ARTICLES

When Are Shareholder Suits in Shareholder Interests?

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I. INTRODUCTION

Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers.[1] Such suits often allege that an officer or director has breached his duty of loyalty; in other words, that the manager has effectively "cheated" the company by self-dealing, accepting kickbacks, appropriating a corporate opportunity, wasting corporate assets, or entrenching his position to avoid removal. Less frequently, because the odds of success are lower, shareholder suits assert that an officer or director has breached his duty of care by harming the corporation through his negli-

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1. We focus here on American law. Many foreign jurisdictions also allow shareholder suits against corporate officers and directors. For example, most common law jurisdictions and Japan permit derivative suits. *See* 1 PALMER'S COMPANY LAW 976-86 (Clive M. Schmitthoff ed., 24th ed. 1987) (Great Britain); BRUCE L. WELLING, CORPORATE LAW IN CANADA 502-17 (1984) (Canada); H. Shimizu, Derivative Suit: Japan and the U.S. (May, 1991) (unpublished paper, on file with the authors). In addition, many civil law jurisdictions also allow other forms of suit in exceptional cases. *See* Klaus J. Hopt, *Directors' Duties to Shareholders, Employees, and Other Creditors: A View from the Continent*, *in* COMMERCIAL ASPECTS OF TRUSTS AND FIDUCIARY OBLIGATIONS 129-30 (Ewan McKendrick ed., 1992) (surveying actions). For example, French shareholders may enforce management liabilities through the *action social*, and 10% or more of German shareholders may formally demand that the corporation's supervisory board undertake such actions. Bernhard Grossfeld, *Management and Control of Marketable Share Companies*, *in* 8 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW ch. 4, 108-11 (G. Alfred Conrad ed., 1973). Nevertheless, shareholder suits are far more important in America than elsewhere, in part for procedural reasons and in part because American provisions for compensating plaintiffs' legal costs are generous by international standards. *See infra* text accompanying notes 31-32 (explaining U.S. contingency fee rules); Ian Ramsay, *Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action*, 15 U. NEW S. WALES L.J. 149, 163-64 (1992).

gent—or grossly negligent—failure to exercise appropriate business judgment.[2]

The procedural form of a shareholder suit depends on whether managers are said to have harmed the corporation or instead its shareholders in the first instance. In the usual case, where the injury is corporate (for example, where directors are accused of self-dealing), a shareholder must sue "derivatively" on behalf of the corporation. If a derivative suit succeeds, any recoveries go to the corporation, while the plaintiff-shareholder (or his attorney) receives legal fees from the company that typically exceed the out-of-pocket costs of prosecuting suit.[3] Sometimes, however, a manager's breach of duty injures shareholders directly—as, for example, where directors are alleged to have wrongfully approved the sale of the company at an unfair price. In this case, a public shareholder can sue directly as the named plaintiff on behalf of the shareholder class, and any recoveries will go to the plaintiff class directly rather than to the corporation.[4]

The legal rules that currently govern both forms of shareholder suits are widely discussed and frequently criticized in the legal literature. Many authors have explored the related problems of frivolous shareholder suits ("strike suits") and of "sweetheart" settlements between plaintiffs' attorneys and corporate defendants that disregard the interests of the corporation and the shareholder body as a whole.[5] Partly in response to these

2. *See* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Director and Officers*, 77 YALE L.J. 1078, 1099 (1968) (director liability for negligence uncomplicated by self-dealing is very rare). Although duty of care actions have been more common during the past decade, it remains difficult to overcome the board's business judgment defense. *See* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE 64-94 (4th ed. 1993).

3. *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW 659-62 (1986) (fee awards).

4. The boundary between derivative and direct suits follows a hazy legal distinction between separate "corporate" and "shareholder" interests. Typical direct actions for fiduciary breach involve shareholder voting rights, dividend policy, or transactions that cash out public shareholders. *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01, cmt. c (Proposed Final Draft 1992) [hereinafter ALI PRINCIPLES]. Most other claims of fiduciary breach (which includes the majority of all claims) are derivative. This distinction has practical import because derivative actions face more rigorous screening than direct actions. *See infra* Part IV.

Note, however, that shareholders may bring direct actions against managers for violations of the disclosure requirements of the federal securities statutes. Indeed, a disputed transaction of this nature often supports both a derivative suit for breach of fiduciary duty and a shareholder class action alleging disclosure violations.

