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Appealability of District Court Orders Disapproving Proposed Settlements in Shareholder Derivative Suits

Harold N. Falls, Jr.

RECENT DEVELOPMENTS

Appealability of District Court Orders Disapproving Proposed Settlements in Shareholder Derivative Suits

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I. INTRODUCTION

Shareholder derivative suits in federal court may be settled only with the express approval of the district judge hearing the case.[1] If the settlement is not approved, litigants may proceed to trial or attempt to appeal the disapproval order. Until recently, only one court had considered the issue of the appealability of disapproval orders, holding that they fell within the "collateral order" exception[2] to the final decision limitation[3] on appellate court jurisdiction and thus could be considered on appeal prior to trial.[4] A Second Circuit panel, however, recently rejected the applicability of the collateral order exception to a district court's refusal to approve a shareholder derivative suit settlement and held such an

1. FED. R. CIV. P. 23.1.

2. *See* text accompanying note 7 *infra.*

3. Under 28 U.S.C. § 1291 (1976), federal appellate courts may entertain appeals only from "final decisions." *See* text accompanying notes 11-12 *infra.* A number of judicial and statutory exceptions, including the collateral order doctrine, have prevented inflexible application of the final judgment rule. *See* note 18 *infra.*

4. Norman v. McKee, 431 F.2d 769 (9th Cir. 1970), *cert. denied,* 401 U.S. 912 (1971). One other circuit court, however, has considered the merits of a disapproval order without addressing the appealability question. *In re* Int'l House of Pancakes Franchise Litigation, 487 F.2d 303 (8th Cir. 1973).

order nonappealable under 28 U.S.C. section 1291.[5]

Although the final judgment rule has been a principal tenet of the federal judicial system since its inception, application of the rule has not been free from difficulty.[6] Similarly, the collateral order exception has been applied inconsistently. The collateral order doctrine generally states that some orders, although not terminating the litigation, are sufficiently separable from the merits of the action and sufficiently dispositive of independent rights, that review should not be deferred until final adjudication of the entire case.[7] Courts and commentators have reached varied conclusions on the doctrine's proper scope, asserting alternatively that it should be interpreted narrowly,[8] or that it should be construed liberally to facilitate a pragmatic balancing approach to appealability questions.[9] In a series of recent decisions dealing with this doctrine, the Supreme Court has indicated a preference for the narrow interpretation.[10] Although these decisions have not expressly purported to reformulate the collateral order test, the Court's language clearly evidences a retrenchment from earlier decisions espousing a pragmatic approach.

This Recent Development will trace briefly the history of the collateral order doctrine, focusing on recent treatment by the Supreme Court. After an examination of the elements of a district court's decision to approve or disapprove a derivative suit settlement, the Recent Development will analyze the conflicting results reached by the United States Court of Appeals for the Second and Ninth Circuits in light of the Supreme Court's apparent retrenchment. Although finding that the Second Circuit's decision to reject appealability is most consistent with recent Supreme Court pronouncements, this Recent Development submits that the Supreme Court has adopted an overly restrictive standard that precludes evaluation of vital policy considerations. Finally, the Recent Development concludes that the Second Circuit's decision also represents the best accommodation of competing policy concerns.

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5. Seigal v. Merrick, Nos. 77-7566, 75-7576 (2d Cir. Dec. 14, 1978).

6. Redish, *The Pragmatic Approach To Appealability in the Federal Courts*, 75 COLUM. L. REV. 89, 90 (1975). The finality requirement was imposed originally in § 22 of the Judiciary Act of 1789. 1 Stat. 73, 84. Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176, 178-79 (1955). For a discussion of the rule's historical development, see Crick, *The Final Judgment as a Basis for Appeal*, 41 YALE L.J. 539, 541-51 (1932).

7. *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949).

8. *See, e.g.*, Weight Watchers of Philadelphia, Inc. v. Weight Watchers Int'l, Inc., 455 F.2d 770, 773 (2d Cir. 1972).

9. Gillespie v. United States Steel Corp., 379 U.S. 148 (1964); Dickinson v. Petroleum Conversion Corp., 338 U.S. 507 (1950); Redish, *supra* note 6.

10. *See* notes 35-51 *infra* and accompanying text.

II. THE FINAL ORDER RULE AND THE COLLATERAL ORDER EXCEPTION

The finality rule in the federal system is presently codified in 28 U.S.C. section 1291, which states in relevant part that "the courts of appeals shall have jurisdiction of appeals from all final decisions of the district courts of the United States . . . ."[11] A "final" decision has been defined traditionally as one that ends the litigation on the merits and leaves the court with no further task except execution of the judgment.[12] The primary purposes of the final judgment rule include the avoidance of delay that would result from piecemeal review, and the promotion of judicial efficiency.[13] In addition, the rule seeks to promote better informed decisions on the part of appellate judges[14] and to maintain the appropriate relationship between trial and appellate courts by preventing the latter from usurping the fact-finding function.[15] Finally, the rule may serve to reduce the number of issues to be considered on appeal because many potentially appealable rulings are corrected during the trial or are mooted by the outcome.[16] Despite these beneficial objectives, the rule has not been applied uniformly, perhaps in recognition of the potential hardship that inflexible application would produce.[17] Although various statutory and judicial exceptions have modified the finality concept to allow certain interlocutory appeals, only the collateral order doctrine is potentially applicable to a district court order refusing to approve a shareholder derivative suit settlement.[18]

