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Recommended Citation

Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 *Vanderbilt Law Review* 387 (2019)

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The Forgotten Derivative Suit

*Kenneth B. Davis, Jr.**

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I. INTRODUCTION

One of U.S. corporate law's most salient features is its flexibility. Those who control and manage the corporation are given a long leash. This is particularly evident when the United States is compared with other countries in studies like the World Bank's annual Doing Business project. According to the detailed study that developed the World Bank methodology for measuring investor protection,¹ the United States scored a 0.33 for "ex ante private control of self-dealing." This was not only below the world average of 0.36, but also well below the 0.58 average for common law countries. The United Kingdom, in contrast, received a perfect score of 1.0.²

That the country with the world's largest and deepest capital markets has, in some respects, among the world's looser corporate laws may seem counterintuitive. It works because of the strength of two underlying institutions. One is our disclosure system, which assures investors that they see the full picture. The other is the fiduciary concept, which replaces standardized prohibitions with the opportunity to evaluate managerial conduct on a more holistic basis. Applied soundly, the fiduciary concept filters opportunistic behavior by those in control of a corporation without deterring good faith efforts to further shareholder welfare in ways that might run afoul of a more technical set of restrictions.

The critical issue, therefore, is who performs the fiduciary evaluation. Traditionally, courts have exercised principal responsibility through shareholder derivative suits. However, over the last three decades, this task has shifted to others, chiefly the independent members of a corporation's board of directors. Shareholders continue to file derivative suits, but they no longer play a central role in the evaluation. Law reviews' attention to the topic likewise has declined. Current scholarship tends to focus on either recent cases in local jurisdictions or comparative law work. Ironically, although we rely on the derivative suit less and less in this country, we are eager to see whether other countries embrace it. To invert a familiar bit of nostalgia, the derivative suit seems to be "forgotten, but not gone."

This Article examines the factors contributing to the decline of the derivative suit and evaluates whether corporations and their shareholders are better off as a result. To assess the state of derivative

1. Simeon Djankov et al., *The Law and Economics of Self-Dealing*, Nov. 16, 2006, <http://www.doingbusiness.org/documents/Protecting-Investors-Self-Dealing.pdf>.

2. *Id.* at tbl.2.

litigation today, it surveys opinions involving derivative suits involving Delaware corporations brought in federal and Delaware courts. In all, 294 cases are considered. This examination suggests that the “forgotten” derivative suit is largely the result of preoccupation with issues facing highly visible, large cap corporations, where a number of alternatives and substitutes have developed to supply most (but not all) of the benefits traditionally associated with derivative litigation. Derivative suits continue to play an essential role, however, in other sectors of the corporate law landscape, particularly for transactions involving controlling persons. Courts have been more creative recently in finding ways to preserve the minority shareholder’s access to court in these sectors, without displacing the framework developed to restrict the typical large cap derivative suit.

The Article is organized as follows: Part II traces the history of how, beginning in the late 1970s, courts shifted their responsibility for overseeing fiduciary conduct to independent directors by taking a more restrictive approach to derivative suits in general and to the role of pre-suit demand in particular. Part III analyzes the reasons for this shift and considers whether subsequent developments have born them out. Part IV reports the results of a survey of judicial opinions. Emerging from that survey is a three-category typology of derivative suits, suggesting the need to look beyond the conventional closely held/publicly held dichotomy. While one category (“Closely Held”) is confined to close corporations and other closely held firms, the other two involve publicly traded corporations, with derivative suits playing a very different role in each. One category (“Corporate Impropriety”) includes derivative suits seeking to impose personal liability on the board for a discrete act of corporate wrongdoing. Corporations in this category tend to be larger and shareholdings more widely dispersed. The final category (“Exploitation of Control”) is confined to suits challenging transactions between the corporation and those who control it. It is in this category that the derivative suit continues to make its most important contributions, both as a source of compensation and deterrence for the corporation’s minority shareholders and as a public good. After analyzing the distinctive issues raised by each of the three categories in Part IV, Part V briefly concludes with a look at some broader implications.

II. SLCS, THE DEMAND REQUIREMENT, AND JUDICIAL DEFERENCE—A BRIEF LOOK BACK

In July 1976, a federal district court in New York decided *Gall v. Exxon Corp.*³ As is often the case with groundbreaking judge-made law, the opinion reads as if its outcome followed inexorably from well-established precedent. But the decision marked the beginning of a fundamental shift in the interaction between courts of equity and corporate boards.

In *Gall*, plaintiffs brought a derivative suit seeking to impose liability on Exxon's directors and officers for alleged payments of \$59 million to Italian political interests. In response, Exxon's board appointed a special litigation committee ("SLC") consisting of three directors who had joined the board after the challenged payments had been terminated. After a four month investigation led by the retired Chief Justice of the New Jersey Supreme Court, the SLC issued a detailed report, on the basis of which it concluded that maintaining the lawsuit was contrary to the interests of Exxon and its shareholders.⁴ Relying heavily on a series of older U.S. Supreme Court cases,⁵ the court agreed that so long as the SLC members acted independently and in good faith, their decision to terminate the suit fell within the business judgment rule.⁶

For the two or three years following the *Gall* decision, the law remained unsettled. Several courts reached the opposite result and declined to apply the business judgment rule to SLC determinations; all of these decisions ultimately would be reversed.⁷ By 1979, the *Gall* court's approach had carried the day in both federal⁸ and state courts.⁹ The crowning event was the U.S. Supreme Court's decision in *Burks v. Lasker*, a derivative suit challenging an investment company's

3. 418 F. Supp. 508 (S.D.N.Y. 1976).

4. *Id.* at 514.

5. See *infra* notes 44-47 and accompanying text.

6. 418 F. Supp. at 514-19.

7. *Lasker v. Burks*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979); *Parkoff v. Gen. Tel. & Elec. Corp.*, 425 N.Y.S.2d 599 (N.Y. App. Div. 1980) (reversing trial court's refusal to dismiss), *aff'd*, 425 N.E.2d 820 (N.Y. 1981); *Auerbach v. Bennett*, 408 N.Y.S.2d 83 (N.Y. App. Div. 1978), *aff'd as modified*, 393 N.E.2d 994 (N.Y. 1979); see also *Cramer v. Gen. Tel. & Elec. Corp.*, 582 F.2d 259, 273-76 (3d Cir. 1978) (reserving decision).

8. *Lewis v. Anderson*, 615 F.2d 778, 783 (9th Cir. 1979) ("*Auerbach* and *Abbey* reflect a clear trend in corporate law, and we are confident that a California court would follow this trend."); *Gaines v. Haughton* (C.D. Cal. Apr. 20, 1979), *aff'd*, 645 F.2d 761 (9th Cir. 1981); *Rosengarten v. Int'l Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Abbey v. Control Data Corp.*, 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979).

9. *Auerbach*, 393 N.E.2d 994.

purchase of Penn Central commercial paper.¹⁰ Below, the Second Circuit had reasoned that it would be contrary to the federal Investment Company Act to allow a minority of the board, no matter how independent, to dismiss the shareholder's complaint against the majority directors.¹¹ A unanimous Supreme Court, in an opinion written by Justice Brennan, disagreed. After recognizing that the disinterested directors' power to dismiss a derivative suit was essentially a question of state law, the Court determined that the existence of that power did not run afoul of the federal regulatory scheme. Inasmuch as the "cornerstone of the [Act's] effort to control conflicts of interest within mutual funds is the requirement that at least 40% of a fund's board be composed of independent outside directors," the Court reasoned that allowing those directors to terminate a derivative suit was consistent with the Act.¹² "Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled."¹³

Over the next decade, an occasional state court would buck the trend and withhold or narrow the availability of the business judgment rule—most notably the Delaware Court of Chancery in *Maldonado v. Flynn*.¹⁴ However, each attempt was eventually overruled, by either an appellate court or the legislature.¹⁵

Especially within the academic community, the arrival of this broad judicial deference to SLC decisionmaking provoked serious concern. Corporate law scholars openly worried about the "death"¹⁶ or "extinction"¹⁷ of the derivative suit, of "lock[ing the] shareholders' door."¹⁸ Using words like "shocking,"¹⁹ "staggering,"²⁰ and

10. 441 U.S. 471 (1979).

11. *Lasker v. Burks*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).

12. *Burks*, 441 U.S. at 482.

13. *Id.* at 485.

14. 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom.* *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

15. In addition to *Maldonado*, see *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 716-18 (Iowa 1983) (superseded by IOWA CODE § 490.744(2) (2007)); *Alford v. Shaw*, 358 S.E.2d 323 (N.C. 1987) (superseded by N.C. GEN. STAT. § 55-7-44(a) (2007)).

16. George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96 (1980).

17. John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 261 (1981).

18. Richard M. Buxbaum, "Maldonado" Cases Could Lock Shareholders' Door, LEG. TIMES WASH., Oct. 13, 1980, at 26.

19. Dent, *supra* note 16, at 109.

20. Buxbaum, *supra* note 18.

"indefensible"²¹ to describe this judicial development, writers called upon the courts to rise above the formulaic application of doctrine and the mistaking of form for substance to see the larger implications of their decisions.²²

Why did *Gall*, *Burks*, and their progeny generate so much controversy? One reason was that, by empowering the corporation's outside directors to displace judicial scrutiny, this new doctrine seemed to turn on its head the institutional reform that was central to the recently enhanced focus on corporate governance. Another reason was a perceived disconnect from the traditional view of the role played by the derivative suit's requirement of pre-suit demand. The next two sections explore each of these concerns in turn.

A. Origins of the SLC

The philosophical lineage of the independent board committee—of which Exxon's SLC was but one example—is traceable to dissatisfaction with the passive role played by the typical outside director of a large, publicly traded corporation. This role typically fell somewhere on a continuum between figurehead and friendly adviser. To be sure, this was a longstanding phenomenon, but two events pushed these concerns to the fore in the early 1970s and helped them to coalesce into the foundation for what is now termed "corporate governance." One was the 1972 publication of an interview-based, comprehensive academic study of what directors do: *Directors: Myth and Reality*, by Harvard Professor Myles Mace.²³ The other was Penn Central's collapse in June 1970. Formed by a merger of the historic Pennsylvania and New York Central railroads in 1968, the company declared bankruptcy only two years later. Government investigations²⁴ and the popular press²⁵ depicted the company's outside directors as disengaged and unaware of the company's precarious financial condition until it was too late.

21. Janet Johnson, *The Business Judgment Rule: A Review of Its Application to the Problem of Illegal Foreign Payments*, 6 J. CORP. L. 481, 481 (1981).

22. See Coffee & Schwartz, *supra* note 17, at 262-63; Dent, *supra* note 16, at 109; Walter Werner, *Corporation Law in Search of Its Future*, 81 COLUM. L. REV. 1611, 1664 (1981); Mark A. Underberg, Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 601-02, 632-33 (1980).

23. MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* (1971).

24. THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY: STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS pt.I-F, at 151-72 (1972).

25. JOSEPH R. DAUGHEN & PETER BINZEN, *THE WRECK OF THE PENN CENTRAL* 17, 259 (1971); Robert Townsend, Book Review, N.Y. TIMES, Dec. 12, 1971, at BR 3.

The principal analytical framework that emerged to address these concerns is most closely associated with the work of Professor Mel Eisenberg. Writing in the mid-1970s, he conceded that the law's traditional view that the board of directors "manages" the corporation was no longer realistic.²⁶ It was feasible and desirable, however, that the board "monitor" those who manage the corporation. Thus, the monitoring model of the board of directors was born, and with it a series of reforms to facilitate that task—more outside directors, with fewer economic and personal ties to management, and the assignment of key tasks to independent board committees. Professor Eisenberg would go on to serve as Reporter for the American Law Institute's ("ALI's") Principles of Corporate Governance project, which initially sought to codify some of these reforms.²⁷

While these broader developments frame the heightened attention to the board's monitoring function that emerged in the 1970s, specific credit for developing the SLC itself goes to the Securities and Exchange Commission's ("SEC") Enforcement Division under Irving M. Pollack, especially to Stanley Sporkin.²⁸ The impetus for developing the SLC was the post-Watergate revelation of illegal or questionable political and foreign payments by many of the country's leading corporations. After the Special Prosecutor brought charges against several corporations and their senior executives for illegal campaign contributions, the SEC began to look into the off-the-books

26. MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 139-85 (1976); Melvin A. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CAL. L. REV. 375 (1975). While Eisenberg was instrumental in articulating the "monitoring" framework as such, other authors and institutions were contemporaneously advancing ideas along the same line. For a summary, see Elliott J. Weiss & Donald E. Schwartz, *Using Disclosure to Activate the Board of Directors*, LAW & CONTEMP. PROBS., Summer 1977, at 63, 73-79; Werner, *supra* note 22, at 1654-56.

27. PRINCIPLES OF CORPORATE GOVERNANCE & STRUCTURE: RESTATEMENT & RECOMMENDATIONS §§ 3.02-07 (Tentative Draft no. 1, 1982). Following the controversy generated by Tentative Draft no. 1, many of these proposals were converted into "recommendations of corporate practice" made to "corporations and their counsel, not to courts or legislatures." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS pt. III-A (1992).

28. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 540 n* (revised ed. 1995); Stanley Sporkin, *SEC Developments in Litigation and the Molding of Remedies*, 29 BUS. LAW. 121, 122 (Special Issue, 1974) ("I believe that the molding of remedies is a very important area for many of your clients . . . [W]e [the enforcement staff] like to look upon ourselves as doctors trying to cure or perhaps preserve a temporarily ill but viable entity."). Sporkin, Pollack's deputy, was appointed Director of the Division in February 1974 when Pollack was named a Commissioner.

"slush funds" and falsified financial records that had facilitated these payments.²⁹

Even before these Watergate-related developments, the SEC had begun to seek two novel forms of ancillary relief in enforcement actions—the appointment of new, independent directors to the corporation's board and internal corporate investigations, typically employing outside special counsel and sometimes special auditors as well.³⁰ Unlike the traditional mainstay of the SEC's enforcement weapons—an injunction against violations of the securities laws³¹—these new remedies provided the mechanism for monitoring ongoing compliance and "rehabilitating" the issuer. And from the issuer's perspective, they were preferable to the appointment of a receiver, which might trigger a default under loan agreements and disrupt relations with suppliers, employees, and customers.³² The leading example of this new approach was the 1974 consent decree between the SEC and Mattel, Inc.³³ The decree required that Mattel add a sufficient number of new independent directors to constitute a majority of its board, create three new independent board committees, and appoint a special counsel to file an investigatory report with both the SEC and the court. In particular, one feature of the decree qualifies it as the archetype of today's SLC.³⁴ Three of the independent directors were to serve on a new "Litigation and Claims Committee," which was to review pending and future claims and questions of

29. Division of Corporate Finance's Views and Comments on Disclosures Relating to the Making of Illegal Campaign Contributions by Public Companies and/or Their Officers and Directors, Securities Act Release No. 5466, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,969 (Mar. 8, 1974).

30. See Arthur F. Mathews, *Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunctive Actions*, 31 BUS. LAW. 1323, 1334-36 (listing cases). See generally James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); Chris R. Ottenweller, Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 GEO. L.J. 737 (1976); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188 (1975).

31. See, e.g., Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (2000); Securities Exchange Act of 1934 § 21(e), 15 U.S.C. § 78u(e) (2000).

32. See SEC v. Bowler, 427 F.2d 190, 196 (4th Cir. 1970); United States v. Handler, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,519, at 94,024 (C.D. Cal. Aug. 3, 1978); Arthur F. Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, 656-57 (1984); Stanley Sporokin, *supra* note 28, at 123-24.

33. SEC v. Mattel, Inc., SEC Litigation Release No. 6467, 1974 WL 163306 (D.D.C. Aug. 5, 1974), *amended*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,807 (D.D.C. Oct. 1, 1974).

34. See, e.g., Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 512 n.38 (1989); Charles W. Murdock, *Corporate Governance—The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 88 (1993).

conflict of interest involving the company's officers, directors, controlling persons, and employees. This committee also was responsible for approving the settlement or other disposition of those claims.

Beginning with the American Ship Building Corporation's settlement in October 1974,³⁵ the SEC extended this approach to settlements of actions charging corporate nondisclosure of illegal or questionable payments. By September 1976, the SEC had obtained almost twenty such consent decrees³⁶ with such household corporate names as Gulf Oil, 3M, Northrop, and Lockheed. The settlements contained essentially the same elements, including a requirement that the corporation create a special review committee composed exclusively of independent directors. Typically using independent counsel and accountants, the committee was to investigate the irregularities alleged in the SEC's complaint and submit a public report to the board of directors, which was responsible for reviewing and implementing the committee's recommendations.³⁷ Many corporations preempted the SEC by launching their own internal investigations, again frequently using independent board committees and outside counsel.³⁸ Starting in 1975, the SEC institutionalized these practices with its "voluntary disclosure program."³⁹ A May 1976 report by the SEC to the Senate Banking Committee identified ninety-five companies that had disclosed illegal or questionable payments. Ultimately, almost 400 publicly traded corporations would be implicated,⁴⁰ with Exxon's \$59 million being the largest of the disclosed payments.

It is therefore understandable why *Gall* and its progeny disquieted corporate governance advocates. Unable to pursue each instance of questionable payments on its own, the SEC had leveraged

35. SEC v. Am. Ship Bldg. Co., SEC Litigation Release No. 6534, 1974 SEC Lexis 2553 (Oct. 4, 1974).

36. See S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 94TH CONG., REPORT OF THE SEC ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 3-5, Exhibit B (Comm. Print 1976) [hereinafter SEC Questionable Payments Report]; Edward D. Herlihy & Theodore A. Levine, *Corporate Crisis: The Overseas Payment Problem*, 8 LAW & POLY INT'L BUS. 547, 578-79 & n.185 (1976).

37. SEC Questionable Payments Report, *supra* note 36, at 4-5; Herlihy & Levine, *supra* note 36, at 581-82.

38. See Mathews, *supra* note 32, at 666-70.

39. *Activities of American Multinational Corporations Abroad: Hearings Before the Subcomm. on International Economic Policy of the H. Comm. on International Relations*, 94th Cong. 186-88 (1975) (statement of SEC Commissioner Philip A. Loomis, Jr.); SEC Questionable Payments Report, *supra* note 36, at 6-13.

40. ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 149 (1982); SELIGMAN, *supra* note 28, at 542.

its resources by pressuring corporations to investigate themselves.⁴¹ That process then was used to limit judicial scrutiny, even in cases where this self-investigation had revealed significant problems.

B. Role of the Demand Requirement

Federal and state pleading rules typically require that the complaint in a derivative suit set forth the efforts, if any, made by the plaintiff to obtain action from the directors and the reasons for either the failure to obtain that action or for not making the effort.⁴² What substantive implications flow from this mandated recital? At the time of *Gall*, two conflicting lines of thought circulated.

One line saw the demand requirement as the procedural complement to the substantive proposition that the decision whether to assert a legal claim belonging to the corporation was, in essence, a business decision. As such, this decision belonged exclusively to the corporation's board of directors, whose resolution of the issue should be shielded from judicial second guessing by the business judgment rule. Some have termed this substantive dimension the "standing" requirement, to distinguish it from the procedural issues surrounding the need to make a demand.⁴³ Proponents of this position chiefly relied on a series of older decisions by the U.S. Supreme Court.⁴⁴ Closer to the time of *Gall*, three federal courts of appeals, along with several district courts, had reiterated this doctrine.⁴⁵ All of these decisions share a limiting characteristic that is not clear on the face of the rule

41. SELIGMAN, *supra* note 28, at 541-42.

42. See, e.g., FED. R. CIV. P. 23.1; DEL. CH. CT. R. 23.1; N.Y. BUS. CORP. LAW § 626(c) (McKinney 2003).

43. See Coffee & Schwartz, *supra* note 17, at 262; Daniel R. Fischel, Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 168 n.5 (1976).