5. Professor John Coffee is the most prominent analyst of these issues and the complex agency problems that arise in shareholder litigation. *See generally* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in Large Class Actions*, 54 U. CHI. L. REV. 877 (1987) [hereinafter *Entrepreneurial Litigation*]; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (1985) [hereinafter *Unfaithful Champion*]; John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986) [hereinafter *Understanding the Plaintiff's Attorney*]. Several commentators have made innovative recent

problems, commentators have also addressed the comparative competence of courts and corporate boards to screen shareholder suits.[6] Finally, there is a promising new literature on the empirical effects of such suits on corporate performance.[7]

Somewhat surprisingly, however, few authors have investigated the fundamental relationship of shareholder suits to shareholder welfare. Shareholder suits are generally acknowledged to generate both significant corporate costs and significant potential benefits. Yet, except in the context of discussing fee awards to plaintiffs' attorneys, almost no one has explored how these opposing effects compare.[8]

We undertake such an inquiry here, with particular attention to derivative suits against corporate managers. The central contribution of our article is the development of a model contrasting the circumstances in which derivative suits tend to increase corporate value with those in which

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contributions to this literature. *See* Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) (arguing that settlement amounts in securities law class actions do not reflect underlying merits of the suits); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (suggesting that the nature of such suits compels a reexamination of current law).

6. *See, e.g.,* John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981) (suggesting a legislative response to court-imposed standing requirements); George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 NW. U. L. REV. 96 (1980) (discussing director prerogatives as obstacles to derivative litigation). Much of the controversy surrounding the successive revisions of the ALI Corporate Governance Project, at least with respect to derivative suits, turns on the relative merits of courts and boards as evaluators of suits. *See, e.g.,* Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503 (1989).

7. Professor Roberta Romano's recent investigations are the most sophisticated studies to date. *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155 (1990) [hereinafter *Aftermath*] (examining the effect of the director and officer insurance crisis on the ability of boards to protect shareholder interests); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991) [hereinafter *Shareholder Suit*] (examining shareholder suits over the past two decades in order to assess the efficacy of litigation as a tool for aligning shareholders' interests with managers' incentives). Other studies examine the effects of shareholder litigation on share prices. *See* Mark L. Cross et al., *The Impact of Directors and Officers' Liability Suits on Firm Value*, 56 J. RISK & INS. 128 (1989); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 277-83 (1986) (examining market reaction to shareholder litigation decisions); Vahan Janjigian & Paul J. Bolster, *The Elimination of Director Liability and Stockholder Returns: An Empirical Investigation*, 13 J. FIN. RESEARCH 53 (1990); *see also* Bryant G. Garth et al., *Empirical Research and the Shareholder Derivative Suit: Toward a Better-Informed Debate*, 48 LAW & CONTEMP. PROBS. 147 (1985) (reviewing pre-1985 empirical work).

8. Two exceptions, discussed *infra* note 9, are A. F. Conard, *Winnowing Derivative Suits through Attorneys Fees*, 47 LAW & CONTEMP. PROBS. 269 (1984), and Charles J. Goetz, *A Verdict on Corporate Liability and the Derivative Suit: Not Proven*, 71 CORNELL L. REV. 344 (1986).

the immediate incentives of self-interested shareholders will lead them to bring derivative suits.

As we develop below, a derivative suit increases corporate value in two circumstances: if the prospect of suit deters misconduct or, alternatively, if the suit itself yields a positive recovery net of all costs that the corporation must bear as a consequence of suit. These are the circumstances in which suit is in the interest of the corporation. But we find that *a shareholder's interest in bringing suit can diverge from the corporation's interest in either direction.* On one hand, a shareholder may rationally decide not to sue when willingness to do so would raise corporate value. This can occur because, even though suit is discouraged by an expected recovery that is small relative to litigation costs, the prospect of suit would have served to deter costly misconduct.[9] On the other hand, a shareholder may elect to bring a derivative suit when this will be likely to lower corporate value. The reason, in essence, is that the expected recovery from managers that motivates suit may be only an apparent gain for the corporation: it will be offset, at least in part, by increases in liability insurance premia, indemnification payments made by the corporation on managers' behalf, and managerial compensation.[10] Indeed, for these reasons, we demonstrate that under a broad class of regimes for allocating the costs and benefits of derivative suits among shareholders—including the typical American contingent fee regime—shareholder incentives to sue may be either excessive or insufficient, relative to the criterion of maximizing corporate value.[11]

