Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis

John C. Coffee Jr.

Columbia Law School, jcoffee@law.columbia.edu

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Criticism of the ALI's Corporate Governance Project has had two very different strains. Most vocal have been those critics who exhibit what one sympathetic observer has aptly termed "a neurotic fear of articulation."1 Although their expressed concern — namely, that courts will be encouraged to second guess boards and impose liability for arm's length business decisions that turned
sour — would be a legitimate cause for anxiety if this indeed were
the intent or likely effect of the Project, the underlying fear of
these critics is more basic and instinctive. It is best revealed in the
title of one critique of the Project by a Harvard Business profes-
sor: Corporate Governance Eludes the Legal Mind. Essentially,
its author argues that corporate governance is an organic and
evolving form that prescriptive legal rules can only freeze or dis-
tort. Such a claim goes beyond viewing lawyers as literalistic pet-
tifoggers and seems actually to assert that the ineluctable should
remain ineluctable. In a world where murkiness is seen as a vir-
tue and clarity a vice, we are advised to let sleeping doctrines lie.

Why is there this fear of a relatively straight-forward attempt to
define the issues and pose basic policy choices? At bottom, this
anxiety arises because any effort to replace chaos with clarity
highlights issues that some would prefer be glossed over: for ex-
ample, are shareholders the owners of the firm? Or is manage-
ment entitled to balance shareholder interests against those of
other constituencies, including creditors, employees, and consum-
ers? To ask these questions is not to answer them, but if one pre-
fers the latter balancing-of-constituencies model of management's
responsibilities, one must address the difficult issue of who, if any-
one, can hold management accountable. Otherwise, the claim that
management should be responsive to all constituencies may mean
in reality that it is accountable to none.

This assertion that "corporate governance eludes the legal
mind" translates then into a claim that some topics are best left
undisturbed — much like sacred mysteries that should only be dis-
cussed by the tribal elders in private councils. It is one thing to
pursue a fuller and more empirically-grounded description of how
boards and managements interact today but quite another to pre-
tend that such description eliminates the need for prescription.
The attempt to state clear legal principles is nothing more or less
than the attempt to articulate a normative theory and, at least
since David Hume, it has been generally recognized that empiri-
cism alone cannot produce a normative theory.

If the posture of this first group of critics thus resembles that of
the schoolboy nervously whistling as he passes the graveyard, an-
other group of critics has not been afraid to face the normative
issues in a candid and provocative manner and to offer substan-
tively different models for the interaction between boards, man-
agement, and shareholders. In particular, both Professor Cox of

2. Andrews, Corporate Governance Eludes the Legal Mind, 37 U. MIAMI L. REV. 213 (1983). Professor Andrews argues that the significant issues in corporate govern-
ance "are beyond the reach of the law" and instead involve only questions of "profes-
sional competence and responsibility" that "cannot be prescribed by black letter law." Id. at 215. Under this view, the law of torts would have long since withered away in
the face of claims by various professions that their standards could not be understood
by the "legal mind." That directors may sometimes be "creative participants" in man-
agement (as Professor Andrews properly argues) and not merely ex post monitors (as
Professor Scott favors, see infra note 3) does not excuse the need for a serious norma-
tive theory.
Duke and Professor Scott of Stanford have been prepared to state clear premises and to propose a different role for a litigation remedy than that contemplated by the ALI's Reporters. Both are also men of incisive intelligence and considerable persuasiveness.

Yet, although both make sophisticated use of the new learning on institutional economics, they have not spoken with a single voice. To the contrary, they have straddled the position of this Reporter, taking positions approximately equidistantly removed from mine but on diametrically opposite sides. Professor Scott would essentially abandon the duty of care, discarding it as a superfluous doctrine that was mistakenly borrowed from the law of trusts and misapplied to the corporate context. Apparently in his view, boards exist to grade management from an exclusively ex post perspective and should seldom, if ever, intervene prospectively in business decisions. Professor Scott would, however, enforce the duty of loyalty zealously against controlling persons and would never permit termination of a derivative action based on the board's recommendation when the action was against a controlling person and was grounded on the duty of loyalty. Convinced of the need for deterrence, he is even prepared to consider eliminating the requirement for an injured plaintiff and appears ready to permit a lawyer to file an action in his own right as a private enforcer. In contrast, Professor Cox states the case for a more compensatory orientation for litigation remedies. In his view, economics suggest that the duty of care should be as vigorously enforced as the duty of loyalty; and thus he objects to our proposal for placing a ceiling on due-care liability. Thus, as the target caught in the cross fire, I find it necessary to conduct a two-sided defense.

In overview, I will argue that Professor Scott has magnified the distance between his position and ours, and ignored the fact (which both Professors Cox and Brudney have pointed out) that Tentative Draft No. 1 adopted premises close to his own on some of the issues that most concern him, and well before he articulated his position. The current draft of Principles of Corporate

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4. See PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982) [hereinafter cited as Tentative Draft No. 1]. In particular, the proposal for a ceiling on liability for negligence in section 7.06 of Tentative Draft No. 1 was intended to reduce the incentive for litigation
Governance: Analysis and Recommendations (Council Draft No. 5) is even more explicit in its view that litigation has only a limited and problematic ability to enforce the duty of care. Where I differ with Professor Scott is chiefly with respect to his overly parsimonious view of the law’s socializing capacity and his too facile treatment of the difficult procedural problems surrounding any reform proposal in this area. Implicit in his criticism of the duty of due care is the assumption that the law simply imposes sanctions and does no more. This reductionist approach ignores the important educational and aspirational role that the law (and lawyers) have long played in our society in setting standards. More generally, Professor Scott’s proposals are confounded by their procedural unfeasibility. As Professor Cox correctly points out, Professor Scott’s proposal that the court should, at the outset, distinguish duty-of-loyalty from duty-of-care allegations (and dismiss the latter immediately) creates an incentive for creative pleading in order to outflank this prohibition on due-care litigation. Although the distinction may not be as unworkable as Professor Cox seems to believe, it is often fuzzy and is not susceptible to a simple either/or test. In this and other respects, Professor Scott, as a litigator, makes a fine economist. A far more practical response is to adjust the incentive to litigate due-care cases by lowering the level of damages obtainable (and thus, by extension, the attorneys’ fees to be awarded successful plaintiffs). The ex ante effect of such a diminished incentive on the profit-motivated plaintiff’s attorney achieves the same objective by a subtler route and without sacrificing the aspirational role of the law of due care. Equally important, because such a ceiling need not apply to all forms of due-care violations (for example, it would not apply to knowing illegality or consciously reckless behavior), it provides a subtler, more discriminating regulatory instrument that does not overbroadly lump together very different forms of behavior for equivalent treatment (as does Professor Scott’s proposal simply to abolish the duty).

With respect to Professor Cox, even less distance separates us as to the critical issues concerning the survival of a litigation remedy over due-care issues. This intent was clearly expressed at the time of the 1982 ALI Annual Meeting. See Discussion of Principles of Corporate Governance and Structure: Restatement and Recommendations, Tentative Draft No. 1, 59 A.L.I. PROC. 406, 530-36 (1982) (discussing impact of ceiling on incentive to litigate). Professor Scott also ignores those academic and other writers who well before him criticized the imposition of substantial financial liability on directors to enforce the duty of care. See Conard, A Behavioral Analysis of Directors’ Liability for Negligence, 1972 DUKE L.J. 895, 914. See also Comments of William F. Kennedy, 59 A.L.I. PROC. at 545-47.

5. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION (Council Draft No. 5, Nov. 1984) [hereinafter cited as Council Draft No. 5]. Although it has been discussed at meetings of the Council of the American Law Institute, this draft has not yet been considered in full, or approved in any part, by the Council. Professor Cox’s article in this issue focuses on Council Draft No. 3, which was dated November 15, 1983, and which has been superseded by Council Draft No. 5. See also PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Council Draft No. 3, 1983) [hereinafter cited as Council Draft No. 3].


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as a monitoring device and the need for judicial review of the termination decision. Although not much emphasized in his contribution here, his views on the problem of structural bias are probably even stronger than those of this Reporter, and we agree fully as to the unsuitability of the “demand required, demand excused” procedural distinction as a screening device by which to sort out those derivative actions that should be terminated. Still, Professor Cox clearly believes that the ALI’s Reporters have come not to praise the duty of due care but to bury it. Curiously and perhaps inconsistently, he also argues that we give excessive attention to one aspect of the duty of due care, the obligation to comply with applicable law, that others have described as its most critical component. Here, he particularly objects to our position that the board’s power to terminate a derivative action is subject

7. This statement is largely based on Professor Cox’s ongoing research with Professor Munsinger, a social psychologist, on the problem of structural bias. See Cox & Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 LAW & CONTEMP. PROBS. - (1985). So critical is Professor Cox of the performance of special litigation committees that he faults the ALI’s proposals for not equally allowing a defendant to make the same motion to terminate as the board’s committee may make. Yet, this equation of the defendants with the special committee glosses over the doctrinal point that the defendant has no claim to represent the best interests of the corporation in the litigation. Frequently, the justification for dismissal that the court must evaluate at this pre-trial stage will be a claim that the litigation, even if it is legally meritorious, will still injure the corporation (because of reputational injury, diverted time, revelation of business practices, etc.). There is no arguable way that the defendant can plausibly advance the claim that a meritorious action should be dismissed because it will result in harm to the corporation that outweighs the probable recovery. If the defendant could do so in the context of derivative actions, he could equally well do so (that is, with equal absurdity) in a direct action by the corporation against him.

Perhaps more importantly, although I agree with Professor Cox as to the likelihood of structural bias, my review of special litigation committee reports does not lead me to believe that they are dishonest documents on which no reliance is warranted at all. Rather, they tend to be factually accurate and often comprehensive reports that predictably reach a preordained conclusion in favor of termination because of the manner in which they balance the factors specified in the report. Sometimes, there may even be therapeutic value in the preparation of such reports, as they may set in motion some internal reforms. In contrast, a report prepared by the defendant is entitled to no reliance and will probably be a wholly self-serving document. Professor Cox suggests that if the ALI’s Reporters seriously wanted a screening mechanism by which to winnow the nonmeritorious suit they would allow the defendant also to make the motion to terminate the litigation. See Cox, Compensation, Deterrence, and the Market, supra note 3, at 786-88. This strikes me as a very misguided proposal.


9. See Brudney, The Independent Director — Heavenly City or Potemkin Village?, 95 HARV. L. REV. 597, 656-58 (1982); See also Engel, An Approach to Corporate Social Responsibility, 32 STAN. L. REV. 1 (1979) (criticizing those advocating more corporate social responsibility without balancing the costs incurred by corporations). In his most recent visit to this topic, Professor Brudney writes: “[T]he most significant role that they [independent directors] can play is in the matter of encouraging corporate compliance with law.” Brudney, supra note 1, at 239.
to a "frustration of public policy" exception. Although I believe he overreads this exception, which is more modest in scope than he suggests, it is clear that Professor Cox is not a champion of all aspects of the duty of due care but only those that produce a compensatory benefit to shareholders. Our disagreement on this point has deeper implications: are directors simply agents of the shareholders with no other responsibility? Or is the state not also a party to the corporate charter and may the state, in return for granting limited liability, not unreasonably expect that directors will manage the corporation within the boundaries set by law?¹¹

This polarized reaction, with Professor Scott viewing us as overly concerned about managerial negligence and Professor Cox as overly skeptical, illustrates how vulnerable is the position of those who occupy the middle of the road. Nonetheless, the middle of the road bends with the road, and I believe the contemporary consensus is turning away from Professor Cox's emphasis on liability for negligence. With respect, he stands like Uncas in The Last of the Mohicans, as the last surviving member of a once proud tribe of law professors who confidently believed that the natural goal of reform was to increase the exposure of corporate officials to liability for negligence. Moreover, there seems to be an unrec-

10. See Cox, Compensation, Deterrence, and the Market, supra note 3, at 780-83.

11. A long-standing debate has divided, on the one hand, those who see the corporation as purely a private contractual relationship in which the state has no role (other than to prescribe a model form in its incorporation statute, which the parties are largely free to vary) and, on the other hand, those who see the corporate form as involving a concession from the state to the extent that shareholders enjoy limited liability, which would not have been available at common law to mere partners. This debate between the contract and concession schools is beyond the scope of this piece, although I do find Professor Cox to be curiously taking the same position in favor of the contract view as do Professors Easterbrook and Fischel (with whom he otherwise seems to disagree). See Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1191 (1981).

