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COMMENTS*

THE ROLE OF PRECONCEPTIONS IN POLICY ANALYSIS IN LAW: A RESPONSE TO FISCHEL AND BRADLEY

Kenneth E. Scott †

INTRODUCTION

Monitoring management in the publicly-held corporation is a complex but vital process that is only recently beginning to receive the rigorous and critical attention, both theoretical and empirical, that it deserves. Professors Fischel and Bradley are to be commended for having made a stimulating and valuable contribution to that study. There is much in their analysis that is sound and insightful, and with which I certainly do not disagree. But the commentator's function is not to lavish praise, but to take issue and provoke discussion. Fortunately, from my point of view, Fischel and Bradley (F&B) proceed at many points to draw conclusions from their able analysis which may be consistent with their prior beliefs but are, however, erroneous or unsupported.

In particular, in their discussion of the role of liability rules and the derivative suit, F&B do not make enough of the distinction between the fiduciary duty of loyalty and the fiduciary duty of care. The centrality of that distinction is a point that I have emphasized elsewhere at some length,[1] and that F&B dispose of briefly, if not cavalierly.[2] On the basis of their own arguments and data, I shall try to demonstrate that their view is incorrect. For convenience of reference, I shall parallel the structure of their paper.

At the outset, however, it is necessary to address the nature of

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* Professor Fischel and Professor Bradley's paper underwent minor revisions after completion of the following comments. Eds.

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1 Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983).

2 Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 290-91 (1986) [hereinafter cited as F&B].

the distinction, which F&B dismiss as "artificial."[3] There is a great deal of case law explicating the content of the duties of care and loyalty, and, as usual, no concise summary of those voluminous opinions can be wholly accurate. The essence of the distinction is in my view nonetheless fairly straightforward:

> The duty of care demands that top officers and members of the board of directors invest a certain amount of time and effort and exercise a certain level of skill and judgment in the operation of the firm. The duty of loyalty requires that officers and directors put the interests of the stockholders ahead of their personal gain and subjects them to oversight in transactions involving conflicts of interest.[4]

This distinction, like a multitude of others in law and logic, is not always sharp and self-defining. F&B offer the standard example: is loafing on the job to be characterized as a care violation or a loyalty violation?[5] Their conundrum is not unsolvable, and I shall return to it subsequently. For the moment, it is enough to note that the two concepts encompass a lot of territory far removed from the boundary line. "Loyalty violations usually involve a knowing appropriation from the firm to the offender's personal gain, while care violations involve the decisionmaker's asserted neglect or incompetence, even in the absence of any personal profit."[6] In polar terms, the difference is between theft and poor business judgment; the distinction may seem artificial to F&B , but it is useful in this as in other areas of law.

I
Liability Rules As a Governance Mechanism

The premise of the F&B argument is that the duties of loyalty and care should be viewed as terms that are currently implied by law in the employment contract between a company and its managers, but that are inessential if not counterproductive.[7] The contract paradigm must not be taken too literally; it would suggest that management's fiduciary duties could simply be abolished by an express term to that effect in their employment contracts, a ploy that almost certainly would not be successful.[8] More accurately, fiduciary duties

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[3] *Id.* at 291. In the draft presented at the conference, F&B described the distinction as "artificial."

[4] Scott, *supra* note 1, at 927-28.

[5] F&B, *supra* note 2, at 291.

[6] Scott, *supra* note 1, at 932.

[7] F&B, *supra* note 2, at 266.

[8] *See, e.g.*, N.Y. Bus. Corp. Law § 722(a) (McKinney 1979) (forbidding corporations to indemnify director or officer "in relation to matters as to which such director or officer is adjudged to have breached his duty to the corporation").

are currently imposed on managers by legislators or judges and enforced through derivative suits, and F&B contend that should not be the law.

Why should the liability rules that back up management's fiduciary duties be dispensed with? Basically, F&B argue that they are an ineffective means of obtaining good managerial performance, for five reasons. First, it is quite difficult to separate bad judgment from bad luck in an uncertain world; it is, therefore, impracticable to write precise performance standards (with liability for their breach) into an employment contract. The substituted general duty of care is properly applicable only to the most extreme derelictions, for the same reason. Second, managers are already sanctioned for poor performance by a reduction in the value that their services can command in the labor market for future periods; liability rules, in F&B's view, presumably add little. Third, the existence of an efficient stock market greatly facilitates the effective operation of the capital and takeover markets in ways that reward good performance and penalize poor performance. Fourth, litigation with poorly performing management would be a deterrent to the willinguess of management to develop firm-specific human capital. Fifth, the possibility of having their liability erroneously assessed on the basis of bad luck instead of bad decisions would lead risk-averse managers to behave in a more cautious manner than shareholders would desire.[9]

Apart from questions about the validity of some of those propositions, it is not altogether clear how they relate to the conclusion F&B wish to draw. Certainly, the system of sanctions and incentives that bear on managers of publicly-held corporations is complex, and liability rules constitute merely a part of the total structure, but for F&B to point out that other mechanisms exist is not enough. To make their point definitively, they must show that liability rules are completely redundant, and they have not attempted to do that. Nor do they discuss the separate situation of the private corporation that has no efficient trading market in its stock.