To avoid any misunderstanding, we emphasize at the outset that our analysis of litigation incentives does not imply that the institution of shareholder suits is categorically flawed. Indeed, as we discuss below, identifying the incentive problems in shareholder litigation also suggests possible reform measures. But if the institution of shareholder suits is not intrinsically flawed, many existing (and proposed) legal rules perpetuate the misalignment of incentives that we model here. To highlight the generality of the problem and its locus in the motives of initiators of shareholder litigation, we refer to the parties who decide to initiate suit generically as "shareholder plaintiffs." Under some legal regimes, these

9. Professors A. F. Conard, *supra* note 8, and Charles Goetz, *supra* note 8, make a similar point: they recognize that deterrence of managerial misbehavior does not lead shareholders to bring suit. As their primary concerns are different from ours, however, these authors do not develop the relationship between shareholder incentives and deterrence, nor analyze how shareholder suits affect corporate value by influencing salary and liability insurance expenses (to be explained shortly).

10. Professor Dale Oesterle has previously suggested the illusory character of corporate recoveries funded by indemnification or insurance. Dale Oesterle, *Limits on a Corporation's Protection of its Directors and Officers from Personal Liability*, 1983 WIS. L. REV. 513, 570-73 (1983).

11. Closely related misalignments of incentives to bring suit in the context of torts are emphasized in Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982).

are ordinary shareholders. Under the American regime, they are more likely to be attorneys (with nominal shareholders in tow) in search of legal fees.[12] But both classes of actors may be shareholder plaintiffs in our terminology because both may face similar distortions in their incentives to bring suit as measured by the yardstick of increasing corporate value.[13]

Our model is discussed in Part II of the article and formally presented in an Appendix. In Part III we briefly examine several extensions of and qualifications to the model. In Part IV we turn to a consideration of the legal regimes that actually regulate derivative suits in most jurisdictions. Here we argue that a variety of regulatory devices—notably, relying on the corporate board, the trial court, or the corporate charter to screen derivative suits—cannot, as they are presently administered, fully correct the distorted litigation incentives identified in our model. In Part V we demonstrate that our basic results apply not only to derivative actions against managers but also to many kinds of shareholder class actions, including suits against controlling shareholders. Finally, in Part VI we assess the practicality of reforms that might improve shareholder incentives to bring suit.

II. A Model of Derivative Suits Against Corporate Managers

In this Part, we examine when derivative suits against managers would be expected to increase corporate value in our model. We then show that even though the shareholders' goal is assumed to be the maximization of corporate value, their incentives whether or not to bring suit may not advance corporate value. As we will see, the essential reason for this conclusion is that the decision whether or not to sue is by its nature made only after a wrongful act has been committed, not before.

We stress that the analysis in this Part concerns the rational behavior of shareholders in the world of the model. When we predict that shareholders will behave in a particular way or when we make a judgment about the desirability (or lack thereof) of an outcome, we will be referring in strict logic only to the model. Moreover, the model is spare. It supposes that a corporation is in business for a single period, at the end of which misconduct may or may not be discovered; that all suits are adjudicated; and that managers' salaries adjust to accurately reflect the personal costs and benefits of prospective litigation. (By contrast, we step outside the model in Part III to address how far our qualitative conclusions continue to hold

12. *See* Romano, *Shareholder Suit*, *supra* note 7, at 55.

13. Whether ordinary investors or entrepreneurial attorneys control shareholder litigation clearly affects shareholder welfare in important ways that we do not analyze in this article, for example, by shaping the disposition of plaintiffs to bring frivolous litigation or to accept sweetheart settlements. Such agency problems in shareholder litigation have been widely discussed elsewhere. See *supra* note 5 (collecting sources). But here we address different—and it seems to us, logically prior—distortions affecting decisions to bring shareholder suits.

in a multi-period setting as well as under more realistic assumptions about managerial compensation and the prevailing legal regime.)

