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Theresa A. Gabaldon

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# Free Riders and the Greedy Gadfly: Examining Aspects of Shareholder Litigation as an Exercise in Integrating Ethical Regulation and Laws of General Applicability

Theresa A. Gabaldon\*

## INTRODUCTION

The term *ethical* popularly is understood to have reference to some underlying system of moral principles.<sup>1</sup> Nonetheless, a number of the recognized rules of conduct for lawyers, generally referred to as *ethical regulations*, are devoid of moral content.<sup>2</sup> Some of these rules proscribe certain activities in order

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\* Associate Professor, University of Colorado School of Law. I would like to thank the University of Colorado for providing the support necessary to produce this Article. I also acknowledge, with gratitude, the research assistance of Thomas Carberry and the comments of Mark Loewenstein. I owe special acknowledgement to the invaluable insights and efforts of Robert Palmer.

1. See WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 780 (1986) (defining *ethics* as "the discipline dealing with good and bad or right and wrong or with moral duty and obligation").

2. See C. WOLFRAM, MODERN LEGAL ETHICS § 2.71, at 68 (1986) (stating that "[m]ost of what is called 'legal ethics' is really discourse on the law of professional regulation"); see also WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 780 (1986) (giving as secondary definition of *ethics*: "the principles of conduct governing an individual or a profession").

Interestingly, both the *Model Code of Professional Responsibility* ("*Model Code*"), promulgated by the American Bar Association ("ABA") in 1969, and the *Model Rules of Professional Conduct* ("*Model Rules*"), promulgated by the ABA in 1983, seem to assume that conduct appropriately subject to regulation is separate from matters of morality (which ethical regulations also may refer to as matters of "ethics"), but that the former is in some sense a subset of the latter. Thus, the *Model Code* is composed of Disciplinary Rules ("DRs"), which it declares to be mandatory statements of minimally acceptable conduct, and Ethical Considerations ("ECs"), which it describes as "aspirational in character and [representing] the objectives toward which every member of the profession should strive." MODEL CODE OF PROFESSIONAL RESPONSIBILITY Preliminary Statement (1980) [hereinafter MODEL CODE]; see generally Sutton, *The American Bar Association Code of Professional Responsibility: An Introduction*, 48 TEX. L. REV. 255, 258 (1970) (summarizing *Model Code*); Frankel, Book Review, 43 U. CHI. L. REV. 874, 877 (1976) (reviewing *Model Code*). The "Scope" statement of the *Model Rules* provides that "[t]he Rules do not . . .

to prevent the opportunity for other, more intrinsically offensive, practices from arising.<sup>3</sup> Like most prophylactic measures, the proscriptions in question tend to be overbroad, because in many cases these intrinsically offensive practices will not actually result.<sup>4</sup> Sometimes, in fact, the prohibited activity might even give rise to desirable consequences.<sup>5</sup>

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exhaust the moral and ethical considerations that should inform a lawyer, for no worthwhile human activity can be completely defined by legal rules. The Rules simply provide a framework for the ethical practice of law." MODEL RULES OF PROFESSIONAL CONDUCT Scope (1983) [hereinafter MODEL RULES].

Every state but California adopted the *Model Code*, or some variation of it. See NATIONAL CENTER FOR PROFESSIONAL RESPONSIBILITY, CODE OF PROFESSIONAL RESPONSIBILITY BY STATE (1980) (noting state variations). The *Model Rules*, sometimes with significant deviations, now have replaced the *Model Code* in slightly more than one-half of the states. See [4 Current Reports] Law. Man. on Prof. Conduct (ABA/BNA) 77 (Mar. 16, 1988); see also C. WOLFRAM, *supra*, § 2.6.3, at 56 (discussing authoritative effect of adoption).

3. See, e.g., MODEL CODE, *supra* note 2, DR 5-103(A) ("A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation he is conducting for a client . . ."); MODEL RULES, *supra* note 2, Rule 1.8(j) (containing substantially same language); see also CANONS OF PROFESSIONAL ETHICS Canon 10 (adopted 1908, superseded by *Model Code* 1970) [hereinafter 1908 CANONS] (prohibiting acquiring interest in litigation). The *Model Code* explains:

[T]he possibility of an adverse effect upon the exercise of free judgment by a lawyer on behalf of his client during litigation generally makes it undesirable for the lawyer to acquire a proprietary interest in the cause of his client or otherwise to become financially interested in the outcome of the litigation.

MODEL CODE, *supra* note 2, EC 5-7 (emphasis added); see also Part III(B), *infra* (discussing acquiring interest in litigation).

For examples of other regulations that appear to be primarily preventive in nature, see MODEL CODE, *supra* note 2, DR 5-101(B) (prohibiting lawyer from acting as advocate in case in which he should be called as witness); MODEL RULES, *supra* note 2, Rule 3.7(a) (same); MODEL CODE, *supra* note 2, DR 7-104(A)(1) (forbidding communications with parties known to be represented by counsel); MODEL RULES, *supra* note 2, Rule 4.2 (same); MODEL CODE, *supra* note 2, DR 3-102(A) (prohibiting sharing of legal fees with nonlawyers); MODEL RULES, *supra* note 2, Rule 5.4(a) (same); MODEL CODE, *supra* note 2, DR 2-107(A) (regulating division of fees among lawyers); MODEL RULES, *supra* note 2, Rule 1.5(e) (same); MODEL CODE, *supra* note 2, DR 3-103(A) (forbidding partnerships with nonlawyers when partnership's activities include practice of law); MODEL RULES, *supra* note 2, Rule 5.4(b) (same); MODEL CODE, *supra* note 2, DR 9-101(B) (prohibiting private employment in matter on which attorney functioned as public employee); MODEL RULES, *supra* note 2, Rule 1.11(a)-(b) (regulating private employment in matter on which attorney functioned as public employee).

4. In other words, it is not a foregone conclusion that a possibility such as that referred to in EC 5-7 always will come to pass. See *supra* note 3.

5. In fact, EC 5-7 recognizes and attempts to minimize the overbreadth problem, providing that "[a]lthough a contingent fee arrangement gives a lawyer a financial interest in the outcome of litigation, a reasonable contingent fee

Concerns with overbreadth of ethical regulations are particularly appropriate when those regulations may conflict with the goals that laws not primarily directed at the conduct of attorneys seek to achieve. This Article refers to such laws as *laws of general applicability* or *generally applicable law*.<sup>6</sup> In some circumstances laws of general applicability can directly limit the enforceability of ethical regulations. For example, jurisdictions with stringent rules governing attorney solicitation found, in the 1960s and early 1970s, that the broad application of those rules conflicted with the constitutional rights of certain groups to associate freely and to petition for redress of grievances.<sup>7</sup> In the late 1970s and the 1980s, ethical regulators have encountered and continue to encounter similar conflicts between rights to free speech and bans on attorney advertising and solicitation.<sup>8</sup>

In other circumstances, however, a conflict between ethical regulations and laws of general applicability can involve a sacrifice in attaining the goals of generally applicable law. The forms of such conflicts can be various and subtle,<sup>9</sup> requiring specific illustration and explanation.<sup>10</sup>

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is permissible in civil cases because it may be the only means by which a layman can obtain the services of a lawyer of his choice." MODEL CODE, *supra* note 2, EC 5-7 (footnote omitted).

6. As used in this Article, the terms *laws of general applicability* and *generally applicable law* may include both substantive law and aspects of procedure, such as standing. For examples of possible conflicts with generally applicable law not necessarily involving preventive regulation, see *infra* note 10.

7. See Riedmueller, *Group Legal Services and the Organized Bar*, 10 COLUM. J.L. & SOC. PROBS. 228, 246-54 (1974) (discussing NAACP v. Button, 371 U.S. 415 (1963), through Brotherhood of R.R. Trainmen v. Virginia *ex rel.* Virginia State Bar, 377 U.S. 1 (1964); United Mine Workers v. Illinois State Bar Ass'n, 389 U.S. 217 (1967); and United Transp. Union v. State Bar of Mich., 401 U.S. 576 (1971)); see also Armstrong, *Ethical Problems in Connection with the Delivery of Legal Services*, 12 SAN DIEGO L. REV. 336 (1975). A possible successor to the line of cases discussed in Riedmueller, *supra*, is *In re Primus*, 436 U.S. 412 (1978). See also *infra* text accompanying notes 128-30 (briefly discussing *Primus*).

8. See, e.g., *Shapero v. Kentucky Bar Ass'n*, 108 S. Ct. 1916, 1924-25 (1988) (solicitation); *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 647-49 (1985) (advertising); *In re R.M.J.*, 455 U.S. 191, 203-07 (1982) (advertising); *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 457-59 (1978) (solicitation); *Primus*, 436 U.S. at 431-32 (1978) (solicitation); *Bates v. State Bar of Ariz.*, 433 U.S. 350, 383-84 (1977) (advertising); see also *infra* notes 123-38 (discussing Supreme Court response to bans on solicitation).

9. This is not meant to suggest, however, that such problems are limitless in number, or that the drafters of existing ethical regulations have not attempted to consider them.

10. Uncomfortable relationships between generally applicable laws and ethical regulations exist even when the ethical regulation in question is not

One specific area in which laws of general applicability are in apparent conflict with ethical regulations is in the instigation of certain types of shareholder litigation. This Article focuses on the ethical aspects of litigation brought under the specific statutory mandate of section 16(b) of the Securities Exchange Act of 1934 ("1934 Act").<sup>11</sup> For purposes of discussion and dif-

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primarily preventive. For example, the *Model Rules* require lawyers to disclose to the tribunal the perjury of a client in a criminal case. See MODEL RULES, *supra* note 2, Rule 3.3(a)(2) (prohibiting lawyer from knowingly failing to "disclose a material fact to a tribunal when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client"); *id.* Rule 3.3(a)(4) (prohibiting lawyer from offering evidence that lawyer knows to be false and requiring lawyer to take reasonable remedial measures upon learning of falsity of material evidence already offered). The drafters recognized, however, that such disclosure arguably infringes the right of the accused to effective assistance of counsel. Thus, the comments to Rule 3.3 provide as follows:

The general rule—that an advocate must disclose the existence of perjury with respect to a material fact, even that of a client—applies to defense counsel in criminal cases, as well as in other instances. However, the definition of the lawyer's ethical duty in such a situation may be qualified by constitutional provisions for due process and the right to counsel in criminal cases. In some jurisdictions these provisions have been construed to require that counsel present an accused as a witness if the accused wishes to testify, even if counsel knows the testimony will be false. The obligation of the advocate under these Rules is subordinate to such a constitutional requirement.

MODEL RULES, *supra* note 2, Rule 3.3 comment.

Even when there is no apparent conflict between the two, integration of generally applicable law and ethical regulation can present substantial difficulty. For instance, in certain circumstances some jurisdictions call for attorney disclosure to third parties of at least nonprivileged information indicating client fraud in the course of representation. See MODEL CODE, *supra* note 2, DR 7-102(B)(1); MODEL RULES, *supra* note 2, Rule 4.1(b). The comment to Rule 4.1 notes that "substantive law may require a lawyer to disclose certain information to avoid being deemed to have assisted the client's crime or fraud." MODEL RULES, *supra* note 2, Rule 4.1 comment; *see also* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 341 (1975) (interpreting *fraud* as active fraud, requiring scienter or intent to deceive). These uses apparently contemplate some kind of incorporation by reference of notions of common law fraud. See generally Note, *Client Fraud and the Lawyer—An Ethical Analysis*, 62 MINN. L. REV. 89, 106 (1977) (discussing the definition of *fraud* in the context of the *Model Code*).

In addition to these examples of conflicts, consider the opportunities for conflict that the examples of preventive regulations given in note 3, *supra*, present.

11. Ch. 404, 48 Stat. 881, 896 (codified at 15 U.S.C. § 78p(b) (1982)). Section 16(b) provides as follows:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in

ferentiation, this Article compares these ethical considerations to similar considerations arising in connection with shareholder derivative litigation at common law.<sup>12</sup>

Part I presents a brief overview of the procedural framework for bringing section 16(b) and common-law derivative actions and discusses the policy objectives behind these actions. Part II examines two traditional ethical concerns—solicitation and acquiring an interest in litigation—that may conflict with implementation of these policy objectives.

The relationship between generally applicable law and ethical regulation in the context of the two types of actions described leads to several conclusions, discussed in Part III, most of which also apply to other ethical regulations that are preventive in nature. For example, although there are ethical improprieties regularly associated with the forms of litigation that this Article examines, there are instances in which the dangers that the relevant ethical prohibitions purport to address either do not exist, or can be handled by alternate methods. Moreover, behavior of attorneys that is a technical violation of ethical regulations can, especially in the section 16(b) context, actually further the goals of generally applicable law. Among the possible results of the type of regulatory overbreadth that the preceding conclusions suggest is a disinclination of ethical enforcement bodies to investigate or prosecute technical viola-

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good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

15 U.S.C. § 78p(b) (1982).

12. The reference to instigation of shareholder derivative litigation at common law is a deliberate generalization adopted for purposes of counterpoise to section 16(b). See *infra* note 21 and accompanying text. There is, of course, substantial statutory regulation of derivative actions brought under state law. See *infra* notes 29, 54.

tions in certain recurring fact situations. In other words, enforcement bodies may not consistently enforce overbroad rules.

At present, there is no acknowledged method of integrating the goals of generally applicable law and those of ethical regulation. Part IV of this Article suggests such a method. Optimally, integration would involve rethinking the way in which legal services are provided in any particular substantive area. Failing such a drastic restructuring, bodies responsible for the adoption or enforcement of ethical rules should apply an analytic method determining, comparing, and, when necessary, weighing the often conflicting goals of generally applicable law and ethical regulation. Despite the ethical scrutiny traditionally given to the tension between attorney and client interests,<sup>13</sup> attorney self-interest can play a positive role in formulating precise responses to conflicts that this integration process reveals.

## I. BACKGROUND

### A. SECTION 16(b)

Section 16(b) provides for disgorgement of all profits resulting from short-swing insider trading that is subject to reporting under section 16(a) of the 1934 Act.<sup>14</sup> More specifically, statutorily-defined insiders, including officers, directors, and certain holders of substantial amounts of the issuer's securities, must turn over to the issuer any profit received from the

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13. See *supra* note 3 and *infra* Part III(B).

14. Ch. 404, 48 Stat. 881, 896 (codified as amended at 15 U.S.C. § 78p(a) (1982)). Section 16(a) provides as follows:

Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78l of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78l(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

15 U.S.C. § 78p(a) (1982).

purchase and sale or the sale and purchase of specified securities<sup>15</sup> taking place within six months of the opposing transaction.<sup>16</sup> Although Congress adopted the provision “[f]or the purpose of preventing the unfair use of information which may have been obtained by such [insider] by reason of his relationship to the issuer,”<sup>17</sup> proof of unfair use is not a prerequisite to liability.<sup>18</sup>

Although the issuer may decide of its own accord to bring a section 16(b) cause of action,<sup>19</sup> the provision also allows a shareholder to instigate suit if the issuer does not respond in a timely fashion to the shareholder’s demand that the issuer sue for disgorgement.<sup>20</sup> Because any recovery as the result of such suit is for the benefit of the issuer, commentators have described section 16(b) as creating a “hybrid type of derivative suit.”<sup>21</sup> Ac-

15. The securities specified are all equity securities of an issuer having any equity security registered under § 12 of the 1934 Act (codified as amended at 15 U.S.C. § 78l (1982)). See *supra* note 14.

16. For general descriptions of the operation of § 16(b), see 2 L. LOSS, SECURITIES REGULATION 1037-44 (2d ed. 1961); Painter, *The Evolving Role of Section 16(b)*, 62 MICH. L. REV. 649 (1964). There are a number of complexities in the application of § 16(b) that are beyond the scope of this Article. For discussion of some of these, see Shreve, *Beneficial Ownership of Securities Held by Family Members*, 22 BUS. LAW. 431 (1967) (discussing inclusion of shares held by family members when determining insider status); Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales—Merging the Objective and Pragmatic Analyses*, 1981 DUKE L.J. 941 (discussing characterization of transactions as purchases or sales); Wagner, *Deputization Under Section 16(b): The Implications of Feder v. Martin Marietta Corporation*, 78 YALE L.J. 1151 (1969) (discussing theoretical deputy status of corporate directors employed by other corporations); Wentz, *Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 NW. U.L. REV. 221 (1975) (advocating use of pragmatic standard to determine liability); Comment, *Section 16(b) of the Securities Exchange Act of 1934: Is a Vice President an Officer?*, 58 NEB. L. REV. 733 (1979) (discussing evolving definition of officer).

17. 15 U.S.C. § 78p(b) (1982).

18. See *Stock Exchange Practices, Part 15, Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 6557 (1934) (statement of Thomas G. Corcoran, Office of General Counsel for the Reconstruction Finance Corporation).

19. See 15 U.S.C. § 78p(b) (1982); see also *supra* note 11 (quoting § 78p(b)); 5 L. LOSS, *supra* note 16, at 3012 (“Increasingly companies seem to be bringing their own suits.”).

20. Section 16(b) provides that the shareholder may initiate suit if the issuer fails or refuses to bring suit within 60 days after request or thereafter fails diligently to prosecute the suit. See *supra* note 11. Courts will excuse the demand requirement if demand would be futile. *Grossman v. Young*, 72 F. Supp. 375, 380 (S.D.N.Y. 1947), *petition for prohibition and mandamus denied sub. nom. Young v. Rifkind*, 2d Cir., Oct. 13, 1947. See *infra* notes 36, 144.

21. T. HAZEN, THE LAW OF SECURITIES REGULATION § 12.3, at 414 (1985). Nonetheless, there are a number of distinctions between the § 16(b) cause of



cordingly, for purposes of this Article, general references to derivative suits or suits in derivative contexts will include actions under section 16(b) unless the context indicates otherwise.

A shareholder instigating litigation under section 16(b) must be a holder of record at the time of suit<sup>22</sup> and throughout trial.<sup>23</sup> Section 16(b) does not require, however, that the instigating shareholder have held any shares at the time of the short-swing transactions giving rise to the cause of action.<sup>24</sup> The instigating shareholder's control over the suit is somewhat limited; ordinarily, the instigating shareholder cannot dismiss or compromise the suit without court approval and notice to the issuer's other security holders.<sup>25</sup>

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action and the "true" derivative action. *See infra* text accompanying notes 53-58. The Fifth Circuit has taken the position that the cause of action merely resembles a derivative action in some respects. *See Dottenheim v. Murchison*, 227 F.2d 737, 738 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1957); *see also Smolow v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir.) (stating that § 16(b) "in effect creates a derivative right of action"), *cert. denied*, 320 U.S. 751 (1943); *Rosenfeld v. Richardson*, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,176 (S.D.N.Y. 1962) (noting similarities and differences between § 16(b) suits and ordinary derivative suits), *cert. denied sub nom. Leighton v. One William St. Fund, Inc.*, 373 U.S. 937 (1963); *Henss v. Schneider*, 132 F. Supp. 60, 63 (S.D.N.Y. 1955) (describing § 16(b) suits as "derivative in nature"); *Arbetman v. Playford*, 83 F. Supp. 335, 336 (S.D.N.Y. 1949) (describing § 16(b) suit as derivative suit in nature of equitable action); *Pottish v. Divak*, 71 F. Supp. 737, 739-40 (S.D.N.Y. 1947) (stating that new cause of action is created resembling shareholder's derivative action). According to Loss:

[T]he terminology is of no great moment; for, whether the action is called derivative, pseudo-derivative or non-derivative, it still owes its existence to the statute and hence does not fall within the frame of reference created by courts of equity for derivative actions except to an extent consistent with the statute.

2 L. LOSS, *supra* note 16, at 1046 n.41.

22. *See Murchison*, 227 F.2d at 740; *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Benisch v. Cameron*, 81 F. Supp. 882, 884-85 (S.D.N.Y. 1948).

23. *See Portnoy v. Kawecki Berylco Indus.*, 607 F.2d 765, 767 (7th Cir. 1979); *Rothenberg v. United Brands Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,045 (S.D.N.Y.), *aff'd*, 573 F.2d 1295 (2d Cir. 1977).

24. *Mission Corp.*, 212 F.2d at 79; *Benisch*, 81 F. Supp. at 884-85; *Pottish*, 71 F. Supp. at 739; *Kogan v. Schulte*, 61 F. Supp. 604, 609-10 (S.D.N.Y. 1945). Section 16(b) differs in this regard from other derivative causes of action, which generally require that the shareholder have owned shares at the time the wrong complained of occurred. *See infra* note 41 and accompanying text.

25. *See Blau v. Allen*, 171 F. Supp. 669, 671 (S.D.N.Y. 1959); *Pottish*, 71 F. Supp. at 739-40. *But see Plaskow v. Peabody Int'l Corp.*, 95 F.R.D. 297, 299 (S.D.N.Y. 1982) (holding that hearing and notice not necessary when cost would substantially deplete settlement recovery representing full statutory damages).

In the event an action by a shareholder against an insider results in some recovery, the shareholder typically will be entitled to reimbursement for reasonable attorneys' fees.<sup>26</sup> In fact, even when the shareholder does not bring suit, a court may award attorneys' fees if the shareholder's demands force the corporation into action it otherwise would have refused to take.<sup>27</sup> In either case, the court must approve the amount of the award and, in doing so, will take into account such considerations as "the fund recovered, the difficulty of the litigation, the time consumed, and the contribution made."<sup>28</sup>

## B. OTHER DERIVATIVE SUITS

At common law,<sup>29</sup> a shareholder's derivative action is "an equitable action by the corporation as the real party in interest with a stockholder as a nominal plaintiff representing the corporation."<sup>30</sup> As this description suggests, any recovery inures to the corporation and benefits the nominal plaintiff only through proportional enhancement of share value. The types of wrongs that may give rise to a common-law derivative action include wrongful acts by corporate officers, directors, or majority share-

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26. Recovery of attorneys' fees is based on the benefit theory described note 50, *infra*. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

27. See *Gilson v. Chock Full O'Nuts Corp.*, 331 F.2d 107, 109 (2d Cir. 1964) (en banc); *Dottenheim v. Emerson Elec. Mfg. Co.*, 7 F.R.D. 195, 197 (E.D.N.Y. 1947); *cf.* *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 473 (2d Cir. 1968) (allowing reimbursement for information leading to corporate recovery when corporation had done nothing for substantial period of time after suspect transactions and inactivity was likely to continue). Simply notifying the corporation that a § 16(b) cause of action exists will not suffice, because courts do not "want lawyers poring over 16(a) reports as soon as they are made public to find a cause of action before the corporation does and thereby collect a fee." *Id.* at 473; see Note, *Securities Regulation: Section 16(b) and Attorney's Fees for Parties Not of Record*, 64 COLUM. L. REV. 1343, 1346 (1964).

