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THE SOCIAL MEANING OF SHAREHOLDER SUITS*

James D. Cox[†]

"Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements." *J.I. Case Co. v. Borak*¹

"There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general [A] complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial" *Blue Chip Stamps v. Manor Drug Stores*²

The two above quotes express very different judgments of the social value of the representative shareholder suit. In *Borak*, the Supreme Court embraced the shareholder suit as an important medium for achieving compliance with the securities laws. *Blue Chip Stamps* warned of the abuses that accompany such suits.³ Although their difference may well be attributed to the gulf that separates the Warren Court from

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[†] Professor of Law, Duke University. An earlier draft of this article was delivered by me at the Eighth Abraham L. Pomerantz Lecture at Brooklyn Law School. I am grateful for the suggestions of the program's commentators, Messrs. Stanley M. Grossman and Robert H. Mundheim as well as those provided by Professors Paul Carrington, Deborah DeMott, Paul Haagen and Randall Thomas.

¹ 377 U.S. 426, 432 (1964).

² 421 U.S. 723, 737-38 (1975).

³ This warning continues to appear in the opinions of the Rehnquist Court. See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 189 (1994) (quoting *Blue Chip Stamps*, 421 U.S. at 739) (holding that there is no aiding and abetting liability on the grounds that such liability would "present[] a danger of vexatiousness in degree and in kind from that which accompanies litigation in general" with the consequent effect of agreeing to quick settlements and leading to high precautionary costs for business transactions).

the more conservative Burger Court,⁴ the opinions are also a reflection of contemporary America. *Borak* was decided at the height of the most dramatic social revolution in America's history—a time when the courts, and more particularly private litigation, were engines for establishing, even redistributing, legal rights within the country. In contrast, *Blue Chip Stamps* reflects the social pendulum's swing in the other direction. By the mid 1970s, economic growth, not social change, had become the dominant ideology in American politics.⁵

This article examines the public image, or expressive value, of the shareholder suit. My purpose is to determine if many features common to the conduct of class actions and derivative suits enhance or detract from shareholder litigation being understood as a positive social force. The premise driving this inquiry is my belief that the higher the public esteem of the shareholder suit, the greater will be its deterrent value. To illustrate why I believe that this premise is correct, consider the following study by social psychologist Robert Cialdini.⁶

Cialdini placed flyers under the windshield wipers of cars and observed how their drivers disposed of the flyers upon returning to their auto. For one group of drivers, an associate of Cialdini would pass by the driver, pick up some litter, and discard the litter in a refuse container. Very few of the drivers in this group threw the flyer on the street. In contrast, over one-third of the drivers who did not witness the responsible behavior of the passerby discarded the flyer onto the street. The study reflects the well-documented tendency of individuals

⁴ See, e.g., Robert H.A. Ashford, *Implied Causes of Action Under Federal Laws: Calling the Court Back to Borak*, 79 NW. U. L. REV. 227 (1984); Thomas L. Hazen, *Implied Private Remedies Under the Federal Statutes: Neither a Death Knell Nor a Moratorium—Civil Rights, Securities Regulation, and Beyond*, 33 VAND. L. REV. 1333 (1980); Lewis D. Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

⁵ This time marked the country's political shift from liberalism to conservatism, hardly an environment for continuing to expand the rights of the "little guy."

⁶ See ROBERT B. CIALDINI ET AL., 24 ADVANCES EXPERIMENTAL SOC. PSYCHOL. 201, 221-23 (1991). This study is recounted by Professor Cass Sunstein in his article, which argues that government should undertake an even larger role than it has now in nurturing and reaffirming societal norms. See Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 905 (1996).

to make social choices by reference to the conduct of others.⁷ The relevance of the littering study to shareholder litigation is whether the commencement, prosecution and settlement of a shareholder suit is like the conduct of Cialdini's responsible associate. Does the suit's commencement, prosecution and settlement cause corporate managers (Cialdini's drivers) not involved in the suit to conform their future behavior to the normative standards invoked by the suit's plaintiff (Cialdini's associates), so that managers will place the shareholders' and investors' interest where they should be rather than irresponsibly discarding them?

In this article, I ask whether shareholder litigation itself is viewed as a responsible actor so that, much like the passerby, the suit's existence deters misconduct by others. The continued existence of the shareholder suit is easier to justify if it has such an effect. Simply stated, we customarily consider the deterrent value of private litigation in terms of the sanctions they provide. Here I add a new consideration, namely, the social opprobrium that attaches to the suits' defendants as a consequence of being pursued in a shareholder suit. In this respect, I consider to what extent certain procedural and substantive features of shareholder suits contribute positively or negatively to their social meaning. Finally, I suggest reform measures that will enhance the status of shareholder suits and hence improve their likely deterrence of misconduct.

I. CONSTRUCTION AND DECONSTRUCTION

Whether and to what extent shareholder suits harbor reputational impacts upon their defendants is proportional to the expressive value enjoyed by all shareholder suits. That is, the message of the individual derivative suit or securities class

⁷ For articles discussing the extensive literature on this point, see generally Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 352-61 (1997); John Scholtz, *Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory*, 60 LAW & CONTEMP. PROBS. 253 (Summer 1997).

action is affected by the company it keeps with other shareholder suits. To be sure, the substance of the claim against a manager has much to do with the sting she will feel from the suit's charges. The charge that a manager has wrongfully usurped a business opportunity that belonged to the corporation can be expected to raise eyebrows higher than the complaint that she wrongfully competed against the corporation. Since competition is a favored feature of business, a complaint against competition can easily be seen as predatory practice on the part of the complainant, whereas cries of taking a corporate business opportunity ring of theft. Similarly, a charge that directors were grossly negligent in approving compensation and perquisites for the firm's senior managers takes on a very different cast when coupled with charges of cronyism or even self-dealing. Even a complaint that a manager failed to disclose adverse confidential information regarding the firm takes on quite a different meaning when it is also alleged that she gained privately through insider trading.

Even though a suit's substantive charges have reputational impacts that depend on the nature of the complaint, the charges are weakened if the medium through which they are asserted itself lacks a credible reputation. Charges of usurping corporate opportunities, self-dealing and insider trading will fail to convey the social condemnation for such misconduct, if the charges are not seen as credible. Much like the shepherd who cries wolf too frequently, shareholder suits, if commonly understood to be frivolous, will not in their commencement, prosecution and settlement affirm the social norms the suit's defendants allegedly violated. Their defendants will instead be seen as the objects of bad luck not derision. Thus, the procedural context in which corporate and securities norms are developed and affirmed are of the utmost significance if those norms are to discipline managers.

Corporate law is about norm management.⁸ The powers of corporations to repurchase their shares, to issue securities, and to combine with one another, as well as the fiduciary standards of their managers and related disclosure obligations, reflect contemporary judgments of how best to arrange relations among owners, managers and capital markets in order to maximize wealth. The existence of shareholder suits, and their procedural requirements, are highly visible components of norm management for corporate law. Most of the content of the fiduciary obligations of officers, directors and controlling shareholders, as well as much of the substantive disclosure obligations of the securities laws, is established through shareholder suits. This section examines to what extent features of shareholder suits are consistent with the process of establishing and affirming norms for business organizations. As discussed below, some features of shareholder suits are destructive to their role in managing norms for corporate law, whereas other features contribute positively toward that role and in turn enhance the suit's social meaning.

The inspiration for organizing the following analysis is Professor Lawrence Lessig's insights on techniques for constructing social meaning.⁹ Even though he focuses on how the social meaning of events is changed—or more positively, con-

⁸ It is perhaps easiest to see corporate statutes as regulating corporate norms. But the regulation also occurs through court decisions interpreting the bounds of fiduciary responsibilities. For example, scholars, in examining the Delaware courts' interpretation of the "good faith" requirement in management buyouts, conclude that results are highly textured, fact-specific, process oriented, and invariably judgmental narratives of the officers' and directors' behavior. Nevertheless, they also determine that the social force of the opinions is not in their results but the guidance lawyers pass on to their clients from the courts' narratives of acceptable and unacceptable conduct. See Deborah A. DeMott, *Puzzles And Parables: Defining Good Faith In the MBO Context*, 25 WAKE FOREST L. REV. 15, 29-31 (1990); Edward B. Rock, *Saints And Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1094-98 (1997). The lawyer, when confronted by broad standards such as "good faith" or "reasonableness," will emphasize in her advice the positive affirmations of director and officer conduct that the lawyer finds in these narratives, preferring the certain over the speculative course. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing The Results: The Role Of Lawyers In Transmitting Legal Rules*, 5 S. CAL. INTERDIS. L.J. 375 (1997). The result is a body of norms regarding appropriate conduct for corporate transactions that are not as highly nuanced as the narratives that produced them.

⁹ See Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943 (1995).

structed—the importance of his contribution to this article is his isolation of the ways the expressive value of an event, such as a sanction's imposition, can be influenced. The four ways he poses, and around which the following discussion is organized, are ambiguation, tying, inhibition and ritual.¹⁰

A. *Ambiguation of the Suits' Mission*

Compensation of the injured and deterrence of misconduct commonly are the joint missions of representative suits. Neither mission conflicts with the other since to hold one accountable to those harmed by his misdeeds provides a powerful disincentive for others to similarly conduct themselves.¹¹ The private shareholder suit, as recognized in *Borak*, serves a public function as well as a private one. However, in the corporate setting, shareholder suits are consistently dismissed when they fail to serve a compensatory end, even though the goal of deterrence would be advanced by the suit's successful prosecution. Simply stated, compensation is the prevailing objective of shareholder suits and deterrence, its valuable byproduct.

The most dramatic illustration of this state of affairs is the "net loss" requirement that applies when the knowing violation of a criminal statute underlies the derivative suit. When directors or officers have knowingly engaged in an illegal act, they no longer are entitled to the presumption of propriety that normally accompanies the disinterested decisions of managers.¹² Nevertheless, the directors who knowingly violate the law are not without a defense. Absent proof that the corporation suffered a net loss through their illegal act, the suit must be dismissed. Therefore, if the plaintiff fails to establish that the harm suffered by the corporation as a consequence of the

¹⁰ See *id.* at 1009-34.

¹¹ For a careful consideration of how the distinction between instances in which an enhanced sanction designed to deter might best be imposed in contrast to the more frequent instances in which a compensatory sanction will fulfill desirable deterrence objectives, see Robert D. Cooter, *Punitive Damages, Social Norms, and Economic Analysis*, 60 LAW & CONTEMP. PROBS. 73 (Summer 1997).

¹² See, e.g., *Miller v. American Tel. & Tel. Co.*, 507 F.2d 759, 762-63 (3d Cir. 1974). See generally Note, *Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions*, 64 COLUM. L. REV. 174 (1964).

misconduct exceeded the benefits it received by their misconduct, the defendant escapes any sanction by a derivative suit.¹³

A further illustration that compensation is the *sine qua non* of the corporate suit is the "vicarious incapacity" principle whereby the corporation is barred from suing its former controlling shareholder when the present controlling shareholder acquired his shares from the suit's defendant. The principle announced here is one of preventing unjust enrichment,¹⁴ since the new controlling shareholder, having purchased control at a fair price, now seeks to recoup part of the purchase price from his seller. Deterrence by removing the defendant's ill-gotten gains is not itself enough to justify the suit's existence: "If the wrongdoer deserves to be punished, it does not follow that others are to be enriched at his expense by a court of equity. A plaintiff must recover on the strength of his own case, not on the weakness of the defendant's case."¹⁵ The vicarious incapacity principle is invoked with equal vigor when the suit is a derivative suit; the bar applies when the derivative suit defendant earlier transferred control to a party who currently controls the corporation.¹⁶ The most frequently invoked evidence of the vicarious incapacity principle is the contemporaneous ownership requirement for derivative suits, which requires the suit's plaintiff to have owned the shares at the time of the defendant's misconduct.¹⁷ The prevalence of

¹³ See, e.g., *Borden v. Cohen*, 231 N.Y.S.2d 902 (Sup. Ct. N.Y. County 1962). See generally Wesley E. Forte, *Liabilities of Corporate Officers for Violations of Fiduciary Duties Concerning Antitrust Laws*, 40 IND. L.J. 313, 333-39 (1965).