In suggesting that the state is entitled to expect that directors will monitor for law compliance, the ALI's Reporters have declined the view offered by Professor Fischel that criminal and civil fines and penalties are simply a price that the legislature puts on the behavior in question, with the result that payment of this price entitles the corporation to engage in the misbehavior. See Fischel, The Corporate Governance Movement, 35 VAND. L. REV. 1259, 1290 (1982). Such a view, at least as applied to most regulatory laws, simply misstates the legislative intent, which was not to establish a tariff but to prohibit certain behavior. In response to the predictable reply that it is the legislature's own fault that it has set the penalty level too low, I would answer that this assumes a superficially anthropomorphic view of the legislature, which is not itself able to monitor violations, act quickly to revise the law, or know the probable gains to the firm from the type of misbehavior in question. Precisely because the legislature cannot know how high to set penalty levels in order to make the expected penalty cost exceed the expected benefit, and because the impact of inflation will ravage any penalty structure over time, the state must rely on enforcement devices other than directly imposed fines. One of these techniques is to define the fiduciary obligations of managers and directors to include obedience to law. This does not mean, however, that directors owe enforceable fiduciary duties to other classes, such as employees, consumers, or communities, as Professor Dodd believed. See Dodd, For Whom Are Corporate Managers Trustees?, 45 HARV. L. REV. 1145 (1932). Rather, the view I take is simply that corporate fiduciaries are not granted the power by the corporate charter to make a knowing cost-benefit decision to disobey the law.

12. Professor Cox's final paragraph in his contribution to this Symposium fills me with nostalgia when he describes due-care cases to be "as susceptible to derivative-suit
conciled tension in Professor Cox's position. His article opens with an elegant description of the role of the derivative action in reducing systematic risk.\textsuperscript{13} This is advanced as a justification for a deterrent rationale, and indeed it is a very useful contribution to the literature in this area. Yet, when he turns from theory to prescription, Professor Cox favors a compensatory rationale without explaining what the relationship between these two justifications should be.\textsuperscript{14} Here, I fear he has abandoned his own theory and understated the problems inherent in any attempt to use compensation as an organizing principle.

I will respond in three parts. Part I focuses specifically on the role of litigation in enforcing the duty of due care. Part II turns to the more general topic of the appropriate rationale for litigation—deterrence or compensation. Finally, Part III moves from the abstract to the specific and defends some specific proposals made in \textit{Council Draft No. 5} based upon the policy premises outlined in the preceding sections.

\textit{I. The Continuing but Problematic Relevance of Due Care: Some Reflections on the Academic Tendency Toward Overstatement}

Professor Scott, in effect, begins where Professor Bishop left off almost twenty years ago. In a well known article, Professor Bishop argued that courts honored the duty of care more in the breach than the observance.\textsuperscript{15} After surveying the case law, he found no decision in which courts had actually imposed liability on facts uncomplicated by an element of self-dealing and only a handful in which the case even survived a pre-trial motion to dismiss. From Professor Scott's vantage point, this apparent fact that the duty of due care has lived only in dicta makes it a judicial fiction and fortunately so, in his judgment. Had it ever been truly en-

\begin{enumerate}
\item \textsuperscript{13} See Cox, \textit{Compensation, Deterrence, and the Market}, supra note 3, at 788. This is the old liberalism of William Douglas, as expressed in Douglas, \textit{Directors Who Do Not Direct}, 47 HARV. L. REV. 1305 (1934). Modern liberalism is, however, better defined by Professor Brudney's very different view about the role of directors. See Brudney, supra note 9 (concluding that the trend to dilute or eliminate regulatory controls because of the use of independent directors is unrealistic and the task of fostering corporate social responsibility should be left to independent directors).
\item \textsuperscript{14} Id. at 777.
\end{enumerate}
forced, he implies, it would have only made directors risk averse and excessively concerned with the creation of "paper trails."\textsuperscript{16}

To assess Professor Scott's claims and Professor Cox's response, it is important to recognize that Professor Bishop's thesis, which they both accept as their factual predicate, involves a measure of overstatement. To begin with, it ignores the central facts that cases are most often resolved by settlement, not judicial decision, and that defendants have a particularly strong incentive to settle derivative actions because, unlike a settlement, an adjudication adverse to them will typically deprive them of eligibility for indemnification.\textsuperscript{17} As a result, it is likely that cases favorable to the plaintiff tend to be settled, whereas those in which the defendant has the relative advantage tend to be dismissed at a pretrial stage, often in recorded decisions. In this settlement process, the parties necessarily bargain in the shadow of the law and, thus, judicial dicta about the scope of the duty has some real world effect. Rather than being a nullity insofar as its affect on financial liability is concerned, the duty of care has led a twilight existence, marginally affecting the size of settlements (a few of which have been significant). Indeed, even if the risk of due-care liability were no greater than that of being struck by a lightning bolt, one must observe that prudent men do not wander out needlessly in a thunderstorm; some are in fact terrified by lightning.

This marginal impact, however, is overshadowed by a more important consequence of the judicial dicta that has elaborated on the nature of the duty: its educational and socializing effect. Professor Scott seems to believe that the relevant audience — managers and directors — ignores legal commands that do not result in the imposition of sanctions.\textsuperscript{18} This view is not only too cynical but also too unsophisticated about the process by which legal rules are communicated. Here I mean more than the obvious point that the bench makes a "bully pulpit." Rather, on a more abstract level the bias of lawyers is to magnify the gravity of relatively remote

\textsuperscript{16} Scott, supra note 3, at 932-37.
\textsuperscript{17} Most state indemnification statutes preclude indemnification of litigation expenses incurred in a derivative action "in respect of any proceeding in which the person shall have been adjudged liable to the corporation." See MODEL BUSINESS CORPORATION ACT § 5(b) (1980). See also CAL. CORP. CODE § 317(c)(1) (Deering 1984); DEL. CODE ANN. tit. 8, § 145(b) (1983); N.Y. BUS. CORP. LAW § 722(a) (McKinney 1984). As a result, settlement ensures that these expenses can be indemnified because the individual has not been "adjudged" liable.

\textsuperscript{18} See, e.g., Scott, supra note 3, at 935. Professor Scott talks only about the "threat of negligence liability." Another view of the law's impact is suggested by Justice Holmes's famous "bad man/good man" distinction. The bad man, said Holmes, looks at the law caring only for its "material consequences," whereas the good man "finds his reasons for conduct . . . in the vaguer sanctions of conscience." O.W. Holmes, The Path of the Law, in COLLECTED LEGAL PAPERS 171 (1920). Moreover, at no point does Professor Scott discuss the informational content of the duty. As he realizes, different monitoring models are possible; the board could monitor \textit{ex ante} or only \textit{ex post} (as he seems to prefer). Although I see little need to draw a categorical distinction here, the formulation of the duty influences the nature of the monitoring that is to be required. Thus, the logic of Professor Scott's argument points not toward abolition of the duty (as he proposes) but toward reformulation of it into a duty to monitor \textit{ex post}. This would restrict liability for negligence but not eliminate it.
legal risks. Indeed, lawyers maximize their income by identifying a problem (or a perceived problem that may in fact be considerably less than urgent) and then communicating this problem to potential clients along with their announced ability to solve it. Because legal risks are a lawyer's stock in trade, lawyers tend to exaggerate their importance, just as environmentalists tend to warn of impending ecological disasters that never quite transpire or as defense officials overreact to perceived foreign military build-ups. Thus, during the last two decades, legions of corporate lawyers have stressed to innumerable boards the need for an adequate investigation and a minimally sufficient record as the procedural prerequisite to the substantive protection of the business judgment rule. Of course, I basically view this as a salutary development, whereas Professor Scott does not. But, whatever one's evaluation, it is myopic to evaluate the law's impact without taking into account the nonadversarial processes by which lawyers advise clients and thereby shape the behavior and consciousness of their clients. Indeed, this legal advice was far from deceptive; not only was it in accord with the prevalent case law to the effect that due care must be exercised before the protection of the business judgment rule applies, but it also was consistent with even more important developments in federal securities law that essentially began with the BarChris decision. The conventional wisdom among lawyers who practiced securities law prior to BarChris was that the decision caused a revolution in board behavior by making directorial negligence a very real basis for the imposition of liability. In light of this significant federal exposure, it is an open question as to who is more the nitpicking purist: the practitioner who focuses on statements in dicta when advising clients, or the academic who, seeing no state decisions clearly imposing liability, pronounces the duty an illusion, thereby ignoring the appearance of a functionally similar duty under federal law. In this light, Professor Scott's proposed abolition of the duty would have only a marginal effect as long as directors still faced significant federal

19. See, e.g., Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (successful derivative suit for breach of duty of due care); Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944) (derivative action unsuccessful where directors committed honest mistakes); H. BALLANTINE, BALLANTINE ON CORPORATIONS § 63a, at 161 (rev. ed. 1946) (business judgment rule presupposes the exercise of diligence and due care); Arsht, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93, 111 (1979) (business judgment defense based on exercise of due care is valid but limited).

liability unless they could establish their "due diligence" defense under section 11 of the Securities Act of 1933.21

This assessment, that Professors Bishop and Scott have overstated the argument against duty of care liability, does not address, however, the critical question: is due-care liability desirable or counter-productive? Here, my response differs from that of Professor Cox. In my view, what is most desirable about the duty of care is its socializing and exhortative impact. Since ancient times, we have worried about "who will guard the guardian?" In the corporate context, this question becomes "who will monitor the monitor?" But all monitors, whether in public or private life, are principally restrained by their own normative standards, including their conception of what persons in their position ought to do under given circumstances. At least within our society (which, to be sure, some view as law-obsessed), the legal profession has generally enjoyed a hegemony over this educational function of communicating standards to the relevant audience. Nor is this soon likely to change because few are willing to rely on industry-drafted standards. Leaving the task of standard setting solely to business groups risks the danger that any resulting code would become an exercise in self-insurance, as potential defendants seek to eliminate any possibility of liability or litigation.22 In this light, Professor Scott's proposal to abolish the duty of care carries with it an unintended normative message to directors: directors are but a vestigial appendix to the corporation who need not closely concern themselves with impending corporate decisions and probably should not interfere (except possibly on an ex post basis).

To this point, I expect that Professor Cox would have no serious objection to my analysis. But a tension arises here between the aspirational role of due-care standards and the role he emphasizes, that of liability determination.23 Put simply, liability-oriented standards are minimum standards; they can neither be aspirational nor evolutionary. Their role is simply to compensate victims and allocate losses. This, I will suggest later, is the role that the duty of care performs least well. Moreover, the impact of minimum standards may well be to communicate an unintended message that compliance with the minimum is all that should be expected.

Perhaps unintentionally, Professor Cox seems to concede that liability and high standards are incompatible. In response to the

22. I certainly agree that business groups should have a substantial role in this process (as they have been invited to have in the ALI's process). Nor do I contend that standards drafted by legal groups will be immune from the temptation to emphasize protection of one's clients over other purposes. For a critical commentary on the recent recodification of the Model Business Corporation Act that sees this influence as having predominated, see Branson, Counter trends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure, 68 MINN. L. REV. 53, 58-62 (1983). Nonetheless, there is a relative difference, and industry drafted standards would exacerbate the danger of self-insurance.
obvious arguments about the unfairness of imposing substantial liability on directors for seemingly minor procedural errors or omissions, he replies that the duty of due care has never demanded very much of directors. This is probably true, but it begs the question of what the substantive content of the duty should be: a minimal compliance with procedural standards or a more active monitoring responsibility. From my perspective, the challenge is to have an aspirational body of law — at least in the sense that the duty comprehends more than simply the residue of cases decided during the administration of William McKinley — and yet not expose corporate officials to a threat of liability that may either chill the movement toward independent directors or produce excessive risk aversion. I will later argue that a ceiling on liability for directorial negligence is responsive to these needs, both because it should reduce the level of risk aversion and because it will not tempt courts to distort the substantive content of the law in order to protect sympathetic defendants. Moreover, because the ceiling need not apply to all forms of due-care violations, it is possible to have a two-tiered structure to the duty: some categories of violations (knowing violations of law or reckless behavior where the defendant subjectively perceived the danger to the corporation) would not qualify for the ceiling and thus would be subject to a more severe deterrent threat. Potentially, such a porous ceiling achieves the best of both worlds by permitting minimal standards to co-exist with more aspirational ones.

