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# THE AMERICAN LAW INSTITUTE PRINCIPLES OF CORPORATE GOVERNANCE AND THE DERIVATIVE ACTION: A VIEW FROM THE OTHER SIDE

DOUGLAS M. BRANSON\*

Market model advocates see no significant role for corporate liability rules and the derivative suit, which historically has been a principal means of enforcing rules applicable to corporate managers. Market forces, arising in the market for the corporation's products, in the market for managers, and in the market for corporate control, should be the principal, if not the only, regulator of corporations and their managers. Hence, the American Law Institute (ALI) project, and in particular its part on remedies, become superfluous.<sup>1</sup>

The remaining commentators, on the other hand, are closely aligned with the ALI project. Some are consultants to the reportorial staff.<sup>2</sup> Another has co-authored an article on derivative actions with the ALI reporter for Part VII, Remedies.<sup>3</sup> These commentators are leading supporters of the ALI point of view.

The commentary on a topic should, however, if possible proffer a well-rounded discussion of that topic. What the commentary on derivative actions lacks is not necessarily someone responding to market model advocates but rather someone tugging at the ALI Proposals from the other side, acting as a counterweight to the Chicago school, economic analysis point of view.

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1. See, e.g., Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U. L. Rev. 913, 944 (1982) ("The function of corporation law . . . is rather limited. Apart from minimizing transaction costs and possibly facilitating the operation of market forces that discipline management, corporation law has little role to play."); Comment, *Shareholders' Derivation Suits and Shareholders' Welfare: An Evaluation and a Proposal*, 77 Nw. U. L. Rev. 856, 902-05 (1983) (proposal to abolish the derivative suit).

2. See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Pt. VII, Remedies, Ch. 1, The Derivative Action, at V. (Discussion Draft No. 1, June 3, 1985) [hereinafter cited as ALI Proposals]. This article will refer to the ALI derivative action material as ALI Discussion Draft or ALI Proposals. The ALI project as a whole will be referred to as the ALI Project, the Project, or PRINCIPLES OF CORPORATE GOVERNANCE.

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

What the commentary lacks is a view from the left as, quite ironically, any pro-shareholder point of view has come to be regarded.<sup>4</sup>

On the right and in the middle, discussion focuses upon the plaintiff's attorney, as the engine who drives the derivative action. He or she has been disparaged as a "bounty hunter" and an "unfaithful champion."<sup>5</sup> The commentators speak of the "'phantom' plaintiffs' attorney whose only specialty is the politics of class action" or derivative suit organization.<sup>6</sup>

Moreover, commentators' and reporters' attention has been riveted upon the tricks and wiles of the Wilmington, Philadelphia, and New York plaintiffs' bars. A large share of the litigation takes place in those precincts and plaintiffs in that litigation inevitably have only the most nominal interests, such as ownership of five or ten shares in the corporation. The true party in interest is the attorney and the focus upon him is justified.<sup>7</sup>

But all corporate litigation does not involve a Harry Lewis<sup>8</sup> and originate in the Wilmington-Philadelphia axis. What of the plaintiff shareholder whose stake, while not alone large enough to justify the costs of litigation, is much greater than nominal? And what of the attorney who represents this genuinely aggrieved shareholder but whose practice does not consist solely, or even primarily, of derivative litigation? What of the attorney who represents a truly aggrieved shareholder in Portland, Oregon, Portland, Maine, or another regional financial center?<sup>9</sup> Any balanced presentation must attempt a sighting

4. In any group other than corporate lawyers, such as academics, the shareholder proponent is considered to be to the right, rather than the left.

5. 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). See also Findlater, *The Proposed Revision of DR 5-103(B): Champerty and Class Actions*, 36 BUS. LAW. 1667, 1674 (1981) (accusations of champerty and maintenance); Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View From the Inside*, 60 WASH. U. L. Q. 311, 333 (1982) ("Filing lawsuits with little or no merit has become . . . a way of life with many lawyers. . .").

6. Coffee, *supra* note 5, at 278.

7. See ALI Proposals *supra* note 2, at 5-6.

8. Harry Lewis is one of several archetypal professional plaintiffs. By his own admission, he has been a "named plaintiff in several hundred . . . class and derivative actions." Affidavit of Harry Lewis, dated Sept. 24, 1984, at 2, in *Lewis v. Berry*, No. C 82-1244 VR, W.D. Wash. at Seattle. One search reveals that he has been the named plaintiff in at least 52 recent reported federal corporation-securities law judicial opinions. See *infra* note 108.

9. The ALI project's primary thrust is "Large Publicly Held Corporations," those with 2,000 or more record owners of securities and \$100 million total assets, and "Publicly Held Corporations," those with 500 or more holders and \$3 million total assets. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE §§ 1.15 & 1.21 (Tent. Draft No. 1, 1982). But the remedies section's intended application is not so limited. See Discussion Draft No. 1 § 7.01(a) (material applicable to closely held corporations). Moreover, in the limited judicial reference thus far, courts have not noted any limitation to large companies. See, e.g., *Miller v. Register and Tribune Syndicate, Inc.*, 336 N.W.2d 709, 717 (Iowa 1983); *Klinicki v. Lundgren*, 298 Or. 662, 695 P.2d 906, 917-18 (1985). Thus, the ALI Project will affect corporations in Florida or Oklahoma, in Maine or in Oregon, as well as Fortune 500 companies, a fact largely forgotten in the discussion of bounty hunters, Delaware cases, and the largest of New York Stock Exchange listed companies. The former category of corporations, with shareholders numbering from 10 to 499, number in the tens of thousands and are sometimes referred to as

through those less jaundiced eyes.<sup>10</sup>

In Part I this article considers the obstacles that such an attorney would find in derivative litigation, that are not present in other forms of litigation. Part II then considers recent developments that have made the derivative action process even more of a gauntlet which plaintiffs must run. These developments include recent, and largely unnoted, substantive law changes which have dramatically lessened a shareholder's legal protections,<sup>11</sup> as well as recent, more publicized procedural developments which permit a corporation more easily to sidetrack or derail derivative actions. Part III first reviews, and then proposes a restructuring of, *Principles of Corporate Governance*, Part VII, Chapter 1. Such a restructuring would attempt to insure that the genuinely aggrieved shareholder will have at least an even chance of litigating his or her claim against corporate officers and directors, and at the same time to reduce significantly the amount of abuse presently surrounding the derivative action. Short of a restructuring, Part IV considers discrete changes to the ALI Proposals that would at least go some way toward giving the Maine or Oregon plaintiff a fighting chance in derivative litigation.

Finally, Part V points toward reasons for supposing that genuinely aggrieved shareholders might exist in numbers sufficient to justify change in the ALI Proposals. The genuinely aggrieved shareholder's presence in reported cases is not proportionate to his true number because at the local and regional levels a lack of incentive and even a chilling effect exists for plaintiffs' counsel in derivative litigation. On those levels the factual setting surrounding derivative litigation might be almost opposite that which the ALI and its reporters have presumed to exist, based upon experiences at the national level and with *Fortune* 500 companies.

## I. A LAWYER'S FIRST LOOK AT A DERIVATIVE ACTION

### A. *Traditional Obstacles and Preliminary Concerns*

A business litigator who had not reviewed material on derivative actions since perhaps law school would discover that, compared to what he would face in other forms of litigation, the derivative action resembles a minefield.

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"quasi public" corporations. See Conard, *The Corporate Census: A Preliminary Exploration*, 63 CALIF. L. REV. 440, 458-59 (1975); *infra* note 155.

10. A complete presentation of points of view regarding derivative actions would include a fourth commentary, by members of the corporate plaintiffs' bar, whose practices have been so severely criticized. Surprisingly, no member of that bar has published views on the ALI Project. Perhaps, in the language of economic analysis, the plaintiffs' bar has been taking a free ride on the efforts of liberal law professors and others on the "left." But see Morris, *A View of Representative Actions, Derivative and Class, From a Plaintiff's Attorney's Vantage Point*, 3 DEL. J. CORP. L. 273 (1978).

11. See generally Branson, *Countertrends In Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53, 56-72 (1983).

There are many traps for the unwary and procedural pitfalls that could cause the litigator to lose the war.<sup>12</sup> More important to the lawyer personally would be his reflection that on numerous occasions, through loss of a motion or failure to comply with a procedural requirement, the lawyer could suffer a diminution in reputation or the loss of a client's other business. More seriously, all his time on the case would be wasted. Most seriously, the lawyer might visualize allegations of malpractice. These reflections must have a chilling effect on the lawyer's enthusiasm for the underlying claim.<sup>13</sup> They might lead the lawyer to counsel a course of conduct other than "tricky" derivative litigation.

The first hurdle in derivative litigation is easy enough. Contemporaneous ownership requirements state that the plaintiff must have been "a shareholder or member at the time of the transaction of which he complains. . . ."<sup>14</sup> This is a simple yes or no determination. An injustice may be caused to the would-be plaintiff who purchased after the wrong occurred but before its existence became known or knowable. Courts sometimes aid such a plaintiff by finding that the transaction has resulted in a continuing wrong.<sup>15</sup>

Next the plaintiff must make a demand on the corporation's board of directors to obtain the action he desires.<sup>16</sup> He must then wait, perhaps for quite a long time,<sup>17</sup> while the board conducts its own investigation, or merely does nothing. If the board investigates, the business judgment rule can

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12. Traps for the unwary attorney in the field of derivative actions have been reviewed elsewhere but largely in the abstract and not from the perspective of a general business litigator about to take the plaintiff's side. See, e.g., Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 965-970. See also W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 885-1001 (1980).

13. And are to be contrasted with "the classic profile of the strike suit: a slapdash action, inadequately researched as to either the facts or the law, brought by an attorney who is currently the attorney of record in a large number of similar pending actions." Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. (1985) (forthcoming).

14. FED. R. CIV. P. 23.1. See also ME. REV. STAT. ANN., tit. 13-A, § 627(1)(A) (1964) (contemporaneous holder must have been record, as opposed to beneficial, holder). Cf. ALI Proposals § 7.02 & comment C at 35 (beneficial owners can sue). As a non-commercial state, Oregon does not have codification of procedural rules for derivative actions in either its court rules or code of civil procedure and no citation to Oregon statutes is therefore possible. Letter from Barnes Ellis, Esq., Stoel, Rives law firm, Portland, Oregon, to Professor Douglas Branson (August 28, 1985) (on file with Washington & Lee Law Review). Mr. Ellis is a business litigator and was counsel for plaintiffs in *Delaney v. Georgia-Pacific Corp.*, 278 Or. 305, 564 P.2d 277 (1977), and for defendants in *Gleason v. International Multifoods Corp.*, 282 Or. 253, 577 P.2d 931 (1978), both derivative actions.

15. See, e.g., *Palmer v. Morris*, 316 F.2d 649 (5th Cir. 1963); *Maclary v. Pleasant Hills, Inc.*, 35 Del. Ch. 39, 109 A.2d 830 (1954); W. CARY & M. EISENBERG, *supra* note 13, at 915. ALI Proposals § 7.02(a)(1) permits a shareholder to sue if the holder "acquired his equity security before the earlier of the time when the material facts relating to the alleged wrong were publicly disclosed or were known by the holder."