¹⁴ For a case illustrating how evidence that the new controlling stockholder bargained for the right to prosecute the suit, see *National Union Elec. Corp. v. Matsushita Elec. Indus. Co.*, 498 F. Supp. 991, 1004 (E.D. Pa. 1980). However, the suit was not against the former controlling shareholder but against third parties. The vicarious incapacity principle was unsuccessfully invoked because the new controlling shareholder allegedly would reap a windfall because the harm depressed the value of the firm before it had assumed control. See *id.* In contrast, *Rock River Savings & Loan Assoc. v. American States Insurance Co.*, 594 F.2d 633, 635 (7th Cir. 1979), barred the suit where the suit's defendants had sold their controlling block of shares to a new group of owners after public disclosure of their fraudulent misbehavior but before the corporation had initiated suit.

¹⁵ *Home Fire Ins. Co. v. Barber*, 93 N.W. 1024, 1035 (Neb. 1903) (Comm'r Roscoe Pound).

¹⁶ See *Jannes v. Microwave Communications, Inc.*, 385 F. Supp. 759 (N.D. Ill. 1974).

¹⁷ See FED. R. CIV. P. § 23.1; DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE

the contemporaneous ownership rule stems from the reasoning that if the derivative suit could be maintained by a plaintiff who did not own her shares when the defendant's breach occurred, the plaintiff could recover for misconduct that did not harm her.¹⁸

The divide between compensation and deterrence also exists in substantive areas of corporate law. The most dramatic illustrations of this are the different approaches courts have taken in determining whether corporate insiders have breached their fiduciary duty to their corporate employer when they trade in its securities on the basis of material nonpublic information acquired by virtue of their positions. Whereas Florida conditions the breach on proof of actual injury to the corporation as a result of the insider's private use of confidential corporate information,¹⁹ New York and Delaware require the fiduciary to disgorge any ill-gotten gains without proof of harm to the corporation.²⁰

ACTIONS: LAW AND PRACTICE § 4.02 (1987) (comprehensive list of states with this requirement).

¹⁸ The most troubling aspect of this reasoning in support of the contemporaneous ownership requirement is that sums recovered in a derivative suit benefit all the corporation's stockholders, regardless of whether they became such after the misconduct or even the initiation of the suit. So understood, the contemporaneous ownership rule is better understood not as a rule to prevent unjust enrichment but rather as a surrogate for concluding whether the suit's plaintiff will be an adequate representative. This view of the purpose of the contemporaneous ownership rule is questionable because it assumes a shareholder who seeks to recoup on behalf of the corporation a loss in which he has indirectly incurred a proportionate loss will be a more adequate representative than one who seeks to recover without having been proportionally harmed. This assumption becomes even more problematic when the object of the derivative suit is to require the corporate fiduciary to disgorge her ill-gotten gains even though the corporation suffered no harm as a result of the fiduciary's breach. *See, e.g., Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (recovery in a derivative suit of insider's trading profits without proof of harm to the corporation). In such a case, the derivative suit's plaintiff is no different than the non-contemporaneous shareholder since neither has suffered a proportional loss as a consequence of the fiduciary's misbehavior, but each will reap a proportional gain.

¹⁹ *See Schein v. Chasen*, 313 So. 2d 739 (Fl. 1975); *cf. Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978) (applying Indiana state law to conclude that insiders breach their fiduciary duty only if their use competes with a possible use of the same information by their employer).

²⁰ *See Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969); *Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949).

The courts' preoccupation with the compensatory rather than punitive aspects of shareholder suits ambiguates the suits' expression of social values. Few shareholder actions entail breaches of a private contract between the plaintiffs and the suit's defendants. Suits are based on breaches of fiduciary obligations or disclosure requirements embodied in common law or state or federal statutes. In all shareholder suits, the norm invoked has a substantial, if not exclusive, public source. In theory, therefore, these suits provide a public link to the norm by requiring resolution in state-funded courts, where potentially a public voice, the courts, will address each case's facts through the lens of the applicable norm. Because compensating the injured is a private matter, whereas deterrence is of public concern, the more squarely the courts place the objectives of shareholder suits in the compensatory sphere, the weaker the public perception will be that such suits are reflections of society's condemnation of the misconduct underlying the suit's charges. To the extent that suits are perceived as addressing purely private injuries, instead of being understood to address violations of the public interest in ways that cause private harms, the public perception will be that derivative suits are but a subset of the standard commercial dispute between two warring financial interests.²¹

Settlements also play a role in ambiguating the public character of shareholder suits. The vast preponderance of shareholder suits that survive pretrial motions result in settlements, not judgments on the merits.²² Settlement breaks the shareholder suit's link to the state. Whereas the authority to impose a judgment arises from the law, and by extension society, settlements are private contractual matters. Professor Owen Fiss, in a classic article,²³ questions the increasing role of settlement and alternative dispute resolution mechanisms

²¹ Thus, when Alpha, Inc. sues Beta Company for the failure to timely deliver widgets, the public norm at stake is not as sharply present as if the suit arose out of alleged price fixing by Beta Company.

²² See, e.g., Carolyn Berger & Darla Pomeroy, *Settlement Fever*, BUS. LAW TODAY, Sept.-Oct. 1992, at 7 (study of 98 corporate and class action suits over a 2½ year period in which the Delaware Chancery Court held a settlement hearing found that more than 95% of the proffered settlements were approved and approximately two-thirds of the attorneys' fee applications were granted in full).

²³ See Owen Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984).

because of their harmful effects on the public norms that underlie the suit:

[T]he purpose of adjudication should be understood in broader terms. Adjudication uses public resources and employs not strangers chosen by the parties but public officials chosen by a process in which the public participates. These officials, like members of the legislative and executive branches, possess a power that has been defined and conferred by public law, not by private agreement. Their job is not to maximize the ends of private parties nor simply to secure the peace, but to explicate and give force to the values embodied in authoritative texts such as the Constitution and statutes: to interpret those values and to bring reality to accord with them. This duty is not discharged when the parties settle.²⁴

To be sure, settlements require the approval of the court regarding their fairness, reasonableness and adequacy. Few settlements, however, are rejected and the isolated published opinions reviewing their terms reflect deference to the litigants' positions rather than the particular norm invoked in the suit.²⁵ The court's role is analogous to opining that the forces of Wellington and Napoleon facing one another at Waterloo were each equal to the task, while withholding any opinion of the issue prompting the conflict between Great Britain and France. That is, settlement approvals speak to the proportionality of the consideration supporting the contract before the court, not to the norm that prompted the suit.²⁶ Settlements are consensual and the practices pursued by the courts in reviewing a settlement do little to change the private character of either the suit or its settlement.

²⁴ *Id.* at 1085.

²⁵ See, e.g., *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.*, No. Civ. A. 13950, 1997 WL 305829 (Del. Ch. May 30, 1997) (approving settlement providing funds from CEO's estate, even though the court questioned several substantive conclusions reached by the special litigation committee that had negotiated the settlement); see also *Shlensky v. Dorsey*, 574 F.2d 131, 147 (3d Cir. 1978); *Krasner v. Dreyfus Corp.*, 500 F. Supp. 36, 39 (S.D.N.Y. 1980); *Fricke v. Daylin, Inc.*, 66 F.R.D. 90, 97 (E.D.N.Y. 1975).

²⁶ See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.14 cmt. e (1992) [hereinafter ALI] (discussing the cost-benefit analysis the courts customarily employ in considering derivative suit settlements in terms of financial adequacy whereby the prospective benefits to the corporation are discounted by considerations of direct and indirect costs posed by the suit's continuance as well as the relative uncertainty of result).

Thus, the public role of shareholder suits is muted, and indeed obfuscated, both by the characterization of their mission as the compensation of those harmed by the defendant's misconduct and by the nurturing of settlements through the courts' extraordinary deference to the bargain struck by the suit's attorneys. In the end, shareholder suits have but a private existence so that in the public's eye they are just another commercial dispute.

B. *Tying Suits to a Failed Objective*

Social scientists have long stressed the importance of "framing" in evaluative decisions. The anchor point that is set forth significantly impacts the judgment made about a proposition. The anchor not only fixes the point at which inquiry begins, but it is also frequently the standard for judging the merits of an idea, argument, or social institution.

The public perception of shareholder litigation and its social meaning has been affected by framing. Complementing the courts' view that shareholder suits are private suits intended to compensate injured investors, the academic and political debate surrounding shareholder suits continues to judge their social value in terms of whether they result in financial awards consistent with this compensatory mission. By finding, as they do, that shareholder suits fail in their compensatory mission, the studies support a negative view of their social value. Against the benchmark of compensation, both the derivative suit and the class action have fared badly in the public contest for political support. Indeed, some studies openly suggest that many such suits are, at best, misguided because they produce small awards to their plaintiffs, and are, at worst, frivolous claims designed to extort an award of attorneys' fees.²⁷

The derivative suit is more vulnerable than the class action to assaults on whether it fulfills its compensatory mission. Two leading studies each conclude that derivative suits yield no significant wealth effects.²⁸ Within Professor Romano's

²⁷ See Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995).

²⁸ See Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71

sample of 139 shareholder suits, 41 resulted in monetary recoveries,²⁹ with the average monetary recovery in derivative suit being \$6 million (\$11 million for class action awards).³⁰ The standard recovery represents a very small proportion of the firm's assets or translates into a small recovery on a per share basis; in such comparisons, the derivative suit recoveries are consistently smaller than for class actions.³¹ In a larger sample of derivative suits, Professors Bradley and Fischel found that the successful derivative suit yields only a slight positive effect for the firm's stockholders.³² They conclude that "derivative suits are not an important monitoring device to curb managerial malfeasance."³³ Additionally, Professor Romano, on examining stock price reactions to announcements of the commencement and termination of class actions and derivative suits, found that stock price changes "do not provide compelling support for the proposition that shareholders experience significant wealth effects from litigation."³⁴ Her condemnation is strongest for the derivative suit: "To the extent that derivative suits consistently return less to shareholders

CORNELL L. REV. 261 (1986); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991). An earlier study provides a slightly more optimistic report. See Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542 (1980).

²⁹ See Romano, *supra* note 28, at 61 n.12 (twelve of the suits were derivative and the remainder were class actions).

³⁰ See Romano, *supra* note 28, at 61.

³¹ See Romano, *supra* note 28, at 61 (derivative suit recoveries constitute 0.5% of firm assets and class actions, 1.6%). Derivative suit recoveries in 11 of the 12 suits within the study averaged \$0.15 per share net of attorneys' fees whereas class action recoveries in the small subset of the sample (7 of the 39 suits) for which she could obtain data averaged \$2.83 per share net of attorneys' fees. See Romano, *supra* note 28, at 62.