But the point I wish to make is a different one. Their arguments are directed almost entirely against the duty of care, with limited or no applicability to the duty of loyalty issues. As previously noted,[10] I am in general agreement with F&B on the matter of liability for care violations. The disadvantages of such liability seem to me to dominate. But all the discussion of the hazards of decision-making in an uncertain world has little to do with the extraction of secret or excessive profits in self-dealing transactions. Market sanctions for such conduct do remain, but they too have shortcomings.

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9 F&B, *supra* note 2, at 264-70.
10 Scott, *supra* note 1, at 932-37.

Labor market revaluations hold few terrors for top executives nearing the end of their careers, and ouster through proxy fights or hostile takeovers is both problematic and ever more costly. The real issue is whether derivative suits for loyalty violations play a useful role in establishing a lower ceiling on this type of agency cost than would otherwise exist, and that is an issue F&B do not address.

Instead, F&B make a general assault on the device of the derivative suit, on the ground that plaintiffs and their attorneys have no incentive to bring only those suits that maximize the value of the firm.[11] In the course of that assault, F&B add to the already ample stores of some common kinds of confusion in legal literature. First, there is the confusion between the desirability of effective enforcement of legal rules and the desirability of the legal rules themselves. If a rule is harmful (e.g., minority shareholder can, on largely technical grounds, block an advantageous merger for strategic bargaining reasons), no doubt its effective enforcement is not beneficial, but the preferable solution is alteration of the rule, not emasculation of all rule enforcement. As for the risk of strategic litigation per se (suits brought in order to be bought off), nothing confines the problem to shareholders as plaintiffs. The problem exists with respect to all forms of litigation, and defendants deal with it in a number of ways, ranging from actions for abuse of process to establishment of a reputation for refusing to pay off. Second, there is confusion over whether the objective of certain rules is compensation to the injured party or deterrence of the harmful conduct. F&B note that derivative suit attorneys will pursue a cause of action if expected attorneys' fees are sufficient to make it a positive net present value project for them, even though the amount of recovery to the firm in a particular case might be exceeded by related costs for it.[12] For effective deterrence, of course, derivative suit attorneys should do exactly that; then the problem will arise less often in the future. Again, one can make arguments against effective deterrence of care liability because of error costs and management risk aversion, as both F&B and I have done, but those arguments have much less weight against loyalty liability. In the case of management theft from the corporation, do F&B really find the "perverse incentive"[13] of the plaintiff's attorney to be an overriding consideration? Would they really believe that a more nearly optimal decision on whether to bring suit would be made by management's "special litigation committee"?

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11 F&B, *supra* note 2, at 271-74.

12 *Id.*

13 *Id.* at 272.

II
ALTERNATIVE METHODS OF ASSURING CONTRACTUAL PERFORMANCE

Liability rules are not the only factor shaping managerial performance incentives. F&B list some of the others: ultimate stockholder control over the firm through voting power, internal monitoring by other managers and through the board of directors, external monitoring in various ways through the capital markets, and performance-related compensation plans.[14] Having reviewed the list, F&B proceed to claim that these other governance mechanisms are more important than legal rules in assuring managerial performance.[15]

This claim is weak and largely irrelevant. The claim is weak because the evidence bearing on it, in either direction, is also weak. Given the existence of a complex, multi-layered structure of incentives and monitoring (of which derivative suits form a part), it is extremely difficult to measure the effects and importance of any one element in isolation, and the evidence F&B adduce is not adequate for that purpose. They claim that Delaware has legal rules which minimize the threat of legal liability and nonetheless leads in reincorporation choices.[16] The argument depends, among other things, on an (unmade) comparative evaluation of state corporation laws and runs counter to such leading decisions as *Zapata v. Maldonado*[17] and *Smith v. Van Gorkom,*[18] as well as to the absence of any security bond requirement for derivative suits in Delaware law. Thus, we have little reason to believe that liability rules are generally less important than the other factors they mention.

But even if the claim of lesser importance were well supported, what of it? The elements in this array of monitoring and incentive devices are not mutually exclusive; they co-exist and play somewhat different and specialized functions. To make their point and support their conclusion, F&B must do more than show that derivative suits are one among a number of mechanisms bearing on managerial performance; they must show that derivative suits based on fiduciary liability rules are actually harmful. That is what they proceed to attempt in the next section.

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14 *Id.* at 274-76.
15 *Id.* at 276.
16 *Id.* at n.43.
17 430 A.2d 779 (Del. 1981).
18 488 A.2d 858 (Del. 1985).

III
EMPIRICAL ANALYSIS OF THE WEALTH EFFECTS OF DERIVATIVE STOCKHOLDER SUITS

In an admirable effort to move the discussion from the domain of prior belief and inconclusive argument to the domain of empirical research, F&B made an abnormal return study of forty-eight firms involved in litigation on the maintenance of derivative suits.[19] In thirty-two of the cases, the court dismissed the derivative suit; in sixteen cases, the court ruling permitted the suit to continue. In each case, F&B set the date of the court's decision as day zero and then calculated the abnormal return on day zero and the cumulative abnormal return from day zero through one and four days thereafter. From their data, F&B conclude that the wealth effects of derivative stockholder suits are trivial[20] and hence that "derivative suits are not an important monitoring device to curb managerial malfeasance."[21]

The main difficulty with the F&B study is that they misinterpret their own results. For clarity, let us re-examine the central findings—the market reactions on the event date to the courts' decision for the two outcome portfolios—without the authors' preconceptions. When the derivative suit was thrown out, the value of the firm fell by 0.7% (AR: -0.69; t-stat: -2.13);[22] when the suit was allowed to proceed, shareholder wealth increased by 1.1% (AR: 1.085; t-stat: 1.76).[23] The market evaluation of derivative suits, in other words, is inconsistent with the hypothesis that they do not serve shareholders' interests.