28. *Cook & Feldman, Insider Trading under the Securities Exchange Act*, 66 HARV. L. REV. 385, 421 (1953).

29. In some jurisdictions, statutes specifically confer and regulate the right to sue on behalf of the corporation. See generally 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 5942-5942.210 (indicating specific statutory provisions); Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 88-89 (1967) (discussing statutes that ease imposed cost burdens on plaintiff shareholders); Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L. J. 875, 929 (citing significant statutory provisions).

30. *Barrett v. Southern Conn. Gas Co.*, 172 Conn. 362, 370, 374 A.2d 1051, 1055 (1977) (citing 13 W. FLETCHER, *supra* note 29, § 5939); see also Comment, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110 U. PA. L. REV. 1147, 1147 (1962) (discussing "blurred area" between direct shareholder suits and shareholder derivative suits).

holders,<sup>31</sup> and wrongful acts by third parties.<sup>32</sup> Shareholders may not base derivative actions on acts within the discretion of the corporate officers or directors unless such discretion has been abused.<sup>33</sup>

Because the decision to bring suits to redress corporate injuries is properly within the discretion of the corporate directors,<sup>34</sup> common law requires a shareholder wishing to sue derivatively first to demand that the corporation bring the suit,<sup>35</sup> unless it is clear that demand would be futile.<sup>36</sup> The decision of the directors not to sue will be conclusive if it is considered<sup>37</sup> and is free of the taint of self-interest.<sup>38</sup> The same generally is true of a decision by the board, or an independent committee thereof, to move for dismissal after a shareholder institutes suit.<sup>39</sup>

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31. See, e.g., *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 319 (1936); *Hawes v. Oakland*, 104 U.S. 450, 460 (1882); see also H. HENN & J. ALXANDER, *LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 358, at 1037 (3d ed. 1983) (recognizing greater need for derivative remedy when insiders perpetrate wrong).

32. See, e.g., *Nelson v. Gammon*, 478 F. Supp. 630, 632 (W.D. Ky. 1979), *aff'd*, 647 F.2d 710 (6th Cir. 1981); *Security Trust Co. v. Dabney*, 372 S.W.2d 401, 403 (Ky. 1963).

33. See, e.g., *Klotz v. Consolidated Edison Co.*, 386 F. Supp. 577, 587 (S.D.N.Y. 1974); *James Talcott, Inc. v. McDowell*, 148 So. 2d 36, 38 (Fla. Dist. Ct. App. 1962).

34. See *Post v. Buck's Stove & Range Co.*, 200 F. 918, 921 (8th Cir. 1912); *S. Solomont & Sons Trust, Inc. v. New Eng. Theatres Operating Corp.*, 326 Mass. 99, 114, 93 N.E.2d 241, 249 (1950).

35. See R. CLARK, *CORPORATE LAW* § 15.2, at 640 (1986) ("The procedural codes of virtually all jurisdictions assume the demand requirement without directly stating it."); see generally Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 746-49 (1960) (explaining rationale for demand requirement).

36. See, e.g., *Cathedral Estates, Inc. v. Taft Realty Corp.*, 228 F.2d 85, 88 (2d Cir. 1955); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 19, 99 N.E. 138, 142 (1912). Courts determine futility in light of the involvement of the directors or those controlling them in the wrong of which the shareholder complains. Typically, demand will be regarded as futile when a majority of the board is involved in, or controlled by those involved in, the alleged wrongdoing. The shareholder may need to demonstrate the existence of control with some particularity. See *Aronson*, 473 A.2d at 818-19.

37. See *Ash v. I.B.M.*, 353 F.2d 491, 492-93 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Findley v. Garrett*, 109 Cal. App. 2d 166, 178, 240 P.2d 421, 431 (1952).

38. See *Nussbacher v. Chase Manhattan Bank*, 444 F. Supp. 973, 976 (S.D.N.Y. 1977); *Groel v. United Elec. Co.*, 70 N.J. Eq. 616, 623, 61 A. 1061, 1063 (1905).

39. See Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 964;

Common law and statutes place various restrictions, in addition to the demand requirement, on the right of a shareholder to act as nominal plaintiff.<sup>40</sup> One restriction is a requirement that the complaining shareholder have owned shares at the time the wrong complained of occurred.<sup>41</sup> In some jurisdictions, the complaining shareholder must post security unless the minimum ownership requirements are met.<sup>42</sup> In addition, many jurisdictions require that the shareholder seeking to bring a derivative suit "fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association."<sup>43</sup> Although the standard for representation is not well-devel-

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Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 97-98 (1980); Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits*, 35 U. MIAMI L. REV. 1, 1 (1980). *Findley* appears to have been the first case in the United States to endorse dismissal at the recommendation of disinterested directors. *Findley*, 109 Cal. App. 2d at 178, 240 P.2d at 431.

At least in Delaware, however, a court may exercise its own business judgment in determining whether to dismiss a derivative suit, and whether to review the decision of the directors for disinterestedness and reasonable diligence. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981). Moreover, in both Delaware and New York, the question courts address in determining the appropriateness of dismissal is whether the derivative suit should continue, rather than whether the shareholder should have brought it in the first place. *Id.* at 785; *Auerbach v. Bennett*, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979).

40. The American Law Institute has proposed relaxation of a number of these restrictions. See PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS §§ 7.01-07 (Tent. Draft No. 1, 1982); see also Cox, *supra* note 39, at 994-1007 (describing and critiquing proposals).

41. Originally, the ownership requirement was a device "for preventing the fabrication of diversity of citizenship in federal courts." See *Hawes v. Oakland*, 104 U.S. 450, 451 (1882). State courts now have adopted the requirement as an indicator of merit. See Conard, *Winnowing Derivative Suits Through Attorneys Fees*, LAW & CONTEMP. PROBS., Winter 1984, at 269, 277; Harbrecht, *The Contemporaneous Ownership Rule in Shareholders' Derivative Suits*, 25 UCLA L. REV. 1041, 1043, 1048 (1978).

42. About one-third of the states have enacted statutes that require plaintiffs in derivative suits to post security for the expenses of defendants in certain circumstances. See R. CLARK, *supra* note 35, § 15.5, at 652-53. Some of these statutes link the requirement to the extent of the plaintiff's shareholdings. *Id.* at 653. See generally Note, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J.L. & SOC. PROBS. 50, 53 (1968) (discussing statutes that discourage unmeritorious derivative claims). The security requirement has been of limited effect because courts have allowed plaintiff shareholders of publicly-held corporations to meet the threshold by aggregating holdings. *Id.* at 62-63.

43. FED. R. CIV. P. 23.1; see, e.g., CONN. GEN. STAT. § 52-572j (1987); OHIO R. CIV. P. 23.1. Courts may infer such a requirement even when the statute

oped,<sup>44</sup> courts have taken into account such matters as knowledge about the suit,<sup>45</sup> intent to vigorously prosecute,<sup>46</sup> and whether the would-be nominal plaintiff is the suit's "moving force."<sup>47</sup>

As in the case of the section 16(b) action, a shareholder who brings a common-law derivative suit may not dismiss or compromise the suit without court approval.<sup>48</sup> The purposes of this requirement are to guard against settlements disproportionately benefiting the nominal plaintiff and to discourage suits intended to spawn such settlements.<sup>49</sup> If the suit results in benefits to the corporation, the nominal plaintiff typically will be entitled to reimbursement for reasonable expenses, including attorneys' fees, in an amount that is subject to court scrutiny.<sup>50</sup> The terms of such scrutiny are similar to those for

does not expressly state it. *See, e.g.,* *Youngman v. Tahmoush*, 457 A.2d 376, 379 (Del. Ch. 1983).

44. *See* Note, *Res Judicata in the Derivative Action: Adequacy of Representation and the Inadequate Plaintiff*, 71 MICH. L. REV. 1042, 1050 (1973) [hereinafter Note, *Adequacy of Representation*]. According to some commentators, the more extensive precedent developed in the context of class actions applies by analogy. *See* 7A C. WRIGHT, A. MILLER & M. KANE, FEDERAL PRACTICE AND PROCEDURE § 1833, at 132 (1986). *But see* Note, *The Attorney as Plaintiff and Quasi-Plaintiff in Class and Derivative Actions: Ethical and Procedural Considerations*, 18 B.C. INDUS. & COM. L. REV. 467, 487-90 (1977) [hereinafter Note, *Attorney as Plaintiff*]; Note, *Adequacy of Representation, supra*, at 1050.

45. *See* *Rothenberg v. Security Management Co.*, 667 F.2d 958, 961 (11th Cir. 1982). *But see* *Lewis v. Curtis*, 671 F.2d 779, 789 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).

46. *See* *Sweet v. Birmingham*, 65 F.R.D. 551, 554 (S.D.N.Y. 1975).

47. *See* *Davis v. Comed, Inc.*, 619 F.2d 588, 597 (6th Cir. 1980); *see also infra* text accompanying note 93. In the class action context, *see* *Bogus v. American Speech & Hearing Ass'n*, 20 Fed. R. Serv. 2d (Callaghan) 859, 861 (E.D. Pa. 1975); *Graybeal v. American Sav. & Loan Ass'n*, 59 F.R.D. 7, 13-14 (D.D.C. 1973); *Eovaldi v. First Nat'l Bank*, 57 F.R.D. 545, 546 (N.D. Ill. 1972). *But see* *Lamb v. United Sec. Life Co.*, 59 F.R.D. 25, 30-31 (S.D. Iowa 1972).

48. *See* FED. R. CIV. P. 23.1 (specifying that plaintiffs may dismiss or compromise derivative actions only with approval of court and after notice to shareholders as court directs). A majority of jurisdictions now have similar rules. *See* Haudek, *The Settlement and Dismissal of Stockholders' Actions—Part I*, 22 Sw. L.J. 767, 767 & n.3 (1968) (citing state statutes).

49. *See* H. HENN & J. ALEXANDER, *supra* note 31, § 374, at 1100. Such suits, typically known as "nuisance suits," may have settlement value without respect to merit, owing, for instance, to the harassment potential of discovery. *See* Conard, *supra* note 41, at 276.

50. The general American rule is that absent a specific statutory authorization, the prevailing party to a lawsuit cannot recover attorneys' fees. *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975). There is a well-established exception, however, providing that a plaintiff in a shareholder derivative action may recover expenses, including attorneys' fees, from the

recovery of attorneys' fees in section 16(b) actions,<sup>51</sup> and include assessment of hours worked, regular billing rate, quality of service, risk of nonrecovery, and extent of benefit to the corporation.<sup>52</sup>

### C. DIFFERENCES BETWEEN SECTION 16(b) AND OTHER DERIVATIVE LITIGATION

At least one of the differences between instigating section 16(b) litigation and instigating other derivative actions should be clear: the standing requirements for bringing section 16(b) litigation are relatively more relaxed, because there is no contemporaneous ownership requirement.<sup>53</sup> Furthermore, section 16(b) precedent does not require formal scrutiny of the nominal plaintiff's ability to represent similarly situated shareholders.

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corporation on whose behalf action was taken, provided the corporation derives a benefit—monetary or nonmonetary—from the action. See *Shlensky v. Dorsey*, 574 F.2d 131, 149 (3d Cir. 1978); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 995 (7th Cir. 1976); see also Note, *Attorneys' Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Reexamined*, 60 CALIF. L. REV. 164, 164 (1972) (evaluating substantial benefit rule for award of attorneys' fees); Note, *Corporations: Stockholders' Suits: Award of Attorneys' Fees Where Corporation Receives a "Substantial Benefit"*, 48 CALIF. L. REV. 843, 844 (1960) (discussing nature of corporate benefits of attorneys' fees).

51. See *supra* notes 26-28 and accompanying text.

52. Presently, the prevailing approach to fee calculation for representative actions—both class and derivative—brought in federal courts is known as the "lodestar." Pursuant to this approach, courts base fees on hours worked, multiplied by an hourly rate (both with checks for reasonableness), adjusted to reflect quality of service, risk, and results achieved. See *Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp.*, 540 F.2d 102, 114-15 (3d Cir. 1976); see also Herzel & Hagan, *Plaintiffs' Attorneys' Fees in Derivative and Class Actions*, 7 LITIGATION 25, 25 (Winter 1981) (discussing problems with standard calculations of attorneys' fees in derivative and class actions); Mowrey, *Attorney Fees in Securities Class Action and Derivative Suits*, 3 J. CORP. L. 267, 301-02 (1978) (discussing basis and size of attorneys' fees awards); Rowe, *The Supreme Court on Attorney Fee Awards, 1985 and 1986 Terms: Economics, Ethics and Ex Ante Analysis*, 1 GEO. J. LEGAL ETHICS 621, 622 (1988) [hereinafter Rowe, *Recent Developments*] (discussing recent developments in the lodestar approach).

Until the late 1970s, awards calculated simply as a percentage of the benefit conferred on the represented corporation were common. See Cole, *Counsel Fees in Stockholders' Derivative and Class Actions—Hornstein Revisited*, 6 U. RICH. L. REV. 259, 273-75 (1972); Dawson, *Lawyers and Involuntary Clients in Public Interest Litigation*, 88 HARV. L. REV. 849, 876 (1975); Hornstein, *Legal Therapeutics: The "Salvage" Factor in Counsel Fee Awards*, 69 HARV. L. REV. 658, 664 (1956). The movement away from percentages may have been a response to antitrust class actions involving estimated benefits in the millions of dollars. See Hammond, *Stringent New Standards for Awards of Attorney's Fees*, 32 BUS. LAW. 523, 524 (1977).

53. See *supra* notes 24, 41 and accompanying text.

In a related vein, there is no requirement that a plaintiff post security, and no restriction on the number or value of shares the nominal plaintiff must own.

There are, in addition, several distinctions between section 16(b) and other derivative litigation that are not related to the qualifications of the nominal plaintiff. One distinction, of course, is that the section 16(b) cause of action is a statutory creation.<sup>54</sup> In addition, the elements of a section 16(b) cause of action are relatively easy to identify and prove. The existence of other derivative causes of action often is more difficult to demonstrate, primarily because they usually are based on circumstances that are more ephemeral and hard to define.<sup>55</sup> Furthermore, although section 16(b) and other forms of derivative litigation generally impose a demand requirement on potential nominal plaintiffs, the consequences of the issuer's refusal to instigate suit in its own behalf are critically different. In the section 16(b) context, the issuer's refusal leaves the nominal plaintiff free to bring the action. In other derivative situations, refusal based on a disinterested exercise of reasonable business judgment<sup>56</sup> generally will preclude the suit. Similarly, any attempt by management to have a section 16(b) suit dismissed after it is brought would be ineffective, but in other derivative contexts courts will respect management's motion for dismissal if certain standards are met. Each of these differences<sup>57</sup> is a signal that section 16(b) suits are, as a matter of public policy, favored over other sorts of derivative litigation.<sup>58</sup> This Article discusses the further significance of this conclusion in Part III.

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54. A number of states do regulate aspects of derivative suits by statute. See *supra* note 29. Nonetheless, the existence of the derivative action substantially predated statutory regulation. See *Boyd v. Bell*, 64 F. Supp. 22, 23 (S.D.N.Y. 1945) (noting that right of stockholder to bring derivative action is not creature of statute and existed independently of any statute for many years); *Bourne v. Williams*, 633 S.W.2d 469, 471 (Tenn. Ct. App. 1981) (noting that derivative actions were recognized in state as early as 1874, but statute was not adopted until 1968); see also Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980, 986 (1957) (crediting *Robinson v. Smith*, 3 Paige Ch. 222 (N.Y. Ch. 1832) with "paternity of the shareholders' derivative action").

55. See *infra* notes 227-45 and accompanying text.

56. See *supra* notes 37-39 and accompanying text.

57. See, however, the proposals of the American Law Institute, *supra* note 40, for a prospective reconciliation of some of these differences.

58. A cause of action's existence expresses a minimal social judgment on its desirability. The ease or difficulty of proving a cause of action may express a qualification of the social judgment. When plaintiffs overcome any difficulties and achieve recovery, however, the recovery presumptively establishes desirability of the action in the particular case.

## II. ETHICAL IMPROPRIETIES PRESENTED BY SECTION 16(b) AND OTHER DERIVATIVE LEGAL PRACTICE

### A. SECTION 16(b)

It is no secret<sup>59</sup> that a small segment of the bar makes a practice of identifying potential claims for the recovery of profit under section 16(b).<sup>60</sup> The willingness of courts to award fees from the amount recovered<sup>61</sup> and the cause of action's relative ease of proof encourage this pursuit. The lawyers in question may solicit shareholders of the traded stock for employment in bringing suit. Alternatively, these lawyers may take advantage of section 16(b)'s relaxed standing requirements<sup>62</sup> by asking acquaintances to purchase the necessary securities and to retain their legal services,<sup>63</sup> or by acquiring the securities themselves.<sup>64</sup>

There is reason to believe that much, if not most, shareholder section 16(b) litigation results from the activities just described. Because a recovery under section 16(b) redounds to the benefit of the issuer of the traded securities, an individual

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59. See 2 L. LOSS, *supra* note 16, at 1052-53 (& Supp. vol. 5, at 3016-17); Cary, Israels & Loss, *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856, 858-59, 862 (1963); Cary, Book Review, 75 HARV. L. REV. 857, 860-61 (1962) (reviewing L. LOSS, *SECURITIES REGULATION* (2d ed. 1961)).

60. A review of the reports filed pursuant to the requirements of § 16(a) reveals potential claims. See *supra* note 14. In addition, the federal proxy rules require disclosure in the proxy statement of the indebtedness to the issuer—including § 16(b) liability—of officers and directors if such indebtedness exceeds \$60,000. See 17 C.F.R. § 240.14a-101 (1988) (incorporating by reference 17 C.F.R. § 229.404(c)); see also *Davis v. Commissioner*, 17 T.C. 549, 552-53 (1951) (requiring corporation to disclose indebtedness of director in proxy statement).

61. See *Magida v. Continental Can Co.*, 231 F.2d 843, 848 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). There generally is no fee award against defendants. Courts have held that attorneys' fees are not available under § 16(b) when the corporation brings the action. See *Super Stores, Inc. v. Reiner*, 737 F.2d 962, 965 (11th Cir. 1984).

62. See *supra* notes 22-24 and accompanying text.

63. For example, an attorney responsible for a significant amount of § 16(b) shareholder litigation brought in the 1960s represented to the relevant courts that various individuals had retained him for the purpose of identifying § 16(b) causes of action. See *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 470-71 (2d Cir. 1968). The attorney did not discuss whether he or the clients initiated these arrangements, but the clients would have little incentive to do so. See *id.* at 470; *infra* notes 65-67 and accompanying text.

64. It is not clear which of these three practices is the prevailing one. The flagrancy of the third, however, renders it the least likely, especially insofar as it might affect the court's generosity in calculating fees.



shareholder frequently will have insufficient motivation to seek out and identify the cause of action, much less to bring suit.<sup>65</sup> This reluctance to engage in an activity, resulting because the participant must share its benefits, is known as the free-rider problem.<sup>66</sup> In circumstances presenting this problem, it often will be only an attorney—hoping for an award of fees<sup>67</sup> at least roughly proportional to the effort exerted and risk undertaken to produce the ultimate recovery—who will have adequate incentive to pursue possible causes of action.

Another aspect of the free-rider problem in the section 16(b) context is that potential nominal plaintiffs may be unwilling to enter into financial arrangements that require them to bear the attorneys' fees and expenses of the suit. Because recovery is for the benefit of the "wronged" corporation, a section 16(b) suit is economic for most holders of securities<sup>68</sup> only if brought on a contingent fee basis.<sup>69</sup> Moreover, even when the

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65. This lack of shareholder motivation is present, of course, in any derivative suit. *See supra* text accompanying notes 29-33 and *infra* text accompanying note 91. In addition, in both § 16(b) and other derivative contexts the prospect of obtaining an individual benefit by extracting a collateral payment, possibly in lieu of filing suit, may provide individual shareholders with different incentives from those described in the text. In such cases, no free-rider problem exists, although there are other problems, and it is possible that the transaction involves neither solicitation nor a contingent fee and expense arrangement. Suits and threatened suits of this nature are outside the scope of this Article.

66. *See generally* C. GOETZ, CASES AND MATERIALS ON LAW AND ECONOMICS, 27-28, 98 (1984) (describing free-rider problem).

67. *See supra* notes 26-28 and accompanying text.

68. This is not the case, however, when the holder is the attorney bringing suit. *See supra* text accompanying note 64.

69. In an effort to deal with similar problems in other contexts, many courts and legislatures have authorized fee shifting on a "private attorney general" theory. *See Rowe, The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651, 662-63 [hereinafter Rowe, *Fee Shifting*]. The Supreme Court, however, has refused to allow federal courts to shift fees under this theory without an authorizing statute. *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 269 (1975). One might expect a legislative response allowing for fee shifting; however, § 16(b) does not require a finding of "fault" before imposing liability and there may be instances in which a legitimate need for liquidity requires a short-swing sale. Thus, the general rule for stripping insiders of short-swing profit alone may provide appropriate deterrence of use of inside information. Deterrence of the transactions themselves through imposition of the plaintiff's attorneys' fees might be unnecessarily harsh. In addition, introducing fee shifting, even when "fault" is involved, may be an unnecessary complication in what is presently a rather streamlined cause of action.