A. THE COSTS AND BENEFITS OF DERIVATIVE SUITS TO THE CORPORATION

Whatever the nature of a derivative claim, bringing suit can increase corporate value in two ways. First, successful suit may confer monetary benefits on shareholders: corporations may recover damages from errant managers for past harms and undo or avert corrupt transactions. Second, suit—or, more precisely, the prospect of suit—can add to corporate value by deterring wrongdoing.[14]

On the other hand, derivative suits impose two types of costs on corporations. First, they generate litigation costs. A corporation and its shareholders together must pay for both defending and prosecuting derivative suits—in time and energy, as well as in dollars.[15] Second, derivative suits can raise the expenses that corporations must incur in order to attract managers. In theory, a manager's net return from his job must equal some "reservation" level for him to be willing to work for the corporation.[16] Hence, if managers face a risk of suit, a corporation must either supply them with adequate liability insurance or raise their salaries by an offsetting amount to induce them to stay on the job. Moreover, if the threat of a derivative suit deters misconduct from which a manager would otherwise benefit, the corporation must raise his salary accordingly. Of course, actual adjustments of salary for this reason may not often occur in real markets for managerial services.[17] Nevertheless, for the purpose of clarity, we

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14. We focus here on the benefits of suit for the company where suit is brought. Of course, some suits, once brought, can confer benefits on other companies as well. We address spillover effects of suit at *infra* note 64. *See also* Gil Orion, *The Social Desirability of Derivative Suits* (1993) (unpublished paper, Harvard Law School) (extending model's results to case where misconduct entails positive externalities to third parties).

15. *See* Coffee, *The Unfaithful Champion*, *supra* note 5, at 17-18 (describing the asymmetrical litigation costs of shareholder suits). And even if shareholder suits settle, as most do, litigation costs are still high. Professor Romano's mixed sample of 128 shareholder suits resolved through either court judgement or settlement resulted in settlement rates of 66% and 79% for derivative suits and class actions, respectively, with plaintiff fee awards averaging $1.45 million in monetary settlements (24% of the average settlement fund) and $287,000 in nonmonetary settlements. Romano, *Shareholder Suit*, *supra* note 7, at 63, 70. Average fee awards were much higher for post-1983 settlements. *Id.* at 69 tbl. 4. Moreover, the financial costs of defense appeared to equal or exceed plaintiffs' fee awards in these cases. *Id.* at 65. Finally, because fees were awarded in 60% of the cases, shareholders paid, through the intermediary of the corporation's insurer, both plaintiff and defense costs in most suits. (Corporate directors and officers are rarely required to shoulder their own attorneys' fees—let alone those of the plaintiff—outside of the corporation's insurance umbrella.)

16. This is the net return that the manager could obtain from the best alternative place of employment.

17. *See* discussion *infra* Part III.

assume here that the salaries of managers fully adjust to the anticipated effects of derivative suits.[18]

B. WHEN DERIVATIVE SUITS INCREASE CORPORATE VALUE

To determine when the bringing of derivative suits will increase corporate value, it is useful to consider a hypothetical breach of fiduciary duty. Suppose that managers in a certain industry have an ownership interest in supply companies that attempt to overcharge corporations for their products. Specifically, suppose that a manager's authorized overcharges will cost a corporation $3,000,000, $1,000,000 of which he will earn as a co-owner of the supplier. Suppose further that the going reservation salary for managers is $2,000,000.

If no derivative suits are brought, a typical manager will anticipate earning $1,000,000 from self-dealing. Accordingly, this manager will be willing to accept a salary of only $1,000,000, rather than $2,000,000. On these assumptions, a corporation will incur $4,000,000 in total manager-related costs: a $3,000,000 loss on the purchase of overpriced products and a $1,000,000 salary.[19]

By contrast, if shareholders bring derivative suits, and these suits succeed in deterring managers from engaging in self-dealing transactions, corporations will be better off. Corporations will not suffer $3,000,000 losses from purchases of overpriced products, but will have to pay managers $2,000,000 in salary. Thus, a corporation's total manager-related costs will be $2,000,000, rather than $4,000,000.[20]

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18. Note that if director and officer ("D & O") insurance is considered to be an element of managers' effective compensation (because premia are paid by the corporation), then managers' compensation packages typically *do* reflect the bulk of their expected liability costs, at least to the extent that these costs can be estimated by insurers. *See infra* note 33. Nothing in our analysis of legal policy turns on our model's assumption that salary costs *fully* anticipate the expected effects of shareholder litigation, and we illustrate this in a series of supplementary examples in *infra* notes 19, 20, 22, 23, & 30, where it is assumed that salaries do not reflect illicit gains from misconduct. Nevertheless, this assumption helps to illuminate actual behavior, because firms do in fact pay much of their managers' expected liability costs by subsidizing D & O insurance. We will address the policy implications of settlement and insurance practices in turn. *See infra* text accompanying notes 93-98.