³² The events examined were the abnormal returns appearing in stock prices upon: 1) dismissal of the suit for failure to make a demand (14 firms—negative returns were not statistically significant); 2) dismissal in response to recommendation of a special litigation committee (18 firms where none of the price changes on an individual firm basis were statistically significant and were so only on a portfolio basis for the date of the announcement, but not for any longer period of time); 3) suit's continuance after judicial finding that demand was excused or satisfied (10 firms where positive, albeit statistically insignificant, returns were observed); and 4) firms where substantive defense of business judgment rule was rejected by the court (6 firms where positive but no statistically significant returns appeared). See Fischel & Bradley, *supra* note 28, at 280-82.

³³ Fischel & Bradley, *supra* note 28, at 282.

³⁴ Romano, *supra* note 28, at 65-66.

than class actions, there is a greater likelihood that more of these suits are frivolous"³⁵ Thus, she concludes that the primary beneficiaries of shareholder suits are attorneys.³⁶

The findings of Professors Bradley, Fischel and Romano frame the arguments over which most of the skirmishes leading up to the Private Securities Litigation Reform Act of 1995³⁷ were fought. This legislation introduced procedural and substantive changes for the securities class action, with the goal of reducing the incidence of lawyer-driven frivolous class actions.³⁸ The legislative history of the Reform Act is replete with empirical reports examining the amounts recovered by class action members as compared to the damages that were allegedly in dispute.³⁹ Those championing the cause of the class action marshalled data to demonstrate that class members receive a significant portion of their losses in settlements,⁴⁰ whereas those arguing that class actions are simply strike suits emphasized the large number of suits settled within the policy limits of applicable D & O insurance,⁴¹ and more generally noted that securities class actions produce small rewards to class members when compared to their alleged damages.⁴²

One may well conclude that the passage of the Private Securities Litigation Reform Act is the most visible symbol of

³⁵ Romano, *supra* note 28, at 61.

³⁶ See Romano, *supra* note 28, at 65. This condemnation is further supported by her conclusion that the nonpecuniary forms of relief are cosmetic and undertaken not for their intrinsic benefits, as she found no empirical support for their benefits. See Romano, *supra* note 28, at 63.

³⁷ Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C. (1994 & Supp. I (1995))).

³⁸ See Private Securities Litigation Reform Act of 1995, H.R. CONF. REP. NO. 104-369, at 1-2 (1995).

³⁹ See *Securities Litigation Reform Hearings Before the House Subcomm. on Telecomm. and Finance of the Comm. on Energy and Commerce*, 103d Cong. 309-14 (1994) [hereinafter 1994 Hearings]; *Private Litigation Under the Federal Securities Laws: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 121, 153, 739-50 (1993) [hereinafter 1993 Hearings].

⁴⁰ See Princeton Venture Research, Inc. Study, in 1993 Hearings, *supra* note 39, at 153.

⁴¹ See 1993 Hearings, *supra* note 39, at 139 (statement of Vincent E. O'Brien).

⁴² See Federick C. Dunbar & Vinita M. Juneja, *Recent Trends II: What Explains Settlements in Shareholder Actions?*, in 1993 Hearings, *supra* note 39, at 750 tbl.3 (reporting average attorneys fees of 31.32% of settlements).

the expressive value of the securities class action. Judged by the standard of compensation, the securities class action was seen as so wanting that Congress constrained their use by enacting restrictive procedures that applied only to securities litigation. Existing class action procedures were not believed to assure that the suit's defendants had violated the securities laws. Simply stated, procedural rules existing prior to the Reform Act were seen as confirming the belief that being a defendant in a securities class action was nothing more than legalized bad luck. And worse, this phenomenon was labeled by the Congress as impeding capital formation and entrepreneurial activities.

Tying the measure of the shareholder suit's social value to its compensatory functions most certainly will condemn it to failure. Certainly this is the case for derivative suits. Consider the characteristics common to derivative suits. Amounts involved in derivative suits typically are quite small in terms of the firm's overall value. The domain of the derivative suit are charges for which a demand on the board of directors can be excused. Such cases overwhelmingly involve self-dealing behavior—wasteful executive compensation, misappropriating corporate opportunities, or gaining on dealings with the corporation—which by their nature tend to involve small sums of money relative to the overall value of the firm. To be sure, managers who thwart a lucrative hostile bid pose potentially large value suits based on their alleged self-interest, but the derivative or class action suit in such cases customarily results in equitable relief and not a financial recovery.⁴³

⁴³ Not only does the derivative suit customarily provide small recoveries, but when the recovery is on behalf of a publicly traded company this necessarily enriches any shareholder who became such after the suit was commenced. In the public corporation, share ownership changes daily so that those who own their shares when the impacts of the defendant's wrongdoing occurred will not be the same owners when damages are recovered. The post-wrongdoing set of shareholders are not unjustly enriched because theoretically a portion of their purchase price reflected the expected value of the derivative suit being prosecuted on behalf of their corporation. Nevertheless, it is difficult to see that they have been injured by the defendant's wrongdoing; they are instead recovering on a purchased chose in action. The view that the post-wrongdoing shareholders have purchased a valuable cause of action, however, is greatly weakened when the nature of the suit is such that any recovery is likely to be small relative to overall share values, so that any recovery can be seen as having no impact on shareholder wealth. So viewed, the recovery does not compensate later arising shareholders because of the

The public image of the securities class actions is no better than that of the derivative suit. As seen earlier, securities class actions are understood by many to be lawyer-driven suits where most recoveries fall within the limits of the company's D & O insurance policy.⁴⁴ Suits are brought only when the amount involved is expected to be sufficiently rewarding for the class action lawyer. Thus, it is not surprising that there is significant under enforcement of fraudulent offerings of small issuers.⁴⁵ Moreover, the fact that a significant percentage of cases involve settlements of less than \$2 million feeds the view that nuisance, rather than actual harm, prompts many suits to be initiated.⁴⁶ This image is further reinforced for both derivative suits and class actions when the sole benefit garnered by the suit is a nonpecuniary award to the shareholders but cash for their lawyers.⁴⁷

The image of the securities class action may well be different if there were more complete data on its effects. Many securities class actions yield not only substantial amounts to the class, but significant amounts for many of the individual class

smallness of the discounted value of a future recovery is such that the rational shareholder would not have taken it into consideration in purchasing the shares and the ultimate recovery is so small that it does not materially alter the value of the firm. See James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984).

⁴⁴ See *supra* notes 27-42 and accompanying text.

⁴⁵ See James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 948 (1996) (in study of fraud claims arising from initial public offerings, the vast number of such cases involved securities offerings in excess of \$10 million in which alleged losses were at least \$5 million).

⁴⁶ See Grundfest, *supra* note 27, at 742-43.

⁴⁷ For evidence of the frequency of such nonpecuniary settlements, see Romano, *supra* note 28, at 61; see also Bryant G. Garth et al., *Empirical Research and the Shareholders' Derivative Suit: Toward a Better Informed Debate*, 48 LAW & CONTEMP. PROBS. 137, 146 (Summer 1985). A more recent study not only finds substantial evidence of nonpecuniary settlements in class actions generally, but concludes the settlements are beneficial and justifiable conclusions to the litigation. See Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 LAW & CONTEMP. PROBS. 97 (Autumn 1997). For classic analyses of the dark incentives that prevail in representative suit litigation, see John C. Coffee, Jr., *Understanding The Plaintiffs Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 948 (1993).

members.⁴⁸ To be sure, small recoveries, especially those within the coverage limits of any available insurance policy, are consistent with the strike suit thesis, which holds that baseless actions are brought by unscrupulous attorneys seeking a fee award as the price for the suit's dismissal. On the other hand, a recovery limited to the amount of any available insurance policy is also consistent with the idea that the defendants have no other available funds to contribute toward a larger settlement or possible judgment. Even the latter view projects a disturbing image of the securities class action. Can a suit that recovers only from the neutral D & O carrier be seen as being compensatory, when the amount recovered is so small in relation to the harm suffered by the class?⁴⁹ Even less appealing is the view that such suits deter misconduct because the recovery comes from an innocent insurance carrier rather than the wrongdoers themselves.

The data regarding the role of insurance in settlements and the frequency of dismissals of shareholder suits⁵⁰ can lead to a more positive view of shareholder suits if the anchor point of the analysis is the inherent indeterminacy of rights that can only be determined through litigation. Consider, for example, that the disclosure demands of the antifraud provisions are continually evolving case-by-case through private and SEC enforcement actions. Standards such as what are material

⁴⁸ See Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2088-97 (1995) (50 largest claimants in 82 class actions had an average loss of \$597,000 with largest and second largest claimants accounting for 13.1% and 6.7%, respectively, of the total in a subsample of 20 suits). For a discussion of the role that institutional investors have played since the passage of the lead plaintiff provision of the 1995 Reform Act, see Keith L. Johnson, *Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors*, 60 LAW & CONTEMP. PROBS. 155 (Autumn 1997).

⁴⁹ The complaint of underrecovery by class members is by no means beyond dispute. Though there are many cases whose settlements are quite small, there remain a good number that produce large settlements. More significantly, there is empirical data supporting the conclusion that class members recover through settlement a significant portion of the damages they have suffered. See Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 499 tbl.2 (1996) (using conservative assumptions regarding percentage of resales by class members trading during the period of fraudulent reporting, 83% of settlements studied occurred within the damages estimated under the two-trader model).

⁵⁰ See Grundfest, *supra* note 27, at 742-43.

omissions or misstatements, as well as what constitutes their reckless commission, are inherently vague, thereby inviting ad hoc determinations. The opaqueness of the antifraud rule most certainly invites many long shot suits,⁵¹ so that what some see as abuses within this process can also be understood as the evolution of federal common law around inherently vague norms.⁵² Therefore, the prevalence of settlement within the bounds of available insurance, or even the frequency of dismissal of shareholder suits, are predictable consequences of the fact that, in most corporate disputes, the contesting rights are inherently indeterminate. It is interesting to speculate why this perspective has not gained as much force as the more negative view described above. The prevailing view, however, is one that lends itself to measures of costs and benefits. To the extent that objectivity is associated with measurement and each is a desideratum within society, the preoccupation with the compensation provided by shareholder suits is understandable since compensation is measurable but deterrence is not. Shareholder suits are thus tied to a metric, i.e., the compensation they provide, that most surely measures their failure, not their success.

⁵¹ See Charles M. Yablon, *The Good, The Bad, and the Frivolous Case: An Essay on Probability and Rule 11*, 44 UCLA L. REV. 65 (1996) (Rule 11 standards should reflect social benefits of permitting long-shot suits); cf. Rock, *supra* note 8, at 1097-99 (compensation is justified for even unsuccessful shareholder suits because they nonetheless produce normative guidance of acceptable conduct).

⁵² Here we might well take note that the most likely weapon to address spurious representative suits should be Rule 11 sanctions against the suit's attorneys and plaintiffs. See FED. R. CIV. P. 11. There have, however, been few such sanctions for securities suits. See, e.g., *Garr v. U.S. Healthcare, Inc.*, 22 F.3d 1274 (3d Cir. 1994) (copycat complaint); *Pelletier v. Zweifel*, 921 F.2d 1465 (11th Cir. 1991) (suit continued despite repeated warnings from the court the complaint was poorly supported by the facts). The Private Securities Litigation Reform Act of 1995 amended the securities laws to require the presiding judge in all securities actions to make a finding whether Rule 11 was violated. See Securities Exchange Act § 27(c)(2), 15 U.S.C. § 77z-1 (Supp. III 1994); *id.* § 78u-4. For a recent fee award under newly enacted section 27D(c)(2), see *Simon DeBartolo Group, L.P. v. The Richard E. Jacobs Group, Inc.*, 985 F. Supp. 427 (S.D.N.Y. 1997). The most pointed criticism of Rule 11 has been its impact on law reform by discouraging suits pursuing novel theories or extensions of existing norms to unusual factual patterns. See, e.g., Arthur B. LaFrance, *Federal Rule 11 and Public Interest Litigation*, 22 VAL. U. L. REV. 331, 333-35 (1988).