44. *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903); *Hawes v. City of Oakland*, 104 U.S. 450 (1881); see also *Ashwander v. Tenn. Valley Auth.*, 297 U.S. 288, 342-44 (1936) (Brandeis, J., concurring). Justice Brandeis's observations in the *United Copper* case summarize the Court's position:

Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion . . .

United Copper, 244 U.S. at 263-64.

45. *Ash v. Int'l Bus. Machs., Inc.*, 353 F.2d 491 (3d Cir. 1965); *Stadin v. Union Elec. Co.*, 309 F.2d 912, 921-22 (8th Cir. 1962); *Swanson v. Traer*, 249 F.2d 854, 858-59 (7th Cir. 1957); *Bernstein v. Mediobanca Banca di Credito Finanziario-S.p.A.*, 69 F.R.D. 592, 595-97 (S.D.N.Y. 1974); *Klotz v. Consol. Edison Co.*, 386 F. Supp. 577, 581-83 (S.D.N.Y. 1974); *Kemper v. Am. Broad. Cos.*, 365 F. Supp. 1272, 1274 (S.D. Ohio 1973).

they set forth: they involve suits against unaffiliated third parties. Obviously, different sensitivities arise when the issue is whether the corporation should sue a competitor on antitrust grounds or challenge the constitutionality of a tax, rather than when the directors are asked to sue themselves or their colleagues on the board.⁴⁶ As to the latter, it is difficult to find even dicta, much less a clear pre-*Gall* holding, on whether the board's power to exercise its business judgment to foreclose a derivative suit extended to suits against the directors themselves.⁴⁷ Yet this is the line of cases that the *Gall* court elected to apply to the suit against Exxon's leadership,⁴⁸ and the decisions that followed never questioned seriously the aptness of these cases.⁴⁹

The alternative line of thinking saw the demand requirement merely as an intra-corporate exhaustion of remedies doctrine. Once the shareholder either made a demand and was rejected or demonstrated that demand would be futile, she was free to proceed with the suit, the board's business judgment notwithstanding. Prior to *Gall*, this second line appears to have been the prevailing view in cases where the suit was against the corporation's directors or senior management.⁵⁰ In many cases, however, the defendant did not raise

46. See *Maldonado v. Flynn*, 413 A.2d 1251, 1258-60 (Del. Ch. 1980), *rev'd sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *Coffee & Schwartz*, *supra* note 17, at 265-71; Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 759-60 (1960). For a typology of the cases, see *Dent*, *supra* note 16, at 100-04.

47. The few examples include *Findley v. Garrett*, 240 P.2d 421, 425-29 (Cal. Dist. Ct. App. 1952); *S. Solomont & Sons Trust, Inc. v. New Eng. Theatres Operating Corp.*, 93 N.E.2d 241, 247-49 (Mass. 1950). In *Findley*, the court upheld the board's refusal to commence suit where nine of the corporation's eleven directors were unaffiliated with the principal defendant, and all or most of them had joined the board after the challenged transactions. The court in *Solomont* held that the shareholders, by majority vote, had the power to terminate a derivative suit even though the defendant was a director or officer. The opinion suggested that the same result might apply to a majority vote by the board.

48. Another Southern District judge likewise invoked this line of cases the year before in *Lasker v. Burks*, 404 F. Supp. 1172, 1179 (S.D.N.Y. 1975), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).

49. The principal exception was *Maldonado*, 413 A.2d at 1257-60.

50. *Papilsky v. Berndt*, 503 F.2d 554, 555-56 (2d Cir. 1974); *Sohland v. Baker*, 141 A. 277, 281-82 (Del. 1927); *Anderson v. Johnson*, 119 A. 642, 644 (R.I. 1923); *cf. Nussbacher v. Cont'l Ill. Nat'l Bank & Trust*, 518 F.2d 873, 878-79 (7th Cir. 1975) (demand not required when board had previously made clear that suit should not be brought); *see also* Note, *supra* note 46, at 760 ("If the alleged wrongdoer is a director, officer, or other agent of the corporation it seems that a suit against him should be permitted, since the high standards of fiduciary responsibility require that he be held directly accountable for his malfeasance even when the board would protect him."). Alternatively, even if the shareholder did not automatically acquire the right to sue following rejection of demand, at least one court claimed the discretion to decide on its own that the suit had sufficient merit to proceed notwithstanding the board's opposition. *Groel v. United Elec. Co.*, 61 A. 1061, 1063-64 (N.J. Ch. 1905).

the demand issue to contest the plaintiff's right to proceed,⁵¹ perhaps because the courts (at least the federal courts) generally were seen as lenient in construing the demand requirement.⁵² In short, before the late 1970s, the issue of demand was not that important.⁵³

This quickly changed after *Gall* and the other questionable payments cases. When the SLC issue reached the Delaware courts in litigation involving the Zapata Corporation, both the Court of Chancery and the Supreme Court seized the opportunity to spell out the demand requirement's role. The Court of Chancery held that, notwithstanding the recent developments in federal court, Delaware adhered to the exhaustion-of-remedies view. The court reasoned that once demand is made and the corporation refuses to bring suit on a claim alleging that directors breached their fiduciary duty, "the stockholder is vested with a primary and independent right to redress the wrong by bringing a derivative suit."⁵⁴ The Delaware Supreme Court reversed, separating derivative suits in which demand is required but the board refuses to bring suit from those in which demand is excusable as futile. For the former, the business judgment rule protects the board's decision not to sue unless it is "wrongful."⁵⁵ Even when demand is excused, the board does not forgo all authority over the litigation. It retains the power to appoint an SLC, whose decision is subject to a two-step process. First, the corporation has the burden of proving the SLC's independence, its good faith, and the reasonableness of its investigation and basis for its conclusions. Even when that burden is satisfied, the court may substitute its own business judgment,⁵⁶ though few courts have exercised this opportunity.⁵⁷

Given the rejection of the exhaustion-of-remedies view, the test for whether demand is required or excused took on far greater significance. Not surprisingly, given the law's recent direction, the

51. Dent, *supra* note 16, at 100 n.21.

52. 7A CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1831, at 375 (1972) (superseded). For surveys of the courts' willingness to excuse demand in the years before *Gall*, see Fischel, *supra* note 43, at 170-82; Note, *supra* note 46, at 753-54.

53. Richard M. Buxbaum, *Conflict-of-Interest Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CAL. L. REV. 1122, 1123 (1980); Coffee & Schwartz, *supra* note 17, at 262; Note, *supra* note 46, at 759.

54. Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del Ch. 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

55. *Zapata Corp.*, 430 A.2d at 784 n.10.

56. *Id.* at 788-89.

57. The best-known example is *Joy v. North*, 692 F.2d 880, 892-97 (2d Cir. 1982). See also *Peller v. Southern Co.*, 707 F. Supp. 525, 530-31 (N.D. Ga. 1988) (*Zapata's* second step as alternative rationale), *aff'd*, 911 F.2d 1532 (11th Cir. 1990).

result was restrictive. If plaintiffs could establish demand futility simply by naming a majority of the board as defendants—because they had approved the challenged transaction and thus would be reluctant to sue themselves—then the courts' enhanced commitment to preserving the board's control over shareholder litigation would be subverted.⁵⁸ The Delaware court's solution, in *Aronson v. Lewis*, was to link the demand requirement to the availability of the business judgment rule.⁵⁹ Specifically, to establish demand futility, the complaint must allege "particularized facts" that create a reasonable doubt that "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."⁶⁰ Because of the business judgment rule, the court saw the threat of personal liability for approving the transaction as insufficient, by itself, to render a director "interested" for purposes of excusing demand.⁶¹

The *Aronson* court took an even stricter approach to the argument for excusing demand because the principal defendant (the corporation's seventy-five-year-old chairman, who was granted a permanently renewable extension to his employment agreement) owned forty-seven percent of the corporation's stock and personally selected each of the directors. Even majority ownership, the court said, would not strip the board of the presumption of independence. In addition to the existence of control, the plaintiff must allege facts demonstrating "that through personal or other relationships the directors are beholden to the controlling person."⁶²

Subsequent Delaware case law reveals that prospective litigants encounter a practical obstacle to mustering sufficient facts to

58. Up until that time, the case law was divided on whether, in the absence of fraud or self-dealing, demand should be excused when a majority of the board approved or acquiesced in the challenged conduct. See Fischel, *supra* note 43, at 176-78; Underberg, *supra* note 22, at 606-07.

59. 473 A.2d 805 (Del. 1984).

60. *Id.* at 814.

61. *Id.* at 815, 817-18. Whatever split of authority may have existed historically, see *supra* note 58, over the 1980s, the rule would become firmly established that the board's approval or acquiescence, or their status as defendants in the suit, did not suffice to excuse demand. In addition to *Aronson*, see MODEL BUS. CORP. ACT § 7.44(c)(2)-(3) (1990), which provides that neither the naming of a director as defendant nor the approval by the director shall by itself cause directors to be considered independent; *Lewis v. Graves*, 701 F.2d 245, 248-49 (2d Cir. 1983), which holds that "absent specific allegations of self-dealing or bias on the part of a majority of the board, mere approval and acquiescence are insufficient to render demand futile"; and *Lewis v. Curtis*, 671 F.2d 779, 784-86 (3d Cir. 1982), which notes that "courts have refused to excuse demand simply because a majority of the directors are named in the complaint" and "[t]he majority view is that the mere approval of an allegedly injurious corporate transaction, absent self-interest or bias by a majority of the board, is insufficient to excuse demand."

62. 473 A.2d at 815.

satisfy Aronson's "particularity" requirement. Because this requirement applies when the complaint is filed, discovery is not available.⁶³ Instead, the plaintiff must rely on the "tools at hand"—SEC filings, media reports, and a possible books-and-records inspection under section 220 of the Delaware law.⁶⁴ One Delaware judge has noted the "almost impossible burden" that results when the relevant facts are not a matter of public knowledge.⁶⁵

Thus, over a period of less than ten years, the demand requirement was recast to pose a higher hurdle to derivative suits alleging directors' breach of duty. While the power to entrust a shareholder suit to an SLC, even under demand-excused circumstances, was the era's truly new development, this modified vision of demand's role in the cases that followed had more far-reaching consequences for the relationship between courts and corporate boards.

III. WHY?

The larger purpose of this Article is to assess, with the benefit of twenty-five years of hindsight, where this more restrictive approach to derivative litigation has led us. To do so, it is important to dig a little deeper into the reasons for this development and to determine whether those reasons still exist. The law's struggle with the sharply competing costs and benefits of the derivative suit is decades old. What was it about the mid-1970s that changed the balance?

Answering this question is an exercise in speculation. Little within the courts' opinions acknowledges any larger economic or legal developments that led to the shift. Indeed, critics voiced this frustration at the time.⁶⁶ But this shift was likely something much broader than a simple case of misguided formalism.⁶⁷ Responsibility for making corporate law is dispersed among a variety of institutions at the state and federal level—legislatures, courts, administrative agencies, and private rulemaking bodies. Yet little of the inter-

63. *Cf. Scattered Corp. v. Chi. Stock Exch., Inc.*, 701 A.2d 70, 77 (Del. 1997); *Levine v. Smith*, 591 A.2d 194, 208-09 (Del. 1991) (representing demand-refused cases, but also discussing the non-availability of discovery in a demand-excused case).

64. DEL. CODE ANN. tit. 8, § 220 (Supp. 2006); *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996); *Rales v. Blasband*, 634 A.2d 927, 934-35 n.10 (Del. 1993).

65. *Brehm v. Eisner*, 746 A.2d 244, 268 (Del. 2000) (Hartnett, J., concurring). For a recent discussion of whether Delaware's strict approach to the availability of discovery should apply in federal courts, see *Melzer v. CNET Networks, Inc.*, No. C 06-03817 WHA, 2006 WL 3716477, at *3-4 (N.D. Cal. Dec 15, 2006).

66. *Coffee & Schwartz*, *supra* note 17, at 262.

67. See *supra* note 22 and accompanying text.

institutional tussle that usually accompanies shifts in the law was present here. The new approach originated in federal court, ironically one of the institutions that is traditionally most sympathetic to the minority shareholder,⁶⁸ and with the exception of the lower court in *Maldonado*, the state courts and legislatures not only quickly followed suit, but also extended this enhanced business judgment deference to independent directors in other contexts.⁶⁹

Identifiable legal and social forces during the 1970s likely contributed to this change in approach.⁷⁰ One force was the public perception that the United States had become excessively legalized and litigious, with representative litigation, such as the class action, singled out as a leading culprit. Another force was the fear that the United States was entering an era of economic malaise, with lax leadership within some of the nation's key industries contributing significantly to the problem. Courts and shareholder suits play an essential role in assuring managerial integrity, but not so much in assuring managerial performance. If, consistent with the monitoring model, stronger and more independent boards were the solution to the latter problem, at least some policymakers may have seen enhanced board autonomy and greater freedom from judicial oversight as an important complement.

Perhaps these forces provide a sufficient explanation. But other factors—more specific to the derivative suit and the duties it seeks to enforce—likely contributed as well. Importantly, almost all of these explanations relate to the particular issues raised by the Corporate Impropriety suits, rather than by the Closely Held and Exploitation of Control suits.

A. *The Corporation's Best Interest*

Analytically, *Gall* and the other SLC cases established two separate propositions: (1) the criteria for dismissing a derivative suit include a determination that the suit is not in the best interest of the corporation and its shareholders, and (2) an SLC is entitled to make that determination on the corporation's behalf, protected by the business judgment rule. The result, as some have observed, is that the

68. See, e.g., Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 84-88 (1967).

69. See Kenneth B. Davis Jr., *Rethinking the Derivative Suit* 15-22 (April 2007) (unpublished manuscript, on file with Vanderbilt Law Review) (discussing enhancement of business judgment deference in the context of special litigation committees).

70. For a more comprehensive discussion of the role played by these forces, see *id.*

SLC nearly always recommends dismissal.⁷¹ Most of the commentary assumes that the culprit is proposition 2 and in response argues that the SLC's "structural bias" should negate the business judgment rule's applicability.⁷² In truth, though, proposition 1 is at least as important as proposition 2, particularly in light of the post-*Gall* developments discussed below.

This focus on proposition 1 suggests why the foreign payments cases invited rethinking of the derivative suit's overall value. These cases highlighted the potential for rift between legal merit—the recognized province of the courts—and the best interests of the corporation and its shareholders. Most obvious was the risk to the corporation's reputation and business prospects from exposing previously secretive foreign dealings to the discovery process and the publicity of litigation. Further, the prospects for any meaningful monetary recovery were quite small. A claim against those responsible for the payment might survive a motion to dismiss,⁷³ at least as to recovery of the amount paid.⁷⁴ But the amount paid is usually trivial compared to the corporation's overall assets. And even that amount might be limited by the "net loss" rule, to the extent that profitable business results from the payment.⁷⁵ Only in special circumstances would there be an overall loss that was both quantifiable and significant.⁷⁶ Indeed, reported recoveries were, on the whole, minor for

71. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1791 n.147 (2004); James D. 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.

72. See generally Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305 (2005); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821 (2004) (proposing a standard of "moderate review of the merits of directors' decisions" in cases involving structural bias).

73. For a survey of the available legal theories and applicable defenses, see John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1161-1241 (1977).

74. The classic case is *Roth v. Robertson*, 118 N.Y.S. 351 (Sup. Ct. 1909), holding the manager of an amusement park liable for hush money paid to allow the park to operate on Sundays, its busiest day of the week. For discussions of the continuing vitality of the *Roth* doctrine, see Coffee, *supra* note 73, at 1167-69; Kenneth B. Davis, Jr., *Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain—A Survey of, and Commentary on, the U.S. Corporate Law*, 13 CAN.-U.S. L.J. 7, 52-56 (1988).

75. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 7.18(c) cmt.e (1992) (discussing the "net loss" rule); Coffee, *supra* note 73, at 1213-22 (detailing the proximate cause defense and the net loss rule).

76. See, e.g., *In re Gen. Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075, 1080 (6th Cir. 1984) (\$100 million estimated loss from forfeiture of television licenses).

cases that settled.⁷⁷ The deterrence argument likewise is attenuated. New laws already had been enacted to address the specific conduct at issue,⁷⁸ so derivative suits contributed little to preventing a recurrence. And more generalized notions of deterrence had to account for the reality that the conduct being challenged entailed senior executives risking their careers for the benefit of shareholders.⁷⁹

B. Compensation and the Duty of Care

The preceding discussion prompts an obvious question: why did judicial deference extend from the foreign payments context to other areas? No doubt, some of the opposition to derivative suits related to the personal risk exposure facing individual directors for what might be deemed a lapse of judgment or failure of oversight years after the fact. Of course, state exculpatory statutes directly addressed this concern a decade later.⁸⁰ Nonetheless, the speed with which those statutes were enacted across the country in the wake of *Smith v. Van Gorkom* suggests that the underlying sentiment was widely felt and longstanding.⁸¹

Corporate lawyers long have agreed that, in practice, the risk of personal liability for negligence was remote. Directors could take comfort in Professor Bishop's oft-quoted observation that finding cases in which directors were held liable for negligence in the absence of self-dealing was a "search for a very small number of needles in a very large haystack."⁸² For a large U.S. corporation, however, the economic consequences of the typical board level decision could be so substantial

77. In his study of shareholder suits between 1970 and 1978, Jones identified only one questionable-payments derivative suit that yielded a monetary recovery to the corporation in excess of \$1 million—the \$3.36 million settlement in the Gulf Oil case. Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542, 548-51 (1980). This is in comparison to Gulf's 1974 assets of \$12.5 billion and gross revenues of \$18.2 billion. JOHN J. MCCLOY ET AL., *THE GREAT OIL SPILL 2* (1976).

78. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended at 15 U.S.C. §§ 78-78n).

79. Walter Werner wrote an interesting essay at the time, observing how the conduct of people like deposed Gulf Oil Corp. CEO Bob R. Dorsey seemed to belie the established Berle-and-Means thesis about the separation of ownership and control. Walter Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 388-90 (1977).

80. See, e.g., MODEL BUS. CORP. ACT § 2.02(b)(4) (1990); DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

81. 488 A.2d 858 (Del. 1985).

82. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099-1101 (1968).

that even a remote risk was unacceptable.⁸³ As the teachings of economics played a greater role in the analysis of corporate law during the 1970s, the problem was reframed in terms of risk allocation. The corporation might find it less costly to pass the risk of unfortunate decisions by its senior management to its shareholders, who can diversify their portfolio holdings, than to impose the burden on its risk-averse managers, who will insist on higher compensation in return.⁸⁴ The securities markets then could perform the task of pricing the resulting arrangement to compensate shareholders for the risk they bear. Thus, in the years leading up to *Van Gorkom*, proposals to eliminate or reduce the directors' liability for negligence appeared with increasing frequency in the corporate law literature.⁸⁵

The exculpatory statutes and enhanced judicial deference to independent directors have combined to marginalize the derivative suit for cases not involving self-dealing or other palpable breaches of the duty of loyalty. In suits challenging the board's oversight, the protection afforded by statutes makes it more difficult to excuse demand on the basis that the directors are the alleged wrongdoers.⁸⁶ Also, when assessing whether the suit is in the corporation's best interest, the board or the SLC can disregard the prospect of monetary recovery for conduct falling within the exculpatory provisions.⁸⁷ This is most significant for those corporations, such as financial institutions, where at least an argument for due care liability existed pre-statute. A notable illustration is *Joy v. North*, where, under the second step of the *Zapata* test, the court rejected the SLC's recommendation for a Connecticut bank to discontinue a derivative suit challenging a series

83. For a pre-*Gall* argument to limit the director's liability in response to these kinds of concerns, see Alfred F. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895.