But, reply F&B, the wealth effects involved are "slight" and "insignificant,"[24] showing that investors do not greatly value liability rules as a governance mechanism. This reply raises the question of the precise formulation of the hypothesis being tested. If derivative suits are in fact efficiently enforcing the fiduciary constraints on management, what does that imply for the amount at stake in the lawsuit? It has to be enough to warrant the cost and risk being assumed by the plaintiff's attorney in maintaining the action, but do we expect it to be a significant fraction of the total value of exchange-listed (i.e., large) firms? If deterrence is at all effective and the market for derivative suits is at all competitive, we would expect

19 The results of F&B's study are included in Tables 5-7, *infra*. For their raw data, see F&B, *supra* note 2, at Tables 1-4.

20 F&B, *supra* note 2, at 281-82.

21 *Id.* at 282.

22 *See infra* Table 5.

23 *See infra* Table 6.

24 F&B, *supra* note 2, at 282.

to see such suits brought at a relatively early time in a course of managerial malfeasance and for amounts that are relatively minor in relation to the size of the firm. "Slight" wealth effects are not inconsistent with the hypothesis.

If the effects one is looking for are slight, however, they may be difficult to ascertain with confidence. The t-statistics on the event date results quoted above are, it should be noted, significant at the ninety-five percent level and the ninety percent level, respectively.[25] F&B deal with the awkwardness of that finding by spreading an admittedly small magnitude effect over a five day period and then reporting that none of the decision-week returns is significantly different from zero.[26]

F&B then proceed to see whether the loyalty/care distinction makes any difference; they separate out the loyalty actions and get almost identical results.[27] That process raises a question as to the criteria they used to make the partition; for example, if a complaint has both care and loyalty claims, to which category was it assigned? I re-checked the sample and made my own division, based on whether the suit contained a demand for the recovery of personal gains received by the defendants. I found my division did make some difference: for the seventeen loyalty violation dismissals, the negative abnormal return rose to 1% (AR: -1.07; t-stat: -1.72), while in the twenty-one care dismissals it fell to a negative 0.4% (AR: -.436; t-stat: -1.19).[28]

To be sure, the sample of cases is too limited, and the effect is in all likelihood too small, to afford a basis for drawing any strong conclusions in either direction. But whatever these preliminary data may be worth, their signs are on the whole contrary to the F&B position and consistent with a position that derivative suits serve shareholders' interests. They certainly do *not* show that the costs to the firm of having its management defend a derivative suit outweigh the anticipated stockholder gains. I trust it is not unappreciative of F&B's innovative and useful work to point that out.

IV
THE ROLE OF LIABILITY RULES IN CORPORATE LAW

Returning to their central argnment, F&B note that other legal rules at times cut back the apparent scope of the fiduciary duties of

[25] That is, given the variability shown in the data, there is only a 5% and a 10% probability (respectively) that the real effect on shareholder wealth is zero (the "null hypothesis").

[26] F&B, *supra* note 2, at 281.

[27] *Id.* at 282.

[28] *See infra* Appendix and Tables 7 & 8.

loyalty and care, as well as the efficacy of derivative suit enforcement. In a descriptive sense, they are unquestionably correct. Regrettably, courts have sometimes applied the business judgment rule to conflict of interest transactions, as well as to the duty of care suits for which it was originally created.[29] Certain courts have allowed the procedure of approval by disinterested directors to obscure the reality of abuse of control.[30] Indemnification and insurance do indeed alter the deterrent impact of liability rules, although again mainly in the area of care liability and not in the area of loyalty liability, which is usually excluded from coverage. The appraisal remedy does cut down on the prospect of care liability for merger transactions, although it is not always treated as the exclusive remedy if the gravamen of the complaint is for self-dealing.[31] And no one would dispute that a number of special burdens have hobbled the derivative suit mechanism.

But what normative conclusion is one supposed to derive from all that? The existence of a jumble of rules and partial exceptions, differing from one jurisdiction to another, proves very little about what the pattern ought ideally to be. Even a member of the Panglossian school of law and economics, who believes that whatever is must be efficient, would gain little guidance from such a confused and conflicting tangle of doctrine. Further, if one considers transaction costs and transitional disequilibria, the status quo can no longer lay firm claim to efficiency, thereby leaving academics free to indulge their professional proclivity for evaluation and debate even on that score.

My own observation is that the countervailing doctrines listed by F&B have undermined care liability more than loyalty liability.

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29 *See, e.g.*, Hendricks v. Mill Eng'g & Supply Co., 68 Wash. 2d 490, 413 P.2d 811 (1966) (business judgment rule invoked to validate decision of board to redeem some of stock held by majority shareholders, reducing their holdings to less than 50% of voting power and preserving board's control); Matteson v. Zeibarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952) (business judgment rule invoked to validate merger agreement whereby controlling shareholder received lucrative employment contract from acquiring corporation); Osborue v. Locke Steel Chain Co., 153 Conn. 527, 218 A.2d 526 (1966) (ex-president's employment contract evaluated under business judgment standard).