C. *Applying the Right Inhibitions*

The social meaning of an act can be shaped by the inhibitions imposed around it. By inhibiting certain behavior, the occurrence of which would otherwise create or reinforce a disfavored social meaning, we shape our perception of the act itself.⁵³ Professor Lessig reminds us that segregated neighborhoods would be reinforced if real estate brokers were permitted to disclose the racial composition of a neighborhood; the Fair Housing Act⁵⁴ bars such disclosure and thus reduces the likelihood that the selection of a new home will be made on the basis of racial considerations.⁵⁵ Similarly, many substantive and procedural requirements provide important inhibitions that contribute positively to the view of shareholder suits being seen as important social mechanisms.

The most important inhibition that can be used to nurture positive deterrent effects flowing from shareholder suits are pretrial procedures that lead to the dismissal of baseless suits. Any pretrial procedure will be less than perfect so that both Type I and Type II errors may occur, but not in equal numbers.⁵⁶ To the extent that pretrial procedures bias results so that meritorious cases tend to survive, a suit's continued prosecution or settlement can be expected to have a greater deterrent value than if there were no pretrial procedures so that on average there would be a lower likelihood that any suit's complaint addressed actual misconduct. Because the class action aggregates a large number of claims such that the amount in controversy is of great significance to the defendant, courts have long appreciated the class action's power to extort sizeable settlements even if the suit's merits were questionable. For example, in *Grady v. Rhone-Poulenc Rorer Inc.*,⁵⁷ Judge Posner decertified a plaintiff class believing it was inappropriate to subject the defendant to the outcome of a single jury trial when "the preliminary indications are that the defendants are not liable for the grievous harm that has befallen the mem-

⁵³ See Lessig, *supra* note 9, at 1013, 1032.

⁵⁴ 42 U.S.C. § 3604(c) (1992).

⁵⁵ See Lessig, *supra* note 9, at 1013.

⁵⁶ See Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Act*, 38 ARIZ. L. REV. 711 (1996).

⁵⁷ 51 F.3d 1293 (7th Cir. 1995).

bers of the class.”⁵⁸ One early response to the enormity of the amount in controversy once a suit was certified as a class was that trial courts, in deciding whether to certify the suit, would undertake a preliminary inquiry into the suit’s merits. This practice was rejected by the Supreme Court in *Eisen v. Carlisle & Jacquelin*,⁵⁹ which held that Rule 23 does not condition class certification on the requirement that the plaintiff plead facts that will prevail on the merits. Rather, the Court held that certification depended upon whether questions of law or fact common to members of the class predominated.⁶⁰ Even though *Eisen* bars formal consideration of the merits as the litmus test for certifying the suit as a class action, a suit’s merits are not divorced from the district court’s class certification decision.⁶¹

The in terrorem effect upon the defendant, and hence upon the suit’s settlement value, of class certification can be addressed through pretrial motions to dismiss and for summary judgment, which provide important tests of the suit’s value. However, a minority of the circuits interpret *Eisen* as requiring the suit’s certification as a class should be resolved before ruling on other pretrial motions.⁶² Regardless of whether the

⁵⁸ *Id.* at 1300. Judge Posner thus side-steps *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974), by basing the holding on the class action not being “superior to other methods for the fair and efficient adjudication of the controversy” as required by Rule 23(b)(3). FED. R. CIV. P. 23(b)(3); see also *Costano v. American Tobacco Co.*, 84 F.3d 734, 748 (5th Cir. 1996). For a decision viewing *Rhone-Poulenc* as inconsistent with *Eisen*, see *Valentino v. Carter-Wallace, Inc.*, 97 F.3d 1227 (9th Cir. 1996).

⁵⁹ 417 U.S. 156 (1974).

⁶⁰ See *id.* at 177-78.

⁶¹ *Eisen* does permit courts to go beyond the pleadings to determine whether common issues are in fact likely to predominate. See *General Tel. Co. of the Southwest v. Falcon*, 457 U.S. 147, 160 (1982) (“[S]ometimes it may be necessary for the court to probe behind the pleadings before coming to rest on the certification question.”); *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 469 (1978) (“[T]he class determination generally involves considerations that are ‘enmeshed in the factual and legal issues comprising the plaintiffs cause of action.’ . . . Evaluation of many of the questions entering into determination of the class action questions is intimately involved with the merits of the claims.”) (citation omitted); *Castano*, 84 F.3d at 744 (“A district court certainly may look past the pleadings to determine whether the requirements of rule 23 have been met.”).

⁶² See, e.g., *Rutan v. Republican Party of Ill.*, 868 F.2d 943 (7th Cir. 1989), *rev’d in part*, 497 U.S. 62 (1990); *Finberg v. Sullivan*, 634 F.2d 50, 64 (3d Cir. 1980); *Horn v. Associated Wholesale Grocers*, 555 F.2d 270 (10th Cir. 1977). But see *Player v. Maher Terminals, Inc.*, 841 F.2d 1123 (4th Cir. 1988); *Floyd v. Bow-*

court rules on the defendant's motions to dismiss and for summary judgment before or after it renders its decision as to whether to certify the class, neither motion subjects the plaintiffs' allegations to the same scrutiny as an assessment of the suit's merits, a practice *Eisen* bars.

Pursuant to the heightened pleading requirement introduced by the Private Securities Litigation Reform Act in 1995, private securities suits can now be subject to a preliminary assessment of their merits as part of the court's response to the defendant's motion to dismiss. Under the Reform Act, the complaint must specify not only each statement alleged to have been misleading and the reasons the statement is misleading,⁶³ but it must also state with particularity facts giving rise to a strong inference that the defendant acted with scienter.⁶⁴ The Reform Act therefore rejected notice pleading that has been a fixture of federal civil procedure since 1938 and replaced it with pleading standards that invite the court to undertake a much closer scrutiny of the plaintiff's allegations *and their factual support* in ruling on the defendant's motion to dismiss.⁶⁵

The degree to which district court judges will scrutinize the complaint under the Reform Act's heightened pleading requirements varies widely among judges and reflects, among other things, their own perceptions of contingency fee litigation, and especially securities class actions. Overall, the Reform Act's heightened pleading requirement will lead to suits

en, 833 F.2d 529, 534-35 (5th Cir. 1987); *Wright v. Schock*, 742 F.2d 541, 543-45 (9th Cir. 1984). Of special note is the more recent Seventh Circuit decision suggesting a switch from the earlier position taken in *Rutan*. See *Cowen v. Bank United of Tex.*, 70 F.3d 937, 941 (7th Cir. 1995) ("Rule 23(c)(1) . . . requires certification as soon as practicable which will usually be before the case is ripe for summary judgment. But 'usually' is not 'always' and 'practicable' allows for wiggle room.").

⁶³ See 15 U.S.C. § 78u-4(b)(1) (Supp. 1996). In the case of an alleged misrepresentation that is made on information and belief, "the complaint shall state with particularity all facts on which that belief is formed." *Id.*

⁶⁴ See *id.* § 78u-4(b)(2).

⁶⁵ For an insightful analysis of how the complaint can, making use of publicly available information, meet the Reform Act's pleading requirements in an open market fraud case and, hence, how the suit's merits become entangled with the pleading requirements, see Elliott J. Weiss, *Enter Yossarian: How to Resolve the Procedural Catch-22 that the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457 (1998).

that survive a motion to dismiss on average having more merit than suits possessed under the pre-Reform Act notice pleading requirement. This in turn should lead to the private securities action enjoying a higher status than existed prior to the Reform Act. Moreover, the Reform Act's bar to any discovery while the defendant's motion is pending further enhances the suit's image.⁶⁶ The filing of a securities suit is no longer seen as the medium for the plaintiff to gain access to the defendant's records so that the plaintiff can determine if there is a basis to allege the defendant violated the securities laws. Thus, whatever impact the Reform Act has had on preventing meritorious securities claims from being redressed, there is every reason to believe its provisions have also inhibited many questionable suits, so that those suits that do survive the defendant's motion to dismiss convey more credible claims of misbehavior.

Through its demand requirement, the derivative suit also involves an important mechanism by which the suit's merits *may* be assessed. In its contemporary formulation, however, the demand requirement fails as a screening mechanism. The ultimate issue the demand requirement places before the court is whether the corporation's board of directors can impartially assess whether the derivative suit is in the corporation's best interest. When a majority of the directors are found sufficiently disinterested in the suit, their good faith determination that it should be dismissed is accepted by the court. Good faith in the context of the demand, however, is an intriguing standard. If good faith were determined through a searching inquiry of the directors' reasons for urging the suit's dismissal—their legal conclusions and the facts that support them—then the good faith standard would permit the court to evaluate preliminarily the claims raised in the derivative suit. Usually, however, courts avoid this inquiry and focus their attention upon the procedures the directors pursued, rather than the reasoning invoked, in supporting their dismissal recommendation.⁶⁷ In

⁶⁶ See 15 U.S.C. § 78u-4(b)(3)(A) (Supp. 1996).

⁶⁷ See, e.g., *Drilling v. Berman*, 589 N.W.2d 503, 509 (Minn. Ct. App. 1999) (explaining that good faith is determined by the procedures and methodology employed and not the report's contents). The leading case for this position is *Auerbach v. Bennett*, 47 N.Y.2d 619, 633-34, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928-29 (1979). Not all courts so limit their review. See JAMES D. COX ET AL., 2

cases when the demand is excused on the basis that a majority of the directors are so linked to the suit or its defendants that they cannot reasonably be believed to be impartial, there is no formal mechanism for assessing the suit's merits. On the other hand, the court's finding that bases exist for excusing a demand on the board forces most derivative suit litigation into areas involving instances of self-dealing behavior by executives rather than broad attacks on executive decision making. Certainly a process that can lead to a finding that the facts sufficiently implicated a majority of the directors in the alleged self-dealing so as to excuse a demand is itself a screening process of sorts. With the demand requirement so viewed, its operation rivals the "pleading with particularity" requirement that applies to securities suits.

Screening the suit's merits provides an important bulwark against the continuation of strike suits past the demand stage. Upon satisfying the demand requirement, the derivative suit can more easily be understood to reflect a public condemnation of the conduct that is the subject of the suit.⁶⁸ The court's early involvement in the facts supporting the derivative suit complaint provides an important pre-trial screening mechanism. Both the Reform Act's pleading requirements and the derivative suit's demand requirement have positive winnowing effects so that shareholder suits that meet these pretrial demands enjoy greater merit than if these requirements did not exist.⁶⁹

CORPORATIONS § 15.8, at 15.7-80 (1995). In special instances, the absence of good faith has been based on other considerations. *See, e.g.*, *Stepak v. Addison*, 20 F.3d 398 (11th Cir. 1994) (directors failed to exercise good faith because they relied on the attorney who had previously represented the suit's defendant); *Thorpe v. CERBCO*, Fed. Sec. L. Rep. (CCH) ¶ 96,416 (Del. Ch. 1991) (decision to oppose suit was driven by the wishes of the controlling stockholder and not the directors' good faith judgment).