Fee shifting also would present another set of difficulties. For instance, allowing a contingency premium when courts shift fees would become problematic, because the cases in which the risk of plaintiff's loss is greatest are

fee arrangement is a contingent one, such a suit would be uneconomic, from the shareholder's viewpoint, if the shareholder must advance the expenses of the action or ultimately bear those expenses in the event of loss. Accordingly, arrangements pursuant to which an attorney undertakes the suit on a contingent fee basis, and advances all expenses on the same basis, are virtually an essential concomitant of section 16(b) enforcement.<sup>70</sup> This Article will refer to such arrangements as *contingent fee and expense* arrangements.<sup>71</sup>

The activities and arrangements described in the preceding paragraphs give rise to a number of technical violations of traditional ethical restraints. The solicitation of employment from existing holders of securities, for example, violates longstanding proscriptions.<sup>72</sup> Although ethical regulations cur-

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also those in which the defendant's case is strongest. Awarding the highest fees against the defendants with the best cases is arguably illogical and inequitable. See Leubsdorf, *The Contingency Factor in Attorney Fee Awards*, 90 YALE L.J. 473, 474, 488-90 (1981).

70. Cf. Findlater, *The Proposed Revision of DR 5-103(B): Champerty and Class Actions*, 36 BUS. LAW. 1667, 1669-70 (1981) (declaring that derivative actions almost always violate Model Code's prohibition against acquiring interest in litigation).

71. When defined in this way, fees and expenses are contingent on the fact of recovery, but are not necessarily calculated as set percentages of the recovered amount. See *supra* note 28 and accompanying text.

72. See 1908 CANONS, *supra* note 3, Canon 28. Canon 28 provided as follows:

It is unprofessional for a lawyer to volunteer advice to bring a lawsuit, except in rare cases where ties of blood, relationship or trust make it his duty to do so. Stirring up strife and litigation is not only unprofessional, but it is indictable at common law. It is disreputable to hunt up defects in titles or other causes of action and inform thereof in order to be employed to bring suit or collect judgment, or to breed litigation by seeking out those with claims for personal injuries or those having any other grounds of action in order to secure them as clients, or to employ agents or runners for like purposes, or to pay or reward, directly or indirectly, those who bring or influence the bringing of such cases to his office, or to remunerate policemen, court or prison officials, physicians, hospital *attachés* or others who may succeed, under the guise of giving disinterested friendly advice, in influencing the criminal, the sick and the injured, the ignorant or others, to seek his professional services. A duty to the public and to the profession devolves upon every member of the Bar having knowledge of such practices upon the part of any practitioner immediately to inform thereof, to the end that the offender may be disbarred.

*Id.*

The later ethical promulgations of the ABA also have imposed limitations on solicitation. DR 2-103(A) reads as follows: "A lawyer shall not, except as authorized in DR 2 101(B) [relating to permitted forms of advertising], recommend employment as a private practitioner, of himself, his partner, or associate to a layperson who has not sought his advice regarding employment of a law-

rently exempt from some proscriptions the solicitation of employment from a friend, relative, or client,<sup>73</sup> it is doubtful that the activity of convincing a friend or relative to "buy into" a cause of action is within the spirit of these exceptions.<sup>74</sup> In addition, when the lawyer purchases the securities for the purpose of personally acquiring standing, the lawyer arguably commits the violation of acquiring an interest in a cause of action.<sup>75</sup>

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yer." MODEL CODE, *supra* note 2, DR 2-103(A) (footnotes omitted). Additional parts of DR 2-103 preclude requesting others to recommend, or compensating them for recommending, the lawyer's employment, except in carefully defined circumstances. *Id.* DR 2-103(B)-(D).

73. DR 2-104(A) states that:

A lawyer who has given in-person unsolicited advice to a layperson that he should obtain counsel or take legal action shall not accept employment resulting from that advice, except that:

- (1) A lawyer may accept employment by a close friend, relative, former client (if the advice is germane to the former employment), or one whom the lawyer reasonably believes to be a client.

MODEL CODE, *supra* note 2, DR 2-104(A) (footnotes omitted).

Subsections 2 through 5 of DR 2-104(A) identify four other limited exceptions to the general rule against in-person solicitation. *Id.*

Model Rule 7.3 provides:

A lawyer may not solicit professional employment from a prospective client with whom the lawyer has no family or prior professional relationship, by mail, in-person or otherwise, when a significant motive for the lawyer's doing so is the lawyer's pecuniary gain. The term "solicit" includes contact in person, by telephone or telegraph, by letter or other writing, or by other communication directed to a specific recipient, but does not include letters addressed or advertising circulars distributed generally to persons not known to need legal services of the kind provided by the lawyer in a particular matter, but who are so situated that they might in general find such services useful.

MODEL RULES, *supra* note 2, Rule 7.3. Thus, there is no exception provided for solicitation of close friends.

*See also* Note, *Advertising, Solicitation and the Profession's Duty to Make Legal Counsel Available*, 81 YALE L.J. 1181, 1181-82 & n.6 (1972) (reviewing historical regulation of solicitation).

The constitutionality of restrictions on solicitation should be considered in light of the discussion in notes 123-138, *infra*. Some jurisdictions have amended their antisolicitation provisions because of constitutional concerns. *See, e.g.*, D.C. CODE OF PROFESSIONAL RESPONSIBILITY DR 2-103 (1988) (in-person solicitation banned only if it involves solicitation in or around courthouse, if it involves false or misleading claims or undue influence, if prospective client's mental or physical condition makes it unlikely that client can exercise considered judgment, or if prospective client has expressed wish not to be solicited).

74. Presumably, the exceptions recognize that a lawyer feels some compulsion by reason of the excepted relationship to advise familiar parties of existing claims, and that it is likely that the parties would prefer that the lawyer in question represent them.

75. DR 5-103(A) provides:

Moreover, regardless of the identity of the nominal plaintiff, some forms of financial support that the attorney gives to the suit may be problematic. Thus, although ethical regulations now generally permit contingent fee arrangements in civil contexts,<sup>76</sup> such regulations do not approve so generally the ad-

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A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation he is conducting for a client, except that he may:

- (1) Acquire a lien granted by law to secure his fee or expenses.
- (2) Contract with a client for a reasonable contingent fee in a civil case.

MODEL CODE, *supra* note 2, DR 5-103(A) (footnotes omitted). Model Rule 1.8(j) is virtually identical. See MODEL RULES, *supra* note 2, Rule 1.8(j).

The text suggests, as a literal matter, that the issuer to whom the benefit of recovery would inure is the client. If one does regard the issuer as the client, and if the issuer has declined to pursue its cause of action under § 16(b), it is arguable that the lawyer's activities constitute the acquisition of an interest in litigation adverse to that of a client. DR 5-101(A) and MR 1.7(b) generally preclude such acquisitions. *But cf. infra* text accompanying note 145 (questioning the importance of any interest on the part of the issuer in refusing to pursue the action).

76. See MODEL CODE, *supra* note 2, DR 5-103(A)(2); MODEL RULES, *supra* note 2, Rule MR 1.8(j)(2). Rule 1.5(c) further provides:

A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter for which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in writing and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal, litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

MODEL RULES, *supra* note 2, Rule 1.5(c). See also MODEL CODE, *supra* note 2, DR 2-106(C) (prohibiting contingent fee arrangements in criminal cases); MODEL RULES, *supra* note 2, Rule 1.5(d) (prohibiting contingent fee arrangements in criminal and domestic cases).

EC 2-20 more broadly provides:

Although a lawyer generally should decline to accept employment on a contingent fee basis by one who is able to pay a reasonable fixed fee, it is not necessarily improper for a lawyer, where justified by the particular circumstances of a case, to enter into a contingent fee contract in a civil case with any client who, after being fully informed of all relevant factors, desires that arrangement.

MODEL CODE, *supra* note 2, EC 2-20. Although the contingent fee received a qualified endorsement in the *Canons of Professional Ethics*, see 1908 CANONS *supra* note 3, Canon 13 (stating "a contract for a contingent fee . . . should always be subject to the supervision of a court, as to its reasonableness"), even this unenthusiastic recognition represented a break with the traditional distaste exhibited for the device by the court and bar. See generally Note, *Contingent Fee Contracts: Validity, Controls, and Enforceability*, 47 IOWA L. REV.

vancement of expenses on a contingent basis.<sup>77</sup> In fact, in many jurisdictions ethical regulations clearly preclude such an advancement.<sup>78</sup>

Finally, in addition to the specific violations just outlined, there is the possibility that some or all of the attorney's described activities and arrangements<sup>79</sup> will present an appearance of impropriety. In some jurisdictions, ethical regulations define such an appearance itself as grounds for ethical concern.<sup>80</sup> Nevertheless, one of the proper analytic requisites for an appearance of impropriety to constitute grounds for discipline<sup>81</sup> appears to be a reasonable probability that the attorney

942, 943 (1962) (reviewing commentators' criticisms of contingent fee arrangements).

77. DR 5-103(B) provides:

While representing a client in connection with contemplated or pending litigation, a lawyer shall not advance or guarantee financial assistance to his client, except that a lawyer may advance or guarantee the expenses of litigation, including court costs, expenses of investigation, expenses of medical examination, and costs of obtaining and presenting evidence, provided the client remains ultimately liable for such expenses.

MODEL CODE, *supra* note 2, DR 5-103(B) (footnote omitted). By contrast, Rule 1.8(e) specifies:

A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

- (1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and
- (2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

MODEL RULES, *supra* note 2, Rule 1.8(e).

78. See MODEL CODE, *supra* note 2, DR 5-103(B).

79. Possibilities for specific conflicts of interest, breach of client confidence, and similar problems arising later in the course of representation are beyond the scope of this Article, except as specifically alluded to in notes 182-87, 200, *infra*, and accompanying text.

80. Canon 9 of the *Model Code* states: "A Lawyer Should Avoid Even the Appearance of Professional Impropriety." MODEL CODE, *supra* note 2, Canon 9. There is no parallel provision in the *Model Rules*. Cf. MODEL RULES, *supra* note 2, Rule 1.10 comment, ¶ 9 (calling appearance of impropriety "question-begging").

81. In fact, the appearance of impropriety seems to be most frequently invoked as grounds for disqualification from representation of a particular client, rather than as the basis for discipline by any ethical enforcement body. See, e.g., *In re Corrugated Container Antitrust Litig.*, 659 F.2d 1341, 1349 (5th Cir. 1981); *In re Coordinated Pretrial Proceedings in Petroleum Prod. Antitrust Litig.*, 658 F.2d 1355, 1362 (9th Cir. 1981) (finding no appearance of impropriety), *cert. denied sub nom. California v. Standard Oil Co.*, 455 U.S. 990 (1982); see also Note, *Disqualification of Counsel for the Appearance of Professional Impropriety*, 25 CATH. U.L. REV. 343, 345 (1976) (reviewing Second Circuit's decisions); Note, *Appearance of Impropriety as the Sole Ground for*

has committed a more specific ethical violation.<sup>82</sup> Consequently, this Article will not consider appearance of impropriety separately from the ethical concerns previously mentioned.<sup>83</sup>

Appearance of impropriety aside, then, the major ethical concerns suggested by the described activities and arrangements involve either solicitation<sup>84</sup> or acquiring an interest in litigation.<sup>85</sup> Although the existence of these violations and the incentives for attorneys to engage in them are well-nigh irrefutable, there has been a marked lack of interest in addressing these matters from either a theoretical or disciplinary perspective. Professor Louis Loss was sufficiently discomfited by the ethical irregularities encouraged by section 16(b) to suggest that enforcement power be given to the Securities and Exchange Commission rather than to private parties.<sup>86</sup> Virtually all

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*Disqualification*, 31 U. MIAMI L. REV. 1516, 1521 (1977) (examining Fifth Circuit's two-pronged test for impropriety).

82. Some courts purport to base disqualification solely on Canon 9. *See, e.g.*, *Pantry Pride, Inc. v. Finley, Kumble, Wagner, Heine, Underberg & Casey (In re Eastern Sugar Antitrust Litig.)*, 697 F.2d 524, 530 (3d Cir. 1982); *In re Petroleum Prod. Antitrust Litig.*, 658 F.2d at 1360; *Renshaw v. Ravert*, 460 F. Supp. 1089, 1092-93 (E.D. Pa. 1978). Other courts appear to consider the appearance of impropriety only as a factor. *See, e.g.*, *Kessenich v. Commodity Futures Trading Comm'n*, 684 F.2d 88, 98 (D.C. Cir. 1982); *Woods v. Covington County Bank*, 537 F.2d 804, 812 (5th Cir. 1976). Still other courts specifically describe the appearance to be avoided in terms of some other rule. *See, e.g.*, *Norton v. Tallahassee Memorial Hosp.*, 689 F.2d 938, 942 (11th Cir. 1982) (preferring state bar disciplinary machinery to Canon 9); *Richardson v. Hamilton Int'l Corp.*, 469 F.2d 1382, 1384-85 (3d Cir. 1972) (applying Canon 4 of the *Model Code*), *cert. denied*, 411 U.S. 986 (1973). Finally, other courts simply have rejected Canon 9 as being unhelpful in most circumstances. *See, e.g.*, *Fred Weber, Inc. v. Shell Oil Co.*, 566 F.2d 602, 609-10 (8th Cir. 1977) (rejecting Canon 9 because it depends on eye of beholder), *cert. denied* 436 U.S. 905 (1978); *Silver Chrysler Plymouth, Inc. v. Chrysler Motors Corp.*, 518 F.2d 751, 753 (2d Cir. 1975); *see also* C. WOLFRAM, *supra* note 2, § 7.1.4 (reviewing criticisms of Canon 9 in disqualification cases); Kramer, *The Appearance of Impropriety Under Canon 9: A Study of the Federal Judicial Process Applied to Lawyers*, 65 MINN. L. REV. 243, 251 (1980) (stating Canon 9 is unnecessary when Canons 4 and 5 apply); Liebman, *The Changing Law of Disqualification: The Role of Presumption and Policy*, 73 NW. U.L. REV. 996, 1000 (1979) (discussing theories and policies underlying vicarious disqualification).

83. This Article will, however, raise the appearance of impropriety issue when relevant to other, more specific violations. *See infra* notes 119-22, 136-37 and accompanying text.

84. *See generally* Part III(A), *infra*.

85. *See generally* Part III(B), *infra*.

86. 2 L. LOSS, *supra* note 16, at 1053-54; *see also infra* notes 258-59 and accompanying text (discussing Loss's recommendation); *cf.* H. DRINKER, *LEGAL ETHICS* 64 (1953) (removing temptation to solicit those injured in accidents by making recovery automatic).

others considering the question, however, seem to have concluded that the ends of section 16(b) enforcement justify means that may involve technical ethical improprieties. Courts, for instance, uniformly have held that an attorney's solicitational acts or provision of illicit financial support may be grounds for disciplinary action, but do not constitute defenses against a section 16(b) cause of action.<sup>87</sup> In fact, courts considering the issue have noted that attorneys' fees may be the only incentive for anyone other than the issuer to bring a section 16(b) suit, and have directed that awards of such fees "not be too niggardly."<sup>88</sup>

It is somewhat puzzling that disciplinary bodies have failed to respond to the courts' statements that certain aspects of section 16(b) enforcement may constitute grounds for disciplinary action. The view that, in these circumstances, the ends justify the means<sup>89</sup> would be somewhat more satisfying if the disciplinary bodies themselves articulated it. Presumably, any action by disciplinary bodies in this regard would involve discussion of both the type and degree of deviation from accepted behavioral standards tolerable in any given situation.<sup>90</sup> Parts III and IV of

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87. See, e.g., *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 473 (2d Cir. 1968); *Magida v. Continental Can Co.*, 231 F.2d 843, 848 (2d Cir.), cert. denied, 351 U.S. 972 (1956); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir.), cert. denied, 320 U.S. 751 (1943). In the *Magida* case, the district court subsequently awarding a fee in the action commented that Congress evidently "regards public policy against proved and repeated violations of fiduciary responsibility by corporate officers at the expense of the public more detrimental to public good than the violation of generally accepted ethics by attorneys." *Magida v. Continental Can Co.*, 176 F. Supp. 781, 783 (S.D.N.Y. 1956). Apparently, no one raised the question whether proof of solicitation would justify disqualification of the attorney in question in these cases. Solicitation in the context of class actions has had consequences for the class suit itself, including occasional refusal to certify the class. See Note, *Developments in the Law—Class Actions*, 89 HARV. L. REV. 1318, 1580 (1976); see also *id.* at 1586 n.30 (suggesting that solicitation should be dealt with in separate disciplinary proceedings to avoid use of delaying tactics and harassment by defendants); *infra* notes 93-94 and accompanying text (discussing refusal to certify when representative is too closely affiliated with attorney).

88. *Smolowe*, 136 F.2d at 241; see *Rayette-Faberge*, 389 F.2d at 472; *Gilson v. Chock Full O'Nuts Corp.*, 326 F.2d 246, 248 (2d Cir.), *aff'd on rehearing*, 331 F.2d 107 (2d Cir. 1964) (en banc). For a discussion of the relation between the actual amounts of such fees and the amount of recovery, see 2 L. LOSS, *supra* note 16, at 1052 nn.70-72 (& Supp. vol. 5, at 3016-17); Cook & Feldman, *supra* note 28, at 421-22 nn.142-43.

89. An alternate and perhaps more practical explanation would be that the goals of § 16(b) excuse the choice to allocate scarce enforcement resources elsewhere.

90. For example, one type of deviation from a general standard that disciplinary bodies have addressed carefully and ultimately excused, apparently on public policy grounds, is disclosure of client confidences for the purpose of

this Article provide a suggested analysis along these lines.

#### B. INSTIGATION OF OTHER FORMS OF DERIVATIVE LITIGATION

The free-rider problem and the usual availability of attorneys' fees out of any benefit provided to the corporation<sup>91</sup> cause the activities and incentives of attorneys in other derivative contexts to parallel those present in section 16(b) contexts. A few differences, however, make problems with ethical improprieties in contexts other than those involving section 16(b) more extreme.

One distinction involves solicitation. In the nonsection 16(b) derivative context, because of the strict standing requirements discussed above, including the requirement that the nominal plaintiff have owned securities at the time the cause of action arose, the attorney will presumably solicit only those shareholders who held securities at the appropriate time and who continue to so hold. These individuals are unlikely to be the soliciting attorney's pre-existing clients, relatives, or friends, and therefore are unlikely to come within any exception to the solicitational ban.<sup>92</sup>

Moreover, even if an attorney generally could contact a prior acquaintance in connection with the bringing of a derivative suit, using an acquaintance as the nominal plaintiff presents difficulties. In some cases, courts have declined to confirm a potential nominal plaintiff's standing on the grounds that he or she is too closely affiliated with the attorney bringing suit and thus is not the "moving force" behind the action.<sup>93</sup>

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preventing crime. See MODEL CODE, *supra* note 2, DR 4-101(C)(3) (allowing lawyer to reveal intention of his client to commit crime and information necessary to prevent crime); MODEL RULES, *supra* note 2, Rule 1.6(b)(1) (allowing lawyer to reveal information reasonably believed necessary to prevent client from committing criminal act believed likely to result in imminent death or substantial bodily harm). The exception contained in Rule 1.6(b)(1) represents careful tailoring by the drafters, albeit with a result that many might criticize. See Subin, *War over Client Confidentiality: In Defense of the Kutak Approach*, Nat'l L.J., Jan. 19, 1981, at 22, col. 1 (noting confusion caused by exception due to lack of guidance for attorneys); *Lawyer's Duty of Disclosure, 1983: Hearings on S. 485 Before the Subcomm. on Criminal Law of the Senate Comm. on the Judiciary*, 98th Cong., 1st Sess. (1983) (proposing to criminalize lawyer's nondisclosure of client fraud in some circumstances).

91. See *supra* note 50 and accompanying text.

92. Although an attorney might monitor possible causes of action related to securities that the attorney, or a client, relative, or friend, owns, it is somewhat unlikely that any attorney specializing in derivative lawsuits consistently would be able to rely on employment from these sources.

93. See *supra* note 47 and accompanying text; see also Note, *Attorney as*



Paradoxically, an attorney's solicitation of a stranger as nominal plaintiff could create similar doubts as to the plaintiff's interest in pursuing the action.<sup>94</sup> By contrast, as noted above, courts specifically have refused to regard solicitation as a bar to section 16(b) suits.<sup>95</sup> At a minimum, this suggests that attorneys soliciting derivative suits not based on section 16(b) have a relatively greater incentive to be discreet.

Another distinction between attorney activities in the section 16(b) area and those in other derivative contexts involves the relative difficulties of suit. Because proof of a common-law derivative claim tends to be more complex<sup>96</sup> and there is some possibility that the board of directors may thwart the action,<sup>97</sup> the risk of loss is greater than in the case of section 16(b) litigation. As a result, it is even more likely that the nominal plaintiff in a non-16(b) action will ask an attorney to undertake the action on a contingent fee basis and, similarly, to advance the expenses of the suit with repayment contingent on the litigation's outcome.<sup>98</sup>

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*Plaintiff, supra* note 44, at 488 n.113 (noting court decisions disallowing derivative lawsuits when plaintiff was close business associate of attorney and when plaintiff was attorney's partner at law).

94. See Note, *Attorney as Plaintiff, supra* note 44, at 487. In the class action context, some courts have considered solicitation as an impediment to class certification. See *Carlisle v. LTV Electrosystems, Inc.*, 54 F.R.D. 237, 240 (N.D. Tex. 1972); *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 16 Fed. R. Serv. 2d (Callaghan) 1021, 1022 (N.D. Tex. 1972). *But cf.* *Bill Minielli Cement Contracting, Inc. v. Richter Concrete Corp.*, 62 F.R.D. 381, 390-91 (S.D. Ohio 1973) (holding that conversation between attorney and plaintiff was not solicitation). One should evaluate the constitutionality of solicitation-related limitations in light of *NAACP v. Button*, 371 U.S. 415 (1963) (recognizing that first and fourteenth amendments protect attorney's speech from state prohibitions) and the subsequent cases referred to in note 7, *supra*, and in light of the line of cases discussed at notes 123-38, *infra*.