16. FED. R. CIV. P. 23.1; ME. REV. STAT. ANN., tit. 13-A, § 627(1)(B) (1964).

17. See, e.g., *Allison on Behalf of General Motors Corp. v. General Motors Corp.*, 604

come into play. The board will refuse the demand to take action and if the board, or a subgroup thereof, has been reasonably diligent and unburdened by disabling conflicts of interest, a court will not second guess or review the directors' decision. The plaintiff's claim will die.<sup>18</sup>

Alternatively, a wise board of directors might choose to take action. The action taken could be little more than a slap on the wrist for the corporate officer or director whom plaintiff has suspected of wrongdoing. Again, director action probably would cause plaintiff's claim to die.<sup>19</sup>

Plaintiff, however, has a third choice. He can and probably will allege that demand would be futile because the wrongdoing implicates a majority of the directors,<sup>20</sup> or because a party implicated in the wrongdoing dominates the directors.<sup>21</sup> Plaintiff must allege "with particularity . . . the reasons for his failure to obtain the action or for not making the effort. . ." to obtain action from the board.<sup>22</sup> This requirement can be a problem because without a complaint on file a plaintiff cannot undertake discovery that would enable him to flesh out his suspicions of a coverup or of other wider involvement in the wrongdoing, or of the alleged wrongdoers' domination of the board.

In addition, under this alternative, demand excused, plaintiff may also meet the business judgment rule. Demand will be excused as futile only if plaintiff can allege, with particularity, why a reasonable doubt exists as to the directors' entitlement to the business judgment rule and its protections had they investigated the plaintiff's claim.<sup>23</sup> The test seems fair enough, in part because plaintiff need only demonstrate reasonable doubt. Proof raising a fair inference that the directors, or a majority of them, were dominated or had a disabling conflict of interest, would seem to suffice. But in a recent

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F. Supp. 1106, 1118-19 (D. Del. 1985) (2 1/2 months delay and "brush off" response from defense counsel did not enable plaintiff to file).

18. See, e.g., Cox, *supra* note 12, at 961, n.7 ("Only in rare cases will courts allow the plaintiff to proceed after a rejected demand."). See also Abramowitz v. Posner, 672 F.2d 1025, 1033 (2d Cir. 1982); *infra* note 61 (Delaware courts have no power to review merits of decision holding that board of directors refused plaintiff's demand).

19. See, e.g., Wolf v. Barkes, 348 F.2d 994 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965). See also Scott, *Corporation Law and The American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 944 (1983) ("the most probable reason for the board to want to take over a suit [against some of its members] would be to undermine it").

20. Plaintiff cannot, however, merely name the directors as defendants without grounds therefor, or allege that the directors were merely passive in the face of wrongdoing by others. See, e.g., In re Kauffman Mutual Fund Actions, 479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). Stronger allegations are usually necessary. See, e.g., Barr v. Wackman, 36 N.Y.2d 371, 377, 329 N.E.2d 180, 185, 368 N.Y.S.2d 497, 504 (1975).

21. See, e.g., Clark v. Lomas & Nettleton Financial Corp., 625 F.2d 49, 52-54 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981).

22. FED. R. CIV. P. 23.1. See also ME. REV. STAT. ANN., tit. 13-A, § 627(1)(B) (1964) (plaintiff also "alleges that at least 10 days before instituting the action he either informed the corporation of such board of directors in writing of the ultimate facts of each cause of action against each defendant or delivered . . . a true copy of the complaint which he proposes to file. . .").

23. Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

case, the Delaware courts have held that receipt of lucrative consulting contracts by an elderly director and ownership by him of 47 percent of the company's shares did not raise even the spectre of board domination that would have made demand on the board futile.<sup>24</sup> Thus, while the facts seemed to speak for themselves, and in publicly held companies even the most unschooled of courts could take notice that 47 percent constitutes nearly unassailable control, the Delaware courts blushing acted the part of naive handmaidens to corporate defendants.<sup>25</sup>

If plaintiff's Portland lawyer understands demand made, demand refused, and demand excused, he must then verify his complaint which, as noted, must allege certain facts with particularity.<sup>26</sup> The attorney must make the verification without the benefit of discovery. In modern court practice, pleadings in general need not be verified.<sup>27</sup> Because verification is not routine, a good lawyer would take such a requirement seriously.<sup>28</sup> Counterallegations that a lawyer or his client had verified allegations without a basis therefore are serious charges and no lawyer would want to leave himself open to that possibility.<sup>29</sup>

Also, the lawyer with the Oregon or Maine client must discuss the possibility of being required to put up security for expenses.<sup>30</sup> In their discretion, many courts can require a derivative action plaintiff to post a bond, with a commercial surety thereon, or collateralized in some other fashion. The bond must stand to cover defendants' costs and attorneys' fees should plaintiff lose and be found not to have brought the action based

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24. See, e.g., *id.* at 808-09.

25. The phenomenon of announcing a sound principle but, in order to comply with it, putting a high evidentiary burden on plaintiffs, or a very low burden on defendant directors, has antecedents in Delaware. See, e.g., *Cheff v. Mathes*, 199 A.2d 548, 551 (Del. 1964).

26. FED. R. CIV. P. 23.1; ME. R. CIV. PRO. 23(b) (1985).

27. See, e.g., FED. R. CIV. P. 11.

28. Verification requirements add little in view of the 1983 amendments to rule 11 of the Federal Rules of Civil Procedure. *Id.* An attorney's signature now "constitutes a certificate by him that he has read the pleading . . . that to the best of his knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law, and that it is not interposed for any improper purpose, such as to harass. . . ." *Id.* Moreover, "[i]f a pleading . . . is signed in violation of [the] rule, the court . . . shall impose upon the person who signed it, a represented party, or both, an appropriate sanction. . . ." ALI Proposals § 7.04 deletes any verification requirement.

29. See, e.g., *Suowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 366-67 (1966) (report of proceeding in trial court and on appeal).

30. See MODEL BUSINESS CORP. ACT § 49 (1971) [hereinafter cited as MBCA]. Maine deleted its security for expenses statute in 1973. See Historical Note to ME. REV. STAT. ANN., tit. 13-A, § 627 (1981). Delaware has never had such a provision. See, e.g., *Eisenberg v. Flying Tiger Line, Inc.*, 451 F.2d 267, 269 (2d Cir. 1971). In fact, with its statutes deeming the situs of Delaware corporations' shares to be Delaware and providing for sequestration of such shares, and its later constructive consent statute, Delaware has a policy of encouraging derivative action plaintiffs to file, if not succeed, in its courts. See *Shaffer v. Heitner*, 433 U.S. 186 (1977) (discussing these Delaware statutes); *Jacobs & Stargatt, The New Delaware Director-Consent-to-Service Statute*, 33 BUS. LAW. 701 (1978) (discussing constructive consent statute).

upon reasonable cause.<sup>31</sup> The potential of first having to give security and then the prospect of forfeiting it must exert a chilling effect on counsel and client.

Another pitfall is that civil practice acts may require a derivative action plaintiff to make a demand on the corporation's shareholders, as well as on the corporation's directors.<sup>32</sup> Courts frequently dispense with this requirement because of the delay and expense involved.<sup>33</sup> Nonetheless, defendants can attempt to exploit the requirement, at least to the extent of filing a motion which plaintiff's counsel must oppose through brief and argument.<sup>34</sup>

### B. Judicial Control Over Plaintiff's Counsel

Peering into the distance, plaintiff's attorney can see that once beyond barriers defense lawyers raise, the attorney still may not have clear sailing. The court will have control over any settlement of the action, as well as over the attorney's fee.<sup>35</sup> Moreover, the fee will be based upon an hourly rate, oddly enough with a contingency bonus in the instance of a long shot or specially problematic case.<sup>36</sup> The attorney might prefer to gamble on the larger payoff of a percentage of recovery method of compensation, which might be well earned based upon the uphill nature of derivative litigation, and which is common in other forms of contingent fee litigation. In a derivative action he will not be able to do so.<sup>37</sup>

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31. Some statutes that require derivative action plaintiffs to post a bond do not apply if plaintiff owns 5% of the corporation's stock or shares having a value exceeding \$25,000. *See, e.g.*, MBCA § 49. Judges often delay ordering security so plaintiffs may seek co-plaintiffs owning the requisite amount. To avoid the publicity that process could generate, one defense strategist recommends not invoking the statute. *See Cox, supra* note 12, at 965. But if the lawyer and plaintiff do not know of that judicial practice, or defense reaction to it, on the surface at least security for expense statutes will have a chilling effect. Of course, the genuinely aggrieved plaintiff, whose stake, while not alone large enough to justify the costs of litigation, is much greater than nominal, by definition may have an investment approaching or exceeding \$25,000.

32. FED. R. CIV. P. 23.1. Maine specifically negates shareholder demand requests. ME. REV. STAT. ANN., titl. 13-A, § 627 (1973).

33. *See, e.g.*, W. CARY & M. EISENBERG, *supra* note 12, at 931-35. *But see Bell v. Arnold*, 175 Colo. 277, 487 P.2d 545 (1971) (demand on 26,000 shareholders required).

34. Where civil practice acts require the derivative action plaintiff to make a demand on the corporation's shareholders, such requirements may be strictly construed. *See, e.g.*, *Mokhiber v. Cohn*, 608 F. Supp. 616 (S.D.N.Y. 1985), *aff'd*, No. 85-7537 (2d Cir. Jan. 30, 1986) (available on LEXIS).

35. FED. R. CIV. P. 23.1; ME. R. CIV. PRO. 23A.

36. *See, e.g.*, *Coffee, supra* note 5, at 261-62 & 286-87. *Cf. Leubsdorf, The Contingency Factor in Attorney Fee Awards*, 90 YALE L.J. 473 (1981).

37. The ALI does not opt for either fee formula, being content with the admonition that, however computed, the fee not exceed a "reasonable percentage of the total recovery." ALI Proposals § 7.17, comment (a) at 224. By contrast, in duty of loyalty cases one commentator has suggested that for effective enforcement perhaps "the recovery in its entirety should go to the attorney." *Scott, supra* note 19, at 941, n.43.



Then, too, for a second, or even a third,<sup>38</sup> time the lawyer will have to face the business judgment rule. On the merits of any duty of care claim the likely defense will be the business judgment rule. "Absent bad faith or some other corrupt motive, directors are normally not liable to the corporation for mistakes of judgment. . . ."<sup>39</sup> At any trial, or even prior to trial in a motion for summary judgment,<sup>40</sup> defense counsel will contend that a mistake in judgment, not a lack of reasonable care, caused any harm the corporation has suffered. Moreover, courts become muddled, applying the business judgment rule in duty of loyalty cases as well, at least when defendant directors have had no direct pecuniary interest in the transaction.<sup>41</sup> The business judgment rule thus may seem to sit as an almost insurmountable obstacle just before the end of the derivative action rainbow.

The pot of gold which sits at the end of the gauntlet or rainbow, depending upon one's point of view, is the common provision for attorney's fees from the corporate treasury.<sup>42</sup> What motivates plaintiff's lawyer to undertake the arduous route is the prospect of attorney's fees if he is successful. Even short of success on the merits, the lawyer will be entitled to attorney's fees if a settlement of the action confers a substantial benefit upon the corporation.<sup>43</sup> In many cases the prospect of fees earned through a settlement results in plaintiff's lawyer never running the gauntlet previously outlined. If plaintiff's attorney survives the first obstacle or two, the parties reach a cosmetic settlement which has as a principal ingredient provision of generous attorney's fees.<sup>44</sup> The fictional personality and really nominal presence of the corporation enable the lawyers to reach such a settlement.

