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IN PRAISE OF DERIVATIVE SUITS: A COMMENTARY ON THE PAPER OF PROFESSORS FISCHEL AND BRADLEY†

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INTRODUCTION

There are not many surprises in the paper that Professors Fischel and Bradley (F&B) have prepared for this conference.[1] The paper is lucidly written and carefully structured; it presents data offered to establish that lawyers' intervention in the marketplace provides little value and that the enforcement of liability rules that tax corporate managers are not worthwhile. Moreover, as expected, the paper is provocative and raises questions which any proponent of the continued use of liability rules and derivative suits must answer. Alas, I do not find most of their conclusions persuasive, and this too is not surprising.

F&B believe that liability rules, and the derivative suits that are used to enforce them, are relatively unimportant in promoting desirable management behavior and in reducing agency costs.[2] They

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

2 Fischel and Bradley (F&B) appear to argue in several places that liability rules and derivative suits should be abolished. At one point they state that an "[a]nalysis of [several] factors suggests that liability rules play a relatively minor role in assuring contractual performance by corporate managers in publicly-held corporations." *Id.* at 263. Further on, the authors contend that

> [m]any analyses of corporate law assume that liability rules enforced by derivative suits play a fundamental role in aligning the interests of managers and investors. We have shown that this widespread assumption is not supported by either the theory of liability rules, the available empirical evidence, or the structure of corporate law.

Id. at 292. F&B concede that the survival of the derivative suit "suggests it has some value," *id.* at 286-87, but they find this value only in the suit's ability to deter large one-shot frauds. *Id.*

At the conference where they presented their paper, F&B denied a charge that they were sub silentio proposing abolishing derivative suits. Instead, they claimed to favor the existing legal scheme. This assertion seems disingenuous or at best renders their conclusion humdrum given the sharp criticism they level at rules and procedures which are so much a part of the conventional wisdom of corporate law.

maintain that these rules fail for several reasons: the high cost and great difficulty in structuring a contract that adequately defines managers' duties;[3] the threat to an otherwise valuable relationship;[4] the superior efficiency of information markets in disciplining management;[5] the chilling effect of liability rules on sensible risk taking;[6] and the existence of less costly alternative methods of assuring proper conduct.[7] Moreover, F&B claim that certain principles of corporate law reduce the scope of liability rules, further demonstrating their relative insignificance.[8]

My own conclusions differ in virtually all respects. Liability rules, enforced by shareholder litigation, are theoretically sound and profoundly affect the conduct of corporate managers, at least some aspects of their duties. Moreover, although I recognize that this system is not costless, I believe that the benefits outweigh the costs, a conclusion, I hasten to add, that is based on experience rather than statistical data. I agree, however, with F&B's observation that certain principles of corporate law reduce the effectiveness of these liability rules, and I favor efforts, mainly those undertaken by the American Law Institute, to strengthen certain substantive corporate law provisions that will enhance the viability of derivative suits and address the cost issues. Reform must be undertaken from two perspectives because practices by both plaintiffs and defendants pose threats to the litigation process. Collusive settlements involving and encouraged by plaintiffs' counsel undermine recoveries by shareholders and corporations, while biased internal corporate procedures cut off the plaintiffs' access to impartial determination of their claims. Although each separate act may be cost-justified, the abuses by both sides may also impose significant burdens on the system, with a potential loss of the benefit of deterrence.[9]

I do not mean to suggest that liability rules and enforcement mechanisms are the only devices appropriate to hold corporate managers accountable and reduce agency costs. The mechanisms F&B describe in their paper are all useful.[10] Indeed, I have more confidence in some of them, such as the increased use of independent directors, than Professor Fischel has.[11] I do not believe, how-

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3 *Id.* at 264-66.

4 *Id.* at 268-70.

5 *Id.* at 267-68.

6 *Id.* at 270-74.

7 *Id.* at 274-76.

8 *Id.* at 283-87.

9 *See* Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation,* 48 LAW & CONTEMP. PROBS. 5 (1985).

10 F&B, *supra* note 1, at 274-76.

11 *See* Fischel, *The Corporate Governance Movement,* 35 VAND. L. REV. 1259, 1283

ever, that any single method, such as the operation of the various markets, is adequate. I am therefore reluctant to abandon reliance on a system that has long been regarded as the heart of the accountability devices.

I
DUTIES OF DIRECTORS AND OFFICERS

Modern corporate law, as applied to publicly-owned corporations, builds on the assumption that stock ownership is separate from control.[12] The stock of most publicly-held corporations is widely dispersed, and managers tend to own relatively small percentages of the stock of companies that they control.[13]

The separation of control from ownership demands a system of accountability. To allow managers to wield power over other people's money without subjecting them to certain constraints is unthinkable. Corporate law has devised rules which perform the function of a standard form contract between the corporation, or its shareholders, and the managers for this purpose.[14]

Corporate law imposes two duties on all managers: the duty of due care and the duty of loyalty.[15] The duty of due care addresses both the decisionmaking function of managers and their obligation to monitor the activities of lower echelon employees. The board of directors is expected to monitor the performance of senior management and select their successors. Directors also make some key business decisions, and they must exercise appropriate care in discharging this duty.

The duty of loyalty is concerned with self-dealing. At one time, corporate law prohibited all transactions between directors and the corporation. Ultimately, however, courts came to understand that the prohibition of all such dealings was not in the interest of the corporation or the shareholders.[16] This stringent rule was replaced by a flexible rule that permitted such transactions as long as they were openly disclosed to disinterested persons acting on behalf of the corporation and as long as the transactions were fair. Self-deal-

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(1982) (board with majority of independent directors will not necessarily increase shareholders' wealth).

12 *See* A. BERLE & G. MEANS, THE MODERN CORPORATIONS AND PRIVATE PROPERTY 113 (1932) (owners hold "legal and factual interests" in enterprise but not "legal and factual powers over it").

13 M. NEWCOMER, THE BIG BUSINESS EXECUTIVE 105 (1955).

14 Fischel, *supra* note 11, at 1264.

15 *E.g.*, Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) ("A board member's obligation to a corporation and its shareholders . . . [is] generally characterized as the duty of care and the duty of loyalty.").