30 *See, e.g.*, Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *Compare* Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979) (approval by disinterested board members makes fairuess inquiry unnecessary) *with* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (fairness inquiry necessary despite approval by disinterested board members).

31 *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) (when sole purpose of merger is cash-out of minority, availability of statutory appraisal remedy does not satisfy controlling shareholders' fiduciary duty to minority); Gabhart v. Gabhart, 267 Ind. 370, 370 N.E.2d 345 (1977) (same); Robb v. Eastgate Hotel, Inc., 347 Ill. App. 261, 106 N.E.2d 848 (1952) (allegation of fraud in sale of assets makes statutory demand for fair value nonexclusive remedy); Pupecki v. James Madison Corp., 376 Mass. 212, 382 N.E.2d 1030 (1978) (same).

My main criticism of that tendency is that courts have not applied it with sufficient consistency and clarity. In particular, reducing the incidence of care liability by making derivative suits more cumbersome and difficult to maintain has had undesirable spillover effects on deterrence of loyalty violations.[32]

V
The Analysis of Derivative Suits in the ALI Report

F&B criticize the ALI Project on Corporate Governance draft proposals, which preserve the derivative suit in something like its traditional form. For example, the ALI drafters suggest that derivative actions reduce average agency costs, and F&B's rejoinder is that they found "no evidence" that investors valued derivative suits.[33] This is a modest rebuttal at best, and one that rests on a tendentious reading of their own data. F&B also attack the ALI draftsmen for repeatedly purporting to choose the "best" rule from a conflicting set, with no real basis in theory or evidence for their personal choice.[34] I have considerable sympathy with that criticism, because one of the dangers of the ALI Project is that its selection of rules may contribute to settling and freezing areas of corporate law before we adequately understand how these rules function. Instead, urge F&B, we should let the individual firm choose the exact set of liability or nonliability rules which will govern it, and in the long run we will be able to determine what rules are optimal, and when, and for whom.[35] However valid that approach might be in the long run, in the short run it would permit wealth transfers from stockholders to managers. If, contrary to F&B's expectations, a corporation's adoption of a no-derivative-suit rule were to create a large negative abnormal return for its shareholders, what would F&B suggest? A lawsuit against themselves?

But I most want to take issue with F&B's comments on the distinction between the duty of care and the duty of loyalty. The distinction between these duties is reflected in the ALI draft, but I would emphasize it still more. F&B's strategy for obliterating the distinction is to focus on the boundary case: loafing on the job can be viewed as inadequate effort and inattention (a care violation) or as the extraction of additional compensation (a loyalty violation).[36] Uncertainty over proper characterization of the boundary case is then supposed to prove that there is no (nonartificial) distinction

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32 *See* Scott, *supra* note 1, at 940-46.
33 F&B, *supra* note 2, at 289.
34 *Id.* at 290.
35 *Id.*
36 *Id.* at 291.

between the two concepts. Leaving that nonsequitur aside, I would suggest that the answer to a problem in characterization is, as usual, to be found by recourse to the purpose for which the characterization is being made. In the world I am advocating, the consequence of calling shirking a care violation would be to leave it to monitoring by the labor and capital markets and not by derivative lawsuits and judges. Because it is difficult to measure effort, concentration, and attention ex post in a court of law, and to disentangle these factors from all others in accounting for a bad outcome, the task is one I believe best left to the market and its replacement mechanisms.

But, say F&B, shirking means that management is realizing undue compensation, and most loyalty violations can be thought of as extracting extra compensation, so why not just leave it all to the market?[37] The answer, I believe, is twofold. First, F&B contend that compensation is even easier for the market to monitor than effort,[38] but that conclusion is not necessarily true when the compensation is hidden and covert, as it often is in loyalty violations. Appropriation through not working very hard is readily apparent to one's peers, and subject to Fama's type of monitoring,[39] but appropriation in conflict of interest transactions is often concealed insofar as possible from everyone. If hidden appropriation is to be ferreted out, someone, such as the plaintiff's attorney, must have profit incentives to do so. The existence of the liability rule and derivative suit, in turn, tends to force management to choose overt means of compensation, thus enabling other monitoring mechanisms (through the board of directors, labor market, and capital market) to work more effectively. Second, the task before a court in a loyalty case is one for which it is better suited. The inquiry is into the terms of one or a few transactions, and the question is often the comparability of a private sale price to a market standard. Although not without its subjective elements, the analysis is far more simple and reliable than in a duty of care case where the court must assess the interaction of a multitude of factors in a business disaster.

CONCLUSION

In short, the distinction between care and loyalty rules is no more artificial than any other and enables us to design intelligently a structure of law for the governance of the modern corporation. Although F&B never quite come out and avow it, apparently they are sympathetic to the abolition of both care and loyalty liability rules and, along with them, the derivative suit, which would no

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37 *Id.*

38 *Id.*

39 Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

longer have any function to serve. That position, I submit, is not supported by either the theory of liability rules, the available empirical evidence, or the structure of corporate law. A better (though still rather tentative) case can be made for the abolition of care liability while maintaining liability for loyalty violations. It is hard to conceive how the interests of shareholders would be advanced in a world where managers who helped themselves in subtle ways to the firm's assets could not be sanctioned short of ouster in a hostile takeover, assuming that possibility even survives the current tolerance of unbridled defensive maneuvers. But that, I take it, is the implicit recommendation of Fischel and Bradley.

