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Are Securities Fraud Plaintiffs Adequate Shareholder Derivative Representatives?

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A shareholder derivative action against the officers and directors of a company is often filed in conjunction with a class or direct action against such officers and directors alleging violations of the federal securities laws based on the same events. At times, the plaintiff filing the shareholder derivative action is the same plaintiff filing the federal securities action. When this occurs, defendants should consider moving to dismiss the shareholder derivative action on the grounds that the plaintiff is an inadequate representative of the other shareholders of the company and, therefore, lacks standing to file the action.

In moving to dismiss a shareholder derivative action, defendants routinely assert that the complaint should be dismissed because the plaintiff failed to comply with the demand requirements under applicable federal and state law.[1] A less-used argument for dismissal, but one that is particularly successful where a shareholder files both derivative and direct claims or actions against the officers and directors of a company, is that the plaintiff fails to meet the adequate-representative requirement of Rule 23.1 of the Federal Rules of Civil Procedure.[2]

Rule 23.1, which governs shareholder derivative actions filed in federal court, provides that a "derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders … in enforcing the right of the corporation."[3] The U.S. Supreme Court has identified adequacy as a "particularly important" issue given the fact that a derivative plaintiff occupies the position of a fiduciary vis-à-vis the shareholders.[4]

The following is a brief look at the 2nd and 3rd Circuits' view and application of the inadequate-representative defense, specifically where the shareholder representative has filed both derivative and direct actions against the directors and officers of a company.

The 2nd Circuit

Historically, courts in the 2nd Circuit have varied widely in their handling of a shareholder derivative plaintiff that also has filed direct claims against the company or its officers and directors. Recently, courts have come close to establishing a "per se rule" that a plaintiff cannot be an adequate representative in a shareholder derivative action where that plaintiff also has filed a direct claim against the company or the director defendants named in the derivative action.

For example, in *Wall Street Systems Inc. v. Lemence*, No. 04 Civ. 5299(JSR), 2005 WL 292744 (S.D.N.Y. Feb. 8, 2005), U.S. District Judge Jed S. Rakoff dismissed with prejudice derivative claims that were brought in the same pleadings as direct claims. The judge held that, "even if one could overlook all the foregoing [demand-related] deficiencies," the plaintiff failed to show that he could fairly and adequately represent the interests of all shareholders.[5] The judge said, "an individual shareholder has a conflict of interest, and therefore cannot adequately represent other shareholders [as required under Rule 23.1], when he simultaneously brings a direct and derivative action."[6]

Similarly, in *Ryan v. Aetna Life Insurance Co.*, 765 F. Supp. 133 (S.D.N.Y. 1991), U.S. District Judge Peter K. Leisure

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dismissed a derivative suit because the relief sought by the plaintiff shareholder in his dual role as a plaintiff in a securities suit and in a derivative suit made him an inadequate representative. While the judge expressly refused to decide whether a "true per se rule exists," he said "courts in this district have applied a strict standard in scrutinizing simultaneous direct and derivative actions for signs of [actual] conflict."[7] Interestingly, Judge Leisure found that the "most compelling argument for a conflict is the incompatibility of the relief sought by plaintiff in his dual role."[8]

Courts in the 2nd Circuit also have considered the adequacy of a shareholder plaintiff who has filed both derivative and securities fraud claims in the context of motions for class certification. The majority of courts in the 2nd Circuit that have considered the issue have recognized that a conflict exists where class plaintiffs also assert derivative claims and, therefore, have denied class certification for failure to satisfy Rule 23(a)(4) of the Federal Rules of Civil Procedure.[9] For example, in *Brickman v. Tyco Toys Inc.,* 731 F. Supp. 101 (S.D.N.Y. 1990), the court denied a motion for class certification due to the potential conflict between proposed class and derivative claims asserted by plaintiff.