19. We are maintaining the assumption in this Part that salaries fully reflect anticipated illicit benefits. If, as we acknowledge in Part III, this assumption is too strong for misconduct as bald as self-dealing, then the corporation will incur up to $5,000,000 in total manager-related costs when no derivative suits are brought: a $3,000,000 loss on overpriced products and a salary cost of $2,000,000. But if the misconduct were systematic indulgence in wasteful perks, for instance, then the notion that salaries do reflect misconduct costs may be easier to accept.

20. Of course, if managers' salaries do not reflect gains from self-dealing, then their salaries will be $2,000,000, whether or not shareholder litigation deters their misconduct. Hence, if shareholders bring derivative suits, a corporation's total manager-related costs will be $2,000,000 rather than $5,000,000, and the corporation will save $3,000,000, the entire amount of the overcharge.

The reason that corporations will be better off if derivative suits deter misconduct is that the $3,000,000 loss that they thereby avoid exceeds the $1,000,000 increase in salary that they must pay. To express the point somewhat differently, permitting self-dealing is an inefficient way for corporations to pay managers $1,000,000 because self-dealing transactions cost corporations $3,000,000 in overcharges; it is cheaper for corporations to pay $1,000,000 in salary directly to their managers and to deter self-dealing. Note, too, that when deterrence is successful, there is no actual litigation of derivative suits (assuming that suits are brought only in response to misconduct).

Finally, if shareholders bring derivative suits that do not deter managerial misconduct, corporations may or may not be better off. For example, suppose that shareholders detect misconduct fifty percent of the time and that if misconduct is detected, a suit is certain to succeed. Suppose too that when a suit succeeds, an offending manager will pay damages of $500,000 and no overcharge will be incurred, saving the corporation $3,000,000 (and denying the manager his $1,000,000).[21] Then managers will not be deterred: a manager's expected gain from self-dealing will be $500,000 (that is, .5 ×$1,000,000), whereas his expected penalty will be less, $250,000 (that is, .5 ×$500,000).

In this case, where misconduct is not deterred, how does suit affect corporate value? Because the probability is fifty percent that shareholders will bring suit and the corporation will reverse a $3,000,000 loss and collect $500,000 in damages, the corporation's expected gain will be $1,750,000 (that is, 0.5 ×$3,500,000). But, the corporation must also raise its manager's salary by $750,000 to offset both his loss of $500,000 in expected gains from self-dealing and his expected liability of $250,000.[22] Hence, the net expected gain to the corporation from suit is not $1,750,000, but only $1,000,000, exclusive of litigation costs. It follows that if expected litigation costs are less than $1,000,000—which is to say, if actual litigation costs are less than $2,000,000—derivative suits raise corporate value, but not otherwise.[23] In general, suits that do not deter are worthwhile for corporations if, but only if, expected litigation costs are less than expected recoveries *net* of expected liabilities of managers, which equal the increase in managerial

21. This hypothetical effectively requires managers who are sued to pay $500,000 in punitive damages. Punitive damages as such are seldom awarded in derivative suits or securities class actions. However, it is realistic to assume a punitive element nonetheless (here the $500,000 award) because courts favor injured corporations in calculating compensatory damages or because successful suits may result in informal sanctions such as injury to reputation or loss of position.

22. Managers' salaries (or liability insurance premia) would be raised by just $250,000 if they reflect only expected liability, not gains from self-dealing.

23. If, as in the previous note, salaries rise by only $250,000, the net expected gain to the corporation from suit would be $1,500,000. Thus, if expected litigation costs are less than $1,500,000, suit raises corporate value.

salaries (or in liability insurance premia). The important point here is that a part of a corporation's recovery—namely, the liability of its manager—is not an actual gain to the corporation because it must compensate the manager for his expected losses (or bear higher liability insurance premia).