95. See *supra* note 87 and accompanying text.

96. See *supra* text accompanying note 55 and *infra* notes 227-45 and accompanying text.

97. See *supra* notes 37-39 and accompanying text.

98. Here, the possible interaction of generally applicable law and ethical constraints is similar to that referred to in note 94, *supra*. Because of the longstanding technical inability of attorneys to advance expenses on a contingent basis, see generally *Radin, Maintenance by Champerty*, 24 CALIF. L. REV. 48, 69-78 (1935) (discussing historical problems with compensating attorneys on contingent fee basis), some courts may require that the proposed nominal plaintiff be able to bear such expenses before confirming standing. See, e.g., *Stavrides v. Mellon Nat'l Bank & Trust Co.*, 60 F.R.D. 634, 635 (W.D. Pa. 1973); *Korn v. Franchard Corp.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,845 (S.D.N.Y. 1970), *rev'd*, 456 F.2d 1206 (2d Cir. 1972). *But see Sanderson v. Winner*, 507 F.2d 477, 480 (10th Cir. 1974) (*per curiam*), *cert. denied sub nom. Nissan Motor Corp. v. Sanderson*, 421 U.S. 914 (1975); *Brame v. Ray Bills*

### III. THE ETHICAL REGULATIONS AND THE PROBLEMS THEY ARE MEANT TO ADDRESS

In considering why disciplinary action did not obliterate long ago the technical ethical violations described in Part II, it is necessary to examine the origin and purpose of each of the rules violated. Among other consequences, this examination sheds light on possible rule alterations that could specifically address the evils, if any, that technical violations committed in the instigation of derivative litigation present. It also suggests differences in rules that might apply depending on the particular type of action involved.<sup>99</sup>

#### A. SOLICITATION

##### 1. In General

As an initial matter, it is necessary to recognize that solicitation of employment is not per se immoral. It is neither an activity unequivocally condemned by religious or philosophical thinkers<sup>100</sup> nor one to which the average person would re-

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Fin. Corp., 85 F.R.D. 568, 576-79 (N.D.N.Y. 1979); *Sayre v. Abraham Lincoln Fed. Sav. & Loan Ass'n*, 65 F.R.D. 379, 384-86 (E.D. Pa. 1974), *modified*, 69 F.R.D. 117 (E.D. Pa. 1975). See generally Annotation, *Effect of Breach of Ethics or Other Misconduct by Plaintiffs' Attorney on Status of Class Action Under Rule 23 of Federal Rules of Civil Procedure*, 16 A.L.R. Fed. 883 (1973). Thus, although it has been acknowledged that attorneys often advance expenses and have an under-the-table agreement with the nominal plaintiff to forgive payment in the event of loss, the financial inability of a plaintiff to pay such expenses may preclude prosecution of the suit. See Findlater, *supra* note 70, at 1669, 1671 n.27; Note, *Class Certification: Relevance of Plaintiff's Finances and Fee Arrangements with Counsel*, 40 U. PITT. L. REV. 70, 91 (1978). This issue logically arises in terms of whether the nominal plaintiff adequately can represent the interests of similarly situated shareholders. See *supra* notes 43-47 and accompanying text.

99. The examination does not, however, attempt to resolve the desirability of existing rules in the abstract or in any non-derivative context. It is a thesis of this Article that contextual variation is a critical consideration in determining the interaction of ethical regulations and generally applicable law. See *infra* notes 263-65 and accompanying text.

100. It is, of course, difficult to demonstrate absence of condemnation. By process of reason, however, this demonstration is possible with respect to at least two major types of philosophies. First, some philosophies, often described as "teleological," regard the outcome of conduct as the determinant of its moral rightness or wrongness. See Smart, *An Outline of a System of Utilitarian Ethics*, in UTILITARIANISM: FOR AND AGAINST 30-42 (1973). From this standpoint, the morality of any act of solicitation presumably would depend on its relevant impact on the actor and all other parties. Thus, teleological theorists would approve or condemn an act of solicitation not in the abstract, but depending on whether it represented a net improvement in general welfare. Another set of philosophical theories, termed "deontological," assesses the mo-

act<sup>101</sup> in the same way as, say, to unprovoked murder, child abuse, or rape.<sup>102</sup> Moreover, it is possible to identify many situations in which solicitation could accomplish social good by, for instance, encouraging oppressed classes to assert legal rights otherwise unappreciated or unrealized.<sup>103</sup> If ethical regulators cannot ground restrictions on solicitation on concepts of morality, however, such restrictions become merely prophylactic, and it is relevant to identify the true objects of prevention.

Commentators have suggested that the initial antipathy of the American bar toward solicitation was, in large part, a reaction to the activity of immigrant lawyers.<sup>104</sup> Because attempts are still made to restrict solicitation,<sup>105</sup> however, other more acceptable justifications must coincidentally support the ban. These appear to be at least six in number.<sup>106</sup>

To begin with, the ban on solicitation has the effect of en-

ality of conduct by preexisting principles of right and wrong. See R. DWOR-KIN, *TAKING RIGHTS SERIOUSLY* 150-83 (1977); C. FRIED, *RIGHT AND WRONG* 7-29 (1978). Protection of the autonomy of individuals is one of the principles that these theories most regularly invoke. See A. DONAGAN, *THE THEORY OF MORALITY* 31 (1977); C. FRIED, *supra*, at 155-60. Presumably, deontological thinkers would condemn solicitation involving overreaching, see *infra* notes 110-14 and accompanying text, or some similar attempt to impose the lawyer's will on the prospective client. When the act of solicitation simply represented a means of conveying information, however, it should, at worst, be value-neutral.

101. One may aptly characterize a test couched in terms of average reaction as a "noncognitive" test of morality. See Hart, *Positivism and the Separation of Law and Morals*, 71 HARV. L. REV. 593, 624-27 (1958).

102. The statement in the text assumes that the actor would not undertake murder, abuse, or rape for any even arguably "moral" purpose, such as bringing about a change in law or public perception.

103. The facts of the case of *In re Primus*, 436 U.S. 412 (1978), provide an example of the accomplishment of social good. There, the lawyer had directed nonpecuniarily motivated solicitational activity toward informing otherwise unaware welfare recipients of certain rights arising from their illegal sterilization. *Id.* at 414-17.

Perhaps the possibility of a good effect does no more than place solicitation in the same category as acts that, like courteous falsehoods and killing in self-defense, continue to be morally troubling. Nonetheless, this possibility distinguishes solicitation from the class of immoral acts described in the text accompanying note 102, *supra*.

104. See, e.g., J. AUERBACH, *UNEQUAL JUSTICE: LAWYERS AND SOCIAL CHANGE IN MODERN AMERICA* 40-41 (1976).

105. See *supra* notes 72-73 (discussing MODEL CODE, *supra* note 2, DR 2-103(A), DR 2-104(A) and MODEL RULES, *supra* note 2, Rule 7.3).

106. A possible seventh justification—creation of an opportunity for conflict of interest, see *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 461 n.19 (1978); *Primus*, 436 U.S. at 426—seems to be no more than a byproduct of the other dangers discussed; this Article will not deal with it separately.

sure that some individual or entity has a sufficient interest in a given right so as affirmatively to seek its vindication. If one regards lawyers' services and use of the court system as scarce resources, it may be desirable to allocate those resources to those who most desire them, as demonstrated not only by their willingness to agree, in advance, to pay for them, but also by their efforts at self-identification. Such an allocation could mean that the adjudication system would function more efficiently<sup>107</sup> than would be the case when the bringing of litigation reflected only an estimation by the lawyer of the value of employment.<sup>108</sup> Accordingly, when lawyers successfully engage in solicitation, popular opinion condemns them as having "stirred up" litigation that otherwise presumably would have remained dormant.<sup>109</sup>

A second justification advanced for the general prohibition of solicitation is protection of the solicited party from the risk of overreaching.<sup>110</sup> The need for protection arguably arises because a fee-seeking lawyer might convince an otherwise disinclined individual to institute an action.<sup>111</sup> When the solicited

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107. Such functioning presumably also would comport with the adjudication system's traditional peacekeeping function. See Hegland, *Beyond Enthusiasm and Commitment*, 13 ARIZ. L. REV. 805, 812 (1971) (stating that wronged party who is not perturbed enough to seek out lawyer probably will not engage in peace-breaching self-help).

108. When the lawyer has a valid interest in the vindication of the right in question, this would not be the case. It is arguable that it is a valid attorney interest—the willingness to bring litigation from which the attorney will not monetarily profit—that justifies the distinction apparently drawn by the Supreme Court, see *infra* notes 123-29 and accompanying text, and the *Model Rules*, see *supra* note 73, between those solicitations from which the attorney will benefit pecuniarily and those from which the attorney will not so benefit. In fact, as used by the Supreme Court, lack of pecuniary benefit simply appears to be an aid in distinguishing commercial from noncommercial speech.

In this same regard, however, it is somewhat paradoxical, possible conflicts of interest aside, that the attorney bringing suit often is precluded from serving as the nominal plaintiff in class and derivative actions. See generally Note, *Attorney as Plaintiff*, *supra* note 44, at 473-77.

109. See *supra* note 72 (discussing 1908 CANONS, *supra* note 3, Canon 28, which condemns "stirring up litigation" in strongest terms).

110. Commentators have defined *overreaching* as "aggressive competition among lawyers for clients which leads to lawyers approaching clients at times when the clients are in no condition to properly consider retention of a lawyer, for example, immediately after an accident." Note, *Duty to Make Counsel Available*, *supra* note 73, at 1184 n.23. This definition appears to collapse both the danger that solicitation will convince a disinclined individual to sue and the danger that solicitation will deprive the solicited party of the right freely to choose a lawyer. See *infra* note 115 and accompanying text. As used in the text, the term *overreaching* refers only to the former.

111. This danger is particularly likely to occur when in-person solicitation

individual is debilitated<sup>112</sup> or otherwise particularly vulnerable,<sup>113</sup> this risk is most intense. The fear of overreaching appears to be rooted in the aversion to inefficiency addressed above and in traditional notions of respect for individual autonomy.<sup>114</sup>

The risk of overreaching is closely related to the third risk arguably posed by solicitation, that of impairing the client's freedom of choice. Here, instead of overcoming a disinclination to take action, the soliciting lawyer prevents the client from freely selecting the attorney whose services the client otherwise would choose. Presumably, this has the effect of inhibiting the exercise of client autonomy, as well as leading to a less congenial pairing than otherwise would have occurred. This danger is particularly acute when the client already is aware of the right to be vindicated<sup>115</sup> and would engage in some rational process of attorney selection if left to his or her own devices. Comparison shopping, or selecting an attorney based on family or social ties, might result in increased satisfaction. Even if the client might have selected an attorney simply by looking in the yellow pages, a limitation of this freedom may lead to lingering resentment and distrust.

A fourth justification for the organized bar's aversion to solicitation, again related to the risk of overreaching, concerns the individual's right of privacy.<sup>116</sup> The bar argues that if ethi-

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permits the soliciting lawyer to exert pressure for an immediate response. See *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 457 (1978); see also Comment, *Attorney Solicitation: The Scope of State Regulation After Primus and Ohralik*, 12 U. MICH. J.L. REF. 144, 155 (1978) (emphasizing Supreme Court's refusal to condone attorney pressure on potential client to make immediate response).

112. The fact pattern in *Ohralik* provides a classic illustration. There, the lawyer subjected to discipline had solicited employment from two teenagers, one of whom was in traction in the hospital recuperating from injuries suffered in an accident and the other who had been released from the hospital the day before. *Id.* at 449-50.

113. The term *undue influence* frequently is used to refer to "[m]isuse of position of confidence or taking advantage of a person's weakness, infirmity, or distress to change improperly that person's actions or decisions." BLACK'S LAW DICTIONARY 1370 (5th ed. 1979). This closely resembles the first definition of *overreaching* given in note 110 *supra*, and similarly collapses both of the dangers described in that note.

114. See *supra* note 100.

115. If the client is not otherwise aware of this right, solicitation arguably has the effect of enhancing freedom of choice.

116. See *Ohralik*, 436 U.S. at 467; see also Comment, *supra* note 111, at 179-81 (refuting claim that privacy rights of individuals justify state solicitation rules).

cal regulations permitted solicitation, lawyers would perch at the bedsides of accident victims, linger outside the doors of quarrelling couples, and engage in similar behavior in a variety of contexts. Not only would the process of identifying potential clients offend the sense of privacy of those being scrutinized, the appearance of a lawyer at a time of stress could disrupt private attempts at problem resolution. Moreover, such situations exacerbate the dangers of overbearing and infringement of freedom of choice.

Some commentators have suggested that attorneys engaged in solicitation also are likely to mislead the individuals solicited about the probability of prevailing, fee arrangements, and related matters.<sup>117</sup> At its most basic, this fifth justification seems to be the equivalent of saying that aggressive lawyers are likely to be liars, but it is possible to elevate it in light of the opportunity created for misleading. Thus, because solicitation may take place in a private, one-on-one context, any claims a lawyer makes will not be subject to public scrutiny.<sup>118</sup> This may expose gullible individuals to substantial risk and make proof of misleading statements extremely difficult.

A sixth, and final, objection to solicitation involves the appearance of impropriety. Traditionally,<sup>119</sup> many members of the bar have regarded certain solicitational activities as undignified,<sup>120</sup> thus detracting from the desired image of professionalism.<sup>121</sup> To the extent that these activities in fact detract from public trust and willingness to use lawyers when advisable,

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117. See *Ohralik*, 436 U.S. at 457-58; see also McChesney, *Commercial Speech in the Professions: The Supreme Court's Unanswered Questions and Questionable Answers*, 134 U. PA. L. REV. 45, 102-12 (1985) (noting that better methods to constrain deception exist than banning commercial speech).

118. See Perschbacher & Hamilton, *Reading Beyond the Labels: Effective Regulation of Lawyers' Targeted Direct Mail Advertising*, 58 U. COLO. L. REV. 255, 261 (1987); Thurman, *Direct Mail: Advertising or Solicitation? A Distinction Without a Difference*, 11 STETSON L. REV. 403, 407 (1982).

119. Cf. 1908 CANONS, *supra* note 3, Canon 28, quoted in note 72, *supra* (calling "stirring up litigation" "unprofessional").

120. This view does not obviously brook exceptions for nonpecuniarily motivated solicitations, which might appear to some as not in the least undignified. See *supra* note 72; cf. *In re Primus*, 436 U.S. 412, 437 n.31 (1978) (commenting on traditional exception from general bans on solicitation for offers of representation without charge).

121. At the same time that lawyers raise concerns about professional image, however, ethical regulations caution that "[the lawyer's] duty to clients or to the public should never be subordinate merely because the full discharge of his obligation may be misunderstood or may tend to subject him or the legal profession to criticism." MODEL CODE, *supra* note 2, EC 9-2. It appears, then, that whether this edict overrides concern with the appearance of impropriety

they may also support a public policy argument against solicitation.<sup>122</sup>

## 2. The Supreme Court Response to Bans on Solicitation

The Supreme Court has considered several of the foregoing justifications, either in the context of solicitation or in the related context of attorney advertising.<sup>123</sup> Typically, the cases have required the Court to decide whether attempts to regulate these activities impermissibly trespass on various rights that the first and fourteenth amendments protect.<sup>124</sup> In response, the Court has indicated that advertising and solicitational activities can have significant constitutional implications. At the least, nonideological advertising and solicitation, when conducted for pecuniary gain, are protected commercial speech,<sup>125</sup> and their regulation is subject to scrutiny for the presence of legitimate state interests.<sup>126</sup> Regulation may be fairly imprecise,

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in the solicitation area reduces to a question of whether there is any arguable preexisting duty to the client or the public.

122. The argument that solicitation presents an improper appearance that lawyers should avoid is a possible exception to the observation that regulation of solicitation is preventive, although the public trust aspect of the argument does have preventive overtones.

123. In fact, all advertising appears to have elements of solicitation. See Langan, *Professional Responsibility*, 1985 ANN. SURV. AM. L. 877, 887 n.63 (discussing distinction that "[n]ot all solicitation is advertising, but all advertising implicitly or explicitly involves solicitation"). Generally, however, courts appear to "use 'solicitation' to refer to direct, in-person contact and 'advertisement' as contact via the media." Note, *The Expanding Constitutional Protection of Commercial Speech: Attorney Advertising after Zauderer*, 1986 DET. C.L. REV. 199, 204 n.46; see also Langan, *supra*, at 887 n.63 (distinguishing advertising, which "[b]rings information to the attention of the public," from solicitation, which "implies a personal petition to a particular person to obtain employment").

124. These rights generally include various interests in expression, see *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 646-47 (1985); *In re R.M.J.*, 455 U.S. 191, 204-07 (1982); *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 455-59 (1978); *In re Primus*, 436 U.S. 412, 433-38 (1978); *Bates v. State Bar*, 433 U.S. 350, 363-64 (1977), or association, see *supra* note 7 (citing cases).

125. Commercial speech is speech that simply "propose[s] a commercial transaction." *Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations*, 413 U.S. 376, 385 (1973). In appropriate circumstances, courts have characterized both attorney advertising, see *Zauderer*, 471 U.S. at 637; *R.M.J.*, 455 U.S. at 199; *Bates*, 433 U.S. at 363-64, and solicitation, see *Ohralik*, 436 U.S. at 454, in this manner.

126. In *Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n*, 447 U.S. 557, 564 (1980), the Supreme Court held that states may regulate commercial speech only if the state's interest in regulation is substantial, the regulation in question directly advances the state's interest, and the regulation is not more extensive than necessary. This analysis has been applied in subsequent law-

however, and in some circumstances may be based on the potential for harm rather than on its actual occurrence.<sup>127</sup> At the other end of the spectrum, any regulation of solicitational activity that is not directed toward pecuniary gain and that it is possible to characterize as political expression is subject to exacting scrutiny.<sup>128</sup> Thus, the state must demonstrate a compelling state interest and the existence of actual harm in order for such regulation to withstand constitutional challenge.<sup>129</sup>

In the process of sketching the spectrum just described, the Court has made it clear that genuine dangers of overbearing or misleading can justify regulation of commercial speech. In this context, the Court has said:

The State's special interest in regulating members of a profession it licenses, and who serve as officers of its courts, amply justifies the application of narrowly drawn rules to proscribe solicitation that in fact is misleading, overbearing, or involves other features of deception or improper influence. . . . [A] State also may forbid in-person solicitation for pecuniary gain *under circumstances likely to result in these evils*.<sup>130</sup>

This language suggests, of course, that states cannot forbid in-person solicitation for pecuniary gain in *all* circumstances. In dicta in a later case, however, the Court described its prior holding as providing that a state may "categorically ban" all in-person solicitation.<sup>131</sup> At the same time, the Court held that states could not categorically ban targeted, direct-mail solicitation, stating that the latter "poses much less risk of overreaching or undue influence" than the former,<sup>132</sup> and constitutes no

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yers' advertising cases. See *Zauderer*, 471 U.S. at 637-38; *R.M.J.*, 455 U.S. at 203 n.15. For a general discussion of the commercial speech doctrine, see Canby, *Commercial Speech of Lawyers: The Court's Unsteady Course*, 46 BROOKLYN L. REV. 401, 401-22 (1980); McChesney, *supra* note 117, at 48-66; Note, *Attorney Advertising—Recent Update*, 8 OKLA. CITY U.L. REV. 505, 509-16 (1983).

127. See *Ohralik*, 436 U.S. at 466-67 (addressing dangers that in-person solicitation presents). See, however, the Court's statement in *R.M.J.*, 455 U.S. at 203, that "the States may not place an absolute prohibition on certain types of potentially misleading information . . . if the information also may be presented in a way that is not deceptive," and in *Zauderer*, 471 U.S. at 644, that "[w]e need not . . . address the theoretical question whether a prophylactic rule is ever permissible in this area [presumably that of potentially deceptive advertising], for we do not believe that the State has presented a convincing case for its argument that the rule before us is necessary to the achievement of a substantial governmental interest."

128. See *Primus*, 436 U.S. at 432-33.

129. See *id.*

130. *Id.* at 438-39 (emphasis added) (footnote omitted).

131. *Shapero v. Kentucky Bar Ass'n*, 108 S. Ct. 1916, 1921 (1988).

132. *Id.* at 1922.



more an invasion of privacy than other types of mailings.<sup>133</sup> Although targeted mailings create some risk of deception, the Court believed this risk to be less than that created by in-person solicitation, and that less drastic means than complete prohibition could adequately address it.<sup>134</sup> Based on this decision, the Court's list of permissible concerns supporting prophylactic regulation appears to include, as it has included in prior cases, "overreaching, invasion of privacy, the exercise of undue influence, and outright fraud."<sup>135</sup> It is unclear whether these factors must appear in combination, although the Court's conclusion with respect to targeted mail suggests that some combination is necessary.

In developing the foregoing list of acceptable justifications for the regulation of attorneys' commercial speech, the Court has forthrightly disposed of two other arguments. First, in the advertising context, the Court has scoffed at arguments based on the appearance of impropriety, noting that the public is already aware that the practice of law is a business typically conducted for private profit.<sup>136</sup> Moreover, the Court has said:

[A]lthough the State undoubtedly has a substantial interest in ensuring that its attorneys behave with dignity and decorum in the courtroom, we are unsure that the State's desire that attorneys maintain their dignity in their communications with the public is an interest substantial enough to justify the abridgment of their First Amendment rights. Even if that were the case, we are unpersuaded that undignified behavior would tend to recur so often as to warrant a prophylactic rule.<sup>137</sup>

Second, on the subject of "stirring up" litigation, the Court has had this to say:

That our citizens have access to their civil courts is not an evil to be regretted; rather, it is an attribute of our system of justice in which we ought to take pride. The State is not entitled to interfere with that access by denying its citizens accurate information about their

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133. *Id.* at 1923.

134. *Id.*

135. *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 641 (1985) (paraphrasing *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 464-65 (1978)). The Court was careful to note, however, that in-person solicitation, the practice presenting these dangers, posed unique regulatory difficulties because it is "not visible or otherwise open to public scrutiny." *Zauderer*, 471 U.S. at 641 (quoting *Ohralik*, 436 U.S. at 466).

136. *Bates v. State Bar*, 433 U.S. 350, 368-69 (1977). This holding suggests that the Supreme Court regards the appearance of impropriety argument as, at best, a "piggy-back" justification, relevant only where other, more substantial dangers are present. *See also supra* note 82 (discussing appearance of impropriety as factor in disqualification).

137. *Zauderer*, 471 U.S. at 647-48.

legal rights. Accordingly, it is not sufficient justification for . . . discipline . . . that . . . truthful and nondeceptive advertising had a tendency to or did in fact encourage others to file lawsuits.<sup>138</sup>

Thus, although the appearance of impropriety and the danger that lawyers will "stir up" litigation might buttress a list of justifications for preventive regulation containing other more substantial factors, neither appears to survive as an independent consideration.

