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New Myths and Old Realities: The American Law Institute Faces the Derivative Action

By John C. Coffee, Jr.*

Nothing in The American Law Institute's (ALI) *Principles of Corporate Governance: Analysis and Recommendations (Principles)* proved more controversial than the effort to develop fair and balanced standards for the derivative action. Only the topic of corporate takeovers seems to evoke an equally intense level of emotion among corporate lawyers. Not surprisingly then, Part VII (Remedies) of the *Principles* attracted the same attention from critics that a lightning rod does in a thunderstorm.

Unlike other ALI Restatements, however, the *Principles* also encountered a professional opposition, which lobbied against its adoption, both inside and outside the ALI, on behalf of various outside groups. The central charge of these critics, repeated endlessly and loudly, was that the *Principles* in general, and Part VII in particular, relied on a "litigation model of corporate governance," which distrusted directors and asked courts to manage the corporation.¹

Within the ALI, these pejorative charges never worked. The ALI's members read the Reporters' drafts, heard the floor debate, and resoundingly defeated, year after year, the motions advanced by The Business Roundtable's spokespersons. In turn, the Reporters listened to the ALI's comments and criticisms (and also those of CORPRO, the ABA liaison committee to the Project), rephrased and fine-tuned their drafts, until eventually a compromise position was reached that received the approval of an overwhelming majority of the ALI's members.

Although the process worked internally, the result has been more ambiguous outside the ALI. Few business lawyers who were not ALI members had the time to read the various Tentative Drafts, and neither the ALI

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1. See, e.g., *Eighth Annual Baron de Hirsch Meyer Lecture Series: ALI Corporate Governance Project: Panel Discussion*, 37 U. MIAMI L. REV. 319, 336 (1983) (comments of Harvard Business Professor Kenneth Andrews). For a similar viewpoint, see Michael Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992).

nor its academic Reporters were in a position to counter the steady stream of memoranda and booklets disseminated by the *Principles'* professional critics. Because of this negative publicity campaign, many lawyers are familiar with the *Principles* only from the heated denunciations of it that they received in the mail. This Article is written for those in this group who have been perplexed by the ALI Corporate Governance Project. Clearly, they know that the ALI is not given to radicalism; nothing about it even qualifies for the word "trendy." Temperamentally, the ALI is cautious and conservative in its pronouncements. Why then has it aroused controversy in the corporate governance area?

The answer cannot be that the *Principles* reflect some radical departure from existing law. Not only is the ALI not given to such deviations, but it is easy to point to recent cases that set forth far more demanding substantive standards² or pose greater procedural standards³ before a derivative action can be dismissed. For those willing to read and compare these cases against the *Principles*, it will be apparent that the ALI has steered an intermediate course between the extreme positions in the case law. Part of the problem may be that few business lawyers have the time to familiarize themselves with the case law in this area and are thus at the mercy of oversimplifying critics who wish to portray the ALI position as radical. Given these time constraints, this Article will not attempt a section-by-section exegesis of Part VII of the *Principles*, but rather will attempt to explain its basic approach and the policy premises underlying that approach. To be sure, there are trade-offs, and many may well prefer a more conservative approach that effectively forecloses the possibility of shareholder litigation. But what cannot be said (at least not honestly) is that the *Principles* idealize derivative litigation. Rather, they clearly recognize that a litigation cost differential favoring the plaintiffs is frequently at work, that it can operate to produce settlements unrelated to the merits, and that exposure to liability for ordinary business decisions can make directors excessively risk averse or cause them to flee the board.⁴

These arguments do not mean, however, that the baby should be thrown out with the bath by denying shareholders any realistic access to a litigation

2. For recent decisions imposing higher substantive standards before the court may dismiss a derivative action, see *Lewis v. Boyd*, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992); *Alford v. Shaw*, 358 S.E.2d 323, 325-28 (N.C. 1987). Both decisions also reject any "demand required, demand excused" distinction under which the court's review of the substantive justifications for dismissal is confined to instances in which demand was excused. Indeed, even under Delaware law, the standard of substantive review is sometimes higher than under the *Principles*, because when demand is excused, Delaware law permits the court to exercise its own "independent business judgment." See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981). This independent business judgment standard is never applicable under Part VII of the *Principles*.

3. See *Will v. Engebretson & Co.*, 261 Cal. Rptr. 868 (Cal. Ct. App. 1989). This decision is discussed *infra* notes 108-109.

4. See *Principles*, *supra* note *, pt. VII Introductory Note, at 588-90.

remedy; rather, they imply that the remedy's scope should be confined to and focused on those areas where other mechanisms of corporate accountability do not work sufficiently well to make a litigation remedy superfluous. Such areas survive, in part, because collective action by shareholders remains costly and is sometimes infeasible. Within these areas—whose core is defined by the traditional area of self-dealing and the duty of loyalty—the ALI's position is that a need persists for a measure of judicial oversight. If the *Principles* are controversial, it is because they do not see the existence of independent directors as a complete and wholly preemptive substitute for judicial oversight of self-dealing.

Why not? Some would respond with lengthy organizational, psychological, or sociological critiques of the board's capability or objectivity.⁵ That was not, however, the judgment that moved the Reporters or the vast majority of the ALI's members. Probably more than anything else, in my judgment, a conservative political judgment shaped the thinking of most of the ALI's members—the business judgment rule traditionally and wisely has stopped short of covering the approval of self-dealing transactions. Many felt that extending the business judgment rule into that context ultimately would weaken it. Like the proverbial rubber band, it could snap if it were stretched too far. More specifically, the long-term result of such an extension predictably would be that courts would graft exceptions and conditions onto the rule. In short, the danger in attempting to make the business judgment rule universally applicable was that it could become a meaningless standard that courts would overwhelm with judicially created conditions. Symptomatically, there are signs that this is precisely what is happening today to the Delaware standard for derivative actions when that standard is interpreted by federal courts in diversity cases.⁶

In this light, the debate between the ALI and The Business Roundtable positions on the appropriate scope of the business judgment rule is basically a disagreement over whether the legitimacy of the business corporation should rest solely on a single premise (i.e., the capacity of independent directors to manage all aspects of corporate affairs) or whether additional safeguards remain prudent. Without doubting the importance of independent directors, the ALI view is that corporate governance rests on a stronger, more stable foundation for the long-run when the law permits a limited role for judicial oversight.

Part VII attempts, however, to limit that judicial role by focusing chiefly on the duty of loyalty and certain closely related areas (such as knowing illegality). In so doing, Part VII articulates several basic policy judgments:

5. For an elaborate summary of these arguments, see James Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 *LAW & CONTEMP. PROBS.* 83 (1985).

6. See *infra* notes 23-26 and accompanying text.

(1) The primary role of the derivative action is to enforce the duty of loyalty, not the duty of care, because other mechanisms of accountability outperform litigation in enforcing the duty of care;

(2) Liability for due care violations should be capped at a level commensurate with the defendant's culpability and the expected benefits from corporate office;

(3) The procedures applicable to the derivative action should create an early screening mechanism that places the directors' actual response to the plaintiff's demand at center stage; and

(4) The standard of review of the board's or committee's motion to dismiss a derivative action should integrate and be consistent with the standard of review applicable to the underlying transaction or conduct at issue; thus, in a duty of care case, the business judgment rule should normally govern, but in a duty of loyalty case, the court should be authorized to review the justifications advanced for the dismissal of the derivative action to the same extent as it would review the fairness of the underlying transaction.⁷

Some of these ideas are now familiar (for example, an early version of section 7.19 of the *Principles* served as the model for section 102(b)(7) of the Delaware General Corporation Law, which authorizes charter amendments eliminating due care liability).⁸ Other ideas, such as "universal demand," remain controversial, but are gaining some legislative acceptance.⁹ Still, other provisions now are beginning to attract support from state courts.¹⁰

7. *Principles*, *supra* note *, pt. VII.

8. DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) authorizes a charter provision reducing or eliminating financial liability of corporate directors, except for liability resulting from certain specified categories of misbehavior. An early discussion draft of what became § 7.19 of the *Principles* was provided to the drafting committee of the Delaware bar that proposed § 102(b)(7). Section 7.19 does not permit complete exculpation of due care liability (as § 107(b)(7) does), but only authorizes a ceiling on due care liability for both officers and directors. Several other states seem to have patterned their statutes even more closely after the ALI model. *See, e.g.*, VA. CODE ANN. § 13.1-692.1 (Michie 1992); CAL. CORP. CODE § 204(a)(10) (Deering 1993). *See generally* James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988).

9. MODEL BUSINESS CORP. ACT. § 7.42 (1989) [hereinafter Model Act] followed an earlier ALI proposal and requires demand on the board in all cases before a derivative action is filed. Several states enacted versions of § 7.42. *See, e.g.*, GA. CODE ANN. § 14-2-742 (Michie 1992); FLA. STAT. ANN. § 607.07401(2) (West 1992). Although the Model Act differs significantly from § 7.03 of the *Principles* in failing to provide for substantive judicial review of the board's response to the demand, the idea of universal demand originated with the ALI Corporate Governance Project. *See Kamen v. Kemper Fin. Servs., Inc.*, 111 S. Ct. 1711, 1722 n.2 (1991).

10. Several decisions already followed (or at least expressed agreement with) the ALI's standards on termination of derivative litigation. *See Alford v. Shaw*, 358 S.E.2d 323, 327 (N.C. 1987) (expressly rejecting the "demand required/demand excused" distinction and requiring substantive judicial evaluation of the merits in all cases before a derivative action

For the future, the *Principles* probably represent the leading alternative to the well developed Delaware case law, particularly with regard to derivative actions. In jurisdictions where the law remains undeveloped, courts will face a choice between the ALI's approach and Delaware's approach. Thus, this Article will use Delaware law as a point of reference. Its intent is not to attack Delaware law,¹¹ but to explore and contrast the general approaches of Delaware and the ALI on a policy level.

A COMPARISON OF THE ALI AND DELAWARE TREATMENT OF DERIVATIVE ACTIONS

THE DELAWARE PROCEDURE

Under Delaware law, the principal screening device for winnowing derivative actions is supplied by the "demand required/demand excused" distinction.¹² When demand on the board is required, the board's response to the demand is governed by the business judgment rule,¹³ and in such cases plaintiffs usually face an insuperable barrier. Thus, the critical question becomes when will demand on the board be excused as futile.

Here, the law of individual states varies considerably. Originally, early Delaware cases on demand futility focused on whether the board would

can be dismissed); *Lewis v. Boyd*, 838 S.W.2d 215 (Tenn. Ct. App. 1992); *Houle v. Low*, 556 N.E.2d 51, 59 (Mass. 1990) (the reviewing court must determine "whether the committee reached a reasonable and principled decision"); *see also* *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983); *Greenfield v. Hamilton Oil Corp.*, 760 P.2d 664 (Colo. Ct. App. 1988). To this author's knowledge, no state court yet has expressed its disagreement with the *Principles*.