C. WHEN WILL SUITS ACTUALLY BE BROUGHT?

Having established when derivative suits increase corporate value, and thus when shareholders should prefer to bring derivative suits, we now apply the model to determine when shareholders (or their representatives) will decide to bring suits under two hypothetical rules for allocating the costs and benefits of suit to plaintiff shareholders: a rule allocating legal costs to shareholders pro rata, and a contingency fee rule. A shareholder's decision whether to bring a derivative suit will depend *only* on his own personal costs and benefits under the applicable plaintiff compensation rule. In particular, this decision will not reflect future deterrence benefits of suit, for there will be none (recall the model is a single-period model).[24] Nor will the decision about suit be made to deter the misconduct that is the basis for the suit, for it is in the past. Deterrence is of course possible in the model, but only if managers know at the outset of the period that they will be sued for misconduct.

1. A Benchmark Regime Allocating Legal Costs Pro Rata

Consider first a simple benchmark regime for allocating legal costs.[25] Specifically, suppose that the corporation bears the costs of defending a derivative suit, and that a shareholder pays a fraction of the costs of bringing a suit in an amount equal to his ownership interest in the corporation. In this case, a shareholder will decide to sue if and only if the corporation's expected recovery exceeds the total litigation costs of defending and prosecuting a suit. This is so because the shareholder both pays litigation costs and enjoys the corporation's net gains from litigation in proportion to his ownership interest. For instance, in an elaboration of our earlier hypothetical, consider a shareholder who owns 1/100 of the shares, where the cost of suit is \$800,000, the cost of defense \$500,000, and the value of recovery \$3,500,000. The cost to the shareholder of suit is 1/100 of \$800,000, or \$8,000. The benefit to the shareholders is 1/100 of the net benefit to the corporation, or \$30,000 (that is $1/100 \times \$3{,}500{,}000 - 1/100 \times \$500{,}000$). Thus, the net benefit to the shareholder is \$22,000, or 1/100 of the corpo-

24. We argue in Part III that shareholders are also unlikely to base decisions to bring suit on future deterrence benefits in multiperiod settings. The reason is that potential wrongdoers are unlikely to see a suit arising from one instance of misconduct as logically related to the likelihood of suit for future misconduct.

25. We will be able to understand actual regimes more easily once we analyze this regime. *See infra* Part II.C.2.

ration's recoveries of $3,500,000 less the total legal costs of $1,300,000.[26] Hence, it is indeed the case that in this benchmark regime, a shareholder will bring suit when and only when the expected recovery exceeds total litigation costs. Note also that this is exactly the criterion on which a sole owner of the corporation would base a decision whether to sue.

However, *this decision criterion—sue only when the expected recovery exceeds total litigation costs—does not result in a willingness by shareholders to bring suit when and only when it will increase corporate value as identified in the previous section* B. First, shareholders might lack an incentive to sue even though the prospect of suit would increase corporate value. This will be the case whenever shareholder willingness to bring suit would raise corporate value by deterring misconduct, but shareholders do not bring suit because the expected recovery is less than the litigation costs. In our example, suppose that misconduct, is always detected and thus would be deterred if shareholders were standing ready to bring suit: a manager contemplating misconduct would then refrain from self-dealing, anticipating that he would never gain $1,000,000 from overcharges but would always have to pay $500,000 in damages. Deterrence of misconduct would increase corporate value by $2,000,000, as explained above. But shareholders will not be willing to bring suit (and knowing this, managers will not be deterred)[27] if total litigation costs would exceed the recovery of $3,500,000.

Why do shareholders sometimes fail to sue when the prospect of suit would increase corporate value through deterrence? The explanation is that by the time a shareholder decides whether or not to bring suit, it is, as observed above, simply too late to deter unwanted behavior. At the moment of decision, the benefits of suit are seen as the net recovery: the $3,500,000 in the example, net of litigation costs.[28] Shareholders could

26. This benchmark regime is not entirely hypothetical. Indeed, an important judicial test for determining when derivative suits should be permitted to proceed mimics the shareholder's calculus under the benchmark regime. *See infra* Part IV.B (discussing the Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982) test). More generally, proposals to reform shareholder litigation by permitting only large investors to sue may be viewed as attempts to approximate the effect of the benchmark regime. Such reforms suppose that shareholders with a large interest in the corporation will weigh the prospective benefits and litigation costs of suit more heavily than the prospects for earning attorney fees. Senator Dodd's recent proposal to reform securities class actions provides an example. *See* S. 1976, 103d Cong., 2d Sess. § 101(o) (1994) (limiting named plaintiffs asserting implied rights under the Securities Exchange Act of 1934, as amended (the "1934 Act"), to investors holding 1% of affected securities or $10,000 in market value of such securities).