Before turning to my prescription, however, Professor Cox’s proposal for an invigorated duty of care that would stand on an equal footing with the duty of loyalty deserves a closer examination in its own right. In making his argument, Professor Cox scores some easy and sensible points off of Professor Scott, but the aggregate significance of his objections is open to doubt. Market-based remedies, he correctly points out, are not a panacea, both because high tender offer premiums shelter a significant margin of managerial ineptitude and because smaller companies are not traded in markets that are generally believed to be efficient. He also makes a useful point that “one shot” errors or breaches will not necessarily lead to the market discounting the firm’s shares by a margin sufficient to trigger market-based remedies, unless the market believes that the lapse or violation in question will recur. True as this is, the market for executive services and internal monitoring within the firm remain as major constraining forces.

24. See infra text accompanying note 85.
25. See Cox, Compensation, Deterrence, and the Market, supra note 3, at 752 & n.29.
26. Id. at 753-54.
Nor is the incentive to "shirk" nearly as strong as that to place one's own self-interest above that of the corporation in a self-dealing transaction. The strongest argument for a litigation remedy available to shareholders that can reach the substantive justification for a transaction is to prevent market remedies from being foreclosed or preempted — such as through "scorched earth" tactics in response to a takeover bid, greenmail, or a preemptive leveraged buyout. These factors imply to me that the civil law need only be concerned with violations or negligence near the top of the corporate hierarchy, where the board's monitoring may be inadequate. Accordingly, the position consistently taken throughout the various drafts of the ALI's Corporate Governance Project has been that dismissal of derivative actions against lower echelon corporate officials should be a relatively uncomplicated process, subject only to minimal judicial review under the business judgment rule.27

On balance, Professor Cox has shown essentially that Professor Scott oversimplified his position (a well known, but forgivable, academic trait), but not that a litigation remedy broadly focused on enforcing the duty of due care is practical or desirable. Nor are Professor Cox's own contentions immune from criticism. For example, his point that most corporations are not traded on public markets28 ignores that the derivative action has essentially functioned as a monitoring mechanism chiefly with respect to publicly traded corporations. This is probably because the engine that drives the derivative action — the professional plaintiff's attorney — is only in a position to monitor the behavior of those corporations subject to federal disclosure standards.29 The underground railroad that somehow connects these attorneys with eligible shareholders seldom runs to smaller corporations, probably because of a difference in what the economist would term "search costs." Whatever the reason, litigation involving closely held corporations has more typically taken the form of either actions for oppression or liquidation, or actions for fraud based on misrepr-

27. See Tentative Draft No. 1, supra note 4, § 7.03(a)(1). Tentative Draft No. 1 provided that an action brought against persons "other than corporate fiduciaries" (a term that was not intended to include those "below the level of the board or the senior executives" of the corporation) could be terminated under a business judgment standard. Id. Council Draft No. 5 refines this approach still further by providing in section 7.07(a) that in an action against persons other than directors, senior executives, or any person having control of the corporation, or an associate of any of them, a business judgment standard applies to the judicial review of a termination decision by either the board or a special litigation committee. Council Draft No. 5, supra note 5, § 7.07(a).


29. Once we view the plaintiff's attorney as a monitoring device (as both Professors Cox and Scott do), it follows that the scope of his monitoring efforts will be influenced by his relative search costs. These costs are lower for publicly held corporations, which are subject to extensive disclosure requirements. In addition, there is a well-established tendency for the private enforcer to piggyback on the enforcement efforts of public agencies. I have discussed both these points at length elsewhere. See Coffee, Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working, 42 Md. L. Rev. 215 (1983).
sentations pertaining to the purchase or sale of securities. These comments do not imply that the derivative action should not be fully available to the shareholder in the close corporation, but they do suggest that the boundaries that Professor Cox described as limiting the reach of market-based remedies also apply (perhaps to a somewhat lesser degree) to litigation as a monitoring device. Thus, the comparative advantage of the derivative action as a monitoring mechanism lies in its ability to deter a "one shot" transaction that will not otherwise trigger an adverse market response or a management ouster.

Ultimately, the central issue that any commentator must face is whether the prospect of substantial financial liability for directorial and managerial negligence is a sound social policy. For the following reasons, I believe that Professor Scott is closer to the truth than Professor Cox, and, as a result, I favor a relatively low ceiling on the maximum liability for a due-care violation not involving knowing or reckless behavior.

First, from the standpoint of economic theory, directors are poor cost avoiders. As Professor Cox notes, the standard approach of economic theory is to ignore fault and look for who is best able to take action to prevent the loss in question. This approach gives a new dimension to the argument made by Professor Brudney and others that directors lack the information and incentive to be able to monitor effectively behavior that occurs at considerable organizational distance from their level within the corporate hierarchy.30 Although Professor Brudney uses this premise to argue that little legal weight should be accorded to the judgment of independent directors, its corollary here is that little legal liability should also attach, unless we are dealing with behavior more culpable than that of negligence. Directors are poor cost avoiders not only because of their lack of information but also because of their limited ability to act on the information they do possess. Although this generalization does not hold as true for illegal actions (where protest is a significant deterrent),31 the dissenting director can generally do little about a business decision that he considers to have been poorly conceived or insufficiently

30. See Brudney, supra note 9, at 633. See also Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. REV. 1099, 1131 (1977) (discussing reasons for information blockages to boards of directors in context of the improper payments controversy).

31. See Barnes v. Andrews, 298 F. 614, 616 (S.D.N.Y. 1924). In Barnes, Judge Learned Hand doubted that the individual director could do much to effect a change in corporate behavior with respect to an ordinary business decision, but he recognized that if an illegal act occurred, protest would be a sufficient deterrent to satisfy the proximate causation standard. The facts of Dirks v. SEC, 103 S. Ct. 3255 (1983), tend to support this generalization because there a former inside officer's disclosure of the fraud to Dirks finally ended the scandal. See id. at 3261-66.
researched. Possibly in part for this reason, the law on proximate causation in this context has long been confused and has provided a measure of protection for even the clearly negligent director.32

Finally, directors are poor cost-avoiders because of their inability to internalize the costs involved. In this respect, the director is very different from the auditor or investment banker who can spread these costs over the many firms he serves. The director is not a “repeat player” in the same sense that the auditor is because he can serve only a few corporations. Of course, we could increase the compensation of directors, but even if this were done by an order of magnitude directors would still not be in the same position as auditors or investment bankers who can serve many firms. Nor would we want the individual director to serve multiple firms in the same manner as the auditor can; no responsible commentator would wish to encourage a return to former practices under which a single individual often served on a dozen or more boards.

Second, managers and directors are inherently likely to be more risk averse than shareholders desire, even without the threat of liability for negligence. Shareholders enjoy limited liability and also have the ability to diversify their portfolios so as to minimize the risk of any single investment. Managers cannot diversify their portfolio equivalently because they are essentially overinvested in their own firms.33 From this premise, modern portfolio theory implies that managers are more likely to be risk averse than the shareholders they represent. Whereas a single bad corporate business decision will have only a minimal effect on fully diversified shareholders, it can devastate the personal fortunes of the corporation’s managers who cannot spread their risks equivalently. In addition, managers, unlike shareholders, face the potential risk of individual civil or criminal liability for actions undertaken on be-

32. Section 7.16(b) of Council Draft No. 5 addresses this topic and deems adequate causation to have been shown if (1) the plaintiff can show that “the performance of the duty would have been a substantial factor in averting the loss,” and (2) injury to the corporation was foreseeable. Notwithstanding Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924), modern decisions have not permitted a director to escape liability by arguing that as a lone director he was powerless to cause a change in corporate policy. See, e.g., Atherton v. Anderson, 99 F.2d 883, 888 (6th Cir. 1938) (applying duty of ordinary care and diligence to each director); Francis v. United Jersey Bank, 87 N.J. 15, 44-45 432 A.2d 814, 829 (1981) (concluding that even if lone director’s mere objection would not have deterred ongoing fraud, consultation with an attorney and the threat of suit would have).

33. This theory has been used to explain why managers wish to make conglomerate acquisitions at possibly excessive prices. See Note, The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach, 88 YALE L.J. 1238 (1979). Because the manager necessarily holds a portfolio that is overinvested in one firm (his own), the manager will seek diversification by causing the firm to make acquisitions that give him the protection of greater diversification. The implications of this theory extend beyond acquisitions and cover all risky decisions generally. In contrast to nondiversified managers, shareholders should be risk neutral if they are diversified. The manager’s portfolio is overinvested in his own firm, both because stock options are typically non-transferable and because, at least for the more senior manager, his future income will likely be a function of the firm’s profitability; in effect, he holds a warrant in the firm, and his economic future is dependent on the firm, not the economy generally.
half of their corporation. Also, given the preference for internal promotion within most firms, the manager laid off by one firm in the wake of an insolvency or financial crisis has little prospect of making a costless transfer to another firm at an equivalent level and salary. As a result, the manager's inability to diversify his substantial investment in his firm implies that he should be more risk averse than the shareholders he serves. Adding substantial financial liability onto this balance would only exacerbate the problem and make it less likely that managers would act as their shareholders prefer.

These reasons are distinct from those offered by Professor Scott because they do rely on the overbroad assertion that market-based remedies are alone adequate, and they do not challenge the duty of care as a normative standard. Rather, they simply suggest that the duty should not be enforced with all the *in terrorem* threats of liability that the law could potentially bring to bear.

More importantly, the foregoing arguments do not take me nearly as far as Professor Scott's analysis leads him because they have considerably less cogency when applied to one critical component of the duty of due care: the duty to monitor law compliance. Within this special context, directors are better cost avoiders—in large part, because even an individual director's protest against any impending illegal act is a substantial deterrent. Of course, directors are not detectives, but they can have a responsibility to set in place internal compliance programs. In addition, the fact that they may be more risk averse than their shareholders is not so clearly a vice in this context and may even be thought a virtue. Otherwise, the limited liability that shareholders enjoy can result in pressure upon managers to adopt a risk-preferring posture with respect to law violations. Law violations also represent the quintessential form of "one shot" violations that the market will not necessarily penalize, because a corporate conviction, even where financially material penalties are involved (as under the antitrust laws), does not imply that successive prosecutions by the government are likely. Because the level of financial penalties to which corporations are typically exposed is often ludicrously


below the potential benefits from the misconduct (in large part because of the effects of inflation on legislatively adopted penalty structures), deterrence as a practical matter, under our existing legal structure, can probably only be achieved by focusing on the individual rather than the entity. The derivative action is one means to this end, insofar as it can shift penalties levied on the firm to its senior managers.\textsuperscript{36} To be sure, the derivative action is an awkward and imperfect instrument for achieving law compliance, but, at least with respect to knowing participation in illegal activities, there is little justification for proposals that would remove even the faint threat of liability that now exists.

\textbf{II. Deterrence versus Compensation: The Case for Compromise}

Professors Cox and Scott again tend to take opposite positions on the question of the rationale underlying the derivative action. Implicit in Professor Scott's analysis is a deterrent view of the action in which it serves to penalize unfair self-dealing. He appears to entertain few doubts about judicial competence and would allow courts to make fairness decisions without seemingly giving significant weight to the board's judgment.\textsuperscript{37} Although he recognizes the potential problem of extortionate and collusive litigation, he minimizes these problems and pronounces them susceptible to simple solution through devices such as fee shifting and a percentage-of-the-recovery fee formula.\textsuperscript{38} In short, he endorses with little apparent reservation the lawyer as bounty hunter. The technical problems in his analysis will be deferred to the next sec-

\textsuperscript{36} Precedent clearly recognizes that knowing illegality is a violation of the duty of due care, even if the actor's intent was to profit the corporation. See, e.g., Miller v. American Tel. & Tel., 507 F.2d 759, 761, 764 (3d Cir. 1974) (failure to collect a debt owed by the Democratic National Committee for communication services amounting to illegal corporate campaign contribution); Wilshire Oil Co. v. Riffe, 409 F.2d 1277, 1283-86 (10th Cir. 1969) (price-fixing scheme); DiTomasso v. Loverro, 250 A.D. 206, 209-210, 293 N.Y.S. 912, 916-17 (illegal contract to restrain competition in the manufacture and sale of ice), aff'd mem., 276 N.Y. 551, 12 N.E.2d 570 (1937); see also Arsh, supra note 19, at 129-30 (1980) (where illegality is clear, however, the courts will not give such conduct by directors the benefit of the business judgment rule).