16 Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

ing transactions include not only directors' purchases of corporate assets or sales of directors' assets to the corporation, but also transactions in the stock of the company and directors' self-utilization of opportunities that might be considered business opportunities of the corporation.

Corporate law treats abuses of the duty of loyalty more harshly than abuses of the duty of due care. The law's greater comfort in dealing with unfairness than with inefficiency may partially explain this differential treatment. This focus is sensible not only because it confines courts to what they do best and because it tends to avoid the higher costs involved in policing breaches of the duty of due care, but also because self-dealing is the more serious problem.

One of the most important principles in corporate law is the business judgment rule, by which courts defer to the decisions of directors and officers that involve no self-dealing and minimize the threat of liability for erroneous decisions.[17] The result of the business judgment rule is that few cases are brought against directors for bad decisions and still fewer cases succeed in imposing liability.[18] One of F&B's concerns about the existence of liability rules is that "a poor outcome will be equated with poor performance" and

> if agents are penalized for poor outcomes as well as poor performance, they will tend to undertake lower risk projects. This tendency to cause agents to behave in a more risk-averse manner is itself a potentially large cost of liability rules as a governance mechanism in contractual situations where principals want agents to behave in a more risk-neutral manner.[19]

This gloomy prediction is made without reference to the business judgment rule, although F&B acknowledge the rule some thirteen pages later.[20]

The business judgment rule should also alleviate F&B's concern that avaricious lawyers will press trivial or unmeritorious derivative suits.[21] The rule minimizes this risk because a plaintiff's lawyer who brings a derivative suit on a contingent fee basis and who expends substantial time and effort to prove his case is very likely to

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17 *See* Arsht, *The Business Judgment Rule Revisited,* 8 HOFSTRA L. REV. 93 (1979).

18 Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers,* 77 YALE L.J. 1078, 1099 (1968) ("The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.").

19 F&B, *supra* note 1, at 270. F&B later advocate a market solution to poor management and note that managers who make bad choices are likely to lose their jobs. *See id.* at 268, 275. If their assertion is true, the risk of liability is a relatively unimportant factor in making managers unduly risk-averse.

20 *Id.* at 283-84.

21 *Id.* at 271-74.

discover that he has drilled a dry hole for all his efforts. Assuming that the lawyer is rational, he will be disinclined to institute a derivative action to recover damages based upon a poor result because the risk of failure is too great; he will observe the old adage, "Don't send good money after bad."

The duty of due care also requires directors and senior managers to be prudent and to monitor the work of others. If losses result from their seriously negligent failure to supervise, they are exposed to liability. But this variation of duty of care liability is unlikely to impose significant burdens on management. The law that prevails in Delaware, for instance, requires a showing not simply of negligence but of gross negligence, thus significantly reducing the likelihood of liability.[22]

Consequently, management's greatest liability exposure is for breaches of the duty of loyalty. Such cases are far more appealing to lawyers who bring suits on contingent fee bases. They are easier to prove, and their facts typically glean more sympathy from judges and juries. The legal rules relax the burden of proof for plaintiffs in cases involving the duty of loyalty.[23] Without actually having made a head count, I am satisfied that over ninety percent of the litigation involving breaches of duty by directors and officers involves cases claiming a breach of the duty of loyalty.[24]

F&B assert that the distinction between the duty of care and the duty of loyalty is artificial because both involve agency costs that reduce shareholder wealth.[25] This purported analysis is too shallow. Although shirking and theft can each cause injury, the incentive to self-deal carries with it far greater rewards than does shirking. Shirking provides leisure time; self-dealing can produce large monetary rewards. Moreover, persons who rise to important management positions tend to be ambitious and industrious and are

22 *See, e.g.*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963) (varied definitions of "gross negligence" prevent uniform application of rule). *See* Francis v. United Jersey Bank, 87 N.J. 15, 31-37, 432 A.2d 814, 821-25 (1981) (directors' duty of care varies according to nature of business). At a minimum, however, courts will probably demand proof of "sustained patterus of inattention" to find liability. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 29 (Tent. Draft No. 4, 1985) [hereinafter cited as ALI PROJECT].

23 *See Norlin Corp.*, 744 F.2d at 264 ("Once a prima facie showing is made that directors have a self-interest in a particular corporate transaction, the burden shifts to them to demonstrate that the transaction is fair and serves the best interests of the corporation and its shareholders.").

24 The ALI reporters found only approximately 30 appellate cases in the twentieth century affirming violations of the duty of due care. ALI PROJECT, *supra* note 22, at 28-29.

25 F&B, *supra* note 1, at 291. In the draft presented at the conference, F&B descrihed the distinction as "artificial."

unlikely to avoid hard work.[26] Therefore, shirking is not really the problem. Moreover, practice, more than theory, limits derivative suits mostly to breaches of the duty of loyalty rather than the duty of due care. Theoretically, the interest of the corporation would be in recovering its losses, and in deterring other losses, whatever the source. The value of the derivative suit is not called into question by a theoretical deficiency, but rather by practical deficiencies which apply almost exclusively to losses from the failure to exercise due care. By no means do these practical limitations call into question the theory of derivative suits or their value. If practical limitations do not apply, or apply only to a lesser degree, the theory underlying derivative suits retains force.

II
THE THEORETICAL CASE FOR DERIVATIVE SUITS

The theoretical case in favor of liability rules enforced by shareholder litigation is, I believe, a strong case, and neither contrary theoretical considerations nor any empirical data that F&B present refute it. Although F&B suggest in their first sentence that the primary purpose of liability rules is to "create incentives to engage in socially desirable conduct,"[27] liability rules also compensate those who have been injured.[28] Even if compensation is not the principal function of liability rules, it is their occasional function. One reason I believe F&B overlooked this compensatory aspect is that their model for shareholder litigation only considers the derivative suit, ignoring shareholder litigation that is brought as a class action in which the shareholders may personally recover for their injuries.[29]

Even if we focus only on the derivative suit in which the corporation recovers any damages[30] and where most certainly the principal purpose is to deter improper conduct, the theoretical case is a strong one. It is especially strong as applied to breaches of the duty of loyalty.[31] Corporate managers, by definition, are not capable of policing the injurious conduct because they are responsible for it and have profited from it. Judicial oversight in these suits does not

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26 *See* M. MACCOBY, THE GAMESMAN (1976).