38. See, e.g., *supra* notes 16-25 and accompanying text (business judgment rule and demand refused or demand excused as futile); *infra* notes 51-56 and accompanying text (motion to terminate based upon special litigation committee report).

39. *Cramer v. General Tel. & Electronics Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). See also PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) (Tent. Draft No. 4, 1985) (general statement of rule).

40. See, e.g., *Beard v. Elster*, 39 Del. Ch. 153, \_\_\_\_, 160 A.2d 731, 738 (Del. 1960), *on remand sub. nom. Elster v. American Airlines, Inc.*, 39 Del. Ch. 476, 167 A.2d 231 (Del. 1961).

41. Commentators trace application of the business judgment rule in duty of loyalty cases to *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964). See *Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 827-28 (1981); Comment, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 NW. U.L. REV. 980, 1001 (1982). The defense of control cases remain good illustrations of the phenomenon. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Johnson v. Trueblood*, 629 F.2d 287, 292 (3rd Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); *Morrissey v. County Tower Corp.*, 559 F. Supp. 1115, 1123 (E.D. Mo.), *aff'd per curiam*, 717 F.2d 1227 (8th Cir. 1983). See also *Unocal Corp. v. Mesa Petroleum Co.*, 1985 FED. SEC. L. REP. (CCH) 92,077 (Del. 1985); *MORAN V. HOUSEHOLD INT'L, INC.*, 490 A.2d 1059 (Del. 1985), discussed *infra* note 78.

42. See *supra* notes 35-37 and accompanying text.

43. See, e.g., *Mills v. Electric Auto-lite Co.*, 396 U.S. 375, 396 (1970) (private attorney general theory); *Reiser v. Del Monte Properties, Co.*, 605 F.2d 1135, 1138-39 (9th Cir. 1979) (later application of *Mills*); ALI Proposals at 227-28, 240-41 (substantial benefit theory).

44. The classic description of the process of settling derivative actions is by the late Judge Friendly, dissenting in *Allegheny Corp. v. Kirby* 333 F.2d 327, 347 (2d Cir. 1964).

In essence fees are taxed to an absent third party with a generous ability to pay and no strong voice of its own with which to object.

Our plaintiff's lawyer in Oregon or Maine, however, at the outset does not know that such is the way the game is played in Delaware or in New York. The procedural gauntlet will deter him from commencing the litigation. Moreover, if the uninitiated lawyer does learn the ropes of cosmetic settlements, his scruples or his client, who is after all aggrieved and has staked at least some costs and possibly fees, may prevent him from participating in any sham or extortionate settlement.<sup>45</sup> Some, perhaps many, lawyers will act at least in small part out of principle. If the Oregon or Maine lawyer does later accept or fall into the cosmetic settlement trap, it may be that once upon the road of the derivative action, the constantly uphill procedural gauntlet and the relentless incantation of "business judgment" edge the lawyer over into doing so.

Apart from cosmetic settlements, state Blue Sky laws may enable plaintiffs to obtain attorney's fees from the corporate "defendant" without having to undertake the long and arduous path of the derivative suit. State Blue Sky laws routinely award attorney's fees to successful plaintiffs.<sup>46</sup> Therefore, the addition of, or primary reliance upon, a state securities antifraud rule violation seems quite common.<sup>47</sup> Derivative action procedural complexity may serve only to shift litigation into other areas in which the prevailing party can obtain fees from defendants and the procedural hurdles are fewer in number.

### C. A Different Analytical Viewpoint

Mr. Justice Holmes bade judges, scholars and others to approach the

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45. The prevalent assumption is flatly that the attorney is "the engine that runs the derivative action," ALI Proposals at 6, and that in turn the prospect of fees from the corporate treasury drives the attorney. See, e.g., Coffee & Schwartz, *supra* note 3, at 316. Those assumptions may represent overaggregation. Loyalty to the aggrieved shareholder client, a desire to retain his other legal business, a desire to do a workmanlike job, a desire to see similar wrongdoing by others deterred, or a desire to see wrongdoers "punished" may also motivate an attorney, especially one whose steady diet is not derivative litigation. Although punishment has never been recognized as a goal of derivative litigation, it may not motivate a plaintiff's attorney who, while not a crusader, believes that the wrongdoer should be "nailed" for his actions. See *Home Fire Ins. Co. v. Barber*, 67 Neb. 644, 673, 93 N.W. 1024, 1035 (1903) (Pound, J.); cf. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 763 (1985).

46. See UNIF. SEC. L. § 410(a), 7A U.L.A. at 670 (1958); ME. REV. STAT. ANN., tit. 32, § 10605 (Supp. 1985); OR. REV. STAT. §§ 59.125(2) & 59.127(2) (1985).

47. Obtaining attorney's fees without pursuing a derivative action may be easier to do under state than under federal securities laws, as state law may grant wider standing. Compare OR. REV. STAT. §§ 59.115(1)(b) & 59.127(1)(b) (1985) (standing for offerees, as well as purchasers and sellers of securities) with SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1951) (prohibiting acts performed only "in connection with the purchase or sale" of securities) and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (affirming narrow purchaser-seller standing requirement). The state of mind required to be proven may also be less under state statutes than under the federal rule. Compare *Kittilson v. Ford*, 93 Wash.2d 223, 608 P.2d 264 (1980) with *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

law as would a "bad man, who cares only for the material consequences . . . knowledge enables him to predict. . . ."48 To a great extent, in analyzing the probable conduct of the bounty hunter in derivative litigation, commentators have only followed Justice Holmes's admonition.<sup>49</sup> Nevertheless, it is helpful to stand Justice Holmes's proposition on its head, approaching the law as would a "good [man], who finds his reasons for conduct," or some of them at least, "in the vaguer sanctions of conscience."<sup>50</sup> To do so certainly gives one a different view of derivative actions and of the chilling effect existing restraints must have had on derivative litigation in much of the country.

## II. RECENT DEVELOPMENTS—PLAINTIFFS AND DERIVATIVE ACTIONS

### A. *The Special Litigation Committee*

The most publicized recent developments in derivative actions came in 1979. In *Burks v. Lasker*,<sup>51</sup> the Supreme Court drew attention to boards of directors' possible state law powers to dismiss derivative actions. Apparently relying on a few older state decisions,<sup>52</sup> the Court found that the Investment Company Act of 1940 contained no federal law obstacle to dismissal.<sup>53</sup> Less than two months later a state court added flesh to the state law component of the idea.

In *Auerbach v. Bennett*,<sup>54</sup> the New York Court of Appeals held that "[t]he substantive aspects of a decision to terminate a shareholder's derivative action . . . are beyond judicial inquiry" if the decision has been made by an independent committee of the board, based upon a reasonably diligent investigation.<sup>55</sup> The business judgment rule would shield the litigation committee's decision. Several federal courts of appeal jumped quickly on the bandwagon, making *Erie* guesses as to what state law might provide in states with no precedent or other authority on the matter.<sup>56</sup>

48. O. W. HOLMES, *The Path of the Law*, in COLLECTED LEGAL PAPERS 171 (1920).

49. See, e.g., Branson, *supra* note 11, at 62-63 (applying Holmes' bad man theory to recent revision of substantive corporation law).

50. O. W. HOLMES, *supra* note 48, at 171.

51. 441 U.S. 471 (1979).

52. While the *Burks* majority opinion cited none of the older state decisions holding that corporate directors have discretion in making corporate decisions, in his concurring opinion Mr. Justice Stewart did cite three such decisions. See 441 U.S. at 487, *citing*, *McKee v. Rogers*, 18 Del. Ch. 81, 156 A. 191 (1931) and *Rice v. Wheeling Dollar Savings & Trust Co.*, 130 N.E.2d 442 (Ohio Ct. Com. Pleas 1954) and *Goodwin v. Castleton*, 19 Wash. 2d 748, 144 P.2d 725 (1944). See also Coffee & Schwartz, *supra* note 3, at 273 (discussing older state decisions).

53. 441 U.S. at 480.

54. 47 N.Y.2d 619, 393 N.E.2d 994, 414 N.Y.S.2d 920 (1979).

55. 47 N.Y.2d at 623, 393 N.E.2d at 996, 419 N.Y.S.2d at 922.

56. See, e.g., *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979) (Delaware law), *cert. denied*, 444 U.S. 1017 (1980); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) (California law), *cert. denied*, 449 U.S. 869 (1980). *Cf.* *Joy v. North*, 692 F.2d 880 (2d Cir. 1982) (Connecticut law), *cert. denied*, 460 U.S. 1051 (1983).

*Burks, Auerbach*, and their progeny struck the derivative action like a lightning bolt. Commentators were quick to decry those cases as the death of the derivative action.<sup>57</sup> Defense lawyers were quick to hone and utilize the committee device.<sup>58</sup> They did so with great success. Litigation committees found very few, if any, derivative actions to be in the corporation's best interests.<sup>59</sup> New directors were added to boards so that independent minions existed, paper trails were laid so that good faith and diligence in investigations could be documented, and motions to terminate were made and granted, so that corporations could get on with their businesses.

When finally faced with the issue, courts in states other than New York were more reluctant. The Delaware Supreme Court held that a trial court could in its discretion review the merits of the litigation committee's decision, as well as the committee's good faith and diligence.<sup>60</sup> Courts in other states narrowed further the use of the litigation committee device.<sup>61</sup>

The advent of the litigation committee should not have surprised the commentators and plaintiffs' bar as much as it did. The device had no less than three antecedents,<sup>62</sup> although neither the Supreme Court nor the New

57. See, e.g., Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. REV. 96 (1980); Note, *Special Litigation Committees—An Expanding and Potent Threat to Shareholder Derivative Suits*, 2 CARDOZO L. REV. 169 (1980).

58. See, e.g., Payson, Goldman & Inskip, *After Maldonado: The Role of the Special Litigation Committee in the Investigation and Dismissal of Derivative Suits*, 37 BUS. LAW. 1199 (1982); Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions—An Analytical Framework of Litigation Strategy and Counselling Directors*, 37 BUS. LAW 1247 (1982).

59. "[N]ot one committee, in all these instances, has decided to proceed with suit." *Alford v. Shaw*, 72 N.C. App. 537, 324 S.E.2d 878, 886 (1985). Cf. ALI Proposals at 124 (in two cases committee recommended action go forward but only against "some, but not all, . . . defendant former employees").

60. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). But, illogically it seems, a Delaware court has no power to review the decision on the merits when demand has been made and refused. See, e.g., *Allison on behalf of General Motors Corp. v. General Motors Corp.*, 604 F. Supp. 1106, 1121 (D. Del. 1985).

61. See, e.g., *Miller v. Register & Tribune Syndication*, 336 N.W.2d 709 (Iowa 1983) (board of directors is without power to delegate to litigation committee when a majority of directors are defendants); *Alford v. Shaw*, 72 N.C. App. 537, 324 S.E.2d 878 (1985) (same).