The collateral order doctrine was first enunciated in *Cohen v.*

11. 28 U.S.C. § 1291 (1976). A similar requirement exists for Supreme Court jurisdiction over state court cases. 28 U.S.C. § 1257 (1976). Although some commentators have argued that the scope of these two statutes should differ, *e.g.*, Boskey, *Finality of State Court Judgments Under the Federal Judicial Code*, 43 COLUM. L. REV. 1002 (1943), treatment by federal courts appears to be largely equivalent. *See* Frank, *Requiem For the Final Judgment Rule*, 45 TEX. L. REV. 292, 295 (1966); 73 YALE L.J. 515 (1964).

12. Catlin v. United States, 324 U.S. 229, 233 (1945); St. Louis, I.M. & S.R.R. v. Southern Express Co., 108 U.S. 24, 28 (1883).

13. Catlin v. United States, 324 U.S. 229, 233-34 (1945); Cobbledick v. United States, 309 U.S. 323, 324-25 (1940).

14. McLish v. Roff, 141 U.S. 661, 665-66 (1891).

15. Coopers & Lybrand v. Livesay, 98 S.Ct. 2454, 2462 (1978); Parkinson v. April Indus., Inc., 520 F.2d 650, 654 (2d Cir. 1975).

16. Comment, *The Appealability of Orders Denying Motions for Disqualification of Counsel in the Federal Courts*, 45 U. CHI. L. REV. 450 (1978).

17. *See* Redish, *supra* note 6, at 90-91.

18. The most significant statutory exception to the finality requirement is 28 U.S.C. § 1292(b), which allows appeal from an order in a civil action upon certification by the district court that the order "involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation." Following such certification, the court

Beneficial Industrial Loan Corp.,[19] which considered a stockholder derivative suit brought in federal court on diversity grounds. Defendants in *Cohen* attempted to invoke a state statute requiring a plaintiff to post a security bond to reimburse defendants for reasonable expenses if the latter prevailed at trial. The district court held the state law inapplicable in federal court and defendant appealed. In ruling that 28 U.S.C. section 1291 did not bar appeal despite the absence of a final judgment, the Supreme Court noted initially that the district court's decision on the security issue was final and would not be reopened.[20] Furthermore, the Court stated that the order did not make any step toward final disposition and was not affected by the merits of the case. Thus the Court concluded that:

> This decision appears to fall in that small class which finally determine claims of right separable from, and collateral to, rights asserted in the action, too important to be denied review and too independent of the cause itself to require that appellate consideration be deferred until the whole case is adjudicated.[21]

The *Cohen* Court thus identified a number of factors contributing to the decision to allow appeal without indicating whether all or merely some had to be satisfied in a particular case. Subsequent

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of appeals has discretion to hear or reject the appeal. Although disapproval of a shareholder's derivative action compromise could conceivably raise a "controlling question of law," disapproval normally results from a factual determination that the proposed settlement is unfair. *See* notes 52-58 *infra* and accompanying text. Other statutory exemptions to the finality requirement include the mandamus power of appellate review provided for by the All Writs Act, 28 U.S.C. § 1651(a), and the provision in Rule 54(b) of the *Federal Rules of Civil Procedure* allowing appeal of orders that are final with respect to only certain parties or issues in multiple party litigation upon certificaton by the district judge. These provisions are inapplicable in the instant context.

In addition, 28 U.S.C. § 1292(a)(1) authorizes courts of appeal to review "[i]nterlocutory orders of the district courts . . . granting, continuing, modifying, refusing or dissolving injunctions, or refusing to dissolve or modify injunctions, except where a direct review may be had in the Supreme Court." Although an argument can be constructed that a district order disapproving a proposed settlement is in effect an injunction against compromise, federal courts generally have been unwilling to expand § 1292(a)(1) beyond the historic concept of an injunction. *See* 9 MOORE'S FEDERAL PRACTICE ¶ 110.20[1], at 232-38 (2d ed. 1975); *see, e.g.*, Gardner v. Westinghouse Broadcasting Co., 98 S.Ct. 2451 (1978) (denial of class certification may not be appealed under 28 U.S.C. § 1292(a)(1) as an order refusing an injunction). Significantly, the applicability of this section was apparently not argued in either of the circuit court cases considering the appealability of an order disapproving compromise.

Also inapplicable in the present inquiry are two additional judicially developed exceptions to the finality requirement: the doctrine enunciated in Forgay v. Conrad, 47 U.S. (6 How.) 201 (1848), which provides for immediate appeal of cases in which the substantive issues have been decided and to delay appeal would render it valueless; and the so-called "death knell" doctrine, which the Supreme Court recently invalidated in Coopers & Lybrand v. Livesay, 98 S.Ct. 2454 (1978). *See* notes 41-51 *infra* and accompanying text.