11. In fairness, it must be acknowledged that Delaware's law on derivative actions is in some respects more favorable to plaintiffs than that of other jurisdictions (most notably, New York). For example, under New York law, the determination of a special litigation committee to seek dismissal of a derivative action must be accorded business judgment rule deference. *See Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979). In contrast, Delaware law permits the court considerable discretion in reviewing such a determination and even speaks of the court using its own "independent business judgment." *See Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). The *Principles* do not go this far, but they do extend substantive judicial review to the justifications for dismissal to all well-pled derivative actions raising certain specified claims. *See infra* text accompanying notes 59-70. Since 1984, Delaware law largely eclipsed the significance of the *Zapata* decision by raising the showing necessary to excuse demand. *See Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). In contrast, New York law is far more liberal on the excuse of demand, and the New York case law reveals that demand is excused regularly. *See, e.g., Barr v. Wackman*, 329 N.E.2d 180 (N.Y. 1975); *Schmidt v. Magnetic Head Corp.*, 476 N.Y.S.2d 151, 160 (N.Y. App. Div. 1984); *Davidowitz v. Edelman*, 583 N.Y.S.2d 340 (N.Y. Sup. Ct. 1992).

12. Delaware is not unique in this regard, although its standard for finding demand to be futile is considerably more unfavorable to plaintiffs than that of other jurisdictions, such as New York. *See supra* note 11. For an overview of the demand rule, *see* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746 (1960); *Kamen v. Kemper Fin. Servs., Inc.*, 111 S. Ct. 1711 (1991).

13. *See Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990) (when a shareholder makes demand, the shareholder "tacitly acknowledges the absence of facts to support a finding of futility"); *Levine v. Smith*, 591 A.2d 194, 212 (Del. 1991).

be hostile to the action, i.e., was the board predisposed to resist the litigation?¹⁴ In a significant doctrinal shift in 1984, however, the Delaware Supreme Court limited the circumstances under which demand would be excused. In *Aronson v. Lewis*,¹⁵ the court shifted the focus from the board's predisposition towards the action to whether the directors' conduct fell within the protection of the business judgment rule.¹⁶ The test has two alternative prongs, either of which, if satisfied, excuse demand:

[I]n determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.¹⁷

Under *Aronson's* first prong, the plaintiff must allege particularized facts that indicate that a majority of the board had a financial interest in the challenged transaction or otherwise lacked independence.¹⁸ This is a severe test, which rarely can be satisfied in the case of a publicly held corporation having a board with a majority of outside directors.

Aronson's second prong, however, has proven more of a wild card. Under this prong, even directors who are financially disinterested can be disqualified if the plaintiff pleads particularized facts showing that the directors failed to exercise proper business judgment.¹⁹ Specifically, plaintiffs avoid the necessity of demand if they can plead "particularized facts creating a reasonable doubt as to the 'soundness' of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction."²⁰ The ambiguities in this second prong have been noted and criticized by others,²¹ but the relevant point here is that this standard is susceptible to highly variant interpretation and application.²² Thus, even if the judges of the Delaware Court of Chancery un-

14. See, e.g., *Sohland v. Baker*, 141 A. 277, 282 (Del. 1927).

15. 473 A.2d 805 (Del. 1984).

16. *Id.* at 814.

17. *Id.*

18. See *Pogostin v. Rice*, 480 A.2d 619, 624-25 (Del. 1984). When a claim is made that the majority of the board lacks independence, the plaintiff must allege particularized facts showing that the board is "dominated by an officer or director who is the proponent of the challenged transaction" or that it is "so under his influence that its discretion is sterilize[d]." *Levine v. Smith*, 591 A.2d 194, 205 (Del. 1991).

19. See *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988).

20. *Levine*, 591 A.2d at 205-06.

21. See, e.g., *Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1174 (7th Cir. 1989).

22. This potential for variant interpretation was heightened further by the most recent Delaware Supreme Court decision on demand, which emphasizes the "highly factual nature of the inquiry" in which the court must engage when demand futility is alleged. *Heineman v. Datapoint Corp.*, 611 A.2d 950, 953 (Del. 1992). Although *Heineman* clearly seems to be the appropriate outcome on its facts, its language predictably will produce a variety of interpretations in federal diversity cases.

derstand *Aronson* and interpret it consistently, federal district courts applying Delaware law in diversity cases demonstrably do not—as recent cases have indicated.²³ In particular, the meaning of the term *reasonable doubt* and the quantum of particularization necessary to rebut the presumption in favor of the board are undefined and invite inherently subjective responses from other courts.²⁴

Arguably, the open-textured latitude inherent in *Aronson's* test may be its saving grace. In the hands of an independent, strong-willed judge, the decision can be read to preserve some judicial discretion. Thus, the harshness of the *Aronson* decision is mitigated by the unpredictability of the test that it formulates. Indeed, federal courts applying *Aronson* recently excused demand in cases where little board involvement was shown.²⁵ For precisely this reason, however, the frequency with which federal courts cite the *Aronson* formula is misleading because the *Aronson* test ultimately is an empty one that seldom dictates the result in a specific case. A strong judge usually can manipulate a “reasonable doubt” standard to reach the outcome that he or she desires.²⁶

Doctrinally, the real bite in the Delaware formula is its waiver rule, which faces the plaintiff with a “Catch 22”-like dilemma: If the plaintiff does not make demand on the board, the plaintiff must overcome the *Aronson* test; but if the plaintiff does make demand, the plaintiff thereby concedes the disinterestedness of the board.²⁷ Because of this constructive “waiver” of all challenges to the board’s objectivity, plaintiffs who make demand may only attack the board’s rejection of demand by raising the functional equivalent of *Aronson's* second prong and attacking the good faith and reasonableness of the board’s investigation.²⁸ Sometimes (but rarely), plaintiffs have succeeded in challenging the reasonableness or good faith of the board’s response to demand.²⁹ Still, there is a sufficient disincentive in the

23. See *RCM Sec. Fund, Inc. v. Stanton*, 928 F.2d 1318 (2d Cir. 1991) (a case in which I doubt that Delaware courts would have excused demand); see also *infra* note 26.

24. This is especially true because, under conventional pleading, almost any well-pled relevant fact is sufficient to overcome a presumption, which in theory operates only to allocate the burden of production and to resolve the case in the rare event that the evidence is in equipoise. See R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, *supra* p. 1337.

25. See, e.g., *In re Storage Technology Corp. Sec. Litig.*, 804 F. Supp. 1368 (D. Colo. 1992); *Miller v. Loucks*, No. 91C 6539, 1992 U.S. Dist. LEXIS 16966 (N.D. Ill. Nov. 3, 1992).

26. Both *Storage Technology Corp.* and *Miller* fit this pattern. I doubt that demand would be excused on the facts of either case in the Delaware Court of Chancery. See *supra* note 25 and accompanying text.

27. See *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990); *Levine v. Smith*, 591 A.2d 194, 212 (Del. 1991).

28. *Levine*, 591 A.2d at 212.

29. See, e.g., *Miller v. Loucks*, No. 91C 6539, 1992 U.S. Dist. LEXIS 16966 (N.D. Ill. Nov. 3, 1992); *Abrams v. Koether*, 1992 Fed. Sec. L. Rep. (CCH) ¶ 96,995 (D.N.J. Aug. 10, 1992); *Thorpe v. Cerbco*, 611 A.2d 5 (Del. Ch. 1991). Attacks on the board’s rejection of demand, however, have been more successful in other jurisdictions. See *Country Nat’l Bank v. Mayer*, 788 F. Supp. 1136 (E.D. Cal. 1992).

Delaware "waiver" rule as to produce an entirely predictable consequence: Plaintiffs today seldom make demand in Delaware, but instead litigate the issue of whether demand was excused.

Delaware's demand rule also results in a substantial amount of collateral litigation and sometimes can be a trap for the unwary. For example, issues arise as to (i) whether a skeptical or protesting letter from a shareholder constitutes a demand (thereby waiving the issue of board independence) or only a request for information;³⁰ (ii) whether a non-specific letter from a shareholder is too indefinite to constitute a demand (and thus requires no board response);³¹ (iii) how long after demand the plaintiff must wait for a response before filing its action;³² (iv) how broadly a demand letter relates when there are multiple issues;³³ and (v) what effect does demand have when there is a subsequent change in the composition of the board.³⁴ Nonetheless, the shareholder plaintiff usually faces an unattractive choice: either (i) not make demand and thereby accept the burden of convincing the court that seemingly respectable directors should be deemed too biased even to deserve an opportunity to respond to demand, or (ii) make demand and thereby acknowledge the applicability of the business judgment rule to the directors' decision whether or not to reject demand (and, for most practical purposes, concede the outcome of the case).

Should the plaintiff survive the significant obstacle of the demand rule, Delaware law then becomes considerably fairer. Under *Zapata Corp. v. Maldonado*,³⁵ even when demand is excused as futile, the "interested" board can appoint a special litigation committee of disinterested directors, which can review the action and recommend its dismissal.³⁶ In *Zapata*, the Delaware Supreme Court adopted a two-step test for review of the committee's decision. First, the court must inquire into the committee's independence and good faith and examine the bases supporting the committee's conclusions.³⁷ Second, the court may, in its discretion, apply its own "independent business judgment" to determine whether the motion should be granted, and, in so doing, may give special consideration to

30. Compare *Rubin v. Posner*, 701 F. Supp. 1041, 1045 (D. Del. 1988) (court found demand had been made); *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1116-17 (D. Del.), *aff'd*, 782 F.2d 1026 (3d Cir. 1985) (same) with *Shlensky v. Dorsey*, 574 F.2d 131, 141 (3d Cir. 1978) (court found demand had not been made); *Brook v. Acme Steel Co.*, No. 10276, 1989 Del. Ch. LEXIS 61 (May 11, 1989) (same).

31. Cf. *Seidel v. Public Serv. Co.*, 616 F. Supp. 1342, 1351 (D.N.H. 1985) (demand letter insufficient under FED. R. Civ. P. 23.1).

32. Compare *Rubin v. Posner*, 701 F. Supp. 1041, 1046 (D. Del. 1988) (27 days sufficient period) with *Mozes v. Welch*, 638 F. Supp. 215, 220-22 (D. Conn. 1986) (eight months insufficient).

33. Cf. *Abrams v. Koether*, 1992 Fed. Sec. L. Rep. (CCH) ¶ 96,995 (D.N.J. Aug. 10, 1992).

34. *Abrams v. Koether*, 766 F. Supp. 237, 257 (D.N.J. 1991) (earlier decision).

35. 430 A.2d 779 (Del. 1981).

36. *Id.* at 785-86.

37. *Id.* at 788.

matters of law and public policy.³⁸ Although the *Zapata* standard strikes a reasonably fair balance, the *Aronson* decision largely eclipsed the significance of the earlier *Zapata* test. Even when *Zapata* is applicable, the process still can take as long as several years between the making of demand and the date on which the special litigation committee renders its report—and even longer before the action reaches the trial stage if the court declines to dismiss.³⁹

THE ALI'S ALTERNATIVE APPROACH

Demand and Demand Rejections

The ALI's approach to the derivative action differs fundamentally at the outset from that of Delaware by abandoning the traditional distinction between "demand required" and "demand excused." Instead, section 7.03 requires demand in every case.⁴⁰ In instances where "irreparable injury" would otherwise result, demand may be made after the filing of the action.⁴¹

The case for the ALI's "universal demand" standard rests on several overlapping justifications. First, the potential for collateral, sidebar litigation is reduced. To be sure, there still will be an important and much litigated issue under the ALI approach, but it will involve the central question of the board's or committee's justifications for dismissal of the action. Many of the peripheral issues that frequently are litigated today (such as whether a demand must be made, what making a demand concedes, the issues to which the demand did or did not relate, and whether shareholders who did not make demand can attack the board's independence when other shareholders did make demand), can be simply sidestepped.