27 F&B, *supra* note 1, at 261.

28 Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 106-08, 460 P.2d 464, 470-71, 81 Cal. Rptr. 592, 598-99 (1969) (en banc) (allowing individual cause of action for breach of fiduciary duty).

29 *See id.* at 107, 460 P.2d at 470, 81 Cal. Rptr. at 598.

30 On rare occasions the recovery in a derivative suit is paid directly to innocent shareholders to prevent windfall gains by offending shareholders. Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

31 The theoretical case for derivative suits is set out in ALI PROJECT, *supra* note 22, at 3-5 (Discussion Draft No. 1, 1985).

question managers' objective business decisions but rather is limited to those things that courts do best. The derivative suit thus provides a remedy that is not burdened by the necessity of requiring concerted action by shareholders. Furthermore, in a derivative suit the plaintiff's counsel is compensated only when successful because he operates on a contingent fee basis. Private enforcers with proper incentives reduce the need for government supervision which, but for the activities of private enforcers, would be necessary. As the ALI Reporters note, "[t]he most important claim that can . . . be made for the derivative action is that it can reduce average agency costs."[32]

The ALI Reporters also note that one of the most important uses for derivative suits is to protect the market for corporate control.[33] The value of the derivative suit in this context has only recently been realized. When confronted with a hostile tender offer, target company management often resorts to various devices to thwart the bid, consequently denying shareholders a profitable opportunity. Whether this conduct is in the best long-term interest of the corporation is debatable, but who bears the immediate cost and who reaps the short-term benefits is clear. Professor Fischel, and his colleague Professor (now Judge) Easterbrook, have surely been two of the most vigorous foes of target management's efforts to block hostile tender offers.[34] Shareholders have challenged many of these tactics, but most of the suits have been unsuccessful.[35] The business judgment rule has been an obstacle to recovery when the defensive measures were authorized by so-called independent directors who allegedly are capable of making an objective decision because their jobs are not at stake in the takeover bid.[36] Recently, the courts,[37]

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32 *Id.* at 13. This point is expanded upon in Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 746-48 (1984).

33 ALI PROJECT, *supra* note 22, at 4 (Discussion Draft No. 1, 1985).

34 *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (legal rules should inhibit managers' ability to thwart tender offers).

35 *See, e.g.*, Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983) (district court lacked authority to judge substantive validity of anti-takeover device), *cert. denied*, 104 S. Ct. 1326 (1984); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.) (business judgment rule protects anti-takeover actions), *cert. denied*, 454 U.S. 1092 (1981); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (business judgment rule applies if directors can show "reasonable grounds for believing" takeover would endanger corporate policy).

36 *Unocal Corp.*, 493 A.2d at 955 (approval by outside independent directors enhances proof that approval of takeover deterrent was reasonable).

37 *Norlin Corp.*, 744 F.2d at 265-66 (directors must demonstrate that anti-takeover actions were "fair and reasonable").

Congress,[38] and the SEC have questioned the premise on which this judicial deference is based.[39] Consequently, changes in the wind may curtail the ability of target managers and target boards to defeat a tender offer by manipulating the corporate machinery. I do not think the market, acting without assistance from liability rules, can sufficiently protect shareholders. The market has not rendered the rules irrelevant, even though it did ultimately discipline some targets that were able to thwart a takeover bid and resist judicial challenge, such as Marshall Field; but the experience is by no means universal. To be sure, the courts must become sensitive to the nature of the resistance undertaken by target managers and their boards so that the liability rules may function effectively. The point is that the courts have the capability of keeping the market for corporate control free from distortion.[40]

The theoretical argument for maintaining and even strengthening the role of liability rules and derivative suits is soundly, and even conservatively, based. Derivative suits assist in maintaining the efficiency of our economic system. No basis exists for believing that proponents of such rules proceed from the premises "that corporate managers *systematically* act in ways contrary to investors' best interests."[41] Proponents of strengthening derivative suits no more urge that corporate managers "systematically" act contrary to investors' best interests than do proponents of tender offers who justify the unfettered functioning of such offers as necessary to discipline inefficient managers. Rather, proponents of each of these devices apparently recognize the value of accountability devices for reducing agency costs and promoting corporate efficiency. In my view, both derivative suits and tender offers are important, even vital, to the functioning of the system.

III
THE EMPIRICAL EVIDENCE

F&B's empirical data does not confirm, nor even strengthen, their argument. I lack sufficient training to dispute the relevancy of the formula F&B employ or the accuracy of the numbers shown by the University of Chicago Center for Research in Security Prices.[42] I note, however, that twenty-eight cases is a small sample. Indeed F&B's sample is not as extensive as my own anecdotal experience in

38 H.R. 5695, 98th Cong., 2d Sess. (1984) (corporation has burden of proof that anti-takeover actions were prudent and fair to shareholders).

39 *See* Legal Times, Apr. 23, 1984, at 35.

40 *See* Oesterle, *Target Managers as Negotiating Agents For Target Shareholders in Tender Offers: A Reply to the Passivity Thesis,* 71 CORNELL L. REV. 53 (1985).

41 F&B, *supra* note 1, at 262 (emphasis added).

42 F&B's empirical data and results are reported in *id.* at 277-83, 293-97.

the field, and it is far smaller than the experience of persons with whom I have compared experiences.