### 3. Section 16(b) Solicitation

Traditional analysis of the permissibility of solicitation has done little to acknowledge the possible effects of varying the type of suit for which the solicitation occurs. For instance, when the Supreme Court loosely, and unnecessarily, characterized a former holding as providing that states could completely prohibit in-person solicitation, the Court apparently ignored the possibility that the rationale for such a ban could be context-specific. The following discussion illustrates the need for more careful application of the Court's own general guidelines.

Solicitation undertaken in the section 16(b) context presumably would be subject to no more than reduced scrutiny under the general analytic spectrum proffered by the Supreme Court.<sup>139</sup> Granting that states could regulate solicitation of section 16(b) litigation on the basis of prospective dangers implicating state interests, it becomes appropriate to consider precisely what dangers exist. This process reveals that section 16(b) causes of action present situations in which the traditional justifications for antisolicitation regulations generally are inapplicable.

Interestingly, it is the very circumstances creating the free-rider problem that suggest that certain of the familiar solicitational dangers may be minimal in the section 16(b) context. For example, because no individual shareholder is likely to have adequate incentive to file suit, no such shareholder should have a substantial interest in maintaining complete freedom in

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138. *Id.* at 643.

139. This statement is true despite the existence of a line of cases suggesting that the rights to associate and to petition for redress of grievances protect collective activity undertaken to obtain meaningful access to the courts. See authorities listed in note 7, *supra*. Although the derivative nature of the § 16(b) suit has implications of representative, if not collective, activity, and even though solicitation may be necessary to give the cause of action meaning in many situations, the cases referred to all involve the solicitational activities of nonprofit advocacy organizations.

choosing a lawyer. Similarly, when any recovery is for the benefit of a corporation and affects each shareholder only through relatively minimal enhancement of share value, implication of substantial privacy interests is unlikely; in other words, the shareholder is not apt to be offended by a stranger's identification of the existence of the cause of action. Finally, because of the attenuated nature of the shareholder's interest in recovery, circumstances meriting concern with overreaching are almost totally lacking. There is no reason to think that shareholders will be overwrought, debilitated, or otherwise incapable of exercising detached judgment in the section 16(b) context.

It is true, however, that permitting solicitation in connection with section 16(b) litigation presents a risk that suits will be brought even though no individual was sufficiently incensed to seek out a lawyer, and thus that lawyers will "stir up" litigation. Nonetheless, the statement of the Supreme Court on the dangers of "stirring up" litigation significantly undercuts the importance of this event.<sup>140</sup> Moreover, it is crucial to recognize that, in the section 16(b) context, solicitation of individuals otherwise disinclined to sue will not necessarily lead to any waste of resources. In fact, there is a sound argument that waste does not occur.

The first step in this argument is to demonstrate that the lack of unsolicited plaintiff interest in the section 16(b) suit is no reflection on its worth. This point is easily made with respect to lack of interest on the part of shareholders; because the benefit of the action inures to the corporation, individual shareholders usually lack sufficient interest to initiate suit.<sup>141</sup> If the section 16(b) cause of action has reached the stage of attorney solicitation of a nominal plaintiff, however, corporate management<sup>142</sup> thus far also has declined enforcement. Nonetheless, even though corporate law charges management with acting on the corporation's behalf, its assessment does not serve as an appropriate measure of the value of the section 16(b) cause of action. This is true for two reasons: the management's assessment of corporate interests may be inaccurate, and, more importantly, the corporation's interests may be irrelevant.

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140. See *supra* text accompanying note 138.

141. Shareholders with substantial percentage ownerships in the corporation might, in fact, be motivated to bring suit, although their motivation will never be as great as would be that of a 100% owner, or as great as would be socially desirable, see *infra* notes 201-02 and accompanying text.

142. This Article loosely defines *corporate management* as including the directors and officers of the entity in question.

Thus, on the one hand, when section 16(b) trading is involved, bringing suit often would require corporate management to accuse one of its own.<sup>143</sup> There is good reason to believe that management is not, in such circumstances, a trustworthy repository of the ability to assess the corporation's best interests,<sup>144</sup> and accordingly may not be the appropriate mechanism to deal with the free-rider problem.<sup>145</sup> Conversely, there may be circumstances in which the decision of management not to bring suit, even against its own, does reflect a good faith and fully informed determination based on a rational perception of the corporation's best interests. Congress nonetheless has specified that, in the section 16(b) context, management's refusal to bring suit is completely superseded by the contrary decision of any security holder. A logical extrapolation from this specification is the conclusion that management may not seek to dismiss a section 16(b) suit after it has been filed. Section 16(b) thus appears to subordinate a specific corporation's best interests to the goal of deterring insider trading, thereby rendering those interests largely irrelevant.

There is, of course, more to demonstrating absence of waste than excusing lack of unsolicited interest. The second logical step consists of ensuring that suits brought have formal merit. Ironically, one of the soundest assurances that section 16(b) suits will not be brought frivolously is a logical corollary of the individual's lack of interest in suing. As discussed above, most fee arrangements for section 16(b) suits will be contingent on the suit's success, either through settlement or judgment and, in any case, will be subject to court scrutiny.<sup>146</sup> Use of a contingent fee arrangement ensures that lawyers themselves will assess the chance of success before instituting any action.

Formal merit, however, does not necessarily translate into acknowledged "value" from the standpoint of a potential plaintiff. There probably are any number of existing legal rights

143. Even when the suit in question would be against a substantial shareholder, the implications of management self-interest are clear.

144. Although in other derivative suits courts may excuse the demand requirement where futile, *see supra* note 36, the plaintiff must prove an allegation of futility, because "it is not every 'insider' who controls the board of directors," *Netter v. Ashland Paper Mills, Inc.*, 19 F.R.D. 529, 531 (S.D.N.Y. 1956). With respect to theoretical operation of demand requirements, see *infra* text accompanying notes 160-62.

145. Even when management does institute suit on demand, the identification of the circumstances justifying demand present a free-rider obstacle.

146. *See supra* text at note 28, notes 68-71 and accompanying text.

that the possessor does not deem worthy of enforcement.<sup>147</sup> Although some determinations of this nature are attributable to the unimportant nature of the right, a more likely deterrent is the size of enforcement costs.<sup>148</sup> Nevertheless, a solicited suit that is brought on a contingent fee and expense basis presents different considerations and calculations than one with costs that must be paid in all events.<sup>149</sup> This is particularly true when the emotional costs associated with the suit are inconsequential, as is most likely the case when the right involved is of an impersonal nature. In these circumstances, clients often may allow lawyers to decide how to allocate their services without reference to any comprehensive analysis by the client of the relative costs and benefits of the right to be enforced.<sup>150</sup> The lawyer may base this decision on such matters as the lawyer's own enjoyment of a particular kind of litigation, or an assessment that the cause of action is particularly cost-effective because of ease of proof.

Unfortunately, the potential for waste is not obviously cured by acknowledging that, in some circumstances, it is the lawyer and not the client who determines the relative worth of a lawsuit. Presumably, some factor other than the potential pecuniary benefit to the lawyer should be determinative. One such factor, when authoritative evidence of public policy exists, may be the social worth of the litigation.

In the section 16(b) context, demonstration of social worth is readily forthcoming. Section 16(b) is an explicit, statutorily-created cause of action consistently favored as a matter of public policy.<sup>151</sup> By establishing a relatively easy derivative cause of action, in which the interests of the represented entity are secondary or irrelevant, Congress and the courts effectively have assessed the intrinsic worth of the section 16(b) lawsuit.<sup>152</sup>

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147. These might include, for example, any number of minor trespass or assault cases.

148. In either case, from an economic standpoint, one could describe such a determination simply as the possessor's choice to allocate to some other purpose the resources—emotional, monetary, and otherwise—that enforcement would require.

149. Thus, when the monetary cost of enforcement will be deducted only from a recovery, a benefit the party-in-interest will not otherwise have, the likelihood that such a party will bring suit is enhanced. The calculation is similar when the cause of action is derivative and the contingent costs will reduce the recovery of the corporation and thus, pro rata, that of other shareholders.

150. See *infra* notes 201-23 and accompanying text.

151. See *supra* notes 53-58 and accompanying text.

152. It is possible to make an interesting parallel argument in the case of solicitations not for pecuniary gain. Consider *In re Primus*, 436 U.S. 412

This assessment is an indication that any such suit having formal merit will not result in a waste of resources and is a more than acceptable substitute for endorsement by a self-selected individual plaintiff.

In summary, solicitation is not unequivocally immoral; the free-rider problem minimizes concern with most solicitational dangers and means that it is foreseeable that no nominal plaintiff will step forward to enforce the interests that Congress intended section 16(b) to protect; management judgment is irrelevant to an assessment of the value of section 16(b) suits; and congressional and court approval of section 16(b) causes of action eliminates verification problems. The case for the allowance of attorney solicitation thus becomes clear. In other words, because the dangers addressed by bans on solicitation are not significant in the section 16(b) context, and because the self-interest of attorneys is necessary for enforcement, there is no need to preclude solicitation in the circumstances giving rise to a section 16(b) cause of action. Consequently, an attempt in this area to ban any type of solicitation, including in-person solicitation, without a requisite showing of actual harm should fail to withstand careful constitutional scrutiny.<sup>153</sup> Moreover, such a regulation of attorney conduct runs counter to articulated public policy and should be reconsidered.

Part IV discusses the precise tailoring of an exception to the existing blanket rules against solicitation. At present, however, it is necessary to reiterate that a premise of the discussion above is that there is an existing practice of bringing section 16(b) actions on a contingent fee and expense basis. The preceding discussion assumed the existence of contingent fee and expense arrangements for two reasons. The practice is necessary if such actions are to proceed. In addition, the practice assures that a cause of action deemed worthy in the abstract is brought only when valid in particular factual circumstances. This Article will discuss the ethical implications of contingent fee and expense arrangements in Part III(B).

#### 4. Solicitation of Other Derivative Actions

Most derivative actions, unlike section 16(b) causes of action, are not specially favored. In fact, in view of the proce-

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(1978), in which the obvious strength of the soliciting attorney's convictions might be said to provide an acceptable substitute form of verification.

153. See the standards discussed in Part III(A)(2), *supra*.

dural barriers,<sup>154</sup> courts and legislatures arguably have identified most derivative litigation as disfavored. The reasons for this treatment largely relate to a perception that, because no individual shareholder has a sufficient interest in bringing litigation to benefit *all* shareholders, the primary motivation for the initiation of such a suit must be a desire to achieve a personal benefit through settlement or the like.<sup>155</sup> Even when the shareholder bringing suit is attempting to bring about a change in corporate policy rather than trying to extract a pay-off, courts and commentators generally suspect self-interest.<sup>156</sup> In other words, the very feature of derivative litigation that discourages its instigation—lack of a substantial personal benefit to individual shareholders—casts doubt on the legitimacy of those actions that shareholders do bring.<sup>157</sup>

While this lack of adequate self-interest suggests that shareholders often will not be motivated to bring derivative actions, it also indicates that considerations of overbearing, undue influence, and invasion of privacy should not be substantial in the usual derivative context. Thus, one can generally dispose of these arguable justifications for antisolicitation regulations as simply there as in the context of Section 16(b).<sup>158</sup>

In contrast, lack of management interest in the non-16(b) derivative action context is more troubling. The circumstances giving rise to section 16(b) causes of action typically suggest that management self-interest may impede the bringing of such actions, but this is not consistently the case in situations that might support instigation of derivative litigation. For instance,

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154. See *supra* notes 35-48, 56-58 and accompanying text.

155. Even though settlements of derivative actions now are subject to court scrutiny, see *supra* note 48 and accompanying text, this has not always been the case. See Haudek, *The Settlement and Dismissal of Stockholder Actions—Part I*, 22 Sw. L.J. 767, 784 (1968) (discussing adequacy of representation in settlement that lawyer affords to class). Moreover, out-of-court accommodations still may take place.

156. A similar bias is present in the federal rules governing which shareholder proposals management must include in its proxy statement. See Cane, *The Revised SEC Shareholder Proxy Proposal System: Attitudes, Results and Perspectives*, 11 J. CORP. L. 57, 89 (1985).

157. The fact that § 16(b) litigation has avoided the same taint may be the result of its relative ease of proof. Thus, if a shareholder files such an action, courts can easily evaluate any later decision to drop it. This is less likely the case with other derivative litigation, where a decision to abandon prosecution frequently might be due to difficulty or uncertainty, and thus raise no flag as to the likelihood of side agreements.

Another explanation is, of course, that even if § 16(b) suits were the result of self-interest, such suits would still satisfy the section's primary policies.

158. See *supra* notes 139-40 and accompanying text.

when the corporation's right is against a third party and there is no allegation of management wrongdoing, there is no general reason to doubt that management itself will fully protect the corporation's interests.<sup>159</sup>

Perhaps not surprisingly, however, the law relating to derivative actions already has attempted to respond to the dichotomy just suggested. Thus, the demand requirement<sup>160</sup> and rules relating to management dismissal of derivative actions<sup>161</sup> contemplate different results when, on the one hand, third parties are the objects of suit and when, on the other, the suit implicates management self-interests.<sup>162</sup> Attorneys operating on a contingent fee basis will doubtless be aware of these distinctions. Accordingly, it is relatively less likely that attorneys will solicit nominal plaintiffs in situations requiring demand on directors and deference to a management determination to terminate the suit.

In those instances, however, in which allegations of underlying management wrongdoing are the basis of derivative actions, it is important to determine whether the evaluation of the worth of a particular cause of action by an attorney soliciting employment is an adequate or necessary substitute for management discretion. Here, the role played by the contingent fee continues to be relevant.<sup>163</sup> If an attorney will receive payment only if a suit successfully generates benefit to the corporation, and if courts will supervise determinations of that success, the attorney should be cautious in determining whether a suit has formal merit. As described above, however, formal merit does

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159. In other words, in terms of determining which sorts of actions against third parties justify dedication of attorney resources, there is no reason to believe that management's lack of interest does not constitute a reliable indicator of an action's lack of worth. Moreover, in such circumstances, any disregard of management's decision would indicate a lack of regard for the corporate form of organization, which carries with it inherent notions of management authority, and thus a lack of regard for the choice of the majority of shareholders—who have voluntarily engaged in the corporate enterprise—to defer to such decision. *Cf. supra* note 100 (addressing value of respect for autonomy). When the right in question is against management, however, there is substantially more reason to think that derivative action—either shareholder or attorney-initiated—will be necessary for vindication, and that lack of management interest in enforcement is not a reliable assessment of lack of worth.

160. *See supra* notes 34-38 and accompanying text.

161. *See supra* note 39 and accompanying text.

162. *See supra* text accompanying note 38. Note, however, that the application by Delaware courts of their own business judgment in evaluating dismissals, *see supra* note 39, reduces the indicated contrast.

163. The relevance of security-for-expense requirements also should be obvious. *See supra* note 42 and accompanying text.



not necessarily indicate either that prosecution of the suit will lead to an efficient allocation of resources or that the suit is socially worthwhile. In this regard, it is critical to note both that derivative litigation generally lacks the affirmations of social value that courts and Congress have bestowed on section 16(b) suits,<sup>164</sup> and that there is increasing legislative interest in cutting down on management liability in general.<sup>165</sup>

In summary, there is less arguable need for solicitation in the context of the ordinary derivative action than in the section 16(b) context. There is no clear public policy specially favoring ordinary derivative actions<sup>166</sup> and, at least in regard to those causes of action not alleging underlying management wrongdoing, the existence of a body of managers charged with providing for corporate well-being seems to adequately address the free-rider problem described above.<sup>167</sup>

The question remains, however, whether lack of general need for solicitation justifies suppression of such activity. The dangers that solicitation presents in the derivative context are limited to the possibilities that lawyers will "stir up" litigation and that the activities involved will give the appearance of impropriety. Although regulations of commercial speech require only reduced scrutiny,<sup>168</sup> it is not clear that these limited risks, by themselves, are adequate justification—from either a constitutional or policy standpoint—for ethical regulators to prohibit solicitation of derivative lawsuits.

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164. There may be some distinctions, however, among kinds of non-16(b) derivative suits. See *infra* notes 227-45 and accompanying text.

165. See *infra* note 243 and accompanying text.

166. But see *infra* notes 230-38 and accompanying text (discussing relative preference for cases based on duty of loyalty).

167. See *supra* note 66 and accompanying text. There may be instances, however, in which management fails to act in the corporation's best interests for reasons other than self-interest. In these instances, monitoring of management may have free-rider implications. There is, of course, a substantial body of scholarship attributing monitoring effects to various market forces. See, e.g., Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 1-7 (1978); Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 42 (1980). Although these effects presumably would monitor both self-interest and other forms of management dereliction, it is extremely doubtful that they would extend to detection or correction of dereliction with respect to individual causes of action.

168. See *supra* note 127 and accompanying text.

## B. ACQUIRING AN INTEREST IN LITIGATION

## 1. In General

The second major category of ethical considerations presented by the practices of attorneys involved in section 16(b) and other derivative suits encompasses the use of contingent fee and expense arrangements<sup>169</sup> and other circumstances giving attorneys a "direct" financial interest in the outcome of litigation. These other circumstances arguably include the attorney's acquisition of shares of the corporation ostensibly benefited by the litigation.<sup>170</sup> They do not, however, include such interests as reputational enhancement and future ability to command higher fees as a result of successful outcomes; these "indirect" interests have never been within the stated ambit of professional ethical concerns.

At least five dangers may be associated with an attorney's procurement of a direct financial interest in litigation. First, commentators have suggested that such an interest may lead the attorney to be overzealous.<sup>171</sup> In other words, the attorney may be more inclined to go beyond the limits of permissible advocacy when there is a personal stake in the outcome. A *personal stake*, however, may describe either a direct or indirect financial interest. Any incentives to push the boundaries of approved conduct in these two circumstances vary only by a matter of degree. For example, an attorney seeking reputational enhancement or fearing reputational injury may have a motivation to win that is nearly as strong as that of the attorney with a direct financial interest. The regulation of the latter but not the former is curious, but may be attributable to expediency.<sup>172</sup> Just as curious, perhaps, is regulatory concern with the overzealousness that an attorney's direct financial interest induces, considering that parties-in-interest, including attorneys themselves, may appear *pro se*.<sup>173</sup>

The second arguable danger is one specifically posed by the use of contingency fees. Here, the relevant concern is that lawyers will use their superior knowledge and abilities to negotiate

169. See *supra* notes 76-78 and accompanying text.

170. See *supra* note 75 and accompanying text.

171. See C. WOLFRAM, *supra* note 2, § 8.13, at 490.

172. The difficulty of prohibiting reputational enhancement is manifest.

173. This self-representation is, of course, notwithstanding the foolishness of the client. Cf. THE CONCISE OXFORD DICTIONARY OF PROVERBS 130 (J. Simpson ed. 1982) ("A man who is his own lawyer has a fool for his client.").

percentage fee agreements not fairly reflecting either costs<sup>174</sup> to the lawyer or the risk of nonrecovery.<sup>175</sup> The tendency to use the same percentage fee for cases that vary in strength provides evidence of this practice, as does the fact that so many cases are settled that there is little actual risk of attorney loss.<sup>176</sup> Still, in any circumstance in which courts must approve fee awards,<sup>177</sup> the relevance of any agreement between attorney and client is secondary, at best,<sup>178</sup> significantly reducing concern about this danger.

The third possible danger is that even when the financial interests of client and attorney are formally aligned, the attorney may be tempted to follow his or her own instincts in making decisions ordinarily thought to be those of the client.<sup>179</sup> Thus, the attorney may deprive the client of the opportunity to make, or have input into, strategy decisions and value judgments.<sup>180</sup> In effect, the lawyer may treat the client simply as the lawyer's "key to the courthouse door," a result that conflicts with traditional views of the attorney-client relationship.<sup>181</sup>

The fourth possible danger is related to the third, but appears even more troubling. When an attorney has a financial

174. For this purpose, this Article assumes that a lawyer determines costs in terms of forgone opportunities for income production, together with out-of-pocket expenditures.

175. See Note, *Duty to Make Counsel Available*, *supra* note 73, at 1200.

176. Grady, *Some Ethical Questions about Percentage Fees*, LITIGATION, Summer 1976, at 20, 24.

177. Court approval is, as described above, required in most derivative contexts. See *supra* notes 27-28, 51-52 and accompanying text.

178. See generally Note, *Class Actions*, *supra* note 87, at 1607 (noting court's general power to override fee contracts).

179. This may be conceptualized as a type of overreaching. See *supra* notes 110-15 and accompanying text. As such, it has implications for the exercise of the client's autonomy. See *supra* note 100.

180. After all, even when the client's interests generally parallel those of the attorney, the client may hold different opinions and values.

181. See MODEL CODE, *supra* note 2, EC 7-7 ("In certain areas of legal representation not affecting the merits of the cause or substantially prejudicing the rights of a client, a lawyer is entitled to make decisions on his own. But otherwise the authority to make decisions is exclusively that of the client . . ."); MODEL RULES, *supra* note 2, Rule 1.2(a) ("A lawyer shall abide by a client's decisions concerning the objectives of representation . . . and shall consult with the client as to the means by which they are to be pursued."). For accounts of the practical allocation of power between client and attorney, see Mazor, *Power and Responsibility in the Attorney-Client Relationship*, 20 STAN. L. REV. 1120, 1120-39 (1968); Spiegel, *The New Model Rules of Professional Conduct: Lawyer-Client Decision Making and the Role of Rules in Structuring the Lawyer-Client Dialogue*, 1980 AM. B. FOUND. RES. J. 1003, 1003 n.3.

interest in the outcome of litigation, there may be circumstances in which the interests of attorney and client diverge. For instance, an attorney who already has devoted as much time to a suit as a contingent fee would compensate in the event of complete triumph at trial may be eager to settle rather than to devote additional time to preparing and trying the case.<sup>182</sup> This eagerness will increase as the likelihood of prevailing at trial decreases.<sup>183</sup> By contrast, the lawyer's sunk costs will not affect the client's attitude toward settlement or continuing to trial.<sup>184</sup> The resulting conflict of interest has been the subject of substantial comment.<sup>185</sup> Nonetheless, ethical regulations could significantly reduce this concern, if not remove it entirely, merely by requiring disclosure of the existence and ramifications of the conflict.<sup>186</sup> After all, provisions more generally regulating attorney-client conflicts of in-

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182. See Morgan, *The Evolving Concept of Professional Responsibility*, 90 HARV. L. REV. 702, 732 (1977). Similarly, consider a situation in which (1) an attorney is relatively certain that the client will recover \$100,000 at trial, 30% of which (\$30,000) the client would pay to the lawyer as the set percentage fee; (2) the attorney already has expended \$20,000 (for purposes of simplicity, composed of amounts paid to investigators, paralegals, and associate attorneys); (3) bringing the case to trial will require expenditure of an additional \$10,000; and (4) the client receives a settlement offer of \$80,000, 30% of which (\$24,000) would go to the lawyer. The lawyer presumably would prefer settlement, which would reward him or her with \$24,000 on a \$20,000 investment, rather than trial, as a result of which the lawyer would break even. The client, however, will net only \$56,000 from the settlement, compared to \$70,000 from prevailing at trial.