27. In the case where salaries do not reflect gains from self-dealing, deterrence would increase corporate value by $3,000,000.

28. The shareholder's decision to sue and the decision that would maximize corporate value also contrast in other ways. Recall that if the prospect of suit deters misconduct, the corporation saves $3,000,000 and all litigation costs because no suits are actually brought; however, it still must pay its managers a higher salary. Thus, not only the deterrence benefit but also the offsetting salary cost are important factors that determine when deterrence increases corporate value. These factors are obviously quite different from the considerations that bear on the shareholder's decision whether to bring suit.

have captured the alternative deterrent benefit of suit only by credibly committing themselves beforehand to sue when misconduct occurs—but in the model, as in real life, diffuse shareholders do not make such commitments.

Second, and conversely, shareholders might have an incentive to bring suit even though suit will decrease corporate value. This will be true whenever shareholder willingness to bring suit will neither deter misconduct nor result in sufficient recovery to increase corporate value, but where recovery is nevertheless higher than litigation costs. In our example, suppose, as previously discussed in Part II.B, that the probability of detecting self-dealing is fifty percent, and that, if detected and sued, managers definitely would pay damages of $500,000 and lose their $1,000,000 gains from self-dealing, and the corporation would reverse its $3,000,000 loss. Suppose further that total litigation costs are $2,500,000. Then suit would certainly be brought by a shareholder since the total recovery from suit would be $3,500,000. Yet suit would lower corporate value: it would result in expected recoveries of $0.5 \times \$3{,}500{,}000 = \$1{,}750{,}000$, but increase salaries by $750,000 and impose expected litigation costs of $0.5 \times \$2{,}500{,}000 = \$1{,}250{,}000$, for a total of $2,000,000 in expected costs.[29] In this instance, the source of the problem for the corporation is that part of the recovery is from the manager: the $500,000 damages and the $1,000,000 that he would have kept from overcharges.[30] While this $1,500,000 is an incentive toward suit, in fact it does not help the corporation because, as the manager anticipates having to surrender this amount, he receives an offsetting addition to his compensation. In a sense, the problem with suit is again due to its timing: when a shareholder decides whether or not to bring suit, managers' salaries have already been negotiated. Thus, when shareholders consider suit after misconduct occurs, it is too late to recoup salary costs paid out in the expectation of suit by deciding not to bring suit after all.

2. A Contingent Fee Regime for Allocating Costs and Benefits

Thus far we have shown that shareholders may face distorted litigation incentives under a hypothetical benchmark regime. It should be evident that similar distortions also arise under other simple regimes for allocating the costs and benefits of derivative suits. Consider a contingent fee regime, which approximates the prevailing method of compensating shareholder-

29. A similar example can be constructed in the case where salaries do not reflect gains from self-dealing. Modify the example in text by assuming that total litigation costs are $3,250,000. Then suit would still be brought, as total recovery is larger, $3,500,000. But suit would again lower corporate value: it would result in expected recoveries of $1,750,000, whereas it would increase salaries by $250,000 and expected litigation costs by $1,625,000, for a total of $1,875,000.

30. Of course, in the case where salaries do not reflect gains from self-dealing, it is only the $500,000 in damages that is the source of the problem for the corporation.

plaintiffs.[31] Under this regime, the corporation pays to defend against a derivative suit, while the shareholder-plaintiff pays to prosecute the suit and receives as compensation a fixed proportion (say, twenty percent) of the value that the suit confers on the corporation.

This contingent fee regime, like the benchmark regime, may distort shareholder incentives to sue relative to the criterion of increasing corporate value. First, contingent fees can fail to induce suits that would deter misconduct and thus raise corporate value. In our example, we noted that a prospective suit would always deter self-dealing that is certain to be detected, because a manager would not be able to enjoy self-dealing gains of $1,000,000 and would pay damages of $500,000 if suit were brought. Yet shareholders will not bring suit under the contingent fee regime if, for example, the plaintiff's litigation costs were $900,000, the contingency percentage of damages were twenty percent, and the shareholder owned one percent of the corporation. In this case, the shareholder's cost of bringing suit would be $900,000 plus his one percent share of the corporation's defense costs. His gain, however, would be only $728,000—$700,000, or twenty percent of corporate recovery as compensation for bringing the suit (0.2 ×$3,500,000), plus $28,000, or one percent of the corporation's gain (0.8 ×$3,500,000 ×0.01).

