining factor. A settlement should be approved as "fair, reasonable, and adequate" if it best serves the interests of all those concerned and should be rejected if it does not. Rule 23.1 requires the court to make this determination based on all the facts and circumstances known to it. The court is aided by the arguments of the proponents and opponents of the settlement, but may, in its discretion, approve a settlement over

\(^{34}\) Id.


\(^{38}\) 1974-1 TRADE REG. REP. (1974 Trade Cas.) ¶ 74,986 (2d Cir. 1974).

\(^{39}\) Id. at 96,363. The court was quoting from the opinion of the Second Circuit in West Virginia v. Chas. Pfizer & Co., 440 F.2d 1079, 1085 (2nd Cir. 1971).

objections, or reject a settlement even where there are no objections presented to the court.

The factor underlying the requirement of the court's approval is the interests of the absent shareholders. The court must determine how the settlement would affect the interests of the absent shareholders before it can give a "reasoned judgment" on the fairness of the proposal. This is often a difficult task since it requires the court to look beyond the evidence offered by the proponents of the settlement. The proponents do not generally propose a settlement that they consider to be against their interest, and are usually well represented by counsel. On the other hand, the absent shareholders are often not well represented at the settlement hearing, and the court cannot rely on the proponents of the settlement to fully present the interests of the absent shareholders, since their interests may be adverse to those of the proponents. Although objecting shareholders may appear at the settlement hearing, they may not adequately represent the interests of the absent shareholders due to a limited opportunity to gather evidence and due to the fact that participation in the hearing is subject to the discretionary control of the court. Objectors are also discouraged by travel and attorney expenses that are not reimbursed by the corporation and which do not come out of the settlement.\textsuperscript{41}

The district court's approval of a proposed settlement has the effect of a final judgment on the merits. Res judicata effect is given to all of the claims in the amended complaint,\textsuperscript{42} binding all of the shareholders, as well as the corporation and the defendants.

Although a "reasoned judgment" of the fairness of the settlement often requires the district court to make factual determinations while considering the factors discussed above, rule 52 of the Federal Rules of Civil Procedure does not require the district court to state its findings of fact in its judgment approving the settlement:

Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).\textsuperscript{43}

This poses a considerable problem for the objectors to the settlement who appeal from the district court's judgment. The appellants' only ground for appeal on the fairness of the settlement is that the district

\textsuperscript{41} See Haudek Part II, supra note 7, at 803.

\textsuperscript{42} The plaintiff typically files an amended complaint after a settlement is agreed to, which includes all claims related to the action, in order to broaden the res judicata effect of the court's approval for the protection of the defendants. See Haudek Part II, supra note 7, at 773.

\textsuperscript{43} Fed. R. Civ. P. 52(a). Rule 41(b) deals with involuntary dismissals. See text accompanying note 59 infra.
court abused its discretion in approving the settlement. Where, as in Greenspun, the district court's judgment merely recites that the settlement is found to be "fair, reasonable, and proper" without indicating the factual basis or reasoning for the court's decision, the objectors are hard pressed to show that the court below abused its discretion. When no analysis of the facts or law is stated in the order approving the settlement, the appellants will have a great deal of difficulty demonstrating to the appellate court that the district court's action constituted an abuse of discretion. Neither the parties nor the appellate court have the benefit of the district court's evaluation of the facts and law, or even the assurance that the district court made an evaluation of the facts and law.

In Protective Committee v. Anderson, the Supreme Court dealt with the compromise of a reorganization proceeding in bankruptcy. Since the standards for approval of proposed settlements are similar, that decision has been applied to the settlement of derivative actions. There the Court stated that

[i]t is essential . . . that a reviewing court have some basis for distinguishing between well-reasoned conclusions arrived at after a comprehensive consideration of all the relevant factors, and mere boilerplate approval phrased in appropriate language but unsupported by evaluation of the facts or analysis of law.

The Court provided the district court with two methods of providing the appellate court with the requisite basis. If the record contains sufficient facts clearly pointing to the fairness of the settlement, then the failure of the district court to adequately state its reasoning and supportive evidence is not fatal to the judgment, though it is desirable. This method of providing the appellate court with some basis for review is undesirable, however, since it is in essence a trial de novo in the appellate court on the fairness of the settlement. This method was only intended to be applied where the district court did set out its findings of law and fact, but they were lacking in some respect that could be cured by reference to the record. The second, and more desirable, method of providing the appellate court with the requisite basis is with an explanation of how the strengths and weaknesses of the debtor's

See note 19 supra.
Greenspun v. Bogan, 492 F.2d 375, 378 (1st Cir. 1974); Newman v. Stein, 464 F.2d 689, 692 n.6 (2d Cir. 1972).
causes of action were evaluated or upon what grounds it was con-
cluded that the settlement . . . was "fair and equitable."48

In affirming the decision of the district court, the appellate court in *Greenspun* assumed that the district court had undertaken the required independent evaluation of the fairness of the settlement, and that that evaluation supported the approval of the settlement. The appellate court’s opinion, however, reflects concern over the district court’s evaluation of the settlement:

the district court’s evaluation of the proposed settlement may not
have been as comprehensive or as intensive as it could have been.
It may be . . . that a different judge with additional data would find
that the settlement fell on the short side of fairness.49

Nevertheless the court, in rejecting the appellants’ claim that the district court had not conducted an independent evaluation of the settlement, held that

the appellants have failed to show that the district court clearly
abused its discretion in approving the settlement because it lacked
sufficient evidence on which an independent appraisal might be
based.50

The court apparently made an inferential leap from the fact that there was sufficient evidence to conduct an independent evaluation of the fairness of the settlement to the conclusion that such an evaluation was in fact made. It is this inference for which the Supreme Court required that there be "some basis." The district court must provide the appellate court with its reasoning and the factual support for its decision so that the appellate court can determine that the evidence available was in fact used to make an independent evaluation of the settlement. Absent "some basis" for showing that the district court did make the required evaluation of the fairness of the settlement, it is difficult to see how the appellate court could determine that the district court’s judgment was not a "mere boiler-plate approval phrased in appropriate language but unsupported by evaluation of the facts or analysis of law."51

The appellate court in *Greenspun* finds further support for the district court’s decision in the lack of evidence offered to support the lone objection made to the fairness of the settlement at the hearing.