84. See, e.g., *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982) ("[S]hareholders to a very real degree voluntarily undertake the risk of bad business judgment."); Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 936 (1983) ("Bad luck is inherent in the nature of an uncertain world, and its risk is better borne by stockholders. They can diversify against this risk to a greater extent than can directors or managers whose human capital is concentrated in the firm.")

85. Coffee & Schwartz, *supra* note 17, at 316-18; Conard, *supra* note 83; Scott, *supra* note 84, at 932-37; Elliot J. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 13-17 (1984).

86. See *Guttman v. Huang*, 823 A.2d 492, 501-02 (Del. Ch. 2003) (asserting that in the event that the charter insulates directors from liability for breaches of duty of care, a serious threat of liability may only be found to exist if the plaintiff pleads a non-exculpated claim against directors with particularized facts); *In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268, 1270-71 (Del. Ch. 1995) (same).

87. Indeed, that determination now derives legitimacy from the facts that the shareholders themselves, whose approval is required by most of the statutes, concluded that exculpation is in their best interest.

of risky loans to a developer.⁸⁸ In the court's view, termination was improper given "the probability of a substantial net return" to the corporation from the suit.⁸⁹ The court might well reach a different outcome today in view of Connecticut's 1990 amendment to its banking laws permitting limitation of directors' liability.⁹⁰

In terms of our three-part categorization scheme, the collective effects of these impediments to recovery for due care violations show up chiefly in the Corporate Impropriety cases, where the predominant theory of liability is failure of oversight. Very few of the cases discussed in Section IV.B reveal any significant monetary recovery. This does not imply that the combined effects of the exculpatory statutes and the more restrictive approach to demand were unintended, or even undesirable. A principal reason for the statutes was to address the concern that highly qualified individuals were refusing to serve on boards due to the threat of personal liability. With the board's oversight function in particular, the ensuing case law suggests a potentially slippery slope from "gross negligence" to "conscious disregard" to "bad faith."⁹¹ Incumbent and prospective directors therefore may regard the issue of who interprets and applies the exculpatory statutes (court or board committee) as the heart of the matter.

In any event, with the enactment of the exculpatory statutes, a highly visible component of the derivative suit's compensation function officially was removed. While the right of recovery for breakdowns in judgment or oversight may have been more theoretical than real, it no longer exists even in theory. As a result, justification for the derivative suit must rely increasingly on the suit's deterrent role, which, as discussed in Section III.D.2, presents problems of its own.

88. 692 F.2d 880 (2d Cir. 1982).

89. *Id.* at 894-97.

90. CONN. GEN. STAT. ANN. § 36a-97 (West 2007).

91. See, e.g., *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795, 809-11 (7th Cir. 2003) (citing *McCall*); *McCall v. Scott*, 250 F.3d 997, 999-1001 (6th Cir. 2001) (holding that, where the duty of care claims arose from the board's unconscious failure to act, with a Certificate of Incorporation which exempts the directors from personal liability, "a conscious disregard of known risks . . . if proven, cannot have been undertaken in good faith[; thus,] . . . plaintiffs' claims are not precluded by [the company]'s § 102(b)(7) waiver provision"). The Delaware Supreme Court, however, has made significant efforts to bring clarity to these issues in recent years. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 62-67 (Del. 2006). But as the recent decision, *In re SFBC Int'l, Inc. Sec. & Derivative Litig.*, No. 06-165 (SRC), 2007 WL 2127213, at *5-*9 (D.N.J. Jul 25, 2007), reveals, the existence of a sufficient number of "red flags" may still suffice to get the plaintiffs past the demand requirement.

C. Spilling over into the Duty of Loyalty

In the wake of the foreign payments cases, some saw the Delaware Chancery Court's opinion in *Maldonado* as a signal that courts would take a tougher stance in cases involving self-dealing or other personal gain—the traditional core of derivative litigation.⁹² While the Delaware Supreme Court's reversal of that decision on appeal dampened this hope, many still saw the care-loyalty distinction as the place to draw a line.⁹³ For example, the ALI prohibited termination of any derivative suit alleging self-dealing by a controlling person in its first draft of the *Principles of Corporate Governance*⁹⁴—a limitation that tracks the Exploitation of Control category. This prohibition was trimmed back over time and, as adopted, dealt only with terminations that would allow certain defendants to retain a significant improper benefit.⁹⁵

On the whole, however, so long as the independence presumptions of the business judgment rule have not been rebutted, courts generally have extended as much deference to the board or the SLC in duty of loyalty cases as in duty of care cases. In this situation, answering the “why” question becomes most speculative. Certainly, no explanation is directly comparable to the risk allocation rationale that was observed with the duty of care. No theoretical or commonsense case can be made that senior management should be able to line its pockets because it is easier for the shareholders to bear the resulting loss.

But the reality is more subtle. Often, an officer, director, or controlling shareholder will be the sole or most qualified source for a good or service of value to the corporation. Compensation relationships with senior management are the obvious example. Were there bright line tests to filter the beneficial self-dealing transactions from the abusive, the courts' job would be straightforward. Instead, courts are required to work with indeterminate criteria such as “good faith” and “entire fairness.”⁹⁶ Referring the decision back to the

92. *Genzer v. Cunningham*, 498 F. Supp. 682, 688 (E.D. Mich. 1980); Coffee & Schwartz, *supra* note 17, at 276-77.

93. *See, e.g.*, Scott, *supra* note 84, at 944-46 (discussing the roles of the duty of loyalty and duty of care).

94. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE, *supra* note 27, § 7.03(c)(iii).

95. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.10(b) (1992).

96. Much has been written in recent years on the indeterminate nature of corporate law, with a particular focus on Delaware. *See, e.g.*, Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1760-62 (2006) (discussing recent scholarship focusing on Delaware corporate law); Ehud Kamar, *Shareholder Litigation Under*

corporation's independent directors, therefore, becomes an inviting institutional alternative.

As a practical matter, three separate lines of judicial inquiry underlie the fairness test. The first two are the familiar fair dealing and fair price inquiries set forth by the Delaware Supreme Court in *Weinberger*.⁹⁷ The fair dealing inquiry fits easily within the court's core competence. If material information is concealed, established corporate practices are not followed, or other process flaws exist, the court can set aside the transaction without having to determine whether a hypothetical arm's length decisionmaker would have approved it. Likewise, courts have established tools to perform the fair price inquiry, especially if comparables are available. But many self-dealing transactions are, by their nature, unique. The court's resulting quandary is captured by the following passage from a law school casebook coauthored by a former Delaware chancellor:

Where the existing precedents leave room for discretionary judgments, the Chancery judges—who, of course, are the ones who must make the actual valuations of “fair prices”—seem more willing to defer to substitute process if it seems to have integrity. These judges understand from practice that valuation decisions are often impossible to make with confidence Gross disparities can be detected with some confidence, but subtle ones are impossible to detect.⁹⁸

The third line of inquiry can be labeled “business purpose”—the very test the court rejected in *Weinberger*.⁹⁹ That rejection notwithstanding, it is difficult to imagine, at least as a conceptual matter, how to evaluate whether a conflicted transaction is fair to the corporation and its shareholders without asking: fairness of the terms aside, is this something that an independent decisionmaker would have done? And answering that question typically will entail even greater indeterminacy than the other components. Consider, by way of illustration, two of the most prominent duty of loyalty suits of the era in which the restrictive approach to demand developed: (1) Zapata Corp.'s acceleration of the exercise date of stock options held by its CEO and other senior executives, which formed the basis of the

Indeterminate Corporate Law, 66 U. CHI. L. REV. 887 (1999) (discussing corporate decision-making in an environment of legal uncertainty); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998) (detailing Delaware's domination of the interstate competition in providing corporate law and the indeterminacy of its laws that contributes to its judicial advantage).

97. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

98. *Note on Cooke v. Oolie and the Delaware Supreme Court*, in WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 321 (2d ed. 2007).

99. In *Weinberger*, the court overruled the business-purpose requirement that it had imposed on parent-subsidiary mergers only a few years earlier in *Singer v. Magnavox Co.*, 380 A.2d 980 (Del. 1977). *Weinberger*, 457 A.2d at 715.

landmark Delaware decision and parallel cases in two federal courts;¹⁰⁰ and (2) Ford Motor Co.'s payment of the monthly maintenance fees on a Manhattan co-op apartment owned by its chairman, Henry Ford II.¹⁰¹ In each case—as with any fringe benefit—the insiders profited and the shareholders paid the price.¹⁰² But who can say with confidence that an arm's length employer would not have done the same? Had either of these suits gone to trial, the nagging question is what point of reference could the court have used to assess whether the board breached its fiduciary duty?

As these cases also illustrate, and as many on all sides of the debate over derivative suits' value have acknowledged,¹⁰³ the compensation element in many kinds of duty of loyalty cases, particularly those falling into the Corporate Impropriety category, is often trivial.¹⁰⁴ Suit nonetheless can be justified from a traditional fiduciary perspective by the deterrent effect of requiring the self-dealing executives to disgorge their ill-gotten gains unless they can prove the entire fairness of their conduct. But so long as it is plausible, though inevitably uncertain, that an independent decisionmaker may have conferred the same benefit, is it appropriate to brand the executives as miscreants simply because they cannot remove that uncertainty?¹⁰⁵ When derivative litigation's expense and potential for

100. In all, there were eleven reported decisions. See Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decision Making—Some Theoretical Perspectives*, 80 NW. U. L. REV. 1, 74 n.246 (1985).

101. See ROBERT LACEY, FORD: THE MEN AND THE MACHINE 620-26 (1986); *Ford Chairman Accused of Nepotism in Shareholder Suit*, WALL ST. J., Apr. 26, 1978, at 21.

102. In the Zapata cases, the benefit was two-fold: By allowing the executives to exercise their options in advance of the company's tender offer announcement, the acceleration reduced their income taxes, with a corresponding decrease in the company's tax deductions. Also, the company granted the executives interest-free loans to cover the tax burden. *Maher v. Zapata Corp.*, 714 F.2d 436, 439-42 (5th Cir. 1983).

103. See, e.g., James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 16 (1999) ("Tying the measure of the shareholder suit's social value to its compensatory functions most certainly will condemn it to failure."); Bryant G. Garth et al., *Empirical Research and the Shareholders' Derivative Suit: Toward a Better Informed Debate*, LAW & CONTEMP. PROBS., Summer 1985, at 137, 139 (referencing "illusory or de minimis compensation").

104. In the Zapata Corp. stock option cases, the cost of the tax benefit to the company was equivalent to about one cent per share. See Davis, *supra* note 100, at 75. In the case of Ford, Henry Ford ultimately reimbursed the company \$34,585, mostly for personal use of the co-op by his estranged wife and her friends, which had occurred without his knowledge. LACEY, *supra* note 101, at 649; Leonard P. Aparc, *Ford Discloses Chairman Repaid Firm After Audit*, WALL ST. J., Apr. 13, 1979, at 4.

105. While purely a matter of conjecture, it seems at least plausible that the Delaware courts' increasing recognition of the non-workability of the business-purpose test in the merger context, see *supra* note 99, at about the same time as the SLC and demand cases were being decided, may have given rise to fresh doubts about the judicial ability to delineate, in other contexts, what transactions were truly business motivated.

abuse is added into the mix,¹⁰⁶ shareholders may be better off with a less costly, even if fallible, process, such as remitting the issue to the corporation's independent directors. The potential for some public and judicial scrutiny of the independent directors' response, combined with the other sources of deterrence discussed in the next subsection, hopefully will keep the risk of managerial self-enrichment within tolerable limits—eliminating the “gross disparities” in the words of the passage quoted above. Admittedly, the independent board members may evaluate their colleagues' conduct more favorably than would a judge (the “structural bias” point¹⁰⁷). But if the residual risk of abuse remains economically significant, shareholders can be compensated for it in the price they pay for their shares.¹⁰⁸

There are limits to this kind of thinking. While the combination of unavoidable self-dealing, small stakes, and legal indeterminacy may justify deferring to the board on everyday loyalty issues, it is more difficult to justify deference for significant transactions outside the ordinary course, particularly when the board is subject to the influence of a controlling shareholder. That is why the distinction between the Corporate Impropriety and Exploitation of Control categories is significant. From that perspective, the most significant step in the case law was not *Gall* or *Zapata* but *Aronson v. Lewis*.¹⁰⁹ In addition to the doctrine *Aronson* articulated, it also marked the first extension of the restrictive approach to an Exploitation of Control situation.¹¹⁰

106. In the Ford suit, for example, all the charges were ultimately dropped. The plaintiff's attorneys nonetheless were paid \$230,000 in fees, which was set aside five years later by a federal court in a separate action. LACEY, *supra* note 101, at 621-24; Iver Peterson, *Suit Naming Henry Ford Is Dropped*, N.Y. TIMES, Jan. 12, 1980, at 27; Cohn, *Another Lawyer Are Ordered to Repay Ford Motor \$230,000*, WALL ST. J., May 17, 1985; *Fee Ruling on Ford Suit*, N.Y. TIMES, May 17, 1985, at D13.

107. See *supra* note 72 (discussing commentary that suggests that an SLC's “structural bias” should negate the business judgment rule's applicability).

108. See Davis, *supra* note 100, at 71-75 (discussing how shareholders “can adjust ex ante by reducing what they pay for their shares”).

109. 473 A.2d 805 (Del. 1984).

110. At issue was an “employment agreement” between the corporation and Leo Fink, its forty-seven percent shareholder, who was seventy-five years old at the time of the agreement. Under the terms of the agreement, which were automatically renewable after five years, Fink was to be paid \$150,000 annually plus a bonus if the corporation's profits exceeded \$2.4 million. The \$150,000 was equivalent to eighteen percent of the corporation's profits at the time. See *Meyers Parking System Reports Earnings for Qtr to Dec 31*, N.Y. TIMES, Mar. 2, 1982, at D19 (detailing revenues of the company). If the agreement was terminated, Fink was to become a consultant, initially at the same level of pay. In excusing demand, the lower court had emphasized that Fink's compensation under the agreement was to be unaffected by his ability to provide any services. *Lewis v. Aronson*, 466 A.2d at 383-84, *rev'd*, 473 A.2d 805 (Del. 1984). Nonetheless, the Supreme Court held that no reasonable doubt was created as to the application

Other courts appear more sensitive to the unique context of Exploitation of Control suits. In fact, the two principal post-*Zapata* decisions that rejected the deferential approach both fell into this category. *Miller v. Register & Tribune Syndicate, Inc.* involved a challenge to the corporation's sale of stock to directors and other key employees for what the plaintiff alleged was grossly inadequate consideration.¹¹¹ The sales were part of a larger plan to preserve control of the corporation in the hands of the founding Cowles family.¹¹² The Iowa Supreme Court ruled that when a majority of the directors are defendants, the board cannot empower an SLC to bind the corporation to terminating the derivative suit.¹¹³ And in *Alford v. Shaw*, the plaintiffs had alleged that the "Shaw group," the majority and controlling shareholder of All American Assurance Company ("AAA"), was responsible for a pattern of self-dealing and looting the corporation's assets.¹¹⁴ Both the North Carolina Court of Appeals¹¹⁵ and Supreme Court¹¹⁶ held that the business judgment rule did not shield the SLC's determination from judicial scrutiny.¹¹⁷

of the business judgment rule. Following remand, the complaint was amended to add allegations that Fink resided in Florida, while the corporate offices were in New York, and that he was receiving double compensation. The Court of Chancery again excused demand. *Lewis v. Aronson*, No. 6919, 1985 WL 11553 (Del. Ch., May 1, 1985). Fink continued to serve as the corporation's chairman until his death at age 84. See *Obituary: Leo Fink, 84, Philanthropist and Executive*, N.Y. TIMES, Nov. 17, 1988, at B22.

111. 336 N.W.2d 709 (Iowa 1983).

112. See *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311, 1315-16 (S.D. Iowa 1981); WILLIAM B. FRIEDRICKS, *COVERING IOWA: THE HISTORY OF THE DES MOINES REGISTER AND TRIBUNE COMPANY, 1849-1985*, at 82-83 (2000).

113. 336 N.W.2d at 715-18.

114. According to the Supreme Court this included:

failing to exercise an option to purchase shares of AAA stock from Great Commonwealth Life Insurance Company (GCL) and failing to exercise a "put" to sell shares of AAA stock to American Commonwealth Financial Corporation (ACFC); paying excessive amounts to affiliated companies for administrative expenses; entering into certain allegedly improper reinsurance and coinsurance agreements; redeeming certain 8% debentures held by affiliated companies; releasing American Bank and Trust Company (ABTC) of Baton Rouge, Louisiana, from an obligation to purchase an office building; and engaging in other allegedly improper transactions with affiliates, including unsecured loans and joint ownership of airplanes.

Alford v. Shaw, 349 S.E.2d 41, 44 (N.C. 1986), *withdrawn*, 358 S.E.2d 323 (N.C. 1987).

115. *Alford v. Shaw*, 324 S.E.2d 878 (N.C. Ct. App. 1985), *rev'd*, 349 S.E.2d 41 (N.C. 1986), *withdrawn*, 358 S.E.2d 323 (N.C. 1987).

116. *Alford v. Shaw*, 358 S.E.2d 323, 328 (N.C. 1987).

117. Following remand, the trial court approved the parties' settlement of some issues but otherwise accepted the recommendations of the SLC, a decision that was upheld on appeal. See *Alford v. Shaw*, 398 S.E.2d 445, 447, 452-60 (N.C. 1990) (reviewing trial court evaluations of SLC).

117. MODEL BUS. CORP. ACT § 7.44(a)-(b) (1984); see IOWA CODE § 490.744(1)-(2) (2007) (adopting deferential MBCA approach); N.C. GEN. STAT. § 55-7-44(a)-(b) (2007) (adopting same).

Neither decision is the controlling law. Both Iowa and North Carolina have adopted the Model Business Corporation Act ("MBCA") provisions requiring the court to defer to the recommendation of the board or the SLC.¹¹⁸ The legal process dimensions of this development are consistent with the theory that the courts' more restrictive approach to derivative suits stems from a stereotype associated with the Corporate Impropriety cases. While courts confront the facts of the case before them, legislators are affected more by general public opinion.

D. The Growth of Alternatives

Two descriptions of the derivative suit were cited regularly over the years. One is the Supreme Court's 1949 statement in *Cohen v. Beneficial Industrial Loan Corp.* that the derivative suit "was long the chief regulator of corporate management."¹¹⁹ Ten years later, Eugene Rostow characterized derivative litigation as "the most important procedure the law has yet developed to police the internal affairs of corporations."¹²⁰ Read today, both statements seem timeworn. By the late 1960s, a number of institutional developments began to supplement and supplant the derivative suit with respect to both of its recognized roles—compensation and deterrence. The availability of alternatives surely contributed to the courts' willingness to entrust greater control of the derivative suit to the corporation's independent directors. In turn, the resulting limitation on the shareholder's access to the courts likely contributed to the further growth and expansion of some of these institutional alternatives.