Professor Scott points out that these decisions, although "included under the 'care' rubric," involve distinct issues. Scott, supra note 3, at 932 n.21. Perhaps, this means he would preserve this obligation under a different heading. Professor Cox also attempts to distinguish a number of decisions, especially Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305 (1942), and Miller v. American Tel. & Tel., 507 F.2d 759 (3d Cir. 1974). See Cox, Compensation, Deterrence, and the Market, supra note 3 at 764-66. The decisions, however, are more numerous and thus less easily dismissed than his account suggests. For a fuller treatment of the law in this area, see Coffee, supra note 30, at 1118-27.

\textsuperscript{37} Scott, supra note 3, at 939-40. Professor Scott asserts, "When shareholders present to the court an allegation of unfair management dealing, they should expect the court to exercise its own judgment. . . ." Id. I believe this view is oversimplified and certainly is more radical than anything proposed in the ALI's Corporate Governance Project. If the court were to use only its own judgment, the board would have no role and its approval would be superfluous. The more sensible position is for the court to determine if the challenged transaction was within a range of fairness, such that truly disinterested directors would have authorized the transaction.

\textsuperscript{38} Id. at 942-43.
tion, but this description is sufficient to show his distance from Professor Cox.

Although Professor Cox also recognizes the deterrent role of the derivative action (indeed, his economic analysis of that role is, I believe, the real strength of his current piece), he criticizes the ALI's Corporate Governance Project in this area for tilting too far in the direction of a deterrent rationale. A lengthy section of his article sets forth a narrow reading of some, but far from all, of the decisions that have legitimized this deterrent role. Yet, he never turns an equally skeptical eye to the basic question of the feasibility of a compensatory rationale. The core problem is not simply that there is little visible evidence that substantial recoveries have ever been obtained in cases not involving some element of suspected self-dealing; rather, the problem is equally that the source of any recovery is ultimately the officers' and directors' liability insurance policy that virtually all public corporations today carry for their officials. Because the premiums on these policies are typically paid by the corporations, these corporations are simply funding their own recovery. Conceptually, it would be far simpler and more direct if the corporation just insured itself against loss due to the negligent acts or omissions of its agents, rather than using the circular procedure of insuring its agents and then suing them for damages that only the insurance policy it purchased can cover. This existing approach, of the principal suing its agent in


40. Liability insurance does make it potentially possible for the corporation to recover substantial amounts from its own officers and directors. For example, Chase Manhattan Bank has recently sued six former senior officers, including two former executive vice presidents, for $175 million in losses allegedly incurred by Chase in connection with the failure of the Penn Square Bank. Allegedly these officers negligently accepted loans from Penn Square without adequate documentation. Obviously, few employees have pockets that deep, but the former officers were covered by insurance policies totaling $140 million. See Glaberson, Is Chase Opening the Gates to Negligence Suits by the Boss?, Bus. Wk., Nov. 5, 1984, at 39. In this light, liability insurance can serve the same function as a surety bond on lower echelon employees. But, officers' liability insurance also has a more problematic effect and may give rise to a "moral hazard" problem, because such insurance today covers precisely the same liabilities against which indemnification was statutorily denied. See Note, Public Policy and Directors' Liability Insurance, 67 COLUM. L. REV. 716, 729 (1967). Since director and officer insurance first appeared in the early 1960s, its popularity has increased enormously so that today it is comparatively rare for directors to be uninsured. Obviously, such insurance serves a compensatory purpose, but it also undercuts the deterrent purpose of the derivative action by reducing the threat of individual liability. If instead, the corporation were insured and the insurance company given a right of subrogation against the individual defendant, then both compensatory and deterrent goals could be achieved. The danger in this approach is, of course, that it may make corporate officials excessively risk averse. See Schuck, Suing Our Servants: The Court, Congress and the Liability of Public Officials for Damages, 1980 SUP. CT. REV. 281, 309-312 (cataloguing risks in permitting tort actions against governmental officials). It is not feasible to assess this danger, but clearly it is
order to recover against the latter's insurance policy that the principal purchased, has a level of complexity that only Rube Goldberg could admire.

If we are to re-examine the fundamental premises underlying the use of litigation (as both Professors Cox and Scott seem prepared to do), I suggest we must recognize that compensation to the firm for negligence necessarily requires insurance. If this premise is granted, then we must ask whether we need the derivative action as the means best suited to raise claims against the insurer. In theory, one can imagine alternative forms of insurance under which shareholders sought payment directly from the insurer (either for themselves or the corporation) without the board having to concede that the firm had in fact been damaged through the board's own acts or omissions. Thus, litigation could occur between the insurance company and a group of shareholders seeking to represent the firm. Much of the procedural complexity surrounding the derivative action could then wither away. Of course, all this may sound hopelessly visionary, but in terms of the theoretical arguments that Professor Cox has raised, the case for a compensatory rationale seems particularly weak. If one believes that a compensatory system to safeguard shareholders against managerial negligence or recklessness is needed, the most logical means to this end would be through insurance, not litigation. To be sure, portfolio diversification is a solution for shareholders, but at least for creditors, employees, and other managers (all of whom may not be able to minimize their risk through diversification), the availability of insurance would offer some protection. Paradoxically, however, these are exactly the classes that lack standing to commence a derivative action.41 My claim here is certainly not that compensation for those injured by negligence is undesirable; but rather, that the justification for intra-corporate litigation cannot serve as the primary justification for a litigation remedy. Fundamental problems with a compensatory rationale come into

more present in tort actions against corporate directors than against accountants and other "repeat players" who can better internalize these costs.

41. The widely prevailing rule is that only a current equity shareholder who held his shares contemporaneously with the time of the alleged wrong can maintain a derivative action. See MODEL BUSINESS CORP. ACT § 49 (1979); N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963). Some decisions have expanded this rule to cover various classes of beneficial holders. See Jones v. Taylor, 348 A.2d 188, 191-92 (Del. Ch. 1975). Creditors are, however, still denied standing. See Dodge v. First Wisconsin Trust Co., 394 F. Supp. 1124, 1127 (E.D. Wis. 1975); Harff v. Kerkorian, 324 A.2d 215, 218-19 (Del. Ch. 1974), rev'd on other grounds, 347 A.2d 133 (Del. 1975). Some have criticized this rule. See Note, Creditors' Derivative Suits on Behalf of Solvent Corporations, 88 YALE L.J. 1299 (1979) (arguing that derivative suits by creditors would both deter corporate misconduct and protect creditors from the increased risk caused by the depletion of assets through mismanagement). I think the rule is basically sound, given the risk averse stance of the creditor and his predictable willingness to seek to block or to attack higher risk transactions that promise him no corresponding gain.
focus once we recognize that ultimately shareholders are the injured victims of managerial negligence or misconduct. Yet, given the existence of secondary securities markets, the class of shareholders who bear the loss are not the same as the class who receive the recovery. These two classes overlap only imperfectly and thus some receive a windfall. Yet, if we reduce the recovery to adjust for this factor, we also reduce the deterrent sanction and thereby create an incentive for misconduct. Professor Cox seems to suggest that the use of pro rata recoveries under which former shareholders would receive their proportionate share of the damages would solve this problem. But this may be too simple a solution for several reasons. First, desirable as pro rata recoveries are in some cases, they invariably direct some portion of the recovery away from the firm, and thus tend to injure creditors and others dependent on the firm’s solvency. Second, it is extremely difficult to identify the shareholders who were truly injured by the fiduciary breach and who merit the individual recovery, because it is not necessarily the shareholders who held at the time of the injury but instead those who bought before and sold after the market’s negative reaction to the discovery of the wrong who were most injured. Third, the market loss of these shareholders may be greater or lesser than the injury done to the firm, depending on the market’s reaction — which will likely be influenced by the market’s judgment as to whether the loss is likely to recur in the future or is, instead, a one-shot transaction. Thus, a $100,000 loss to the firm could cause a $1,000,000 loss to shareholders in the form of a decreased stock price if the market anticipates repetition. One cannot compensate for such a loss under a system that directs the compensation to the firm. In short, the problems of equitably distributing the recovery under a compensatory rationale are probably beyond the practical capacity of the derivative action.

What then should be the relationship between the compensatory and deterrent rationales for intra-corporate litigation? Pursued dogmatically, either rationale can lead to absurd results, as discussed below. Rather than follow either principle to the limits of its logic, the sounder course is to compromise by treating the compensatory rationale as primarily a limit on the deterrent justification. Alone, a deterrent rationale can justify a corporation expending almost any sum to bring a wrongdoer to account; whereas, a compensatory rationale gives the defendant a strategic incentive to threaten to conduct a prolonged and expensive defense. For example, assume a corporate official has embezzled $200,000 in a

42. See Cox, Compensation, Deterrence, and the Market, supra note 3, at 774-75.
complicated fraud. *Ex ante*, a compensatory rationale could justify expenditures of up to $199,999 to recover that sum; any greater expenditures, however, would not produce a net recovery. Under this logic, shareholders would be better off if the wrong is not rectified than if more money is wasted. Yet, this logic also implies that as long as a defendant can make it expensive for the corporation to win a litigated recovery against him, he (or a special litigation committee intent on protecting him) can cite these same expenses as a justification for a corporate termination of the action, even though the fiduciary breach was open and notorious. The rebuttal to this argument is well elaborated in Professor Cox’s article.43 If we posit that the corporate expenditures in the litigation will discourage other potential wrongdoers, then it follows that such expenditures reduce the average agency cost that shareholders must incur in order to hold their management accountable, even if they do not produce a compensatory benefit. As is implicit in Professor Cox’s analysis, the fully diversified shareholder may benefit even if $300,000 is expended to recover $200,000.

The problem with the deterrent rationale, however, is that it is open-ended: one does not know whether expenditures of $400,000, $500,000 or even more would also produce a deterrent benefit in excess of the costs incurred. Nor can one begin to estimate the marginal deterrent benefit, if any, of each additional successful derivative action. Finally, the greatest problem with a single-minded focus on systematic risk and average agency cost is that not all (and probably not most) shareholders are fully diversified.44 These shareholders lose, rather than gain, when the corporate recovery falls below the corporation’s expenditures in a derivative action, even if a deterrent surplus is created that benefits the other, fully diversified shareholders. For all these reasons, a deterrent rationale should be constrained by a compensatory ceiling. Clearly at some point a disproportion between the expected costs and the expected recovery should justify dismissal, even if the action is a legally meritorious one. One cannot define with precision where this point lies and, because of this indeterminacy, one must rely upon judicial discretion. As a result, Part VII of the *Principles of Corporate Governance* does not attempt any precise balancing formula between the two rationales but instead contemplates case-by-case judicial balancing.

43. *Id.* at 782.

44. Most investors are not fully diversified because they hold assets other than marketable securities, such as real estate, insurance, pensions, or small business holdings. As a result, they may wish to hold an undiversified securities portfolio to wrap around their other investment assets in order to achieve full diversification on an overall level. I have developed this theme elsewhere. See Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717, 748-49 (1984).
III. From Theory to Practice: The View from Part VII

Stripped of their rhetoric, Professors Cox's and Scott's main criticisms of the specific proposals made in Part VII basically boil down to the following. Professor Scott believes we have been overly timid and have given too much credence to the possibility of extortionate or frivolous litigation. Thus, within the duty of loyalty area, he criticizes us for unnecessarily limiting and burdening the plaintiff's ability to maintain a derivative action. Conversely, Professor Cox thinks we have been overly aggressive in pursuing a deterrent rationale but also too restrictive with respect to duty-of-care litigation. He thus disagrees both with Part VII's proposed ceiling on liability for negligence and with the provision that instructs a court not to dismiss a derivative action if to do so would "frustrate any authoritatively established public policy." It is easier to engage the criticisms of each separately, although in substance, the same positions are being defended against attacks from diametrically opposed directions.

A. What Price Deterrence?: A Response to Professor Scott

That deterrence is necessary and can be achieved through the format of the derivative action are not issues on which Professor Scott and I differ. We also appear to agree that the action against the control group for a duty-of-loyalty violation presents the strongest justification for the existence of the derivative action as a monitoring mechanism. But here, as elsewhere, deterrence can come at too high a price. In abstract theory, the hanging of an innocent man should produce deterrence (if his innocence could be hidden) and could be justified under a cold-blooded utilitarian logic. Similarly, forcing a corporate fiduciary to pay a settlement under fear of what an unpredictable jury might do seems unjust, at least when the original transaction was at a price equivalent to what fully informed parties trading at arm's length would negotiate. Yet, by empowering the court to determine the fairness of all transactions between the corporation and members of the control group and not according weight to the board's prior determination, Professor Scott would invite this problem. One must ask,

45. Scott, supra note 3, at 944-46.
46. Professor Cox is here criticizing the phrasing in Council Draft No. 3, supra note 5, § 7.08(a)(3). This provision was formerly section 7.03(c)(ii)(B) of Tentative Draft No. 1. However, the current version of this language in Council Draft No. 5 is different. It bars termination when dismissal would "frustrate any legal rule that operates for the protection of shareholders." Council Draft No. 5, supra note 5, § 7.08(a)(4).
therefore, if he has adequately considered the danger of frivolous or extortionate litigation.