The court recognized that "[s]ubstantial recovery on the class claim may reduce the potential recovery on behalf of the corporation on the derivative claim."[10] While the court declined to "embrace the per se rule against contemporaneous derivative and direct class suits," it held that "putative class representatives in such suits should at least be expected to explain why potential conflicts are not likely to materialize in their particular case."[11] To this end, the court denied certification because the plaintiff failed to explain why conflicts were not likely to materialize.[12]

In *Ruggiero v. American Bioculture Inc.,* 56 F.R.D. 93 (S.D.N.Y. 1972), the plaintiffs brought a derivative claim and amended their complaint to include a class-action claim. The court denied class-action status to the plaintiffs because it found that they could not "fairly and adequately represent the class" due to their derivative action.[13] In doing so, the court said "it is difficult to see how [the plaintiffs] can reconcile their existing duties to [the company] and its present shareholders as derivative plaintiffs with the duties which they seek to assume on behalf of a class which attacks [the company] and embraces persons who now hold no [company] shares."[14]

Specifically, the court failed to "see how, on the one hand, [the plaintiffs] can vigorously seek recovery on behalf of those who have an equity interest in the corporation and, on the other hand, vigorously seek recovery from the corporation on behalf of those who have no equity interest in the corporation."[15] Significantly, the court also said there was "a substantial question" as to whether the attorney for the plaintiffs could represent them in the derivative suit and the class action "without violating the canons of ethics."[16]

Accordingly, the court consolidated the case with another related action and directed a consolidated amended complaint be filed, with counsel for the derivative plaintiffs limiting their representation to the derivative claim "for the benefit of [the company]" and another firm acting as lead counsel for the class-action securities claim.[17]

The 3rd Circuit

Unlike the 2nd Circuit, courts in the 3rd Circuit have rejected a per se rule that a conflict exists where a shareholder derivative plaintiff has filed a separate direct action against the subject corporation and director defendants. For example, in *Miller v. Fisco Inc.,* 63 F.R.D. 132 (E.D. Pa. 1974), the court said a conflict did not exist "on the mere basis of simultaneously suing a corporation and bringing a derivative action on its behalf."[18] The court therefore rejected the defendants' argument that both the direct and derivative claims should be dismissed due to the conflict of interest.[19]

It is important to note, however, that the court did not appear to consider the "fairly and adequately represent" language of Rule 23.1 and only stated that the "stiff adequate representation" prerequisite of Rule 23(a)(4) was "not present here."[20] Ultimately, the court concluded that while a finding of conflict could possibly be appropriate on a class-action determination under Rule 23, it was "premature" in this case.[21]

While the 3rd Circuit does not recognize a per se conflict, it has recognized the existence of a separate direct suit as one of a list of factors to be considered in determining whether a derivative plaintiff is a fair and adequate representative. In the 3rd Circuit, to satisfy the adequate-representation requirement of Rule 23.1:

- The plaintiff's attorney must be qualified, experienced and generally able to conduct the proposed litigation, and
- The plaintiff must not have interests antagonistic to those of the class.[22]

In determining whether the plaintiff's interests are antagonistic to those of other shareholders, the 3rd Circuit, in *Vanderbilt v. Geo-Energy Ltd.,* 725 F.2d 204 (3d Cir. 1983), identified the following non-exhaustive list of "important factors" for courts to analyze:

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> Economic antagonisms between representative and class; the remedy sought by plaintiff in the derivative action; indications that the named plaintiff was not the driving force behind the litigation; plaintiff's unfamiliarity with the litigation; other litigation pending between the plaintiff and defendants; the relative magnitude of plaintiff's personal interests as compared to his interest in the derivative action itself; plaintiff's vindictiveness toward the defendants; and, finally, the degree of support plaintiff was receiving from the shareholders he purported to represent.[23]

Courts in the 3rd Circuit have largely analyzed the issue of a separate direct suit under the "economic antagonisms between representative and class" and "other litigation pending between the plaintiff and defendants" factors. In *Banks v. Whyte,* No. CIV. A. 94-CV-0711, 1994 WL 418997 (E.D. Pa. Aug. 9, 1994), plaintiff Barton Banks purported to sue derivatively certain officers, directors and counsel for the Vanguard Savings & Loan Association. Banks also had made numerous direct claims against Vanguard, and Vanguard asserted a claim against the plaintiff.