Second, by making demand obligatory, the ALI approach shifts the focus from the *potential* capacity of the board to evaluate the derivative action to its *actual* response to the demand. The great failure of the "demand required/demand excused" approach is that for all its rhetorical deference to the board of directors it actually minimizes the board's role in the litigation. Because plaintiffs today do not make demand (in order not to

38. *Id.* at 789.

39. In *Kaplan v. Wyatt*, 484 A.2d 501, 511 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985), Chancellor Brown noted that it took three years between the date of filing of the amended complaint and the date of his decision on the litigation committee's report. More than an additional year passed before the Delaware Supreme Court upheld his decision granting the committee's motion. Had the Delaware Supreme Court reversed the Chancellor, it is easy to imagine a total period of five or more years before plaintiffs could have proceeded to discovery and trial. Although such a delay would chill the efforts of many plaintiffs (and their lawyers), it also is true that the existence of asymmetric litigation costs could allow some plaintiffs to exploit this cost differential to obtain a settlement unrelated to the merits.

40. See *Principles*, *supra* note *, § 7.03(a).

41. *Id.* § 7.03(b).

concede the board's independence), the only issue that the court can examine is whether the board was disinterested. This is a speculative, "what-if" inquiry because the board never actually receives the opportunity to respond to the demand that was not made. In short, the actual (if unintended) consequence of the prevailing demand rule is to short-circuit the board out of the decisional process and to leave only the court to pass judgment. In contrast, by mandating demand in all cases, the ALI approach allows the court to review not simply the independence level of the board, but also the procedures it followed in responding to demand and its actual substantive justifications for rejection. The difference is between a constrained form of "phantom" judicial review that is limited to the board's alleged financial and other conflicts of interest, and a fuller review that includes consideration of the board's actual deliberation. More importantly, under the Delaware procedures, the board may never even learn of the action and will not be required to evaluate its allegations because counsel to the corporation can challenge the plaintiff's predictable failure to make demand on the board without consulting the board in any real detail.

Finally, the Delaware demand rule places excessive weight on an arbitrary and often trivial boundary. Consider, for example, a thirteen-person board. Suppose that the court finds that seven directors are disinterested and independent and six are not. Under the *Aronson* rule, demand is required, and thus the action must be dismissed. Conversely, if the court finds only six directors are disinterested and independent and seven interested or not independent, then demand is excused, and the action may continue. Yet, the difference between these two boards is unlikely to be substantial. Boundary problems are endemic in the law, but a goal of reform should be to reduce the weight placed on arbitrary boundaries.

The conclusion that the Delaware demand rule provides a flawed screening mechanism does not imply, however, what should replace it. Indeed, the ALI's major policy premise is that no single screening test exists that can be employed wisely across all contexts to separate out those actions that should go forward from those that should be terminated. Context counts because the costs and benefits of a litigation remedy also vary with the context. Thus, Part VII draws a sharp distinction between the duty of care and the duty of loyalty (which it terms the "duty of fair dealing"). Although this distinction is made at several points, the most important juncture arises when the disinterested directors respond to the plaintiff's demand. Here, section 7.04(a) governs both the particularity with which the plaintiff must plead its case and how the plaintiff must respond to the rejection of the demand. It provides:

(a) *Particularity: demand rejection*

(1) *In general.* The complaint shall plead with particularity facts that, if true, raise a significant prospect that the conduct or transaction

complained of did not meet the applicable requirements of Parts IV (Duty of Care and the Business Judgment Rule), V (Duty of Fair Dealing), or VI (Role of Directors and Shareholders in Transactions in Control and Tender Offers), in light of any approvals of the conduct or transaction communicated to the plaintiff by the corporation.

(2) *Demand rejection.* If a corporation rejects the demand made on the board pursuant to section 7.03, and if, at or following the rejection, the corporation delivers to the plaintiff a written reply to the demand which states that the demand was rejected by directors who were not interested [section 1.23] in the transaction or conduct described in and forming the basis for the demand and that such directors constituted a majority of the entire board and were capable as a group of objective judgment in the circumstances, and provides specific reasons for those statements, then the complaint shall also plead with particularity facts that, if true, raise a significant prospect:

- (A) That the statements in the reply are not correct; or
- (B) If Part IV, V or VI provides that the underlying transaction or conduct would be reviewed under the standard of the business judgment rule, that the rejection did not satisfy the requirements of the business judgment rule as specified in section 4.01(c); or
- (C) If Part IV, V, or VI provides that the underlying transaction or conduct would be reviewed under a standard other than the business judgment rule, either (i) that the disinterested directors who rejected the demand did not satisfy the good faith and informational requirements [section 4.01(c)(2)] of the business judgment rule or (ii) that disinterested directors could not reasonably have determined that rejection of the demand was in the best interest of the corporation. If the complaint fails to set forth sufficiently such particularized facts, defendants shall be entitled to dismissal of the complaint prior to discovery.⁴²

Unquestionably, the foregoing provision is a textual mouthful, but in substance it establishes both who can reject demand and what the plaintiff must plead to overcome that rejection. In essence, it contains the following rules:

1. Rejection of demand by the board only will be given legal effect if a majority of the board's directors are both not "interested" in the action⁴³ and "capable of objective judgment in the circum-

42. *Id.* § 7.04(a).

43. The term *interested* is defined in § 1.23 of the *Principles*. A special provision (§ 1.23(c)) applies only for purposes of Part VII and provides that a director is not "interested" in the action simply because of the fact the director is named as a defendant in the action if two conditions are satisfied: (1) The action "is based only on the fact that the director approved of or acquiesced in, or took action with respect to, the transaction or conduct that is the subject of the action," and (2) the action "does not otherwise allege with particularity facts not patently false, that raise a clear likelihood that the director would be adjudged liable to the corporation or its shareholders." *Id.* § 1.23(c).

stances."⁴⁴ Both these tests are marginally more rigorous on defendants than the Delaware standard for demand futility, but they will not disqualify outside directors absent concrete specific evidence indicating bias or a lack of objectivity.

2. If the transaction is a self-dealing transaction that the *Principles* elsewhere subject to a limited fairness review, then the directors' rejection of demand is correspondingly made subject to an objective standard of fairness (i.e., could the directors "reasonably have determined that rejection of the demand was in the best interests of the corporation").⁴⁵ In addition, the disinterested directors also must satisfy the business judgment rule by adequately informing themselves.
3. Conversely, in a simple business judgment case, the rejection of demand will be dispositive unless the board's response fails even the deferential test of the business judgment rule.

Therefore, the ALI's two principal departures from Delaware law are (i) universal demand,⁴⁶ and (ii) an explicit dichotomy between a "reasonableness" standard of review (applicable largely to fair dealing cases and cases involving knowing violations of law) and a "business judgment" standard (applicable to duty of care cases and certain fair dealing cases where a business judgment standard governs).⁴⁷ Under both the ALI and Delaware approaches, there is, however, one procedural similarity: the plaintiff need not actually prove anything to survive the demand rejection stage. In Delaware, the judicial determination is made on the basis of the pleadings, and the plaintiff need raise only a "reasonable doubt" by pleading particularized facts.⁴⁸ Similarly, under the ALI approach, the plaintiff's obligation at the demand stage is to raise by particularized pleadings a "significant prospect" that (in a fair dealing case) the board "unreasonably" rejected demand.⁴⁹

44. The Commentary to § 7.09 explains this concept. See *Principles, supra* note *, § 7.09 cmt. g. Essentially, there are two elements to this standard. The directors must "be able to understand and evaluate the transaction at issue" and they must lack other relationships to the defendant that might "bias the inquiry." *Id.* An example is given in the Commentary to § 7.09 of individuals who were long-time personal friends and neighbors; in such a case, each might lack the objective capacity to evaluate the other's conduct.

45. See *id.* § 7.04(a)(2)(C).

46. *Id.* § 7.03(a).

47. *Id.* §§ 7.04(a), 7.10(a).

48. Under well established Delaware precedents, the court must accept all well pled allegations in the complaint as true for purposes of applying the *Aronson* "reasonable doubt" test. See *Heineman v. Datapoint Corp.*, 611 A.2d 950, 953 (Del. 1992).

49. Section 7.04(a)(2) provides that in response to a statement from disinterested directors rejecting demand, "the complaint shall also plead with particularity facts that, if true, raise a significant prospect . . . that disinterested directors could not reasonably have determined that rejection of demand was in the best interests of the corporation." The key term *significant prospect* is not defined, and is deliberately not quantified in terms of any specific percentage.

The operation of the ALI's approach to demand rejection cannot be understood fully based only on a reading of the black-letter text of section 7.04(a). Read without the Commentary, that language may convey a misleading impression. To illustrate, consider the following case: In a duty of loyalty case governed by section 7.04(a)(2)(C), the disinterested directors respond to plaintiff's demand with a conclusory assessment that the action was without merit or, even if it was potentially meritorious, that it was unlikely to yield a net recovery to the corporation after deduction of all costs. At this point, plaintiffs face the following problems: (i) many reasonable justifications exist for not suing, (ii) the plaintiffs are not entitled to any detailed statement of reasons, and (iii) discovery is not available to them at this stage. How then can plaintiffs ever prove that the directors "could not reasonably have determined that rejection of the demand was in the best interests of the corporation"⁵⁰ when the only statement from the directors provided no justification for their decision?

Unquestionably, the plaintiffs at this stage face an uphill struggle, and many derivative actions (some potentially meritorious) will be screened out by section 7.04(a). The basic compromise reached at the ALI's 1992 Annual Meeting, however, was to determine the "reasonableness" of the directors' action (in a fair dealing case) by balancing the legal merit of the case, as pled with particularity by the plaintiff under section 7.04(a)(1), against the justifications, if any, raised by the directors in rejecting demand. Specifically, the Commentary to section 7.04(a)(2) expresses this trade-off in the following language:

In applying section 7.04(a), a court should balance the strength and seriousness of the case made by the particularized pleading of the plaintiff under section 7.04(a)(1) with that made under section 7.04(a)(2). The stronger the plaintiff's claim as tested under section 7.04(a)(1), the less the complaint must allege with particularity to establish under section 7.04(a)(2) that there is a significant prospect the directors could not . . . reasonably have determined that rejection of the demand was in the best interests of the corporation under section 7.02(a)(2)(C).⁵¹

What this balancing test implies is that where an action is strong on its merits, less must be shown by the plaintiff in response to the board's rejection of demand in order to raise a "significant prospect" that the

Suffice it to say that the Reporters believe that courts will use this phrase as authority for a judicial "smell test": Do the pleadings raise serious and specific enough charges to merit further inquiry, notwithstanding the board's rejection?

50. *Principles*, *supra* note *, § 7.04(a)(2)(C).