APPENDIX*

Fischel and Bradley's study was rerun using several different partitions of their data base. We used the date of the announcement of a court decision as the zero date, as they did, and computed beta-adjusted abnormal returns as of the zero date and for one week thereafter.[40]

Before rerunning the study, we made some adjustments to the F&B data base. After reading the cited cases, we first determined that some of their data points had been misspecified: the corporation listed was not the entity on whose behalf the derivative suit had been brought. In most of those cases, the entity on whose behalf the suits had been brought was not a corporation with stock listed on the New York or American Stock Exchange, and we had to delete the data point from the base. In one case, the entity was listed on the New York Stock Exchange, so the data point was retained as corrected. These deletions and corrections are noted on Tables 1 through 4. Second, we noted that a number of the decision dates used as zero dates in their study represented affirmances or reversals by appellate courts of dismissals or refusals to dismiss by lower courts. We suspected that investors might generally expect a lower court's decision to be affirmed, so that abnormal returns on the date of an affirmance might be lower in absolute value than abnormal returns on the date of the original decision, while abnormal returns on the date of a reversal would not exhibit the same tendency. We therefore attempted to determine in each case the dates of the lower court opinions not cited by F&B.

We then calculated abnormal returns using two different data bases: first, a data base which included all the decision dates, whether of lower or appellate courts; second, a data base which included only the dates of lower court decisions and of appellate reversals, omitting affirmances.

We first calculated abnormal returns while preserving F&B's partition of the data base into cases in which the court's decision centered on the issue of demand requirements and cases in which the decision centered on the effect of a ruling by a special litigation committee. These results are reported in Tables 5 and 6.

We then repartitioned the data base in an effort to distinguish between abnormal returns in cases involving allegations of self-enrichment or personal dishonesty on the part of officers and directors and cases involving only allegations of poor business judgment.

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* This reexamination of the F&B empirical study was a joint undertaking with my research assistant, Greg Shrock.

40 Our data and results are set out and compared to F&B's in Tables 1-8, *infra*.

F&B made a partition based on whether the plaintiffs had made allegations of "breach of loyalty," but the criteria by which they made this separation are not clear. We therefore read the cases and made our own partition based on whether the plaintiffs had made allegations of personal enrichment. Most of the complaints alleging personal enrichment focused on management remuneration, but a significant minority alleged actual misuse of corporate assets or entrenchment in control by blocking takeover attempts by outsiders. Tables 1 through 4 indicate how we made this partition. The results are reported in Tables 7 and 8.

The insignificant results in the sample of cases in which the plaintiffs had not alleged personal enrichment by management led us to investigate this sample further. Many of the data points in this sample involved cases in which the primary allegation had been that management paid or allowed others to pay illegal foreign bribes or illegal foreign or domestic campaign contributions. We suspected that investor concern over such allegations might be minimal, since such payments might well enhance the corporation's profitability despite their illegality. If so, we would not expect significant negative abnormal returns from the dismissal of a suit seeking to discipline management for making such payments. We therefore partitioned this sample into those cases that had primarily involved allegations of illegal payments and those that had not. Tables 1 through 4 indicate how this partition was made. Table 8 reports the results.

The apparently significant abnormal returns to the sample of cases in which the plaintiffs had alleged personal enrichment led us to also investigate this sample further. We suspected that this sample might have been skewed by the presence of a number of cases involving allegations that management had entrenched itself in control by resisting an attempted acquisition by outsiders, since mergers and acquisitions often induce large price movements in a corporation's stock. We therefore computed abnormal returns in cases involving allegations of entrenchment and report these returns in Table 7.

Our results were in many respects similar to F&B's. They found average abnormal returns to shareholders of all firms having derivative suits dismissed by court action of -0.690% (significant at the 5% level); we found average abnormal returns of -0.642% (significant at the 10% level) for the sample of dismissals only and -0.692% (significant at the 5% level) for the sample of dismissals and affirmances of dismissals.[41] The results of our partition of all dismissals into

41 *See* Table 5.

those in which the demand requirement had not been met and those in which a special litigation committee had ruled against the plaintiffs also looked similar to their results. Both sets of results supported the hypothesis that shareholders' derivative suits benefit stockholders and that the dismissal of a derivative suit should unfavorably affect the stock's price.

Our results differed from those of F&B in one important respect. They found positive abnormal returns to the stockholders of firms having derivative suits challenged by management but not dismissed by the courts of 1.085% (significant at the 10% level) on the date of the decision and 1.794% (significant at the 5% level) for the two days beginning on the date of the decision.[42] We found insignificant negative abnormal returns both on the decision date and for the two days beginning with the decision date.[43] In a sense, our results are disappointing—F&B's results tend to support our hypothesis that shareholders benefit from derivative suits, while our results tend to support their thesis that derivative suits have little effect on shareholders' well-being. In defense of our thesis, however, we make two observations. First, our sample is too small to interpret the results as strong support for anything; the sample contains only thirteen data points. Second, insignificant abnormal returns upon refusals to dismiss are not necessarily inconsistent with our thesis; a dismissal is (except in the rare case where a dismissal is reversed by an appeals court) a final disposition of a case and thus may have a larger effect on the stock price than a refusal to dismiss, which is not a final disposition.