The defendants moved for dismissal of the derivative claims on the grounds that, among other things, Banks did not fairly and adequately represent the interests of the depositor-members of Vanguard. Analyzing the eight *Vanderbilt* factors the court found that the plaintiff's interests were antagonistic to those of the other depositor-members and dismissed the derivative claims.

Specifically, the court said: "If Banks pursued his claims against Vanguard, and prevailed, he alone would benefit. Furthermore, he would benefit at Vanguard's expense. Such a result would clearly not benefit the depositor-members. Likewise if Vanguard prevails in its claims against Banks … the depositor-members would benefit at Banks' expense. This tension between Banks and the depositor-members concerning existing or potential claims indicates that there is substantial economic antagonism between Banks and the depositor-members."[24]

Similarly, in *Recchion v. Kirby,* 637 F. Supp. 1309 (W.D. Pa. 1986), the court analyzed the *Vanderbilt* factors in determining that the plaintiff was an inadequate representative. In *Recchion*, the plaintiff, a shareholder and ex-employee of Westinghouse Electric Corp., brought suit on behalf of the company against certain past and present officers and directors of Westinghouse and its subsidiaries. At the time of the derivative action, the plaintiff also had a pending wrongful-discharge action against Westinghouse.

"While a plaintiff is not disqualified from bringing suit merely because some of his interests extend beyond those of the class, the court may take into account other litigation between the parties, especially where the plaintiff has initiated the suits, that render it likely that the representative plaintiff may disregard the interests of other class members."[25]

"Courts have recognized that the representative plaintiff might use the derivative action as leverage to obtain a favorable settlement in other actions brought against the corporation. This is especially true when the representative's stake 'paled' in comparison with his outside interests, and his interests in the derivative claim is 'infinitesimally small.'"[26] In light of the plaintiff's other action against Westinghouse and considering certain other *Vanderbilt* factors, the court concluded that the plaintiff was not a fair and adequate representative and dismissed the complaint.

Also, in *Salovaara v. Jackson National Life Insurance Co.,* 66 F. Supp. 2d 593 (D.N.J. 1999), the court found that the plaintiff could not serve as an adequate representative under Rule 23.1 because the plaintiff's interests in the numerous other suits indicated antagonism toward the company. In *Salovaara* the plaintiff and a director defendant entirely and evenly owned the corporation on whose behalf the derivative suit was brought. The plaintiff filed five separate suits, all related to the same events, against his co-owner and certain other officers and third parties. While the court did not expressly discuss the eight factors in *Vanderbilt*, it found that the plaintiff's interests were antagonistic on the basis of the other suits and dismissed the derivative action.[27]

Conclusion

The inadequate-representative defense is an effective tool that counsel should not overlook in moving to dismiss a derivative complaint. Establishing this defense is not difficult in the 2nd Circuit, particularly where the plaintiff also has filed direct claims against the named defendants in the derivative action or the corporation it purportedly seeks to represent. While the inadequate-representative defense is not as popular as the traditional "demand futility" defense, the use of this defense is likely to increase considering the recent rise in opt-out suits among the plaintiffs' securities bar.[28]

It is recommended that, at the outset of the derivative suit, defense counsel research the litigation activity between the shareholder representative and the corporation and defendant officers and directors and determine whether an inadequate representative defense exists.

Notes

[1] Shareholder derivative litigation is a unique form of litigation subject to special pleading and standing rules. Unlike a claim a

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plaintiff brings on his or her own behalf, shareholder derivative claims belong to the corporation, and not to the individual shareholder who has commenced the action. Thus, the corporation, not the shareholder commencing the action, is the real plaintiff. *Ross v. Bernhard,* 396 U.S. 531, 534 (1970). As a result, the shareholder is required to make a demand on the corporation's board of directors before he or she is permitted to commence litigation on the corporation's behalf. The requirement of a pre-suit demand ensures that the directors, as managers of the corporation, will have the opportunity to address the claims asserted on the corporation's behalf. Failure to make this demand precludes the shareholder from bringing a derivative action unless the shareholder can plead particularized facts satisfying the exacting standards under applicable state law that demand is excused. *Kamen v. Kemper Fin. Servs.,* 500 U.S. 90 (1991); *Kanter v. Barella,* 388 F. Supp. 2d 474, 477-78 (D.N.J. 2005). To this end, a court will apply the law of the state of incorporation in deciding the demand issue. *See, e.g., Kanter,* 388 F. Supp. 2d at 478.