62. The first antecedent to corporations' use of litigation committee was the increased emphasis upon boards of independent directors and use of committees of those directors in many phases of corporate life. The audit committee and the compensation committee, as components of the so-called monitoring model, were well known and much discussed in 1979 and before. See, e.g., M.A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 170-77 & 206-11 (1976); Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*, 63 CALIF. L. REV. 375, 404-09, 436-38 (1975).

Second, courts had recognized boards of directors' power independently to settle, if not dismiss, the corporation's claims against directors and officers. *Wolf v. Barkes*, 348 F.2d 994 (2d Cir.), cert. denied, 382 U.S. 941 (1965). If properly done, the result was the same. Board action would oust the derivative action plaintiff.

Third, in the early 1970s counsel increasingly had used litigation committees to respond to or to head off SEC investigations, principally into illegal political and foreign payments.

York Court of Appeals discussed any of them. Moreover, the litigation committee or similar device has a place. Just as a natural person should be able to decide whether or not to pursue a good, or a not so good, cause of action, a corporation should be able to decide not to pursue a lawsuit.<sup>63</sup> Since a corporation has no readily identifiable soul or body, unlike a natural person, the principal question is which of the corporation's various organs should have the principal voice or final say on the decision to sue or not to sue.

Most of the better reasoned criticism has focused on how corporations have implemented the special litigation device. For example, when a board committee must decide whether the corporation should pursue a cause of action against directors or senior management, the problem of so-called structural bias is ubiquitous. Subliminally, at least, directors will favor individuals with whom they have worked or whom they have known for years.<sup>64</sup> New directors, added to the board to staff and make more independent the committee, might also tend to favor the defendants' side. After the committee completes its work those new directors have implicitly been guaranteed continuation as board members. That is an inducement to reach the "right" outcome. In addition, candidates for the new directorships and the litigation committee will remove themselves from candidacy if they sense that they might have to go against the grain, reach an outcome different from what they sense the "right" outcome to be, or be involved in a possible corporate "mess." In the remaining pool of candidates for special litigation directorships, a strong structural bias must exist. A principal question facing the commentators and the ALI is how to correct for or minimize this structural bias.

Thus it is misleading, and even incorrect, to state, as market model advocates have done, that recent proposals have "focused on the need to strengthen the derivative suit."<sup>65</sup> Rather, efforts such as the ALI Proposals

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Although the device differed from the derivative action litigation committee in that the SEC closely monitored and reviewed the merits, a properly conducted committee investigation could forestall formal SEC action. See Matthews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655 (1984).

63. See *Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.*, 326 Mass. 99, 111-12, 93 N.E.2d 241, 247-48 (shareholders vote may be able to preclude a suit even when there exists no shareholder power to ratify). "The question whether it is good judgment to sue is quite apart from the question of ratification. . . . It is not always best to insist upon all one's rights. . . ." *Id.*

64. See, e.g., Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1985). See also *Maldonado v. Flynn*, 485 F. Supp. 274, 282 (S.D.N.Y. 1980), *rev'd in part*, 671 F.2d 729 (2d Cir. 1982) (court considered and rejected argument based on structural bias as "cynical"); *Joy v. North*, 519 F. Supp. 1312, 1321-22 (D. Conn. 1981), *rev'd* 692 F.2d 880 (2d Cir. 1982) (structural bias arguments "place in jeopardy the concept of a litigation committee at a time when such committees have become widely accepted, useful tools for disposing of detrimental derivative actions").

65. See, e.g., Comment, *supra* note 1, at 858-59.

merely have sought to maintain the status quo in the face of market model advocates and large corporation apologists who would all but eliminate the derivative action. Other efforts have been to recover some of the vast amount of ground lost very suddenly in 1979-80, or to correct for the problem of structural bias, or to balance the litigation committee tool so that it accommodates legitimate shareholder, management and corporate interests.

### B. *The Interaction of Substantive Corporation Law and Derivative Action Developments*

Proposals with regard to the derivative action must also be viewed against the backdrop of corporation law developments other than the litigation committee device's rapid development over the last several years. Fifteen years ago shareholders in American corporations had a multi-layered, complex set of protections. Federal securities law was often used directly or indirectly to protect shareholders, as well as investors.<sup>66</sup> State corporation law contained a number of discrete commands for corporate managements. Such commands included, for example, prohibitions on stock issuances for promissory notes or future services, or in violation of shareholder preemptive rights; prohibitions on loans to officers and directors without shareholder approval; and prohibition of the taking of certain actions unless approved at a shareholders' meeting in which a quorum of a majority had been represented, and in which approval had been by a majority or even two-thirds of the shares entitled to vote.<sup>67</sup> State law also had a system of checks and balances in a structural, or governance, system that allowed shareholders to protect themselves, principally through election and removal of directors.<sup>68</sup> Finally, as a backup, state law had general principles, namely the fiduciary duties of care and loyalty and the duty of majority to minority shareholders, to protect shareholders when the governance structure or the discrete commands of statutes and cases had failed.<sup>69</sup> Beyond federal and state law, markets for corporate control and for managers operated to protect shareholders, although their operation was only first theorized or understood fifteen years ago.<sup>70</sup>

Since that time many of these shareholder protections have been swept away. In an impressive string of decisions for defendants, over a short span

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66. See, e.g., Coffee & Schwartz, *supra* note 3, at 264, 289-300.

67. See Branson, *supra* note 11, at 58-62 (treatment of hypothetical transaction under MBCA's of 1965 and 1983).

68. State laws providing for election and removal of directors arguably are ineffective at protecting shareholders, because it was long ago recognized that large publicly held corporations' shareholdings were atomized and unable to recombine, resulting in an ability for management to utilize the governance system to perpetuate itself. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 47-116 (rev. ed. 1967).

69. See Branson, *supra* note 11, at 59-61.

70. See, e.g., Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1970); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

of years, the Burger court removed shareholder protection from the arena of federal law.<sup>71</sup> Subsequently, corporation law revision has taken a pronounced turn toward the elimination of substantive commands for corporate managements. Prohibitions on loans to officers and directors, restrictions on share issuances generally, and many other substantive do's and don'ts are being swept away.<sup>72</sup> Simultaneously, many of the traditional underpinnings of the governance system are disappearing, such as presumptive cumulative voting, which allows minority shareholders to have representation on the board of directors, and preemptive rights, which aid shareholders in maintaining their proportionate ownership and voting interests.<sup>73</sup> Requirements for shareholder votes on certain issues, majority quorum requirements for valid action at meetings, high voting requirements at meetings once a quorum is present, and more, will soon be gone as well.<sup>74</sup>

A principal justification for all of the relaxation and change in the corporation law area has been the existence of fiduciary duty.<sup>75</sup> Policymakers expect that general fiduciary principles will fill the void created by the elimination of other protections. Yet even as a backup, fiduciary duty has not worked well. At best it produces inconsistent results.<sup>76</sup> With the vast expansion of the business judgment rule in recent years,<sup>77</sup> fiduciary duty and its requirements have become even more amorphous, if not attenuated. Corporation law's entire mass rests upon a bed of mushy general principle.<sup>78</sup>

Finally, fiduciary duty and reliance upon it as the basis for elimination

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71. See, e.g., Conard, *Securities Regulation in the Burger Court*, 56 COLO. L. REV. 193 (1985); Hazen, *Symposium Introduction—The Supreme Court and the Securities Laws: Has the Pendulum Slowed?* 30 EMORY L.J. 5 (1981). A centerpiece of the string of Supreme Court decisions rendering federal law unavailable for shareholder protection was *Sante Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977), holding that plaintiffs may not address state corporation law claims under the guise of federal securities laws.

72. See REVISED MODEL BUSINESS CORP. ACT §§ 8.32(a)(2) (loans to directors), 6.21(b) (broadened eligible consideration for shares), 6.02 (increased director authority for blank check preferred stock), 6.24 (broad director authority to issue share rights, options or warrants) (1984) [hereinafter cited as REV. MODEL ACT].

73. See, e.g., REV. MODEL ACT §§ 7.28(b) (presumptive cumulative voting eliminated), 6.30(a) (presumptive preemptive rights eliminated).

74. See, e.g., REV. MODEL ACT §§ 11.03(g) (shareholder vote eliminated for "small scale" mergers), 7.25(a) & Comment 5 (no floor or provision for low quorums), 10.03(e)(2) & 7.25 (articles can be amended by plurality of those present and voting rather than a majority of two thirds of all shares entitled to vote).

75. See Branson, *supra* note 11, at 70-72.

76. See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 381 (2d Cir. 1980) (share issuance to dilute tender offeror's position upheld); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 364, 230 A.2d 769, 776 (1967) (share issuance to defeat tender offer struck down).

77. See *supra* note 41.

78. See *Moran V. Household Int'l Inc.*, 500 A.2d 1346 (del. 1985) ("poison pill" tender offer defense analyzed in terms of fiduciary duty and business judgment rule); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (selective share repurchase by tender offer target analyzed in terms of business judgment rule or principle of equal treatment for shareholders).

of other, traditional shareholder protections becomes an empty promise when shareholders find that through rigid demand requirements and the litigation committee device, boards of directors and not laws or judges will determine the degree to which fiduciary duty actually will protect shares. The result is that those corporation law protections which remain have boiled down to nothing more than a shareholder right to petition directors, hat in hand, for a redress of grievances.

True, market forces protect shareholders. Yet it requires a great leap of faith into the icy waters of market forces to abandon so many legal protections in such a short span of time. Furthermore, although redundant systems such as the old, multi-layered system of shareholder protections impose costs, all redundancy need not be eliminated. A complex web of federal and state law rules may dampen significantly corporate managers' willingness to enter transactions or take risks. On the other hand, some consistent legal protections, even if redundant when placed next to market forces, impose few costs or impose costs that are outweighed by benefits.<sup>79</sup> An opportunity to have a fair day in court may encourage investment as much or more than the assurance that, on average, or if the investor's portfolio is diversified, the market will protect him, as the Chicago school law and economics movement smugly asserts.

### C. *The Plaintiff's Viewpoint.*

Less globally, what is the effect of these recent developments on the genuinely aggrieved shareholder and his lawyer in Portland, Oregon or in Portland, Maine?

First, upon groping about, the Portland lawyer may find that he has far fewer substantive rules to apply, argue for, or otherwise use.<sup>80</sup> Statutory do's and don'ts are a convenient short hand for the plaintiff seeking to constrain management. They also carry weight with a court, giving the court a convenient peg on which to hang its hat. The lawyer, however, will have to fall back on general principle and fiduciary duty, where bright lines fade and issues of fact abound.<sup>81</sup>

Second, in addition to all the traditional obstacles in the way of derivative litigation, the provincial litigator will read up a bit about the advent and implementation of the litigation committee device. The certain use of the committee will exert further chilling effect on any enthusiasm the lawyer had

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79. *Accord*, Cox, *supra* note 45, at 748.

80. *See supra* notes 72-74 and accompanying text. This dearth of substantive rules assumes that the state follows the letter or trend of the Revised Model Act.