In both the section 16(b) and ordinary derivative contexts, courts will award attorneys' fees. As discussed, *see supra* text accompanying notes 28, 51-52, courts generally base the calculation on hours worked multiplied by an hourly charge adjusted for results achieved and other factors. Although this calculation should mean that the attorney's preferences are less rigidly defined than in the preceding example, there is still ample opportunity for conflict of interest.

183. The reduced likelihood of winning at trial, however, would also affect the client's preferences.

184. See *supra* note 182.

185. See, e.g., D. ROSENTHAL, *LAWYER AND CLIENT: WHO'S IN CHARGE?* 96-116 (1974); Clermont & Currihan, *Improving on the Contingent Fee*, 63 CORNELL L.Q. 529, 534-37 (1978); Morgan, *supra* note 182, at 732; Note, *Of Ethics and Economics: Contingent Percentage Fees for Legal Services*, 16 AKRON L. REV. 747, 749-51 (1983).

186. For instance, although hourly payments to lawyers also pose a formal conflict of interest—because a client prefers to pay less and a lawyer prefers to receive more—the conflict is so obvious that clients generally are left to watch out for themselves. The only protection provided by the *Model Code* or the *Model Rules* inheres, respectively, in the requirement that no fee be illegal or clearly excessive, MODEL CODE, *supra* note 2, DR 2-106(A), and in the requirement that fees be reasonable, MODEL RULES, *supra* note 2, Rule 1.5(a).

terest rely heavily on disclosure as a "remedy."<sup>187</sup> Consequently, adequate attorney disclosure to a consenting client of the conflicts inherent in contingent fee and expense arrangements should alleviate a significant proportion of ethical discomfort with such potential conflicts.

The fifth possible danger involves the effect of an attorney's direct financial interest on the manner in which the potential plaintiff weighs the costs of litigation against its benefits to determine whether to pursue an action. Traditionally, it is up to the potential plaintiff to perform a cost-benefit analysis in deciding whether to bring, and how far to pursue, a particular suit. Whenever the potential plaintiff does not bear all the costs and reap all the benefits of the suit, however, there is a significant danger that the decision will not be the most efficient one.

To illustrate this danger, consider a simple breach of contract case brought by an attorney, on behalf of an individual plaintiff, pursuant to an hourly fee agreement.<sup>188</sup> From the standpoint of the self-interested client, it is efficient to pursue the cause of action as long as the anticipated recovery outweighs the anticipated cost of the hourly retainer and other miscellaneous expenses.<sup>189</sup> Provided there is alternative employment at an equivalent hourly rate,<sup>190</sup> the self-interested lawyer should be indifferent to whether the plaintiff continues the suit.

Substituting a contingent fee arrangement for the hourly arrangement, however, distorts the simplicity of the analysis. For instance, when recovery is highly unlikely and large amounts of attorney time will be required to bring the suit to

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187. See, e.g., MODEL CODE, *supra* note 2, DR 5-104(A) (allowing business transactions involving differing interests between lawyer and client to proceed after full disclosure and client's consent); MODEL RULES, *supra* note 2, Rule 1.8(a) (same); MODEL CODE, *supra* note 2, DR 5-105(C) (allowing multiple representation after full disclosure and consent, except when it is not obvious lawyer can adequately represent interests of each client); MODEL RULES, *supra* note 2, Rule 1.7(a) (same general effect); MODEL CODE, *supra* note 2, DR 5-101(A) (allowing lawyer to accept employment when lawyer's professional judgment may be affected by lawyer's own interests if client consents after full disclosure); MODEL RULES, *supra* note 2, Rule 1.7(b) (same, provided lawyer reasonably believes representation will not be adversely affected).

188. For simplicity, all examples will involve plaintiff's attorneys, although the same general considerations may arise with respect to defense counsel.

189. This conclusion assumes that courts generally will not allow shifting of the plaintiff's attorneys' fees to the defendant. See *supra* note 69.

190. Alternative equivalent employment may or may not be available. See *infra* note 205.

trial,<sup>191</sup> a client nonetheless might choose to prosecute the case, believing that there is nothing to lose. Conversely, in the same situation,<sup>192</sup> the lawyer may prefer to settle or abandon the suit. Consequently, the outcome may depend on who actually controls the litigation.

Although the foregoing discussion demonstrates potential dangers, not all of these will exist every time an attorney acquires a financial interest in litigation. Moreover, absent other factors, obtaining an interest in a client's litigation is not intuitively immoral.<sup>193</sup> This means that ethical restraints on such acquisitions are preventive in nature. As a result, there may be instances in which strict application of this sort of regulation precludes desirable consequences. This fact has become sufficiently clear to justify approval of contingent fee arrangements in most civil suits,<sup>194</sup> as well as toleration of contingent expense arrangements in a number of jurisdictions.<sup>195</sup> No jurisdiction, however, has attempted to develop specific rules for contingent fee and expense arrangements other than to stipulate that they must be in writing.<sup>196</sup> Consideration of the utility of such arrangements in section 16(b) and derivative litigation suggests the shape of a few additional requirements.

## 2. Acquisition of an Interest in Section 16(b) Actions

The concerns suggested above are substantially less important in the context of section 16(b) litigation than they are in the abstract. First, the relative clarity of section 16(b) suits should substantially alleviate concern with overzealousness, because in many instances attorneys should not need to use questionable practices<sup>197</sup> or assertions in order to prevail. Second, the requirement that courts approve fees paid out of the section

191. This scenario assumes, of course, that the lawyer entered into the contingent fee arrangement before understanding that the chance of recovery was so dim.

192. Consider also the situation described in note 182, *supra*.

193. See *supra* note 100 and accompanying text.

194. See *supra* note 75 and accompanying text.

195. See *supra* note 77 (citing MODEL RULES, *supra* note 2, Rule 1.8(e)); see also *supra* note 2 (discussing number of jurisdictions adopting *Model Rules*).

196. See MODEL RULES, *supra* note 2, Rule 1.5(c). This statement of course disregards the exclusions for criminal and domestic cases, see *supra* note 76, as well as the statement of the *Model Code*, *supra* note 2, EC 2-20, that lawyers generally should not use contingent fees if the client can afford a fixed fee, see *supra* note 76; see also *supra* note 186 (discussing requirements that all fees be reasonable or not excessive).

197. This statement obviously excepts the practices of soliciting and obtaining an interest in the outcome of litigation.

16(b) litigation award<sup>198</sup> limits the possibility that attorneys will mislead nominal plaintiffs when establishing the contingent fee and reduces the significance of any misleading that does occur. Third, as discussed above, the nominal plaintiff does not have substantial personal interests in section 16(b) litigation, so his or her interest in controlling the lawsuit may not be a significant one.<sup>199</sup> In response to the fourth danger, disclosure can alleviate conflict of interest concerns in section 16(b) actions to the same extent as in any other context. Moreover, the requirement that a court approve any termination of litigation brought under section 16(b)<sup>200</sup> provides substantial assurance that lawyers subject to such conflicts will not ride roughshod over the other interests at stake.

Finally, in section 16(b) litigation, concern over fragmented cost-benefit analysis takes on a somewhat different character. In fact, substituting almost any other type of lawsuit for the individual breach of contract action, previously referred to in the simple model set forth in Part III(B)(1), significantly complicates matters. The popular view is that remedies for breach of contract are premised exclusively on policies looking to plaintiff compensation.<sup>201</sup> Other types of actions may have additional social benefits, such as deterring unwanted forms of conduct.<sup>202</sup> In the latter types of actions, a plaintiff anticipating only an award directed at personal compensation<sup>203</sup> will, from a social perspective, undervalue the benefits of the suit.

In derivative-type lawsuits the problem of undervaluation is even more pronounced. A nominal plaintiff conducting a

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198. See *supra* notes 27-28 and accompanying text.

199. Moreover, to the extent one views the nominal plaintiff as a representative of either the corporation or those similarly situated, it is obvious that the plaintiff's autonomy with respect to suit management already is substantially constrained. To the extent that autonomy of the corporation itself might be a concern, such concern is subordinate to public policy in § 16(b) cases. See *supra* text following note 145.

200. See *supra* text accompanying note 25.

201. See, e.g., E. FARNSWORTH, *CONTRACTS* § 12.18, at 896 (1982) (stating that "the law's goal on breach of contract is not to deter breach by compelling the promisor to perform, but rather to redress breach by compensating the promisee").

202. See W. KEETON, *PROSSER AND KEETON ON THE LAW OF TORTS* § 4, at 25 (5th ed. 1984) ("The 'prophylactic' factor of preventing future harm has been quite important in the field of torts. The courts are concerned not only with compensation of the victim, but with admonition of the wrongdoer.").

203. Actually, in light of the American system's rejection of fee shifting, any such "making whole" necessarily will be imperfect. See Rowe, *Fee Shifting*, *supra* note 69, at 657-59.

cost-benefit analysis from a personal standpoint will tend to give any societal value other than the amount of recovery short shrift and also will be likely to disregard most of the value of the recovery itself. There is no straightforward way to force the nominal plaintiff to place a more appropriate value on the amount recovered from the defendant, short of permitting the plaintiff to keep the entire award. This solution would create a windfall, however, and presumably would result in litigiousness, races to the courthouse, and similar consequences.

In the typical section 16(b) lawsuit, however, there is another party logically available, and in fact somewhat more prone, to conduct a serious cost-benefit analysis.<sup>204</sup> This, of course, is the attorney operating on a contingent fee and expense basis.<sup>205</sup> As already noted, the attorney also may be inclined to conduct any cost-benefit analysis from a personal standpoint.<sup>206</sup> Nonetheless, in a lawsuit based on section 16(b), the lawyer's perspective is much more likely than that of the nominal plaintiff to mirror the broad and presumably desirable social perspective.<sup>207</sup> As long as the attorney expects to recover opportunity costs<sup>208</sup> and out-of-pocket expenses, appropriately risk-adjusted,<sup>209</sup> he or she will be inclined to pursue

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204. See *supra* text accompanying notes 149-50 (discussing why nominal plaintiff readily may defer to evaluation of lawyer).

205. An attorney receiving an hourly fee should, as a matter of professional responsibility, advise the client of the chances of recovery and aid the client in making the necessary assessments. In the absence of a contingent fee arrangement, however, the attorney will have no strong *financial* incentive for doing so. Moreover, in the absence of alternative employment, the attorney may even have an incentive to conceal poor chances of recovery in order to increase billing hours.

206. Thus, the lawyer with a direct financial interest may be motivated to substitute an analysis of his or her own costs and benefits for those of the client and to manipulate information and strategies accordingly.

207. In some circumstances, however, the lawyer's perspective may be somewhat different. For example, an attorney may seek to extract some value from the litigation other than victory, such as becoming known in the field. See *supra* text accompanying notes 171-73. For the most part, however, even an attorney with this kind of interest will prefer to prevail, and will screen cases accordingly. Only when the lawyer is motivated by something on the order of an irrational dislike of the defendant is the lawyer's perspective apt to vastly diverge from that assumed in the text.

208. These costs include, of course, an element of forgone profit. Although calculation of opportunity costs presents substantial difficulties, see Conard, *supra* note 41, at 282-83, the attorney's ordinary billing rate is a possible starting point.

209. To the extent that a premium over actual costs must be allowed to provide adequate incentive to bear risk, its discounted present value should not vastly exceed actual costs at any given time. Moreover, when the cause of



the suit,<sup>210</sup> and thus aid in the effectuation of section 16(b)'s underlying policy goals.

Accordingly, if the lawyer is assured of recovering the risk-adjusted amount described above,<sup>211</sup> *up to the full amount extracted from the defendant*,<sup>212</sup> maximization of the lawyer's own welfare should lead to the closest approximation of the so-

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action is relatively certain, the risk of nonrecovery is not great and a substantial premium may not be necessary. Thus, the risk premium in the typical § 16(b) case need not be large. With respect to the many difficulties that may be encountered in attempting to determine an appropriate risk premium, however, see Leubsdorf, *supra* note 69, at 497-501 (analyzing practice of awarding "contingency bonuses for lawyers who successfully bring marginal cases") and Rowe, *Recent Developments*, *supra* note 52, at 632-34 (discussing Supreme Court's disapproval of enhancements based on quality of lawyer's work).

210. Thus, a lawyer whose opportunity and other costs always approximate 30% of recovery, and who expects to receive a constant 30% of any recovery, generally would prefer to prosecute, rather than settle, as long as the probable magnitude of recovery at trial, multiplied by the likelihood of prevailing, outweighs the settlement offer. This preference parallels the preferences of a client who would receive the full recovery in question, but would expect to pay the costs of litigation, calculated at a constant 30% of recovery. Similarly, when the lawyer's costs vary as a proportion of recovery, but the client reimburses them, the same incentive structure should apply. Unlike the attorney employed on an hourly fee basis, an attorney employed pursuant to a contingent arrangement will have unreimbursed sunk costs, and thus will not be even theoretically indifferent as between continuing suit and taking alternate employment.

211. Whenever actual costs exceed, or are less than, prospective fee recoveries, the attorney's incentive structure will not necessarily lead to the desirable social outcome. Remarkably, however, permitting a lawyer's contingent fee recovery to equal actual costs appropriately adjusts the incentive structure in all instances except those in which the lawyer's input of time and other costs already exceeds total prospective recovery. Thus, when a lawyer believes the contingent return, appropriately risk-discounted, will cover costs and provide a reasonable profit, the appropriate motivation will exist for deciding when a suit should be settled or brought to trial. Only when an error already has led to an expenditure of effort that cannot be compensated is this not the case. This type of miscalculation, however, is less likely in the § 16(b) context, because validity of a cause of action based on particular facts is often fairly easy to assess. It is hoped, therefore, that reasonably vigilant lawyers will not often find themselves in a situation in which they already have "over-expended." This should be particularly true if, because of lack of client interest, the attorney wields substantial control over suit termination. But see the discussion of the critical role of court approval of such determinations in the text accompanying note 223, *infra*. Commentators have argued that when the maximum possible recovery from a defendant is very high, but its probability of being recovered is very low, an attorney will, from a social desirability standpoint, have an over-incentive to bring suit. See Conard, *supra* note 41, at 281-82. This is not true, however, unless the attorney calculates the fee as a percentage of recovery.

212. This limit is logically derived by application of the "benefit" exception to the general refusal to fee-shift. See *supra* note 50.

cially desirable result—the largest recovery from the pool of potential defendants<sup>213</sup>—that is available as long as enforcement is in private hands.<sup>214</sup> This conclusion is related to the idea that enforcement of section 16(b) requires that attorneys' fees not be niggardly.<sup>215</sup> It goes substantially further, however, in describing how courts are to calculate such fees and in limiting them only by the amount extracted from the defendant.

Three caveats, however, are in order. First, to the extent that the deterrent value of a suit is higher than the amount that the suit may extract from the defendant,<sup>216</sup> attorney self-interest will not completely reflect social interest. Neither, of course, will the interest of the nominal plaintiff, who typically will not consider either social interest or the amount of recovery benefiting other shareholders.<sup>217</sup> Nevertheless, as suggested above, this result is virtually unavoidable as long as enforcement is in private hands.<sup>218</sup>

213. Here, it seems fair to assume that, from a public policy standpoint, all payments extracted from defendants in settlement or in satisfaction of judgment represent social good.

214. Consideration of the desirability of a cause of action from a broad, social perspective presumably would take into account the costs and benefits of both prosecution and defense. See Conard, *supra* note 41, at 271-73. This assertion should be especially true in common-law derivative suits, when the corporation on behalf of which suit is brought is aligned as a nominal defendant. See *id.* Any attempt to select the viewpoint of a single individual as surrogate for the social perspective must necessarily sacrifice this comprehensiveness, however, unless one makes some allowance for the shifting of the prevailing party's attorneys' fees and other expenses as an inducement to the other party to take them into account. See *id.* at 284-85 (suggesting that fees and expenses that defense incurs be reflected, in appropriate cases, in assessments against initiating attorney). The American system, however, generally has rejected such shifting. See Rowe, *Fee Shifting*, *supra* note 69, at 657-59. See *infra* notes 258-59 and accompanying text, for a discussion of the idea that enforcement by public agencies may be the best way to deal with "spillover" benefits.

215. See *supra* text accompanying note 88.

216. The desired level of deterrence in connection with § 16(b) suits appears to be located precisely at the point at which the insider has no affirmative incentive to engage in short-swing trading on the basis of inside information. See *supra* note 69.

217. See *supra* text accompanying notes 203-04.

218. Moreover, whenever deterrent value is higher than the amount to be paid to the plaintiff, other, often public, enforcement mechanisms may be brought into play. For instance, private enforcement actions, Securities and Exchange Commission enforcement actions, and criminal prosecutions brought against violators of Rule 10b-5, 17 C.F.R. § 240.10b-5 (1988), no doubt supplement § 16(b)'s effect on trading involving actual use of inside information. Here, it is relevant to note the increased sanctions made available to the Commission by the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified at 15 U.S.C. § 78u(d)(2) (Supp. IV 1986)) and the Insider

The second difficulty presented by the argument that attorney self-interest can be an adequate proxy for social interests is that under this model courts may allow the lawyer a fee equal to the full amount extracted from the defendant. This result is less objectionable than full recovery by the nominal plaintiff, because recovery by the lawyer is not a windfall—the lawyer will have worked for it. Nonetheless, it may be disturbing to contemplate an arrangement in which there is virtually no monetary benefit to the corporation ostensibly represented. Such circumstances are not unheard-of, however, when fees are paid on an hourly, noncontingent basis. In addition, such a situation should not be distressing when the primary benefit of litigation is defined in terms of the effect on the adverse party. Section 16(b) is a perfect example of this; that section 16(b) does not require misuse of inside information, or even injury to the corporation, as a predicate to suit and the refusal to permit the “injured” corporation to decide when its own interests outweigh the bringing of the suit make clear that the purpose of the cause of action is deterrence rather than recompense.<sup>219</sup>

The third and most serious problem connected with the “lawyer as social proxy” argument involves the role of the courts in approving fee awards and settlements. As indicated above, lawyers will be motivated to enforce section 16(b) most appropriately if they anticipate recovery of their risk-adjusted opportunity costs and out-of-pocket expenditures. This has implications for the calculation of court-approved fee awards.<sup>220</sup> The most important such implication is that courts must be *clearly* willing to permit the awards thus computed to approach, or even to equal, the amount paid by the defendant.<sup>221</sup>

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Trading and Securities Fraud Enforcement Act of 1988. Pub. L. No. 100-704, Fed. Sec. L. Rep. (CCH) No. 1304 (pt. II) (Sept. 21, 1988).

219. See also *supra* note 11 (citing preamble to § 16(b)).

220. See *supra* text accompanying note 28 (discussing current approach to fee calculation).

221. To the extent that one requires precedent for this adjustment, it might be found in the recent case of *City of Riverside v. Rivera*, 477 U.S. 561 (1986), awarding \$33,350 in damages and \$245,456.25 as attorneys' fees, in which a plurality of the Supreme Court determined that the amount recovered by the plaintiff in a civil rights action did not dictate the amount of attorneys' fees to be awarded against the defendant. *Id.* at 580. The plurality declined even to allow the amount recovered to act as a ceiling on attorneys' fees. *Id.* When the fee award comes out of the common fund created, however, see *supra* note 50, the size of the fund logically does limit the size of the award. It is important to note, however, that the Court did not regard results achieved as irrelevant; rather, the plurality indicated that damages awarded did not reflect fully the public benefit advanced by the litigation. *Id.* at 574. If system-

To date, there is no indication that this clear willingness exists.<sup>222</sup>

The effect of "clear willingness" on attorney motivation also has implications for the courts' role in approving settlements. It is foreseeable that, at some point in litigation, a lawyer will perceive that continued prosecution will require inputs of time or other resources not likely to increase the recovery enough to cover the lawyer's increased costs.<sup>223</sup> At this point, the lawyer presumably will prefer to attempt a settlement. If the court does not permit settlement—perhaps because trial may result in a higher gross payment from the defendant—the lawyer may incur a loss. Moreover, refusals to allow settlements in such instances may negatively affect the incentives for other lawyers contemplating section 16(b) enforcement actions. Accordingly, courts should relate settlement determinations, as well as fee awards, to the lawyer's risk-adjusted opportunity costs. Courts must clearly acknowledge and understand this relation in order to achieve the most favorable impact on attorney motivation.

### 3. Acquisition of an Interest in Other Derivative Litigation

The arguable dangers that an attorney's direct financial interest in litigation presents are, as described above, overzealousness, misleading the client, impairment of client control, conflict of interest, and fragmented cost-benefit analysis.<sup>224</sup> Discussion of most of these dangers in the context of common-law derivative actions parallels the above discussion in the context of section 16(b) litigation.

Thus, as is the case with section 16(b) litigation, the role of the courts in approving fee awards may alleviate concern over misleading the nominal plaintiff. Moreover, the interests of the nominal plaintiff in most derivative litigation, like the interests of the section 16(b) shareholder litigant, will be minimal and impersonal; thus, the interest in controlling litigation will not be significant. Similarly, as in the section 16(b) context, court

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atic deterrence value is attributed to the § 16(b) action, the same reasoning would seem to apply. For discussion and criticism of *Rivera*, see Rowe, *Recent Developments*, *supra* note 52, at 623-27.

