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John C. Coffee Jr.
Columbia Law School, jcoffee@law.columbia.edu

Michael P. Dooley
University of Virginia

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Corporate Law

What is the impact of new ALI proposals on shareholder litigation?

When the American Law Institute's Corporate Governance Project meets this month, one of the most hotly debated agenda items is likely to be its new rules governing shareholder litigation, which are now up for final approval.

The proposed change means that corporate boards will now have to prove in court that a decision to dismiss a shareholder claim alleging self-dealing was in the corporation's best interest. In addition, the requirement for a formal "demand" on the board by shareholders will be uniform, rather than subject to excuse, as it is under Delaware law and in the majority of states.

Drafters of the proposal say it will allow courts necessary scrutiny of self-dealing; critics charge it will tie up corporate boards in needless litigation.

Debating the issue are the project's reporter, John C. Coffee, a Columbia University law professor, and Michael P. Dooley, a University of Virginia law professor. Coffee says the proposals strike a balance between oversight and efficient operation, while Dooley contends that the new rules will drive up the settlement value of shareholder suits.

A Watchdog for the Guardians

BY JOHN C. COFFEE JR.

All systems of governance—public and private—must answer the same ageless question: Who will guard the guardians?

Every mechanism of accountability has its flaws, but over the last dozen-odd years, the Corporate Governance Project of the American Law Institute has struggled to develop balanced standards that preserve accountability without exposing directors to unnecessary risk.

All the while, our critics have responded there is no problem that needs solving—in effect, the guardians can guard themselves.

The debate over derivative litigation is illustrative. Although the ALI Reporters have never regarded the derivative suit as a primary mechanism of corporate accountability, we have seen it as a necessary fail-safe protection—but only for certain types of abuse.

Absent some means of judicial recourse, fiduciary duties become only precatory standards, not enforceable law. Yet, there is also a countervailing danger of overdeterrence.

Given this trade-off, the ALI standards seek not to expand the role of the derivative action, but to focus it on the context that it has traditionally best enforced: namely, the duty of loyalty rather than that of care.

Accordingly, the ALI standards provide that disinterested directors can terminate a derivative action that raises only negligence (or "duty of care") issues so long as their decision meets the test of the business judgment rule.

In contrast, when unfair self-dealing is alleged, the court cannot dismiss the action without a finding that the directors "reasonably determined that dismissal was in the best interests of the corporation, based on grounds that the court deems to warrant."

Although this standard preserves the possibility of substantive judicial review, it in no sense amounts to *de novo* review. Modest as this proposal is, some of our critics claim that it invades the board's autonomy and undermines the business judgment rule. Frankly, Chicken Little's fears were more realistic.

A Second Objection

Traditionally, the business judgment rule has not applied to self-dealing. Our more sophisticated critics recognize this, but raise a second objection: We are "liberalizing" standing to sue. This is at best a half-truth (because we raise the barriers to due-care litigation and necessitate demand in every case).

Under Delaware law, the board's decision to reject a proposed derivative action is insulated from judicial review by the "demand rule," which effectively denies standing to a shareholder to bring a derivative action unless a majority of the directors personally benefited from the transaction (in which case demand is "excused" as "futile").

The ALI Restatement rejects this distinction, because it has produced nothing but confusion and can insulate boards from charges of self-dealing. Instead, we require demand in virtually every case (and the ABA already has followed our lead in section 7.42 of its Model Business Corporation Act).

Because demand on the board is a low-cost, easy step, it makes sense to require it in every case in order to give the board a prior opportunity to review and possibly resolve the dispute before courts become involved. But requiring demand does not imply the courts must defer to boilerplate justifications for dismissal. Unfortunately, Delaware law does exactly this by treating the shareholder's demand as an absolute concession that the board has an unreviewable discretion to reject the action.

As a result, plaintiffs no longer make demands in Delaware-derivative actions and instead claim it was excused. Inevitably, courts become immersed in collateral issues.

The ALI's more balanced approach, which requires demand but permits judicial review (at least in some duty of loyalty cases), has already been followed by the highest state courts in Massachusetts, North Carolina and Iowa. They have recognized what the studies show: that directors almost invariably reject every derivative action that they are asked to review. To give directors unreviewable discretion leaves the guardians watched only by themselves. ■

Not in the Corporation's Best Interests

BY MICHAEL P. DOOLEY

There are sound reasons for rejecting the American Law Institute's recommendations for rules that would limit the board's control over corporate litigation and ease traditional restrictions on the standing of individual shareholders to bring suits in the corporation's name.

A board of directors' litigation decision should be subject to judicial review the same as any other business decision—no more and no less. This has been the law for more than a century.

The present restrictions on standing are logically compelled by the statutory requirement in all states that the board manage the corporation. If individual shareholders were afforded easy access to the courts, the result would be to transfer ultimate decision-making authority from the board to any shareholder who is willing to sign a complaint.

This is not only inconsistent with the statutory structure but with common sense: If individual shareholders had the time, information and inclination to manage the business directly, there would be no need for a board of directors and no reason to defer to the directors' authority.

The institute proposes that a shareholder is free to commence an action without regard to the independence and good faith of the directors who disagree. Once filed, a shareholder's complaint alleging a plausible cause of action can be terminated only if the board convinces the court that it is not in the corporation's best interests to pursue the suit.

The level of justification required to dismiss a shareholder's suit will depend on who the defendants are and the nature of the allegations. Considerably more will be required to dismiss a suit alleging a breach of loyalty on the part of senior managers or a board member.

Requiring greater formalities to terminate will increase the settlement value of derivative suits and lawyers' incentives to bring them. Moreover, the institute proposes no effective screening mechanism to replace the board of directors. In particular, the ALI's proposed standing requirements are illusory because they depend almost entirely on the type of allegations made in the complaint, and can be controlled wholly by the plaintiff's attorney.

Ineffective Pleading

There is almost no internal dispute that, as a matter of pleading, cannot be attributed to someone in the corporate hierarchy, and it can be argued that a particular business misadventure must have been at least partially motivated by self-interest.

My reservations about the ineffectiveness of pleading requirements are based on the fact that derivative suits most often involve publicly held corporations whose shareholders are unlikely to have any personal knowledge of the events in question and who must, therefore, base complaints on accounts as published in newspapers or other public documents.

Finally, it is unlikely that these proposals will increase judicial oversight of corporate management. Given that corporate indemnification and insurance are not available to reimburse any defendant who has been adjudged liable for breach of fiduciary duty, proceeding to a judgment on the merits poses substantial risks for all concerned.

This includes the plaintiff's attorney who risks "winning" an uninsurable—hence uncollectible—judgment against individual defendants. In most instances, then, it is in the best interests of the corporation, the defendants and plaintiff's attorney to agree to some settlement that admits no individual wrongdoing but that agrees to some minor change in internal corporate procedures that can be claimed as a "substantial benefit" sufficient to warrant an award of attorney fees.

In some cases, the parties have even been able to finesse making cosmetic changes and to obtain court approval of settlements that provide only for the payment of attorney fees.

In terms of tangible shareholder benefits, our experience with derivative suits has been disappointing. It is hard to know what the ALI expects to gain by easing the standing requirements and increasing the settlement value of such suits—other than increased lawyer income. ■

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