51. This Commentary and the current text to § 7.04(a) do not appear in the Proposed Final Draft of the *Principles* since they are changes made at the May 1992 Annual Meeting. The revised text and Commentary of § 7.04(a) will appear in the Final Draft of the *Principles*, which is forthcoming in 1993.

rejection was unreasonable (in a duty of fair dealing case). Indeed, the Commentary states that a reply to demand that is only conclusory or that "does not state the reasons for the disinterested directors' rejection should be given only limited weight as against a particularized allegation that strongly raises a significant prospect of a violation under the standard of section 7.04(a)(1)."⁵² Phrasing this point even more simply, the Commentary adds that the "stronger and more serious the showing under section 7.04(a)(1), the more difficult it will be to dismiss the action in the absence of a statement of equivalently credible reasons for the rejection in the reply."⁵³ In short, although the disinterested directors need not justify their rejection, it will be the rare corporation that exercises this option of silence.

At this point, the contrast between the ALI and Delaware approaches comes into clearer focus. Both use the demand stage as a filtering device to screen out those actions that should not go forward. Under the Delaware formula, the focus primarily is on the composition of the board (and, to a lesser degree, on whether the board's response satisfies the business judgment rule).⁵⁴ Under the ALI approach, the focus is substantially similar in a duty of care case, but in those actions not governed by the business judgment rule (i.e., primarily fair dealing actions), the focus will be on the relative balance between the action's legal merit and the disinterested directors' justifications for dismissal.⁵⁵ At the same time, however, the ALI's balancing approach gives real weight to the justifications raised by disinterested directors. Unlike *Zapata*, Part VII of the *Principles* does not instruct the court to employ its own "independent business judgment," nor does it use the seemingly diluted "reasonable doubt" standard of *Aronson*—a phrase that invariably carries with it misleading criminal law associations.

In their accompanying critique of the ALI position, Messrs. Block, Radin, and Maimone offer a revisionist history of section 7.04(a), and argue that the above-described "balancing approach" was "never mentioned in any of the written materials circulated . . . at the ALI's May 1992 meeting, and that was first raised publicly by Professor Coffee during the course of the debate. . . ."⁵⁶ They argue that this test undermines the intent of the motion made by Richard B. Smith at the May 1992 Annual Meeting, which added section 7.04(a)(2) to the *Principles*.⁵⁷ They are correct to focus on this balancing test as critical, but wrong to think they correctly understand its history from their considerable distance from the ALI Cor-

52. *Id.*

53. *Id.*

54. *See supra* notes 8-12.

55. *Principles, supra* note *, §§ 7.04(a), 7.10(a).

56. *See* Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute, infra* pp. 1473-74.

57. *Id.* at 1474.

porate Governance Project. The motion to which they refer inserted section 7.04(a)(2), and it was a carefully fashioned compromise that was drafted jointly by the Reporters, Richard Smith, and W. Loeber Landau (the latter two being members of the ABA's CORPRO Committee). Far from opposing the Smith motion, the Reporters joined in it in an effort to reach a broad consensus on the role for the board at the demand rejection stage. Not only was the balancing test described above explained to, and understood by, those who participated in the drafting process prior to the floor debate, but it was described elaborately to the ALI's membership at the Annual Meeting as the basis on which the Commentary would be written.⁵⁸ The balancing test was part and parcel of the total

58. As the Reporter for Part VII, the author stated to the membership at the Annual Meeting in opening the discussion of the pending Smith Motion:

[W]e want to indicate to you two statements that we plan to add to the Comments under this new 7.04. . . . And this has already been cleared with the sponsors of the motion.

We would say, first, that in considering whether a significant prospect has been pleaded under 7.04(a) the court may consider the nature and specificity of the reasons provided by the corporation for rejecting demand, or the fact that no reasons were provided. [An elaboration followed.] That creates an incentive to give a full statement at the demand rejection and permits the plaintiff to be able to plead with greater particularity why those specific reasons given to it were inadequate. . . .

The next statement really involves what I'll call a balancing concept. That is, there should be some balance between 7.04(a)(1) and 7.04(a)(2). The stronger the showing of an egregious violation under (a)(1), the more you have pleaded with particularity reasons that show that the transaction looks like it flunks the standard of Parts IV, V or VI, that the merits are bad, then the higher should be the required showing and statement by the corporation under (a)(2) with respect to what its reasons were for rejecting this demand of this seemingly meritorious case.

In that light we have the following language, which, again, with some possible modifications, we expect to add to the commentary. It would say, "The more egregious the violation that is pleaded with particularity under 7.04(a)(1), the more it is likely that the court would be expected to focus on and consider the reasons provided by the corporation for rejecting demand." And that's a way—there may be more to that concept than that single sentence but it is this notion of balancing the showing under (a)(1) with the showing of demand rejection under (a) (2). . . .

Almost immediately following my statement, Chief Reporter Eisenberg added:

Secondly, I think that we should say—and this is a variation, perhaps, of what Jack said, and I think it's been implicit in the debate, on both sides—that the stronger the particularized showing that there is a significant prospect that a violation occurred, especially a violation of the duty of fair dealing, the more likely that a reasonable prospect will be shown that disinterested directors could not reasonably have determined that rejection is in the best interests of the corporation. I think also we should say that the decision, although discovery is not available, the decision can take into account the fact that discovery was not available.

And finally, I believe that all of these points should be exemplified by illustrations. Now, my plan at least on the commentary is to circulate the proposed commentary widely, make it available and circulate it for comments, so that people will have a chance to react to the commentary as they see it, but I'm also making this statement so that people aren't surprised, or if they are surprised they can say so now, as to what I propose

compromise, and without it, it is uncertain (and unlikely in my judgment) that the compromise would have passed. During the year since the May 1992 Annual Meeting, the Commentary to section 7.04(a) has been worked out in numerous joint drafting sessions with Messrs. Landau and Smith and, to the best of my understanding after consultation with them, is viewed by them as appropriately reflecting that compromise. As in all compromises, both sides gave up something, but there was full disclosure.

SPECIAL LITIGATION COMMITTEES

If a complaint survives the section 7.04(a) hurdle, the plaintiff still does not proceed automatically to discovery and trial. Once past the demand rejection stage, Part VII's procedures thereafter largely parallel the Delaware "special litigation committee" procedure. At most, the ALI's procedures for the use of a special litigation committee are marginally more restrictive than those of Delaware. Procedurally, section 7.09 requires only: (i) the use of a two or more member committee;⁵⁹ (ii) the assistance of counsel "capable of exercising independent professional judgment under the circumstances;"⁶⁰ (iii) an adequate evaluation of the action; and (iv) the preparation of a report or other written submission setting forth the determinations of the board or committee in sufficient detail to permit judicial review.⁶¹ Even material departures from these provisions can be waived by the court for good reason,⁶² and in actual practice it is unlikely that a Delaware corporation, advised by sophisticated counsel, would deviate significantly from any of these standards once it was in the "demand excused" context.

The key substantive ALI provision at this litigation committee stage is set forth in section 7.10, which once again provides for a bifurcated stan-

would go into it.

See also Melvin A. Eisenberg, *An Overview of the Principles of Corporate Governance*, *supra* p. 1271.

59. Section 7.09(a)(1) provides: "The board or committee should be composed of two or more persons, no participating member of which was interested [§ 1.23] in the action and should as a group be capable of objective judgment in the circumstances."

60. *See Principles, supra* note *, § 7.09 cmt. h, at 717.

61. Section 7.09(a)(3) provides: "The determinations of the board or committee should be based upon a review and evaluation that was sufficiently informed to satisfy the standards applicable under § 7.10(a)." Section 7.10(a) then distinguishes actions in which the gravamen of the claim involves a transaction or conduct that would be reviewed under the business judgment rule, and an action in which the gravamen of the claim involves transactions or conduct to which the business judgment rule would not be applicable. In the latter case, the board or committee must be "adequately informed under the circumstances" and provide "grounds that the court deems to warrant reliance."

62. Section 7.08 requires substantial compliance with the procedures specified in § 7.09, unless "any material departures therefrom were justified under the circumstances."

dard of judicial review. Basically, if the gravamen of the action is a violation of the duty of fair dealing,⁶³ or if the action alleges a “knowing and culpable violation of law”⁶⁴ (or other violation of the duty of care to which the business judgment rule is not applicable),⁶⁵ then the court may dismiss the action based on the litigation committee’s report only “if the court finds, in light of the applicable standards under Parts IV or V, that the board or committee was adequately informed under the circumstances and reasonably determined that dismissal was in the best interests of the corporation, based on grounds that the court deems to warrant reliance.”⁶⁶ The last clause—“based on grounds that the court deems to warrant reliance”—does not require that the court employ its own “independent business judgment” (as in *Zapata*), but it does preclude the court from simply deferring to the asserted greater expertise of the board or committee.

In contrast, if the gravamen of the action involves the duty of care or some other duty that would be reviewed under the business judgment rule, then a business judgment standard similarly governs the court’s review of the determinations of the board or committee and its justifications for dismissal of the action.⁶⁷ This bifurcated standard of review is basically similar to that under section 7.04 at the demand rejection stage, but it is fleshed out with additional detail to reflect the fact that the litigation committee typically will have made detailed findings and presented well-briefed arguments favoring its recommendation that the action be dismissed.

Although the Part VII procedural rules probably are stricter than the minimum allowable under Delaware’s current law, Part VII’s attitude toward termination of actions raising only ordinary due care litigation probably is more relaxed than Delaware’s. Under Delaware law, once demand is excused, any motion to terminate the action based on a special committee report is discretionary with the court, which can apply its own “independent business judgment.”⁶⁸ Yet, under section 7.10, the com-

63. One qualification is necessary here—some “fair dealing” claims are reviewed under a business judgment standard pursuant to Part V. An example is compensation. See *Principles*, *supra* note *, § 5.03. In such cases, Part VII similarly provides that a business judgment standard of review applies to the motion of the board or committee requesting dismissal. See *Principles*, *supra* note *, § 7.10(a)(1). The other sections of Part V that reference a business judgment standard are §§ 5.04, 5.05, 5.06, and 5.08. Also, a business judgment standard applies under § 6.02 to an action for damages against a director with regard to defensive actions designed to block an unsolicited tender offer.

64. See *Principles*, *supra* note *, § 7.10(a)(2). Not all violations of law necessarily are “knowing and culpable.” See *id.* §§ 7.10 cmt. f, 7.19 cmt. f (discussing when legal violations, including criminal acts, should be deemed “knowing and culpable”).

65. By its usual terms, the business judgment rule also is not applicable in cases where corporate officials did not inform themselves adequately in order to satisfy the procedural prerequisites of the rule. See *id.* § 4.01(c)(2).

66. *Id.* § 7.10(a)(2).

67. *Id.* § 7.10(a)(1).

68. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981).

mittee's motion to terminate an ordinary duty of care case is reviewed explicitly under a business judgment standard, even if the majority of the entire board was interested.

This does not mean that there are no teeth in the *Principles*, but it shows that where the teeth of the *Principles* chiefly bite is in the area of self-dealing (and not the duty of care). In particular, section 7.10(b) sets forth a strong prophylactic rule, but it is carefully limited exclusively to the context of self-dealing. It provides that, absent special circumstances, the action may not be dismissed if dismissal would permit a defendant to retain a "significant improper benefit" and if certain other conditions are present.⁶⁹ This provision will not be triggered frequently (because the plaintiff bears the burden of proving the misappropriation and retention of such a benefit), but its existence points out the deterrent rationale that underlies Part VII's approach to self-dealing. Even if the action will not yield a net financial recovery, it cannot be terminated under section 7.10(b) if to do so would permit certain defendants to retain significant unjust enrichment. Although a few Delaware decisions at times have hinted at a public policy rationale for the derivative action,⁷⁰ this rationale is explicit in the *Principles* (but also limited to self-dealing and knowing violations of law).