19. 337 U.S. 541 (1949).

20. *Id.* at 546.

21. *Id.*

decisions suggested that the *Cohen* test would not be applied rigorously. In *Swift & Co. v. Compania Colombiana*[22] the Court allowed appeal of an order somewhat similar to that in *Cohen,* employing language that suggested a more relaxed test. Plaintiff in *Compania Colombiana* brought a libel in personam in federal district court charging negligent nondelivery of a sea cargo by a foreign steamship company. Plaintiff also attached a vessel allegedly owned by defendants. The district court dissolved the attachment pending trial, holding that plaintiff had failed to establish that defendants owned the ship.[23] The Supreme Court held appeal of the order proper, stating that review at a later date might be an "empty rite" and that the claim was *"fairly severable* from the context of a larger litigious process."[24]

In *Mercantile National Bank v. Langdeau*[25] the Court indicated that the appealability problem might be affected by considerations of fairness to appellants. *Mercantile Bank* confronted the issue whether a federal or state venue statute controlled in a fraud action brought by an insurance company against two national banks in Texas state court. The Texas Supreme Court had denied defendants' motion for change of venue, holding that the state statute controlled. Before reaching the merits, the United States Supreme Court addressed appellee's argument that the trial court's venue ruling was not a final order and thus was nonappealable. In rejecting this argument, the Court first noted that the venue question was a separate and independent matter anterior to the merits and not enmeshed in the factual and legal issues comprising plaintiff's cause of action.[26] In addition, the Court asserted that the policy underlying the requirement of finality[27] was better served by presently determining the venue question rather than by subjecting the parties to long and complex litigation that might be rendered useless by a subsequent venue ruling on appeal.[28]

The Court temporarily abandoned the requirement that nonfinal orders must at least be "collateral" in *Gillespie v. United States Steel Corp.,*[29] stating that the requirement of finality is to be

22. 339 U.S. 684 (1950).

23. *Id.* at 689.

24. *Id.* (emphasis added).

25. 371 U.S. 555 (1963).

26. *Id.* at 558.

27. Because *Mercantile Bank* considered an appeal from a state court, the finality requirement imposed by 28 U.S.C. § 1257, rather than that in § 1291, was in issue. *See* note 11 *supra.*

28. 371 U.S. at 558.

29. 379 U.S. 148 (1964).

given a practical rather than a technical construction.[30] The *Gillespie* Court asserted that the finality issue is frequently so close that application of a rigid test is unworkable.[31] Thus the Court held that such questions should be resolved by an evaluation of the competing considerations: the inconvenience and costs of piecemeal review versus the danger of denying justice by delay.[32] In addition to finding the latter consideration compelling in *Gillespie,* the Court characterized the question on appeal as "fundamental to the further conduct of the case."[33] The pragmatic approach to finality articulated in *Gillespie* was reiterated by the Court in *Eisen v. Carlisle & Jacquelin.*[34]

In a series of recent opinions, the Burger Court has suggested that the increasingly liberal approach to finality and to the *Cohen* doctrine is at an end. The first of these decisions, *Abney v. United States,*[35] considered the appealability of a district court order denying a criminal[36] defendant's motion to dismiss his indictment on double jeopardy grounds. Although ultimately finding the order

30. In *Gillespie* an administratrix brought an action in federal court against a shipowner seeking recovery for the death of her son, an employee of the shipowner. Plaintiff, alleging that the shipowner's negligence was the cause of death, claimed the right to recover for herself and decedent's brother and sisters under the Jones Act, which subjected employers to liability for negligently causing injury or death to seamen. In addition, plaintiff sought recovery under an Ohio wrongful death statute. The district court held that the Jones Act was the exclusive remedy and also that plaintiff could not recover on behalf of her other children. The circuit court examined the merits without reaching the question of appealability. Applying a pragmatic balancing approach, the Supreme Court upheld the appealability of the trial court ruling, despite characterizing the appealability of the order as "marginal." *Id.* at 152-54. Thus, although the order appealed from primarily raised questions of law, it was clearly enmeshed in the merits of the case. The approach taken in *Gillespie,* however, has recently met with Supreme Court disapproval. *See* text accompanying notes 45-46 *infra.*

31. 379 U.S. at 152.

32. *Id.* at 153.

33. *Id.* at 154. The *Gillespie* Court did not elaborate on the specific role of this concept. Although subsequent decisions have not relied on the notion of "fundamental" importance, an evaluation of the importance of the issue appealed plays an inevitable role in appealability cases.

34. 417 U.S. 156 (1974) (allowing appeal of a district court order requiring defendant in a class action to bear the cost of notifying class members).

35. 431 U.S. 651 (1977).