81. Good faith is an issue likely to be ubiquitous. The accompanying issue of fairness, another question of fact, will also remain. Resolution for plaintiff in advance of trial, as on motion for summary judgment, will not be possible, as it might have been in the days of more substantive rule. *See, e.g.*, *Cermetek, Inc. v. Butler Avpak, Inc.*, 573 F.2d 1370, 1377 (9th Cir. 1979) (issues of fact which remain must be resolved against party moving for summary judgment); *U.S. v. Western Electric Co.*, 337 F.2d 568, 572 (9th Cir. 1964) (same).



for the litigation. A possibility does exist, though, that the lawyer can persuade the trial court first to review and then to disagree with the litigation committee's recommendation of dismissal. Although such a victory is a tenuous reed upon which to rely, the possibility may rekindle the lawyer's enthusiasm. Equally likely, though, since neither Maine nor Oregon has precedent for court review of litigation committee decisions,<sup>82</sup> the lawyer may foresee the local court's adoption of the *Auerbach* approach which creates a wide ambit for the business judgment rule.<sup>83</sup> Under the *Auerbach* approach, no review of the merits of the committee's decision would occur if the committee and its counsel have been careful in their preparations and deliberation. The chilling effect of that prospect may be complete. Even the truly aggrieved shareholder's complaint will be frozen in its tracks.

### III. THE ALI PROPOSALS: A RESTRUCTURING.

#### A. *Elimination of Technical Barriers and Implementation of a Balanced Approach.*

The ALI Proposals eliminate many of those overly broad, technical obstacles which have had a chilling effect on plaintiffs and have inhibited all derivative litigation, regardless of the claims' merits.<sup>84</sup> The draft eliminates any requirement that a derivative plaintiff be a record holder of shares, as opposed to a beneficial owner and in particular an owner who has his stock held in street names.<sup>85</sup> Provisions requiring security for expenses and verification of pleadings serve to single out the derivative action unnecessarily. As a result the ALI draft deletes them.<sup>86</sup> Any language that could be used by a court or by a defendant to urge that demand be made on the shareholders has been eliminated.<sup>87</sup>

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82. State courts have addressed the issue of review of the litigation committee's decision in only five states—Alabama, Delaware, Iowa, New York, and North Carolina. ALI Proposals, *supra* note 2, at 97. In addition, in Oregon, all other procedural attributes of the derivative action remain uncodified. *See supra* note 14.

83. Even under the Delaware two-stage approach, which gives the court power to review the merits even after finding good faith and diligence on the committee's part, no review of the merits will take place in a demand made and refused rather than demand excused-special litigation committee case. *See supra* note 60.

84. Seldom has an ALI reporter immersed himself so thoroughly and learnedly in a topic as had the reporter for Part VII. Moreover, the reporter's attempt to take a balanced view is evident on the face of the document itself, despite pulls and tugs in many directions, some of which he has described. *See Coffee, Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789 (1984). Deserving as he is of high praise, however, the reporter would be the last to suggest that the ALI Proposals should not be examined from every possible viewpoint.

85. *See* ALI Proposals, *supra* note 2, § 7.02. *Cf. id.* at 44 (8 states now require plaintiffs to be record holders).

86. *See* ALI Proposals, *supra* note 2, §§ 7.04(a) (verification), 7.04(c) (security for expenses). *Cf. REV. MODEL ACT, supra* note 72, § 7.40 (1984) (verification and other requirements retained).

87. ALI Proposals, *supra* note 2, § 7.03(c). The draft also grafts on to the contempora-

The ALI Proposals retain the special litigation committee device but take an "intermediate position."<sup>88</sup> In its discretion a court has power to review the merits of the committee's recommendation.<sup>89</sup> A litigation committee's findings must be "particularized and corroborated,"<sup>90</sup> to the end that committees will be dissuaded from relying on makeweight effects, such as injury to management morale or harm to corporate good will. If the corporation takes over and pursues the action, the displaced plaintiff's attorney should be "entitled to remain in the litigation in the same status as intervenor and may be entitled to an award of attorneys' fees. . . ."<sup>91</sup> If the corporation proposes to settle a claim against a wrongdoing director or officer, objecting shareholders are given liberal opportunity to appear and present evidence in opposition to the settlement.<sup>92</sup>

### *B. Further Evaluation of the ALI Proposals: Some Reservations*

#### 1. Inadequate Treatment of Structural Bias

The draft leaves itself open to three criticisms. First, the draft does not adequately deal with the structural bias problem. Indeed, it barely treats the problem at all.<sup>93</sup> Even when seemingly independent of the wrongs and persons complained of, litigation committee members will have an innate inclination to favor the derivative action defendants. The probable reasons are many: pat-on-the-backism, the "there but for the Grace of God go I" syndrome, the choice not to participate by those prospective committee and board members who would conduct a searching inquiry, and new directors' expectations that if the committee completes its work "properly" they will be held over as permanent additions to the board.<sup>94</sup> The strong and easily understood possibility of structural bias will lead to a lessening of public and investor confidence in the results special litigation committees reach. A corresponding loss of confidence in our corporate governance system ensues.<sup>95</sup>

neous ownership requirement standing for holders of equity securities at any time before an alleged wrong has been "publicly disclosed" or "known by the holder." *Id.* § 7.02(a)(1).

88. *Id.* at 89.

89. *Id.* § 7.08 ("authority to dismiss" if the litigation committee has followed procedures specified in § 7.10).

90. *Id.* § 7.08(b).

91. *Id.* at 88. In the status of intervenor, plaintiff's attorney would be a watchdog over the corporation's prosecution of the action.

92. *Id.* § 7.13(a).

93. *See id.* at 103 ("[D]isagreement will persist about whether a 'structural bias' affects litigation committee decisions.") *Cf. id.* at 102 ("[N]ot one committee, in all these instances, has decided to proceed with suit," quoting the North Carolina Court of Appeals in *Alford v. Shaw*, 324 S.E.2d 878, 886 (1985), which concluded that "[t]his strongly suggests that the problem of structural bias is indeed real.") *See also* Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 3 (1984) (ALI must "recommend more radical, nonincremental changes to the present system").

94. *See supra* note 64 and accompanying text.

95. *Cf.* ALI Proposals, *supra* note 2, at 103 ("the public impression created by such a

In fact, the ALI draft declines to follow the one guideline courts have evolved for dealing with the structural bias problem. Even when a majority of directors face colorable claims against them, under the ALI proposal the board of directors will retain power to delegate the decision whether to pursue the claims to a special litigation committee.<sup>96</sup> The ALI version directs courts only "to consider any relevant evidence relating to the committee's selection."<sup>97</sup> Because the problem of structural bias is so ubiquitous, or because popular perceptions are that it is so, the special litigation committee device needs some bright line protections against structural bias. Courts in Iowa and North Carolina have developed rules which could serve as examples. When a plaintiff has colorable claims against a majority of directors, those courts have held boards to be without power to delegate to a litigation committee.<sup>98</sup> Along these lines, an ALI draft could advise that the corporation must consult plaintiff's counsel in the process of selecting litigation committee members. The terms of directors added to the board solely to serve on the committee could be limited to the next scheduled election of directors, or in some other way. Other fixed rules to deal with the structural bias problem are possible.<sup>99</sup>

## 2. An Excess of Backup or Redundant Systems

The second area of criticism is that the ALI draft has evolved a complex procedural pipeline whose seeming goal is to facilitate intra-corporate treatment of nearly every conceivable case. As a result few if any cases can ever get out into full light of day.

Under the ALI draft demand will be excused only when "a majority of the board has benefited from, or knowingly participated in, the alleged wrong, or is otherwise clearly biased."<sup>100</sup> An avowed aim is to make the "futility exception . . . a narrow one,"<sup>101</sup> despite the structural bias problem and the empirical observation that demand required usually constitutes "a death sentence" for the derivative action.<sup>102</sup>

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non-adversarial [litigation committee] process is unsettling and might erode public investor confidence in our system of corporate governance.").

96. See *id.* at 88-89, 117-18 and 158.

97. *Id.* at 137.

98. *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 715-16 (Iowa 1983); *Alford v. Shaw*, 72 N.C. App. 537, 324 S.E.2d 878, 886 (1985). See also *Clark v. Lomas & Nettleton Fin. Corp.*, 625 F.2d 49, 53-54, (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981).

99. See *Cox*, *supra* note 12, at 1007-11; *Dent*, *supra* note 57, at 122-27. See also *Gevurtz, Who Represents the Corporation? In Search of a Better Method For Determining The Corporate Interest in Derivative Suits*, 46 U. PITT. L. REV. 265, 325-33 (1985) (automatic appointment of provisional directors as the litigation committee in every instance of suit).

100. ALI Proposals, *supra* note 2, § 7.03(b).

101. *Id.* at 54.

102. *Cox*, *supra* note 12, at 997. That requiring demand amounts to a death sentence for the derivative action is especially true under the illogical Delaware approach, in which a court has no authority to review the merits of a decision to terminate in demand required, as opposed

As has been seen,<sup>103</sup> at the litigation committee stage there are no per se or bright line rules dealing with structural bias. If structural, or palpable, bias seems to be a problem anyway, as a backup device and under a liberal waste standard shareholders can terminate the derivative action.<sup>104</sup> Alternatively, as another backup device, a court can appoint a "panel in lieu of a committee of directors" or "individuals who are not directors" to fulfill the litigation committee role.<sup>105</sup> In the complex ALI pipeline there are so many alternative and cumulative filters that very few, if any cases, will see light of day.<sup>106</sup>

The ALI draft intends that a corporation should never be paralyzed, unable to dispose of a derivative suit at the corporate level. The opportunity should exist for the genuine grievance actually to be tried. Plaintiffs should be able to paralyze corporations from time to time if the benefit is that meritorious actions will see the light of day. The prospect that a shareholder might be able to pursue a claim would remove an otherwise inordinate chilling effect on suits being brought in the first place.

The complex ALI procedural machine also carries a political analogy too far. At times, a majority, or even a super majority of directors, or even shareholders, should not be able to carry the day.<sup>107</sup> Even a purely political institution should not be tantamount to a spoils system. In some cases a shareholder who stands on principle should be able to remove his dispute to the neutral outside arbiter, the judge. Alternatively, a plaintiff shareholder should be able to do so when one or perhaps two, but not five or six, intra-corporate obstacles have been surmounted.

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to demand refused cases. See, e.g., ALI Proposals, *supra* note 2, at 54-55; Coffee, *supra* note 85, at 826 n.96-97; *supra* note 60.

103. See *supra* notes 93-99 & accompanying text.

104. ALI Proposals, *supra* note 2, § 7.09. The waste standard is that "a transfer for no consideration amounts to gift or waste of corporate assets." Alternatively, "[t]he essence of a claim . . . is the diversion of corporate assets for improper or unnecessary purposes." *Michelson v. Duncan*, 407 A.2d 211, 217 (Del. 1979), cited in ALI Proposals at 130.

105. ALI Proposals, *supra* note 2, § 7.12. See also *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983) ("Under Iowa law, equity has broad powers to make appointments to enable corporate functions to be carried out.").

106. Of course very few derivative actions reach trial anyway. See Coffee, *supra* note 85, at 796. A principal reason is that if defendants go to trial, rather than settle, an adverse adjudication will typically deprive them of eligibility for indemnification. *Id.* Yet there does exist a penumbra, if not light of day, between intracorporate resolution and trial.