222. The split in the Supreme Court in *Rivera* provides evidence of the lack of universal endorsement of fee awards of this magnitude. *See supra* note 221.

223. *See supra* note 182.

224. *See supra* notes 171-92 and accompanying text.

approval of suit termination can alleviate conflict of interest concerns for most derivative litigation.

There are, however, two differences between analysis of direct financial interests for purposes of section 16(b) and analysis for other derivative litigation. Because of the relatively difficult nature of most derivative actions,<sup>225</sup> there may be more opportunity for overzealousness than arises in the context of fairly straightforward section 16(b) litigation. A more important difference, however, involves the treatment of fragmented cost-benefit analysis and the conclusion that using the self-interest of attorneys to override the self-interest of the nominal plaintiff may be necessary to effectuate public policy. This important difference is attributable to the varying purposes of the relevant suits.

a. *Suits Against Third Parties*

With respect to those derivative causes of action not premised on management wrongdoing, deterrence is, at best, a subsidiary goal. The threat to a third party of being sued by means of a cumbersome derivative action probably adds little deterrence value to the prospect of being sued by the corporation itself. It is much more apposite to characterize the availability of derivative remedies in such cases as a "steam valve" for disgruntled shareholders, one of several available methods of drawing the presence of possible corporate claims to the attention of management, or an indirect way of assuring that the evaluation called for by management's duty of care is made, even if management itself does not make it.<sup>226</sup> In these circumstances, responding to deficiencies in the incentives of nominal plaintiffs by enhancing attorney incentives is not a particularly compelling solution. In other words, motivating attorneys to prosecute suits by allowing their fees to approach or consume total recoveries may be inappropriate when the goal of the suit is not defined primarily in terms of its effect on the potential defendant class.

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225. See *supra* notes 53-58 and accompanying text and *infra* notes 226-45 and accompanying text.

226. Attempts to articulate the deterrence value of derivative lawsuits against third parties in terms of effect on management ultimately must fail. Although it may be mildly embarrassing to management to have a successful derivative suit brought against a third party, this mild embarrassment is not apt to be a powerful motivator. Bringing such a suit may or may not cause an otherwise disinclined management to evaluate its merits.

b. *Suits Against Management*

For purposes of analysis, this Article divides derivative causes of action premised on underlying management wrongdoing into two primary categories.<sup>227</sup> The first of these implicates management's duty of loyalty;<sup>228</sup> the second implicates management's duty of care.<sup>229</sup>

i. *The Duty of Loyalty*

The fiduciary duty of loyalty requires good faith and fair dealing toward the beneficiaries of the duty<sup>230</sup> and prohibits the fiduciary from taking advantage of such beneficiaries by means of fraudulent or unfair transactions.<sup>231</sup> In some contexts, the fiduciary acts improperly simply by maintaining a state of affairs in which the fiduciary has a conflict of interest with the beneficiary.<sup>232</sup> Traditional classifications of violations of the duty include competing with the corporation, usurping corporate

227. There are ways in which corporate managers or directors can be guilty of malfeasance or nonfeasance of duty that might not strictly fall under the duty of care or duty of loyalty labels. One example is the duty to act *intra vires* and within the authority of the position held. Under one view, directors and officers are absolutely liable for any loss to the corporation resulting from *ultra vires* acts. See RESTATEMENT (SECOND) OF AGENCY § 383 comment b (1958); 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1021-28 (rev. vol. 1986). Under another view, they are liable only when they negligently or knowingly act beyond the scope of the corporation's powers. See *Lappaluoto v. Eggleston*, 57 Wash. 2d 393, 402, 357 P.2d 725, 731 (1960). Nonetheless, these miscellaneous activities often will resemble one of the two major categories described.

228. For purposes of this Article, the duty of loyalty encompasses the duties of the officer or director to act in good faith toward, and deal fairly with, the corporation and, in some cases, its shareholders. See *infra* notes 230-33 and accompanying text. For a general analysis of the elements of the duty of loyalty, see Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPAL AND AGENTS: THE STRUCTURE OF BUSINESS 55, 71-79 (1985); Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 823 (1983). At least some commentators prefer to refer collectively to these duties simply as "fiduciary duties," distinguished from the duty of care. See, e.g., H. HENN & J. ALEXANDER, *supra* note 31, § 231, at 612.

Interestingly, the duty of loyalty itself often is described as a "residual concept," into which otherwise uncategorized violations often fall. See, e.g., R. CLARK, *supra* note 35, § 4.1, at 141; see also H. HENN & J. ALEXANDER, *supra* note 31, § 235, at 627 (describing fiduciary duty as requiring good faith and fair dealing).

229. As used in this Article, the term *duty of care* generally contemplates management's duty to act diligently. See *infra* note 239 and accompanying text.

230. See *supra* note 228.

231. See R. CLARK, *supra* note 35, § 4.1, at 141.

232. See *id.*; see generally Frankel, *supra* note 228, at 808 (discussing inher-

opportunities, engaging in insider trading, engaging in other transactions involving conflicts of interest, and oppressing minority shareholders.<sup>233</sup>

Several early applications of the duty of loyalty appear to have developed primarily as matters of prophylaxis. Examples include prohibitions against taking advantage of corporate opportunities, even when the corporation could not or would not do so itself,<sup>234</sup> and the position that transactions in which management is interested are voidable, even when not unfair to the corporation.<sup>235</sup> Both of these rules reflected the attitude that an ounce of prevention was worth a pound of cure. This preventive approach, however, precluded some transactions that actually might have been beneficial, or at least not harmful. This approach foreshadowed the section 16(b) enthusiasm for general improvement in the conduct of potential defendants, even at the cost of arguable loss of benefit to a particular entity

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ent risk of fiduciary relations and various control methods used to limit breach of fiduciary duty).

233. See H. HENN & J. ALEXANDER, *supra* note 31, § 235, at 627.

234. See, e.g., *Procario v. 74 & 76 West Tremont Ave. Corp.*, 3 N.Y.2d 973, 974-75, 169 N.Y.S.2d 39, 39, 146 N.E.2d 795, 795 (1957); *Young v. Columbia Oil Co.*, 110 W. Va. 364, 370, 158 S.E. 678, 681 (1931). More typically, the director is not held liable. *Northwestern Terra Cotta Corp. v. Wilson*, 74 Ill. App. 2d 38, 46-48, 219 N.E.2d 860, 864-65 (1966); *Urban J. Alexander Co. v. Trinkle*, 311 Ky. 635, 639-42, 224 S.W.2d 923, 926-27 (1949); *Black v. Parker Mfg. Co.*, 329 Mass. 105, 111, 106 N.E.2d 544, 549 (1952); see generally Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981) (arguing that closely held corporations should be subject to different standard); Slaughter, *The Corporate Opportunity Doctrine*, 18 Sw. L.J. 96 (1964) (summarizing scope and elements of corporate opportunity doctrine).

235. *Alabama Fidelity Mortgage & Bond Co. v. Dubberly*, 198 Ala. 545, 549, 73 So. 911, 914 (1916); *Hotaling v. Hotaling*, 193 Cal. 368, 384, 224 P. 455, 462 (1924); *Munson v. Syracuse, Geneva & Corning Ry.*, 103 N.Y. 58, 73-74, 8 N.E. 355, 358 (1886). Other cases have held that interested management transactions are voidable when there is fraud or bad faith, see, e.g., *Briggs v. Scripps*, 13 Cal. App. 2d 43, 45, 56 P.2d 277, 278 (1936); *GOS Cattle Co. v. Bragaw's Heirs*, 38 N.M. 105, 109, 28 P.2d 529, 532 (1933), or unfairness, see, e.g., *Crawford v. Mexican Petroleum Co.*, 130 F.2d 359, 361-62 (2d Cir. 1942); *Wyman v. Bowman*, 127 F. 257, 274 (8th Cir. 1904). More modern cases tend to apply the test of whether an independent fiduciary in an arm's length bargain would have bound the corporation to such a transaction. See, e.g., *Murphy v. Washington Am. League Base Ball Club, Inc.*, 324 F.2d 394, 396 (D.C. Cir. 1963); *Johnston v. Greene*, 35 Del. Ch. 479, 490, 121 A.2d 919, 925 (1956); see generally Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335, 341-42 (1948) (promoting comparison of interested director's action with action of independent fiduciary under same circumstances). With respect to statutory approaches to conflict of interest questions, see Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 NOTRE DAME LAW. 201, 204-23 (1977).

in a particular case.<sup>236</sup>

There has been substantial relaxation of the positions referred to above.<sup>237</sup> Nonetheless, frequent requirements that management bear the burden of justification<sup>238</sup> when shareholders allege that management has breached the duty of loyalty suggest a continuing prejudice against the activities in question and a corresponding attitude that, derivative complications aside, policing lawsuits should be relatively easy to bring.

## ii. *The Duty of Care*

Directors and officers must, in managing the corporation, exercise that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances.<sup>239</sup> Relative to the duty of loyalty, the duty of care reflects more concern with consequences to the corporation than with deterrence or prevention. Courts have traditionally limited recovery for violations of the duty of care to actual damage caused to the corporation.<sup>240</sup> Moreover, they give wide latitude to the discretion of the corporate decision makers,<sup>241</sup> manifesting a disinclination

236. See *supra* notes 145-46 and accompanying text. For the proposition that, at least in the context of publicly-held corporations, there is no systematic benefit to transactions in which management has an interest, see R. CLARK, *supra* note 35, § 5.4.

237. See *supra* notes 235-36.

238. See, e.g., *Lewis v. S.L. & E., Inc.*, 629 F.2d 764, 768 (2d Cir. 1980); *Bellis v. Thal*, 373 F. Supp. 120, 122-23 (E.D. Pa. 1974), *aff'd mem.*, 510 F.2d 969 (3d Cir. 1975); *Schreiber v. Pennzoil Co.*, 419 A.2d 952, 956-57 (Del. Ch. 1980). In some circumstances, management may shift this burden by demonstrating that independent shareholders ratified the transaction in question. See, e.g., *Harman v. Masoneilan Int'l, Inc.*, 442 A.2d 487, 498-99 (Del. 1982); *Michelson v. Duncan*, 407 A.2d 211, 224-25 (Del. 1979).

239. See *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939); R. CLARK, *supra* note 35, § 3.4, at 123. Courts sometimes apply an arguably stricter formulation requiring that the director or officer act as a reasonably prudent person would act in the conduct of his own affairs. See *Selheimer v. Manganese Corp.*, 423 Pa. 563, 573-79, 224 A.2d 634, 642-43 (1966).

240. See, e.g., *Bellis*, 373 F. Supp. at 123; *Barnes v. Andrews*, 298 F. 614, 619 (S.D.N.Y. 1924); *Allied Freightways, Inc. v. Cholfin*, 325 Mass. 630, 632, 91 N.E.2d 765, 767 (1950).

241. Inactivity has provided the basis for liability under the duty of care. See, e.g., *Francis v. United Jersey Bank*, 87 N.J. 15, 21, 432 A.2d 814, 817 (1981). But see *Allied Freightways*, 325 Mass. at 634-35, 91 N.E.2d at 768-69. Cases finding reasonably active officers or directors liable, however, are relatively rare. See Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099-1100 (1968) (locating only four cases in several decades). For a recent case imposing liability on the basis of a rather cursory, but not atypical, consideration of a merger proposal, see *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), *criticized*



nation either to tinker with corporate control or to constrain managers substantially in the performance of their duties. The business judgment rule, which effectively establishes a presumption "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company,"<sup>242</sup> provides strong evidence of the courts' unwillingness to interfere with corporate management and control.

Recent legislative actions that permit corporations to limit liability for breaches of the duty of care further support the view that the law generally should not hamper management's decision-making functions.<sup>243</sup> Commentary on these legislative

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in Herzel & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187, 1188 (1986). It is, in part, this case that has stimulated the legislative activity referred to in the text accompanying note 243, *infra*. See Balotti & Gentile, *Commentary from the Bar: Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 7 (1987).

242. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); see also *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) (noting that general corporation law dictates that affairs of corporation are under management of board); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785 (Del. 1981) (noting that board decides whether suit would be detrimental to corporation); see generally Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157 (1970) (arguing that business judgment rule appropriately strikes balance between court control and directors' independent judgment). Although most often discussed in reference to the actions of directors, the business judgment rule also applies to officers, see 3A W. FLETCHER, *supra* note 227, § 1029, and, in extraordinary circumstances, to controlling shareholders, see *Cole v. National Cash Credit Ass'n*, 18 Del. Ch. 47, 58, 156 A. 183, 188 (1931).

243. Since early 1986, more than 30 states have adopted legislation relating to the limitation of liability of directors and, in some cases, officers. See, e.g., ARIZ. REV. STAT. ANN. § 10-054 (Supp. 1987); CAL. CORP. CODE § 204 (West Supp. 1988); COLO. REV. STAT. § 7-3-101 (Supp. 1987); DEL. CODE ANN. tit. 8, § 102 (Supp. 1986); see also Balotti & Gentile, *supra* note 241, at 5 (discussing Delaware legislation); Nader, *The Corporate Drive to Restrict Their Victims' Rights*, 22 GONZ. L. REV. 15, 15 (1986-87) (blaming insurance industry for tort law changes that restrict victims' compensation and litigation rights); Wright, *Colorado Expands Protections for Corporate Directors*, 16 COLO. LAW. 1387, 1387-89 (1987) (describing amendment to Colorado Code that limits or eliminates personal liability of directors for duty of care); Note, *1986 Ohio Corporation Amendments: Expanding the Scope of Director Immunity*, 56 U. CIN. L. REV. 663, 663 (1987) (criticizing Ohio's liberalized indemnification statute). The typical statute provides that a corporation may include in its articles of incorporation a provision eliminating or limiting the personal liability of a director to the corporation or its shareholders for monetary damages for breaches of fiduciary duty, except with respect to any breach of the director's duty of loyalty, any acts or omissions not in good faith or involving intentional misconduct or knowing violation of law, and certain other specified acts. See, e.g., DEL. CODE ANN. tit. 8, § 102 (Supp. 1986).

developments has brought to the fore, however, the interesting points that the same circumstances often may give rise to both duty of care and duty of loyalty considerations, and that, in practice, the lines between the two are quite hazy.<sup>244</sup> As a corollary, it is possible that plaintiffs may avoid limitations on cases based on the duty of care by bringing actions based on the duty of loyalty.<sup>245</sup> This presumably would have significant negative implications for the effectuation of legislative intent.

### iii. *Appropriate Cost-Bearing Arrangements*

Once it becomes apparent that derivative actions are not necessarily intended to deter wrongful conduct, it also appears that the conclusion reached with respect to the computation of fee awards in the section 16(b) context does not automatically extend by analogy. The objection to awards thus measured is that they deplete the corporate recovery. Once stripped of its social value as a deterrent, a suit typically is justified primarily by its ability to make the real party-in-interest whole. Substantial pecuniary benefits to the lawyer at the expense of the party-in-interest significantly undercut this goal.<sup>246</sup>

More interesting, however, is a second possible objection to contingent fee recoveries approximating the lawyer's risk-adjusted costs of bringing an action. This objection is that such recoveries may provide more incentive for the prosecution of suits than the system actually wishes to provide.<sup>247</sup> This objection is valid despite the argument, made above, that suits brought on contingent fee bases should tend to have formal merit.<sup>248</sup> Even if deterrence is not the primary purpose of a particular cause of action, the threat of litigation presumably does have a preventive effect *vis a vis* the activities giving rise to the threat and thus might hamper progressive management

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244. See Linsley, *Statutory Limitations on Director's Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule*, 24 HARV. J. ON LEGIS. 527, 552 (1987).

245. See Balotti & Gentile, *supra* note 241, at 16-17; Shaffer, *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J.L. & PUB. POL'Y 665, 669 (1987).

246. This problem might be exacerbated when any part of the lawyer's fee represents a subsidy for unsuccessful claims brought on a contingent basis. See Rowe, *Fee Shifting*, *supra* note 69, at 674-75.

247. Cf. Note, *Class Actions*, *supra* note 87, at 1583 (noting that deterrent effect of statutes increases when individuals refrain from conduct that statute does not prohibit).

248. See *supra* text accompanying note 146.

techniques or nonconservative decision making.<sup>249</sup> The prospect of liability for every formal transgression might even discourage some individuals from accepting positions, such as corporate directorships, that would leave them open to suit.<sup>250</sup>

This objection, based on the "overkill" potential of bringing suits—even those with formal merit—indicates some belief that courts and legislatures have not yet carefully thought out management policing devices.<sup>251</sup> It may also indicate, however, the possible impact of attorney activities on those devices and thus the importance of integrating the requirements of the relevant causes of action and those ethical restrictions that may bear heavily on their enforcement. In this situation, some focus by legislatures or courts on the appropriate relationship of the incentives of potential managers and the incentives of attorneys should advance the goals underlying the different types of derivative actions. Such a focus is particularly timely in light of recent legislative efforts to overhaul management liability schemes.<sup>252</sup>

#### IV. SYNTHESIS

The discussion above shows that there is substantial interaction between ethical regulation and enforcement of the laws applicable to section 16(b) and other derivative litigation. This Part will present a synthesis and restatement of the various observations and recommendations made with respect to the retooling of this interaction. First, however, this Part will examine a few broad principles and suggestions relating to the integration of ethical regulation and generally applicable law.

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249. See Herzel & Katz, *supra* note 241, at 1189; see also Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1482 (1984) (contrasting decision-making process of business to that of law).

250. See Baum, *The Job Nobody Wants*, BUS. WK., Sept. 8, 1986, at 56 (directors resigning to avoid personal liability); Galante, *Corporate Boardroom Woes Grow*, NAT'L L.J., Aug. 4, 1986, at 1 (increased costs and cancellations of insurance causing directors to examine options). In this regard, it is interesting to note that some causes of action primarily based on deterrence, such as § 16(b) actions, may be sufficiently clear-cut to discourage the unwanted activity, such as short-swing trading, without leading insiders to fear unpredictable impositions of liability. In other words, one might still accept a directorship, even if well aware of the possibility of § 16(b) liability, simply as a result of believing that such liability is relatively well-defined and easy to avoid, and that if it is imposed, it will result only in loss of profit.

251. The legislative activity described in note 243, *supra*, and accompanying text also reflects this doubt.

252. See *supra* note 243 and accompanying text.

It is hoped that these general themes will be applied in various areas where such integration would be helpful, and that their specific application to section 16(b) and other derivative litigation will serve as a useful paradigm.

A. BROAD THEMES IN THE INTEGRATION OF ETHICAL REGULATION AND LAWS OF GENERAL APPLICABILITY

1. Integration and the Need for a Central Decision Maker

This Article has described a few situations in which at least partial integration of ethical regulation and laws of general applicability already has occurred. For instance, the constitutional right to free speech has resulted in some relaxation of rules governing advertising and solicitation.<sup>253</sup> The right to associate freely also has had some effect on ethical regulation.<sup>254</sup> For the most part, as is the case with these examples, laws of general applicability simply have placed limits on permissible regulation when the rights they secure have been impaired.

In at least one area discussed in this Article, however, laws of general applicability have played a part in bringing about relaxation of ethical restrictions on general policy grounds: the need for contingent expense arrangements in class and derivative actions undoubtedly contributed to the recent legitimization of those arrangements in some states.<sup>255</sup> This kind of interrelationship is valuable, but requires careful scrutiny and tailoring. For instance, it would be possible to permit or require contingent fee and expense arrangements in those types of suits in which such arrangements are necessary for enforcement and play a role in screening for validity, but to continue a general stance of disapproval in others.<sup>256</sup>

The main obstacle to a more complete effort to integrate laws of general applicability and ethical regulation in any given context is the lack of a central decision maker. Ideally, a central decision maker would evaluate the desirability of particular causes of action and the dangers of various forms of attorney conduct in such actions, and then would determine the struc-

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253. See *supra* notes 123-38 and accompanying text.

254. See *supra* note 7 and accompanying text; see also *supra* note 10 (referring to right to effective counsel).

255. See *supra* note 77 and accompanying text; see generally Findlater, *supra* note 70, at 1670 (discussing effect of prohibiting attorneys from advancing expenses of litigation).

256. The suggestion in the text notwithstanding, the author regards contingent expense arrangements as conceptually indistinguishable from the well-established contingent fee, and thus susceptible to regulation on the same terms.

ture of attorney activities and incentives necessary to achieve appropriate results. To some extent, Louis Loss's call for public enforcement of section 16(b) suits was a call for such decision-making on a limited basis.<sup>257</sup> If an agency were legislatively established, charged with responsibility to enforce all law in a particular area, and appropriately funded, it could achieve coordination of public policy, attorney incentive, and at least general forms of attorney conduct.<sup>258</sup> This type of coordination will not, however, and should not, take place across the board, even when strong public interests are implicated. Constraints on the public fisc exist, and private interests in enforcing certain rights<sup>259</sup> preclude turning over all control of litigation to governmental agencies.

The involvement of courts in approving settlement and compensation in suits of the type discussed in this Article may be a crucial aspect of any attempt to deal with the particular integrative problems described. Nonetheless, it is extremely unlikely that, in the course of substantive litigation,<sup>260</sup> courts will provide the impetus for the needed retooling, either in specific problem areas or on a general basis.<sup>261</sup> Apparently, it will be left to those directly responsible for ethical regulation<sup>262</sup> to address the considerations raised in the foregoing pages. It is

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257. See *supra* note 86 and accompanying text.

258. One might extend the line of reasoning in the text to the position that, in some circumstances, there is no reason to cling to such requirements as standing. Those issues are beyond the scope of this Article.

259. Such a private interest might exist, for instance, with respect to the prosecution (or, more to the point, nonprosecution) of rights of a highly personal nature or claims against close friends or relatives.

260. But see *infra* note 262 (referring to courts' role in ethical rule-making).

261. This is clear from courts' past hit-or-miss approach to the integration of attorney behavior and generally applicable law, illustrated by their attempts to enhance attorney incentives in § 16(b) suits while acknowledging that this may give cause for discipline by some other body. See *supra* note 87. There may be some question about the courts' capability to respond to the considerations raised, as well as about their inclination. For specific criticism of the Supreme Court's inadequate economic analysis in approving fee awards, see Rowe, *Recent Developments*, *supra* note 52, at 634-37.