[2] An important advantage in regard to the inadequate-representative defense is that the court may consider facts outside the complaint in analyzing the merits of this defense. *See Banks v. Whyte,* No. CIV. A. 94-CV-0711, 1994 WL 418997, at *2 (E.D. Pa. Aug. 9, 1994). On a traditional motion to dismiss, the court can only consider the complaint, certain public filings and documents referenced in or integral to the complaint. *See e.g., Yung v. Lee,* 432 F.3d 142, 146 (2d Cir. 2005); *In re Burlington Coat Factory Sec. Litig.,* 114 F.3d 1410, 1426 (3d Cir. 1997).

[3] Fed. R. Civ. P. 23.1. Unlike a class action under Rule 23, in which the burden of proving adequacy is generally on the plaintiff, the defendant in a shareholder derivative action has the burden of demonstrating that the plaintiff is an inadequate representative. *Compare Lewis v. Curtis,* 671 F.2d 779, 788 (3d Cir. 1982) (finding that the burden of showing inadequacy under Rule 23.1 is on the defendants), *cert. denied,* 459 U.S. 880 (1982), with *Weisman v. MCA Inc.,* 45 F.R.D. 258, 262 (D. Del. 1968) (finding that the burden of showing adequacy under Rule 23 is on the plaintiffs).

[4] Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549 (1949).

[5] *Wall Street Sys. Inc. v. Lemence,* No. 04 Civ. 5299(JSR), 2005 WL 292744 at *3 (S.D.N.Y. Feb. 8, 2005).

[6] *Id.*

[7] *Ryan v. Aetna Life Ins. Co.,* 765 F. Supp. 133, 135 (S.D.N.Y. 1991).

[8] *Id.* at 135-36. *See also St. Clair Shores Gen. Employees Ret. Sys. v. Eibeler,* No. 06 Civ. 688(SWK), 2006 WL 2849783, at *7 (S.D.N.Y. Oct. 4, 2006) ("Courts in this circuit have long found that plaintiffs attempting to advance derivative and direct claims in the same action face an impermissible conflict of interest."); *Diana v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 75 Civ. 6194, 1977 WL 1046, at *3 (S.D.N.Y. October 5, 1977) (denying plaintiff's motion to amend their derivative complaint to include class-action claim because "[a] plaintiff cannot bring a class action against a corporation and at the same time bring a derivative action on behalf of that corporation").

[9] Rule 23(a)(4) requires that plaintiffs may only be class representatives if "the representative parties will fairly and adequately protect the interests of the class." Fed. R. Civ. P. 23(a)(4).

[10] *Brickman v. Tyco Toys Inc.,* 731 F. Supp. 101, 108-09 (S.D.N.Y. 1990).

[11] *Id.* at 109.