A more serious quarrel with the usefulness of the data is that it measures stock prices occurring around a nonevent, or at best a highly ambiguous event. What, after all, should the marketplace make of the filing of a lawsuit or its termination prior to a decision on the merits? Did the complaint state a good cause of action that holds promise of an award to the corporation or its shareholders? Did the filing of the lawsuit demonstrate that management was inefficient, or worse? Has a knowledgeable analyst studied the complaint at the time of filing to judge its probable success? The same questions arise at the time of termination. Did the plaintiff abandon anything of value? Did the termination of the lawsuit change the status quo? Who is adequately informed to be able to make such a judgment? The data's ambiguity is further compounded because disclosure of the event or the litigation reveals both an alleged injury to the corporation or shareholders (cost) and a possible recovery (benefit). The cost probably influences the market more than the benefit, but the market would surely react more severely if there were only costs to contemplate without prospect of possible recovery.

The period of time in which F&B chose to examine stock prices is also faulty.[43] Most private suits are filed in response to the public disclosure of an event. Stock prices are more likely to react to the public disclosure of the litigable facts than to the filing of the unsurprising lawsuit. For example, Union Carbide prices declined upon news of the catastrophe in Bhopal, not upon the filing of the already discounted lawsuit.[44] I would think the efficient market would have it no other way.

F&B also fail to account for the suit that is too small to materially affect the corporation's earnings. A theft of ten million dollars from IBM is trivial to the company; a lawyer making a representation to an auditor would regard litigation over such an amount as immaterial. Neither the loss nor its recovery is financially significant. Should we iguore the theft because the market did not react? If F&B's study required this conclusion, I fear that the reaction of government agencies and more particularly investors in general would be harsh. Indeed, would not the market discount for all agency costs increase dramatically?

Thus, in general, F&B's event study is largely irrelevant. Most

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[43] F&B look solely at judicial decisions to terminate or continue a derivative suit, not at public disclosure of the litigated facts or settlement. *Id.* at 277.

[44] *See* N.Y. Times, Dec. 4, 1984, § D, at 16, col. 6; *id.*, Dec. 5, 1984, § D, at 10, col. 6.

of the lawsuits covered by their study involved amounts which, if fully recovered, would have barely affected earnings per share. Termination of these suits involved abandonment of relatively insignificant amounts. Yet the study reveals a small decline in stock prices, thus suggesting that derivative suits are worthier than F&B suspect. Nor would one expect a significant market reaction to the filing of the suit. The market has been conditioned to expect little from the filing of a suit because courts are inclined to grant motions to terminate based upon the recommendation of a special litigation committee. The events under study do not provide an opportunity to develop much understanding of liability rules or derivative suits.

F&B observe that their own conclusions cannot be pushed too far because the sample is small and because it does not measure the final resolution of litigation.[45] I can understand the desire to amortize the cost of the CRSP tape, but I think that this experiment goes too far.

In sum, my main objection to F&B's use of their data to prove that liability and recovery rules are without effect on investor wealth is that F&B study the ex post effects of a mechanism for which the rationale is essentially its ex ante impact. Deterrence is the major reason for and principal effect of derivative suits.[46] Data on stock prices cannot measure the deterrent effect on management behavior achieved by liability rules that can be readily enforced by private parties. With all modesty, I believe my own anecdotal experience and the experience of more seasoned lawyers in the board room is relevant. For many years, the late Abe Pomerantz, the dean of the derivative suit bar, was an unseen presence in the board room whenever major transactions were considered. Today Mel Weiss and Lowell Sachnoff have replaced him. The plausible threat of a shareholder suit has influenced the terms of many transactions and discouraged others from being undertaken. Experience suggests that transactions that boards scrutinized in this manner were almost always self-dealing transactions involving serious questions of fairness. Rarely, in my experience, has fear of a derivative suit affected transactions within the scope of the business judgment rule. In addition, the terms of the transactions, when approved, often provide greater benefits, in the form of a better price, to the corporation or to the shareholders. Finally, this process improves the quantity and quality of the information provided to the marketplace.

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45 F&B, *supra* note 1, at 282.

46 *See* Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 302-09 (1981) (deterrence is better rationale for derivative suits than compensating wronged shareholder).

IV
SPECIFIC CRITIQUE OF DERIVATIVE SUITS

I would like now to turn to some of the specific criticisms that F&B level against the utility of liability rules in reducing agency costs.

F&B initially note that managers' obligations depend upon contract, but specifying the performance obligations in the contract is difficult and hence costly.[47] The contract, however, is essentially one of adhesion, consisting of the broad statutory requirement to act in good faith and exercise due care, in addition to the more finely detailed requirements that have emerged through common law. F&B fear that courts will improperly and restrictively apply the contract because "most lawsuits follow poor outcomes [and] courts naturally tend to assume that such outcomes are a product of bad actions."[48] Experience does not bear out this observation, however, because their fear overlooks the effect of the business judgment rule. Since the benefits of an enforcement remedy are contingent on a successful judgment, shareholders will challenge only the most glaring departures from behavior. Thus, the vagueness of the "contract" has not produced a large body of frivolous litigation. Plaintiffs' lawyers aim to achieve a high percentage of winners, and they have generally succeeded in obtaining favorable outcomes for their clients.[49] This result is accomplished because lawyers avoid litigating those cases where all they can show is a bad outcome.[50]

F&B's observation that it is costly to monitor the effort or output of individual managers, thereby making it difficult to use liability rules effectively as a remedy for managers' "lack of effort,"[51] is a valid point, but one whose thrust is aimed more at the duty of due care than the duty of loyalty. Of course, plaintiffs' lawyers are acutely aware of the difficulty, reserving their efforts for the most egregious cases.

F&B also make the sound point that shareholders should not assert some claims because, on balance, the corporation is best served by not upsetting a valuable relationship.[52] This observation, however, should not be overstated. Sometimes the defendant is a

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47 F&B, *supra* note 1, at 264-66.

48 *Id.* at 265.

49 *See* Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978,* 60 B.U.L. REV. 306, 307 (1980) (commentators have exaggerated the "explosion of shareholder litigation").

50 *See* Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits,* 60 B.U.L. REV. 542, 545 (1980) (plaintiffs received some relief in over three-fourths of studied lawsuits).