262. In most circumstances, of course, this regulation will involve the exercise of the courts' inherent power to regulate lawyers. See generally Comment, *Separation of Powers: Who Should Control the Bar?*, 47 J. URB. L. 715, 721-23 (1969) (arguing that Michigan legislature should not take control of legal profession from judicial branch); Note, *The Inherent Power of the Judiciary to Regulate the Practice of Law—A Proposed Delineation*, 60 MINN. L. REV. 783, 785-87 (1976) (examining doctrine that Minnesota Supreme Court has exclusive power to regulate practice of law in state).

hoped that they will do so in a manner more or less in harmony with the suggestions that follow.

## 2. Systematic Review

### a. *The Preventive-Inherent Distinction and Context Specificity*

One important component in the systematic integration of ethical regulation and generally applicable law is recognition and approval of the idea that different circumstances may justify application of different behavioral standards.<sup>263</sup> It is likely that many instances in which law and regulation are at cross purposes are the result of attempts to regulate attorney conduct through broad and generalized rules.

Broad rules may be reasonably appropriate if the conduct regulated is inherently immoral or undesirable. Although there may be instances in which an activity that is in and of itself extremely undesirable presents an opportunity to achieve some benefit,<sup>264</sup> these circumstances will be relatively rare. There should be little need to respond to this rarity by providing in advance for formal exceptions from general prohibitions.

Conversely, if the regulation in question is only preventive

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263. Commentators often have remarked that the practice of law involves application of an ethic that neither nonlawyers nor lawyers do or should apply in their extra-professional lives. See, e.g., Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relation*, 85 *YALE L.J.* 1060, 1061 (1976); Wasserstrom, *Lawyers as Professionals: Some Moral Issues*, 5 *HUM. RTS.* 1, 3-4 (1975). Others have strenuously criticized this view. See D'Amato & Eberle, *Three Models of Legal Ethics*, 27 *ST. LOUIS L.J.* 761, 765-70 (1983); Dauer & Leff, *Correspondence: The Lawyer as Friend*, 86 *YALE L.J.* 573, 575-80 (1977). Commentators in the former group have tended to recognize general adversarial behavior as appropriate for lawyers even though not broadly desirable for the populace at large. See M. FREEDMAN, *LAWYERS' ETHICS IN AN ADVERSARY SYSTEM* 43-49 (1975); see also Curtis, *The Ethics of Advocacy*, 4 *STAN. L. REV.* 3, 3-6 (1951) (discussing lawyer's duty of loyalty to client). But see Frankel, *The Search for Truth: An Umpireal View*, 123 *U. PA. L. REV.* 1031, 1032 (1975) (arguing that adversary system should value search for truth more highly); Rhode, *Ethical Perspectives on Legal Practice*, 37 *STAN. L. REV.* 589, 595-601 (1985) (advocating that attorneys take personal responsibility for ethical partisanship). If one contemplates that ethics may vary contextually, it is a short step to subdividing the relevant contexts. In other words, if it is legitimate to establish one ethic for lawyers and another for nonlawyers, it is not much of a conceptual leap to establish different behavioral guidelines for lawyers in different situations.

264. One possible example is the making of a false statement in the course of representation (prohibited by MODEL CODE, *supra* note 2, DR 7-102(A)(5) and MODEL RULES, *supra* note 2, Rule 4.1(a)) in order to avert a murder or serious assault.

in nature, it is more likely to interfere with the attainment of favorable results on a predictable basis. This distinction means that it is much more likely that well-tailored exceptions developed with particular attention to factual context would realize benefits. In light of this conclusion, attempts to integrate ethical regulation and generally applicable law should be directed initially at preventive regulation. Ethical regulators could reserve for some date in the future their efforts to deal with regulation of activities that are inherently immoral or otherwise undesirable.<sup>265</sup>

b. *The Absolute Limits Imposed by Generally Applicable Law*

Any attempt at a systematic review of the integration of ethical regulation and laws of general applicability would do well, as a preliminary matter, to identify the absolute limits imposed by the latter on the former. For instance, it would be logical for ethical regulators to commence projects by voluntarily examining regulations for constitutional infirmity. Thus, regulators should search for possible impairment of the rights of attorneys<sup>266</sup> and clients<sup>267</sup> and, when they identify impair-

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265. It is true, of course, that there is considerable opportunity for disagreement regarding whether a particular regulation is merely preventive. Reasonable people probably would agree that embezzlement of client funds is inherently bad and ethical regulations should forbid it. See MODEL CODE, *supra* note 2, DR 9-102 (requiring safekeeping property of client); MODEL RULES, *supra* note 2, Rule 1.15 (requiring safekeeping property of clients and third parties); MODEL CODE, *supra* note 2, DR 1-102(A)(3) (prohibiting illegal conduct); MODEL RULES, *supra* note 2, Rule 8.4(b) (same); MODEL CODE, *supra* note 2, DR 1-102(A)(4) (prohibiting dishonesty); MODEL RULES, *supra* note 2, Rule 8.4(c) (same). But see C. WOLFRAM, *supra* note 2, § 2.72, at 74 (embezzling from would-be cockroach benefactor to feed starving people). They might, however, differ as to whether disclosure of client confidences is an inherent betrayal of a trust relationship and thus intrinsically bad, or whether attorneys should avoid such disclosures simply as a means of enhancing client trust and willingness to pass enough information on to lawyers to facilitate effective representation. In partial answer, however, it is important to note that a number of regulations are clearly preventive, see *supra* note 3, and that these regulations alone provide substantial raw material with which the integrative effort could begin. As the effort proceeds and experience is gained, it is even possible that the preventive-inherent distinction eventually can be discarded as only a matter of degree. Thus, if analysis concentrates simply on permitting previously prohibited activities to proceed when opportunity for harm is limited and occasion for good presented, the need for labels may disappear.

266. As indicated above, see *supra* notes 123-29 and accompanying text, the right most frequently implicated to date has been that of free speech. Even with respect to this single right there are many unanswered questions.

267. Frequently litigated clients' rights have included freedom of associa-

ment, should systematically deal with it by means of a test case or otherwise.<sup>268</sup>

c. *The True Integrative Process*

Beyond determining the limits that laws of general applicability impose on ethical regulation lies true integration of the two. As an initial matter, integration requires identifying the goals of each in the context of various categories of attorney activity. This simple step may, in some cases, reveal instances in which these goals are congruent. In such cases, nothing more may be required. In other cases, such as those specifically addressed in the earlier parts of this Article, examination may reveal that, when goals apparently diverge, the goal of the ethical regulation in question may be irrelevant, or may be attained by a means not at odds with the policies of generally applicable law.<sup>269</sup> It may be a simple matter to align the two by using the tools discussed below. There will be instances, however, in which regulators cannot easily achieve harmony. Although it is difficult to say without a thorough examination of a variety of

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tion, *see supra* note 7 and accompanying text, and the right to effective counsel, *see supra* note 10.

268. Ethical regulators should, of course, consider the effects of other laws of general applicability. For instance, it would be rather easy to develop a more straightforward approach to the interaction of obstruction of justice statutes and attorneys' obligations with respect to physical evidence. *See* MODEL CODE, *supra* note 2, DR 7-102(A)(3) (prohibiting lawyer from concealing or knowingly failing to disclose that which "he is required by law to reveal"); MODEL RULES, *supra* note 2, Rule 3.4(a) (prohibiting lawyer from "unlawfully" altering, destroying, or concealing "a document or other material having potential evidentiary value"); *see also* Note, *Disclosure of Incriminating Physical Evidence Received from a Client: The Defense Attorney's Dilemma*, 52 U. COLO. L. REV. 419, 463 (1981) (examining attorney's choices and obligations when client discloses incriminating evidence); Note, *Legal Ethics and the Destruction of Evidence*, 88 YALE L.J. 1665, 1682-88 (1979) (proposing amendment to MODEL CODE, *supra* note 2, addressing destruction of evidence).

Similarly, ethical regulators could, in a straightforward manner, reconcile a lawyer's obligation under the federal securities laws with obligations to maintain client confidences. *See generally* Block & Ferris, *SEC Rule 2(e)—A New Standard for Ethical Conduct or an Unauthorized Web of Ambiguity?*, 11 CAP. U. L. REV. 501, 527-28 (1982) (examining appropriateness of SEC rule regulating attorneys); Gruenbaum, *Corporate/Securities Lawyers: Disclosure, Responsibility, Liability to Investors, and National Student Marketing Corp.*, 54 NOTRE DAME LAW. 795, 795 (1979) (discussing ethical and legal principles behind attorney liability and responsibility under federal securities laws). It is important to note, however, that the current lack of resolution in this area is not attributable to lack of attention.

269. This is especially likely to be true when the ethical regulation in question is preventive.



possible conflicts, it seems quite likely that the appropriate response in most cases of actual conflict will be articulation of the conflict and development of a method for ethical regulation to defer to the goals of generally applicable law.

d. *Available Tools*

In those circumstances in which it is appropriate to revise a particular ethical regulation in light of generally applicable law, ethical regulators may use a variety of tools. Incentive structuring and the use of rebuttable presumptions are two examples of such tools.

i. *Incentive Structuring*

Although incentive structuring is itself a kind of preventive regulation, it can be a much more delicate instrument than flat prohibition. For instance, ethical regulators may alleviate concerns with solicitation by developing rules that encourage the bringing of certain suits on a contingent basis. Conversely, forbidding the use of contingent fees is one method of controlling the number of some types of undesirable suits, short of completely eliminating a particular cause of action. In fact, rules aligning self-interest and policy goals are often effective. Examples of such alignment range from the governmental ideals expressed by the founders<sup>270</sup> to the willingness of courts to award substantial fees in section 16(b) suits.<sup>271</sup> Consequently, addressing attorney behavior from the standpoint of self-interest need appear neither undignified nor undesirable.

ii. *Rebuttable Presumptions*

Ethical regulators also should consider casting certain prohibitions as rebuttable presumptions.<sup>272</sup> Thus, a rule might prohibit an act generally, but allow a lawyer to establish, in a given circumstance, that some set of standards or guidelines justified the particular act. Although this formulation would cast some pall over the activities in question even when they

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270. Cf. THE FEDERALIST No. 51 (J. Madison) (proposing system of separation of powers as method of check and balance based on self-interest).

271. See *supra* note 88 and accompanying text.

272. In the free speech area, the Supreme Court has distinguished activities that states can regulate on the basis of possible harm and those that states can regulate only on the basis of actual harm. See *supra* notes 127-29 and accompanying text. Although the approach suggested in the text might be overbroad as to the latter, as to the former it might represent a less restrictive alternative than complete prohibition.

are desirable, the chilling effect would be less than that which would result from a complete prohibition.<sup>273</sup>

## B. THE SPECIFIC CASE OF SECTION 16(b) AND OTHER DERIVATIVE LITIGATION

### 1. Preventive Regulation and Context Specificity

The foregoing general discussion easily applies to existing ethical regulations relating to the instigation of section 16(b) and other derivative litigation. The two major categories of such regulation—restrictions on solicitation and the acquisition of direct financial interests in litigation—are primarily preventive in nature. In light of the earlier discussion regarding preventive rules, it may be appropriate to vary the rigor with which these restrictions are applied or to make some other adjustment in response to the demands of particular situations—in other words, context-specific exceptions may be merited. Exceptions of this sort are exactly the type that ethical regulators should be prepared to take up at this time.

### 2. The Absolute Limits Imposed by Generally Applicable Law

Once they have determined that problems in the section 16(b) and other derivative contexts are appropriate for consideration, regulators should consider the extent to which generally applicable law imposes absolute limits on ethical regulation. Here, the primary issue involves the free speech implications of solicitational bans. As discussed above, restriction of solicitation when the dangers of overreaching and misleading are extremely limited arguably abridges the

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273. Some will argue that the creation of loopholes is undesirable, and in many instances this will be true. This Article intends the suggested formulation, however, only for use in the circumstances in which there is some consensus that a loophole is not a bad thing. For instance, it would seem quite unobjectionable for ethical regulators to provide an exception from solicitational bans when the attorney successfully demonstrates that the solicitational activity was no more than reasonably necessary to inform the solicited individual of some right, protection of which is generally in the public interest. Similarly, they might none too controversially choose to prohibit in-person solicitation except when the lawyer makes the demonstration called for above or when the cause of action is derivative in nature and not disfavored. This wording is, of course, uncertain and capable of refinement. At a minimum, the uncertainty involved would impose some burden on the attorney seeking to come within the exception. In fact, existing ethical regulations are not themselves models of clarity and precision. See Comment, *ABA Code of Professional Responsibility: Void for Vagueness?*, 57 N.C.L. REV. 671, 680-92 (1979).

constitutional rights of the attorneys whose actions the rules curtail.<sup>274</sup> Solicitation in any type of derivative litigation presents few, if any, such dangers.<sup>275</sup> Accordingly, any significant curtailment in this area is at least constitutionally dubious. Given the public policy considerations discussed below,<sup>276</sup> it is not necessary to draw any final conclusions about constitutionality. Nonetheless, any doubts in this regard buttress arguments that ethical regulators should make solicitational rules less restrictive.

### 3. The True Integrative Process

Next, it is important to recognize that relaxation or relaxed enforcement of restrictions on solicitation and acquisition of interests in litigation will contribute to the bringing of suits. In deciding whether to encourage a more relaxed approach in any given area, one factor for ethical regulators to consider is whether a given type of suit is particularly desirable. Another factor is whether litigation in the context under consideration actually would present an opportunity for any of the traditional dangers associated with the regulated activities. A third factor is whether these activities themselves might present the likelihood of beneficial outcomes.

The first relevant inquiry thus is whether various derivative causes of action are particularly desirable. For this purpose, it is useful to rank the causes of action discussed above along a general continuum. Based on various emanations from legislatures and courts, it appears that section 16(b) suits are desirable.<sup>277</sup> Derivative suits are less desirable, although those premised on violation of the duty of loyalty are more attractive than those premised on rights against corporate outsiders or on breach of the duty of care.<sup>278</sup>

Given this ranking, the next inquiry involves the dangers and benefits of the regulated activities. In the general context of derivative litigation, these dangers and benefits are fairly easy to identify. Solicitation in this area presents few traditional dangers and it actually may be necessary to overcome the free-rider problem that frequently occurs.<sup>279</sup> The dangers that

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274. See *supra* text following note 152.

275. See *supra* notes 139-52, 157-65 and accompanying text.

276. See *infra* notes 284-86 and accompanying text.

277. See *supra* notes 53-58 and accompanying text.

278. See *supra* notes 240-41 and accompanying text.

279. See *supra* notes 66-67 and accompanying text.

contingent fee and expense arrangements present also are limited in the derivative context and required disclosure may minimize them further.<sup>280</sup> Moreover, the use of contingent fee and expense arrangements can be beneficial insofar as such arrangements address free-rider problems and constitute devices to screen out frivolous suits.<sup>281</sup> In addition, at the same time that these arrangements give an attorney a financial interest in the outcome of litigation, they create a direct incentive to analyze derivative litigation for costs and benefits. This analysis is more likely to approximate a general social perspective than would any such analysis conducted by a nominal plaintiff, who distinctly and consistently would be likely to undervalue the suit's benefits.<sup>282</sup> In fact, the more assurance an attorney has that courts will not limit recovery of costs by any measure other than the amount extracted from the defendant, the closer the approximation is likely to be.<sup>283</sup>

#### 4. The Use of Available Tools and the Integrated Ideal

##### a. *Section 16(b)*

Because section 16(b) suits generally are desirable, the dangers that solicitation and acquisition of a direct financial interest present in this context are minimal. These activities generally are necessary for suit to proceed, and ideal effectuation of public policy in this situation requires that ethical regulations permit solicitation.<sup>284</sup> Public policy also suggests that any attorney wishing to solicit employment in the section 16(b) area should be required to offer to accept employment on the basis of a contingent fee and expense arrangement<sup>285</sup> and to disclose the arguable dangers associated with such arrangements. If the plaintiff chooses a contingent arrangement, ethical regulations also should require the attorney to specify that the amount sought for recompense will approximate the lawyer's risk-adjusted opportunity costs and out-of-pocket expenditures.

Presumably, regulators could implement these standards largely by way of amendment to, or formal interpretation of,

280. See *supra* notes 186-87 and accompanying text.

281. See *supra* notes 68-71 and accompanying text.

282. See *supra* notes 203-04 and accompanying text.

283. See *supra* note 212 and accompanying text.

284. Generally applicable law also may mandate this result as a matter of absolute limitation. See *supra* text accompanying notes 274-75.

285. This requirement primarily is a means of ensuring that suits solicited have formal merit. See *supra* text accompanying note 281.

existing ethical codes.<sup>286</sup> The body responsible for implementation also should undertake a program to thoroughly acquaint courts with the desirability of "incentive structuring." Thus, in appropriate circumstances, such as those presented by section 16(b) suits, regulators should encourage courts to allow fee and expense awards calculated as described above and to approve settlements at the point at which the attorney's prospective costs threaten to exceed the comparative benefits.

b. *Other Derivative Litigation*

In non-16(b) derivative contexts, the dangers that solicitation poses also are limited. The prospect of solicitation in these suits, however, does present some likelihood that attorneys will "stir up" litigation without any particular social mandate. Moreover, although free-rider problems may exist in the prosecution of derivative suits, there is no reason to believe that derivative action regularly is necessary to enforce at least those underlying causes of action accruing against third parties. In addition, in light of the varying desirability of non-16(b) derivative suits, the desirability of solicitation also varies. Nonetheless, if suits in derivative form are to proceed, solicitation is helpful and no argument against it is very strong. Moreover, the conclusion that ethical regulations should not prohibit solicitation in these suits has the advantage of avoiding constitutional issues that might otherwise arise.

The reasoning with respect to the acquisition of direct financial interests roughly tracks the above discussion relating to solicitation. The dangers that such acquisitions present are not great, and contingent fee and expense arrangements will be necessary for some derivative suits to proceed. It thus appears that regulations should allow contingent fee and expense arrangements in some form.<sup>287</sup> This conclusion does not mean, however, that attorneys should receive maximum encouragement to bring all derivative suits, or even all those of formal merit. Accordingly, there is some doubt about answering, in these circumstances, the call made in the context of section 16(b) suits for the specialized revamping of settlement approvals and fee and expense awards.

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286. With respect to the significance of ethics opinions issued by various bar organizations, see C. WOLFRAM, *supra* note 2, § 2.6.6, at 65-67.

287. This might even extend to a requirement that contingent fee and expense arrangements be offered in some circumstances. See *supra* note 284 and accompanying text.

Nonetheless, distinctions remain to be drawn on the basis of the desirability and purpose of the different types of suits under consideration. Thus, revamping fee awards and settlement approvals in derivative actions based on the duty of loyalty is appealing. After all, public policy favors such suits relative to other non-16(b) derivative suits, and the discussion above characterized the duty of loyalty itself—like section 16(b)—as largely preventive in nature.<sup>288</sup> Unfortunately, however, the lines between the kinds of conduct implicating the duty of loyalty and those implicating the duty of care are, at best, indistinct. As noted above, for instance, some commentators believe that litigation that could be based on breach of the duty of care may be rather easily recharacterized in terms of the duty of loyalty.<sup>289</sup>

One possible response to the difficulty of distinguishing the causes of action underlying derivative suits is the use of a rebuttable presumption. In other words, attorneys seeking in non-16(b) derivative suits to recover fees or settle cases on the basis of the standards suggested for section 16(b) suits could be allocated the burden of establishing that the suit implicates only the duty of loyalty. Even this modest step seems a premature complication, however, until courts and legislatures thoroughly scrutinize the presently changing law of management liability. The wisest and most efficient course for ethical regulators appears to be simply to wait until the generally applicable law in this area has stabilized. During the waiting period, however, ethical bodies should bring to the attention of lawmakers the possible implications of different approaches to attorney conduct.

### CONCLUSION

It is clear that thorough integration of substantive law and ethical regulation will not be quick or easy. Nonetheless, existing regulations are neither so extensive nor so strict as to make the prospect unattainable. Even if integration is slow, and achieved only on a context-by-context basis, it is a worthy goal. Moreover, once the legal profession regards integration as an ideal rather than an aberration, ethical regulators can enlist formally the aid of courts and legislatures in the endeavor.

Courts can play a crucial role in the integrative process as a

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288. See *supra* notes 234-38 and accompanying text.

289. See *supra* text accompanying note 245.

result of their power over incentive structuring.<sup>290</sup> Their enunciation of public policy, and even their expression of opinion on the appropriate role that lawyers might play in the effectuation of such policy, also might be helpful in this process. Similar statements by the legislature, and considered tailoring of the substantive and procedural rules relating to various causes of action, could be of additional use.

No doubt any suggestion that courts or legislatures should regularly concern themselves with attorney activities—or, in the case of legislatures, should think about such activities at all—will represent to some an undesirable attempt to encroach upon the time-honored custom of attorney self-regulation.<sup>291</sup> In fact, it is possibly the emphasis on professional regulatory autonomy that has prevented a more significant integration of such regulation with laws of general applicability in the past.<sup>292</sup> The heyday of self-regulation passed, however, with the Supreme Court's first deregulation of advertising in the 1970s.<sup>293</sup> It is now clear that ethical self-regulators are not infallible, and that attorneys may challenge their shortcomings. In this light, it seems that subjecting their own determinations to scrutiny and directing scrutiny by others through particularized requests may, in the long run, be the most practical strategy for self-regulators to retain control.

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290. See *supra* notes 220-23 and accompanying text.

291. As thus used, *self-regulation* primarily contemplates the role of bar organizations as initiators of regulation. See C. WOLFRAM, *supra* note 2, § 2.3; see also *supra* note 262 (referring to courts' exercise of inherent power to regulate attorney conduct).

292. With respect to some of the conflicts implicit in self-regulation by the legal profession, see Rhode, *Why the ABA Bothers: A Functional Perspective on Professional Codes*, 59 TEX. L. REV. 689 (1981).

293. See *supra* notes 8, 123-24 and accompanying text.