⁶⁸ The current operation of the demand requirement provides much closer and sweeping scrutiny of the suit's pleadings and supporting affidavits than may occur under contemporary pretrial motions such as a motion for summary judgment or motion to dismiss. *See* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 118-120 (Summer 1985).

⁶⁹ However, both do so with the serious likelihood of causing meritorious actions to be dismissed because the securities class action plaintiff cannot meet the Reform Act's particularity requirement or the derivative suit plaintiff cannot allege facts sufficient to excuse a demand on the board of directors so that the directors' judgment that the suit be dismissed would be unassailable should the plaintiff make a demand on the board.

The conditions for availability of insurance and indemnification merit consideration as to whether their limitations provide the right inhibitions. Overall, there is something of a mixed message that one derives from the standard source—insurance—for the funds obtained through settlements or judgments of shareholder suits. In these suits, insurance plays as important a role as it does in other types of litigation. Testimony that preceded the enactment of the Private Securities Litigation Reform Act estimated that 96 percent of securities class action settlements were for amounts within the limits of available insurance coverage.⁷⁰ One implication of this is that those individuals who are actually responsible for violation rarely are required to recompense those they have harmed from their own funds. Even when there is no insurance, the employing corporation's vicarious liability for the misstatements of its officers or directors produces a joint liability between the active wrongdoing officers or directors and their passive employer. Because the employing corporation is more likely to have greater resources to contribute toward the suit's settlement or judgment, the active wrongdoers rarely contribute toward the suit's settlement.⁷¹

There are some distinctive inhibitions within the law that nevertheless prevent the complete insulation of officers and directors from accountability for their misconduct.⁷² The scope of the standard D & O insurance policy and state indemnification statutes assure that any award arising from an officer's or director's knowing or willful misbehavior will not be paid by the insurer or indemnified by the employer. Among the numerous exclusions to the standard D & O policy are those for dis-

⁷⁰ See *supra* note 41.

⁷¹ The infrequency of holding individuals accountable for their misconduct as officers or directors also appears in government enforcement actions. See Stephen Calkins, *Corporate Compliance and the Antitrust Agencies' Bi-Modal Penalties*, 60 LAW & CONTEMP. PROBS. 127, 139-40 (Summer 1997) (citing statistics that during the past 17 years the Department of Justice has indicted for antitrust violations nearly as many individuals as corporations, but only rarely are individuals the object of either Department of Justice or Federal Trade Commission civil actions).

⁷² For an analysis of how such matters as the "claims made" feature in most D & O policies, coverage disputes with the insurer, as well as the risk assessments by insurers prior to issuing a policy in combination dampen concerns that the availability of D & O insurance weakens the deterrent effect of private litigation, see James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 26-27 (Autumn 1997).

honesty, a breach in which the director or officer has reaped a personal gain, and intentional wrongdoing.⁷³ Similar restrictions are likely under contemporary indemnification statutes, which typically condition indemnification on the officer's or director's having acted in "good faith."⁷⁴ Thus, in *Waltuch v. Conticommodity Services, Inc.*,⁷⁵ the Second Circuit barred an officer who knowingly engaged in a series of manipulative acts from obtaining indemnification rights under the broad indemnification provision of the company's articles of incorporation. The court reasoned that the Delaware indemnification statute conditioned permissive indemnification on the agent acting in good faith.

Both the standard insurance exclusions and the "good faith" requirement of state indemnification statutes, therefore, reinforce the view that those who intentionally misbehave are personally accountable for the harm they cause, even though as a practical matter the misbehaving officer or director may lack the funds to fully compensate the plaintiffs. More importantly, the D & O policy's exclusions and state indemnification statutes' conditions reflect a public judgment that certain types of conduct are beyond the pale of legitimate business practices and should be condemned. Thus, suits to redress such officer and director misconduct are more sharply seen as vindicating public not private values.⁷⁶

Moreover, the D & O policy is not the umbrella everyone believes it to be. First, the standard policy is a "claims made"

⁷³ See RALPH C. FARRARA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 13 (1997) (thorough review of the provisions of the typical D & O policy).

⁷⁴ See, e.g., DEL. CODE ANN. tit. 8, § 145(a)(b) (1991); N.Y. BUS. CORP. LAW § 722(a)(c) (McKinney 1986); MODEL BUS. CORP. ACT. § 8.51(a) (1984).

⁷⁵ 88 F.3d 87 (2d Cir. 1996).

⁷⁶ Even though we can see the exclusions as tying the suit to a strong social norm, the incentive of the private attorney is to loosen those moorings by alleging conduct that does not fall within the *policy's* exclusions. Thus, rarely do pleadings allege that the officers and directors knowingly committed the alleged misrepresentations; the complaint customarily also charges the misrepresentation was recklessly committed. By so broadening the charges, the insurance policy remains a viable source for funding the settlement or judgment. See Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 1995 DUKE L.J. 255, 258-60 (1995). This practice has the harmful effect of weakening the social meaning of suits because it mischaracterizes the misconduct so that it falls within the sphere of an acceptable and insurable business practice.

policy covering only claims made during the policy's life. Thus, the standard claim can, and generally does, arise from misbehavior that occurred in a year earlier than that in which the current policy was written. It is standard procedure among insurers to require those who seek coverage to complete a lengthy application that inquires into events and activities that may give rise to a claim against the policy.⁷⁷ Even though there may be a rich D & O policy, the insurer may deny coverage on the ground that the insured concealed important information when it applied for insurance.⁷⁸ Certainly disputes between the insured and the insurer regarding coverage under D & O policies occur with sufficient frequency to suggest that coverage is by no means automatic.⁷⁹ Further bases for coverage disputes involve matters such as whether the misconduct giving rise to the claim fell within one of the enumerated exclusions in the policy. In combination, these considerations warn the manager that it is unwise to consciously misbehave on the assumption that the firm's D & O policy will shield her from any responsibility for the harm her misconduct causes others.

It thus appears that socially desirable inhibitions exist that contribute to shareholder suits serving a valuable deterrent to misbehavior by corporate managers. Both the Reform Act's heightened pleading requirement and the courts' decisions excusing the demand requirement for derivative suits provide screening mechanisms that tend to eliminate weak suits. Insurance and indemnification provisions and practices also contain important inhibitions that address the fears of a moral hazard that may result if managers could then believe that broad insurance or indemnity coverage would bear the ultimate burdens of their delicts.

⁷⁷ For a compilation of such applications, see THE WYATT CO., SUMMARY OVERVIEW OF TYPICAL PROVISIONS OF D & O POLICIES (1993).

⁷⁸ Similarly, former officers frequently are not favored sons when they seek indemnification from the board that ousted them. See, e.g., *Mr. Cough-It Up*, DEL. LAW WKLY., June 28, 1999, at 6 (former CEO of Sunbeam was successful in suit seeking indemnification for costs of his defense in 17 pending suits alleging he had committed numerous misrepresentations of earnings during his tenure as CEO).

⁷⁹ See WATSON WYATT WORLDWIDE, WATSON WYATT DIRECTORS AND OFFICERS LIABILITY SURVEY 46 (1996) (among 1010 surveyed companies, 15% of those with D & O claims reported they had coverage disputes with the insurer).

D. *Beyond Ritual: The Private Nature of Public Settlements*

Lessig's fourth technique for shaping social meaning is through rituals that induce actions that are likely either to support or weaken a particular social meaning.⁸⁰ His examples include supporting patriotism and political orthodoxy by allowing schools to maintain the voluntary practice for students to stand and salute the flag as well as our singing the national anthem at sporting events.⁸¹ The most visible and important ritual for the shareholder suit is the procedural requirements that accompany the suits' initiation and settlement.

The public character of the shareholder suit is heightened by some important recent procedural developments. In the case of securities class actions, under the Reform Act courts must follow a process that can lead to the appointment of a lead plaintiff whose powers include selecting and retaining class counsel.⁸² The Reform Act provides a rebuttable presumption that the member of the class with the largest financial stake in the relief sought is the "most adequate plaintiff."⁸³ Though the history of the lead plaintiff provision remains short, there have been some highly publicized instances in which the independence of the lead plaintiff vis-à-vis class counsel suggests that there is a new "gun" in town.⁸⁴

There can be little doubt that the lead plaintiff provision has shaken the quiet life of the class counsel. More significantly, the lead plaintiff provision alters the perception of the securities class action as being a lawyer-driven suit. The lead plaintiff provision replaces the tainted image of the plaintiff as figurehead with that of the plaintiff as a true functioning representative of the class with statutory powers over the suit's attorney.⁸⁵ The lead plaintiff's large financial stake provides

⁸⁰ See Lessig, *supra* note 9, at 1013-14, 1032-34.

⁸¹ See *id.*

⁸² The appointment of a lead plaintiff is also within the presiding court's power in other class actions not involving securities violations. See generally Weiss & Beckerman, *supra* note 48, at 2105-06.

⁸³ See 15 U.S.C. § 77z-1(a)(3)(b)(iii) (Supp. III 1994); *id.* § 78u-4(a)(3)(iii).

⁸⁴ See generally Johnson, *supra* note 48, at 159 (reporting there have been lead plaintiff appointments in only 8 of 105 surveyed securities class actions).

⁸⁵ Thus, courts have rejected coalitions of individual investors in favor of a single institutional investor, reasoning that a group of individual lead plaintiffs

much needed incentives with respect to the suit's diligent prosecution, tempers the award of attorney's fees, and curbs the continued prosecution of unmeritorious suits, since the harm of such suits to the corporation is also harmful to the interests of the lead plaintiff. Moreover, the court's appointment of the lead plaintiff removes the self-selecting, even professional,⁸⁶ image of the suit's plaintiff. By virtue of the court's power to appoint the suit's representative, the suit gains an important public connection. As a result, the selection of a lead plaintiff not only enhances the legitimacy of the suit's basis but also raises its overall public character.⁸⁷

In contrast to the securities class action, derivative suit plaintiffs remain self-selecting and derivative suit procedures do not systematically invite other shareholders to become the suit's plaintiff. As seen earlier, only through satisfying or excusing the demand requirement does the plaintiff earn the right to prosecute the action.⁸⁸ The derivative suit exists because the real plaintiff, the corporation, is disabled by its board of directors' self-interest to terminate the derivative suit.⁸⁹ Courts customarily find such director self-interest ex-

would "inevitably delegate more control and responsibility to the lawyers for the class and make the class representatives more reliant on the lawyers." *Gluck v. Cellstar Corp.*, 976 F. Supp. 542, 549 (N.D. Tex. 1997). See generally Steven M. Pesner & Andrew J. Rossman, *Choosing Lead Plaintiffs Under the Private Securities Litigation Reform Act: Who Shall Lead*, 27 SEC. REG. L.J. 195 (1999). But it may not be groups as such that are disfavored in contesting petitions to serve as a lead plaintiff. See *Switzenbaum v. Orbital Sciences Corp.*, 1999 WL 339040 (E.D. Va. May 21, 1999) (group of pension funds chosen over less cohesive and reliable group of individuals).

⁸⁶ The deprofessionalization of the plaintiff also appears in other Reform Act provisions which bar the practice of compensating the suit's plaintiff for efforts on behalf of the class and limit to five times in three years the number of suits for which a person can serve as lead plaintiff. See 15 U.S.C. §§ 78u-4(a)(2)(vi), (3)(vi) (Supp. 1997).

