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SECOND CIRCUIT REVIEW

Expert Analysis

Jurisdictional Effect of Plaintiff's Loss of Financial Interest in a Derivative Suit

By **Martin Flumenbaum** And **Brad S. Karp**

When a plaintiff loses her individual stake in litigation through a transaction or intervening event, should her case be dismissed as moot or may the court retain jurisdiction to consider plaintiff substitution under Rule 17(a)(3) to avoid dismissal? As it turns out, the answer is "*it depends*." The Supreme Court recently held that the flexible mootness inquiry that would allow for substitution in the class action context is unavailable for collective actions under the Fair Labor Standards Act and for criminal actions in which there is no claim aggregation mechanism. By contrast, earlier this month, the Second Circuit held that Rule 17 substitution was appropriate in certain actions styled as derivative actions under the Securities Exchange Act—even where the nominal corporate defendant had failed to join not due to an honest mistake, but because it refused demand. See *Klein v. Qlik Techs.*, 2018 WL 4700200 (2d Cir. Oct. 2, 2018). The decision is notable because it addresses an issue of first impression over a spirited dissent by Judge Ray Lohier, and because it offers insight into the thinking of New York Southern District Judge Richard Sullivan, who sat on the panel by designation and has since been elevated to the Second Circuit.

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Background

Section 16(b) of the Securities Exchange Act requires that any corporate insiders and beneficial owners of more than 10 percent of a company's stock disgorge any so-called "short swing profits," i.e., profits derived from the sequential sale and purchase (or purchase and sale) of that company's securities within a six-month period. To guard against insider abuse, Congress chose to impose strict liability for short swing transactions and to create a private cause of action in the event that the issuer declined to bring suit upon demand. 15 U.S.C. §78p(b).

In 2014, Qlik securities were traded in alleged short-swing transactions by entities affiliated with the Cadian Group, which owned more than 10 percent of Qlik's stock. In June 2015, another Qlik shareholder, Ms. Klein, demanded that the company bring a Section 16(b) action against the Cadian Group, and, when it refused, Ms. Klein sued the company herself. Almost a year later, with the litigation still pending, Ms. Klein's ownership interest in the company was extinguished by a cash-out merger, and the Cadian Group moved to dismiss on the grounds that Ms. Klein lacked standing.

The district court agreed, holding that the lack of a continuing

financial interest deprived the plaintiff of standing. The court further held that Ms. Klein could not move under Fed. R. Civ. P. 17(a)(3) to substitute Qlik—now under new management—for two independent reasons. *First*, the court was powerless to rule on the motion to substitute once it determined the plaintiff lacked standing. *Second*, Rule 17(a)(3) only applied to situations in which the substitute plaintiff had not been included at the beginning due to an "honest mistake" rather than its refusal to pursue the action.

On Oct. 2, 2018, a divided panel of the Second Circuit reversed the district court's ruling.

The Jurisdictional Effect Of Mootness

The key disagreement between the panel majority's opinion and the dissent concerns the jurisdictional implications of a finding of mootness.

Writing for the court, Judge Rosemary Pooler concluded that "[a] legal controversy is not like an electrical circuit, such that a court's power switches off as soon as the personal stake of all of the named parties on either side of the controversy drops below the legally adequate threshold." Id. For the court, a plaintiff's loss of a personal stake in the litigation over the course of the lawsuit does not necessarily implicate the "constitutional minimum a party must establish at the onset of a case" in whose absence the court has no choice but to dismiss for lack of jurisdiction. 2018 WL 4700200, at *4. To the contrary, when mootness arises, the courts "maintain jurisdiction long enough to determine whether the concrete adverseness that existed at the outset of the case can be maintained without undue prejudice to defendants," for example, through substitution under Rule 17 or intervention. Id. at *5.

Judge Lohier dissented, observing that a non-class action case that becomes moot at any point is no longer a "case or controversy" that can confer jurisdiction on the federal courts under Article III. Id. at *8 (citing *United States v. Sanchez-Gomez*, 138 S. Ct. 1532, 1537 (2018)). Thus, he would have found that the cash-out merger had deprived Ms. Klein of her financial position in Qlik and, thereby, of her stake in the outcome of the suit, requiring dismissal. Id.

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Implications of Recent Supreme Court Jurisprudence

The *Klein* panel's views on mootness turned, in large part, on its interpretation of the recent Supreme Court decisions in *Genesis Healthcare v. Symczyk*, 569 U.S. 66 (2013), and *United States v. Sanchez-Gomez*, 138 S. Ct. 1532 (2018). Those decisions held, respectively, that an employee who brings a collective action under the Fair Labor Standards Act cannot be replaced by another plaintiff-employee if his individual action is mooted before others opt in, and that a criminal case that did not involve any formal mechanism for aggregating claims was not subject to a flexible mootness inquiry that took into account the interests of nonparties. The application (or extension) of these rulings to Section 16(b) actions was an issue of first impression both in the Second Circuit and elsewhere.