In fact, Professor Scott appears to have little interest in addressing these problems and would wholly reject the device of the special litigation committee. He writes: "A simple answer to all these problems is a rule that the board (or any variant thereof) cannot terminate a derivative suit. This rule . . . would leave a dismissal of a derivative action to the discretion of the courts, as with any other lawsuit."\(^{48}\) If our legal system could be redesigned from the ground up, one could make a strong argument for treating the derivative action like "any other lawsuit." But so long as the possibility that courts may err remains with us, one must recognize that the derivative action is not in fact like "any other lawsuit" in several important respects. What is most unique about the derivative action is the breadth of standing it theoretically confers on shareholders to challenge virtually any transaction in which the corporation engages. As a result, a minimally creative pleader can potentially bring before a court any significant decision reached by senior corporate management. In contrast, other forms of intracorporate litigation focus on relatively narrow transactions — the purchase or sale of securities, the solicitation of proxies, or the making of a tender offer.\(^{49}\) The universality of its scope thus distinguishes the derivative action and justifies concern about excessive reliance on it — unless one believes that courts can decide cases without error.

In addition, courts are traditionally hostile toward the use of summary judgment and similar pretrial motions for dismissal. Regrettably, courts are simply too familiar with the proposition that factual disputes are to be resolved at trial to expect them to screen actions on their own by evaluating the action's likely merit and dismissing those in which the probable recovery would be substantially below the probable corporate expenditures. Accordingly, even a nonmeritorious action has a nuisance value. To be sure, this is a generic problem, which is not limited to the derivative action; but the uniquely broad reach of the derivative action and the superficiality of the injury required to give standing makes the need for a screening procedure more compelling in this context if procedure is not to dominate over substance. In this light, the key attraction of the standing doctrine, under which the board has power to reject the plaintiff's demand, is that it serendipitously supplies a doctrinal foundation that courts can use to justify such an early screening. So viewed, Professor Scott misses the forest for the trees when he criticizes the elaborate procedural restrictions that surround the derivative action in much the same overprotective manner as sand traps guard the green on a champi-

\(^{48}\) Scott, supra note 3, at 945 (original emphasis).

\(^{49}\) For example, under Rule 10b-5, the plaintiff can state a cause of action only if the misstatement or omission occurred in connection with a purchase or sale of a security. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
onship golf course.\textsuperscript{50} Justifiable as his criticisms are on an individual basis, they ignore the subtler point that, absent a reliable screening mechanism, corporate officials would be exposed to nearly constant litigation. Of course, we have such a screening mechanism today in the form of the special litigation committee, but it is such an overbroad mechanism that it is susceptible to great abuse. One might even debate whether a bad screening mechanism is worse than none at all, but a choice between all or nothing is unrealistic and unnecessary. If the device were wholly eliminated (as Professor Scott proposes), and any lawyer could file a derivative action without the "formality" of a client (as Professor Scott favors), then the resulting litigation explosion might soon terrify courts back into their former posture of near absolute deference to the board. Real reform, then, requires that we candidly face the problem of nonmeritorious litigation.

Professor Scott is not unaware that nonmeritorious litigation is often initiated and may induce risk-averse defendants to agree to a settlement. But, in response, he claims that "the legal system has evolved ways for defendants to attack groundless suits and obtain their dismissal at early stages in litigation (demurrer, motion for summary judgment) and to impose penalties on plaintiffs for abuse of the legal process."\textsuperscript{51} Here, I submit, he has overstated the adequacy of our existing system of sanctions substantially; conversely, Professor Cox is unduly pessimistic about the capacity of the legal system to develop an early screening mechanism.\textsuperscript{52} To believe that a motion for summary judgment will frequently be granted in a complex case involving the fairness of a self-dealing transaction, one has to blind oneself to a great deal of evidence that our legal system is not currently dealing adequately with the problem of litigation abuse (either by plaintiffs or defendants). The successes in this area have been very few indeed. Perhaps in consequence, courts have legitimized the special-litigation committee and some have accepted the blatantly overbroad thesis, which is enunciated in its most extreme form in \textit{Auerbach v. Bennett},\textsuperscript{53} that the board has the same business judgment discretion to reject a derivative action as it does to make ordinary deci-

\textsuperscript{50} See Scott, \textit{supra} note 3, at 941-42.
\textsuperscript{52} See Cox, \textit{supra} note 3, at 783-87. Professor Cox contends that if the ALI's Reporters were serious about the desirability of an early screening mechanism, we would permit the defendant to raise such a liberalized motion for summary judgment. For a response to this claim see \textit{supra} note 7.
sions not involving any element of self-dealing. Easy as it is to criticize courts on this score, the real dilemma is that they have not had adequate alternatives available to them. The experience of courts with imposing penalties against attorneys who act in an unreasonable manner has reached only the embryonic stage, and the idea of fee shifting along the lines of the English rule is both anathema to most of the Bar and inconsistent with the contingent fee system that Professor Scott describes as the common law’s efficient answer.54

If Professor Scott’s summary of the law’s capacity to deal with the nonmeritorious action seems overconfident, he is even more sanguine in his predictions about defendants’ behavior. Defendants, he says, would learn to resist extortionate litigation and to call plaintiff’s “bluff” because defendants are repeat players who know that if they “choose to pay off on suits without merit [they] will soon find that their number is infinite.”55 This explanation is much too simple. In fact, the empirical evidence today shows that defendants in derivative actions are not repeat players, because the odds are quite low that any one corporation will be sued repetitively with respect to different transactions. The best known empirical study found that the typical firm would be involved in a derivative action only once every 17.5 years as long as the rate that prevailed between 1971 and 1978 continues.56 Of course, this rate may change (particularly if Professor Scott’s approach were adopted), but any substantial increase would also mean that directors who today face only a limited exposure to litigation (whatever their subjective sense) would truly enter a world in which they were repeat players facing a recurrent threat of litigation. Unlike auditors or other professionals, directors cannot spread the risk over multiple firms. For most outside directors, there is probably no realistic risk premium that could compensate them adequately and thus, the composition of the typical board would shift in the direction of risk preference as the more risk-averse directors fled the board. Even if an adequate risk premium existed, the possible

54. Scott, supra note 3, at 940. Professor Scott is quite correct that the derivative suit is a solution to the free-rider problem that hobbles effective opposition by minority shareholders. But, so long as a contingent fee system is essential to the enforcement of derivative actions, the English rule of fee shifting would deter most plaintiffs from commencing such an action, because the nominal plaintiff stands to receive no portion of the recovery in a derivative action (if successful) and yet would be liable for the other side’s attorneys’ fees (if unsuccessful). Even if the lawyer could enforce the action himself (without the need for a client), a substantial asymmetry would remain because the defendants’ fees would typically exceed the expected fee award to the plaintiff. In any event, the very hostile reaction that the recently proposed amendment to Federal Rule of Civil Procedure 68 encountered before it was withdrawn shows that the Bar is unlikely to accept fee shifting as a general rule. See Committee on Rules Practice and Procedure of the Judicial Conference of the United States, Preliminary Draft of Proposed Amendments to the Federal Rules of Civil Procedure, 98 F.R.D. 339, 361-67 (1983). For a critique, see Note, The Impact of Proposed Rule 68 on Civil Rights Litigation, 843 Colum. L. Rev. 719 (1984).

55. Scott, supra note 3, at 942.

additional compensation required to induce directors to accept this increased risk could well exceed any reduction in unfair self-dealing, and this risk premium might increase, rather than decrease, average agency costs. In short, the criticisms made earlier of Professor Cox's proposals for a more zealous enforcement of the duty of due care also have relevance to Professor Scott's brave new world in that the effect of his proposals could prove perversely counter-productive to his goals. Nor is it a sufficient difference that Professor Scott would confine litigation to the duty of loyalty. Some conflict-laden areas — such as executive compensation — are as unavoidable as death and taxes; and thus, for example, the directors who set compensation levels would become inevitable targets.

If one wishes to choose between extreme alternatives, I suppose that in the last analysis I would prefer Professor Scott's proposals to the law of *Auerbach v. Bennett*. But such a choice is unnecessary. The sensible alternative is to convert the special-litigation-committee device from an insurmountable barrier into a screening mechanism that requires courts to evaluate at an early stage the probable merit of the action. Of course, such judgments will be based on imperfect information and will frequently be erroneous. But the risk of error pervades this area, and by granting courts this discretion we are in effect balancing one type of error against another.

Finally, Professor Scott is equally unconvincing with respect to the problem of collusive settlements that has long plagued the de-

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57. Professor Cox gives the tradeoff too little attention in his analysis of average agency costs. If we ask directors to bear the increased risk for negligence, we either have to expect that they will demand increased compensation or, if not, that a shift will occur in the composition of the typical board toward those having a high tolerance for risk. Risk-preferring directors would hardly seem the ideal candidates for a monitoring role.

58. Of course, the crux of this conversion is to transfer discretion from the board to the court, so that the termination decision would essentially rest on a judicial determination that the action was either likely to be nonmeritorious or that other reasons made its continuation harmful to the corporation's best interests.

59. One must balance errors of underinclusion against errors of overinclusion. Underinclusion occurs when the court erroneously predicts that the action has little prospect of success and so dismisses it, even though fuller discovery would have shown that substantial evidence supported the plaintiff's position. The second type of error occurs when the action is permitted to proceed and plaintiffs negotiate a favorable settlement from risk-averse defendants although they would have been unable to prove their case at trial. Of course, the more discovery the court permits, the greater the likelihood of a more accurate decision and the incidence of error is minimized. But one cannot stop with this observation. Discovery occurs over time and is costly; moreover, the longer the action proceeds, the greater the likelihood that plaintiffs' leverage will be increased and that defendants will be compelled to settle. In general, in making a screening decision, the court needs to balance the desirability of some discovery against the danger that extended discovery will defeat the purpose of an early screening mechanism.
rivative suit context. His answer again is simple: switch from the current time-based "lodestar" system of compensating the plain-
tiffs' attorney to a percentage-of-the-recovery formula. Once this is done, he implies, the plaintiffs' attorney would no longer have an incentive to swap a low recovery (to the corporation) in return for a high attorneys' fee award (to himself); instead, the attorney's interests and those of the shareholders would be aligned. This proposal is, however, less optimal than it first sounds. Well known economics literature has long argued that a formula based on a percentage of the recovery creates an incentive for premature settlements at inadequate amounts that are below that at which the class would settle if it had the ability to control its attorney's actions. In effect, when we shift from a time-based formula to a formula based on a percentage of the recovery we are simply exchanging one conflict of interest for another: under both formulas, the attorney has an incentive to accept a settlement offer that the class would refuse had it the ability to do so. It may well be that there is a case for re-introducing a percentage-of-the-recovery component into the case law on attorneys' fees (and Council Draft No. 5 does this), but the irony here is that Professor Scott is proposing the one reform that would reduce settlement size and hence the deterrent value of the derivative action. In the last analysis, Professor Scott's premises are sound at least in terms of his desire to focus the litigation remedy on the control group and the duty of loyalty. At the implementation level, however, the means he chooses do not lead to the ends he seeks.

B. Professor Cox's Critique

Professor Cox's specific disagreements with former Council Draft No. 3 center largely around two provisions: the "frustration of public policy" exception to the board's power to terminate derivative litigation, and the proposed ceiling on damages for due

60. Scott, supra note 3, at 941, 943.

61. See Clermont & Currivan, Improving the Contingent Fee, 63 CORNELL L. REV. 529, 536, 543-46 (1978) (summarizing earlier economics literature). A bias toward early settlements that do not maximize the recovery to the class is said to exist because the increase in the expected attorney's fee from continuing to litigate (rather than settle) the action will often not equal the attorney's opportunity costs over the period of the delay.