107. ALI Proposals, *supra* note 2, § 7.08(d) (even though costs outweigh benefits court can refuse board recommendation if "dismissal . . . would . . . frustrate any legal rule that operates for the protection of shareholders."). See also *id.* § 7.09(d) (same limitation on shareholder power to terminate). These narrow, and cryptic, limitations on board or shareholder power recognize that principle should at times surmount majority rule. They replaced less cryptic language in an earlier draft: "dismissal . . . would not frustrate any authoritatively established public policy." PRINCIPLES OF CORPORATE GOVERNANCE § 7.08(a)(3) (Tent. Draft No. 3 1983). Commentators criticized the earlier language as too broad. Compare Cox, *supra* note 45, at 781-83 with Coffee, *supra* note 85, at 815-17. Perhaps a hybrid of the two would work: "dismissal . . . would not frustrate any legal rule or *authoritatively established public policy* that operates for the protection of shareholders."

### 3. The Nominal and Professional Plaintiff Problem

The ALI draft eliminates one set of overly broad and often unnecessary barriers. But in eliminating those historical relics the draft substitutes a complex procedural structure that will have a new and different, but still broad, chilling effect on all potential derivative claims, good or bad. Instead, the real derivative action problem seems to be how to police the "bad" action, that with the abusive plaintiff and bounty hunter lawyer, while permitting the "good" action, that with the genuinely aggrieved shareholder, to go forward on a relatively unfettered basis.<sup>108</sup> It is the professional plaintiff and his counsel who cause most of the problems with the derivative action and which corporate counsel and commentators decry.<sup>109</sup> It is professional plaintiffs' actions which lead to the need for reform in the first place.

In derivative actions involving *Fortune* 500 or New York Stock Exchange listed companies, typically the lawyer, not the client, is at risk. The client owns but a few shares. Ethical proscriptions to the contrary, the lawyer will have staked the costs of the litigation.<sup>110</sup> The lawyer will have expended hours of time without a steady inflow of fees out of which to pay overhead and other expenses.<sup>111</sup> A result is that the Philadelphia or Wilmington derivative action lawyer is more risk averse than he would have been had the client advanced some costs and fees. Because the client has so little invested, in either an emotional or monetary sense, the lawyer is free of any client control over the lawyer's actions. The result is early, and inadequate,

108. Colloquially, the question is how to slow a Harry Lewis without also unduly affecting the genuinely aggrieved shareholder. Mr. Lewis has been the named plaintiff in "several hundred" filed, and at least 52 reported, corporation-securities law federal cases. Defendants' Memorandum In Support of Motion For Order Staying Discovery (Dec. 9, 1982) at 6 and Exhibit A, *Lewis v. Berry*, No. C82-1244 VR, W.D. Wash. at Seattle (Lexis search of federal cases only). Mr. Lewis owns a few shares in a great number of New York Stock Exchange listed companies. *See, e.g.*, Affidavit of Harry Lewis (Jan. 17, 1983) at 3, *Lewis v. Berry*, *supra* (purchase of 25 shares of Seafirst Corp.). Those few shares in myriad companies give Mr. Lewis standing to act as plaintiff for lawyers bringing numerous lawsuits. When pressed under oath Mr. Lewis deposes that in each of his suits he stands ready to pay all costs, as Disciplinary Rule 5-103(B) of the Model Code of Professional Responsibility require him and not his lawyer ultimately to do:

[I] confirm that I am ultimately responsible for the payment of a costs of this action. I am aware that these costs may be substantial and involve and include such items as the cost of notifying members of the class . . . deposition transcripts, experts, reproduction of documents, filing and service fees, travel, and other litigation expenses. . . . I am ready, willing and able to pay these costs in the event that the action is unsuccessful.

Affidavit of Harry Lewis, *supra* at 4; MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 5-103(B) (1981). The affidavit is silent as to the amount of costs Mr. Lewis actually has paid in the hundreds of cases in which he has been plaintiff.

109. *See, e.g.*, Duesenberg, *supra* note 5, at 332-33.

110. *Cf.* Affidavit of Harry Lewis, *supra* note 108.

111. Unlike the Portland firm, which probably has a diversified practice, in the plaintiffs' bar derivative action firm at best the cash flow will be lumpy and the pressure to smooth out the flow of fees will be constant.

often cosmetic, settlements of derivative suits in which the lawyer's fee and cash flow are the first considerations.<sup>112</sup>

It is the naked "self interest" of the lawyer which controls when the plaintiff has only a nominal holding.<sup>113</sup> Worse than risk averse, the lawyer becomes fair game for a bribe, or is not checked or reined in from extortionate activity. The derivative action is settled for generous fees paid by the corporation. Very little deterrent or compensatory effect results.

Another incentive for the quick settlement is the free rider problem. Since the first plaintiff's lawyer lacks any property right in the suit, other lawyers can and will intervene.<sup>114</sup> They will then joust for position as lead counsel. Backroom negotiations resembling Chicago wardheelers' meetings take place between lawyers regarding allocation of work and fees. By contrast, an early settlement will cut off intervenors and the need to share fees. Yet those late arrivals and free riders must have clients. In all likelihood those clients will be professional plaintiffs and shareholders with nominal holdings.<sup>115</sup> Restrictions on nominal plaintiffs may ameliorate the free rider problem and thereby lessen the compulsion to settle early and in an abusive manner.

Last of all, "[t]he attorney without a 'true' client lacks the initial source of information that the attorney has in other forms of litigation—the data that his client provides him."<sup>116</sup> Thus, the efforts of the Philadelphia-Wilmington plaintiffs' bar focus upon *Fortune* 500 companies whose affairs are regularly reported by the media.<sup>117</sup> Alternatively, derivative litigation is parasitic, following in the wake of federal or state agency investigations, and resembles an attack by a wolf pack, with many members of the plaintiffs' bar buying at a single door.<sup>118</sup> Private enforcement is overly concentrated on a few targets and produces unseemly appearances.

The answer to much of what ails the derivative action seems to be to reduce drastically the field of play for the professional plaintiff. That end might be accomplished by adoption of minimum ownership requirements for derivative action plaintiffs, at least in publicly held firms. Coupled with other reforms, such a requirement might best serve to refocus the derivative action away from Philadelphia and Wilmington into a sphere where it is more likely to play a useful role.

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112. Coffee, *supra* note 5, at 229-35. Much of the following identification of problems caused by the presence of nominal shareholders as plaintiffs comes from Professor Coffee's work.

113. *Id.* at 232.

114. *Id.* at 233.

115. *Cf.* ALI Proposals, *supra* note 2, at 83 (normally derivative action will not involve as many lawyers and plaintiffs as securities or antitrust class actions).

116. Coffee, *supra* note 5, at 234.

117. See Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-78*, 60 B. U. L. REV. 306, 315 & Table IV (1980) ("[s]ize related differentials in the incidence of shareholder suits . . . are quite pronounced"); *id.* at 317 n.26 (correlation of suits filed and listings in Wall Street index).

118. See Coffee, *supra* note 5, at 222-24.

Restricting nominal shareholders from becoming plaintiffs does impose costs. In American capitalism an egalitarian ideal has long prevailed, epitomized by "shirt sleeve" capitalism and "Own Your Own Share of American Business" campaigns in the 1950s.<sup>119</sup> The ideal would be eroded by minimum ownership requirements for derivative action plaintiffs. Yet the egalitarian ideal has already been eroded. Many stock brokerage firms no longer do business with the small and odd lot shareholder.<sup>120</sup> The SEC now imposes minimum ownership requirements upon those who submit proxy proposals for inclusion in managements' proxy solicitations.<sup>121</sup> The ALI has raised the possibility that parties to a derivative action settlement need not give notice to holders of small numbers of shares.<sup>122</sup> While abandonment of the egalitarian ideal is not without costs, the real question is whether the benefits of maintaining that eroded ideal outweigh the cost of nominal plaintiffs' continued abuse of the derivative action.

A second cost in reducing the field of play for the nominal or professional plaintiff is that the reform could provide merely an additional procedural escape for defense attorneys. Emphatically, any such reform must be a substitute for the procedural impediments which now lie in the derivative action's path. Moreover, the reform must take shape as a bright line rule. Any subjective restriction on shareholders' eligibility as plaintiffs would become a mechanism with which defense attorneys would shamelessly question every plaintiff's bona fides. Indeed, that is already too much the strategy of the defense bar.

A last cost that might be feared in eliminating nominal, and therefore many professional, plaintiffs is the resulting loss of the deterrent effect on corporations. In fact, elimination of the nominal plaintiff might improve matters for shareholders generally. Professional plaintiffs do real plaintiffs and shareholders few favors. Just as "hard cases make bad law," bad plaintiffs seem to have made hard law. Subliminally or otherwise, judges react adversely to professional plaintiffs' presence and to the strategems of the lawyers who represent them.<sup>123</sup> From the truly aggrieved plaintiff's point of view, many of the harshest precedents seem to have come down in cases

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119. See Branson, *Securities Regulation After Entering the Competitive Era: The Securities Industry, SEC Policy, and the Individual Investor*, 75 Nw. U. L. Rev. 857, 860-61 (1980).

120. See *id.* at 895-96.

121. SEC Rule 14a-8(a), 17 C.F.R. § 240.14a-8(a) (1984) (minimum ownership requirement is 1% or \$1,000 in market value of securities to be voted at the shareholders' meeting).

122. ALI Proposals, *supra* note 2, at 174. Also, security for expense provisions have applied only to plaintiffs whose shares have a market value below \$25,000. See MBCA, *supra* note 30, § 49; *supra* note 31. Cf. *Marshall v. Spang & Co.*, 321 F. Supp. 1310, 1312 (W.D. Pa. 1971) (other than for purposes of security for expenses, size of plaintiff's investment held irrelevant in derivative litigation). See also *Sanderson v. Winner*, 507 F.2d 477, 480 (10th Cir. 1974) (as a general rule courts do not review litigants' financial status or their ability to pay costs), *cert. denied*, 421 U.S. 914 (1975).

123. See *Alleghany Corp. v. Kirby*, 333 F.2d 327 (2d Cir. 1984) (Friendly, J., dissenting); *Lewis v. Curtis*, 671 F.2d 779, 782-83 (3rd Cir.) (review of district judge's open, visceral hostility to professional plaintiff and his attorney), *cert. denied*, 459 U.S. 880 (1982).

in which a professional plaintiff sought to feather a plaintiffs' lawyer's nest.<sup>124</sup>

It has been the professional plaintiff, and counsel who regularly represent him,<sup>125</sup> who have given the derivative suit a bad name. Through minimum ownership requirements or by means of other reforms,<sup>126</sup> restriction of the field of play for professional plaintiffs, and not the weighing down of all shareholders equally, is the tack the ALI must pursue.