36. Numerous Supreme Court decisions have indicated that adherence to the rule of finality should be particularly stringent in criminal prosecutions because "the delays and disruptions attendant upon intermediate appeal are especially inimical to the effective and fair administration of the criminal law." DiBella v. United States, 369 U.S. 121, 126 (1962). *See also* Cobbledick v. United States, 309 U.S. 323, 324-26 (1940). Although this factor may have played a part in the decisions in *Abney* and *United States v. MacDonald,* discussed in notes 39-40 *infra* and accompanying text, the Court's discussions of the finality requirement expressly extended to civil cases. Moreover, the case most clearly reflecting theoretical retrenchment, *Coopers & Lybrand v. Livesay,* arose in the civil context. *See* notes 41-51 *infra* and accompanying text.

appealable,[37] the Court indicated a marked shift in its approach to the problem of appealability. Before examining the particular order before it, the Court stated that appealability questions must be considered in light of two principles: the absence of a constitutional right to appeal and the "firm congressional policy" against interlocutory or piecemeal review.[38] The following Term in *United States v. MacDonald*,[39] the Court again emphasized the disfavored status of interlocutory appeals and the importance of finality as a predicate to federal court jurisdiction in holding that a defendant, prior to trial, may not appeal an order denying his motion to dismiss on speedy trial grounds.[40]

The retrenchment from previous finality decisions was manifested clearly during the 1977 Term. In *Coopers & Lybrand v. Livesay*[41] the Court held that a district court determination that a suit may not be maintained as a class action is not appealable prior to trial. Justice Stevens, writing for the Court, began his analysis by reiterating the traditional rule that federal appellate jurisdiction generally depends on the existence of a decision that ends the litigation on the merits and leaves nothing for the court to do but execute the judgment on the merits.[42] Because an order denying class action status is not final in that sense, Justice Stevens noted that the order was appealable only if it fell within an appropriate exception to the final judgment rule. First considering the collateral order exception, Justice Stevens in effect reformulated the *Cohen* test, stating that all three strands of *Cohen* must be met to obtain appeal: "[T]he order must conclusively determine the disputed question, resolve an important issue *completely separate* from the merits of the action, *and* be effectively unreviewable on appeal from a final judgment."[43] Finding that an order denying class certification failed to satisfy the three-pronged test, the Court held *Cohen* inapplicable.[44]

37. The Court found the order collateral because it was completely separate from the principal issue of guilt and because post-trial review would be ineffective since the double jeopardy clause protects an individual not only against being subjected to double punishment, but also against being twice tried for the same offense. 431 U.S. at 657-62.

38. *Id.* at 656-57.

39. 435 U.S. 850 (1978).

40. The Court attempted to distinguish *MacDonald* from *Abney*, asserting that resolution of a speedy trial claim necessitates a careful assessment of the particular facts of the case, including the degree to which the defendant has been prejudiced, and thus should be considered only after the relevant facts are developed at trial. *Id.* at 1551.

41. 98 S.Ct. 2454 (1978).

42. *Id.* at 2457.

43. *Id.* at 2458 (emphasis added). Neither the conjunctivity of the test nor the "completely separate" language was present in *Cohen*.

44. *Id.* The Court's application of this test was cursory at best. *See* text accompanying note 51 *infra*.

The Court relegated to a footnote respondent's argument that *Gillespie* supported the appealability of a class designation order as a matter of right. Justice Stevens asserted that the *Gillespie* Court had upheld appeal of a "marginal" final order because the appeal presented a question of national significance and because the finality issue had not been raised until argument on the merits. Thus the policy of judicial economy served by the finality requirement would not have been achieved had *Gillespie* been remanded without a decision.[45] Justice Stevens therefore concluded that if *Gillespie* were extended beyond its own unique facts, the final order rule "would be stripped of all significance."[46] Although the precise import of this footnote is unclear, the Court's language strongly suggested disapproval of the balance-of-competing-factors approach employed in *Gillespie.*

In addition to its narrow interpretation of *Cohen* and *Gillespie, Livesay* invalidated another exception to the final judgment rule—the so-called "death knell" doctrine, under which an order that is likely to sound the "death knell" of the litigation is appealable.[47] Utilizing this judicial doctrine, a number of circuit courts had allowed appeals of class certification denials, reasoning that without the incentive of a possible group recovery, the plaintiff might find it economically uninviting to pursue the action to a final judgment and then seek appellate review of the adverse class determination.[48] Justice Stevens attacked the death knell doctrine on several grounds. He argued that because appealability would depend on the court's perception of the impact of denial in a particular case, results would be inconsistent and judicial resources would be expended unnecessarily in individualized scrutiny.[49] In addition, the Court asserted that allowing appeals from nonfinal orders that turn on the facts of a particular case "thrusts appellate courts indiscriminately into the trial process" and therefore disrupts the appropriate relationship between the respective courts.[50] Thus Justice Stevens concluded that the prospect that a plaintiff might abandon his

45. 98 S.Ct. at 2462 n.30.

46. *Id.*

47. *Id.* at 2458.