62. In section 7.18(a)(i), Council Draft No. 5 permits the court to increase the attorney's fee over and above the level justified on a time formula basis in order to reflect "the nature of the results obtained." This approach is substantially in accord with the decision of the Delaware Supreme Court in Sugarland Indus. v. Thomas, 420 A.2d 142, 153 (Del. 1980), which rejected the lodestar approach and authorized the court to adjust the fee award upward to reward the attorney for the benefit obtained.

63. Council Draft No. 3, supra note 5, § 7.08(a)(3). This restriction has support in the case law. See Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980); see also Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981) (emphasizing that before dismissing an action on the board's recommendation the trial court should give "special consideration to matters of law and public policy in addition to the corporation's best interests"). In his criticisms of this section of Council Draft No. 3, Professor Cox gives little attention to Zapata and ignores Galef.
care. Basically, he overreads the former, which has in any event been revised in Council Draft No. 5, and overreacts to the latter, which has precedent in terms of a similar ceiling proposed by the ALI in its Federal Securities Code.

1. **Frustration of an Authoritatively Established Public Policy**

Section 7.08(a)(3) of Council Draft No. 3 instructed the court not to dismiss a derivative action based upon the board's determination that the action is adverse to its interests if to do so would "frustrate any authoritatively established public policy." To Professor Cox, this language implies that the corporation, at considerable cost to itself, must permit the plaintiff to prosecute any action involving an alleged criminal violation or any violation of a similar statute embodying a public policy. If indeed this language did turn the corporation into an engine for the discovery of corporate misbehavior and did convert the derivative action into a private grand jury proceeding, it should give cause for alarm. However, such a reading exaggerates by a considerable margin what can reasonably be implied from these words. First, the word "frustrate" is itself a transitive verb that connotes considerably more than an insensitivity to a particular public policy. That a conflict can be perceived between a board's decision and a public policy does not mean that the latter is "frustrated." It is difficult to see how a board's judgment that a particular action was non-meritorious or that it resulted in costs vastly disproportionate to its benefits could be said to "frustrate" most public policies. Second, the current draft has replaced the term "established public policy" with the phrase "frustrate any legal rule that operates for the protection of shareholders."!

64. This ceiling was originally in section 7.06 of Tentative Draft No. 1. In a substantially revised form it is now section 7.17 of Council Draft No. 5. As of the date of this Article, the Council of American Law Institute has yet to consider this revised proposal.

65. See supra note 46.

66. Fed. Sec. Code § 1708(c)(2) (1980) (limiting damages for an individual defendant with respect to liability for an individual filing or misrepresentation or omission to the greater of $100,000 or any profit attributable thereto). This section would not apply if the defendant made a “misrepresentation made with knowledge by the particular defendant.” Id. The $100,000 limit was subsequently raised to $200,000 after negotiations with the SEC before the Code was submitted to Congress.

67. Council Draft No. 3, supra note 5, § 7.08(a). Section 7.08(a)(3) provided that: “the court should dismiss the action . . . if it finds that:

(3) dismissal of the action would not frustrate any authoritatively established public policy.”

This same provision was contained in section 7.09(c)(ii)(B) of Tentative Draft No. 1.

Ironically, this provision strikes me as precisely the sort of limitation on the board's power to terminate a derivative action that Professor Cox would seem to be contemplating when he develops his "average agency cost" rationale for shareholder litigation. The likely application of this standard becomes clearer when we consider those legal rules that particularly relate to the protection of shareholders. For example, most statutes on indemnification prohibit indemnification of a corporate officer's litigation expenses in a derivative action when the officer is adjudged, in the same proceeding, to have breached a fiduciary duty owed to the corporation. Assume, however, that the directors of a corporation decide to indemnify a corporate official for $150,000 of litigation expenses incurred by him in a derivative action in which he was adjudged liable to the corporation. Such action would, of course, flout the legislative policy against indemnification in this instance, but the directors would have violated no criminal statute and no civil remedy would apply. The directors could, of course, be sued derivatively, but in any subsequent derivative action commenced against them, one might well argue that the potential recovery to the corporation (the wrongfully paid $150,000 indemnification) would be less than the financial and time expenditures needed to litigate the action. Here, the "frustration" standard would typically apply to preclude termination of the action, because the legislative ban on such indemnification payments would, on these facts, have been frustrated by the termination of the derivative action. Phrased differently, this is a situation in which (in Professor Cox's own terminology) the average agency costs of corporate governance are reduced by insisting that the action proceed.

A different and potentially more controversial example is presented by the facts of the landmark case of Garner v. Wolfinbarger. There, in a derivative action that made important law on the scope of the attorney-client privilege, the plaintiff sought to uncover what had happened to substantial corporate funds that had been paid out in questionable transactions. In a deposition taken in that case, a corporate official acknowledged that approximately $50,000 had been paid to the Attorney General of Alabama. Suppose at this point with this evidence in the record, the corporation sought to terminate the action on the grounds that its continuation would stigmatize the corporation and interfere with its method of doing business. I submit that a court that

69. See supra note 17.

70. 430 F.2d 1093 (5th Cir. 1970) (holding that attorney-client privilege could be waived for good cause in a derivative action), cert. denied, 401 U.S. 974 (1971).

71. The former president of First American Life Insurance Co. of Mobile, Alabama, testified that, in return for a $50,000 loan and certain other consideration, the Attorney General of Alabama (who was also the Securities Commissioner of Alabama) had approved a stock offering by the company. See Patrick, Limitations on a Corporation's Claim of Attorney-Client Privilege or Work-Product Privilege in Litigation Between the Corporation and the Stockholders; Garner v. Wolfinbarger and Related Cases in D. Block & J. Solovy, CORPORATE DISCLOSURE AND ATTORNEY-CLIENT PRIVILEGE 405 (PLI 1984). See also Garner v. Wolfinbarger, 56 F.R.D. 499 (S.D. Ala. 1972). Mr. Patrick was the attorney for plaintiffs in this action.
dismissed the action on this justification would in effect be sweeping a half-uncovered scandal back under the rug. Such conduct could well undermine public confidence in the judiciary. Once private disputes are brought into a public courtroom, a limited public interest must be recognized as attaching to the process by which they are resolved. This public interest does not require that every cause of action be litigated to the hilt at whatever the cost to the corporation and its shareholders, but it does necessitate that courts conduct their business in a seemly fashion. If a court is told that bribery is a profitable (albeit illegal) means of doing business and that the corporation has no plans to discontinue these practices, that court is morally compromised if it thereupon dismisses the action.

The difficult issue then is how to permit the court to protect its own integrity without requiring it to resolve disputes involving asserted public policies that a shareholder owning a single share and having ulterior motives might wish to see enforced. The derivative action is clearly a poorly adapted mechanism by which to resolve disputes involving, for example, environmental, civil rights, or labor laws. Yet, unless some dividing line is recognized, it might be possible to dress up disputes that fundamentally involved these issues as derivative actions in order to focus liability on directors who will typically be more risk averse than their firm. What distinguishes the Garner case discussed above from some hypothetical derivative action alleging environmental violations or employment discrimination is that the defendants in Garner appeared to have engaged in conduct that both injured shareholders and disregarded the most basic norms of accountability by perpetuating a fraudulent system of accounting. Thus, I believe that, properly interpreted, a standard that precluded termination when it would "frustrate a legal rule that operates for the protection of shareholders" would require a court to hear the merits of a Garner type case; yet, this same standard would permit early dismissal in a case where the claimed violation of laws involved employment discrimination, labor, or environmental statutes. This is not to say that any form of knowing illegality that causes or threatens loss to the corporation is beyond the reach of the derivative action, but only that in cases outside the scope of the foregoing "frustration" exception, the court may permit an early termination based on grounds advanced by the special-litigation committee and the court is not compelled to inquire fully into the merits of the action.

2. The Ceiling on Due-Care Liability

The proposal made in Tentative Draft No. 1, that a relatively low ceiling be placed on the liability of corporate officials for negli-
gence, has encountered considerable opposition — symptomatically, both from those who favor and oppose liability for negligence. That strange bedfellows have united to criticize this idea illustrates the "fear of articulation" theme that has characterized much of the opposition to the ALI's Corporate Governance Project. For example, a committee of the American Bar Association has opposed a low ceiling on liability, worrying that such a ceiling might make courts more prepared to find liability. Yet, if this curious logic were followed to its conclusion, those who wish to minimize the likelihood of liability for negligence should propose capital punishment as the penalty for negligence. Conversely, Professors Brudney and Cox have correctly recognized that any such ceiling reduces the expected recovery and therefore the proposal would facilitate the termination of due-care cases by the special-litigation-committee device.

Who is correct — the ABA Committee or Professor Cox who worries that such a ceiling would abolish all liability for negligence? In fact, both have a piece of the answer, but in each case they have not considered the full implications of the proposal. Conceivably, a ceiling on liability might, in some instances, make a court more prepared to impose liability because it would not have to impose potentially crushing liability on individuals who did not appear culpable in the usual sense of that term. I will not dwell on this judicial nullification thesis — that courts are reluctant to impose penalties that are disproportionate to the actor's culpabil-

72. Professor Cox opposes the ceiling because it would reduce liability for negligence. Conversely, the Committee on Corporate Counsel of the American Bar Association has recently prepared a report, which was approved by the Section of Litigation of the ABA, that argues against the ceiling on precisely the opposite grounds: that it would increase the prospect of liability for negligence. See American Bar Association, Section of Litigation's Consolidated Comments to the American Law Institute Project on "Principles of Corporate Governance: Analysis and Recommendations," 250-56 (1984) [hereinafter cited as ABA, Section of Litigation's Consolidated Comments]. The report argues that "the imposition of a ceiling would... have precisely the detrimental effects on our business and economic system which the Reporters now say can only be avoided by its adoption, i.e., a decreased willingness of independent directors to serve and excessive risk aversion by all corporate officials in the decisionmaking." Id. at 256. This position wholly ignores the effect of the ceiling on the termination decision for which the court must balance the probable recovery (necessarily diminished under a ceiling) against the expenses to the corporation from the action's continuation; termination also becomes easier when the expected recovery is reduced by a ceiling. In addition, a ceiling also creates a disincentive for the plaintiff's attorney to litigate due-care cases, because a lower recovery implies a lower attorney's fee. Professor Scott also seems to have missed this point. His only comment about the ceiling is that it will reduce the derivative action's "compensatory potential further." Scott, supra note 3, at 936 n.36. Yet, from his perspective, this is more a virtue than a vice.

73. See supra text accompanying note 1. Given that a ceiling on liability for innocent misrepresentation under Rule 10b-5 was broadly welcomed in the ALI's Federal Securities Code, see infra note 85, this reaction seems reflexive and unthinking.

74. See ABA, Section of Litigation's Consolidated Comments, supra note 72, at 250-56.

75. Brudney, supra note 1, at 230 n.29, 232, 241; Cox, supra note 3. Professor Brudney characterizes us as having proposed only an "iron lung... in which to preserve the increasingly moribund derivative suit...." Brudney, supra note 1, at 232.
ity — because I have developed it elsewhere.76 Apparently, the ABA Committee and others have found this argument so persuasive that they are scared of the ceiling. Yet, even if this possibility is conceded, imposing a ceiling does not therefore make the status of the director more risky. Any increase in the risk of an adjudication of liability should be more than offset by a decrease in the magnitude of the sanction. If we assume that directors are risk averse (which means technically that they fear a combination of severe penalties coupled with a low probability of their imposition more than they fear an alternative combination of more modest penalties coupled with a higher probability of imposition),77 then the impact of a ceiling would be to mitigate the deterrent threat focused on the risk averse director, even if the combination of probability and severity levels yielded the same product.

Professor Cox opposes this proposal that the law not resort to threatening penalty levels for liability for negligence. He observes, as Council Draft No. 5 explicitly states, that a ceiling would facilitate the termination of due-care actions because it would reduce the expected recovery that the court would consider in determining whether the action's costs exceeded its expected recovery.78 However, this reduction would be marginal, and it is a serious overstatement to view a ceiling as equivalent to the abolition of financial penalties for the duty of due care.

Three reasons support this assessment. First, because a ceiling would be computed against the liability of each individual defendant, the total recovery to the corporation would be the product of

76. See Coffee & Schwartz, The Survival of the Derivative Suit: An Evaluation and Proposal for Legislative Reform, 81 COLUM. L. REV. 261, 309 (1981). Although the ABA Section of Litigation's Consolidated Comments, supra note 72, has used this same argument to support its thesis that a ceiling would increase the prospect of liability for negligence, it confuses apples and oranges in doing so. A ceiling might well result in a few more reported decisions imposing liability, but one cannot judge the total impact of the change from this ex post perspective. Instead, from an ex ante perspective, one must look at the impact on the incentive held out to the plaintiffs' attorney to litigate such cases, which would be reduced, and at the impact on the termination decision where a reduced prospective recovery implies easier judicial dismissal.