[12] *Id. See also Koenig v. Benson,* 117 F.R.D. 330, 334-35 (E.D.N.Y. 1987) (holding that a plaintiff was not an adequate class representative because the plaintiff brought a separate derivative suit in addition to the class action and thereby created an "inherent conflict"); *Kamerman v. Steinberg,* 113 F.R.D. 511, 516 (S.D.N.Y. 1986) (the court denied class certification and found that the plaintiff's "mere assertion is insufficient to dispel the doubt that recovery in the class action may reduce potential recovery in the derivative action"); *Hawk Indus. Inc. v. Bausch & Lomb Inc.,* 59 F.R.D. 619, 623-24 (S.D.N.Y. 1973) (ruling that plaintiffs' co-counsel in securities class action may not represent the plaintiff class due to a conflict arising from counsel's representation of plaintiffs in a pending derivative suit); *but see Grace v. Rosenstock,* No. CV-85-2039, 1986 WL 2709 (E.D.N.Y. 1986) (finding that plaintiffs were adequate class representatives despite the existence of simultaneous derivative and individual claims because any antagonism is "no more than a 'surface duality'") (citations omitted); *Kane Assocs. v. Clifford,* 80 F.R.D. 402, 407-08 (E.D.N.Y. 1978) (granting class certification where the court determined no conflict from simultaneous derivative and class actions existed because the assets of the corporation had been sold and the value distributed to shareholder in a liquidating dividend).

[13] *Ruggiero v. Am. Bioculture Inc.,* 56 F.R.D. 93, 95 (S.D.N.Y. 1972).

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.* at 96. Interestingly, in *Stull v. Baker,* 410 F. Supp. 1326, 1336-37 (S.D.N.Y. 1976), in approving the settlement of related actions, the court stated, "it is difficult to understand how an attorney can properly represent the interests of a corporation and its present shareholders in a derivative action brought on their behalf, and, at one and the same time, properly represent its present and/or former shareholders in a class action against the corporation, without compromising his independence of professional judgment and loyalty to these two groups of clients with potentially conflicting interests."

[18] *Miller v. Fisco Inc.,* 63 F.R.D. 132, 134 (E.D. Pa. 1974).

[19] *Id.*

[20] *Id.*

[21] *Id.* In *Mayer v. Development Corporation of America,* 396 F. Supp. 917, 931 (D. Del. 1975), the court rejected a per se rule: "[T]his type of conflict presents itself anytime a shareholder institutes derivative as well as individual claims against a corporation; the court is ill-disposed to foreclose the possibility of a derivative action whenever a plaintiff shareholder also has individual claims against a corporate defendant."

[22] *Lewis v. Curtis,* 671 F.2d at 788.

[23] *Vanderbilt v. Geo-Energy Ltd.,* 725 F.2d 204, 207 (3d Cir. 1983) (quoting *Davis v. Comed Inc.,* 619 F.2d 588, 593-94 [6th Cir. 1980]). The *Vanderbilt* court itself did not discuss each factor and only stated that the lower court abused its discretion in failing to make the requisite findings of fact that would support a holding of antagonism such that plaintiff was an inadequate class representative. On remand, in *Vanderbilt v. Geo-Energy Ltd.,* 590 F. Supp. 999 (E.D. Pa. 1984), the court found that plaintiff was an adequate representative under Rule 23.1.

[24] *Banks v. Whyte,* 1994 WL 418997. The *Banks* court also compared the $150 stake that the plaintiff had in Vanguard at the time of derivative suit and the $100,000 of claims made by the plaintiff in his direct suits and found that the relative magnitude of the plaintiff's personal interests was significantly greater than his interest in the derivative litigation. *Id.* *5. After considering the contentiousness of the litigation and a statement by the plaintiff's counsel regarding the "enormous hostility" between the parties, the court found that "vindictiveness" was a motivating factor in

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the plaintiff's conduct. *Id.* In this regard, the court found that "[i]mplicit" in the plaintiff's request for the removal of the defendants from control of the company was the desire of the plaintiff, as a former executive of the company, to resume control of the company." *Id.* at *6. The court also noted that there was no evidence of any support for the plaintiff from the other depositor-members. *Id.* Finally, the court found that there was "no question that [plaintiff] is completely familiar with this litigation and is the driving force behind it." *Id.*

[25] *Recchion v. Kirby,* 637 F. Supp. 1309 (W.D. Pa. 1986).

[26] *Id.* at 1315 (internal citations omitted).

[27] *Salovaara v. Jackson Nat'l Life Ins. Co.,* 66 F. Supp. 2d 593, 603 (D.N.J. 1999).

[28] Lorraine Woellert, *Fractured Class Actions,* Bus. Week, Feb. 27, 2006.

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