1. Compensation

Many observers question whether derivative suits perform a meaningful compensatory function.¹²¹ In a 1991 study, Professor Roberta Romano evaluated shareholder suits against 535 present and former NYSE and NASDAQ National Market firms from the late

118. IOWA CODE ANN. § 490.744(2); N.C. GEN. STAT. ANN. § 55-7-44(a) (West 2007).

119. 337 U.S. 541, 548 (1949).

120. Eugene V. Rostow, *To Whom and for What Ends are Corporate Management Responsible?*, in *THE CORPORATION IN MODERN SOCIETY* 46, 48 (Edward S. Mason ed., 1960).

121. In addition to the studies discussed in the text, see Daniel R. 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, 277-83 (1986) (suggesting that the positive wealth effects of allowing a derivative suit to proceed are, at most, slight).

1960s through 1987.¹²² Only twenty-one percent of the derivative suits that she identified resulted in “cash payouts to shareholders,” and the average suit amount was \$6 million, equivalent to 0.5 percent of the corporation’s assets or eighteen cents per share.¹²³ Because most of the suits in her sample predated the enactment of the exculpatory statutes,¹²⁴ recoveries may be even lower today. In their study of Delaware derivative suits filed in 1999 and 2000, Professors Robert Thompson and Randall Thomas found that of fifty lead cases resolved, only six resulted in monetary recovery.¹²⁵ Even when monetary recovery is obtained on behalf of the corporation, a circularity problem arises when, as is often the case, the corporation’s D&O insurer pays the recovery. Increases to the corporation’s premium rates may offset a substantial portion of the recovery.¹²⁶

The dismissal of the derivative suit’s compensation function may be yet another byproduct of the tendency to think principally in terms of large cap corporations. The prospect of substantial monetary recovery may depend heavily on the category of case at issue. Of the six cases that produced a monetary recovery in the Thompson and Thomas study, four appear to fit the Exploitation of Control category.¹²⁷ In a similar vein, a recent study by Professors Bernard Black, Brian Cheffins, and Michael Klausner identified only six derivative suits against outside directors of public companies that had gone to trial from 1985 through 2000.¹²⁸ The only two cases won by plaintiffs were again Exploitation of Control cases.¹²⁹

For Corporate Impropriety cases, on the other hand, the evidence suggests that securities and other class actions now perform many of the functions previously associated with the derivative suit. A

122. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 61-62 (1991).

123. *Id.* at 61-62.

124. *See supra* notes 80-91 and accompanying text.

125. Thompson & Thomas, *supra* note 71, at 1775-76.

126. *See* John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 805-06 (1984) (discussing circularity problem of corporations funding their own recovery and noting that premium rate increases may shelter managers).

127. Thompson & Thomas, *supra* note 71, at 1776-78, 1777 tbl.13A. Likewise, all three of the large settlements Thompson and Thomas identify as producing monetary relief for non-publicly-traded entities appear to have Exploitation of Control characteristics with owners claiming against corporate managers. *Id.* at 1777-78, 1778 tbl.13B.

128. Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1155 (2006).

129. *See id.* at 1156 tbl.B3 (noting two suits won against outside directors of public companies).

starting point is the sheer number of filings and size of recoveries.¹³⁰ Over the last ten to fifteen years, securities class actions have been filed against publicly traded companies at a rate of roughly 250 per year.¹³¹ Median settlements have been in the \$6 to \$7 million range. This compares to the roughly fifty suits per year brought against publicly traded companies in the Delaware state courts in 1999-2000.¹³² Even more dramatic is the rise of the state law class action challenging the directors' conduct in connection with a merger or acquisition transaction. The Thompson and Thomas data show that class action cases now outnumber derivative suits by several-fold in Delaware.¹³³

A plausible inference is that because of Delaware's stricter approach to demand and deference to SLCs, shareholders are relying more on class actions to litigate the fiduciary-based claims that were once the principal province of derivative litigation. Professors Robert Thompson and Hilary Sale report that securities class actions typically involve misrepresentations rooted in a failure by the corporation's senior officers to perform their duty of care and their oversight function—a traditional focus of state law¹³⁴ that exculpatory statutes have foreclosed.¹³⁵ Along similar lines, in a study of acquisition-related class actions, Professors Thompson and Thomas found that a majority of the filings, and an even higher proportion of the cases resulting in monetary relief, raised classic duty of loyalty issues—a transaction with a controlling shareholder or incumbent

130. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2006: A YEAR IN REVIEW 1-3 (2007), available at http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf; TODD FOSTER ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: FILINGS PLUMMET, SETTLEMENTS SOAR 1-3 (2007), available at http://www.nera.com/Publication.asp?p_ID=3028.

131. See FOSTER ET AL., *supra* note 130, at 2 (graphing total number of filings between 1991 and 2006).

132. Thompson & Thomas, *supra* note 71, at 1761-62. More than half these suits resulted in no relief for the plaintiffs, and only six of fifty-seven complaints led to monetary recovery. *Id.* at 1775-77, 1775-77 tbls.12 & 13A.

133. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 168-69, 169 tbl.2 (2004). Among all fiduciary duty complaints against public companies filed in Delaware in 1999-2000, Thompson and Thomas identified 108 derivative suits filed against public entities compared to 765 acquisition-related class actions filed against public entities. *Id.* at 169 tbl.2. If the data are confined to lead complaints, the numbers are fifty-six and 194, respectively. *Id.*

134. See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 897-99, 904-05 (2003) (discussing consequences of misrepresentation and federalization of claims traditionally seen in state courts).

135. See *supra* Part III.B (discussing consequences of enacting exculpatory statutes).

management.¹³⁶ Duty of loyalty issues figure less prominently in securities class actions—parties invoke them most often to plead scienter¹³⁷—but they remain the mainstay of the derivative suit.¹³⁸ Today's derivative suit therefore may function mostly as the repository for self-dealing and other duty of loyalty claims that neither arise in an acquisition context nor involve substantial stock market losses. That the overwhelming majority of the recent stock option backdating cases have been filed as derivative suits¹³⁹ supports this characterization.

Serious questions exist, however, regarding whether the securities class action will continue to play as visible a role as it has in the past. The number of new filings has dropped in recent years.¹⁴⁰ Further, the securities class action has become at least as much of an anathema as the derivative suit once was. Although the last comprehensive legislative efforts to trim class actions back is barely ten years old,¹⁴¹ there are calls for another round.¹⁴² Litigation reform has been a theme in a series of recent reports addressing the threats to the global competitiveness of U.S. capital markets.¹⁴³ Two years

136. See Thompson & Thomas, *supra* note 133, at 138-39, 173-75, 175 tbl.5, 196 (discussing nature of cases resulting in monetary relief). Indeed, class actions involving controlling shareholder transactions and MBOs represent approximately half of all acquisition-related complaints and approximately eighty-one percent of the cases resulting in additional monetary consideration. See *id.* at 199-204, 199 tbl.17 (distinguishing form of relief in acquisition cases by transaction type).

137. See Thompson & Sale, *supra* note 134, at 901, 908 (discussing the scienter element and noting that duty of loyalty claims in class actions often serve as "hooks, not substantive claims").

138. See Thompson & Thomas, *supra* note 71, at 1772-74, 1772 tbl.11 (noting that "almost 60 percent of the complaints raise principally a duty of loyalty claim").

139. See *infra* notes 158-162 and accompanying text (discussing backdating cases filed as derivative suits).

140. CORNERSTONE RESEARCH, *supra* note 130, at 3-4; FOSTER ET AL., *supra* note 130, at 1-2. After a dramatic decline in 2006, filings increased in 2007 (due largely to the subprime lending crisis), but remain well below the average for the prior ten years. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2007: A YEAR IN REVIEW 2-7 (2008), available at <http://securities.cornerstone.com/pdfs/YIR2007.pdf>; STEPHANIE PLANCICH ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTIONS: FILINGS RETURN TO 2005 LEVELS AS SUBPRIME CASES TAKE OFF; AVERAGE SETTLEMENTS HIT NEW HIGH 1-2 (Dec. 2007), available at http://www.nera.com/image/BRO_Recent_Trends_12-07_web_3_FINAL.pdf.

141. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. § 77z-1 (2000)).

142. See H.R. 3931, 110th Cong. (2007) (proposing amendments to 15 U.S.C. § 77z-1 that would allow courts to impose fees and expenses of litigation on losing plaintiffs).

143. See MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 73-78, 100-04 (2007), available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (discussing threat of litigation and offering remedial recommendations); COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT 74-84 (2006), available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (same); COMM'N ON

ago, the Supreme Court opted for a restrictive approach to establishing loss causation in securities fraud cases.¹⁴⁴ Last term, it adopted a restrictive approach to pleading scienter,¹⁴⁵ and this term, it rejected “scheme liability.”¹⁴⁶

2. Deterrence

By the time *Gall* and the other SLC cases were decided, several regulatory and enforcement mechanisms had evolved to challenge the derivative suit’s historical reputation as the “the chief regulator of corporate management.”¹⁴⁷ Most visible was the SEC’s enforcement program. The SEC’s civil injunctive actions soared from an eight-year low of sixty-seven in 1966 to 178 in 1973.¹⁴⁸ In August 1972, a separate Division of Enforcement was created; it pursued high-visibility actions against Penn Central,¹⁴⁹ Robert Vesco, Equity Funding, C. Arnholt Smith, and National Student Marketing Corp.¹⁵⁰ The threat of criminal prosecution also had a greater role in the corporate arena. The 1970s and early 1980s have been described as the “heyday” for focusing on white collar crime at the federal level, as its share of total prosecutions more than doubled in less than a decade.¹⁵¹

How effective are these alternative sources of deterrence today? Certainly, the priority given various enforcement and prosecution initiatives will ebb and flow, as scandals such as Enron burst into the

THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 28-31 (2007), available at <http://www.capitalmarketscommission.com/portal/capmarkets/default.htm> (select “Download the full report”) (same).

144. See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-45 (2005) (rejecting Ninth Circuit loss-causation standard that allowed plaintiffs to show only that the price of a security on the purchase date was inflated because of misrepresentations).

145. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504-05 (2007) (“[A]n inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”).

146. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, 2008 WL 123801 (U.S. Jan. 15, 2008).

147. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949).

148. U.S. SEC. & EXCH. COMM’N, 39TH ANNUAL REPORT 170 tbl.26 (1973), available at http://www.sec.gov/about/annual_report/1973.pdf.

149. U.S. SEC. & EXCH. COMM’N, 38TH ANNUAL REPORT 17-18 (1972), available at http://www.sec.gov/about/annual_report/1972.pdf.

150. U.S. SEC. & EXCH. COMM’N, *supra* note 148, at 21-24, 80-81, 84-85.

151. JEROLD H. ISRAEL ET AL., *WHITE COLLAR CRIME: LAW AND PRACTICE* 24 (1996) (quoting 1986 testimony from the Deputy Attorney General). For a discussion of the reasons for this enhanced reliance on criminal prosecutions during the 1970s, see Jack Katz, *The Social Movement Against White-Collar Crime*, 2 *CRIMINOLOGY REV.* Y.B. 161 (Egon Bittner & Sheldon L. Messinger eds., 1980).

public consciousness, then fade from memory. Whatever the climate at the time, the criminal or administrative sanction is rooted in the corporate consciousness as a viable deterrent to serious wrongdoing.

Even in the absence of formal sanction, the stigma of corporate misconduct now looms larger than ever for those, such as outside directors, whose career opportunities are dependent on their business reputation and public image. The case of Enron's directors makes this dramatically clear.¹⁵² And the enhanced coverage of business and financial news make it unlikely that any newsworthy misdeed will go unreported.

The recent disclosures of stock option backdating afford a unique cross-company insight into the relative prevalence of these various sources of deterrence in the contemporary legal climate. The *Wall Street Journal* maintained and regularly updated an "Options Scorecard" of "companies that have come under scrutiny for past stock option grants and practices."¹⁵³ As of August 1, 2007, the list included 141 companies that had disclosed misdated options, governmental investigations, accounting restatements, or the departure of senior executives.¹⁵⁴ Of these, 105 had been contacted by the SEC and fifty-four had received subpoenas from the Justice Department. What role has private litigation played in comparison? A blog entitled "The D&O Diary" maintains an up-to-date listing of the relevant suits.¹⁵⁵ As of August 1, 2007, it identified 160 companies that were the subject of

152. See Gretchen Morgenson, *Sticky Scandals, Teflon Directors*, N.Y. TIMES, Jan. 29, 2006, at C1 (describing stigmatizing effect of facing trial on Enron executives); Anil Shivdasani, *Damaged Directors, Non-Executive Directors of Companies Accused of Fraud Quickly Find Their Reputation Under Scrutiny. Is This the Result of Legislation or Market Forces?*, FIN. TIMES, June 2, 2006, pt. 2, at 2 (positing that the "appearance of impropriety" may be enough to ruin a business career). Empirical research on the issue of reputational sanctions facing outside directors is now beginning to appear and confirm these impressions. See Eliezer M. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, 86 J. FIN. ECON. 306 (2007) (investigating reputational impact of fraud investigations); Suraj Srinivasan, *Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members*, 43 J. ACCT. RES. 291, 291-92 (2005) (examining significant labor market penalties for outside directors).

153. Wall Street Journal, Options Scorecard, <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html> (last updated Sept. 4, 2007).

154. *Id.* The site noted that the list contains "[s]ome companies that have undertaken or disclosed internal probes but no further news may not be included." *Id.*

155. *Counting the Options Backdating Lawsuits*, D & O DIARY, July 20, 2006, <http://dandodiary.blogspot.com/2006/07/counting-options-backdating-lawsuits.html> (last updated Feb. 9, 2008).

derivative suits, twenty-nine of which were also the subject of securities class actions and five of ERISA actions.¹⁵⁶

These numbers are consistent with the critique that derivative suits simply piggyback on what the government (or perhaps even the media) already has uncovered and investigated.¹⁵⁷ As a result, the derivative suit can contribute to deterrence only when either the private plaintiff follows through with litigation that the governmental agency lacks the resources or willingness to continue, or when the plaintiff can obtain relief not available to the government.¹⁵⁸ Too often, however, the economic pressures facing the plaintiff's attorney, coupled with the defendant's access to indemnification and insurance, leads to a quick and non-pecuniary settlement that supports the award of attorneys fees but imposes little, if any, monetary cost on the individual defendant.¹⁵⁹

A separate challenge to evaluating the marginal deterrence created by the derivative suit is that deterrence often will vary with the beholder. A recent article on class actions comments that "[e]xecutives tempted to lie about earnings are more concerned about [plaintiff's attorneys] Bill Lerach and Melvyn Weiss than they are about the Securities and Exchange Commission."¹⁶⁰ This is a provocative comment; many onlookers might argue exactly the opposite. Consider, for example, former SEC Commissioner Joe Grundfest's recent observation that the explanation for the recent sharp decline of securities class actions might be simply that there is

156. *Id.* Two companies (PainCare Holdings, Inc. and Wireless Facilities, Inc.) were the subject of securities class actions, but not derivative suits. *Id.* Neither of these was on the *Wall Street Journal* list. Options Scorecard, *supra* note 153.

157. In virtually none of the cases is there any indication that the plaintiff's attorney unearthed the violation. Typically, detection of potentially improper backdating was the product of a governmental inquiry, internal corporate investigation, or research by a securities analyst. This "piggyback" aspect is not limited to the derivative suit, but characterizes other forms of representative litigation, as well. See John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215, 220-22, 222 n.16 (1983) (collecting examples of private litigation piggybacking off government prosecution).

158. For a general review of the advantages and disadvantages of private litigation as a supplement to public enforcement, see Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 106-20 (2005).

159. See John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 23-33 (discussing pressures to settle cases and noting significant examples); Romano, *supra* note 122, at 63-65 (noting that data "make[s] plain that the principal beneficiaries of cash payouts in shareholder suits are attorneys").

160. Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 106 (2006).

now less fraud, due to aggressive SEC and Justice Department enforcement in the wake of Enron and WorldCom.¹⁶¹

Notwithstanding this challenge to assessing the derivative suit's incremental contribution to deterrence, circumstances are identifiable where that contribution is likely to be greatest. Sections IV.A through IV.C confirm that these factors are prevalent in the Closely Held and Exploitation of Control cases. Misconduct at smaller companies, whose shares are traded less actively, will be more likely to escape the awareness and the interest of governmental agencies and the media. Further, many shareholders at these companies will be closer to corporate affairs than their counterparts at more widely traded companies, so that litigation will be client driven more frequently than lawyer driven. Second, cases seeking the return of a substantial personal benefit pose a greater threat of personal loss to individual defendants, which will not be covered by indemnification or insurance.

IV. A THREE-CATEGORY TYPOLOGY OF DERIVATIVE SUITS

To understand the role of derivative litigation today, this study collects reported decisions in suits asserting derivative claims against Delaware corporations during the current decade (2000 through the first quarter of 2007). "Derivative claims" include both claims pleaded as derivative claims and claims pleaded as direct claims but adjudged to be derivative. In all, the study identifies 294 separate cases.¹⁶² Multiple opinions in the same case or in separate cases that subsequently were consolidated are treated as a single case for purposes of the study. Of the 294 cases, 121 were in Delaware state court and 173 were in federal court.

As noted in the Introduction, the three-category typology that emerges questions the wisdom of the conventional public/private dichotomy in understanding the derivative suit's role. The Closely Held category includes corporations, limited liability companies, and limited liability partnerships in which equity participation is confined to a relatively small number of active participants, capital suppliers,

161. Joseph A. Grundfest, Editorial Commentary, *The Class-Action Market*, WALL ST. J., Feb. 7, 2007, at A15.

162. The cases were identified based on searches using the term "derivative" in the Lexis-Nexis "DECTS" and the Westlaw "DEBUS" and "DE-CS" databases, and the string "derivative and Delaware" in the Westlaw "ALLFEDS" database. No effort was made to include derivative suits involving Delaware corporations that were decided in other state courts. All opinions dated between January 1, 2000, and March 31, 2007, were reviewed. In all, more than 2100 separate opinions were screened to yield the 294 for this study. Case list is on file with Vanderbilt Law Review.

family members, and employees. The other two categories consist of widely held firms. At issue in the Corporate Impropriety cases is the directors' responsibility for some wrongful act at the corporate level—typically a violation of law or a regulatory requirement. The Exploitation of Control category involves corporate transactions with, or on behalf of, the persons who control it. For cases in this category, the corporations tend to be smaller, the plaintiffs tend to hold significant blocks of stock, and the stock tends to be thinly traded, especially compared to that of the corporations in the Corporate Impropriety category. Table 1 indicates the breakdown of suits among categories. As it reveals, the Corporate Impropriety cases tend to be brought in federal court, likely due in part to the exclusive federal jurisdiction over claims to enforce the Securities Exchange Act of 1934, while the Exploitation of Control cases tend to be brought in Delaware state court. The Closely Held cases are more evenly divided.

Table 1. Total Cases

| | Closely Held | Corporate Impropriety | Exploitation of Control |
|-----------------------------|---------------------|------------------------------|--------------------------------|
| Federal Court | 32 | 109 | 32 |
| Delaware State Court | 26 | 43 | 52 |
| Total | 58 | 152 | 84 |

It is worth emphasizing that the cases were not collected with the intention of fitting them into these categories. Rather, the objective was to evaluate cases involving publicly traded corporations on a variety of grounds. But the pattern became apparent when the first group of cases was being evaluated, and it held with the extension of the study to the full 7.25-year period. Questions as to category fit arose in only twelve percent (thirty-six) of the cases. For example, some of the subject firms, though not publicly traded, had such high numbers of outside investors that they could not be described accurately as closely held. Also, recurring issues occasionally arose involving publicly traded firms that did not fit neatly into either the Corporate Impropriety or the Exploitation of Control category. For example, some involved a failure to pursue a possible merger or the sale of the company. Such cases were relatively few, and every effort was made to evaluate their individual facts and place them in whichever category was the better fit.