Our results also differed from F&B's in the pattern of abnormal returns we found after partitioning the sample into cases alleging personal enrichment by managers and directors and cases not making such allegations. F&B's partition based on "breach of duty of loyalty" found insignificant negative returns upon dismissals of derivative suits charging breach of the duty of loyalty and insignificant positive abnormal returns upon refusals to dismiss.[44] Our partition found abnormal returns upon dismissals and affirmances of dismissals of derivative suits alleging personal enrichment of -1.007% (significant at the 10% level) on the date of the decision and -1.661% (significant at the 5% level) for the two days beginning on the date of the decision.[45] These results support our thesis that derivative suits are valuable to shareholders in policing management self-dealing. Moreover, the inclusion of cases involving hostile takeover at-

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42 *See* Table 6.

43 *Id.*

44 *See* Table 7.

45 *Id.*

tempts in the sample has not distorted these results; the abnormal returns in such cases were positive, and their exclusion only increases the size and significance of the negative abnormal returns to the stockholders of firms in this category.

F&B did not exhibit their findings concerning abnormal returns to the stockholders of firms involved in derivative suits not alleging a breach of the duty of loyalty. For our corresponding sample, however, we found insignificant negative abnormal returns upon dismissals and affirmances of dismissals of derivative suits not alleging personal enrichment by managers and directors.[46] The insignificance of these results would seem to support F&B's thesis. For the sample which deleted cases primarily alleging illegal campaign contributions and foreign bribes, however, we found negative abnormal returns that were much larger in absolute value than the abnormal returns to the sample as a whole and whose t-statistics approached significance, despite the fact that this subsample included only seven data points.[47] We think that these results also support our hypothesis that derivative suits are positively valued by the market.

46 *See* Table 8.
47 *Id.*

TABLE 1

Cases Dismissed for Failure to Meet Demand Requirements

Case (company if not named)	Decision Date(s)	Illegal Payments	Breach of Duty of Loyalty
Cramer v. General Telephone & Electronics Corp., 582 F.2d 259 (3d Cir. 1978).	07/18/78 affirming 08/22/77	x	
Elfenbein v. Gulf & Western Industries, 454 F. Supp. 6 (S.D.N.Y. 1978), aff'd, 590 F.2d 445 (2d Cir. 1978).	12/21/78 affirming 06/20/78		x
Greenspun v. Del. E. Webb Corp., 634 F.2d 1204 (9th Cir. 1980) (date of original decision not in data base)	12/29/80 affirming		x
Haber v. Bell (Oneok Corp.), 465 A.2d 353 (Del. Ch. 1983).	06/13/83		x
Kemper v. American Broadcasting Companies, Inc., 365 F. Supp. 1272 (S.D. Ohio 1973). [Deleted because ABC was not the corporation on whose behalf the suit was brought. The suit was brought on behalf of Kittyhawk Television Corp.]	Deleted		
Laufer v. Olla Industries, 729 F.2d 1444 (2d Cir. 1983), aff'g 96 F.R.D. 230 (S.D.N.Y. 1982)	04/29/83 affirming 12/29/82		
Lewis v. Graves (McDermott), 701 F.2d 245 (2d Cir. 1983) (date of original dismissal not in data base).	02/28/83 affirming		x
Mills v. Esmark, Inc., 91 F.R.D. 70 (N.D. Ill. 1981).	06/18/81		x
Shlensky v. Dorsey (Gulf Oil), 574 F.2d 131 (3d Cir. 1978).	03/06/78 affirming 11/18/76	x	
Smachlo v. Birkelo (Burlington Northern), 576 F. Supp. 1439 (D. Del. 1983).	12/27/83		x
Stotland v. GAF Corp., 469 A.2d 421 (Del. Supr. 1983), aff'g Del. Ch. Civil Action No. 6876 (Sept. 1, 1983).	12/05/83 affirming 07/10/83		x
Tanjer v. Sharon Steel Corp., [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,915 (S.D.N.Y. 1979).	06/22/79		x