77. To understand this point, consider the following investment alternatives: an investment having a 10% chance of yielding a return of $1,000,000 and a 90% chance of a zero return; and an investment having a 100% chance of yielding a return of $100,000 (but no higher). To the risk neutral investor, both alternatives are equal because they each have a discounted present value of $100,000. The risk preferrer would opt for the first, whereas the risk-averse investor would prefer the second. If we assume that directors are risk averse (an obvious assumption that need not be defended here), they would prefer a world in which the possible financial liability was greatly reduced, even though its imposition was made correspondingly more likely, than a small risk of astronomic liability — even if the two legal regimes had an equivalent deterrent value to the risk neutral individual.

the ceiling times the number of defendants held liable. Whatever the level of the ceiling, this amount will frequently be substantial enough to exceed the expected litigation costs. Second, in most "real world" instances at least one defendant will have allegedly breached a duty of loyalty or would otherwise be ineligible for the ceiling; this also increases the total expected benefit and prevents automatic termination of all actions alleging due-care violations. Third, as proposed, the ceiling would not apply to several categories of due-care violations: (i) a "knowing violation" of law; (ii) reckless behavior in which there was a "conscious disregard or indifference to the defendant's duties to the corporation"; (iii) "a sustained and unexcused pattern of inattention that amounted in substance to an abdication of the defendant's duties to the corporation;" and (iv) transactions in which the defendant or an associate received an "improper benefit." One can, of course, debate the phrasing of these exceptions, but I believe they essentially cover the limited number of decisions, such as Francis v. United Jersey Bank, in which courts have actually imposed substantial liability. In this sense, the proposal is less revolutionary than it first appears and is essentially a "restatement" of the existing reality of judicial behavior.

At the same time, a ceiling on due-care liability should have the following desirable impacts. First, it should reduce the leverage that the typically high damages involved in most serious errors of business judgment would give a plaintiff if we were to enforce the duty of due care as Professor Cox proposes. The perverse irony is that it is precisely in those instances that we least need a litigation remedy (i.e., situations involving arm's length business errors such as manufacturing the Edsel, excessive bank lending to third world countries, or mistaken decisions to start a new product line) that the damages are typically the highest, and that the plaintiff would thereby have the greatest leverage to compensate for the inherent weakness of his case.81

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79. Council Draft No. 5, supra note 5, § 7.17(a). This is only proposed language that has never been approved or discussed by the Council of the American Law Institute. It is quoted here only to give a clear sense of the proposal criticized by Professor Cox in his piece.

80. 87 N.J. 15, 432 A.2d 814 (1981). Francis arose out of behavior far from ordinary negligence, as members of the defendant's family looted the bank by making illegal loans. One may reasonably infer that the behavior of the defendant in Francis (who was the mother of the individuals who looted the bank in addition to being the remaining director) amounted to recklessness.

81. Absent a ceiling, the directors of a public corporation that has experienced a major financial crisis might easily be alleged to have negligently made or tolerated decisions that resulted in a $500 million loss. Assume that there is only a 5% chance of obtaining a plaintiffs' verdict at trial (although in a jury trial this may be overly conservative), on these facts, the product of the possible recovery times the probability of such a recovery here is $25 million. This amount is well in excess of the likely costs of the action. Because the formula announced in Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982), cert. denied, 406 U.S. 1051 (1983), instructs the court to determine whether the "likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action . . . ", id. at 892, the impact of such a formula is to require the continuation of this action,
Second, the cost of liability insurance to directors and officers (which is generally borne by the corporation) would be reduced because exposure would be lessened. Although directors' and officers' insurance today mitigates the risk-aversion problem, it is neither a perfect solution (because most insurance policies are surprisingly ambiguous) nor a costless one. Having shareholders bear the cost of insurance that protects directors against paying damages to shareholders seems pointlessly circular. The simpler solution is either to reduce the liability exposure or to insure the corporation directly against negligent acts of its agents.

Third, reduced damages also implies reduced attorneys' fees for plaintiffs' attorney in due-care cases. Such a legal rule provides an incentive to the plaintiffs' attorney to focus on duty-of-loyalty cases.

Fourth, a ceiling protects corporate officials in circumstances in which even an absolute right in the board to terminate derivative litigation would fail to provide protection. For example, the board's existence does not survive bankruptcy (when the trustee in bankruptcy can and recently has instituted suit on due-care grounds) and the composition or loyalty of the board is no longer certain in a corporate marketplace where hostile takeovers have become very common.

Finally, there is a less obvious impact of a ceiling on due-care liability: it protects the law's traditional insistence that the disgorgement of unjust enrichment not be funded through insurance. Directors' and officers' insurance policies today typically

even though most would regard it as frivolous. Moreover, if the firm were in receivership, no board would exist that could reject demand and seek dismissal. See infra note 82. In this light, the impact of a ceiling is far more significant and quite different than the hasty assessment the ABA Committee suggests. See supra note 72.

82. See, e.g., Meyers v. Moody, 693 F.2d 1196 (5th Cir. 1982), cert. denied, 104 S.Ct. 287 (1983). In Meyers, a substantial jury verdict on theories of both gross negligence and ordinary negligence against a former chief executive officer of a bankrupt firm was sustained on appeal by the Fifth Circuit. As I read Meyers, the defendant did not appear to have received or sought any improper benefit from his firm, but simply accepted high risks.

83. For example, in the aftermath of a recent control contest at GAF Corporation, derivative actions were pending against the ousted former management. Attorneys for the corporation have informed me that the incoming board has decided not to oppose these derivative actions maintained by shareholders against the prior management, but will seek to take the actions over. Similarly, in the wake of the debacle at Continental Illinois, the board has also decided not to oppose derivative actions commenced against former officials of that corporation. See Williams, Continental Cites Lax Lending, N.Y. Times, July 23, 1984, at D1, col. 6 (Continental Illinois special litigation committee favors continuation of action against three middle echelon officers and dismissal against others).

84. The common law of insurance has long precluded insurance of punitive damages, fines, penalties, and the gains from misconduct. Northwestern Nat'l Casualty Co. v. McNulty, 307 F.2d 432 (5th Cir. 1962). Some state statutes expressly preclude insurance of any liability that results from an adjudication that a corporate official
exclude liability based on self-dealing or improper benefit. As a result, the parties may find it in their mutual interest to recharacterize a duty-of-loyalty claim as a duty-of-care claim in order to obtain access to insurance that can fund settlement. But such recharacterization undercuts the deterrent threat necessary to prevent improper self-dealing and thus gives rise to a "moral hazard" problem. However, once a ceiling is placed on liability for due care it becomes much less possible to convert a loyalty claim into a due-care claim for purposes of funding the settlement because the liability would often exceed the low ceiling on the duty of care. In this light, a ceiling guards the common law's traditional refusal to permit insurance for self-dealing.

Still, the proposal for a ceiling will strike many as unorthodox and therefore undesirable. After all, it may be argued, other professionals, including doctors and lawyers, face the threat of liability without the benefit of a ceiling. But the analogy between directors and professionals is imperfect because it overlooks two basic distinctions. First, doctors and other professionals are entrepreneurs who factor into their price a cost to cover this risk of liability. At least with respect to directors, it is doubtful that many have agreed to bear this risk; rather, they may see themselves more as part-time volunteers than as risk-taking entrepreneurs. Second, although the need for compensation is urgent for the patient injured by malpractice, it is considerably weaker in the case of the shareholder, who can, after all, diversify his portfolio.

Given that the argument for a ceiling is strong, where should the level be set? Tentative Draft No. 1 used a $200,000 level, borrowing it from section 1708(c)(2) of the ALI's Federal Securities Code, which basically used this level to limit liability for a non-trading defendant who was sued under the Code's equivalent to Rule 10b-5. The original approach taken in Tentative Draft No. 1 sought only to piggyback on a prior compromise in recognition that the same conduct could be attacked often under either a due-care or a federal-securities-law theory of liability. For example, a corporate official who prepares a misleading press release has in effect committed a due-care violation. Presumably, his liability should be the same whether he is sued under the Federal Securities Code or the state law duty of due care.

Concededly, a serious problem with the approach taken in Tentative Draft No. 1 is that any fixed ceiling is necessarily arbitrary and lacks a conceptual foundation. Furthermore, over time a fixed ceiling will be trivialized by the impact of inflation. The current proposal in Council Draft No. 5 therefore attempts a more
flexible ceiling that also has a firmer conceptual underpinning.\textsuperscript{86} It proposes that the measure of damages for a due-care violation should be determined not by a tort formula (i.e., all damages proximately caused by the breach) but by a contract formula.\textsuperscript{87} If one looks to contract law, two analogies suggest themselves. First, the law of restitution suggests that a negligent director would receive unjust enrichment if he were allowed to retain the director's fee that he was paid in order to exercise reasonable care. Section 373 of the \textit{Restatement (Second) of Contracts} provides that a defaulting party can be required to restore any benefit received as a result of partial performance.\textsuperscript{88} Here, by analogy, the director's fee can be said to be a benefit received in a situation in which the promised services were not adequately performed. On this theory, the director's liability should be to return the benefit.

The law of restitution implies only that a director's compensation can be an element of damages, not that damages are limited to this amount. The doctrinal basis for suggesting that damages should be limited to this amount comes from section 351(3) of the \textit{Restatement (Second) of Contracts} which provides that a court "may limit damages for foreseeable loss by excluding recovery for loss of profits ... or otherwise, if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation."\textsuperscript{89} The official comment to this section indicates that the "fact that the [benefit received by the defendant] ... is relatively small suggests that it was not intended to cover the risk of such liability."\textsuperscript{90} Few would argue that annual directors' fees were computed on the assumption that directors agreed to be insurers.

\textsuperscript{86} See Council Draft No. 5, supra note 5, § 7.17. Professor Cox does not discuss specifically Council Draft No. 5, which was not available to him at the time he wrote. Again, this draft, like Council Draft No. 3, has not been approved by the Council of the American Law Institute, and is only a proposal.

\textsuperscript{87} Others had argued earlier against a mechanical application of the traditional tort rule of damages to the context of due-care liability. See Conard, \textit{A Behavioral Analysis of Directors' Liability for Negligence}, 1972 Duke L.J. 895, 913-15 (damages should be limited by what a prudent director would risk).

\textsuperscript{88} \textit{RESTATEMENT (SECOND) OF CONTRACTS} § 373 (1981). Section 373, "Restitution When Other Party Is In Breach," provides that "the injured party is entitled to restitution for any benefit that he has conferred on the other party by way of part performance or reliance." \textit{Id.}

\textsuperscript{89} \textit{Id.} § 351(3).

\textsuperscript{90} \textit{Id.} at comment f ("Other Limitations on Damages"). For decisions supporting this rule that the extreme disproportion of the damages in relation to the benefits of the contract may be considered, see Lamkins v. International Harvester Co., 207 Ark. 637, 640, 182 S.W.2d 203, 205 (1944); Kerr S.S. Co. v. Radio Corp. of America, 245 N.Y. 284, 287-92, 157 N.E. 140, 141-43, \textit{cert. denied}, 275 U.S. 557 (1927); Newsome v. Western Union Tel. Co., 153 N.C. 153, 154, 69 S.E. 10, 11 (1910). Another factor cited in these decisions is the absence of a formal contract in which the defendant assumed such liability. This factor also favors the corporate official as defendant because I doubt any director has executed such a contractual assumption of liability in favor of the corporation he serves.
for business losses. As a result, section 351(3) can be read to suggest that imposing the full measure of the losses upon directors would result in "disproportionate compensation." 91 Accordingly, the currently pending section 7.17 of Council Draft No. 5 proposes that a corporate official's liability for negligence be limited to his "direct compensation received from the corporation during the corporate fiscal year in which the violation principally occurred." 92 Losses equal to this amount would still have to be proven by the plaintiff, however, because section 7.17 is only a ceiling and not a penalty.