Any study that relies on reported decisions to make inferences about the larger body of litigation faces methodological objections.¹⁶³ No assurance exists that written decisions or the opinions included in databases are truly representative. That the opinions divide neatly into certain categories does not prove that the entire universe of shareholder derivative claims would do the same—but the prospect of a significant “phantom” category that never finds its way into the written opinions seems remote. More plausibly, that the cases in a particular category of written opinions have certain attributes does not establish that all cases in that category have those attributes. Yet written opinions are the lawyer’s stock and trade. The solution therefore is not to dismiss judicial opinions as the focus of study, but rather to be sensitive to possible sources of sample bias, and qualify the inferences drawn from these opinions accordingly.

Institutional characteristics of the derivative suit, however, make representativeness less of a problem than in other litigation contexts. For example, if, as will often be the case,¹⁶⁴ defendants settle more egregious cases quickly, then written opinions would give a misleadingly low portrayal of the true risk of liability. But prospective derivative suit defendants will be less drawn to out-of-court settlements¹⁶⁵ because, in the absence of court approval, settling with one shareholder may not bar others from bringing the same claim.¹⁶⁶

163. See Lee Epstein & Gary King, *The Rules of Inference*, 69 U. CHI. L. REV. 1, 15 (2002) (“We find that serious problems of inference and methodology abound everywhere we find empirical research in the law reviews . . . of the legal community.”); George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 3-4 (1984) (noting habit among legal scholars to infer rules from collections of cases and the challenges presented by these inferences); Vicki Schultz, *Telling Stories About Women and Work: Judicial Interpretations of Sex Segregation in the Workplace in Title VII Cases Raising the Lack of Interest Argument*, 103 HARV. L. REV. 1749, 1766 n.71 (1990) (recognizing limitations of study based on inference from searched sample of cases); Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges To Executive Pay: An Exercise In Futility?*, 79 WASH. U. L.Q. 569, 574-75 (2001) (recognizing impossibility of determining frequency of shareholder challenges because of limits of empirical research and sample selection bias). *But see* Richard L. Revesz, *A Defense of Empirical Legal Scholarship*, 69 U. CHI. L. REV. 169 (2002) (offering defense of legal empirical scholarship and counter-critiquing Epstein & King, *supra*).

164. *Cf.* Priest & Klein, *supra* note 163, at 14-17 (arguing parties are more likely to settle disputes further removed from the standard of liability).

165. Judicially approved (or rejected) settlements, in contrast, often lead to written opinions, which are included in the data set.

166. Of course, the corporation itself can always settle out of court with the defendants, at which point the shareholders’ attack is on the settlement rather than the underlying transaction. *E.g.*, *Wolf v. Barkes*, 348 F.2d 994, 996-97 (2d Cir. 1965); *Kahn v. Kaskel*, 367 F. Supp. 784, 789 (S.D.N.Y. 1973) (“[N]othing . . . prohibits a corporation from making an out-of-court settlement Nonetheless, the corporation settling out of court acts at its peril for such a settlement . . . fails to compromise or dismiss the derivative action [and] leaves the derivative plaintiff free ‘to challenge the settlement’”).

Further, prospective derivative plaintiffs and their attorneys may seek to get their claims to the courthouse in hopes of being awarded control of the case. For both of these reasons, a higher proportion of derivative claims should result in filed lawsuits than for other types of disputes, particularly in the Corporate Impropriety category. Out-of-court resolution remains a more realistic possibility in the Closely Held category and, to a lesser extent, the Exploitation of Control category, where the number of prospective parties is smaller.

The Thompson and Thomas study of derivative litigation gives insight into how many derivative suit filings lead to judicial resolution.¹⁶⁷ By focusing on derivative suits filed in the Delaware state courts during 1999 and 2000, their work includes many of the cases that led to the written opinions in the present study. Derivative litigation is characterized by extensive pretrial motion activity, which enhances the likelihood that any particular filing will lead to a written opinion. Thompson and Thomas identified eighty-three lead case filings for the two-year period, with substantive motions filed in fifty-three of them.¹⁶⁸ The present study identified written decisions in one hundred separate Delaware cases filed, in whole or in part, as derivative suits over the relevant 7.25-year period.¹⁶⁹ On average, therefore, at least one of every three lead cases yields at least one written opinion. The breakdown between private and public companies provides an additional check on the representativeness of the data. In the Thompson and Thomas study, private companies represented thirty percent of the total cases and twenty-eight percent of those in which substantive motions were filed.¹⁷⁰ In the present study, twenty-one percent of the Delaware cases that were filed as derivative suits involved private companies.

The most interesting differences between the present results and those of Thompson and Thomas relate to the role of the demand requirement. Thompson and Thomas found that courts made a ruling on demand in only eight of their eighty-three lead cases, with defendants prevailing in five of them.¹⁷¹ They concluded that “demand

167. Thompson & Thomas, *supra* note 71.

168. Substantive motions were filed in fifteen of the twenty-five private-company cases in their study, *id.* at 1767, and in thirty-eight of the fifty-seven public-company cases, *id.* at 1780.

169. Consistent with Thompson and Thomas, these one hundred cases include only those in which a derivative claim was filed as such, and omit the twenty-one cases in which a purported direct claim was ruled to be derivative. *See id.* at 1762 (selecting only suits originally filed as derivative claims).

170. *See id.* at 1762 tbl.3 (distinguishing private and public entity derivative cases); *see also supra* note 168 (calculating cases in which substantive motions were filed in study by Thompson & Thomas, *supra* note 71).

171. Thompson & Thomas, *supra* note 71, at 1783.

does not appear to be carrying as much of the weight of derivative litigation as one might think given the attention devoted to that topic in the academic literature and case commentary.”¹⁷² The written opinions in the present study suggest a different characterization: Demand was at issue in forty of the opinions,¹⁷³ was alluded to in six others, and had been addressed in prior opinions in six more. Consistent with the Priest-Klein hypothesis,¹⁷⁴ outcomes in the forty cases were evenly split—demand was excused in nineteen and required in twenty-one. Further, of the twenty additional Delaware cases where purported direct claims were ruled to be derivative, seven were dismissed for failure to make a demand or to establish its futility. Demand was an issue in an overwhelming number of the federal cases as well.

This indicates, at a minimum, that active, substantive litigation in derivative suits often concerns the demand requirement. Thus, a fair inference is that the parties’ assessment of the plaintiff’s ability to survive the demand requirement figures significantly in the settlement value of those claims that never result in written opinions. The resulting story is as follows: Prospective plaintiffs hardly ever make pre-suit demands on the board.¹⁷⁵ The reasons are understandable. To do so works as a concession of the board’s independence,¹⁷⁶ and the plaintiff only can overcome the board’s rejection of the demand by establishing that it was “wrongful.”¹⁷⁷

172. *Id.*

173. Compare this forty percent rate with Thompson and Thomas’s data on substantive motions, which they defined to include “motions to dismiss for failure to state a claim, motions for summary judgment, and motions to dismiss for failure to make demand.” *Id.* at 1767 n.84. The eight rulings on demand in their study represent only fifteen percent of the fifty-three cases in which substantive motions were filed. *Id.* at 1767, 1780, 1783. This suggests that judges are more likely to issue written opinions when demand is at issue than when other grounds for dismissal are asserted.

174. See Priest & Klein, *supra* note 163, at 17-20 (hypothesizing that because parties are likely to take only close cases to trial, the outcomes of those cases should be split evenly between plaintiff and defendant victories).

175. Thompson and Thomas found no Delaware cases in which a demand was made. Thompson & Thomas, *supra* note 71, at 1782. I found only two. *Burns v. Friedli*, 241 F. Supp. 2d 519, 525-26 (D. Md. 2003); *Canadian Commercial Workers Indus. Pension Plan v. Alden*, No. Civ.A. 1184-N, 2006 WL 456786, at *10 (Del. Ch. Feb. 22, 2006). Also, wrongful refusal had been addressed in an earlier opinion in another of the cases in the study. *Grimes v. Donald*, 673 A.2d 1207, 1219-20 (Del. 1996).

176. *Grimes v. Donald*, 673 A.2d 1207, 1217-20 (Del. 1996); *Levine v. Smith*, 591 A.2d 194, 212 (Del. 1991); *Spiegel v. Buntrock*, 571 A.2d 767, 775-76 (Del. 1990).

177. *Levine*, 591 A.2d at 210-12; *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 n.10 (Del. 1981).

without the benefit of discovery.¹⁷⁸ Unwilling to make demands, plaintiffs must take their chances and hope to establish either that demand is futile or that their claims qualify as direct rather than derivative.

A. Closely Held Firms

For closely held businesses, the derivative suit plays a subordinate role in redressing harm to minority shareholders. Plaintiffs can use three alternative remedies and theories, at least one of which is available in the vast majority of states.

Most prevalent are statutes that allow shareholders to petition for dissolution or other relief on a variety of grounds, most notably “illegal, fraudulent, oppressive, or unfairly prejudicial” conduct by those in control of the corporation.¹⁷⁹ Focusing on the term “oppressive,” several courts have interpreted this language broadly, embracing any course of conduct that defeats the “reasonable expectations” of the minority shareholder,¹⁸⁰ although some recent decisions have rejected such a broad approach.¹⁸¹ A second source of redress derives from the doctrine originated by the Massachusetts courts. Accordingly, because of the unique vulnerability of shareholders in a close corporation, they owe one another the same “utmost good faith and loyalty” as is owed among partners in a general partnership.¹⁸² Several other states now take this or a similar position.¹⁸³ Because these duties run to the individual shareholder,

178. *Scattered Corp. v. Chi. Stock Exch., Inc.*, 701 A.2d 70, 77 (Del. 1997); *Levine*, 591 A.2d at 208-09.

179. See, e.g., MODEL BUS. CORP. ACT § 14.30(2)(ii) (1984) (dissolution); MODEL STATUTORY CLOSE CORP. SUPP. § 40(a)(1) (1984) (multiple remedies). Similar provisions have been enacted in the overwhelming majority of states. See 3 MODEL BUS. CORP. ACT ANN. § 14.30 statutory comparison (Supp. 2005); MODEL STATUTORY CLOSE CORP. SUPP. statutory comparison (1988), reprinted in 4 MODEL BUS. CORP. ACT ANN.

180. *Fox v. 7L Bar Ranch Co.*, 645 P.2d 929, 932-34 (Mont. 1982); *Brenner v. Berkowitz*, 634 A.2d 1019, 1028-30 (N.J. 1993); *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1179 (N.Y. 1984); *Balvik v. Sylvester*, 411 N.W.2d 383, 385-88 (N.D. 1987); Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 715-18 (1993); cf. MINN. STAT. ANN. § 302A.751(3a) (expressly incorporating “reasonable expectations” test); *Meiselman v. Meiselman*, 307 S.E.2d 551, 558-60, 562-65 (N.C. 1983) (noting that the statute authorized relief “reasonably necessary for the protection of the rights or interests of the complaining shareholders”).

181. *Franchino v. Franchino*, 687 N.W.2d 620, 629-30 (Mich. Ct. App. 2004); *Kiriakides v. Atlas Food Sys. & Servs., Inc.*, 541 S.E.2d 257, 264-66 (S.C. 2001).

182. The seminal case is *Donahue v. Rodd Electrottype Co.*, 328 N.E.2d 505, 513-16 (Mass. 1975).

183. For a survey of the various state laws and decisions and a critical analysis of whether Massachusetts truly represents the majority position, as many observers claim, see Mary Siegel,

she need not sue derivatively to enforce them.¹⁸⁴ Finally, a few states follow the recommendation of the ALI¹⁸⁵ and grant the court discretion to allow close corporation shareholders to obtain individual recovery by bringing in a direct action what would otherwise be a derivative claim.¹⁸⁶

Delaware, on the other hand, does not extend these protections to the shareholders of close corporations. Neither its general corporation provisions nor its subchapter governing close corporations includes statutory dissolution or alternative remedies for oppression or similar harm to minority shareholders.¹⁸⁷ The Delaware Supreme Court has rejected a shareholder's right to "equal treatment,"¹⁸⁸ which was the original focus of the Massachusetts case law, and disclaimed, as a general proposition, the propriety of judicially created remedies specific to the close corporation.¹⁸⁹ And its courts have shown no inclination to vary the traditional rules distinguishing derivative from direct claims because the corporation in question was closely held.¹⁹⁰

Clearly, minority shareholders in Delaware close corporations suffer the same vulnerability that led other states to develop special remedies. Given the absence of these remedies as a formal matter, Delaware courts therefore might approach derivative suits involving close corporations in either of two opposing ways. On the one hand, they might take a more relaxed approach to the procedural hurdles ordinarily facing derivative suit plaintiffs, as this is the sole means for the close corporation shareholder to obtain redress. Alternatively, they might treat the fact of Delaware incorporation in contractual terms—as a choice by the close corporation's organizers to avoid the prospect of judicial intervention present in other states. While Delaware is the

Fiduciary Duty Myths in Close Corporate Law, 29 DEL. J. CORP. L. 377, 380-82, 423-35, 471-89 (2004).

184. See *Donahue*, 328 N.E.2d at 508 n.4; *Crosby v. Beam*, 548 N.E.2d 217, 220-22 (Ohio 1989) (holding that such suits in the context of close corporations may be brought as direct suits).

185. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 7.01(d) (1992).

186. *Barth v. Barth*, 659 N.E.2d 559, 561-63 (Ind. 1995); *Richards v. Bryan*, 879 P.2d 638, 647-48 (Kan. Ct. App. 1994); *Durham v. Durham*, 871 A.2d 41, 45-46 (N.H. 2005).

187. The general provisions include a procedure for revocation of a corporation's charter on grounds of "abuse, misuse or nonuse of its corporate powers, privileges and franchises," but that remedy is available only to the Attorney General. DEL. CODE ANN. tit. 8, § 284(a) (2001). The only special remedy created by the close corporation subchapter is the appointment of a provisional director if the board is deadlocked. *Id.* § 353(a).

188. *Nixon v. Blackwell*, 626 A.2d 1366, 1377 (Del. 1993).

189. *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 39 n.2 (Del. 1996); *Nixon*, 626 A.2d at 1379-81.

190. See *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 383-84 (7th Cir. 1990) (summarizing the Delaware case law).

jurisdiction of choice for publicly traded corporations,¹⁹¹ its role for closely held firms is more limited, as organizers and their lawyers often favor local chartering of either a corporation or limited liability company.¹⁹² A fair inference is that closely held businesses opting for Delaware are ones in which planning, certainty of legal treatment, and perhaps private ordering arrangements play a more significant role. Courts might require that legal challenges by minority shareholders be filtered through the conventional requirements governing derivative suits out of respect for these arrangements (or their absence).

The Delaware Supreme Court's decision in *Nixon v. Blackwell* may appear to favor the latter, stricter approach. The court observed:

The tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.¹⁹³

Some aggrieved shareholders of Delaware close corporations based in Massachusetts or other states with stricter fiduciary standards have brought suit close to home, arguing for the application of local law. This approach is not unfounded, given the preponderance of local relationships that characterize the majority of closely held firms. Thus far, however, courts generally have rebuffed these efforts and looked to Delaware law under the "internal affairs" doctrine.¹⁹⁴

Minority shareholders of Delaware close corporations actually may fare better than the *Nixon* language suggests. Of the fifty-six cases with opinions addressing substantive issues in the Closely Held category, the plaintiff prevailed in full or in part in thirty-two. Subject to the issues of representativeness discussed in the introduction to this Part, a fair inference from these results is that a substantial

191. According to the Delaware Department of State, more than fifty percent of all U.S. publicly traded companies and sixty percent of the Fortune 500 are incorporated in Delaware. Delaware Division of Corporations, <http://www.corp.delaware.gov/default.shtml> (last visited Jan. 4, 2008).

192. For example, out of the thirty-nine states for which responses for 2006 are available, Delaware accounted for only 4.1 percent of the new business incorporations and 7.2 percent of the new LLCs. National Association of Secretaries of State, *Survey on Company Formation Processes in the States 1-2* (July 25, 2007); see also Thompson & Thomas, *supra* note 71, at 1761 (estimating Delaware's share of non-public incorporations at less than 3.5 percent).

193. 626 A.2d 1366, 1380 (Del. 1993).

194. *E.g.*, *Nagy v. Riblet Prods. Corp.*, 79 F.3d 572, 576-78 (7th Cir. 1996); *Harrison v. NetCentric Corp.*, 744 N.E.2d 622, 627-29 (Mass. 2001); *Olsen v. Seifert*, No. 976456, 1998 WL 1181710, at *4-5 (Mass. Dist. Ct. Aug. 28, 1998). *But see Powers v. Ryan*, No. CIV. A. 00-10295-00, 2001 WL 92230, at *1 n.1 (D. Mass. Jan. 9, 2001) (applying Massachusetts law under the "significant relationship test").

number of close corporation shareholders are able to overcome the procedural restrictions facing derivative plaintiffs, at least at the pleading stage.

Close corporation shareholders may have some of this success because their suits are more likely client driven, in contrast to the stereotype of their public corporation counterparts. But there are additional explanations. For one, many of the Closely Held cases share characteristics with the Exploitation of Control cases (the only difference being the dispersion of the equity ownership). Therefore, they benefit from the Delaware courts' evolving view of the direct/derivative distinction discussed in Section IV.C.¹⁹⁵ Further, the classic close corporation case involves those in control receiving some benefit to the exclusion of the minority. Those circumstances give rise to self-dealing or other duty of loyalty claims that are often difficult to dismiss at the pleading stage.¹⁹⁶ Of course, pleading a breach of loyalty is different from proving it, but the burden is ordinarily on the directors to prove the entire fairness of their dealings. In terms of ultimate outcomes, Thompson and Thomas found that plaintiffs obtained affirmative relief in nine of the twenty-five close corporation derivative suits that they studied.¹⁹⁷

The recent case of *Feldman v. Cutaia* illustrates many of these points. At issue was a series of private placements of the corporation's stock and other securities, followed by a repurchase offer two or three years later.¹⁹⁸ The plaintiff, a cofounder of the company but no longer a director, challenged both the inadequacy of the issue price and the excessiveness of the repurchase price. Specifically, he alleged that the defendants had paid the equivalent of between \$1.90 and \$4 per share

195. Thompson and Thomas, for example, found twice as many direct actions as derivative actions filed against close corporations. Thompson & Thomas, *supra* note 71, at 1785. In the present study, on the other hand, cases consisting only of direct claims that are upheld as such would not be included. Claims held to be direct enter the study only because: (i) they are joined with derivative claims in the same case, or (ii) an initial decision holding them to be derivative claims was reversed on appeal. *E.g.*, *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006). *Gentile*, by the way, is an example of one of the cases that raised issues as to categorization. It was placed in the Exploitation of Control category due to the court's reference to "public" shareholders, although there is little to indicate the stock was publicly traded.

196. *See* Siegel, *supra* note 183, at 419-21 (noting that greater scrutiny does not reflect special rules for close corporations, but prevalence of self-dealing claims governed by entire fairness standard); Thomas & Martin, *supra* note 163, at 586 (discussing reasons why shareholder challenges to executive compensation are more successful in close corporations); Thompson & Thomas, *supra* note 71, at 1767 (remarking that close-corporation claims usually entail majority shareholder's duty of loyalty, so independence required for demand is lacking).