51 F&B, *supra* note 1, at 265.

52 *Id.* at 269.

former officer or director with whom the company no longer has a continuing relationship. Furthermore, the lawsuit will not always involve the board of directors, thus leaving any relationship intact. For instance, when liability rules are enforced by a class action rather than a derivative suit, no demand on the board of directors is necessary, nor does the board of directors have any power to terminate the suit. A class action is a dispute between shareholders in their individual capacity and officers, directors, and sometimes the corporation itself as defendants. No colleague need harshly judge another colleague, and the relationship may continue into the future regardless of the outcome of the lawsuit. The point worth extracting from F&B's observation is that in a derivative suit, where the board does have a role to play, terminating the lawsuit prior to a judgment on the merits is often in the best interests of the corporation. I agree that the power to dismiss should be recognized. I disagree with F&B as to the scope of this power and the manner in which it is exercised and reviewed.

F&B repeat an oft-stated charge that "[t]he greater the threat of litigation, the less willing those who remain with the firm will be to make firm-specific investments of human capital."[53] If the liability rules are generally applicable to all corporations, that chilling effect is unlikely to occur simply because there will be no competitive firm to whom those persons can turn and thereby escape the rules.

The authors note that liability rules implicate special problems in the corporate context. For example, plaintiffs' attorneys, who are the engine of the derivative suit mechanism, "have very poor incentives to maximize shareholders' wealth."[54] That observation ignores the fact that plaintiffs' attorneys recover nothing at all if they do not succeed in the lawsuit and that the extent of their success determines the size of the fee, at least in part.[55] Plaintiffs' lawyers have little incentive to consume their time on suits that have a low prospect of success or for that matter a low prospect of substantial recovery. Although abusive conduct does exist, remedies short of those F&B imply are available.

The authors also suggest that shareholder suits create a risk of strategic behavior by minorities. They show that corporate law discourages such strategic behavior by permitting transactions to proceed with majority approval rather than unanimous consent. In

53 *Id.* at 270.

54 *Id.* at 271.

55 F&B note that this area is beyond the scope of their paper, but it is highly relevant to considering the overall scope of derivative suits. Incentives based more on value created than on time expended probably best serve the shareholder's interest. *See* Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983).

contrast, a single shareholder may initiate a lawsuit to block a favorable transaction in order to gain a disproportionate benefit.[56] The strategic games that a shareholder can play when the rules demand unanimity, however, are not the same games that a litigant plays. A shareholder may withhold consent according to his own whims. He is accountable to no one, and the game is over when he says it is. But a litigant who plays a strategic game by bringing a derivative suit will bear all his own costs and expenses if an objective party—a court—decides that his suit lacks merit. His game is over when a court says it is. Surely this obstacle should discourage strategically motivated or even ill-informed lawsuits. F&B are nonetheless correct in observing that derivative litigation may produce undue costs, and some reform of the law is probably appropriate to minimize this drawback. Imposing attorney's fees on trigger-happy lawyers may well be a useful control on this behavior.

V
Corporate Structure: Not a Bar to Derivative Suits

F&B argue that principles of corporate law reduce the scope of liability rules, rendering derivative suits still more insiguificant. In particular, they cite (A) the business judgment rule, (B) the substitution of procedural for substantive rules in self-dealing transactions, (C) the liberal rights of indemnification and insurance, (D) the exclusivity of appraisal rights, and (E) the restrictions on plaintiffs' ability to bring derivative suits.[57] I believe that they exaggerate considerably the restraining effect of corporate law, although they point out several areas in which change is desirable.

A. Business Judgment Rule

F&B contend that the business judgment rule precludes liability in a wide variety of situations.[58] The business judgment rnle imposes an appropriate limitation on the right to bring and to recover damages in a derivative suit, but the rule does not apply to cases alleging self-dealing. Although courts have misapplied the rule from time to time to protect essentially self-dealing transactions, such cases are hardly the rule. Moreover, even absent self-dealing, the business judgment rule has not precluded suits based upon totally indefensible business decisions nor those based upon grossly negligent conduct of corporate managers. I disagree with Professors Scott and Weiss who believe that derivative suits should play no

56 F&B, *supra* note 1, at 272.
57 *See id.* at 283-86.
58 *See id.* at 283-84.

role in cases involving a breach of the duty of due care or a failure by managers to monitor,[59] but I agree that shareholders should rarely bring such suits.[60] Courts have probably gone too far in protecting managers in due care cases, however, because of a fear of imposing ruinous liability in situations where the managers did not personally profit.[61] Limiting liability or creating other remedies is desirable so that the courts will not find it necessary to distort the substantive standards of care that should properly apply in order to avoid an excessive award of damages. The ALI's proposal to limit recovery to the director's direct compensation from the corporation during the year in which the violation occurred, except for egregious cases, moves in that direction.[62]

B. Substantive or Procedural Rules

F&B allege that in self-dealing cases corporate law requires that courts review only the process by which such transactions were approved, rather than their substance. To F&B this requirement further demonstrates the impotence of liability rules.[63] Once again, I disagree. Corporate law does not, in my opinion, substitute procedural for substantive review of self-dealing transactions.

Some corporation statutes, such as section 144 of the Delaware Corporation Law, appear to validate a self-dealing transaction without regard to its fairness if independent directors have approved it. A literal reading aside, corporate law generally permits judicial review of the fairness of a self-dealing transaction although it shifts the burden of proof on the question of fairness to a plaintiff if the transaction has been fully disclosed to independent directors and approved by them.[64] Section 5.01 of the ALI Project accurately states

59 Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 935-37 (1983); Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 13-17 (1984).

60 Egregious situations will always need redress, lest directors or managers come to believe that abdication of their functions is acceptable. *See* Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981) (defendant director negligent for failing to notice misappropriation of corporate funds held in implied trust).

61 Bellis v. Thal, 373 F. Supp. 120, 133 (E.D. Pa. 1974), *aff'd mem.*, 510 F.2d 969 (3d Cir. 1975) (disallowing recovery for shrinkage of corporate assets despite showing that defendants acted willfully and maliciously).

62 ALI PROJECT, *supra* note 22, § 7.16 reporter's note, at 221-22 (Discussion Draft No. 1, 1985). The ALI Council, which governs the institute, has not yet accepted or rejected the proposal to limit liability. *Id.*, comment h, at 201.