⁸⁷ A collateral effect of the court's appointment of a lead plaintiff would seem to be that there would no longer be cause for the court to employ a bidding process to select counsel for the suit as has occurred in some instances. See, e.g., *In re Oracle Sec. Litig.*, 136 F.R.D. 639 (N.D. Cal. 1991). In contrast, the practice of selecting lead counsel through sealed bids appears to reduce the suit to a private chattel. See *Sherleigh Assocs. v. Windmere-Durable Holdings, Inc.*, 184 F.R.D. 688, 699 (S.D. Fla. 1999).

⁸⁸ See *supra* note 67 and accompanying text.

⁸⁹ See James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 960-61 (1982) (plaintiff's legitimacy to represent the corporation's interest regarding suit's

ists when the derivative suit plaintiff successfully pleads that the challenged conduct is so extreme that it is beyond the protection of the business judgment rule or when a majority of the board's current members are either so connected to the challenged transaction, or financially dependent on those that are the suit's defendants, that they cannot be expected to act impartially if they were called upon to assess whether the corporation's interests would be served by the suit's prosecution. These inquiries customarily occur through the court's decision as to whether the suit's plaintiff is excused from making a demand on the board of directors as a precondition to maintaining the suit.⁹⁰ Even in those jurisdictions that have adopted the universal demand requirement, where a demand is required in virtually all derivative suits, the court's decision whether to abide by the directors' resulting recommendation that the suit be dismissed will be guided by these same considerations.⁹¹ Overall, the derivative suit lacks the same legitimizing of the plaintiff as occurs with the securities class action's lead plaintiff. The demand requirement does not require an inquiry into whether the derivative suit plaintiff has

continuance is second to that of an independent body of directors).

⁹⁰ The most intricate of the approaches are those found in Delaware and New York. *See* *Levine v. Smith*, 591 A.2d 194, 205 (Del. 1991) (futility found where well-pleaded complaint overcomes presumption of director disinterest and honesty or creates reasonable doubt that the challenged transactions were the product of a valid exercise of business judgment); *see also* *Marx v. Akers*, 88 N.Y.2d 189, 200-01, 666 N.E.2d 1034, 1040-41, 644 N.Y.S.2d 121, 127-28 (1996) (complaint alleged with particularity that a majority of the directors was interested in the challenged transaction, that the majority did not fully inform themselves about that transaction, and that the transaction was so egregious on its face "that it could not have been the product of sound business judgment of the directors.").

⁹¹ The source of the universal demand requirement is the American Law Institute's corporate governance project. *See* ALI, *supra* note 26, at § 7.03. The Model Business Corporations Act now also embraces universal demand. *See* MODEL BUS. CORP. ACT § 7.42 (1989). For states adopting the Model Act's approach, *see* MODEL BUS. CORP. ACT ANN. § 7.42. An enthusiastic adoption of ALI's recommendations is that by the state of Pennsylvania. *See* *Cuker v. Mikalauskas*, 692 A.2d 1042 (Pa. 1997). Earlier, the Seventh Circuit also embraced the universal demand requirement for derivative suits, but was reversed by the Supreme Court. *See* *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90 (1991), *rev'g* 908 F.2d 1338 (7th Cir. 1990). The Supreme Court held that unless the federal statute provides otherwise, the federal court should defer to state law when determining whether such demand is required. *See id.* at 96-97.

a substantial economic interest in the firm such that he will diligently oversee the suit's progress or, most importantly, its settlement.⁹²

Both the class action and the derivative suit, however, may easily lose their public character through weaknesses in the settlement process. Though the lead plaintiff provision in the securities class action and the demand requirement confer a public status on their suit's plaintiff, weaknesses in the settlement ritual prevent the shareholder suit from securing a position as a mechanism for vindicating public norms.

The weak incentives for the attorneys and their clients to aggressively pursue the representative suit to trial are well recognized.⁹³ With the exception of the lead plaintiff provision for securities class action, there is no legal requirement that the representative suit plaintiff have a substantial financial interest in the suit's successful prosecution. Lacking such an interest, the plaintiff bears little of the consequences if the suit produces either adverse consequences to the corporation or yields insubstantial awards to its intended beneficiaries, namely, fellow class members or the derivative suit corporation. A further financial firewall between the suit's plaintiff and its adverse effects is the contingent fee arrangement that holds the plaintiff harmless for the litigation costs of a misguided suit. Because of the contingent fee arrangement, any possible adverse impact of an ill-advised suit is not likely to rein in the maverick plaintiff. Moreover, the presence of a contingency fee arrangement separates the plaintiff from the suit's counsel. Further, the plaintiff's counsel enjoys a strategic advantage

⁹² Indeed, modern pleading allows the derivative suit plaintiff to join an individual claim with the derivative suit claim, a result that can easily pose conflicts of interest between her interests as an individual litigant and as a representative of the corporation's cause of action. Thus, in *Clark v. Lomas & Nettleson Financial Corp.*, 625 F.2d 49 (5th Cir. 1980), the derivative suit plaintiff successfully opposed the corporation's settlement of the suit with its defendants because that settlement did not make provisions for the plaintiff's personal suit against the defendants. See Kenneth W. Kossoff, *Director Independence and Derivative Suit Settlements*, 1983 DUKE L.J. 645 (1983). The demand requirement provides a means to consider the suit's merits but not the plaintiff's vigilance during the suit's prosecution. Moreover, the demand requirement does not address the plaintiff's ability to represent claims that technically are not before the court but which, under *Matsushita Electric Industrial Co. v. Epstein*, 516 U.S. 367 (1996), discussed *infra*, may be included in the terms of the settlement.

⁹³ See, e.g., Coffee, *supra* note 47, at 671-77.

vis-à-vis the suit's defendants in aggressively pursuing risky claims. While the defendant's focus is upon the risk posed by a single suit, the plaintiff's attorney assesses a particular suit in light of a portfolio of suits being prosecuted by its office. Tipping the strategic balance further in favor of the plaintiff's counsel is that while the defendant assesses outcomes in terms of its overall liability exposure, the plaintiff's counsel's assessment is the much smaller incremental cost of pursuing the suit and negotiations to the next level.⁹⁴

The defendants are not, however, without their own advantages. First, to the extent their litigation costs fall within available D & O coverage, and perhaps even liberal indemnification under applicable state law or provisions of their employment contracts, defendants are somewhat above the financial consequences of the fray. This reality does, however, introduce a new actor into the scenario, namely, the insurer. The natural temptations of the defendants to clear their names and see justice done may well be tempered by the terms of the D & O policy. The control of the issuers is even greater when the policy includes a so-called "hammer clause" whereby insurer's obligations to its insured can be limited to the settlement offered by the plaintiff that was acceptable to the insurer but which was rejected by the insured.⁹⁵ Furthermore, the possibility of a judgment beyond the policy coverage has the same salient impact on the defendant as the "wasting asset" feature common to D & O policies has on the plaintiff.⁹⁶ Plaintiffs may gain nothing by pursuing a suit beyond a settlement offer supported by the insurer if the insurer's responsibility under the policy is limited to that offer. Moreover, the plaintiff's counsel has little interest in prolonging the suit; most insurance policies are in the nature of a wasting asset whereby their coverage limits are eroded by defense costs so that any sums from the insurance policy for the award of plaintiff's

⁹⁴ See Lucian Arye Bebchuk, *A New Theory Concerning the Credibility and Success of Threats to Sue*, 25 J. LEGAL STUD. 1 (1996).

⁹⁵ THE WYATT CO., 2 SUMMARY OVERVIEW OF TYPICAL PROVISIONS OF D & O POLICIES § 4.04, at 9 (1993).

⁹⁶ D & O policies commonly provide a fixed maximum coverage for all costs related to the suit against the insurer. Therefore, as the defendants' attorneys' fees increase with the passage of time and efforts related to the suit's defense, the funds for settlement provided by the policy are reduced *pro tanto*.

counsel fees is what remains after the plaintiff's adversaries have been compensated. This is a point missed by neither the plaintiff nor the insurer, especially when the corporation and other named defendants have insufficient funds to cover any resulting settlement or judgment. Finally, both the plaintiff's counsel and the insurer are well aware of the law of diminishing returns; an early settlement for a known amount is valued more highly than a potentially larger judgment discounted by the time and riskiness of a trial.

No one had the pulse of the settlement process better than the late Judge Henry Friendly, whose insights are helpful in assessing the settlement ritual:

There can be no blinking at the fact that the interests of the plaintiff in a stockholder's derivative suit and of his attorney are by no means congruent The plaintiff's financial interest is in his share of the total recovery less what may be awarded to counsel, *simpliciter*; counsel's financial interest is in the amount of the award to him less the time and effort needed to produce it. A relatively small settlement may well produce an allowance bearing a higher ratio to the cost of the work than a much larger recovery obtained only after extensive discovery, a long trial and an appeal. The risks in proceeding to trial vary even more essentially. For the plaintiff, a defendant's judgment may mean simply the defeat of an expectation, often of relatively small amount; for his lawyer it can mean the loss of years of costly effort by himself and his staff.⁹⁷

In the face of such weak incentives to pursue the complaint or defense aggressively, it is natural that settlements are the predominant outcome of those shareholder suits that survive pretrial motions. In another opinion, Judge Friendly reminds us that the settlement hearing is the ritual corrupted by weak incentives:

Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork—as is vividly shown here where the stockholders' general counsel sometimes opposed [the objectors'] efforts to gain information, although the settlement so vigorously defended before the Referee would have produced less than a quarter as much cash for Allegheny, \$700,000, as the \$3,000,000 ultimately secured.⁹⁸

⁹⁷ *Saylor v. Lindsley*, 456 F.2d 896, 900-01 (2d Cir. 1972).

⁹⁸ *Allegheny Corp. v. Kirby*, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, C.J., dissenting).

Judge Friendly's observations enshroud the shareholder suit in a cynical veil. They project, perhaps aptly, that representative suits at the settlement stage succumb to their attorneys' utility curves so that neither compensatory nor deterrent objectives guide their resolution. Stated differently, settlements are lawyer and insurance driven. They do not reflect the broader private interest of the class or corporation, or, for that matter, the public objective of deterrence. Against this background, we can surmise that whatever opprobrium or public condemnation the shareholder suit directs toward the suit's defendants is undermined by the hollowness of the condemnation embodied in the suit's settlement. Was this a baseless action to extort an insurance-funded settlement or was it a meritorious suit quickly settled before the wasting asset, qua insurance policy, was depleted by defense costs? Adding to our malaise is the realization that few settlements are rejected by the courts⁹⁹ and that there is little evidence of settlements where the officer and directors who have misbehaved contribute substantially personally toward the settlement fund in substantial amounts.¹⁰⁰

We also should appreciate the overall reluctance of the court to disturb the settlement before it. Here we should note that Judge Friendly's quote in *Saylor*, the first quote above, was in an opinion in which the panel on whose behalf he crafted the majority opinion approved the derivative suit settlement over the objection of the suit's plaintiff. *Saylor* reflected the panel's opinion that the objecting plaintiff did not fully appreciate the costs and benefits of the suit's continuance in light of the present value of the settlement before the court. Might Judge Friendly have doubted his own certitude in *Saylor* on the basis of his powerful insight in *Allegheny Corp.*? Lacking

⁹⁹ See Berger & Pomeroy, *supra* note 22, at 9. There are some hopeful developments here. See, e.g., *Weiser v. Grace*, 216 N.Y. L.J. 22 (N.Y. Sup. Ct. 1996) (institutional investor was permitted to intervene to question why settlement was occurring after very limited discovery by the suit's counsel and why settlement did not include pecuniary award to the corporation).