POLICY PREMISES: THE POLICY ASSUMPTIONS UNDERLYING THE ALP'S POSITION

The preceding thumbnail sketch of Part VII of the *Principles* sets the stage for a closer examination of its underlying rationale. No assessment of the derivative action, or of any of the competing legal systems for its regulation, can proceed very far without having to face the following fundamental questions.

BOARDS VERSUS COURTS: HOW SHOULD RESPONSIBILITY BE ALLOCATED?

The most controversial issue surrounding the derivative action involves the relative competence of the board versus the court. Liberals point to evidence that boards always reject demand and that special litigation com-

69. *Principles, supra* note *, § 7.10(b). Essentially, this section is triggered only if the plaintiff can show that the "significant improper benefit" was obtained either (i) by a controlling person or a control group, or (ii) as the result of fraud or without advance authorization or the requisite ratification of such benefit by disinterested directors. Even then a showing of special harm or injury can justify dismissal if it "convincingly outweighs" any adverse impact on the public interest from dismissal of the action. *Id.*

70. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981) ("The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.").

mittees tend to recommend dismissal almost invariably.⁷¹ Conservatives reply that courts do not understand business decision making and fail to recognize that legitimate reasons frequently exist why even a meritorious litigation should not be pursued. Both sides have their point, but, so framed, their arguments pass each other like the proverbial ships in the night.

More importantly, there is an irony about this debate that has been overlooked. Those who believe that the board should have the lion's share of the discretion tend to favor the Delaware law on demand. The problem with the Delaware approach, however, is that plaintiffs seldom make demand under it (but instead litigate the issue of demand futility). As a result, courts by default become the only decisionmaker to pass on whether the action should proceed. In this light, the real impact of the "demand required/demand excused" distinction is to deny the court any input from the board, except in those "demand excused" cases where the directors' credibility seems least likely. In other cases, the court is left to speculate about what the board might have believed or how it might have responded to demand.

If one believes that there should be a shared responsibility between the board and the court (both to better inform the court and to trigger possible internal corrective responses), then the superiority of the ALI's "universal demand" rule becomes clear. Still, a deeper reason also explains why a system is preferable that forces demand rejection to be justified to the court, even when the board clearly is independent. Although the conventional wisdom seems to assume that the granting of any residual oversight to the court subtracts from the power in the board, this is a shallow premise. The dynamics between the outside directors and senior management are subtler, and the existence of judicial oversight may enhance the board's leverage. The knowledge that one is being watched and that one must justify one's actions improves the behavior of most individuals. Above all, the need to explain one's justifications to the court gives disinterested directors a basis for refusing to accept reasons that merely are pretextual or cosmetic. Absent judicial oversight, if no response is required of the outside directors in order to secure dismissal of the action, passivity may sometimes be the path of least resistance. But once it is understood that the directors' position must be expressed to the plaintiffs and ultimately

71. Duke Law Professor James Cox surveyed the field in 1982 and found only one instance in which the special litigation committee had not concluded that the suit should be dismissed. See James Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 963 (1982). More recently, his colleague at Duke, Professor Deborah DeMott, found only one recent case in her treatise where the committee recommended suit against any corporate official. See DEBORAH DEMOTT, *STAKEHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* 98 (1991 Supp.). Undoubtedly, there are other instances that diligent research could uncover, but it would prove little. The tendency of the process is clear.

defended in court, passive acquiescence becomes less attractive. Internally, disinterested directors can justify their resistance to senior management not in terms of their personal objections or misgivings, but in terms of the legal risks or public appearances ("It just won't wash in court, Joe."). In short, the existence of judicial review should strengthen the hand of outside directors and enhance internal systems of accountability.

None of the foregoing arguments depend upon any theory of structural bias. That theory, which asserts that directors share a natural empathy and sense of collegiality that ensures they will band together to protect a colleague who has been sued,⁷² certainly is plausible, but it is not the foundation underlying Part VII of the *Principles*. Although the evidence to date on the actual decisions of special litigation committees does little to dispel the fears of those who believe social and psychological pressures induce the board to protect senior managers,⁷³ Part VII recognizes that there are legitimate and important reasons why even meritorious actions should not go forward. If disinterested directors make a reasonable case for dismissal, then Part VII provides, both in section 7.04 and section 7.10, that the action must be terminated even in the self-dealing context.

WHY SHOULD THE DUTY OF LOYALTY BE TREATED DIFFERENTLY FROM THE DUTY OF CARE?

Nothing is more evident about the structure of Part VII than that it draws a sharp distinction between the duty of loyalty (or "fair dealing" in its parlance) and the duty of care. Not only do section 7.04 and section 7.10 employ a "reasonableness" standard for termination of duty of fair dealing claims, but section 7.19 authorizes charter provisions placing a low ceiling on the director's or officer's financial liability to the corporation for most duty of care violations.⁷⁴ But why should the law treat claims raising the duty of care so dissimilarly from claims raising the duty of fair dealing? The standard academic answer has been that judicial competence is lesser in the former case, and thus the prospect of judicial error is greater in cases where a conflict of interest is absent.⁷⁵ Clearly, when a business decision proves erroneous, multiple explanations for that failure are possible. It could be that the decisionmaker was negligent, but, conversely, the truth may be that a risk that was accepted knowingly and

72. See Cox & Munsinger, *supra* note 5; see also Hasan v. CleveTrust Realty Investors, 729 F.2d. 372, 376-77 (6th Cir. 1984).

73. See *supra* note 71.

74. See *Principles*, *supra* note *, § 7.19 (authorizing charter provision placing ceiling on corporate official's liability for certain due care violations equal to one year's compensation from the corporation).

75. Harold Demsetz, *A Commentary on Liability Rules and the Derivative Suit in Corporate Law*, 71 CORNELL L. REV. 352 (1986); Kenneth Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983).

prudently simply came to an unfortunate fruition. Or, it could be that a new and unforeseeable risk arose and matured after the time the business decision was irrevocably made. Because business decision making involves unavoidable trade-offs between risk and return, some prudent decisions will prove disastrous. Examining these decisions with the 20/20 vision of judicial hindsight, courts may be unable to distinguish accurately lack of care from statistical bad luck. If this risk of judicial error is considerable, then to the extent the derivative action is relied upon to enforce the duty of care, it may deter risk taking by management and service on the board, rather than negligence.

In contrast, within the context of the duty of loyalty, the possibility of non-culpable error is much smaller. When a corporate fiduciary fails to disclose a conflict of interest to disinterested directors, the chances are much greater that the fiduciary did so opportunistically, not innocently. Self-dealing seldom is unavoidable in the same manner as business risk. With the exception of compensation decisions (which the ALI in fact subjects to a business judgment review),⁷⁶ there usually is another party with whom the corporation could have transacted on similar terms. Conflicts of interest are something that courts have a long history of policing, and, unlike the duty of care, they do not require courts to evaluate risk/return trade-offs with which they are uncomfortable and inexperienced.

Although the differing competence of courts in handling duty of care versus duty of loyalty actions represents the conventional justification for focusing the derivative action on duty of loyalty claims, another justification may be even more important. Within the corporate context, the duty of care is at least partially self-policing. Thus, less need exists for legal institutions to generate additional deterrence. To the extent that both the corporation and its managers operate in reasonably competitive financial, product, and labor markets, the cost of negligent errors will be borne, at least partially, by those who commit them. Any incentive to slack is at best marginal. Because there is little incentive to commit negligent errors (and because real stupidity tends to reveal itself, thereby increasing the probability of detection), the usual logic of the deterrence theory, which focuses on the magnitude of the gain and the difficulty of detection, does not require substantial penalties for negligence.

In the case of duty of loyalty violations, however, the likelihood of detection is lower, and the magnitude of the expected gain is higher. Not only can self-dealing be concealed, but it tends to become self-perpetuating. Once a manager has engaged in one unfair self-dealing transaction, there is less social or moral inhibition to dissuade that manager from engaging in similar transactions. In addition, other managers may detect the self-dealing behavior and emulate it. In short, unlike simple incompetence, self-dealing can be contagious and can corrupt the organizational

76. Compare *Principles*, *supra* note *, § 5.03 with *id.* § 7.10(a)(1).

culture. Given this greater likelihood that undetected self-dealing will lead to recidivism, the deterrent gains from a derivative action contesting duty of loyalty violations seem greater.

DETERRENCE VERSUS COMPENSATION

In principle, either a deterrent or a compensatory rationale could underlie the derivative action.⁷⁷ If compensation is to be the fundamental justification of the action, then a simple decision rule exists for when the suit should be allowed to proceed: Does the expected recovery exceed the expected litigation costs that the corporation will bear (including plaintiff's attorney fees)? Some decisions have approached adopting such a rule (at least with regard to judicial review of special litigation committee reports),⁷⁸ but the *Principles* do not. Instead, section 7.10(b) announces a special (but limited) rule that clearly rests on a deterrent rationale: Absent special circumstances, the action may not be terminated if "dismissal would permit a defendant . . . to retain a significant improper benefit" where in substance the defendants either controlled the corporation or obtained the benefit through fraud or without advance authorization.⁷⁹

The case for a deterrent rationale rests on an unknown and probably unknowable variable: the gains to shareholders resulting from future misconduct that is deterred. Although these gains cannot be quantified reliably, it is easy to understate them. In part, this is because a successful derivative action is likely to produce a positive externality: it will deter misconduct at other corporations. As a result, even if the deterrent benefits to the corporation in whose name the action is brought do not exceed the corporation's direct and indirect litigation costs, its shareholders still may benefit. Because shareholders generally do not own stock in a single company, but hold diversified portfolios, they benefit if a derivative action deters potential defendants who are situated similarly at other companies, even if it involves a net loss to the corporation in whose name the action is brought.⁸⁰

Why would there be such a benefit? The logic is the same as in the case of criminal enforcement. Both the derivative action and criminal enforcement depend on an external enforcer—the public prosecutor or the plain-

77. Although many decisions assume a compensatory rationale, others expressly articulated a deterrent rationale. See *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (N.Y. 1969) (noting that function of derivative action "unlike an ordinary tort or contract case, is not merely to compensate plaintiffs for wrongs committed by the defendant but . . . 'to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit.' ") (citation omitted).

78. See *Joy v. North*, 692 F.2d 880, 892 (2d Cir. 1982) (balancing expected value of recovery against legal costs of continuing suit), *cert. denied*, 460 U.S. 1051 (1983).

79. *Principles*, *supra* note *, § 7.10(b).