63 *See* F&B, *supra* note 1, at 284.

64 *See* Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952) (self-dealing transaction voided because of unfairness to minority shareholders despite statutory compliance); *see also* Scott v. Multi-Amp Corp., 386 F. Supp. 44 (D.N.J. 1974) (statute does not alter traditional fiduciary duty); Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (same); Aronoff v. Albanese, 85 A.D.2d 3, 446 N.Y.S.2d 368

the law. That section states that a director or senior executive violates the duty of loyalty if he has not made adequate disclosure *or,* to oversimplify the language, if the transaction was not *reasonably* believed to be fair to the corporation by independent directors.[65] These criteria require a court to review both the procedure and the substance of the transaction. A number of judicial decisions support this outcome regardless of the wording of the applicable corporation statute.[66]

C. Indemnification and Insurance

As F&B note, management's entitlement to indemnification and insurance does soften the effect of liability provisions,[67] but it does not relegate them to insignificance. First, indemnification in a derivative suit does not cover the amount of the judgment, only the expenses involved in the litigation.[68] Although this point seems obvious, it deserves mention because I so often find it misunderstood. Second, if the litigation involves violations of the federal securities laws, public policy considerations may make indemnification unavailable.[69] Third, although the law may allow companies to offer insurance beyond indemnification, insurance companies generally will narrow their coverage to exclude coverage for fraud or other serious misconduct. Insurance contracts often exclude all coverage for claims under the federal securities laws, contain deductible features that leave insureds exposed to more than trivial amounts,[70]

(1982) (same); REVISED MODEL BUSINESS CORP. ACT § 8.31 comment 1 (1984) (transaction involving self-dealing may be voidable despite meeting statutory tests).

65 ALI PROJECT, *supra* note 22, § 5.01(a) (Council Draft No. 2, Nov. 1985).

66 *See* cases cited *supra* note 64.

Section 8.31 of the Revised Model Business Corporation Act uses standard statutory language to prevent the invalidation of all self-dealing transactions, i.e., if they have been approved by disinterested directors, *or* if they have been approved by disinterested shareholders, *or* if they are fair, but the comment thereto states:

> The elimination of the automatic rule of voidability does not mean that all transactions that meet one or more of the tests set forth in section 8.31(a) are automatically valid. These transactions may be subject to attack on a variety of grounds independent of section 8.31—for example, that the transaction constituted waste, that it was not authorized by the appropriate corporate body, that it violated other sections of the Model Business Corporation Act, or that it was unenforceable under other common law principles.

REVISED MODEL BUSINESS CORP. ACT § 8.31 comment 1 (1984).

67 F&B, *supra* note 1, at 284-85.

68 *See* Mattar, *Indemnification and Liability Insurance for Corporate Boards of Directors and Trustees—A Legal Guide for the Director,* 83 COM. L.J. 550, 553 (1978) (discussing California, Delaware, and New York law).

69 *Cf.* Globus v. Law Research Serv., 418 F.2d 1276, 1287-89 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970) (denying enforcement of indemnification clause between issuer and underwriter).

70 Mattar, *supra* note 68, at 556.

and exclude reimbursement for self-dealing violations.[71] Moreover, some companies find insurance simply unavailable. Thus, insurance coverage may not be as helpful in practice as it appears to be in theory.

D. Appraisal

F&B contend that because the appraisal remedy, whereby shareholders may not block a transaction but are confined to a monetary award equal to the fair value of their shares, is effectively the exclusive remedy in connection with mergers and certain other transactions, it minimizes the importance of liability rules in that important context.[72] Again, they overstate the case. In *Weinberger v. UOP, Inc.*,[73] the Delaware Supreme Court indicated that appraisal may be inappropriate as an exclusive remedy "in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved."[74] Section 13.02(b) of the revised Model Business Corporation Act does not limit shareholders to an exclusive appraisal remedy.[75] Similarly, the ALI Project, in a tentative position announced in Reporter's Study No. 1, would limit the exclusivity of the appraisal remedy to transactions that do not involve the duty of loyalty.[76] Thus, much activity remains subject to liability rules notwithstanding the existence of an appraisal remedy.

E. Restrictions on Derivative Suits

The authors note that restrictions on plaintiffs' ability to bring derivative suits further curtails the efficacy of liability rules as a means of constraining management.[77] Their point is valid, but it has limits they do not acknowledge. A number of the restraints they recite are not significant. For example, the contemporaneous ownership rule and the rules that require the plaintiff to post security for expenses are not significant curtailments of the use of derivative suits. Legislatures may have intended these restraints to be deterrents, but because they are ineffective, they should probably be eliminated or modified.[78]

Moreover, the restrictions F&B discuss do not apply to class ac-

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71 *Id.*

72 *See* F&B, *supra* note 1, at 285-86.

73 457 A.2d 701 (Del. 1983).

74 *Id.* at 714. *See* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099 (Del. 1985).

75 REVISED MODEL BUSINESS CORP. ACT § 13.02(b) (1984) (appraisal not exclusive remedy if transaction was unlawful or fraudulent).

76 ALI PROJECT, *supra* note 22 (Reporter's Study No. 1, Feb. 22, 1985).

77 *See* F&B, *supra* note 1, at 286.

78 *See* Note, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4

tions, and not all liability rules are enforced in derivative suits. Some of the most significant cases involving liability rules, such as *Jones v. H.F. Ahmanson & Co.*,[79] which challenged management's actions in denying minority shareholders an equal opportunity to improve the marketability of their shares, were brought as a class action.

Futhermore, not all shareholders' substantive rights are enforced under state corporation law. Many cases are brought under the federal securities laws where the restrictive rules do not apply. The federal securities laws do involve essentially failures to disclose, but these cases can still raise substantive questions of fiduciary conduct.[80] For example, in *Goldberg v. Meridor*[81] a shareholder brought suit on behalf of the minority shareholders of a controlled subsidiary, alleging that the parent had imposed an unfair transaction on the subsidiary. The transaction did not involve shareholder approval, and consequently no deception of shareholders could have caused the transaction. However, an allegedly misleading press release was issued, and the plaintiffs claimed that it deceived them in a transactionally significant way. Had they not been misled, they could have marched into state court seeking an injunction against the unfair transaction. The inaccurate press release lulled them into acquiescence.