48. *E.g.*, Ott v. Speedwriting Publishing Co., 518 F.2d 1143 (6th Cir. 1975); Hartmann v. Scott, 488 F.2d 1215 (8th Cir. 1973).

49. 98 S.Ct. at 2459-60.

50. *Id.* at 2462. This assertion is questionable. The courts of appeals are in the business of reviewing district court orders "that turn on the facts of a particular case"; such is their appropriate relationship with trial courts. Certainly, allowing appeals from nonfinal orders interrupts the trial process. The policy arguably undermined by this interruption, however, is that of avoiding piecemeal litigation. The relationship between trial and appellate courts remains the same regardless of the time of appeal.

claim before final judgment provided an insufficient reason for considering an order final within the meaning of 28 U.S.C. section 1291.

Although the *Livesay* Court's invalidation of the death knell doctrine in theory has no direct effect on the collateral order doctrine, it demonstrates the pervasiveness of the Court's restrictive approach toward appealability. The Court's cursory modification and application of the collateral order test are of even more importance because of their direct impact on the derivative suit settlement question. In support of the conclusion that an order denying class certification is not "collateral," the Court simply asserted that such an order is subject to revision in the district court, requires consideration of factors enmeshed in the legal issue comprising plaintiff's cause of action, and may be effectively reviewed after final judgment.[51] These arguments, conclusory at best, are questionable. First, although a district court may have discretionary authority to revise the denial of certification, reconsideration by the trial judge after trial has begun would appear sufficiently unlikely to provide a reasonable basis for denying appeal. Second, "enmeshment" with the merits of the case is tenuous. To make the certification determination, a district court need consider only the relationship of the claims of the prospective class members to each other. Evaluation of the merits of any of those claims against the defendant is unnecessary. Last, review following trial cannot be characterized as "effective" if the order in fact results in the abandonment of the claim. Thus the Court's treatment of *Cohen,* combined with its disapproval of the *Gillespie* approach, indicates that future application of the collateral order doctrine will be carefully limited to orders completely satisfying all elements of the reformulated test.

III. District Court Evaluation of a Proposed Shareholder Derivative Suit Settlement

Once the opposing parties in a federal derivative suit negotiate a compromise, the settlement must be submitted for court approval as required by Rule 23.1. The district court sets a hearing date and orders that all shareholders be notified. At the hearing all interested parties may offer evidence in support of or in opposition to the proposed settlement. Approval, which rests in the discretion of the court, generally is granted if the settlement is in the interest of the class or corporation represented by plaintiffs.[52] A compromise must

51. *Id.* at 2458.

52. *See* Haudek, *The Settlement and Dismissal of Stockholders' Actions,* 23 Sw. L.J. 765, 792 (1969).

serve that interest in order to be deemed fair and reasonable.[53]

In evaluating a settlement's "fairness," the district court's primary task is to weigh the benefits of the compromise against the likelihood of recovery.[54] Clearly, the adequacy of a particular settlement depends not only upon the damage suffered by the class or the corporation, but also upon the probability of success at trial. Thus, in addition to considering the fairness of an amount and the equity of its proposed distribution, a court must attempt to appraise the factors that will affect the ultimate outcome, including the presence of serious questions of law and the extent to which the case turns on disputed issues of fact.[55] To evaluate these factors effectively, a court must go beyond the arguments of counsel and scrutinize available evidence.[56] This necessity places the court in a delicate position because the central purpose of compromise is to avoid the expenses and delay of trial. The court is concerned only with the likelihood of success and should avoid any actual determination of the merits.[57] Thus the court should receive only enough proof to evaluate the litigation's probable outcome, not enough to decide it.[58]

If the court rejects a settlement as unreasonably low or otherwise unfair, the parties are free to renegotiate.[59] Any subsequent proposal, however, must be submitted to the court for consideration at a new hearing. Alternatively, the parties may attempt to appeal the court's disapproval order. Because such an order does not terminate the action, however, parties seeking appellate review must rely on the collateral order doctrine to avoid the traditional finality requirement.[60]

53. Ashbach v. Kirtley, 289 F.2d 159, 163 (8th Cir. 1961); Masterson v. Pergament, 203 F.2d 315, 330 (6th Cir.), *cert. denied,* 346 U.S. 832 (1953); Schreiber v. Jacobs, 128 F. Supp. 44, 50 (E.D. Mich. 1955).

54. Protective Comm. for Independant Stockholders v. Anderson, 390 U.S. 414, 424-25 (1968); Florida Trailer & Equip. Co. v. Deal, 284 F.2d 567, 571-73 (5th Cir. 1960); Masterson v. Pergament, 203 F.2d 315, 330 (6th Cir.), *cert. denied,* 346 U.S. 832 (1953).

55. *See* Haudek, *supra* note 52, at 794.

56. *Id.* at 794-95. Haudek notes that the inadequacy or lack of evidence is perhaps the most frequent ground for the judicial rejection of a settlement.