#### 4. Complementary Restructuring

The ALI might accomplish the goal of more selective deterrence by taking a radically different approach consisting of several steps. As noted above, the principal step is the elimination of the professional or nominal shareholder as plaintiff. Insofar as the derivative action problem is a lawyers' problem, another step might lie in the direction of curbs on lawyers and not upon litigants generally. Next, the ALI should reverse its current position

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124. See, e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *supra* notes 23-25 & accompanying text (discussing *Aronson*). See also *Lewis v. Transamerica Mortgage Investors, Inc.*, 444 U.S. 11, 24 (1979) (denial of private right of action under Investment Advisers Act of 1940); *Lewis v. Anderson*, 615 F.2d 778, 782-83 (9th Cir. 1979) (9th Circuit's adoption of *Auerbach v. Bennett* rule), *cert. denied*, 449 U.S. 869 (1980); *Lewis v. Oppenheimer & Co.*, 481 F. Supp. 1199 (S.D.N.Y. 1979) (dismissal of proxy rule and state law claims); *Lewis v. Teleprompter Corp.*, 88 F.R.D. 11, 14-22 (S.D.N.Y. 1980) (fee splitting and other practices of plaintiffs' law firms discussed).

125. See *Coffee*, *supra* note 5, at 262. At least part of the derivative action problem seems to be lawyers' lack of ethics and professionalism in certain segments of the bar or in a few cities, claims that it is just a few "bad apples" to the contrary. *Id.* And, if in policing the bar courts are a "week reed upon which to rely," *id.* at 236, in some manner courts and bar associations must be made squarely to face those aspects of the problem which are lawyers' problems. To weigh down litigants everywhere in order to police lawyers in a few locations is manifestly unfair. Courts should enforce at least those ethical proscriptions worth enforcing. *Cf. id.* at 280 (ability to split fees would allow plaintiffs' lawyers to diversify and thereby be more efficient; diversified law firms are permitted to split fees among partners not even remotely connected with cases). *But see Coffee*, *supra* note 84 at 812 (proposed Federal Rule of Civil Procedure 68 and fee shifting Rule 68 contemplated would not work in derivative action area); *Coffee*, *supra* note 5, at 236 (courts have a number of opportunities at which to make lawyers toe the line but do not as a rule use those opportunities). *Cf. Lewis v. Teleprompter Corp.*, 88 F.R.D. 11, 22-23 (S.D.N.Y. 1980) (reduction of fees for "tag along" lawyers and other sanctions).

126. The professional plaintiff could also be policed by enforcement of the requirement that the derivative action plaintiff be "able to represent fairly and adequately the interests of the shareholders in the corporation." ALI Proposals, *supra* note 2, at § 7.02(a)(4); FED. R. Civ. P. 23.1. Courts, however, have used the provision as grounds for evaluating plaintiff's counsel rather than for scrutinizing the professional plaintiff himself. See, e.g., *Lewis v. Curtis*, 671 F.2d 779, 788-89 (3d Cir.) (plaintiff's small investment is "irrelevant" and his "complete ignorance of facts concerning the transaction" does not make him an inadequate representative), *cert. denied*, 459 U.S. 880 (1982). Moreover, courts have refused even to compel discovery of a professional plaintiff's other corporate-securities law cases, his record in settling those cases, his financial arrangements with his attorney, or his litigious motives in purchasing small amounts of stock in many companies. See, e.g., *Lewis v. Black*, 74 F.R.D. 1, 3 (E.D. N.Y. 1975).



and liberally excuse demand,<sup>127</sup> principally because of the structural bias problem. Moreover, bright line rules regarding structural bias should be allowed on occasion to shoulder aside the special litigation committee or, indeed, any of the backup devices the ALI Proposals contemplate for the litigation committee.<sup>128</sup> The undoubtedly pervasive existence of structural bias and the responsive dischord it strikes in any neutral observer informed of how the litigation committee device operates militate in that direction.

Moreover, the ALI probably should eliminate the alternatives to the litigation committee altogether. Demand, with demand liberally excused, and the litigation committee, with judicial discretion and bright line rules to guard against structural bias, should make up the entire procedural scheme.<sup>129</sup> The gauntlet should be compact and clearly demarcated. The restructuring would result in greater potential for extra-corporate resolution of derivative actions. Advocacy of that result stems from a conviction that a salutary effect might be achieved if a few cases involving real plaintiffs in Portland, Oregon, Portland, Maine, or elsewhere, actually went to trial.

#### ALI PROPOSALS: A FEW FINE TUNING IDEAS

Regardless of whether any radical restructuring takes place, a few other changes to the ALI Proposals are in order. With regard to procedural matters affecting the corporation in a derivative action, such as "consolidation and appointment of lead counsel," the draft proposes "no 'black letter' provision with respect to these topics because it is assumed that prevailing law permits the corporation . . . to move for consolidation of multiple actions. . . ."<sup>130</sup> With regard to procedural burdens for plaintiffs, however, the draft is not content with reliance on prevailing law. Instead the draft reiterates common provisions of codes of civil procedure. The result is that the draft weighs down plaintiffs alone with extra baggage and does so unnecessarily.

It goes with saying that in a lawsuit plaintiffs have the burden of proof.<sup>131</sup> It goes without saying that by his signature on a pleading an

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127. The ALI proposal to make demand universal really is an effort to reduce demand's importance. Under the ALI schematic the demand refused case is subject to the same scrutiny as the demand excused case. ALI Proposals, *supra* note 2, at 54. Under current Delaware law no judicial review takes place to the board of directors' refusals in demand refused cases while in demand excused cases a court can review the merits of the litigation committee's later decision. See *supra* note 60. Thus demand required or demand excused has an importance out of proportion to its proper role.

Because in the past demand has lead so frequently to adverse results, however, *ex ante* any demand requirement nonetheless has a disproportionate chilling effect on plaintiffs and their counsel. Demand, therefore, should be liberally excused, or eliminated altogether. See Gevurtz, *supra* note 98, at 332 (demand should be "abolished as an unnecessary source of confusion").

128. See *supra* notes 100-107 and accompanying text.

129. That is, ALI Proposals §§ 7.09 & 7.12 should be deleted. See ALI Proposals, *supra* note 2, §§ 7.09 & 7.12.

130. *Id.* at 80, relying on MANUAL FOR COMPLEX LITIGATION (4th ed. 1977).

131. *But see* PRINCIPLES OF CORPORATE GOVERNANCE ANALYSIS AND RECOMMENDATIONS §

attorney certifies the pleading's good faith and adequate grounding in fact.<sup>132</sup> Routinely, codes of civil procedure provide that allegations of fraud and the like be pleaded "with particularity."<sup>133</sup> To remain within even the parameters it sets for itself, such as "striking a proper balance" between plaintiffs and defendant corporate officials,<sup>134</sup> the ALI draft should expunge all black letter references to matters applicable to law suits and plaintiffs generally and with which codes of civil procedure already deal on an adequate basis.

The ALI Proposals contain a number of filtering and backup filtering mechanisms funneling toward intra-corporate resolution of derivative action disputes.<sup>135</sup> Boards of directors, committees of boards of directors, shareholders, judicially appointed special committee members, or judicially appointed panels in lieu of committees of directors can act. In addition the draft presents those various organs with a smorgasboard of possible actions to take, either simultaneously or in series. Committee members can choose from a panoply of choices the draft sets out, ranging from "seek[ing] dismissal [for] . . . failure to exhaust intra-corporate remedies," "seek[ing] a stay of the action" or a stay of discovery, possibly pending an intra corporate investigation, investigating internally, or adopting or pursuing "the action in its [the corporation's] own right."<sup>136</sup> Courts have already found the less clearly contoured common law litigation committee device a source of excessive delay and cost.<sup>137</sup> With the well mapped route to delay that the ALI Proposals may represent, and the superior resources and large law firms that corporations are able to command, corporations will use the ALI's proliferation of choices to wage wasteful wars of attrition with plaintiffs. The ALI might therefore consider black letter time limitations, or guidelines in the comments, for the exercise of some or all of these corporate choices.<sup>138</sup>

4.01(d) (Tent. Draft No. 4, 1985) (approved by the Institute May 15, 1985 for ultimate inclusion in Part VII, Chapter 1, at § 7.16).

132. Compare ALI Proposals, *supra* note 2, § 7.04(a) with FED. R. CIV. P. Rule 11.

133. Compare ALI Proposals, *supra* note 2, § 7.04(b) with FED. R. CIV. P. Rule 9(b).

134. ALI Proposals, *supra* note 2, at 3.

135. See *supra* notes 103-06 & accompanying text.

136. ALI Proposals, *supra* note 2, § 7.06(a).

137. See *Kaplan v. Wyatt*, 484 A.2d 501, 511-12 (Del. Ch. 1984), *aff'd*, 17 SEC. REG. & L. REP. (BNA) at 1888 (Oct. 9, 1985). In *Kaplan*, Chancellor Brown stated:

[T]he new *Zapata* procedure . . . has the pragmatic effect of setting up a form of litigation within litigation. (At this point in this case, we are some three years after the amended complaint was filed, we have had three full-scale, briefed arguments, we have had all the investigation and activity previously mentioned, and as yet we have not reached the point of any normal discovery and motion practice. . .). The *Zapata* procedure adds, in effect, a new party to derivative litigation—the Special Litigation Committee—and a new battery of lawyers—counsel for the committee. . . . It sidetracks derivative litigation as we have heretofore known it for approximately two years at a minimum while the committee goes through its functions and while the plaintiff passively awaits. . . .

484 A.2d at 511-12.

138. Other possibilities for clarification of ALI Proposals also exist. See *supra* note 106 (suggesting language limiting board and shareholder power).

THE GENUINELY AGGRIEVED SHAREHOLDER:  
DOES HE OR SHE EXIST?

This article supposes the existence of a derivative action plaintiff denominated the "genuinely aggrieved shareholder," defined as a "shareholder whose stake in the corporation, while not alone large enough to justify the costs of litigation, is much greater than nominal."<sup>139</sup> Moreover, that plaintiff has as counsel a lawyer whose practice does not consist solely, or even primarily, of derivative suit litigation. On those factual assumptions, this article then proposes a restructuring of the ALI derivative action provisions.

Three questions are in order. First, does the genuinely aggrieved shareholder exist in numbers sufficient to justify change to the ALI proposal? Some observers infer that he does not.<sup>140</sup> Second, if the genuinely aggrieved shareholder in Portland, Oregon or Portland, Maine does exist, is he adequately represented? The Wilmington, Philadelphia, and other plaintiffs' bars may cover the waterfront sufficiently. Alternatively, between local counsel and occasional forays into the "hinterlands" by members of the plaintiffs' bar, adequate representation results. No change is necessary. Third, if the genuinely aggrieved shareholder does exist, and if he or she is consistently under-represented, why are these would-be plaintiffs under-represented? Without empirical research, no certain answers are possible. Nonetheless, some reasoned speculation can go forward.

From time to time, the genuinely aggrieved shareholder does surface in reported cases.<sup>141</sup> Most opinions, however, neither report on nor inquire into the extent of plaintiffs' interest or ownership, in large part because existing law deems it irrelevant.<sup>142</sup>

One line of thought considers that the genuinely aggrieved shareholder does not exist in any number because shareholders in companies below the *Fortune* 500 level simply do not find out about possible wrongdoing. The *Wall Street Journal* and other business media do not follow, investigate, or report on the affairs of over-the-counter (OTC) or American Stock Exchange companies, or do not do so in depth.<sup>143</sup> This view, however, is extremely

139. See *supra* notes 8-9 and accompanying text.

140. See Coffee, *supra* note 84, at 800:

[T]he derivative action has essentially functioned as a monitoring mechanism chiefly with respect to publicly traded corporations. This is probably because the engine that drives the derivative action—the professional plaintiff's attorney—is only in a position to monitor the behavior of those corporations subject to federal disclosure standards. The underground railroad that somehow connects these attorneys with eligible shareholders seldom runs to smaller corporations. . . . (footnotes omitted).