80. See *id.* pt. VII Introductory Note.

tiff's lawyer operating as a private bounty hunter.⁸¹ When a local U.S. Attorney apprehends and convicts a corporate official for some violation of the federal securities laws, this conviction presumably deters not only other individuals at the same corporation, but also other officials at other corporations. Indeed, in the case of profit-motivated plaintiffs' lawyers, one successful action may encourage them to search for other violations elsewhere in order to efficiently use their new expertise. The real difference between these two enforcement mechanisms is that the criminal law can threaten incarcerative sanctions, while a derivative action can employ only the threats of financial penalties, loss of reputational capital, and social stigma. These latter costs, particularly stigmatization, are real, and those subject to them understand that the plaintiff's lawyer who successfully prosecuted a derivative action at Corporation X will search for other opportunities to employ the same legal theory at other corporations.⁸² Hence, one successful derivative action implies that others are likely to follow as an entrepreneurial plaintiffs' bar searches for similar profitable litigation opportunities.

To describe the operation of derivative litigation in this fashion is not to argue that the incentives held out to the plaintiff's lawyer today are appropriate or efficient.⁸³ But the real question is how to better focus the deterrent threat of such private enforcement. As already noted, Part VII does not focus simply on the net financial recovery to the corporation.⁸⁴ Indeed, Part VII generally precludes dismissal when a "significant im-

81. Many are offended by the idea of "entrepreneurial" lawyers who are not truly constrained by clients who hire them. The *Principles* seek neither to idealize the problems inherent in such a relationship nor to ignore the reality that the shareholder client's role is minimal in the derivative action. Its real concern is with the vulnerability of a system that depends on private enforcers to collusive settlements that benefit the enforcers more than the class. See *id.* § 7.17.

82. Several subsidiary reasons can be given for this contention that entrepreneurial lawyers will follow a success at one corporation by seeking to pursue similar cases elsewhere. First, specialization is efficient, and the plaintiffs' bar tends to be extremely specialized (with some lawyers specializing in areas as narrow as § 16(b) of the Exchange Act, 17 U.S.C. § 16(b) (1988 & Supp. III 1991)). Second, by investing substantial time and expense in one large action, the plaintiff's lawyer will typically gain human capital—that is, special expertise that it is in the lawyer's interest to exploit by pursuing similar cases at other corporations. In fact, the lawyer may be able to use the same research and pleadings virtually over again when a similar action is pursued. Third, the lawyer's success also may make it easier for him or her to finance other contingent fee actions raising similar claims and to gain control of (or at least an effective voice in) the plaintiff's team that will organize the new case.

83. Indeed, few have been as outspoken as this author about the existence of perverse incentives in the legal rules pertaining to fee awards and derivative litigation. See generally John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff's Attorney As Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (1985).

84. Instead, § 7.17 focuses on the "value of the relief (including non-pecuniary relief) obtained by the plaintiff for the corporation" in measuring the plaintiff's attorney's fee award. See *Principles*, *supra* note *, § 7.17.

proper benefit" has been retained.⁸⁵ More significantly, it shifts both the corporation's own legal costs and expenses and those of the plaintiff's lawyer to the defendant in the case of knowing violations of the duty of fair dealing.⁸⁶ This has the significance of raising both the net financial recovery to the corporation *and* the expected penalty to the wrongdoers.⁸⁷ In this light, dismissal of the action cannot be justified as easily under Part VII on the usual rationale that the litigation expenses to the corporation will exceed the likely recovery.

DOCTRINAL CONSISTENCY: WHERE DOES THE ALI POSITION COME FROM?

As a historical proposition, no generalization about American corporate law is safer or sounder than that the fiduciary duty of loyalty has long been subject to judicial oversight. In a well known article, Harold Marsh traced the evolution of the duty over the last century.⁸⁸ Starting from a time when self-dealing transactions were always voidable at the election of the corporation, he followed the doctrinal evolution of the duty until the prevailing rule became that courts would invalidate only unfair transactions between the fiduciary and the corporation. Beginning in the 1950s with the adoption of the Model Business Corporation Act, a number of states enacted "sanitizing" statutes, which established procedures for the approval of "interested director" transactions. In general, courts and commentators have read these statutes, not as eliminating the issue of fairness, but as shifting the burden on the plaintiff to prove unfairness.⁸⁹ What has not changed, at least in most jurisdictions, is the idea that a court still can

85. *Id.* § 7.10(b).

86. *Id.* § 7.18(d).

87. In effect, this is a fee shifting standard for duty of loyalty violations that protects the corporation's recovery from depletion as a result of either corporate legal fees or a judicial award of plaintiff's attorney's fees. The doctrinal rationale for this position is the familiar tort law idea that "danger invites rescue." Here, the premise is that the fiduciary who knowingly overreaches the corporation should anticipate that such conduct is likely to necessitate shareholder litigation that is costly to the corporation. Therefore, the fiduciary should hold the corporation harmless from these foreseeable expenses caused by the fiduciary's knowing misconduct.

88. Harold Marsh, Jr., *Are Directors Trustees? Conflicts of Interest and Corporate Morality*, 22 *BUS. LAW.* 35 (1966).

89. See Ahmed Bulbulia & Arthur Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 *NOTRE DAME L. REV.* 201 (1977); Note, *The Status of Fairness Under Section 713 of the New York Business Corporation Law*, 76 *COLUM. L. REV.* 1156 (1976).

review the fairness of a self-dealing transaction.⁹⁰ Thus, the common law's baseline is that fairness remains relevant, even if a transaction is approved after full disclosure by disinterested directors.

This was the position adopted by the ALI in Part V (Duty of Fair Dealing) of the *Principles*. Under section 5.02, the effect of full disclosure by the fiduciary to disinterested directors is to shift the burden of proof to the plaintiff to prove that the directors could not "reasonably have concluded that the transaction was fair to the corporation at the time it was entered into."⁹¹ Within the ALI, this test was never controversial, because few members argued that the business judgment rule should apply to a self-dealing transaction.

Given this position in Part V, Part VII comes into better focus as simply an attempt to maintain consistency between the substantive right and the procedural remedy. If Part V provides that full disclosure and disinterested approval do not alone immunize a self-dealing transaction (if its terms are outside the range that the board reasonably could have concluded were fair to the corporation), then Part VII could not provide for a business judgment standard of review of the demand rejection decision without overriding Part V.

How then does one explain Delaware's position? There are two alternative answers to this question. First, at least formally, Delaware does not follow the prevailing rule that a court may examine the substantive fairness of a self-dealing transaction even though full disclosure was made and disinterested board approval was received. Rather, Delaware case law seems to say that the business judgment rule applies to such a transaction.⁹² Thus, there is no inconsistency for Delaware to employ a demand rule that precludes suit whenever a majority of the board is disinterested because it already adopted a business judgment rule approach with respect to the underlying transaction. Yet, to adopt the Delaware demand rule in jurisdictions that wish to preserve judicial oversight of self-dealing would not be a neutral change; rather, it would distort and quietly overrule the substantive law applying to the underlying transaction by adopting an inconsistent procedural rule.

90. For decisions adopting the burden-shifting approach (or variations thereof), see *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 73-74 (Cal. Ct. App. 1952); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 56-57 (D.N.J. 1974); *Cohen v. Ayers*, 596 F.2d 733, 740-41 (7th Cir. 1979); *Holi-Rest, Inc. v. Treloar*, 217 N.W.2d 517, 525 (Iowa 1974). For recent cases recognizing that the burden of proof shifts to the defendant in a duty of loyalty case, see *Cookies Food Prods. v. Lakes Warehouse Distrib., Inc.*, 430 N.W.2d 447, 453 (Iowa 1988); *Warren v. Century Bankcorp.*, 741 P.2d 846, 849-50 (Okla. 1987).

91. *Principles*, *supra* note *, § 5.02(a)(2)(B), (C). Not only is the burden shifted to the plaintiff to prove unfairness, but § 5.02 effectively defines *fairness* in terms of a range of fair value, rather than in terms of the highest valuation standard. Section 5.02 does not use phrases such as "entire fairness," "intrinsic fairness," or "inherent fairness" as has the traditional case law, because these suggest a single valuation standard.

92. *See, e.g., Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987) (*dicta*).

Second, notwithstanding the formal logic of Delaware's position, there are suggestions in recent decisions in the Delaware Court of Chancery that the second prong of its *Aronson* test for demand futility applies largely (and possibly only) in self-dealing cases.⁹³ If the substantive terms of the transaction appear unreasonable, a Delaware court can reason backwards from this fact to conclude that the process leading to its adoption was defective, and hence that a reasonable doubt exists that the challenged transaction qualifies for the protection of the business judgment rule. Although the court may seldom exercise this discretion, when it does, *Aronson* would excuse demand and permit the action to proceed to the *Zapata* stage where the court has independent discretion.⁹⁴ In short, even in Delaware, substantive judicial review of self-dealing transactions sometimes may survive. In this light, the ALI approach only may make overt what was covert. But this is the traditional goal of the ALI—to make the law clearer, more candid, and less recondite.

THE NEW MYTHS OF DERIVATIVE LITIGATION

To this point, this Article has explained the premises underlying Part VII. But the critics of Part VII have raised policy arguments that also need to be considered, some of which broadly challenge the very need for a litigation remedy. This section will briefly examine three such arguments.

ARGUMENT NUMBER ONE: THE LAW ON DERIVATIVE ACTIONS IS WELL SETTLED AND THE DELAWARE RULES ARE THE COMMON LAW

In their Article, Messrs. Block, Radin, and Maimone argue that the common law on derivative actions is uniform nationally; everyone, they claim, has followed Delaware (except the ALI).⁹⁵ Without doubt, Delaware corporation law has long been followed—sometimes almost reflexively—by other American jurisdictions. This deference reflects (i) the unquestioned expertise of the Delaware judiciary; (ii) the “first mover” advantage that Delaware enjoys by virtue of the sheer volume of corporate litigation

93. In *Andreae v. Andreae*, 1992 Fed. Sec. L. Rep. (CCH) ¶ 96,571 (Del. Ch. Mar. 5, 1992), the Delaware Court of Chancery found that, although the complaint failed to satisfy the first prong of the *Aronson* demand futility test, the second prong was satisfied (and demand thus was excused) where the self-dealing transaction allegedly was approved at less than the best obtainable price and without the directors adequately informing themselves. See also *Avacus Partners L.P. v. Brian*, 1990 Fed. Sec. L. Rep. (CCH) ¶ 96,232 (Del. Ch. Oct. 24, 1990) (where corporation paid over 10 times fair market value for stock and 100 times recently established purchase price of another corporation, waste sufficiently was alleged to withstand motion to dismiss under FED. R. CIV. P. 23.1).