¹⁰⁰ For an illustration of a rare instance where the settlement included recovery from the individual defendant, see *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.*, No. Civ. A. 13950, 1997 WL 305829 (Del. Ch. May 30, 1997) (albeit, the recovery was from the *estate* of the former CEO and at the instance of a settlement supported by the corporation's special litigation committee).

true adversaries at the moment of settlement, how is a court to assess the adequacy and overall fairness of the settlement before it? With the pressures of its docket, the limited resources a court can employ to retain masters to review a settlement, and the absence of adversaries, not only do courts rarely reject settlements but often they do not closely review the settlement's terms in light of the suit's merits. Perhaps the following statement regarding shareholder suits reflects accurately the position of most courts called upon to review a settlement: "[T]he court starts from the familiar axiom that a bad settlement is almost always better than a good trial."¹⁰¹

Further tainting the settlement process as an important ritual is the Supreme Court's decision in *Matsushita Electric Industrial Co. v. Epstein*¹⁰² (*Epstein I*), arising out of alleged misconduct on the part of MCA, Inc. directors in response to Matsushita Electric Industrial Company's tender offer for MCA. The defendants' actions produced parallel suits, one a class action in federal district court alleging violations of the Williams Act and the other, a suit brought in the Delaware Chancery Court alleging the MCA directors breached their fiduciary duty to MCA shareholders by failing to obtain the best price in the acquisition. Each of the suits was prosecuted by different sets of lawyers, but the class members overlapped substantially.¹⁰³ The federal district court dismissed the suit.¹⁰⁴ While that suit was on appeal to the Ninth Circuit, a settlement of the Delaware suit was approved by the Delaware court.¹⁰⁵ The Delaware settlement was unsuccessfully in-

¹⁰¹ In re Warner Communications Sec. Litig., 618 F. Supp. 735, 740 (S.D.N.Y. 1985), *aff'd.*, 798 F.2d 35 (2d Cir. 1986).

¹⁰² 516 U.S. 367 (1996).

¹⁰³ The class action filed in Delaware alleged that various MCA officers and directors had breached their fiduciary duties to the shareholders with the effect of depriving them of the best price for their shares; the class action filed in federal court alleged the MCA shareholders who had tendered their shares to Matsushita were entitled to the higher price per share it had paid to MCA's chairman and chief operating officer. *See id.* at 370.

¹⁰⁴ *See Epstein v. MCA, Inc.*, 50 F.3d 644, 648 (9th Cir. 1995) (noting the district court's refusal to certify the class, denial of plaintiffs' motion for summary judgment and granting defendant's motion for summary judgment).

¹⁰⁵ *See In re MCA, Inc. Shareholder Litig.*, Civ. A. No. 1174, 1993 WL 43024 (Del. Ch. Feb. 16, 1993), *aff'd.*, 633 A.2d 370 (Del. 1993). Earlier, the Delaware Chancery Court had refused to approve a settlement because it believed the federal claims had "substantial merit" and that the settlement before it was "illusion-

voked by the defendants before the Ninth Circuit, which reversed the district court and granted the plaintiff's motion for summary judgment.¹⁰⁶ The Supreme Court reversed the Ninth Circuit, holding that full faith and credit must be accorded the state court's approval of the settlement.¹⁰⁷ It reached this conclusion even though the Delaware state court settlement released the Williams Act claims for which the federal courts enjoyed exclusive jurisdiction.

The notice of the Delaware settlement did not prompt the federal class action plaintiffs either to opt out of the Delaware class action or to object to its terms.¹⁰⁸ Instead they continued to press their federal claims, even after the Supreme Court's refusal to disturb the Delaware settlement. In *Epstein v. MCA, Inc.*¹⁰⁹ (*Epstein II*), a divided¹¹⁰ Ninth Circuit panel held that the earlier Delaware settlement of the federal claims arising from the takeover of MCA violated due process because their claimants were not adequately represented before the Delaware court:

It was plainly in the best interest of counsel to settle the federal claims at any price. For them, any settlement was better than no settlement because settlement was the only way they could make any money on the federal claims—indeed, given that the state claims were essentially worthless, it was the only way that the Delaware counsel could get any compensation at all.¹¹¹

Subsequently, on rehearing, a reconstituted, albeit divided court, in *Epstein III*,¹¹² withdrew its opinion in *Epstein II* and

ary" because it provided only a modest modification of MCA's poison pill with the only financial award being the \$1 million to be paid to class counsel. See *In re MCA, Inc. Shareholder Litig.*, 598 A.2d 687, 696 (Del. Ch. 1991). The final Delaware settlement did provide an overall \$2 million fund out of which class counsel's fees would be paid so that the ultimate recovery by class members would not be greater than a few cents per share. See *In re MCA*, 1993 WL 43024, at *4.

¹⁰⁶ See *Epstein v. MCA, Inc.*, 50 F.3d 644, 648 (9th Cir. 1995).

¹⁰⁷ See *Matsushita Electric*, 516 U.S. at 373.

¹⁰⁸ There were, however, objectors to the settlement who claimed the settlement was collusive and therefore harmful to the class members. The objectors, however, were not the individuals that represented the securities claims that were being prosecuted in the federal court.

¹⁰⁹ 126 F.3d 1235 (9th Cir. 1997).

¹¹⁰ Circuit Judge O'Scannlain dissented, reasoning that because the issue of adequacy of counsel had been raised before the Delaware court by objectors other than the federal class action plaintiffs, all members of that class were barred from relitigating the issue of adequacy. See *id.* at 1259 (O'Scannlain, C.J., dissenting).

¹¹¹ *Id.* at 1250.

¹¹² *Epstein v. MCA, Inc.*, No. 92-55675, 1999 WL 359511 (9th Cir. June 7,

replaced it with a decision in which the majority concluded that the Supreme Court in *Epstein I* had addressed the adequacy of representation issues so that the plaintiffs were barred from relitigating that issue.

Epstein I and *Epstein II* are stark reminders that class litigation is lawyer driven and that the law and the courts provide too few restraints on such a view. The cold facts of attorney self-interest set forth in *Epstein II* do not become less stark because of the conclusions reached in *Epstein III*; the settlement process failed and failed badly in *Epstein I*. This is not to suggest the primacy of *Epstein II* to *Epstein III*. We may well view *Epstein II* as merely substituting one type of forum shopping—that of seeking a hospitable court where a collateral attack on the global settlement was approved by another court—for the type of forum shopping legitimized by *Epstein I*.¹¹³ *Epstein II* weakens the policy of finality and federalism which underlies the Full Faith and Credit Clause,¹¹⁴ but also reflects the seductive litigation environment, which permits such self-interest to occur. At the same time, we justifiably fear a world in which such interjurisdictional competition among competing teams of plaintiff's lawyers could occur without there being a basis to question the grounds for concluding there was adequate representation of the various classes' members in the global settlement.¹¹⁵ Though there are many possible solutions,¹¹⁶ the most fundamental point is to recognize

1999).

¹¹³ See Marcel Kahan & Linda Silberman, *The Inadequate Search for "Adequacy" in Class Actions: A Critique of Epstein v. MCA, Inc.*, 73 N.Y.U. L. REV. 765, 784 (1998).

¹¹⁴ U.S. CONST. art. IV, § 1; see also 28 U.S.C. § 1738 (1994) (the implementing statute); William T. Allen, *Finality of Judgements in Class Actions: A Comment on Epstein v. MCA, Inc.*, 73 N.Y.U. L. REV. 1149 (1998).

¹¹⁵ See, e.g., John C. Coffee, Jr., "*Epstein II*:" *Adequacy v. Finality*, N.Y. L.J., Jan. 29, 1998, at 5.

¹¹⁶ The main question will be whether the adequacy issue has been fully explored. *Epstein III* resolved this by deference to what it believed the Supreme Court decided in *Epstein I*. For arguments asserting that if there were no intervening Supreme Court decision, a collateral attack would still be possible, see, for example, Kahan & Silberman, *supra* note 113; Geoffrey P. Miller, *Full Faith and Credit to Settlements in Overlapping Class Actions: A Reply to Professors Kahan and Silberman*, 73 N.Y.U. L. REV. 1167, 1175-76 (1998) (addressing the three part inquiry on whether class had opportunity to challenge the adequacy of representation, whether counsel was disabled in *Epstein III* from litigating the claims that were the subject of the challenge in the second forum, and, if so disabled, whether

that the cause of this problem is *Epstein I*: rules that inherently lead to forum shopping, as *Epstein I* does, are harmful and lead to more harmful results. Commentators have long recognized the harmful effects of state courts entertaining global settlements. This effects a reverse auction whereby the suit's defendants seek cooperative plaintiffs' lawyers to enter into settlements in favorable state courts for amounts that are substantially below the suit's fair settlement value.¹¹⁷

Epstein I legitimizes such harmful forum and plaintiff shopping and thus weakens the ritual of settlement.

Settlement is an important ritual in the life and image of the shareholder suit. Unfortunately, it is a ritual that appears to confirm all that is wrong with the shareholder suit: settlement procedures systematically nurture, indeed reinforce, the attorney-driven tendencies of shareholder suits. This occurs through perfunctory review of both the ends served by settlement, and, most notably, of whether the settlement is a fair conclusion of the issues raised in the suit and the relative culpability of the suit's defendants.

II. ENHANCING THE SOCIAL MEANING OF SHAREHOLDER SUITS

Ambiguation, tying, and ritual currently weaken the social influence of the shareholder suit. On the other hand, the above review found important strengthening inhibitions for shareholder suits in their procedural requirements that fostered court screening of the suit's merits, as well as inhibitions that prevail in D & O policies and state indemnity provisions. This section considers strategies that can be pursued to reverse the negative effects of those forces that weaken the social meaning of shareholder suits so that the shareholder suit is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting.

there was additional indicia that attorney did not fairly represent the class).

¹¹⁷ See generally John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343, 1370-72 (1995).

A. *Reorienting the Judiciary's Focus*

The most apparent error courts make is elevating compensation over deterrence in defining the mission of the derivative suit. This concern also arises with respect to class actions where the preoccupation in approving settlements is the extent the settlement makes the class members whole. Courts instead should reverse their orientation so that their examination of the shareholder's standing to initiate a derivative suit and their approval of settlements emphasizes the public character of the norms raised by the suit.

Useful guidance in understanding the purpose of this new emphasis is provided by Pennsylvania, which liberalized the contemporaneous ownership requirement to confer standing to bring a derivative suit when necessary to avoid the injustice of a serious wrong to the corporation going unredressed.¹¹⁸ Other departures from the strict contemporaneous ownership requirement condition such liberalization on there being no public disclosure of the wrongdoing before the plaintiff acquired his shares. This, however, carries forward the concern of avoiding unjust enrichment to the plaintiff rather than preventing the defendant from being unjustly enriched by retaining her ill-gotten gains.¹¹⁹ Certainly, the present retention of the contemporaneous ownership requirement is an important commitment to the compensatory orientation of the derivative suit and obscures the deeper concern of why such suits exist at all and who the most adequate representative is for the suit. In contrast, an approach such as that taken in Pennsylvania invites early consideration of the important public character of derivative suits.