57. Florida Trailer & Equip. Co. v. Deal, 284 F.2d 567, 571 (5th Cir. 1960); *In re* Prudence Co., 98 F.2d 559, 560 (2d Cir. 1938); Schleiff v. Chesapeake & O. Ry., 43 F.R.D. 175, 178 (S.D.N.Y. 1967).

58. Glicken v. Bradford, 35 F.R.D. 144, 148 (S.D.N.Y. 1964); Schrieber v. Jacobs, 128 F. Supp. 44, 50 (E.D. Mich. 1955).

59. Upson v. Otis, 155 F.2d 606, 614 (2d Cir. 1946); Berger v. Dyson, 111 F. Supp. 533, 534 (D.R.I. 1953).

60. As noted previously, the collateral order doctrine is the only exception arguably applicable to such an appeal. *See* note 18 *supra.*

IV. Disapproval of Settlement as a Collateral Order

A. *Appeal Allowed:* Norman v. McKee

The first case to consider the appealability of an order denying approval of a proposed shareholder derivative suit settlement was *Norman v. McKee.*[61] Considering the question prior to recent Supreme Court developments, the Ninth Circuit noted the pragmatic approach employed in finality cases, citing both *Cohen* and *Gillespie.* The court first applied the *Cohen* test, finding the disapproval order "collateral" because it was independent of the merits, was not a step toward final disposition or an "ingredient of the cause of action," and represented a final resolution of the question whether the proposed settlement should be given judicial approval.[62]

Although finding *Cohen* satisfied, the *McKee* court nevertheless addressed the *Gillespie* balance between "the inconvenience and costs of piecemeal review on the one hand and the danger of denying justice on the other."[63] In view of the complex and lengthy nature of derivative suits, the court found the danger of piecemeal review to be of diminished importance.[64] The court also noted the duty incumbent upon plaintiffs to represent the class fairly, asserting that the right of unnamed plaintiffs to fair representation might be infringed by an erroneous disapproval of a settlement. To such parties, the court continued, the disapproval of a settlement would only delay justice.[65] Concluding that the inconvenience of piecemeal review was outweighed by the danger of denying justice due to delay, the court held the order appealable.

B. *Appeal Denied:* Seigal v. Merrick

The Second Circuit panel in *Seigal v. Merrick*[66] recently reached a contrary resolution of the identical question decided in *McKee.* The court, citing *Livesay,* initially asserted that *Cohen* had "spawned a host of legitimate and illegitimate progeny" and should be read narrowly to prevent the exception from undermining the benefits of the final judgment rule.[67] Quoting the Supreme Court's language, the court reasserted that allowing appeals of right from

61. 431 F.2d 769 (9th Cir. 1970).
62. *Id.* at 773.
63. *Id.* at 774.
64. *Id.*
65. *Id.* This strand of the court's analysis is unsound. *See* text accompanying note 83 *infra.*
66. 590 F.2d 35 (2d Cir. 1978).
67. *Id.* at 37.

nonfinal orders that turn on the facts of a particular case thrusts appellate courts indiscriminately into the trial process and disrupts the proper relationship between trial and appellate courts.[68]

The court next focused upon the decision to approve or disapprove a settlement, a determination which it characterized as an amalgam of fact and law. The court stated that a disapproval order failed to satisfy the requirement that an order, to be appealable, must conclusively determine the disputed question, arguing that disapproval is based partially on an assessment of the merits and permits the parties to proceed with the litigation or to propose a different settlement.[69] In addition, the court stated that the settlement process is not a deviation from the main path of litigation, but is rather "a step on that path directly leading to final judgment."[70] Noting that an approval of a compromise becomes a final judgment, the court suggested that a disapproval of a compromise that would have resulted in a final judgment had it been approved did not differ from a denial of summary judgment or the grant of a new trial, neither of which is appealable.[71]

The *Seigal* court also rejected appellant's argument that the district court judge had abused her discretion in failing to evaluate plaintiff's likelihood of success at trial.[72] Suggesting that the trial judge might evaluate the appropriate factors on remand and nevertheless reach an identical result, the court concluded that a remand order would be pointless. In addition, the court noted that if the present appeal were allowed and the trial court's disapproval affirmed, the appellate court might be required to entertain appeals from subsequent orders disapproving modified settlement proposals in the same case.

Finally, the *Seigal* court acknowledged the contrary result reached in *McKee.* Addressing the balancing approach employed by the Ninth Circuit, the Second Circuit again asserted that the denial of justice argument would inevitably undermine the finality rule.[73] In addition, the court expressed the belief that, since the decision in *McKee,* a "contrary trend" manifested by the decision in *Livesay* had been established in the Supreme Court's view of appealability.[74]

68. *Id.* at 38.
69. *Id.* at 37-38.
70. *Id.*
71. *Id.* at 38.
72. District Judge Motley apparently considered only the amount of the settlement. *Id.* at 38-39.
73. *Id.* at 39.
74. *Id.*

C. *Proper Analysis of the Appealability Question in* Seigal *and* McKee

The *McKee* court viewed the disapproval order as a final resolution of the question whether the proposed settlement should be given judicial approval. The court held such an order collateral, arguing that it is independent of the merits and does not constitute a step toward final disposition of the case. Conversely, the *Seigal* court asserted that disapproval of a compromise does not conclusively resolve the disputed question, but is a step on the path to final judgment, analogizing to a denial of summary judgment. In addition, the court noted that disapproval is based partially on an assessment of the merits of the case. Although these conflicting results can be partially explained by the more restrictive view of finality taken by the Second Circuit panel, the primary source of divergence lies in confusion over the precise question confronted by a district court in deciding whether to approve or disapprove a proposed compromise in a shareholder derivative suit.