197. Thompson & Thomas, *supra* note 71, at 1766-67.

198. For relevant facts, see *Feldman v. Cutaia*, Civ. A. No. 1656-N, 2006 WL 920420, at *5-8 (Del. Ch. Apr. 5, 2006).

while the repurchase offer had been at \$10. Because a majority of the board or their affiliates participated in the private placements, the court agreed that demand was excused as futile and allowed the claims to proceed. In a subsequent opinion, however, the court expressed some skepticism as to whether Feldman actually had been foreclosed from participating in the private placement.¹⁹⁹ What did him in was the company's merger following the earlier opinion, which, under the doctrine of *Lewis v. Anderson*,²⁰⁰ defeated his standing to pursue the derivative claims. Feldman tried to avoid this outcome by arguing that his claim for wrongful dilution qualified as "direct" in light of the recent Delaware cases discussed in Section IV.C. But the court held that he had failed to establish that the directors were tantamount to a single controlling shareholder for purposes of that doctrine.²⁰¹

In sum, the aggrieved minority shareholder of a Delaware close corporation presents a mixed blessing. The distinctive characteristics of the typical shareholder dispute within a close corporation may make it easier for the plaintiff to bring a direct claim or establish demand futility than it would be in the publicly traded context. Yet, as the *Feldman* case reminds us, derivative litigation includes several other procedural obstacles that may impede the plaintiff's path to ultimate relief.

B. Corporate Impropriety

1. Surveying the Cases

Plaintiffs did not fare well in the Corporate Impropriety cases. They prevailed or survived a motion to dismiss in only twenty-six of the cases, while courts dismissed their claims in eighty-six. The opinions in the other forty cases in this category involved either procedural matters (consolidation, appointment of lead counsel, remand to state court, etc.) or judicial review of settlements and fee awards. The results are even more lopsided when the cases for recovery of short swing profits under section 16(b) of the Securities Exchange Act are removed.²⁰² These suits must be brought derivatively but with no demand requirement. Without these cases,

199. *Feldman v. Cutaia*, No. Civ.A. 1656-VCL, 2007 WL 2215956, at *9 (Del. Ch. Aug. 1, 2007).

200. 477 A.2d 1040 (Del. 1984).

201. *Feldman*, 2007 WL 2215956, at *6-9.

202. 15 U.S.C. § 78p(b) (2000 & Supp. II).

the plaintiffs' survival rate on motions to dismiss drops to eighteen out of one hundred cases.

On the issue of demand, courts dismissed fifty-seven of the cases for failure to make a demand and excused demand in only sixteen, two of which then were dismissed on the merits. This one-sidedness is not surprising. The Corporate Impropriety cases typically involve issues of oversight, with duty of loyalty claims usually confined to matters of executive compensation. As a result, a majority of the board rarely will have a disabling conflict of interest.

To the extent that the opinions in the data set are representative of the underlying litigation, the message is clear. The demand requirement and other grounds for an early motion to dismiss operate as rigorous screening mechanisms to block plaintiffs with Corporate Impropriety claims from access to the courts, including the right to discovery. Is this sound policy? An examination of the features of the underlying claims gives a better appreciation of the consequences of this screening.

a. Financial Falsehoods; Fraud

The largest share of cases (sixty-four of 152) involved claims that the defendants were responsible for false or misleading information about the corporation's business and financial condition, or that they concealed negative information. While an occasional case was premised on defrauding a specific third party, almost all involved fraud upon the financial markets generally, in circumstances where securities class actions also had been filed. Thus, it is questionable what these cases add by way of either compensation or deterrence. They simply may be the result of a lawyer whose client neither bought nor sold during the applicable class period, but still held shares and wanted a piece of the case. Active participation in the fraud was rarely alleged; rather, liability was premised on the defendants' failure to detect or stop it. In about twenty-eight percent of the cases, plaintiffs also included claims of insider trading.

Plaintiffs fared worse in this subcategory of cases than in the Corporate Impropriety category as a whole—surviving dismissal in only six of the forty-five rulings. The breakdown between demand-required and demand-excused cases was twenty-six to six.²⁰³

203. While the numbers are too small to support much in the way of generalization, nothing suggests a systematically different approach to demand between the federal and Delaware state courts. Combining the financial fraud claims with the other oversight cases discussed below, two of the eight demand-excused decisions were by the Chancery Court, as were ten of the forty decisions requiring demand.

Interestingly, though, this category produced the largest monetary settlement—\$54 million in the Cendant Corporation case, although that amount pales in comparison to the record \$3.2 billion settlement of the securities class action that was the basis for the derivative claim.²⁰⁴

b. Other Oversight

Plaintiffs fared no better in oversight cases not based principally on the corporation's financial fraud. Courts excused demand in only two of seventeen cases and dismissed the rest.²⁰⁵ These cases generally involved *Caremark*-type claims,²⁰⁶ where shareholders sought recovery for losses resulting from the board's failure to prevent wrongful conduct, ranging from racial discrimination²⁰⁷ to bid rigging in the insurance industry.²⁰⁸ Only the occasional case included allegations of an affirmative act by the board.²⁰⁹

While plaintiffs in suits alleging financial fraud or other types of oversight claims may succeed rarely, the successful case is likely to be lucrative. At least four of the eight cases where plaintiffs survived a motion to dismiss ultimately settled, all with significant attorneys' fees or monetary awards.²¹⁰ A plaintiff in an oversight case therefore faces a dilemma. These cases are highly fact-dependent, turning on how much the board members knew and when they knew it. The plaintiff must convince the court to excuse demand, relying only on whatever information has become publicly available. This study suggests that success is a long shot, a proposition consistent with Chancellor Allen's characterization of oversight cases as "possibly the

204. *In re Cendant Corp.*, Derivative Action Litig., 232 F. Supp. 2d 327, 336 (D.N.J. 2002).

205. Opinions in four other cases in this sub-category dealt with other procedural issues.

206. *In re Caremark Int'l Inc.* Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (requiring "sustained or systematic failure of the board to exercise oversight" in order to establish lack of good faith). The *Caremark* standard recently has been endorsed by the Delaware Supreme Court in *Stone v. Ritter*, 911 A.2d 362, 364-65 (Del. 2006).

207. *In re Texaco Inc. S'holder Derivative Litig.*, 123 F. Supp. 2d 169, 170 (S.D.N.Y. 2000).

208. *Fener v. Gallagher*, No. 04 C 8093, 2005 WL 2234656, at *3 (N.D. Ill. Sept. 8, 2005).

209. *See, e.g., White v. Panic*, 783 A.2d 543 (Del. 2001) (settlement of paternity suit against CEO); *Litt v. Wycoff*, No. Civ.A. 19083-NC, 2003 WL 1794724 (Del. Ch. Mar. 28, 2003) (bonus plan that encouraged high-risk lending).

210. *McCall v. Scott*, 250 F.3d 997 (6th Cir. 2001) (corporate governance provisions and \$14 million settlement); *In re TASER Int'l S'holder Derivative Litig.*, No. CV-05-123-PHX-SRB, 2006 WL 687033 (D. Ariz. Mar. 17, 2006) (corporate governance provisions; \$1.75 million in attorneys fees); *Dollens v. Zions*, No. 01 C02826, 2002 WL 1632261 (N.D. Ill. July 22, 2002) (corporate governance provisions; \$600,000 attorneys fees); *Saito v. McCall*, No. Civ.A. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004) (\$30 million settlement, of which \$6 million was attorneys fees).

most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”²¹¹ But the substantial corporate losses incurred in these cases increase the settlement value of a successful demand-excused claim. And based on an analysis of the written opinions, outcomes are difficult to predict. This uncertainty likely is caused by the requirement that the judge predict, at this early stage of the case, where the facts ultimately will fall on the spectrum between a “mere threat” and “substantial likelihood” of liability.²¹² Economic theory predicts that, under these conditions, risk-averse plaintiff’s attorneys would tend to settle before testing their demand futility allegations in court, and many probably do. But the substantial number of cases in this subcategory suggests that, for whatever reason, a significant number of plaintiffs take their chances.

The substantial literature generated by the Priest-Klein hypothesis contributes several possible explanations for this reluctance to settle at the demand stage—among them the differential stakes of the parties and the relatively low cost of litigating demand.²¹³ Especially relevant are the incentives for strategic behavior created by asymmetric information.²¹⁴ Dependent as they are on the subjective knowledge of individual directors at particular points in time, oversight claims typically will give rise to a significant differential between what the plaintiff and defendant know at the outset of the case. Defendants who appreciate that they are at risk therefore might be tempted to settle the case early, when the demand requirement still blocks the plaintiff’s access to discovery. But plaintiffs, aware of their low overall probability of success, likely would see this early willingness to settle as a tip-off of the defendant’s liability and therefore will hold out. Innocent defendants, on the other hand, lack a low-cost means of convincing the plaintiff that the case

211. *Caremark*, 698 A.2d at 967.

212. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993). Given this indeterminacy, it is significant that the Delaware Supreme Court now reviews demand futility *de novo*. *Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000). After an oversight claim is dismissed at the chancery level, the plaintiff’s threat to appeal retains substantially more settlement value than under a more deferential standard.

213. For summaries of the reasons why the success rate of plaintiffs may deviate from the tendency toward fifty percent predicted by Priest & Klein, see Daniel Kessler et al., *Explaining Deviations from the Fifty-Percent Rule: A Multimodal Approach to the Selection of Cases for Litigation*, 25 J. LEGAL STUD. 233, 237-48 (1996); Leandra Lederman, *Which Cases Go to Trial?: An Empirical Study of Predictors of Failure to Settle*, 49 CASE W. RES. L. REV. 315, 319-24 (1999).

214. See, e.g., Lucian Arye Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404 (1984); Keith N. Hylton, *Asymmetric Information and the Selection of Disputes for Litigation*, 22 J. LEGAL STUD. 187 (1993) (examining the effects of asymmetric information upon parties’ decisions whether or not to settle).

has no merit, so they often will find it cheaper to seek dismissal based on the plaintiff's failure to make a demand.

Because the core conduct in these oversight cases is already the subject of legal prohibitions, it is again doubtful that the derivative suit provides additional deterrence. Officers and directors already are stigmatized—and perhaps penalized—for their involvement in the underlying violations. And indemnification and insurance usually will cover any personal liability that the derivative suit creates. Furthermore, as the foreign payments cases and current stock option backdating cases reveal, the conduct giving rise to the suit may come to light years after the fact. Legal standards and public attitudes may have changed in the interim. Thus, if the case goes to trial, the court must attempt to recreate the circumstances of the prior time in assessing what board members should have foreseen.

c. Executive Compensation

The second largest group of cases (thirty-two, including three cases that overlapped with the financial fraud category) arose from compensation arrangements. The most frequent claims related to stock option irregularities and compensation based on subsequently restated earnings. Once again, plaintiffs fared poorly on the whole, surviving dismissal in only five of twenty-two rulings.²¹⁵ Courts dismissed claims for either failure to make a demand or failure to state a claim. The underlying rationale was essentially the same in both contexts: the business judgment rule protected the board's decision and the plaintiff failed to make an adequate case for waste.

From a policy standpoint, this subcategory is more compelling than the oversight subcategories because it is more likely to raise duty of loyalty issues, and derivative litigation often will be the shareholder's sole means to raise them.²¹⁶ Nonetheless, in a comprehensive survey of decisions going back to the early 1900s, Professors Randall Thomas and Kenneth Martin found that public corporation shareholders succeeded far less often in challenging compensation arrangements than did their counterparts in close

215. One of these was an earlier ruling in the *Disney* case, *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003), which plaintiffs would go on to lose. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

216. See Thomas & Martin, *supra* note 163, at 576 (noting that shareholder challenges to executive pay almost always take the form of derivative suits).

corporations.²¹⁷ Compare this with the present study, where plaintiffs in this subcategory succeeded only by identifying a specific flaw in the process for approving the compensation arrangement.²¹⁸ However, this is one subcategory of Corporate Impropriety cases where the risk of out-of-pocket liability continues to pose a viable deterrent threat. For example, in *Valeant Pharmaceuticals International v. Jerney*, the Delaware court ordered a former officer-director not only to repay the full \$3 million bonus he had received—with no offset for the amount of what a “fair” bonus might have been—but also to reimburse a share of the corporation’s SLC expenses.²¹⁹ Also in this subcategory is the proposed settlement that, if approved, would be the largest derivative suit recovery ever²²⁰—the more than \$900 billion to be repaid by former UnitedHealth Group executives to settle backdating charges.²²¹

d. Other Claims

The only other substantial subcategory of claims (thirteen) encompassed those arising from a merger or other change-of-control transaction, as challenges either to a board’s decision to enter a particular transaction or to its failure to pursue an alternative. In almost all of these cases, the shareholders had the opportunity to pursue direct claims through a class action, so the availability of derivative relief was not essential for them to obtain redress.

Few of the Corporate Impropriety claims raised classic duty of loyalty issues. Outside the compensation and merger areas, only three cases alleged self-dealing or corporate opportunity. And those plaintiffs attained more success than other plaintiffs in this category—perhaps because these cases tend to border on the Exploitation of Control category.

217. *Id.* at 585-87. This is an example of a context in which it would be interesting to go beyond the conventional public-close dichotomy and examine the experience of controlled public corporations as a separate group.

218. See, e.g., *Seinfeld v. Barrett*, No. Civ.A. 05-298-JJF, 2006 WL 890909 (D. Del. Mar. 31, 2006) (misleading disclosure of tax consequences); *In re Tyson Foods, Inc.*, 919 A.2d 563 (Del. Ch. 2007) (issuance of spring-loaded options while in possession of non-public information); *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) (backdating of options in violation of shareholder-approved plan).

219. 921 A.2d 732, 751-56 (Del. Ch. 2007).

220. Margaret Cronin Fisk & Avram Goldstein, *UnitedHealth’s Former Chief to Repay \$600 Million* (Update8), BLOOMBERG.COM, Dec. 6, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a.lhETzJe3CQ&refer=home>.

221. See Eric Dash, *Former Chief will Forfeit \$418 Million*, N.Y. TIMES, Dec. 7, 2007, at C1; Vanessa Fuhrmans & James Bandler, *Ex-CEO Agrees To Give Back \$620 Million*, WALL ST. J., Dec. 7, 2007, at A1.

Interestingly, all three of these cases arose from situations that were front-page news, and the Delaware Court of Chancery decided them all. *HealthSouth*²²² challenged the corporation's acceptance of stock from its CEO in retirement of his \$25 million debt. The court granted the plaintiffs summary judgment on the grounds of unjust enrichment and equitable fraud.²²³ The plaintiff in *Teachers' Retirement v. Aidinoff*²²⁴ claimed that AIG executives diverted valuable business to an affiliated company whose principal shareholder was AIG's CEO. Its claim for a constructive trust survived a motion to dismiss.²²⁵ Finally, plaintiffs established demand futility and stated a claim for relief in alleging that eBay insiders had usurped a corporate opportunity by participating in IPO allocations from the company's investment banking advisor.²²⁶

The relative paucity of classic duty of loyalty cases in the data set suggests one of two things. Either the current combination of deterrent forces (media scrutiny, public enforcement, and class and derivative litigation) effectively operates to prevent more blatant loyalty breaches in our largest and most closely watched corporations, or the parties are quick to settle any litigation when these situations arise. Whichever the explanation, the results in these cases should provide some reassurance to those who fear that the derivative suit is on its deathbed.

2. Derivative Suits as Public Goods

One consequence of SLCs and the best interest test has been to focus attention on the extent to which much of the potential benefit traditionally attributed to derivative litigation represents a classic public good.²²⁷ As such, the particular corporation that is subject to suit and its shareholders are called on to underwrite the cost for the benefit of shareholders generally. This point is especially relevant to evaluating the case for oversight and other subcategories of Corporate Impropriety claims where the prospect for meaningful monetary recovery is remote and, even when obtained, almost always will be covered by indemnification or insurance paid for by the corporation.

222. *In re HealthSouth Corp S'holders Litig.*, 845 A.2d 1096 (Del. Ch. 2003), *aff'd*, 847 A.2d 1121 (Del. 2004).

223. *Id.* at 1099.

224. *Teachers' Ret. Sys. of La. v. Aidinoff*, 900 A.2d 654 (Del. Ch. 2006).

225. *Id.* at 673.

226. *In re eBay, Inc. S'holders Litig.*, No. C.A. 19988-NC, 2004 WL 253521, at *4 (Del. Ch. Jan. 23, 2004).

227. See, e.g., Romano, *supra* note 122, at 85.

With the compensation rationale thus marginalized, justification for the suit must come from other sources.

The most obvious candidate is deterrence. But even though deterrence is widely cited as one of the principal benefits of derivative litigation, how much of that benefit does the subject corporation capture? Obviously, it is too late to deter the misconduct that spawned the suit. As to the future, maintaining the derivative suit operates as a deterrent only to the extent that it signals future management that some future shareholder, board, or SLC also will maintain a suit.²²⁸ The derivative suit also might deter future harm for corporate America, in an amount that substantially exceeds the costs of suit, and therefore may be socially desirable.²²⁹ But should the shareholders of the corporation that is subject to the suit be forced to subsidize it?

One class of shareholders may endorse this subsidization. As repeat players, institutional investors stand to reap the benefits of general deterrence across their portfolio holdings.²³⁰ As the securities class action faces more obstacles, these investors increasingly may see derivative litigation as an alternative to address corporate improprieties. On the whole, the discussion of administrative enforcement and white collar criminal prosecution in Section III.D.2 suggests that the fight against corporate impropriety now is funded more by public dollars. While shareholders generally may welcome this result, it will not always work to their favor, because public enforcement means that the best interests of the corporation and its shareholders are no longer the touchstone. One can imagine circumstances in which public officials elect to pursue general deterrence objectives even at the risk of harming some of the shareholders that the law is designed to protect. No comparable threat arose when the misconduct was solely the subject of derivative litigation capable of settlement at the corporation's behest. The prospect of Apple shareholders losing the unique talents of CEO Steve

228. Cf. Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1748-50 (1994) (discussing future deterrence benefits as an incentive to bring suit).

229. Note, though, the assumption necessary for even this external deterrence to operate. What does the decision by Corporation X's SLC to bring suit communicate to managers of other corporations about the willingness of their own boards or SLCs to bring suit down the road?

230. See Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 100-02 (1974) (discussing repeat players' incentives to play for rules rather than outcomes).

Jobs as a result of the stock options backdating scandal is a recent case in point.²³¹

Even though the costs and benefits of general deterrence ordinarily may favor public over private enforcement, situations likely exist where establishing the bounds of permissible conduct will yield deterrence benefits that are substantial and specific to the corporation. One example is a corporation in a highly regulated industry or whose businesses or business practices otherwise gives rise to the recurrent risk of unlawful conduct.²³² This case typically will fall in the Corporate Impropriety category, and, as discussed earlier, the deterrent role of derivative litigation must be evaluated relative to the body of other enforcement mechanisms. Substantial corporation-specific deterrence also is likely when dealings between the corporation and a parent company, controlling shareholder, or other affiliated party create an ongoing risk of abuse—the kinds of cases that make up the Exploitation of Control category.

The other public good that sometimes is cited on behalf of derivative litigation is the production of precedent. Over the years, derivative suits have served as a principal source of this precedent. But there are certainly alternative settings in which courts address the duties of care and loyalty. These include direct suits by the corporation itself, suits by bankruptcy trustees or representatives of creditors following the corporation's insolvency, and class actions in the context of an acquisition. The present study used two sources to test the continuing importance of derivative suits as a source of precedent—corporate law casebooks and the Delaware Supreme Court's recent *Disney* opinion.