TABLE 2

Cases Dismissed Based on Rulings by Special Litigation Committees

Case (company if not named)	Decision Date(s)	Illegal Payments	Breach of Duty of Loyalty
Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), aff'g 460 F. Supp. 1242 (D. C. Minn. 1978).	08/06/79 affirming 12/07/78	x	
Abella v. Universal Leaf Tobacco Co., Inc., 546 F. Supp. 795 (E.D. Va. 1982).	09/07/82		
Abramowitz v. Posner (NFV), 672 F.2d 1025 (2d Cir. 1982).	02/09/82		x
Ash v. IBM, 353 F.2d 491 (3d Cir. 1965), aff'g 236 F. Supp. 218 (E.D. Pa. 1964).	11/17/65 affirming 11/25/64		
Auerbach v. Bennett (GTE), 419 N.Y.S.2d 920, 393 N.E.2d 994 (N.Y. App. 1979) (reversing decision dated 8/17/78 (Table 4), which reversed decision dated 5/13/77).	07/09/79 affirming 05/13/77		
Burke v. Gulf, Mobile and Ohio RR Co., 324 F. Supp. 1125 (S.D. Ala. 1971).	03/30/71	x	
Gaines v. Haughten (Lockheed Aircraft), 645 F.2d 761 (9th Cir. 1981).	05/18/81 affirming 04/20/79	x	
Genzer v. Cunningham (Burroughs), 498 F. Supp. 682 (E.D. Mich. 1980).	09/26/80	x	
Lewis v. Anderson (Disney), 615 F.2d 778 (9th Cir. 1980) (date of original dismissal not in data base)	10/29/79 affirming		x
Maldonado v. United Brands Co., 485 F. Supp. 274 (S.D.N.Y. 1980).	01/24/84		x
Meer v. United Brands Co., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,794 (S.D.N.Y. 1979).	02/21/79	x	
Mills v. Esmark, Inc., 544 F. Supp. 1275 (N.D. Ill. 1982).	08/16/82		x
Mills v. Esmark, Inc., [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,571 (N.D. Ill. 1983).	09/06/83		x
Parkoff v. GTE, 74 App. Div. 2d 762, 425 N.Y.S.2d 599 (1980).	03/11/80	x	
Rosengarten v. ITT Corp., 466 F. Supp. 817 (S.D.N.Y. 1979)	02/28/79	x	
Stein v. Bailey (McDermott), 531 F. Supp. 684 (S.D.N.Y. 1982).	02/04/82	x	
Zapata v. Maldonado, 430 A.2d 779 (1981), rev'g Maldonado v. Flynn, 413 A.2d 1251 (1980) (reversing opinion dated 4/18/80 (Table 4)).	05/13/81		x
Byers v. Baxter (Allied Chemical), 419 N.Y.S.2d 497 (1979) (Table 4) (reversing opinion dated 6/28/78).	06/28/78		

TABLE 3

Cases Not Dismissed for Failure to Meet Demand Requirement
Demand Excused

Case (company if not named)	Decision Date(s)	Illegal Payments	Breach of Duty of Loyalty
Altman v. Place (Anaconda Corp.), 405 N.Y.S.2d 257 (1978). [The suit was brought on behalf of Anaconda; I U International Corp. was the defendant.]	05/25/78		x
Barr v. Wackman (Talcott National Corp.), 368 N.Y.S.2d 497, 329 N.E.2d 180 (1975), aff'g 43 App. Div. 2d 689, 350 N.Y.S.2d 428 (1973) (affirms affirmance dated 12/20/73 of dismissal dated 7/3/73).	04/01/75 affirming		x
Bergstein v. Texas International Co., 453 A.2d 467 (Del. 1982). [The original decision was issued 10/4/82; the opinion was modified 10/12/82.]	10/04/82		x
Fradkin v. Ernst (Mohawk Rubber Co.), 571 F. Supp. 829 (N.D. Ohio 1983).	09/01/83		x
General Electric Co. v. Bucyrus-Erie Co., 563 F. Supp. 970 (S.D.N.Y. 1983). [The suit was brought on behalf of a corporation not listed on any exchange, namely, a corporation owned 60% by Bucyrus-Erie and 40% by General Electric.]	Deleted		
In re Ceasar's Palace Securities Litigation (Lum's Ins.), 360 F. Supp. 366 (S.D.N.Y. 1973).	05/23/73		x
Kaufman v. Beal (Englehard), Del. Ch., Civil Action No. 6485, Hartnett, V.C. (Feb. 25, 1983).	02/25/83		x
Lewis v. Curtis (Hammermill Paper), 671 F.2d 779 (3d Cir. 1982).	03/03/82		x
Siegel v. Merrick (Twentieth Century Fox), 84 F.R.D. 106 (S.D.N.Y. 1979).	10/24/79		x
Tarlov v. Paine Webber Cashfund, Inc., 559 F. Supp. 429 (D. Conn. 1983). [The suit was brought on behalf of a mutual fund (managed by Paine Webber) which was not listed on any exchange. It was not brought on behalf of Paine Webber; Paine Webber was the defendant.]	Deleted		

TABLE 4

Cases Not Dismissed Contrary to Recommendation by
Special Litigation Committee
Business Judgment Rule Does Not Apply

Case (company if not named)	Decision Date(s)	Illegal Payments	Breach of Duty of Loyalty
Byers v. Baxter (Allied Chemicals), 419 N.Y.S.2d 497 (1979) (reversing dismissal dated 6/28/78 (Table 2)).	06/26/79		
Galef v. Alexander (TRW), 615 F.2d 51 (2d Cir. 1980).	01/22/80		x
Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976).	07/30/76	x	
Levy v. Sterling Drug Co., N.Y.L.J., Nov. 23, 1977, p. 10, col. 3 (N.Y. Supp. 1977). [The opinion was published 11/23/77 but was issued on an earlier date.]	11/22/77	x	
Maldonado v. Flynn (Zapata), 413 A.2d 1251 (Del. Ch. 1980).	04/18/80		x
Maher v. Zapata, 490 F. Supp. 348 (S.D. Tex. 1980).	05/27/80		x
Auerbach v. Bennett (GTE), 419 N.Y.S.2d 920 (1979) (Table 2) (reversing decision dated 8/17/78).	08/17/78		