The *McKee* court's conclusion that a decision to disapprove compromise is independent of the merits is not entirely accurate. In considering a proposed settlement, a district court must evaluate the likelihood of plaintiffs' success at trial. Of course, the court does not attempt any resolution of the merits at this stage. Thus the assertion in *Seigal* that the order constituted a step on the path to final judgment is erroneous; the decision to approve or disapprove has no effect on the court's final judgment if the case proceeds to trial.[75] Nevertheless, the merits of the case play an important part in the decision to approve or disapprove a compromise.

Yet the decision to approve or disapprove a settlement, which determines the fairness of a proposed compromise, is in a real sense separate from the decision after trial on the merits, which determines the amount of plaintiffs' damages, if any, and orders appropriate compensation. Resolution of the question whether a settlement is "fair" is based upon only an incomplete and summary evaluation of the merits and does not purport to ascertain damages or causation with any degree of preciseness. The fact that courts approve the large majority of proposed settlements[76] indicates that

75. Of course, if the judge is the finder of fact in the subsequent trial, his ultimate decision will be based on the evidence introduced at trial, some of which may have been presented at the settlement proposal hearing. This simply indicates, however, that similar considerations affect both the disapproval order and final judgment, not that the order itself has any effect on final judgment. A disapproval order constitutes a "step" toward final resolution only in the sense that the former precedes the latter.

76. Haudek, *supra* note 52, at 793.

they require only that a compromise approximately reflect the probable outcome at trial. More importantly, in determining whether to approve, the court is concerned only that the settlement is fair to the shareholders. The purpose of the approval requirement is to protect those shareholders who have an interest in the action but who have no control over the course of the litigation.[77] A court is not concerned with protecting defendants' interests and would approve a compromise even if initial evaluation of the merits suggested an eventual recovery lower than that proposed in the settlement. Thus the *Seigal* court's assertion that a disapproval order does not conclusively determine the disputed question is erroneous.

It should be noted that the fact that the decision to approve or disapprove a compromise determines whether the parties will be forced to bear the burden of further litigation has no effect whatsoever on the question whether a disapproval order answers a question separate from the determination of the merits. As noted by the *Seigal* court, a ruling on a motion for summary judgment, which does address the merits, also determines whether trial is necessary. The difference, however, is that these two court orders decide whether trial is required by answering different questions: a summary judgment ruling potentially *decides* the merits, while a settlement order merely *considers* the merits in resolving a separate issue. Thus the *Seigal* court's analogy is unhelpful.

Despite the conclusiveness of a disapproval order and its unreviewability following trial,[78] the foregoing discussion indicates that such an order fails to satisfy one element of the rigid *Livesay* standard—that the order resolve an issue *completely separate* from the merits of the action. Although a disapproval order decides a question somewhat different from that presented by the merits, a *consideration* of merits is a critical element of the settlement question. Thus the decision in *Seigal* was a correct application of the *Livesay* reformulation.

D. Livesay *Reconsidered*

As construed in *Livesay,* the collateral order exception will not apply to a court order that requires any consideration of the merits of the case. Despite the virtue of certainty, the test is simply too strict. Some nonfinal decisions that hinge partially on the merits of the case have so substantial and immediate an impact upon the

77. *See* 590 F.2d at 37-38; Haudek, *supra* note 52, at 792-93.

78. After a full trial determining the extent of defendant's liability, the fairness of a pretrial settlement proposal is clearly a moot issue.

parties to an action that interlocutory review must be allowed. For example, a request for a preliminary injunction requires a court to examine the merits to determine if plaintiff has a probability of success at trial.[79] Yet, such an injunction is, by statute, appealable prior to final judgment, reflecting congressional recognition of the potentially irreversible effect on the defendant's rights.[80] Similarly, the federal courts should not be bound by an appealability standard so rigid that they cannot respond equitably to the almost limitless range of potential court orders.

In its original articulation of the collateral order doctrine, the *Cohen* Court did not purport to create an inflexible test capable of mechanical application. The approach implicit in *Cohen* and more visible in subsequent cases was sufficiently pragmatic to permit an evaluation of relevant policy considerations, including the policies underlying the finality rule and, perhaps to a lesser extent, the impact on the parties. This approach is sound: if the application of a judicially created test does not allow consideration of underlying policies, application may become counterproductive. Thus the appealability question should be resolved by a consideration of "the inconvenience and costs of piecemeal review on the one hand and the danger of denying justice on the other,"[81] particularly when, as in the case of orders disapproving derivative suit settlements, the different components of the judicial standard yield conflicting results.