Six leading casebooks were considered, and all cases included in the chapters dealing with the duties of directors or controlling shareholders were tallied.²³³ This produced a total of 120 cases.²³⁴ A

231. See Conrad de Aenlle, *Figuring out the P.E. Ratio of Steve Jobs*, N.Y. TIMES, Jan. 20, 2007, at C6; Alan Murray, *If Mr. Jobs Is Punished, Would Holders Suffer?*, WALL ST. J., Jan. 17, 2007, at A14; Joe Nocera, *Nice Phone, Mr. Jobs, But . . .*, N.Y. TIMES, Jan. 13, 2007, at C1 (discussing Apple shareholders' reactions to the fact that Steve Jobs might leave).

232. The risk of price-fixing in the power equipment industry at issue in the classic case of *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963) is an example.

233. JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 904-17 (5th ed. 2003 & Supp. 2006); JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 851-61 (6th ed. 2004); MELVIN ARON EISENBERG, CORPORATION AND OTHER BUSINESS ORGANIZATIONS—CASES AND MATERIALS 667-96 (9th ed. unabr. 2005); ROBERT W. HAMILTON & JONATHAN R. MACEY, CORPORATIONS—INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 720-57 (9th ed. 2005); WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS—AGENCY, PARTNERSHIPS, AND CORPORATIONS 232 (6th ed. 2006); CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 367-98 (5th ed. 2006).

slight majority (sixty-three) was pure derivative suits. Of the remaining cases, fifty-three were direct suits, and four were either mixed or unclear as to the nature of the claim. As in other contexts, however, the evidence suggested that tighter demand requirements and deference to SLCs might be reducing the significance of derivative litigation as a source of leading cases. Of the 120 cases, seventy-two were decided after 1980. Of these, derivative suits represented only 45.8 percent of the total, compared to 62.5 percent of those decided earlier.

The *Disney*²³⁵ case was selected as the most important recent case on the duties of directors. The court relied on fifteen (thirteen different) Delaware decisions in its separate discussions of the business judgment rule, the duties of care and loyalty, good faith, and the test for waste.²³⁶ Of these, nine were derivative suits. Further, the age distribution of these cases is the opposite of the casebook opinions—all but one of the derivative suits were decided after 1980, compared to only half of the other cases. Thus, even though derivative suits may be losing some of their centrality as a teaching tool, their role as the leading source of precedent on directors' duties retains its vitality, at least outside the acquisition context, where class actions now dominate.

The composition of the cases by category likewise is instructive. Among the casebook derivative suits, slightly more than half (thirty-four) fell into the Corporate Impropriety category. Of the others, twenty involve exploitation of control, and thirteen involve closely held corporations. The make-up of the *Disney* precedents is even more one-sided—eight of the nine derivative suits involve corporate impropriety. A recurring theme of this article has been the emergence of substitutes for much of the role traditionally played by derivative litigation in the Corporate Impropriety setting. These results reveal an important exception: derivative suits grounded on corporate impropriety continue to be a fundamental source of governing legal principles. Further, they make a different kind of contribution to the body of corporate law than do the other two categories. Specifically, cases in the Exploitation of Control and Closely Held categories typically involve concrete applications of the duty those in control owe to minority shareholders. Corporate law gives controlling insiders

234. As is to be expected, several of the cases were included in multiple casebooks. For purposes of this study, each such inclusion was counted as a separate case, as a means of weighting the case's relative importance.

235. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

236. Again, when a case was cited in multiple discussions it was counted separately each time.

considerable latitude to run the corporation as they see fit. Understandably, they generally will favor their own priorities and objectives over those of the minority. Derivative litigation performs the task of translating the abstract concepts of fiduciary obligation, good faith, and fairness into the specific limits on the insiders' ability to favor themselves.

To be sure, Corporate Impropriety cases do this as well, though in situations involving managerial rather than shareholder control, such as executive compensation. And the judicial guidance more typically goes to permissible process rather than to permissible outcome. But these cases do something more. Over the years, they have provided the foundation for discussing what it means to be an outside director of a public corporation.

There is no field manual, code of conduct, formal training, or licensing body to spell out what directors ought to do in a particular situation. Instead, this responsibility usually has begun with the courts and works in two separate ways. Most visibly, the courts are (subject to the legislature) the definitive author of the director's formal legal obligations. Equally as important, their opinions are the raw material for a dialogue across the business and legal professions as to what should be expected of directors.²³⁷ The factually rich chronicles of boardroom behavior that are the hallmark of the Delaware courts are particularly well suited to this task.²³⁸ These judicial pronouncements then are analyzed, critiqued, and extrapolated in law review articles, client memos, the business and financial press, continuing legal education programs, and training institutes for present and prospective directors. In the process, an updated appreciation of what it means to be an outside director often evolves. We can think of this as the "culture" of corporate governance. While this culture may lack the force of law, it nonetheless remains highly influential in shaping the attitudes of the business, education, and former governmental leaders who constitute public company boards and whose reputation for integrity and competence is critical to their careers.

One effect of the stricter demand requirements has been to reduce the volume of case law available to shape culture. Perhaps "reorient" is a better term than "reduce." Litigation over demand

237. For a fuller explication of the continuum of performance criteria for directors, from obligation to expectation then to aspiration, see Kenneth B. Davis, Jr., *The Director's Duty of Oversight*, in PROCEEDINGS TO COMMEMORATE THE 40TH ANNIVERSARY OF THE KOREAN COMMERCIAL CODE 2-7 (Seoul Oct. 2002).

238. Ed Rock has elaborated on this process in the case of MBO opinions. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016, 1024-25 (1997) (describing Delaware opinions as "corporate law sermons").

futility and deference to independent directors has produced a substantial number of fact-specific discussions on what it means to be independent. Likewise, because challenges to acquisitions typically are direct claims by the corporation's shareholders or competing bidders, a rich body of law and culture has developed to address how directors should act in an acquisition context. But detailed performance assessments in other settings are rare. This is unfortunate. Even though, for the reasons discussed earlier, the Corporate Impropriety cases rarely will lead to liability in derivative suits, the courts' opinions can help shape a boardroom culture that reduces the risk of the underlying impropriety.

Delaware's restrictive approach to demand in Corporate Impropriety cases has affected the production of precedent in a second, more subtle way. Many derivative plaintiffs are choosing to file elsewhere. Almost all of the option backdating suits involving Delaware corporations, for example, have been brought either in federal court or in the courts of the state where the corporation is headquartered or does substantial business. Conversations with lawyers indicate that a principal reason for this phenomenon is that corporations want to avoid Delaware's demand requirement. However respected these other courts may be, their opinions, lacking both the precedential value and narrative style of their Delaware counterparts, are unlikely to make the same kind of contribution to corporate governance law and culture.

From a choice-of-law standpoint, this forum shopping seems pointless, given the consensus that issues of demand are to be governed by the state of incorporation's law.²³⁹ The assumption must be that Delaware judges will interpret and apply the state's law of demand more strictly than their out-of-state colleagues.²⁴⁰ To date, the evidence on this point from the backdating cases is to the contrary.²⁴¹

239. See, e.g., *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108-09 (1991); *McCall v. Scott*, 239 F.3d 808, 815, *amended in part by* 250 F.3d 997 (6th Cir. 2001); *Blasband v. Rales*, 971 F.2d 1034, 1047 (3d Cir. 1992); *Hicks v. Lewis*, 148 S.W.3d 80, 83-87 (Tenn. Ct. App. 2003); *Moonlight Invs., Ltd. v. John*, 192 S.W.3d 890, 893-94 (Tex. App. 2006) (holding that under Texas statute, demand requirement is substantive rather than procedural); SETH ARONSON ET AL., *Shareholder Derivative Actions: From Cradle to Grave*, in PRACTISING LAW INSTITUTE, 2006 SECURITIES LITIGATION & ENFORCEMENT INSTITUTE, 1557 PLI/Corp 125, 147 (2006).

240. For example, one leading law firm has counseled Delaware-incorporated clients to amend their bylaws to require Delaware as the forum for any derivative suit. Leslie A. Gordon, *Partner Advisory: Pick Your Forum*, 8-K MAG., Summer 2006, at 37-38, available at <http://www.bingham.com/Media.aspx?MediaID=2991>.

241. The D&O Diary lists fifteen backdating derivative suits that have been dismissed to date, with all but one in federal court. (The lone Delaware decision is *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007).) Conversely, four of the five suits that have survived a motion to dismiss have been in the Delaware Court of Chancery. See *Options Backdating Lawsuits*:

Nonetheless, these developments highlight the significance of the Chancellor's observations in *Ryan v. Gifford* about Delaware's strong interest in having its own courts decide novel questions of fiduciary duty under Delaware law.²⁴²

C. *Exploitation of Control*

1. Surveying the Cases

Exploitation of Control cases typically involve transactions with someone who arguably was in control of the corporation. The most common fact pattern involved direct self-dealing, often in connection with the issuance or redemption of the corporation's shares. In all, thirty-one cases fell within this subcategory, in whole or in part. Another fifteen cases involved intercompany dealing or asset shifting among organizations under the defendant's common control. The only other substantial subcategory, something of a catch all, included cases where the defendant pursued a particular strategy for its own benefit to the detriment of the shareholders. In some cases, this was accomplished through the corporation, such as by causing it to buy out the stock of a competing block holder. In other cases, it was done directly, by failing to provide promised financing, for example. No claims of the latter variety survived a motion to dismiss, but interestingly the cases were never dismissed for failure to state a claim.

Given the element of control and the attendant duty of loyalty issues, plaintiffs should be more successful in these cases than in Corporate Impropriety cases. The data supports this hypothesis. Plaintiffs prevailed or survived a motion to dismiss in twenty-eight cases; courts dismissed their suits in forty-three cases. The remaining thirteen cases dealt with procedural or settlement issues. This breakdown is closer to the even split predicted by the Priest-Klein hypothesis, which may indicate that the applicable legal standards embody less uncertainty than in the Corporate Impropriety cases, particularly in the oversight subcategories. Likewise, given the small size of the corporations in this category and the tendency of the plaintiffs to hold larger shares of the equity, each side will have access

Settlements, Dismissals, Denials, D & O DIARY, available at <http://69.177.1.186/clients/blog/optionsbackdatingtable.doc> (last updated Feb. 28, 2008) (tracking settlements, dismissals, and denials).

242. 918 A.2d 341, 349-50 (Del. Ch. 2007).

to the facts. As a result, opposing counsel more likely will place similar value on the shareholder's claim.

Notwithstanding the control dimension to these cases, the demand requirement continued to present a challenge for plaintiffs. Courts dismissed derivative claims for failure to make demand in twelve of the cases, compared to ten in which courts ruled that demand was futile. This pattern reflects plaintiffs' difficulty in overcoming the demand requirement where a majority of board members is not interested personally in the transaction, even though their status as board members is subject to the defendant's control.

Understandably, claims of self-dealing and intercompany dealing experience the greatest success in overcoming the demand requirement. Of the thirty-five claims that fall into one or both of these subcategories, courts only dismissed four on demand grounds. Importantly, these results may signal a subtle shift away from the strictness of *Aronson* when a controlling shareholder is involved.

To evaluate the significance of this, we start with the recognition that Delaware law features a range of context-specific tests for challenging transactions involving controlling shareholders. Among these, the requirements for excusing demand as futile may be the most rigorous. As we saw in Section II.B, to overcome the presumption of director independence, *Aronson* makes clear that the plaintiff must do more than show that the director was nominated or elected at the behest of the defendant. Even proof of majority share ownership will not suffice. Rather, in addition to overall control, particular facts must demonstrate that "through personal or other relationships the directors are beholden to the controlling person."²⁴³ That person's influence over the directors must be so great that it "sterilizes their discretion."²⁴⁴

Whether this full force of *Aronson* should extend to the Exploitation of Control cases is questionable. As we have seen, both the remedial and deterrent aspects of derivative litigation play a far more substantial role for these cases than for those in the Corporate Impropriety category. Thus, entrusting the suit to those selected by and serving at the pleasure of the defendant is much more problematic. Further, under Delaware law, self-dealing transactions involving a controlling shareholder generally are subject to the "entire fairness" test²⁴⁵—a standard sufficiently rigorous that its applicability

243. *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

244. *Id.* at 814.

245. *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115-17 (Del. 1994); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 719-20 (Del.

is sometimes described as outcome determinative.²⁴⁶ Unlike most situations to which the demand requirement applies, negotiation and independent-director approval of the transaction does not invoke the protections of the business judgment rule; it simply shifts the burden of proving fairness.²⁴⁷ Nonetheless, under *Aronson's* second prong, demand will be required so long as the challenged transaction was "the product of a valid exercise of business judgment."²⁴⁸ Likewise, a director can be deemed independent under the first prong of *Aronson* even though the corporation is treated as controlled for purposes of the entire fairness test. The latter occurs whenever a shareholder owns a majority of the shares or exercises actual control over the corporation's business and affairs²⁴⁹—neither of which is sufficient to satisfy the "beholden" requirement of *Aronson*.

The upshot is that, taking the legal doctrine at face value, plaintiffs in many Exploitation of Control cases face higher formal hurdles in overcoming the demand requirement than in prevailing on the merits. However, two factors mitigate this result in practice. First, as discussed below, many types of transactions involving controlling shareholders will give rise to individual claims, making demand unnecessary. Second, as some of the opinions in the data set suggest, where the control relationship is clear, courts may be exhibiting greater flexibility in excusing demand, the black letter of *Aronson* notwithstanding.²⁵⁰

1971). While *Lynch*, *Weinberger*, and many of the other leading cases involved mergers, several post-*Lynch* decisions have treated the entire fairness standard as applicable to controlling shareholder transactions generally. *T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536, 552 (Del. Ch. 2000); *In re MAXXAM, Inc./Federated Dev. S'holders Litig.*, No. Civ. A. 12111, 1997 WL 187317, at *13 (Del. Ch. Apr. 4, 1997); *Kahn v. Tremont Corp.*, No. 12339, 1996 WL 145452, at *7 (Del. Ch. Mar. 21, 1996), *rev'd on other grounds*, 694 A.2d 422 (Del. 1997).

For analytical surveys of Delaware's approach to controlling shareholders, see Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003); Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 47-70 (1999); Steven M. Haas, Note, *Toward a Controlling Shareholder Safe Harbor*, 90 VA. L. REV. 2245, 2250-70 (2004).

246. See, e.g., *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (discussing how the standard of judicial review is outcome determinative).

247. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997); *Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994); *Cooke v. Oolie*, No. Civ. A. 11134, 2000 WL 710199, at *13 n.41 (Del. Ch. May 24, 2000); see Siegel, *supra* note 245, at 39-42 (discussing shifting burdens).

248. *Aronson*, 473 A.2d at 814.

249. *Kahn*, 638 A.2d at 1113-14; *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989); *In re PNB Holding Co. S'holders Litig.*, No. 28-N, 2006 WL 2403999, at *9-10 (Del. Ch. Aug. 18, 2006); *In re W. Nat'l Corp. S'holders Litig.*, No. 15927, 2000 WL 710192, at *6 (Del. Ch. May 22, 2000); see Siegel, *supra* note 245, at 33-39 (discussing controlling shareholders).

250. The Exploitation of Control cases in the data set that excused demand in the face of allegations of self-dealing by a controlling shareholder include *In re Trump Hotels S'holder*

In addition to the demand requirement, however, shareholders in the Exploitation of Control cases face another obstacle that plays a far more important role than in the other categories: standing. In all, courts dismissed twenty-six of the derivative claims on standing grounds.²⁵¹ The most frequent reasons were a subsequent merger (seven cases) or bankruptcy (eight cases), but other difficulties satisfying either the contemporaneous or the continuing ownership requirements were present as well. It is understandable, given the typically thin trading in the stock of these corporations, that identifying a plaintiff who has retained ownership of his or her shares throughout the required period may prove a challenge. Accordingly, the distinction between direct and derivative claims is particularly important in this category.

Here too, Delaware courts have demonstrated an increasing willingness to provide minority shareholders of controlled corporations access to the courts. The law on these issues continues to evolve and some recent opinions are particularly noteworthy. For a claim to be deemed direct rather than derivative, Delaware courts traditionally looked to whether the shareholder suffered a "special injury," either a wrong "separate and distinct" from that suffered by other shareholders or a contractual right (such as the right to vote) independent of the rights of the corporation.²⁵² Nonetheless, there are well-recognized categories of direct claims where the harm by its nature tended to affect all shareholders equally, such as claims involving false or misleading disclosures²⁵³ or claims challenging a merger on grounds of fairness of the price or approval process.²⁵⁴ Thus, minority shareholders in controlled corporations (and, indeed,

Derivative Litig., Nos. 7820 DAB & 8527 DAB, 2000 WL 1371317 (S.D.N.Y. Sept. 21, 2000); *In re Limited, Inc.*, No. 17148-NC, 2002 WL 537692 (Del. Ch. Mar. 27, 2002); *In re Student Loan Corp. Derivative Litig.*, No. C.A. 17799, 2002 WL 75479 (Del. Ch. Jan. 8, 2002); *In re New Valley Corp.*, No. 17649, 2001 WL 50212 (Del. Ch. Jan. 11, 2001); *Grace Bros., Ltd. v. Uniholding Corp.*, No. 17612, 2000 WL 982401 (Del. Ch. July 12, 2000).

251. Plaintiffs in three of these cases, as well as one of the demand-required cases, were held to have direct claims in addition to their dismissed derivative claims, so a portion of their cases survived.

252. *Lipton v. News Int'l*, 514 A.2d 1075, 1078 (Del. 1986); *Moran v. Household Int'l Inc.*, 490 A.2d 1059, 1069-70 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985); *Elster v. Am. Airlines, Inc.*, 100 A.2d 219, 222 (Del. Ch. 1953).

253. *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 282 (Del. 1977); *Agostino v. Hicks*, 845 A.2d 1110, 1120-21 (Del. Ch. 2004).

254. *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999); *Cede & Co. v. Technicolor, Inc.*, 1987 WL 4768, at *5 (Del. Ch. Jan. 13, 1987). *But see Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 353 n.4 (Del. 1988) (holding that the claim that golden parachute payments and excessive fees reduced consideration paid to shareholders in merger was derivative not direct).

shareholders generally) regularly have been allowed to pursue these sorts of claims through individual suits or class actions, without having to satisfy the pleading and other requirements for a derivative suit. Similarly, courts have been more willing to allow shareholders to proceed directly, even in the absence of a “special injury” to the plaintiff, when the shareholders are seeking equitable relief to invalidate corporate action for lack of authority or other procedural improprieties.²⁵⁵

In its 2004 *Tooley* decision, the Delaware Supreme Court sought to rationalize this divergent body of law by formally abandoning the “special injury” test. Instead, to decide whether the claim is direct or derivative, “the analysis must be based solely on the following questions: Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?”²⁵⁶ By framing the test in this manner, the court specifically rejected the proposition that “an action cannot be direct if all stockholders are equally affected or unless the stockholder’s injury is separate and distinct from that suffered by other stockholders.”²⁵⁷

While this expanded availability of direct recovery applies to shareholders across the range of corporations, it has special relevance to the Exploitation of Control cases. The fact that the controlling shareholder’s fiduciary duty runs not only to the corporation but also to the shareholders creates an accommodating framework for recognizing separate harm at the shareholder level. As a result, some forms of self-dealing can be characterized, even though the corporation is the party directly impacted, as giving rise to direct, as well as derivative, grounds for relief.²⁵⁸ Thus far, this has been most evident in cases alleging dilution as the result of an issuance of shares to those in control for inadequate consideration. The *Tri-Star* line of cases, each of which reversed the chancery decision below, demonstrates the Delaware Supreme Court’s openness to creative approaches through which minority shareholders challenging that dilution can sue and recover on their own behalf.²⁵⁹ And a recent chancery opinion takes

255. See, e.g., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 7.01 cmts. c-d (1992); see also *Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996) (citing PRINCIPLES OF CORPORATE GOVERNANCE).