TABLE 5

Average Abnormal Returns to the Stockholders of Firms Having Derivative Suits Dismissed by Court Action

Reason for Dismissal	Number of Firms	% Abnormal Return (t-statistic) Decision Day	Decision Day Plus One Day After	Decision Week*
Demand Requirements Not Met				
— Fischel & Bradley	14	−0.679 (−1.34)	−1.365 (−1.90)	−1.091 (−0.96)
— Dismissals Only	9	−0.534 (−0.91)	−1.508 (−1.75)	−1.328 (−0.96)
— Dismissals and affirmances of dismissals	16	−0.841 (−1.56)	−1.177 (−1.54)	−0.846 (−0.80)
Ruling of Special Litigation Committee				
— Fischel & Bradley	18	−0.698 (−1.72)	−0.092 (−0.16)	0.475 (0.51)
— Dismissals Only	18	−0.696 (−1.40)	0.135 (0.20)	1.125 (1.04)
— Dismissals and Affirmances of Dismissals	22	−0.565 (−1.32)	−0.118 (−0.20)	0.297 (0.36)
TOTAL				
— Fischel & Bradley	32	−0.690 (−2.13)	−0.650 (−1.42)	−0.190 (−0.26)
— Dismissals Only	27	−0.642 (−1.69)	−0.413 (−0.75)	0.333 (0.42)
— Dismissals and Affirmances	38	−0.692 (−2.17)	−0.791 (−1.74)	−0.235 (−0.37)

*Decision Day Plus Four Days After

TABLE 6

Average Abnormal Returns to the Stockholders of Firms Having Derivative Suits Challenged by Management But Not Dismissed by Court Action

Reason for Challenge (Reason Dismissal Refused)	Number of Firms	% Abnormal Return (t-statistic): Decision Day	% Abnormal Return (t-statistic): Decision Day Plus One Day After	% Abnormal Return (t-statistic): Decision Week*
Demand Requirements Not Met (Demand Excused)				
— Fischel & Bradley	10	1.063 (1.10)	1.513 (1.11)	1.034 (0.48)
— Adjusted Sample	8	−0.936 (−1.01)	−1.066 (−0.94)	−1.35 (−0.95)
Ruling of Special Litigation Committee (Business Judgment Rule Does Not Apply)				
— Fischel & Bradley	6	1.122 (1.58)	2.263 (2.25)	2.550 (1.61)
— Adjusted Sample	5	0.465 (0.57)	1.699 (1.49)	1.92 (1.17)
TOTAL				
— Fischel & Bradley	16	1.085 (1.76)	1.794 (2.06)	1.602 (1.16)
— Adjusted Sample	13	−0.397 (−0.62)	−0.002 (−0.00)	−0.09 (−0.08)

*Decision Day Plus Four Days After

TABLE 7

Average Abnormal Returns to the Stockholders of Firms Involved in Derivative Suits Charging Breach of Duty of Loyalty

		% Abnormal Return (t-statistic)		
	Number of Firms	Decision Day	Decision Day Plus One Day After	Decision Week*
Suit Dimissed by Court Action				
— Fischel & Bradley	11	−0.759 (−1.16)	−0.547 (−0.59)	−1.261 (−0.86)
— Dismissals Only	12	−0.840 (−1.24)	−1.465 (−1.49)	−0.395 (−0.29)
— Alleging Entrenchment in Control	2	0.321 **	−0.048 **	1.342 **
— Dismissals and Affirmances of Dismissals	17	−1.007 (−1.72)	−1.661 (−1.97)	−0.750 (−0.68)
Suit Challenged by Management But Not Dismissed by Court				
— Fischel & Bradley	6	1.000 (0.80)	0.078 (0.04)	1.246 (0.45)
— Adjusted Sample	11	−0.492 (−0.64)	−0.152 (−0.16)	−0.346 (−0.26)
— Alleging Entrenchment in Control	1	0.739 **	0.179 **	3.086 **

*Decision Day Plus Four Days After

TABLE 8

Average Abnormal Returns to the Stockholders of Firms Involved in Derivative Suits Not Charging Breach of Duty of Loyalty

		% Abnormal Return (t-statistic)		
	Number of Firms	Decision Day	Decision Day Plus One Day After	Decision Week*
Suit Dismissed by Court Action				
— Dismissal Only	15	−0.483 (−1.04)	0.429 (0.63)	0.970 (0.85)
— Primarily Alleging Illegal Payments	10	−0.342 (−0.53)	0.896 (0.96)	2.007 (1.35)
— Not Primarily Alleging Illegal Payments	5	−0.764 (−1.39)	−0.505 (−0.58)	−1.105 (−0.23)
— Dismissals and Affirmances of Dismissals	21	−0.436 (−1.19)	−0.087 (−0.16)	−0.194 (−0.23)
— Primarily Alleging Illegal Payments	14	−0.277 (−0.57)	0.142 (0.21)	0.752 (0.72)
— Not Primarily Alleging Illegal payments	7	−0.755 (−1.50)	−0.547 (−0.73)	−0.925 (−0.73)
Suit Challenged by Management But Not Dismissed by Court (All primarily alleging illegal payments)	2	0.125 (0.15)	0.822 (0.81)	1.312 (0.85)

*Decision Day Plus Four Days After