Judge Lohier believed that *Sanchez-Gomez* established a categorical rule that "flexible mootness" analysis applied only to class actions. 2018 WL 4700200, at *8. The panel majority noted that the key question is whether the particular traits of an action before the court called for it to be treated "like" a class action for mootness purposes. Id. at *5.

Even assuming that the functional comparison embraced by the panel majority is the correct inquiry, the panel majority and the dissent still disagreed on the outcome. The panel majority held that Rule 16(b) involves a "representative plaintiff" and, like a Rule 23.1 action, is a "derivative action" because a corporation like Qlik is bound by the judgment in litigation brought on its behalf and is "considered a party in many important respects." Id. at *8. By contrast, Judge Lohier pointed to treatises and Circuit case law suggesting that Rule 16(b) actions are not subject to the requirements of Rule 23.1, and therefore are not comparable to true derivative actions—let alone to

true class actions, which are treated differently under *Sanchez-Gomez*.

Rule 17 and the 'Honest Mistake Requirement'

The panel majority also rejected a reading of recent Second Circuit precedent that would require a showing of an "honest mistake" before allowing substitution under Rule 17(a)(3).

Rule 17 allows for substitution "when the change is merely formal and in no way alters the original complaint's factual allegations as to the events or the participants." *Advanced Magnetics v. Bayfront Partners*, 106 F.3d 11, 20 (2d Cir. 1997). When those conditions are met, the motion ought to be denied only if it is proposed "in bad faith or in an effort to deceive or prejudice the defendants," or if it will "otherwise result in unfairness" to them. Id. at 21.

In a pair of 2015 and 2016 decisions, panels of the Second Circuit appeared to require an "understandable or honest mistake" leading to the selection of the wrong plaintiff. *Cortland Street Recovery v. Hellas Telecomms., S.A.R.L.*, 790 F.3d 411 (2d Cir. 2015); *DeKalb Cnty. Pension Fund v. Transocean Ltd.*, 817 F.3d 393 (2d Cir. 2016). The panel majority distinguished those decisions, and read *DeKalb* as requiring a less burdensome showing of a "reasonable basis" for failing to join the suit earlier. 2018 WL 4700200, at *7 & n.8. Ultimately, the panel majority focused on the "bad faith" requirement announced in *Advanced Magnetics*, and clarified that substitution will be allowed so long as the movant can show that the substitute plaintiff's failure to join at earlier stages of the litigation was not "deliberate or tactical."

On this point, Judge Lohier again disagreed, reading *Cortland* and *DeKalb* as merely codifying a well-established understanding and noting that Rule 17 was "a mechanism to account for 'when an honest mistake has been made in choosing the party in whose name the action is to be filed.'" Id. at *10. Judge Lohier also concluded that the "honest mistake" standard was not an open question, but the settled law of the Circuit—which could only be overruled by an en banc panel or the Supreme Court. Id. at *9.

The majority and dissenting opinions in 'Klein' reflect not only sharply divergent views about the mootness doctrine and the intent behind Rule 17, but also differences of opinion about the weight to be accorded to policy considerations in derivative lawsuits generally and Rule 16(b) lawsuits in particular.

Policy Concerns

The panel majority also pointed to other relevant considerations supporting its ruling: *First*, that courts should be mindful of the possibility of opportunistic transactions to extinguish a plaintiffs' financial interest in litigation once the limitations period has run, particularly in the Section 16(b) context. *Second*, that substitution may be "necessary to avoid injustice" because a strict Rule 17 interpretation would result in a needless multiplicity of actions, as multiple shareholders would be required to maintain Rule 16(b) and other derivative actions to ensure against the vicissitudes of that litigation.

Judge Lohier dismissed these policy concerns as "laudable," but "wrong as a matter of law," and expressed confidence that the courts had "ample tools" to manage proceedings so as to address the possible proliferation of Section 16(b) litigation.

Conclusion

The majority and dissenting opinions in *Klein* reflect not only sharply divergent views about the mootness doctrine and the intent behind Rule 17, but also differences of opinion about the weight to be accorded to policy considerations in derivative lawsuits generally and Rule 16(b) lawsuits in particular. As Circuit Courts grapple with these questions, the judicial debate embodied in *Klein* will likely prove influential.