The ability to use federal courts in the manner just described permits the courts to determine the fairuess of the transaction in the course of determining whether a misstatement or omission was material. Of course, this situation will arise only when management makes a press release or other communication, but virtually every transaction will involve some communication because the federal securities laws or self-regulatory organizations require public companies to publish something about the transaction.

State procedural restrictions on the use of shareholder litigation often will be irrelevant because the federal securities laws are a presence in almost every case involving a securities transaction, including a great many cases involving self-dealing transactions. Yet,

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COLUM. J.L. & SOC. PROBS. 50 (1968) (security for expense statutes have little effect on plaintiffs or defendants).

79 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

80 *See* McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.) (actions under federal securities laws do not require bond), *cert. denied*, 368 U.S. 939 (1961); H. HENN. & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 362, at 1063 (3d ed. 1983) (contemporaneous ownership rule inapplicable to actions under federal securities laws). Federal courts have praised derivative suits for their role in protecting shareholders' rights. *See, e.g.*, Mills v. Electric Auto-Lite Co., 396 U.S. 375, 396 (1970) (shareholder suits help enforce federal statutes protecting investors).

81 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

F&B totally neglect the critical role of federal law as an influential source of managers' duties and provider of remedies.

The most significant impediment under corporate law to the effectiveness of liability rules, as noted by F&B, is the ability of boards of directors, usually acting through a special litigation committee, to cause the termination of a derivative suit.[82] Legal scholars have observed that this power threatens the survival of the derivative suit because if courts regard the decision to terminate as simply another exercise of the board's business judgment then they will rarely examine the action's underlying merits.[83] Recently, however, courts have shown some resistance to yielding so much power to boards, thus checking an earlier trend that once seemed to be a juggernaut.[84] In Delaware, when demand on the board of directors is unnecessary because it would be futile, the decision of the board or the special litigation committee will not be viewed as simply another exercise of business judgment.[85] The courts will review the merits of the decision to terminate the action. On the other hand, if demand is required, the Delaware courts will apply the business judgment doctrine to the board's decision. The greatest danger to the future of the derivative suit in Delaware is the courts' reluctance to excuse demand. For instance, in a case based on self-dealing between the corporation and its forty-seven percent shareholder, the court insisted that demand was necessary.[86] Furthermore, Delaware courts do not permit discovery on the issue of demand-futility, and even

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82 *See* F&B, *supra* note 1, at 286.

83 *See* Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform,* 81 COLUM. L. REV. 261 (1981); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?,* 75 NW. U.L. REV. 96 (1980); Edwards, *Compelled Termination and Corporate Governance: The Big Picture,* 10 J. CORP. L. 373 (1985). Courts also have recognized this danger. *See* Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982), *cert. denied,* 460 US. 1051 (1983); Zapata Corp. v. Maldonado, 430 A.2d 779, 783-84 (Del. 1981). *But see* Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

84 In *Zapata Corp.,* 430 A.2d 779, the Delaware Supreme Court ruled that if a plaintiff is excused from demanding that the board bring suit, the board's subsequent decision to dismiss the suit should be subject to a court's independent business judgment. *Id.* at 788-89. Several other recent decisions have either disallowed terminations or remanded for consideration of whether the proposed dismissal would serve the corporation's best interests. *See* Hassan v. Clevetrust Realty Investors, 729 F.2d 372 (6th Cir. 1984) (summary judgment precluded by issues of fact regarding good faith and fairness of special litigation committee); Joy v. North, 692 F.2d 880 (2d Cir. 1982)(high probability of substantial return to corporation precludes dismissal of suit), *cert. denied,* 460 U.S. 1051 (1983); Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981) (further development of record necessary to determine whether litigation committee had adequate basis for seeking termination).

85 *See Zapata Corp.,* 430 A.2d at 784.

86 Aronson v. Lewis, 473 A.2d 805 (Del. 1984). *See also* Pogostin v. Rice, 480 A.2d 619 (Del. 1984) (shareholder claims that directors had personal interest in alleged wrong insufficiently particularized to satisfy futility test).

when discovery to question the committee's decision is permitted, the court views it warily.[87] Certain other jurisdictions, notably Iowa[88] and more recently North Carolina,[89] are more solicitous of the shareholder's right to maintain the suit despite the contrary views of the special litigation committee. Nevertheless, the danger to the derivative suit is serious, and without reform it may succeed in reducing the derivative suit to impotence.

VI
REFORMING THE LAW: THE ALI PROJECT

The danger of abusing the special litigation committee provides the strongest case for reform in corporate law. Change may occur through legislation or merely through courts' recognition that they need to restrain the application of the business judgment doctrine as applied to the termination of derivative suits. This is not to say that the courts should revert to the state of affairs before 1976 when demand on directors was mainly a ministerial act.[90] Using a screening device to preclude some derivative suits is valuable. In this respect I agree wholeheartedly with F&B that derivative suits are not costless and that we need a mechanism to identify and terminate unworthy suits at an early stage.

I believe the American Law Institute has succeeded in striking a balance between the burdens and the benefits of the derivative suit. F&B do not describe the balancing efforts of the ALI Project, so I must set forth some of its detail. Their quarrel with the ALI Project is seemingly not with its detailed solution, but with its very undertaking.

The ALI Project serves mainly to clarify rather than alter basic substantive rules. The Project recognizes the existence of a corporation's power to seek dismissal of a derivative suit on the grounds that dismissal is in the best interests of the corporation,[91] as long as the proper procedures are followed. The procedures vary depending upon the nature of the suit and who is sued.[92] Moreover, the ALI permits the board to delegate this authority to a committee of

87 *See* Kaplan v. Wyatt, 484 A.2d 501 (Del. Ch. 1984) (judge has discretion to order limited discovery to aid court's examination of committee's independence and basis of its decision), *aff'd*, FED. SEC. L. REP. (CCH) ¶ 92,345 (Oct. 9, 1985).