Though standing for class actions does not pose the same problem as it does for derivative suits, there continues to be a need to underscore the deterrence features of the class actions. As seen earlier, few settlements of securities class actions call upon the defendants to contribute to the award to the class; settlements are paid by the employer or, where recklessness is alleged, fall within an available insurance policy. This is not

¹¹⁸ See 15 PA. BUS. CORP. LAW § 1782(b) (Purdon 1995).

¹¹⁹ See CAL. CORP. CODE ANN. § 800(b)(1) (West 1990); ALI, *supra* note 26, § 7.02(a)(1).

an important weakness in derivative suits if the award arises from wilful or self-dealing behavior, but it is a problem when the misconduct falls under the more benign charges of inattention or wastefulness. Deterrence is poorly served and the suit is robbed of its public character when its defendants are not called upon to make a significant contribution to the settlement. At a minimum, settlement procedures should regularly require as part of the court's approval an affirmative finding as to why the individual actors were not required to contribute toward the settlement. Here the courts should consider the insights provided by the American Law Institute in its corporate governance project, which embraced a liability ceiling for directors and officers equal to the defendant's annual compensation from the corporation.¹²⁰ The courts could include within their finding why the directors or officers were not called upon to contribute to the suit's settlement by an amount at least equal to their most recent year's compensation from the corporation. To be sure, such a new dimension to settlement procedures is likely to prolong suits without increasing the amount of the overall settlement. Complaints along these lines can easily be seen as merely documenting the unfortunate set of incentives that predominate for shareholder suits that rob the suits of their public and deterrent effects. In this regard, courts should address these weak incentives by increasing the fees to be awarded plaintiff's counsel when the defendants have made a non-trivial contribution to the overall settlement. Correlatively, settlements that, without convincing explanation, fail to extract non-trivial contributions from the defendants and do not adequately protect against the defendant's recouping her contribution through insurance, indemnity or other arrangements should include a visible penalty in the court's determination of the attorneys' fees it will award.

¹²⁰ See ALI, *supra* note 26, at § 7.19. This provision of the ALI is in one sense less generous than the immunity shield for corporate directors common in most state statutes today which authorize provisions in the articles of incorporation that provide full immunity, rather than only immunity above a ceiling amount, for non-wilful misconduct. See generally Deborah A. DeMott, *Limiting Director's Liability*, 66 WASH. U. L.Q. 295, 297-310 (1988) (reviewing the various approaches the states have taken in drafting their immunity provisions). The ALI approach is broader than most state statutes because it also authorizes the articles of incorporation to extend immunity to officers.

B. *Confirming the Public Nature of Shareholder Suits*

Prosecuting shareholder suits is a risky business for which the plaintiff's attorney must receive large rewards in order to avoid poor or under representation. Though incentives, as suggested above, can be tweaked to accomplish fairly targeted objectives, such as extracting from the individual defendant some contribution toward the settlement, it remains likely that the overall incentives of shareholder suits will continue to cause them to be lawyer driven. Assuming this is the case, then the role of the law should be to direct the suits in such a way as to increase their stature.

The easiest step for more closely harnessing the derivative suit to the corporate interest it represents is for the courts to invigorate the long dormant requirement that the suit's representative be an adequate one. Borrowing from the lead plaintiff provision introduced by the 1995 Reform Act, the derivative suit court should actively seek one or more shareholders to serve as advisors to the court on matters related to the selection and retention of class counsel. This change, however, must confront the legitimate fear that a lead plaintiff is armed with the power to substitute counsel for those that initiated the suit. The concern here is that if counsel could easily be supplanted, the attorney will be reluctant to invest his time and money in the many activities that are necessary to file a complaint. Thus, the lead plaintiff provision may have the unintended consequence of reducing the deterrent effects of derivative suits by reducing the incentives for attorneys to pursue events that suggest misbehavior by company executives. Similarly, the lead plaintiff provision may cause the complaint's allegations to be poorly supported because the attorney is unwilling to invest heavily in a preliminary investigation of the facts until finally chosen as the suit's attorney. Courts could pursue several strategies to address these concerns. For example, the court should, in its consideration of who should represent the action, give substantial attention to the overall quality of the filing attorney's efforts in preparing and pleading the case. Thus, any recommendation by the lead plaintiff that another attorney should be selected to represent the action should address the quality of representation the attorney will provide. Here the court should be very reluctant to substitute

counsel if it has been satisfied with the thoroughness of the preparation and pleadings submitted to date by the filing counsel. Even if it believes new counsel should be appointed, it can call for quantum meruit compensation for the suit's filing attorney if the suit is successfully concluded by new counsel. The important objective is to more closely link the suit's prosecution to the public norm that is to be vindicated on behalf of the derivative suit corporation. If the court fails to do this, then much like the passive plaintiff in securities class actions, the court will merely be confirming that the true combatants are the attorneys and not the public interest that underlies the corporation's or investor's rights that give rise to the suit.

A further reform that would raise the public stature of the shareholder suit is to accord to non-intervening shareholders or class members greater rights to review settlements. The standing of non-interveners to pursue appeals in both derivative and class actions is a matter over which the circuits are badly divided.¹²¹ It is not uncommon for shareholders or class members to seek review of a settlement, even though they have not formally intervened in the shareholder suit. Not surprisingly, the charge they raise on appeal is that the class or derivative suit's lawyers have failed to achieve a settlement that is in the best interest of their client. Sometimes these disputes reflect the competing turf war of rival law firms, such as occurred in *Epstein I* and *II*. Thus, in *Bell Atlantic Corp. v. Bolger*,¹²² two derivative suits—the Lazar action and the Taub action—were initiated in response to the announcement that Bell Atlantic would refund \$40 million to settle a consumer fraud action brought by the state of Pennsylvania. The defendants moved to settle the Taub action, agreeing to make certain disclosures in their forthcoming proxy materials and to employ new marketing and sales procedures. The proposed settlement also provided for attorneys' fees not to exceed \$450,000. Lazar was among those objecting to the settlement. The district court approved the settlement over the objections of Lazar and 24 other Bell Atlantic shareholders. The court

¹²¹ For a review of the positions among the circuits, see Timothy A. Duffy, *The Appealability of Class Action Settlements by Unnamed Parties*, 60 U. CHI. L. REV. 933, 935-40 (1993).

¹²² 2 F.3d 1304 (3d Cir. 1993).

held that the shareholders in a derivative suit may pursue a review in the appellate court, even though they did not intervene in the suit. It was sufficient that Lazar had objected at the settlement hearing.¹²³ More frequently, however, the complaint in such cases is not raised among warring sets of clients and their respective lawyers, but centers upon the weak incentives surrounding the suit's attorney that may tempt her to support an unfair settlement.

Intervention into a shareholder suit is not without its procedural difficulties.¹²⁴ We ought not to deny to non-intervenors standing to appeal on the ground that they could have easily qualified themselves to pursue an appeal. And, certainly any rule that restricts the ability of a shareholder or class member to appeal the suit enhances the named party's control over the settlement.¹²⁵ At the same time, without the formal recognition of the court (as would occur when a party was permitted to intervene), the non-party appellant possesses the same stature as the plaintiff in *Epstein II* to challenge on appeal a court-approved settlement whether appeals may be pursued by non-intervenors or only by intervenors. Each position reinforces the image that the contest is among the attorneys and not against the corporate officials who have misbehaved.¹²⁶ Nevertheless, according rights to obtain review of settlements to non-intervening objectors would provide both an important ritual and an inhibition for settlement procedures.

According standing to appeal the settlement of a shareholder suit to non-intervenors who had raised their objections to the settlement before the trial court would recognize the substantial public nature of the shareholder suit. Indeed, such a rule would likely encourage objectors to step forward so as to establish their standing to seek an appeal of an arguably unfair settlement. Moreover, according such non-intervenors standing to appeal would provide a useful inhibition to the

¹²³ See *id.* at 1310. We might question whether a personal appearance at the settlement hearing is required or whether it is sufficient to file a written objection with the court. See, e.g., *Weinberger v. Kendrick*, 698 F.2d 61, 69 n.10 (2d Cir. 1982).

¹²⁴ See Duffy, *supra* note 121, at 954 n.112.

¹²⁵ See *id.* at 951.

¹²⁶ Indeed, this was the policy justification invoked in *Bell Atlantic* to permit non-intervenors to appeal. See *Bell Atlantic Corp.*, 2 F.3d at 1309-10.

suit's attorney proposing settlements that would not benefit the interests of the class or derivative suit shareholders. The need for such an inhibition was the basis raised in the petition for certiorari in *California Public Employees' Retirement System v. Felzen*.¹²⁷ The derivative suit grew out of more than \$190 million Archer Daniels Midland (ADM) had paid to settle various civil and criminal antitrust cases for its alleged price fixing activities. The derivative suits alleged ADM's officers and directors had breached their fiduciary obligations in connection with the antitrust violations and sought to recover \$190 million. A proposed settlement of the suit under which an \$8 million award would be recovered by ADM was submitted to the derivative suit court. Over the objections of the California Public Employees Retirement System and the Florida State Board of Administration, the district court approved the settlement. Without opinion, the justices divided evenly,¹²⁸ thereby affirming the Seventh Circuit's decision to dismiss the appeal on the ground that only parties could pursue an appeal.¹²⁹ In their petition for certiorari, the funds argued that "the prohibition of appeals by nonparty shareholders eliminates a critical safeguard against collusive derivative settlements that benefit only plaintiffs' attorneys and defendants." The power of such a party to challenge the settlement on appeal would most easily be recognized in suits where the suit's plaintiff did not have a substantial financial interest in the suit that would qualify her as a most adequate plaintiff.

The Supreme Court should stop supporting plaintiff and forum shopping by reversing *Epstein I*. Even after the passage of the Securities Litigation Uniform Standards Act (SLUSA), which preempts the jurisdiction of state courts over securities fraud class actions involving large public companies, *Epstein I* retains its former vitality. SLUSA preserves the so-called "Delaware carve out" which permits suits based on disclosure obligations arising under state law to continue to be filed in state courts. Thus, even after SLUSA, state law claims, such as that brought in Delaware against the MCA directors and officers, may be brought in state court, and the settlements of those

¹²⁷ 67 U.S.L.W. 4073, 4090 (Jan. 26, 1999).

¹²⁸ See *id.*

¹²⁹ See *Felzen v. Andreas*, 134 F.3d 873, 876 (7th Cir. 1998).

actions can extend to federal securities claims that could not be brought in state court. As seen earlier, *Epstein I* promotes the harmful image that shareholder suits are attorney driven and are characterized by attorneys shopping for a forum that will maximize their utility curve.¹³⁰ As reasoned earlier, the appropriate position should be one that promotes finality with respect to the first decision. *Epstein I* does not accomplish this because it invites the very complaint that made *Epstein II* credible, namely, that lawyers can never be an adequate representative of a class of claims that the lawyer did not and could not have raised in that court. To hold otherwise is to institutionalize the view that shareholder suits are about lawyers and not their claimants. As such, the ritual of where suits may be settled poorly serves the expressive value of shareholder suits.

¹³⁰ Note also that *Epstein II* reinforces this image because it encourages the attorneys disfavored in the competing forum to pursue their quest in a more satisfactory forum. It is not clear in all cases that the antidote for *Epstein II*'s brand of forum shopping will be the conclusions reached in *Epstein III*. It remains to be seen whether, in other disputes, the court will be faced with the same type of record as that in *Epstein III*, which supported a finding that the question of adequacy of representation was resolved in the prior proceeding involving the same plaintiffs and their lawyers.