256. *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004).

257. *Id.* at 1038-39.

258. See, e.g., *Gentile v. Rossette*, 906 A.2d 91, 99-100 & n.19 (Del. 2006) (noting the possible dual character of a claim).

259. *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007); *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006); *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319 (Del. 1993). While *Tri-Star* arose under

this doctrine one step further, permitting the shareholder to sue directly in the case of other types of self-dealing by controlling shareholders when the alleged purpose was to drive down the value of the plaintiff's shares.²⁶⁰

In sum, these two still-evolving bodies of doctrine—a more flexible approach to control under *Aronson* and the creative expansion of the *Tri-Star* doctrine—have important implications for aggrieved minority shareholders of controlled public corporations. They carry with them the potential to reverse some of the effects of the restrictive post-*Gall* approach to pre-suit demand.

2. Deterrence, Again, and the MBCA

Attempts to measure directly the deterrent effects of derivative suits necessarily will be speculative. It is the classic challenge of proving a negative. The observable event that some scholars have focused on is the derivative suit filing. Yet this is a rare event in the life of any firm.²⁶¹ And because deterrence lies in the prospect of suit, the actual filing is often, if anything, a signal that deterrence has broken down.²⁶² An alternative is to measure the underlying conduct

the “special injury” rubric and entailed an element of deception, the more recent, post-*Tooley*, cases seem willing to ground a direct dilution claim on breach of fiduciary duty alone. See *Rossette*, 906 A.2d at 99-100. In the most recent of these cases, *Gatz v. Ponsoldt*, the court went so far as to recast the transaction into its economic equivalent in order to bring it within the doctrine, much as in a tax case. 925 A.2d at 1278-81.

Another evolving issue is what suffices to establish “control” for purposes of this doctrine. In *Tri-Star*, although the defendant did not own a majority of the shares, the court detailed its defendant's control at both the board and shareholder levels, including the existence of shareholder agreements that embraced affecting 56.6 percent of the voting power. 634 A.2d at 328-29. *Gatz* involved the holder of 38.45 percent of the equity which nonetheless had conceded its “de facto control” in response to another argument. 925 A.2d at 1275. On the other hand, as we saw in Section IV.B, *Feldman v. Cutaia*, No. Civ. A. 1656-VCL, 2007 WL 2215956, at *1-12 (Del. Ch. Aug. 1, 2007), recently refused to extend the *Tri-Star* doctrine to a less-than-majority holder. Although the directors and their families collectively held more than a majority, the court declined to aggregate these holdings in the absence of a voting agreement or other pact. *Id.* at *8-9.

260. *Rhodes v. Silkroad Equity, LLC*, No. Civ. A. 2133-VCN, 2007 WL 2058736, at *5 (Del. Ch. July 11, 2007).

261. Romano's study of 535 public corporations found that a corporation will experience any type of shareholder suit (derivative suit or class action), on average, only once every forty-eight years. Romano, *supra* note 122, at 59.

262. An early event study by Fischel and Bradley illustrates the problem. They examined abnormal stock price returns on the dates of court decisions dismissing or refusing to dismiss a derivative suit against the issuing corporation. Abnormal returns were positive (negative) when the suit was allowed to proceed (dismissed), but were in no cases statistically significant. Based on this lack of significance, Fischel and Bradley concluded that “derivative suits are not an important monitoring device to curb managerial malfeasance.” Fischel & Bradley, *supra* note 121, at 282. This ignores, however, any pre-filing deterrence created by the threat of suit. We

targeted for the deterrence. The problem, of course, is that parties ordinarily will try to cover up the targeted activity (fraud, self-dealing, mismanagement, etc.). At least in the case of self-dealing, however, SEC filings require disclosure under threat of penalties strong enough to assure substantial compliance. While few will be forthcoming about what they would have tried to get away with had the rules been looser, a rough estimate can be derived by comparing behavior before and after a particular deterrent is implemented or removed.

In 1990, the MBCA adopted a tough approach to derivative suits. Demand is required as a pre-condition to suit in all cases,²⁶³ and courts are required to accept the independent directors' recommendation to dismiss the suit so long as that recommendation was made in good faith following a reasonable investigation.²⁶⁴ To date, these provisions have been enacted in twenty-one states.²⁶⁵ In at least some of those states, these statutes overruled case law that had taken a more accommodating approach to the derivative suit.

Three states provide instructive examples: Texas, Iowa, and North Carolina. Texas is the largest state to adopt the MBCA derivative suit provisions. Prior Texas case law recognized the board's ultimate authority over the decision whether to sue on the corporation's behalf, but did not go as far as the MBCA amendments. Demand was excused when the alleged wrongdoers controlled the corporation, at either the shareholder or the board level.²⁶⁶ A 1979 decision indicated that, in such a demand-excused case, the board was divested of the power to terminate the shareholder's suit²⁶⁷—an issue that the Texas Supreme Court specifically left open on appeal.²⁶⁸ Conversely, when demand was required, the shareholder could not proceed with the suit without showing fraud, oppression, or abuse of power in the board's refusal to act.²⁶⁹ On balance, therefore, the MBCA provisions appear to have weakened the threat of derivative litigation as a deterrent in Texas.

cannot dismiss the possibility that even more misconduct might have occurred had that threat not existed.

263. MODEL BUS. CORP. ACT § 7.42(1) (1990).

264. *Id.* § 7.44(a).

265. 2 MODEL BUS. CORP. ACT ANN. § 7.44 Stats. (3d ed. Supp. 2005).

266. *Becker v. Dirs. of Gulf City St. Ry. & Real Estate Co.*, 15 S.W. 1094, 1098 (Tex. 1891); *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932, 937 (Tex. Civ. App. 1979); *Barthold v. Thomas*, 210 S.W. 506, 507-08 (Tex. Comm'n App. 1919).

267. *Zauber*, 591 S.W.2d at 938-39.

268. *Zauber*, 601 S.W.2d at 940.

269. *Cates v. Sparkman*, 11 S.W. 846, 848-49 (Tex. 1889); *Langston v. Eagle Publ'g Co.*, 719 S.W.2d 612, 616-17 (Tex. Ct. App. 1986).

Iowa and North Carolina are states whose pre-statute case law went the furthest in protecting the shareholder's right to maintain suit. In *Miller v. Register & Tribune Syndicate, Inc.*, Iowa's Supreme Court held that director-defendants in a derivative suit lacked the power to create an SLC with the authority to decide whether that suit should proceed.²⁷⁰ The North Carolina Supreme Court adopted the structure of *Zapata's* two-step test, but in the second step, it *required* the trial court to exercise its own business judgment as to whether the suit should continue.²⁷¹ As part of the process, the court was to make its own "fair assessment of the report of the special committee, along with all the other facts and circumstances in the case, in order to determine whether the defendants will be able to show that the transaction complained of was just and reasonable to the corporation."²⁷²

These states' approaches to derivative suits are most relevant to the Exploitation of Control cases. Corporations whose shares are not widely traded may see the benefits of Delaware law as unnecessary and opt for local incorporation. A list of the public companies incorporated in these three states reveals only a few "household names," and their SEC filings indicate that many have shareholders with majority control or a substantial control block.

To evaluate whether the adoption of the MBCA provisions in these states affected behavior that might be deterred by the threat of derivative suit, this study examined both cash compensation to the CEO²⁷³ and related party transactions for the two years before and after enactment. The study included all SEC-reporting companies with data available for the relevant five-year period, which produced seventy-seven corporations. The group consists of twelve Iowa corporations, thirty-six North Carolina corporations, and twenty-nine Texas corporations. The resulting data are summarized in Table 2 and are consistent with the propositions that derivative suits may have some deterrent effect on self-dealing, and that the MBCA provisions temper that effect. But the evidence is weak at best.

270. 336 N.W.2d 709, 718 (Iowa 1983).

271. *Alford v. Shaw*, 398 S.E.2d 445, 452-53 (N.C. 1990).

272. *Alford v. Shaw*, 358 S.E.2d 323, 328 (N.C. 1987).

273. Non-cash compensation might create an even greater risk of abuse. Because of changes in disclosure rules over the course of the study, however, comparisons had to be confined to the cash component.

Table 2. Compensation and Self-Dealing

| | Pre-Statute | Post-Statute |
|-----------------------------------|--------------------|---------------------|
| Median CEO Compensation | | |
| Iowa | \$321,943 | \$397,230 |
| North Carolina | \$412,650 | \$487,800 |
| Texas | \$496,500 | \$562,749 |
| Mean CEO Compensation | | |
| Iowa | \$414,653 | \$668,898 |
| North Carolina | \$558,321 | \$691,287 |
| Texas | \$758,729 | \$864,182 |
| Related Party Transactions | | |
| Iowa | 17 | 19 |
| North Carolina | 38 | 47 |
| Texas | 36 | 42 |

For the seventy-seven companies, median annual CEO compensation grew by 21.9 percent, and the mean by 23.1 percent, between the two-year periods before and after enactment of the MBCA amendments. This is roughly equivalent to an increase of ten percent per year. Given the combination of inflation and the growth of CEO compensation generally, this rate appears modest. Among individual companies, twenty-three saw increases of fifty percent or more, with CEO compensation more than doubling at four companies and tripling at another. As the numbers in Table 2 imply, Iowa had a disproportionate share of the substantial increases. But given the obstacles to challenging the level of CEO compensation, even under unrestricted access to derivative litigation, much more evidence is needed to support the conclusion that the statutory changes played a role in these increases.

Evidence of the effect on related party transactions is somewhat more persuasive. This inference is based not so much on the quantity of transactions, but on their nature. The data in Table 2 indicate that between sixty and seventy percent of the companies reported at least one related party transaction annually both before and after the amendments.²⁷⁴ Overall, the number of such reports

274. The data in Table 2 count the number of companies, not the number of transactions, each year. A company that reported related-party transactions in each year of the relevant two-

increased by 18.7 percent between the two year periods, with the increases spread fairly evenly among the three states. To get the full flavor, however, one needs to read the descriptions of the reported transactions in the companies' proxy statements. The proxy statements indicate a noticeable increase in the number of transactions that, because of either their size or character, might invite attention, particularly in corporations with controlling or substantial block holders. Examples include opening a corporate office in Pakistan, the residence of the company's chairman and controlling shareholder (Burke Mills. Inc.); the \$4.5 million sale of a company to an entity controlled by the chairman of the board (Cash America International); regularly housing management trainees and other employees at hotels co-owned by the CEO (Food Lion Corp.); cash advances to the controlling shareholder and a diverse range of business dealings with his son-in-law (Ingles Markets, Inc.); and \$200,000 in payments for using a controlling shareholder's private aircraft (Meredith Corp.).

Some, perhaps all, of these transactions may have substantially benefited the corporations and their shareholders. That is the point about self-dealing made in the Introduction—it will often be mutually desirable. It is plausible, though, that companies nonetheless might be reluctant to enter into these kinds of transactions for fear of shareholder criticism and that diluting the risk of shareholder litigation, at the margin, can cause the corporation to take the risk (and to openly disclose it).

Further complicating this assessment is the fact that the MBCA's restrictions on derivative suits have not proven as comprehensive in practice as the statute's black letter might suggest. Thus far, the case law in the states adopting the MBCA has yielded wide-ranging outcomes and reveals the confusion that can result when a body of traditionally judge-made law becomes the subject of detailed codification. While far from uniform, the predominant tendency has been for courts to find ways to offset the statute's strictness. Chief among these has been the continuing willingness to excuse demand when deemed futile,²⁷⁵ notwithstanding the clear statutory intent to

year period would be counted as "2" whether the number of transactions, or the amounts involved, increased or decreased.

275. *Simon Prop. Group, Inc. v. Taubman Ctrs., Inc.*, 261 F. Supp. 2d 919, 934-36 (E.D. Mich. 2003), *vacated on other grounds*, 373 F.3d 656 (6th Cir. 2004); *Foslip Pharm., Inc. v. Metabolife Int'l, Inc.*, 92 F. Supp. 2d 891, 908 (N.D. Iowa 2000); *McDonough v. Americom Int'l Corp.*, 151 F.R.D. 140, 142-43 (M.D. Fla. 1993); *Saunders v. Firtel*, No. CV054007690, 2006 WL 3908560, at *3 n.7 (Conn. Super. Ct. Dec. 27, 2006); *Guarino v. Livery Ltd., Inc.*, No. X04CV030127824, 2003 WL 22853729, at *1 (Conn. Super. Ct. Nov. 18, 2003); *Ezzone v. Riccardi*, 525 N.W.2d 388, 394

make the demand requirement universal.²⁷⁶ Courts in MBCA states also have been receptive to allowing disgruntled shareholders to bring their claims directly, whether through resort to the ALI's close corporation exception,²⁷⁷ Delaware's *Tri-Star* doctrine,²⁷⁸ or another avenue.²⁷⁹ Finally, in those cases where the board or an SLC has recommended dismissal, courts applying the MBCA test generally have taken a rigorous approach to assessing the directors' independence and good faith, as well as the reasonableness of their investigation.²⁸⁰

There is, on balance, significant evidence that courts in MBCA states have been inclined to temper the strict approach embodied by the statute. One explanation, consistent with the overall thrust of this Article, is that they are being called on to apply doctrines that arose out of, and are best suited to, the Corporate Impropriety category to cases falling almost exclusively in the Closely Held and Exploitation of Control categories.

n.2 (Iowa 1994) (dicta); *Kubik v. Kubik*, 683 N.W.2d 330, 336-37 (Neb. 2004); *Sadler v. Jorad, Inc.*, 680 N.W.2d 165, 170 (Neb. 2004); *Schrager v. Isquith*, No. CH05-272, 2005 WL 2546648, at *1 (Va. Cir. Ct. Aug. 19, 2005).

276. MODEL BUS. CORP. ACT § 7.42 & official cmt. (1990). Illustrative of the overall level of uncertainty, several courts—including some in jurisdictions cited in the preceding footnote—have held that the Model Act abolished the futility exception. *Firestone v. Wiley*, 485 F. Supp. 2d 694, 701-02 (E.D. Va. 2007); *Virginia M. Damon Trust v. N. Country Fin. Corp.*, 325 F. Supp. 2d 817, 821-22 (W.D. Mich. 2004); *Dunn v. Ceccarelli*, 489 S.E.2d 563, 567-68 (Ga. Ct. App. 1997); *Mannos v. Moss*, 155 P.3d 1166, 1173 (Idaho 2007); *McCann v. McCann*, 61 P.3d 585, 593 (Idaho 2002); *Speetjens v. Malaco Inc.*, 929 So. 2d 303 (Miss. 2006); *Allen ex rel. Allen & Brock Constr. Co., Inc. v. Ferrera*, 540 S.E.2d 761, 765 (N.C. Ct. App. 2000); *Norman v. Nash Johnson & Sons' Farms, Inc.*, 537 S.E.2d 248, 261-62 (N.C. Ct. App. 2000); *Schroeder v. Equitable Bank, SSB*, No. 97-2960, 1998 WL 538499, at *4 (Wis. Ct. App. Aug. 26, 1998).

277. *Byelick v. Vivadelli*, 79 F. Supp. 2d 610, 624-25 (E.D. Va. 1999); *Durham v. Durham*, 871 A.2d 41, 44-46 (N.H. 2005); cf. *Derouen v. Murray*, 604 So. 2d 1086, 1091 n.2 (Miss. 1992) (discussing court discretion to treat derivative claims as direct).

278. *Albers v. Edelson Tech. Partners*, 31 P.3d 821, 826-28 (Ariz. Ct. App. 2001); *Grace Bros., Ltd. v. Farley Indus., Inc.*, 450 S.E.2d 814, 816 (Ga. 1994).

279. *Jorgensen v. Water Works, Inc.*, 582 N.W.2d 98, 104 (Wis. Ct. App. 1998) (reviewing a claim that majority shareholders and directors paid themselves fees and bonuses that were in fact dividends).

280. *Klein ex rel. Klein v. FPL Group, Inc.*, No. 02-20170, 2004 WL 302292, at *15-24 (S.D. Fla. Feb. 5, 2004); *Kloha v. Duda*, 226 F. Supp. 2d 1342 (M.D. Fla. 2002); *McDonough v. Americom Int'l Corp.*, 905 F. Supp. 1016, 1020-21 (M.D. Fla. 1995); *Melton v. Blau*, No. X04CV030103953S, 2004 WL 2095317, at *6 (Conn. Super. Ct. Aug. 26, 2004); *Batur v. Signature Props. of Nw. Fla., Inc.*, 903 So. 2d 985, 994-97 (Fla. Dist. Ct. App. 2005); *Einhorn v. Culea*, 612 N.W.2d 78, 84-93 (Wis. 2000).

V. CONCLUSION

This Article has examined how the role played by derivative litigation today varies significantly with the category of cases involved. To a considerable extent, it is a lesson in the availability and functioning of substitutes. For Corporate Impropropriety, efficient securities markets, media scrutiny, and public enforcement combine to provide shareholders with much of the protection traditionally associated with the derivative suit, without the cost and distraction associated with nuisance litigation. For closely held firms, inter-shareholder conflicts can be addressed before the fact by contract and after the fact by a variety of ad hoc remedies. None of these alternatives realistically is available, however, for the kinds of companies and situations that typify the Exploitation of Control category. While their stock trades in the public markets, making private arrangements and shareholder-specific remedies unworkable, these companies often are too small to merit serious scrutiny by financial analysts or the media. Consequently, the derivative suit retains critical importance.

The fact that these Exploitation of Control cases have been overlooked throughout much of the recent debate over derivative suits has broader implications. Historically, these issues were an important focus of the law school casebooks and the study of corporate law. However, with the emergence of corporate governance as a stand-alone topic, and continuing with the takeover wave of the 1980s, the issues raised by large-cap, widely held corporations increasingly have dominated the discourse in both corporate law teaching and scholarship. Just as the close corporation emerged as a distinct object of study in the 1960s, perhaps the time has come for similar recognition of the controlled publicly traded corporation.

Corporate control has substantial value, as recognized by both the law and the marketplace. Yet the legal limitations on that value depend on the vague precepts of fiduciary obligation. Derivative litigation performs not only the task of righting particular wrongs but also of translating these general precepts into tangible rules. These rules well may be the most exportable part of U.S. corporate governance. Outside the United States and the United Kingdom, the controlled publicly traded corporation is the predominant form of private business organization.²⁸¹ Thus, in the words of two leading

281. See, e.g., Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1645-48 (2006) (discussing

international finance scholars, “the main focus of the literature on investor protection and its role in the development of financial markets . . . is on the amount of private benefits that controlling shareholders extract from companies they run.”²⁸² For countries seeking to improve their corporate governance without the tradition or institutional infrastructure to develop a case law of their own, the United States’ accumulated doctrine on the limits of control will prove highly valuable.

corporate control in various countries); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) (discussing various forms of business ownership around the world).

282. Alexander Dyck, & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 537 (2004) (citing Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000)).