*Cf.* Cox, *supra* note 45, at 761. For the most part, Professor Coffee means large publicly held companies for the *Fortune* 500 or NYSE listed variety and the underground railroad running to professional and other nominal plaintiffs.

141. See, e.g., *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 368 (1965) (named plaintiff and invested \$2,000 in 1957 while her son-in-law had purchased \$45,000 in stock and \$10,000 in bonds).

142. See *supra* note 122.

143. See, e.g., Coffee, *supra* note 5, at 235; Coffee, *supra* note 84 at 800-01; Jones, *supra* note 117, at 317 n.26.

provincial. Regional media often report on imbroglios and failures of local and regionally held public, and even quasi-public, companies with a zest and taste for scandal that surpasses anything in the *Wall Street Journal*.<sup>144</sup> The shareholder in those local and regional companies is more likely to discover and be angered by corporate developments<sup>145</sup> than is the professional plaintiff, who discovers through and then has to be recruited by the professional plaintiffs' lawyer.

A possible reason why the genuinely aggrieved shareholder is not more visible is that some shareholder litigation in local and regional companies may go forward under other guises. It is still possible to dress some mismanagement claims in federal securities law wraps.<sup>146</sup> Some cases might be brought and settled as state securities law claims, where standing is broader than under federal law and attorney's fees are provided the successful plaintiff by statute.<sup>147</sup> Still other claims could be brought under the banner of denial of rights associated with shareholding, in which case a representative rather than derivative suit will lie.<sup>148</sup> That significant numbers of aggrieved shareholders are hidden in those disguises, though, is unlikely. The volume of all such litigation is not great, nor does the volume seem to have increased since the advent of the special litigation committee or other developments inimical to derivative actions. A number but certainly not a flood of cases are probably so disguised.

It is possible, though, to identify categories of shareholders whose stake is more than nominal and for whom the sale of shares is not an adequate response to wrongdoing. Very recently much attention has focused on those categories, labeled generically as inframarginal shareholders.<sup>149</sup> Inframarginal shareholders have become increasingly aggrieved and militant in at least two types of situations, change of control transactions and business failures and workouts.<sup>150</sup> These shareholders, for example, may be long term employees who have relatively non-diversified portfolios with substantial, but less than

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144. On the other hand, in some regional centers media may be imbued with an uncritical boosterism which resembles that prevalent in Sinclair Lewis' mythical town of Zenith. See S. LEWIS, *BABBITT* at 134 (1922) (Signet Classics ed. 1961).

145. See *infra* notes 149-50 and accompanying text. Geographical proximity or employment, or both, may heighten a shareholder's identification with a company and, indeed, lead to characterization of that shareholder as inframarginal. *Id.*

146. See, e.g., *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977) (federal securities law claim for failure to disclose facts giving rise to state law fiduciary duty or other claim), *cert. denied*, 434 U.S. 1069 (1978).

147. See *supra* notes 46-47 and accompanying text.

148. See ALI Proposals, *supra* note 2, at 26-27; W. CARY & M. EISENBERG, *supra* note 12, at 896-99.

149. See Levmore, *Efficient Markets and Puzzling Intermediaries*, 70 VA. L. REV. 645, 652-56 (1984). In more technical terms, the inframarginal shareholder is one who will not offer his shares at the equilibrium price. The price at which the market, or submarket, for his shares will clear is above and to the left of the cartesian coordinates indicating equilibrium price for the market as a whole. See generally A. ALCHIAN & W. ALLEN, *EXCHANGE AND PRODUCTION* 239-56 (3d ed. 1983).

150. See, e.g., Cohn, *Eastern Airlines Union Leaders are Taking Steps Toward Possible Bid for Control*, *Wall St. J.*, Jan. 9, 1986, at 5, col. 1-4; Long, *Danville Va., Joins Dan River's*

controlling, interests in the employer corporation. Members of the community where the corporation has headquarters or significant facilities may own more than nominal amounts of stock and perceive that they have enough at stake to voice a grievance against management. Long term investors and owners of shares in so-called opportunity companies<sup>151</sup> are other inframarginal shareholders who have a stake, or perceive themselves as having a stake, larger than just the dollars invested. While the legitimacy of many inframarginal shareholders' activities is undoubtedly subject to debate, inframarginal shareholders increasingly have come to the fore and support the plausibility of the genuinely aggrieved shareholder scenario.

Another source of aggrieved shareholders can be a group of shareholders, inframarginal or otherwise, who band together to affect corporate conduct, possibly by litigation.<sup>152</sup> The author of this article has participated in two such cases, both involving regional OTC companies. In one case, approximately 45 of 2,000 shareholders, holding 14-15 percent of the shares, joined as named plaintiffs, or supported the litigation by contributions for costs and fees.<sup>153</sup> In another example, 20 or so shareholders, owning approximately 550,000 of 5.8 million shares, met to consider combined securities and fiduciary duty claims against management of a prominent regional financial institution. Prospective group members were all "mere" investors.

Nonetheless, anecdotal evidence indicates only the plausibility of the truly aggrieved shareholder scenario. It does not establish the frequency or reality of the phenomenon. Assuming, however, a not insignificant frequency of possible wrongdoing and resulting shareholder grievances in local and regional companies, the next question is why the rate of litigation does not approach that in larger companies.<sup>154</sup> Consistent underrepresentation, rather than a lack of suspected wrongdoing, or a lack of genuinely aggrieved shareholders because of shareholder ignorance or apathy, may be the answer.

The plaintiffs' bar does not exist beyond a handful of cities. Unless the stakes are very large, established plaintiffs' firms do not wish to litigate in distant locales. Changes in time zones and travel time can make a single

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*Battle Against Icahn's Offer*, Wall St. J., Nov. 29, 1982, at 19, col. 2. Dan River, Inc., shareholder employees and shareholder residents of the company's headquarters town were active in the corporation's defense against Carl Icahn's takeover efforts, as were Phillips Petroleum shareholder employees in the Mesa Petroleum Co. bid for Phillips' shares, and Eastern Airlines shareholder employees in Eastern's acquisition by Texas Air Corp. Cohn, *supra*; Long, *supra*.

151. "Opportunity companies" are those companies whose present assets and earnings may be insubstantial but whose long term growth prospects are perceived to be the reverse, such as so-called high tech companies.

152. See generally Branson, *Organizing the Inframarginal Shareholder: Shareholder Opposition To, Or Shareholder Participation in Management Opposition To, A Tender Offer*, L. Rev. (forthcoming) (1986) (copy on file with Washington & Lee Law Review).

153. *Peterson v. Wien Air Alaska, Inc.*, No. C 79-914 M (W.D. Wash., complaint filed Aug. 3, 1979).

154. See Jones, *supra* note 117, at 316 (3.6 year frequency of suit for largest 80 of Fortune 500 compared to 17.6 year frequency for random 110 from Fortune 1000 largest firms).

deposition or motion in Portland, Oregon or Portland, Maine into a two or three day proposition. With the number of cases in *Fortune* 500 or similar companies required for adequate diversification and cash flow, plaintiffs' firms cannot afford the time necessary to litigate in distant places. Only infrequently will established plaintiffs' firms venture far afield, when the perceived chance of success is high and a large publicly held company is involved.<sup>155</sup>

Consequently, aggrieved shareholders in local and regional public companies, of which there are very many,<sup>156</sup> may be consistently underrepresented. Contrary to assertions that the derivative action results in excessive and perverse incentives for lawyers,<sup>157</sup> on the regional level a marked lack of incentive for counsel exists. The derivative action has a bad name.<sup>158</sup> It is procedurally complex. Procedural impediments impose an untold chilling effect on counsel.<sup>159</sup> The special litigation committee has chilled counsel still more. The defending law firm is likely to have vastly superior resources. The plaintiff's side of the litigation will be consistently underfunded, at least until the plaintiff gains some measure of success and the attorney obtains fees in settlement or otherwise. Meanwhile, overhead, including rent and associates' salaries, must be paid. Meanwhile, too, has become a long while, since under right to speedy trial acts criminal prosecutions take precedence on court calendars.<sup>160</sup> The time frame for civil litigation has been stretched out interminably and the law firm must be prepared to carry overhead for that period. Quite dramatically, on local and regional levels, lawyers and law firms qualified for prosecuting corporation law cases do not want contingent fee business litigation anymore, regardless of the chance for success or the ability to recover fees from the corporation's treasury. On the regional level, meritorious cases seem to go begging for want of qualified counsel.

The ALI should think twice about the ALI Proposals' present course. That course would add delay and increase the chilling effect that derivative

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155. Cf. *Lewis v. Berry*, No. C 82-1244 VR, W.D. Wash. at Seattle (suit arising from failure of Seafirst Corp. due to extensive bank energy lending).

156. See 49 SEC ANN. REP. 99 (1984). Below the *Fortune* 500 level there remain 2554 other issuers with shares listed on national securities exchanges. *Id.* There are 3700 issuers with shares traded OTC, quoted nationally over the National Assn. of Securities Dealers Automated Quotation system. *Id.* at 93. Beneath that level there are again as many, or more, companies with shares traded OTC, registered with and reporting to the SEC. These companies have a class of equity securities held by 500 or more persons and \$3 million or more in assets. Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 781(g) (1981), modified by SEC Release No. 34-18,647 (April 15, 1982). Below that level the SEC estimated that 84,000 quasi-public companies, issuers with 10-499 shareholders exist. See Conard, *supra* note 9, at 458.

157. See, e.g., Coffee, *supra* note 5, at 262.

158. Some litigators and business lawyers opine that, in regional financial centers when a law firm takes the plaintiff's side in shareholder actions more than on an isolated occasion, that law firm will be ostracized both by the corporate bar and by the corporate community.

159. See *supra* notes 12-50 and accompanying text.

160. See Project, *The Speedy Trial Act: An Empirical Study*, 47 *FORDHAM L. REV.* 713, 726-34 (1979).

action procedure has on counsel, not only at the plaintiffs' bar but on local and regional levels as well. On those levels the disincentives involved in derivative litigation already may be excessive.

#### CONCLUSION

This jeremiad's purpose has been to demonstrate that a significant other side to the derivative action exists that the ALI and its reporter have yet closely to examine. On this other side, conditions may be quite different, indeed almost opposite, from those prevailing in litigation involving *Fortune* 500 and other large national companies. This other side may have significance not only for individual shareholders and for lawyers not members of the plaintiffs' bar, but also for larger corporations and their counsel, who as investors in other companies could one day litigate a derivative action. On a macroeconomic basis, this other side also represents a not inconsiderable sector of the economy.

This article's conclusion is that the proper approach for the American Law Institute is to facilitate litigation on the other side, or at least to permit it to go forward in as unfettered a manner as possible. With all due respect to the ALI reportorial staff, who in the corporate governance project have done a superb job, in the derivative action area the best reform might be one that insofar as possible only affects derivative suits that readily can be identified as, or predicted to be, abusive. The ALI might best achieve that result by attempting to restrain or eliminate the nominal shareholder and professional plaintiff who have given the derivative action such a bad name.

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