94. See *supra* text accompanying note 68.

95. See Block, *supra* note 56, at 1443-44. New York and Delaware, of course, glaringly disagree on the standards relating to the termination of derivative suits. See *supra* notes 11-12.

in its courts; and (iii) the absence of other authoritative sources to which to look. Nonetheless, it is an egregious overstatement to characterize the law on demand or on special litigation committees as largely resolved.⁹⁶ To the contrary, outside of Delaware, most of the cases dealing with derivative litigation in recent years were federal decisions.⁹⁷ These cases are at best predictions of what the highest state court in a jurisdiction would say, and to date these predictions often have proved wrong or at least suspect.⁹⁸ In truth, relatively few of the nation's highest state courts (outside of Delaware and New York) have issued an authoritative modern opinion on derivative litigation.⁹⁹ Of these, decisions in Iowa,¹⁰⁰ Massa-

96. Block, *supra* note 56, pp. 1443-44.

97. In the following states, there appears to be no clear decision by the highest state court on the status of special litigation committees, but federal courts hearing derivative actions based on diversity jurisdiction have reached decisions construing the authority of such a committee. California: *Gaines v. Haughton*, 645 F.2d 761, 770-72 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); Colorado: *Bach v. National W. Life Ins. Co.*, 810 F.2d 509, 510-12 (5th Cir. 1987); Connecticut: *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); Georgia: *Peller v. Southern Co.*, 707 F. Supp. 525, 527-28 (N.D. Ga. 1988), *aff'd*, 911 F.2d 1532 (11th Cir. 1990); Illinois: *Weiland v. Illinois Power Co.* [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,747, at 98,581 (C.D. Ill. 1990); Maryland: *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1488-1500 (D. Md. 1985); Michigan: *Genzer v. Cunningham*, 498 F. Supp. 682, 686-87 (E.D. Mich. 1980); Ohio: *In re General Tire & Rubber Co. Sec. Litg.*, 726 F.2d 1075, 1082-83 (6th Cir.), *cert. denied sub nom. Schreiber v. Gencorp., Inc.*, 469 U.S. 858 (1984); Virginia: *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 798-800 (E.D. Va. 1982). Among these jurisdictions, there is now legislation in Georgia and Virginia addressing the power of independent directors to terminate derivative litigation. See Ga. CODE ANN. § 14-2-744 (Michie 1992); VA. CODE ANN. § 13.1-672(D) (Michie 1993).

98. For example, in *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980), the Eighth Circuit predicted that Delaware would apply a business judgment standard to a special litigation committee's motion to dismiss, thus failing to anticipate *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). Similarly, the Ninth Circuit's decision in *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), which reached a similar result, seems in tension with later California cases that refused to terminate derivative litigation. See, e.g., *Will v. Engebretson & Co.*, 261 Cal. Rptr. 868 (Cal. Ct. App. 1989); *Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702 (Cal. Ct. App. 1989). The Fifth Circuit's decision in *Bach v. National W. Life Ins. Co.*, 810 F.2d 509, 510-12 (5th Cir. 1987), which favored a business judgment standard, also may not reflect the eventual attitude of Colorado state courts in light of the stricter approach taken toward such committees in *Greenfield v. Hamilton Oil Corp.*, 760 P.2d 664 (Colo. Ct. App. 1988).

99. Except for the decisions listed in the next three footnotes, the only other decisions of importance by state appellate courts are *Roberts v. Alabama Power Co.*, 404 So. 2d 629, 632 (Ala. 1981), *Black v. NuAire, Inc.* 426 N.W.2d 203 (Minn. Ct. App. 1988), and *Lewis v. Boyd*, 838 S.W.2d 215 (Tenn. Ct. App. 1992). *Black* has since been overruled by a statutory amendment of the Minnesota law.

100. *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983). In their article, Messrs. Block, Radin, and Maimone dispute my citation of *Miller* (which rejects the use of special litigation committees appointed by the defendants). They point out that the *Principles* stop well short of *Miller's* stronger prophylactic rule. See Block, *supra* note 56, at 1445-46 n.11. This is correct, but it hardly negates my statement that the Iowa Supreme Court clearly rejected the Delaware position. Moreover, the fact that the ALI takes a more

chusetts,¹⁰¹ and North Carolina¹⁰² have indicated a preference for the ALI's approach—or for even stronger rules.

Nonetheless, Messrs. Block, Radin, and Maimone argue that virtually all decisions follow Delaware and provide a lengthy list of string citations.¹⁰³ Most of the cases they cite are federal decisions, but the state decisions they rely on truly are worth the reader's attention because they almost uniformly reject a simple business judgment rule approach. For example, they cite *Gaillard v. Natomas Co.*¹⁰⁴ for the proposition that California follows the business judgment rule with regard to derivative litigation.¹⁰⁵ In fact, the *Gaillard* decision, which involved golden parachutes issued on the eve of a takeover, held that the business judgment rule did "not apply to a judicial review of the conduct of the insider directors."¹⁰⁶ Although it did find the business judgment rule potentially applicable to the outside directors, the California Court of Appeal still found sufficient issues of triable fact as to whether the outside directors engaged in a proper exercise of business judgment as to require a reversal of the summary judgment granted for the defendants.¹⁰⁷ *Gaillard* is not an aberration, because later California appellate decisions were even more skeptical of the board's performance in derivative litigation and have not adopted a traditional business judgment analysis.¹⁰⁸ As a practical matter, summary judgment is probably unavailable today in a derivative action filed in a California state court.¹⁰⁹ In any event, to read these decisions as reflecting the same at-

conservative position than Iowa hardly shows either that the ALI position is radical or that the common law is uniform.

101. *Houle v. Low*, 556 N.E.2d 51, 56-59 (Mass. 1990) (requiring that committee reach a "reasonable and principled decision").

102. *Alford v. Shaw*, 358 S.E.2d 323, 325-28 (N.C. 1987). *Alford* is emphatic that there must be substantive judicial review of the motion to dismiss a derivative action in all cases, not just in the "demand excused" context. *Id.* at 327.

103. See Block, *supra* note 56, at 1447-48. Their list of cases again shows the danger of string citations. In many of these decisions, the court simply makes a perfunctory bow to the business judgment rule and then explains why it does not apply to the case before it.

104. 256 Cal. Rptr. 702 (Cal. Ct. App. 1989).

105. Block, *supra* note 56, at 1447-48 n.15.

106. *Gaillard*, 256 Cal. Rptr. at 706.

107. *Id.* at 717.

108. See *Will v. Engebretson & Co.*, 261 Cal. Rptr. 868 (Cal. Ct. App. 1989) (finding structural bias a significant danger but assuming that a court may not engage in substantive review); see also *Country Nat'l Bank v. Mayer*, 788 F. Supp. 1136, 1144 (E.D. Cal. 1992) ("[I]f the board refuses in good faith and in the reasonable exercise of its business judgment to commence the action, the shareholder may not institute the action.") (emphasis added). This emphasis on "reasonable exercise" hardly is consistent with the standard formulation of the business judgment rule.

109. In *Will*, a California intermediate appellate court found that the board cannot make a motion for summary judgment based on the committee's report when the plaintiff disputes factual conclusions or determinations in the report. *Will*, 261 Cal. Rptr. at 874-75. As a practical matter, this leaves no procedural vehicle by which the special litigation committee's report can terminate the case short of a trial on the merits.

titudes and analytic framework as Delaware's is to reveal an extreme degree of myopia.

Other decisions relied upon by Messrs. Block, Radin, and Maimone are equally wide of the mark.¹¹⁰ Strangest of all is their citation of *Lewis v. Boyd*,¹¹¹ which expressly rejects a "demand required/demand excused" analysis.¹¹² *Lewis* is in fact the latest of several recent decisions to insist on a judicial power to review substantively the rationale for any attempt by the corporation to terminate a derivative action.¹¹³ This is the core of the ALI position and exactly the kind of inquiry to which The Business Roundtable objects. In light of these decisions, the claim made by Messrs. Block, Radin, and Maimone that the law outside of Delaware does not differ materially from the law within Delaware only can be described as bizarre.

My point is not that these recent cases are in all respects ideally articulated; indeed, some already go well beyond the ALI's more carefully measured standards. In other jurisdictions (such as California), it is simply uncertain when and if a derivative action can be terminated based on the board's motion. Traditionally, it is when the law is unsettled that courts most frequently look to ALI Restatements. Given this backdrop of uncertain legal standards and the general lack of familiarity of most state courts with derivative litigation, the advantage of the *Principles* is that they provide a detailed roadmap—that is, an integrated set of rules that instructs the court on how to proceed from demand to the final resolution of the

110. Messrs. Block, Radin, and Maimone also cite *Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc.*, 430 N.W.2d 447 (Iowa 1988); *Warren v. Century Bankcorp.*, 741 P.2d 846 (Okla. 1987); *Rosenthal v. Rosenthal*, 543 A.2d 348 (Me. 1988); *Lewis v. Boyd*, 838 S.W.2d 215 (Tenn. Ct. App. 1992); see Block, *supra* note 56, at 1447 n.14. *Cookies Food* contains a strong statement that the business judgment rule governs only where a director is shown not to have a self interest in the transaction at issue. *Cookies Food*, 430 N.W.2d at 453. *Warren* actually holds that an "intrinsic fairness" test must be applied, and that defendants had the burden of proof. *Warren*, 741 P.2d at 849-50 n.11. *Rosenthal* not only cites the *Principles*, but carefully limits the application of the business judgment rule. *Rosenthal*, 543 A.2d at 353-54. Moreover, the case was not even a derivative action.

111. 838 S.W.2d 215 (Tenn. Ct. App. 1992).

112. *Id.* at 224. ("We agree with the Supreme Court of North Carolina that a special litigation committee's recommendation should be reviewed using a single standard and that the depth of review should not depend upon whether or not the shareholder made a demand prior to filing suit.")

113. *Lewis* expressly cites *Houle v. Low*, 556 N.E.2d 51 (Mass. 1990), and *Alford v. Shaw*, 358 S.E.2d 323 (N.C. 1987), and then states:

The review should extend to the rationale of the committee's decision. . . . The court should critically evaluate the committee's findings and recommendations to determine whether they were made in good faith, whether they are supported by the record of the investigation, and whether they are consistent with the corporation's best interests as articulated in the special committee's report.

Lewis, 838 S.W.2d at 224. This is in substance probably stronger than the ALI position. All three cases, along with *Will v. Engrebretson & Co.*, 261 Cal. Rptr. 868 (Cal. Ct. App. 1989), reveal a clear skepticism of pro forma justifications for dismissal.

action. In the many jurisdictions where the law on derivative actions appears uncertain, this attraction should not be underestimated.

ARGUMENT NUMBER TWO: DERIVATIVE ACTIONS PRODUCE LITTLE BENEFIT AND THUS DO NOT JUSTIFY THEIR COSTS

This claim rests on various types of empirical studies. Some of these studies find shareholder litigation to have little effect on share prices.¹¹⁴ The plausibility of this form of evidence depends on one's view of stock market efficiency. Even a proponent of the semi-strong version of the Efficient Capital Market Hypothesis can doubt the market's ability to measure the deterrent value of the derivative action in chilling future misconduct.¹¹⁵

A second type of study examined the actual outcome of derivative actions.¹¹⁶ Professor Roberta Romano's careful research paints a picture not unlike earlier studies. Most actions settle (sixty-six percent in her sample), but only about half these actions resulted in any monetary recovery.¹¹⁷ The average recovery in those actions having a monetary settlement was \$6 million.¹¹⁸ Plaintiffs' lawyers received an average fee award of \$1.45 million (or twenty-four percent of the average settlement fund) in cases involving monetary settlements.¹¹⁹ Because the financial costs of the defense were probably higher and were passed on to the corporation indirectly (through either indemnification or insurance), the direct financial benefit to the corporation of these actions appears very modest and often may be negative.

What does this evidence really prove? First, the same critique could be made of the criminal law—the fines imposed by a criminal court often may fall below the state's cost of prosecution. Nonetheless, criminal prosecutions continue, either because society believes in general deterrence or because it enjoys retribution. Similarly, the value of the derivative action

114. See, e.g., Wallace N. Davidson et al., *The Impact of Directors' and Officers' Liability Suits on Firm Value*, 56 J. RISK & INS. 128 (1989); Daniel Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986).