Interestingly, both the *McKee* and *Seigal* courts addressed the propriety of appeal from a policy standpoint, although the latter decision purported to follow the mechanical *Livesay* approach. The primary factors militating against pretrial review of a compromise disapproval are those policies underlying the final judgment rule itself. Unquestionably, the danger of wasting judicial resources through piecemeal review is acute in this context. As noted by the *Seigal* court, if appeal were allowed, the appellate court might be required to review a number of orders disapproving various attempts at compromise in a single case. Nevertheless, the *McKee* court found that the danger of piecemeal review was of diminished importance in light of the long and complex trial normally required in a shareholder's derivative suit. This argument, although not

79. W. A. Mack, Inc. v. General Motors Corp., 260 F.2d 886 (7th Cir. 1958); Henson v. Hoth, 258 F. Supp. 33 (D. Colo. 1966).

80. 28 U.S.C. § 1292(a)(1) (1976). For the history and policies behind this rule, see Stewart-Warner Corp. v. Westinghouse Elec. Corp., 325 F.2d 822, 829-30 (2d Cir. 1963) (Friendly, J., dissenting).

81. *See* notes 29-34 *supra* and accompanying text.

without merit, is ultimately unpersuasive. To review a disapproval order, an appellate court would be required to scrutinize all factors leading to the district court's decision, which itself required considerable factual scrutiny. Although this process would be less time consuming than a full-scale trial, the disapproval order, as a finding of fact, would be reversible only if clearly erroneous.[82] Thus the vast majority of disapprovals would be affirmed on appeal. This fact, combined with the possibility of multiple appeals from a single action, compels the conclusion that judicial economy would be best served by denying appeal.

The *McKee* court additionally asserted that disapproval of a settlement would delay justice for the unnamed plaintiffs, infringing upon their right to fair representation. This argument fails to recognize that if a settlement proposal is in fact unfair, its approval would hardly achieve justice. Certainly, denying interlocutory appeal may postpone resolution. The unnamed plaintiffs, however, do not bear the burden and expense of trial. Moreover, as noted above, the great majority of disapproval orders will not be reversible.

In summary, the excessive cost of interlocutory review of disapproval orders is not outweighed by the minimal danger of denying justice. This conclusion rests, however, on an assumption that a district court has evaluated the necessary factors in reaching its factual determination. This was not the case in *Seigal,* in which the trial court failed to consider the likelihood of success at trial. Thus the court's conclusion was not a pure finding of fact, but was defective as a matter of law: without an appraisal of the probability of success on the merits, the fairness of a settlement proposal cannot be adjudged. If no chance of success at trial exists, an order disapproving a compromise as unfair to the plaintiffs is clearly erroneous. Failure to consider this integral factor renders an order defective.[83] Stated alternatively, the district court judge abuses his discretion by failing to consider the factors necessary to properly evaluate the fairness issue. Thus appeal from an order disapproving compromise in a shareholder derivative suit should be allowed only when an appellant can demonstrate that the district court abused its discretion by failing to consider a settlement's fairness in relation to both

82. FED. R. CIV. P. 52(a).

83. The *Seigal* court argued that appeal under these circumstances was pointless because the district court might evaluate the proper factors on remand and nevertheless reach an identical result. This argument carries the policies behind finality to an untenable extreme. When the district court has not considered the probability of success at trial, the fairness of a proposed compromise has in effect not been evaluated, and disapproval has been improperly granted. Under such circumstances, the rights of all parties have been violated flagrantly and appeal is necessary.

the damages allegedly sustained and the likelihood of success at trial. If the order on its face purports to consider these factors, appeal should be denied, regardless of the decision's factual correctness.

V. CONCLUSION

Recent circuit court decisions have reached conflicting answers to the question whether a district court order disapproving a proposed compromise in a shareholder derivative action is appealable under the collateral order exception to the final judgment rule. Resolution of this issue is affected by recent Supreme Court decisions indicating a retrenchment from the pragmatic approach formerly taken toward the finality requirement and, in effect, reformulating the collateral order test. Rigid application of this new standard will foreclose evaluation of appropriate policy considerations and will overly restrict the ability of appellate courts to deal effectively with appealability questions. In holding that orders disapproving derivative suit settlements are not appealable, the Second Circuit panel in *Seigal v. Merrick* reached a result consistent with the Supreme Court's formulation of the collateral order test. More importantly, this result reflects the proper conclusion that, in such a case, the inconvenience and costs of piecemeal review outweigh the minimal danger of denying justice. This conclusion is valid, however, only when the basis of the district court decision was an evaluation of the factors necessary to determine the fairness of a settlement proposal. When the district court judge ignores the appropriate considerations, his decision to disapprove settlement is defective as a matter of law and appellate review is necessary.

HAROLD NAILL FALLS, JR.