88 Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709 (Iowa 1983).

89 Alford v. Shaw, 324 S.E.2d 878 (N.C. App. 1985).

90 Gall v. Exxon, 415 F. Supp. 508 (S.D.N.Y. 1976), was the first case to allow the decision of a special litigation committee to be the basis for termination of a derivative suit.

91 ALI PROJECT, *supra* note 22 § 7.07 (Discussion Draft No. 1, 1985).

92 *Compare id.* (general rule) *with id.* § 7.08 (suits against directors and other influential persons) *and id.* § 7.09 (suits against actions approved by shareholder resolution).

disinterested directors.[93] If the special committee determines to dismiss a suit against third parties or junior officers, any challenge to that termination will be analyzed under the business judgment rule (or doctrine), and hence the decision will almost never be disturbed.[94]

Suits against senior executives or directors create the thorniest problem. In this situation the ALI permits the corporation to terminate the suit subject to more intensive judicial review and without the benefit of the business judgment doctrine. The court must find that certain procedures were substantially followed, that the justification for termination is adequately particularized, that the determination is made in good faith and warrants dismissal when the costs and benefits are balanced, and that dismissal would not frustrate public policy.[95] By and large the burden of proof on these issues rests with the corporation seeking to dismiss.[96] The ALI Project provides for an even higher standard of review for decisions to dismiss suits against controlling persons. If the suit involves the receipt of an improper personal benefit by the controlling person, then the burden is on the corporation to show that the action is without merit or that it will suffer harm from the continuation of the suit.[97]

The Project also specifies the composition of a special litigation committee. The committee must be composed of at least two independent directors who are capable of making informed and objective judgments, and they must be assisted by independent counsel of their choice.[98] They must conduct an investigation and prepare a written report.[99] If the corporation contains no such committee, for example, when all of the directors are involved in a self-dealing transaction, then the corporation may ask a court to appoint a special panel to act in lieu of the special litigation committee.[100] When the corporation seeks dismissal based on the recommendation of the special panel, the burden of proof is reduced. The ALI would continue to require that a plaintiff make a demand on directors prior to initiating a derivative suit.[101] Unlike the position taken in Delaware,[102] however, the proposal severs the demand requirement

93 *Id.* § 7.06(b).
94 *Id.* § 7.06(a)(4), (b).
95 *Id.* § 7.08(a)-(d).
96 *See id.* § 7.11(b) (corporation bears burden of proof except on issue of frustration of other legal policies).
97 *Id.* § 7.08(e) comment h, at 117.
98 *Id.* § 7.10.
99 *Id.*
100 *Id.* § 7.12.
101 *Id.* § 7.03.
102 *See supra* text accompanying notes 84-87.

from the question of whether the board may terminate the suit.[103]

The ALI deals with other issues involved in derivative suits, although these are not as significant as the proposed statement and analysis concerning termination. The Project would eliminate the requirement that a shareholder must be a contemporaneous owner of shares if he acquired his shares before facts relating to the alleged wrongdoing were publicly disclosed.[104] As noted earlier, the proposal considers different methods to cap director liability for some breaches of the duty of due care.[105] The Project attempts to deal with settlement and counsel fees in a way that more closely ties the amount of the fee to the success of the litigation.[106] Later drafts will deal with indemnification, insurance, and ancillary remedies.

Finally, the ALI reporters are cognizant of a factor which F&B trivialize in their analysis. In the absence of liability rules and an effective enforcement mechanism, regulation would almost certainly ensue. F&B conclude that "making any meaningful statement about the desirability of private, public, or no enforcement is simply impossible."[107] Their observation can have meaning only in a highly theoretical construct. In the real world, not that of the computer or blackboard model, a legislative reaction would be almost certain. Nor would the nature of that reaction be difficult to predict. Legislators have already introduced bills to curtail the business judgment rule in the context of takeovers,[108] and new laws impose stiffer penalties on insider trading[109] and discourage "golden parachute" payments.[110] Legislators cannot ignore the corporate accountability problem, and they are unlikely to regard the marketplace as the only appropriate mechanism to constrain managers. If F&B think that there are costs to private enforcement of the duty of due care and the duty of loyalty, I wonder what they think is the price of added government regulation?

The ALI's resolution is both balanced and sufficiently attentive to the cost implications of derivative suits. F&B are not the first scholars to observe that liability rules and their enforcement are not costless. I am not sure how they would propose to deal with the costs that they identify, but their paper implies that we could elimi-

103 ALI PROJECT, *supra* note 22, § 7.03 comment c, at 54-55 (Discussion Draft No. 1, 1985).

104 *Id.* § 7.02(a)(1).

105 *See supra* note 62 and accompanying text.

106 ALI PROJECT, *supra* note 22, § 7.17 (Discussion Draft No. 1, 1985).

107 F&B, *supra* note 1, at 289.

108 H.R. 5695, 98th Cong., 2d Sess. (1984) (corporation has burden of proof that anti-takeover actions were prudent and fair to shareholders).

109 Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered sections of 15 U.S.C.A. 78 (West Supp. 1985)).

110 I. R. C. § 280G (West Supp. 1985).

nate derivative suits, and perhaps even liability rules, and investors would not seem to care nor be adversely affected. Although this implication is not the formal conclusion of their paper, they march right to the brink of that recommendation. I believe that neither logic nor experience supports that view.

CONCLUSION

Liability rules are critical for the protection of investors' interests in a corporation. Experience, common sense, and judgment all point to this conclusion, and no available empirical data contradicts it. A sound theoretical base supports liability rules, principally the reduction of agency costs where market forces fail to achieve that result. Liability rules are most significant with respect to breaches of the duty of loyalty but also serve to deter breaches of the duty of due care, and hence should be preserved in both contexts.

If liability rules persist, so must enforcement mechanisms. The most controversial mechanism is the derivative suit, but notwithstanding its defects, the derivative suit is a candidate for reform, not rejection. F&B have made no case for its abolition, nor have they spelled out a coherent program of reform. The ALI Project does present a reform program, however, and its themes, if not all of its precise measures, should be accepted.