This formula, of course, imposes higher liability on inside directors and managers than on outside directors, but such a differential is also logically related to the probable difference in their level of risk aversion and to the degree to which they occupy a truly entrepreneurial position. The ceiling would also be subject to the same exceptions as previously noted for knowing violation of law, conscious recklessness, abdication of duty and improper benefit. 93 Doctrinally, the argument for using a contract measure of damages rests on the assertion that the corporation is, itself, a creature of contract (to be sure, one to which the state is a necessary party). Nothing in statutory law compels the conclusion that a legislature ever choose a tort formula (especially in view of the paucity of decisions that have ever sought to compute damages for a due-care violation). But, the troubling issue is how this established tort formula can be replaced by the more appropriate contract measure of damages, given that legislation is not likely to be soon adopted in most states. My own view is that charter amendments provide the most logical means of implementation. To be sure, this avenue of reform is fraught with peril, for once Pandora's box is opened, it may lead to attempts to adopt other less justifiable limitations on damages, including those that purport to limit damages for duty-of-loyalty violations. Although a host of issues arise here that the ALI's proposals do not at present address, I believe that a sophisticated court would accept a self-imposed limitation on liability for negligence so long as it did not purport to cover reckless or knowingly illegal behavior. 94 Thus, the practical rele-

91. Restatement (Second) of Contracts § 351(3) (1981).
92. Council Draft No. 5, supra note 5, § 7.17(b). This phrase "direct compensation" would not include stock option appreciation (from options awarded in prior years) or pension plan contributions. This formula would obviously vary the level of damages in proportion to the director's or executive's status within the corporation.
93. See supra text accompanying note 79.
94. Case law has only infrequently considered the issues raised by a provision in the corporation's certificate of incorporation that sought to reduce the potential liability of a fiduciary. Typically, the issues that have arisen involved the scope of the duty owed by the fiduciary and not the extent of the damages obtainable for a breach. In Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (1952), the Court upheld a charter provision that specified that, in the absence of fraud, a transaction with an interested director was not invalidated by the presence of interlocking directors, and that further authorized the vote of the interested directors to be counted for purposes of a quorum. Id. at 310, 93 A.2d at 117. Unsurprising as this specific result is, it is highly relevant here that the court announced a relatively lenient standard for re-
view of charter provisions that deviated from traditional common law standards. Essentially, it viewed the enabling provisions of the Delaware corporate law as permitting any provision to be placed in a charter, except those that “achieve a result forbidden by settled rules of public policy.” Id. at 312, 93 A.2d at 118. Although it wisely declined to address what the term “public policy” incorporated, it clearly indicated that the term was not coextensive with the common law:

[W]e say that the stockholders of a Delaware corporation may by contract embody in the charter a provision departing from the rules of the common law, provided that it does not transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation Law itself.

Id. Is the standard tort measure of damages such a “public policy settled by the common law?” I think not for several reasons. First, the common law of trusts has historically permitted a trustee to contract to relieve himself of liability for negligence but not for breaches of duty that were in bad faith, intentional, or recklessly indifferent to the interests of the beneficiary. See RESTATEMENT (SECOND) OF TRUSTS § 222 (1959). This line between negligence and recklessness is precisely that recognized by the ceiling proposed by section 7.17. In addition, the case law has repeatedly upheld indemnification agreements by which one party agrees to hold another harmless from the consequences of the latter’s own negligence, despite the evident “moral hazard” problem that arises in this context. See Simon v. Corbetta Constr. Co., 391 F. Supp. 708, 709 (S.D.N.Y. 1975); Levine v. Shell Oil Co., 28 N.Y.2d 205, 211-13, 269 N.E.2d 794, 801-03, 321 N.Y.S.2d 81, 85-87 (1971); Dillon v. Riverso Constr. Co., 39 A.D.2d 744, 745, 332 N.Y.S.2d 432, 433 (N.Y. App. Div. 1972), aff'd, 33 N.Y.2d 530, 301 N.E.2d 422, 347 N.Y.S.2d 494 (1973). According to the New York Court of Appeals, such contracts will be strictly construed, but they are valid unless there is evidence of “fraud or over-reaching conduct.” Levine v. Shell Oil Co., 28 N.Y.2d at 213, 269 N.E.2d at 803, 321 N.Y.S.2d at 87. One recent federal case has even enforced such an agreement absolving one party of liability for negligence in a case explicitly involving a claimed breach of fiduciary duty. See Quintel Corp., N.V. v. Citibank, N.A., [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,819, at 90,117 (S.D.N.Y. 1984) (where bank had absolved itself of liability for negligence by contract with its limited partners, plaintiff could not maintain an action for “conduct less than gross negligence or willful misconduct.” Id. at 90,119. Thus, the common law seems to permit contractual exculpation, except in cases involving self-dealing, fraud or egregious incompetence (whether described as “gross negligence” in Quintel or “recklessness” in the Restatement of Trusts), and in these cases the ceiling in section 7.17 would not apply in any event.

95. This has been the valuable use to which the American Bar Foundation’s Commentaries on Indentures (1971) has been put, and the same arguments apply to any exculatory provision limiting liability for negligence. As the fifth circuit noted in Broad v. Rockwell Int’l Corp., 642 F.2d 929, 943 (5th Cir.), cert. denied, 454 U.S. 965 (1981):

A large degree of uniformity in the language of debenture indentures is essential to the effective function of the financial markets: uniformity. . . . is what makes it possible meaningfully to compare one debenture issue with another, focusing only on the business provisions of the issue . . . without being misled by peculiarities in the underlying instruments. See also Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1038, 1048 (2d Cir. 1982), cert. denied, 460 U.S. 1012 (1983) (“Uniformity in interpretation is important to the efficiency of the capital markets”). Put simply, we economize on the monitoring costs that both courts and shareholders would incur (and we reduce the uncertainty for defendants as to the validity of such provisions) if an acceptable boilerplate provision limiting directorial liability could be commonly accepted and given a uniform interpretation by courts.
of the safe harbor that section 7.17 would offer, but these individually tailored provisions should receive closer judicial scrutiny because there is little basis for believing that shareholders could effectively monitor them. In particular, little confidence should be placed on limitations adopted in the original certificate of incorporation to the extent that they immunized corporate officials from any liability to shareholders for due-care violations. At this point, traditional contract principles, such as those applicable to contracts of adhesion, would become relevant, and a sophisticated court could use them to reach a just result under the circumstances. These issues, however, present a topic for another day.

Conclusion

My response to Professors Scott and Cox may sound as if we share little common ground. In fact, as I read them, we largely agree on the major issue that today is in dispute in most courts concerning derivative litigation: whether a derivative action should be dismissed on the board’s recommendation without substantive review by the court. Professor Cox has explicitly rejected the demand-required, demand-excused test, which, after the Delaware Supreme Court’s decision in Aronson, threatens to undercut the basic logic of its earlier decision in Zapata. Professors Scott and Brudney clearly also concur on this point. Indeed, in all the recent outpouring of articles on derivative litigation, I have yet to find a serious academic effort to justify this formalistic distinction. Thus, rather than conclude on a note of discord, I think it best to end by stressing the consensus that appears to exist within the academic legal community. Among both those writing in the “law and economics” mode of discourse and those whose orientation is toward the traditional law of fiduciary duties there is a common recognition of the need for an effective litigation remedy as part of an overall system of corporate accountability. The dispute among us is limited to the subsidiary question of what duties should be so enforced and to what extent. At one end of the continuum, some would limit the operation of a litigation remedy to the protection of the market for corporate control, whereas at

96. See Aronson v. Lewis, 473 A.2d 805 (Del. 1984). In Aronson, the court held that the justification for dismissal advanced by a duly qualified special litigation committee could only be reviewed by the court in those circumstances where demand on the board was excused on grounds of its futility. Id. at 818. Because the defendant owned 47% of the corporation’s stock and allegedly controlled the board, this holding may trivialize the original result in Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). Prior to Aronson, some federal courts had declined to read Zapata as placing dispositive emphasis on the demand required, demand excused distinction. See In re Continental Illinois Securities Litigation, 572 F. Supp. 928 (N.D. Ill. 1983); Mills v. Esmark, 544 F. Supp. 1275, 1282-84 (N.D. Ill. 1982). For a subsequent refinement of Aronson’s formula, see Pogostin v. Rice, 480 A.2d 619 (Del. 1984).

97. There are, of course, those who largely reject the need for a litigation remedy, preferring to rely on market-based remedies. See Fischel, supra note 11, at 1272, 1292. But the weight placed by Aronson on the formality of the demand required, demand excused distinction has, to my knowledge, no serious academic support.

98. Even Professor Fischel, as I read him, would accept the need for a litigation
the other end, some, including Professor Cox, would use it to enforce the duty of care. Although I tend to agree with those who believe that a distinction should be drawn between the duty of care and the duty of loyalty in terms of the reliance placed on litigation as a remedy, but the larger point is that virtually all concur on the desirability of a litigation remedy for some contexts.

This consensus stands in sharp opposition to those who continue to becloud the issue of proper scope of a litigation remedy with a smokescreen of diversionary topics such as vivid, if apocryphal, stories about "strike suit" attorneys, vague references to the Japanese success without litigation, or paeans to the superior wisdom of independent directors. Those who so argue always glide over the distinction between loyalty and care, and present all litigation as an attempt to second guess the business decisions of disinterested directors. In fact, except for a brief spurt of litigation over "illegal payments" in the 1970s, due-care litigation has been only a small tail on a much larger dog. The real world of derivative litigation (to the extent that it survives) typically involves takeover defense tactics, greenmail, golden parachutes, and intra-corporate transactions between parent corporations and partially owned subsidiaries. Here, a monitoring mechanism is needed, because these are anything but ordinary business transactions, and they are frequently beyond the effective reach of market-based remedies.

The basic reality of the litigation remedy then is sufficiently simple as to be almost academically uninteresting. Once a derivative action is consigned to the tender mercies of a special litigation committee, its fate is predictable: almost invariably, the independent directors vote to terminate it. Thus, the central issue not debated here between Professor Cox and myself, but central to

remedy to remove impediments to the free operation of the market for corporate control. See Fischel, supra note 11, at 1290-91. The derivative action is the most logical, although not the exclusive, route to this end.


100. Professor Cox has undertaken the valuable task of cataloguing the results reached by special litigation committee reports. In his last study, he found only one instance in which the committee had not recommended termination against all defendants. See Cox, Searching for the Corporation's Voice, supra note 3, at 963 nn.13-14. In the lone case he cites, Joy v. North, 692 F.2d 880 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983), termination was recommended against a majority of the defendants, but the Second Circuit reversed this result. Since then, the Continental Illinois committee recommended continuing the action against certain defendants (none of them senior officials). See supra note 83. However, the trial court in this case also rejected the recommendation. See In re Continental Illinois Securities Litigation, 572 F. Supp. 928 (N.D. Ill. 1983). Most recently, Chase Manhattan Bank has, itself, commenced suit against six former officers, including two former executive vice presidents, for losses incurred by those in connection with the Penn Square Bank failure. Chase alleges, however, that the conduct of the former officers knowingly
the ALI's Corporate Governance Project and illustrative of the need for that Project, is the relevance of the experience of special litigation committees. In fashioning legal rules, should we take note of this experience or ignore it and begin instead by deducing our answer from the traditional premise that the business and affairs of the corporation are to be managed by its board of directors? Sound as the business judgment rule basically is, reliance on it here is misplaced once we recognize that the duty of loyalty has always been exempt from the business judgment rule. Even more important than the doctrinal error in attempting to expand the business judgment rule into this area is the fallacious methodology involved in this approach. Unless we are to reject all that we have learned from the Legal Realists, an approach that simply seeks to derive conclusions deductively from first principles is misguided. The standards of the ALI's Project in this area instead proceed from an inductive starting point: that the life of the law has not been logic but experience. All experience with the special litigation committee strongly suggests that there is need for close judicial oversight of its performance. On this less than revolutionary premise, Part VII of *Principles of Corporate Governance: Analysis and Recommendations* will either stand or fall.

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violated explicit internal credit policies that the bank had long established. See Glaberson, *supra* note 40. In this light, the Chase action is not a negligence based action.

101. As Professor Buxbaum has cogently argued, state law has generally permitted a court to review the substantive fairness of a self-dealing transaction (to varying degrees) and has given very little weight to a retrospective ratification of such a transaction by even disinterested directors. The decision to terminate is the functional equivalent of a retrospective ratification and should not therefore receive substantially dissimilar treatment. See Buxbaum, *Conflict of Interest Statutes and the Need for Demand on Directors in Derivative Actions*, 68 Calif. L. Rev. 1122, 1125-27 (1980). This argument is seldom, if ever, addressed by the proponents of the Aronson rule.