48 *Id.*
49 492 F.2d at 379.
50 *Id.*
In *Protective Committee v. Anderson*, the court rejected this approach:

The argument that the compromises were properly approved because no creditors objected to them seems doubly dubious. When a bankruptcy court either fails adequately to investigate potential legal claims held by the debtor, or refuses to provide an adequate explanation of the basis for approving compromises, it is scarcely surprising that creditors fail to come forward with objections to the compromises. Moreover, this Court has held that a plan of reorganization which is unfair to some persons may not be approved by the court even though the vast majority of creditors have approved it.52

In *Norman v. McKee*,53 a shareholder derivative action, the court said that “[t]he absence or silence of investors does not relieve the judge of his duty and, in fact, adds to his responsibility.”54

The simplest and most effective method of providing reviewing courts with a basis for distinguishing between well-reasoned conclusions and mere boiler-plate approval would be to revise rule 52 to include judgments approving settlements in derivative actions. Requiring the district court to set forth its findings of fact and conclusions of law would be the best means for protecting the purpose of the requirement that the court approve these settlements.

Rule 52 requires findings of fact in “all actions tried upon the facts without a jury . . .,”55 but the stated purpose of the rule has far wider application than actual trials:

The purpose of findings of fact and conclusions of law is to aid the trial court in making a correct factual decision and a reasoned application of the law to the facts; to define for purposes of res judicata and estoppel by judgment the issues then adjudicated; and to aid the appellate court.56

Thus, the rule is presently applied to the granting of involuntary dismissals under rule 41(b), and to the granting or refusing of interlocutory injunctions. The objectives of rule 52 also apply to the purpose of requiring the court’s approval of settlements in derivative actions.

The 1946 amendment to rule 52 specifically exempted the decision of motions, other than those under rule 41(b), from the requirements of rule 52. Professor Moore expresses the view that rule 52

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52 Id. at 435.
54 290 F. Supp. at 32.
should still apply to motions where the court must make a factual
determination in order to rule on the motion. With specific reference
to motions under rule 12, Moore states that

[The 1946 amendment should be read in conjunction and harmo-
nized with the earlier provision of the Rule requiring findings of fact
in all actions "tried upon the facts"; and the reasons for findings of
fact are equally pertinent to this [motion under rule 12].

Although a good argument may be made for requiring findings
of fact to be set forth whenever there is a factual determination by
the district court, the inclusion of the settlement and dismissal of
derivative actions in rule 52 should not depend on the persuasiveness
of this argument. There are factors which make an even stronger case
for the inclusion of judgments approving derivative actions than for
the other motions presently exempted from rule 52.

Unlike the approval of settlements under rule 23.1, motions
under rules 12 and 56 are not discretionary with the district court.
Appellate review of an abuse of discretion must focus on the reason-
ning of the trial judge, and this requires that that reasoning be set out.

The stated purpose underlying the requirement of court approval
in rule 23.1 also distinguishes the settlement of derivative actions
from other motions. The interests of the absent shareholders cannot
be adequately protected unless the appellate courts can determine
that there was a legitimate factual basis for the district court's
decision. Just as the purpose of the protection provided by court
approval of settlements would be defeated if the district court rubber
stamped the proposed settlement, that protection would also be de-
feated if the appellate court merely rubber stamped the decision of
the district court. The right of appeal from the district court's judg-
ment will be of real value only when the appellate court has an
adequate basis for reviewing the action of the district court.

Rule 23 also requires the court's approval for the settlement of
actions brought under that rule. Unlike the members of a class in an
action brought under rule 23, however, the shareholders in a deriva-
tive action cannot exclude themselves from the class to pursue the
cause of action separately. Thus there is a greater need to require
findings of fact under rule 23.1 to ensure that the settlement proposed
fairly represents the interests of the shareholders.

The Federal Rules recognize that the interests of a plaintiff who
suffers an involuntary dismissal under rule 41(b) require that the

Id. at ¶ 52.08.

Id. (footnotes omitted).
Although the dismissal of a derivative action following the approval of a settlement is voluntary on the part of the plaintiff of record, the effect of the dismissal on the objecting shareholders is that of an involuntary dismissal. Thus the objecting shareholders, who will be bound by the settlement, should be given the same protection given to a plaintiff whose action is dismissed over his objections.

Although it is often said that the district court should not merely rubber stamp a proposed settlement in a shareholder's derivative action without an independent evaluation of the fairness of the settlement, the present procedure provides no safeguard against such an approval. Where the district court fails to set forth its findings of fact and reasoning in approving a settlement, the appellate court does not have an adequate basis for reviewing the district court's judgment. This defeats the purpose of requiring the district court's approval and negates the protection that was intended to be given the absent shareholders.

A revision of rule 52 to include the settlement and dismissal of derivative actions among those requiring the court to set forth its findings of fact and conclusions of law makes no change in the underlying intent and purpose of the Federal Rules, but would merely give effect to an intent and purpose that already exists. It would provide the appellate court with an adequate basis for reviewing the judgment of the district court, and the objecting shareholders with the assurance that their interests were protected.

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59 FED. R. CIV. P. 52(a); FED. R. CIV. P. 41(b).