115. Such a conclusion is in fact reached in a working paper authored by Harvard Law Professors Reinier Kraakman and Steven Shavell. See Reinier Kraakman et al., *When Are Shareholder Suits In Shareholder Interests?* (Feb. 1993) (on file with author). They conclude that existing legal rules may sometimes "create too weak an inducement to sue because they fail to reflect the deterrent benefits of a decision to bring suit." In other cases, they conclude the incentive may be too strong because the existing rules fail to consider implicit legal costs.

116. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*, 7 J.L. ECON. & ORG. 56 (1991).

117. *Id.* at 60-63.

118. *Id.* at 61.

119. The fee award fell to \$287,000 in cases settled based on nonmonetary relief. *Id.* at 63, 70.

arguably lies in its deterrent capacity, which such studies do not measure. Although the deterrent threat of the derivative action may be undercut to some degree by liability insurance, most directors' and officers' liability policies do not cover repayment of an improper benefit. In addition, there also are non-monetary sanctions, such as loss of reputation and social stigma. These intangibles are even harder to estimate, yet only a fool ignores them.

Second, the real problem with any study finding a negligible benefit is that it cannot measure the deterrent or compensatory capacity of the derivative action in the abstract, but only under a specific set of legal rules. Recent studies, which have focused on publicly listed companies, are thus principally measuring the effectiveness of Delaware law, because Delaware is the corporate home for nearly half of such companies. That these studies find only negligible benefits and substantial costs hardly is reassuring about Delaware's legal rules for the derivative action. By the same token, such studies prove little about alternative legal regimes, including the ALI's proposals.

The bottom line then is that any claim that the empirical data prove the derivative action useless is circular. The outcome of derivative actions is determined largely by the incentives that the law holds out to private enforcers. If the operative legal rules tell the plaintiff's lawyer that there is a high probability of dismissal, regardless of the action's merit, the predictable result of such rules will be small settlements. All this proves is the old truism that the parties "bargained in the shadow of the law." Ultimately, empirical research cannot prove that the derivative action cannot work. All that empirical studies can measure (and only incompletely) is the impact of existing legal rules. The more one credits this new research, the more one is led to the conclusion that the existing legal rules for the derivative action need to be redesigned—and that is what, to a modest degree, the ALI has sought to accomplish.

Another type of empirical research about contemporary litigation further suggests the need for caution in assessments about the potential utility of the derivative action. These studies find very high rates of plaintiff success in securities class actions. In a study of securities class actions involving initial public offerings, Stanford Professor Janet Cooper Alexander found that such actions tend to settle at a fixed percentage of the damages sought regardless of their legal merit.¹²⁰ Ironically, this evidence is just the other side of the same coin from the evidence that derivative actions yield modest recoveries.¹²¹ Yet, securities class actions are not fun-

120. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 *STAN. L. REV.* 497 (1991).

121. The Romano study found that in cases involving a monetary settlement, derivative actions yielded an average cash recovery (\$6 million) that was roughly half that for shareholder class actions (\$11 million). Romano, *supra* note 116, at 61.

damentally different from derivative actions. Indeed, the same plaintiffs' lawyers bring them against the same defendants often based on the same transactions. That these lawyers succeed (perhaps too well) in securities class actions and not well at all in derivative actions is ultimately proof of a very simple truth: legal rules count. Design a system in which plaintiffs cannot often win and you will predictably observe low average recoveries; design one in which plaintiffs seemingly seldom lose and you will observe the reverse. There has to be a happy medium between these extremes.

ARGUMENT NUMBER THREE: THE ALI'S RULES ONLY WILL SERVE TO DRIVE UP THE SETTLEMENT VALUE OF ALL DERIVATIVE ACTIONS

This claim that the effect of any reform ultimately will be only to drive up the settlement value of all actions, meritorious and non-meritorious alike, rests on the view that the merits do not matter. Admittedly, some evidence from the context of securities class actions seemed to support such a claim. A well-known study of securities class actions that were brought in the wake of initial public offerings by computer related companies seemed to show that all these cases settled at roughly the same percentage of their investors' trading losses.¹²² But this study was based on a small sample of twenty cases in a special context (initial public offerings) where the law strongly favored the plaintiff. More recent research on securities class actions involving larger and randomly selected samples found wide variation in settlements as a percentage of the investors' trading losses.¹²³ The most logical inference to be drawn from such data is that the merits do matter. Strong cases settle at a higher percentage of the stakes involved than do weak cases.

Even so, the claim will be made by some that Part VII gives enhanced settlement value to weak claims. But this is demonstrably false. Under Part VII, it is probably as easy or easier to dismiss a duty of care claim than under Delaware law. For example, in cases where Delaware would excuse demand and, under *Zapata*, permit the court to exercise its "independent business judgment," Part VII still applies a business judgment standard to duty of care cases not involving knowing and culpable illegality.¹²⁴ Only in cases not covered by the business judgment rule (chiefly, duty of fair dealing cases) does Part VII express a more liberal attitude. But even in this more sensitive context, the plaintiff must make demand on the board, and the plaintiff can survive demand rejection only if the plaintiff has pled

122. Alexander, *supra* note 120, at 517-19.

123. See VINCENT O'BRIEN & RICHARD HODGES, A STUDY OF CLASS ACTION SECURITIES FRAUD CASES (1991); FREDERICK DUNBAR, RECENT TRENDS IN SECURITIES CLASS ACTIONS SUITS (NERA 1992). Both these surveys involve samples of several hundred cases that were settled at various times between 1988 and 1992.

124. See *Principles*, *supra* note *, § 7.10(a)(1).

with particularity facts that raise a “significant prospect” that (i) there was a breach of duty, and (ii) the disinterested directors reasonably could not have rejected plaintiff’s demand. This is a significant hurdle, and frivolous cases will not survive it.

More importantly, Part VII cannot be exploited in ways that exacerbate the litigation cost differential that sometimes allows weak cases to justify a settlement and fee award. Part VII does not require expensive or time-consuming studies by the board or a litigation committee simply because a plaintiff filed an action. Demand rejection need not be accompanied in a weak case by any explanation of reasons, and even in a stronger case, the directors need only show a reasonable basis for their rejection of demand. Thus, securing dismissal is not costly for the corporation, unless special circumstances are present. It is only when the plaintiff has pled facts that in effect raise the suspicious odor of fraud or fiduciary abuse that the defendants will have any real need to defend themselves. And only when the disinterested directors’ rejection of demand has been insufficiently explained to satisfy the court in relation to the particularized facts in the complaint, will there be any need to proceed to the full scale litigation committee procedure exemplified by the *Zapata* decision.¹²⁵

The truth is that Part VII may increase the settlement value of a meritorious duty of fair dealing action when the disinterested directors cannot supply a persuasive justification for demand rejection. Otherwise, Part VII does nothing to aid the plaintiff who pleads only conclusory facts or whose action is otherwise non-meritorious. The Reporters’ premise is that courts can recognize and distinguish such cases reasonably well, and Part VII insists that conclusory or non-meritorious pleadings be dismissed at the outset. Thus, the only colorable charge directed at Part VII is that it increases the settlement value of meritorious cases. And that is as it should be.

CONCLUSION

Far from a radical or bold new reform package, Part VII basically keeps alive the flickering possibility of judicial oversight of fiduciary duties in the corporate context. Its core idea can be best expressed in the negative. In substance, opponents of the *Principles* have argued that a “lawsuit is just another corporate asset—no more, no less.” It is not. At least when duty of loyalty issues involving senior executives are at stake, the derivative action is a mechanism of corporate accountability. Admittedly, it is an imperfect and flawed mechanism, but so are most others (including shareholder voting and the tender offer), and such a skeptical assessment only suggests the need for reform, not abolition.

125. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

Part VII is an attempt to preserve this mechanism of accountability and to address some of its flaws. In truth, it is far from an unqualified success at either goal. Although Part VII recognizes that the real benefit of the derivative action is more likely to lie in the deterrence it generates than the financial recovery it yields, it by no means seeks to maximize deterrence. Only a system that restricted insurance or invoked punitive damages for knowing breaches of the duty of loyalty conceivably could deter in terms of the traditional logic of deterrence.¹²⁶ Part VII stops well short of such an attempt. Still, some deterrence is better than no deterrence at all, particularly in a world where other social and cultural forces also play a significant restraining role.

In its attempts to reform the misincentives associated with the derivative action, Part VII is probably less successful. The evidence is clearcut that derivative actions frequently result in settlements that are of little benefit to shareholders, but are very lucrative for plaintiffs' lawyers.¹²⁷ Defense lawyers are eager to point out this failing, but not to reform the settlement process. Yet, because it takes two to tango, collusive settlements are not the responsibility of plaintiffs' lawyers alone. Given that the vast majority of derivative actions are settled,¹²⁸ settlement is clearly the critical stage at which reforms seem necessary. Part VII's provisions regarding settlements are, however, less than bold, and this may reflect the legal profession's conservatism about reforms that affect their own welfare. The one important provision in Part VII in this regard is section 7.17's limitation of the fee award to a "reasonable proportion of the value of the relief . . . obtained by the plaintiff for the corporation."¹²⁹ Properly enforced, such a rule should curb the more egregious examples of settlements based on cosmetic non-pecuniary relief and associated corporate therapeutics that benefit the lawyer but not the shareholders.

In the last analysis, the *Principles* do not place their primary reliance on courts or litigation. Litigation is ultimately a failsafe remedy, a safety net

126. Punitive damages for breaches of fiduciary duty by a corporate official received relatively little attention in the case law. The Restatement (Second) of Torts recognizes that punitive damages are appropriate "for conduct that is outrageous, because of the defendant's evil motive or reckless indifference to the rights of others." RESTATEMENT (SECOND) OF TORTS § 908(2) (1979). Certainly, some fiduciary violations could satisfy this standard. At common law, the law of trusts generally does not allow punitive damages, but it makes exceptions "in cases of extraordinary fiduciary disloyalty or malicious conduct." See *Leigh v. Engle*, 669 F. Supp. 1390, 1413 (N.D. Ill. 1987), *aff'd*, 858 F.2d 361 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078 (1989); GEORGE G. BOGERT & GEORGE T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 862, at 39-41 (2d ed. 1982). For a recent case authorizing punitive damages against trustees as a matter of federal common law, see *Ampere Automotive Corp. v. Employee Benefit Plans, Inc.*, No. 92 C 2580, 1993 U.S. Dist. LEXIS 601 (E.D. Ill. Jan. 21, 1993).

127. For a review of the empirical studies, see *Principles*, *supra* note *, pt. VII Introductory Note. See also *supra* text accompanying notes 116-23.

128. Sixty-six percent of the derivative actions in Professor Romano's study settled. See Romano, *supra* note 116, at 63-70.

129. *Principles*, *supra* note *, § 7.17.

for instances when other mechanisms fail. Under Part VII, the court's role is essentially confined to those instances when the board cannot give a reasonable account for its actions in rejecting the shareholder's demand. In essence, this defines when the safety net is needed. Those who would remove the safety net at this point should bear the burden of explaining why it is prudent to do so.