Second, the contingent fee regime can also induce suits that would decrease corporate value. In the previous section, we demonstrated that suit lowers corporate value in an example where the probability of detecting self-dealing is fifty percent (implying that misconduct is not deterred because expected gains exceed expected penalties) and total litigation costs are $2,500,000, because the total expected costs incurred by the corporation ($1,250,000 in expected litigation costs plus $750,000 in increased managerial salaries) exceed expected recoveries of only $1,750,000. Nevertheless, it is perfectly conceivable that suit would be brought under a

31. All jurisdictions award contingent attorney fees in derivative suits and class actions. *See* Romano, *Shareholder Suit, supra* note 7, at 60-63 (fee awards). In derivative suits, courts award fees if a suit confers a "substantial benefit" on the corporation, which may take the form of monetary recovery or structural relief (such as an agreement to add outside directors to the corporate board). ALI PRINCIPLES, *supra* note 4, at § 7.17 cmt. a. Settlements routinely purport to confer such benefits, and thus routinely produce fee awards. *See* Romano, *supra* note 7, at 63 (settlements yield cosmetic benefits to justify fees). The amount of the fee in most jurisdictions is based either on a percentage-of-the-recovery formula (assuming a monetary recovery results) or on compensation for the amount of time reasonably devoted by the plaintiff attorney, adjusted upward by a "multiplier" to reflect the risk of the case (the so-called "lodestar" formula). *Id*; *see also* William J. Lynk, *The Courts and the Plaintiffs' Bar: Awarding the Attorney's Fee in Class Action Litigation*, 28 J. LEGAL STUD. 185, 186 (1994). In practice, both formulas seem to produce similar fee awards (between 20% and 30% of recoveries) in most cases. *See* Alexander, *supra* note 5, at 541; Robert T. Mowrey, *Attorney Fees in Securities Class Actions and Derivative Suits*, 3 J. CORP. L. 267, 343-48 (1978); Romano, *Shareholder Suit, supra* note 7, at 63 n.14; *But cf.* Lynk, *supra,* at 208-09 (neither fee formula fully explains actual fees in class actions).

contingency fee arrangement. If the contingency percentage is twenty percent, the plaintiff's cost of suit is $500,000, defense costs are $2,000,000, and the shareholder owns one percent of the corporation, then the cost of the suit to the shareholder is $500,000 plus $20,000 in implicit defense costs (0.01 ×$2,000,000), or $520,000, whereas his benefit is his expected recovery fee of $700,000 (that is, 0.2 ×$3,500,000) plus one percent of the corporation's gain (0.01 ×0.8 ×$3,500,000), adding to $728,000 once again.[32]

III. GENERALIZATIONS AND EXTENSIONS

The preceding discussion of the divergence between shareholders' incentives to bring derivative suits and the litigation criteria that would maximize corporate value raises a variety of issues about the underlying rationale for our conclusions and their generality. In this Part we inquire how three apparent limitations of our model affect our qualitative conclusion of a misalignment of incentives to bring derivative suits: (1) our assumption of a well-functioning market for the services of risk neutral managers, (2) our assumption of a single-period firm, and (3) the restricted range of legal regimes that we model.

A. THE MARKET FOR MANAGERS AND D & O INSURANCE

Our model assumes a well-functioning market for the services of risk neutral managers who demand (and receive) full compensation ex ante for the expected personal costs and forgone benefits that result from prospective liability. Thus, an important issue concerns how far recoveries from managers—as well as illicit benefits that they give up—are actually offset by corporations through insurance, indemnification, or salary.

Looking first to the expected recoveries from managers in derivative suits, the answer seems straightforward. Liability insurers absorb most out-of-pocket losses in shareholder suits,[33] which strongly implies that

32. Obviously, we have chosen the dollar figures in these examples for expository convenience rather than descriptive realism. If it seems implausible that a corporation might choose to litigate an action rather than settle it, when defense costs totalled $2,000,000 and the potential recovery was only $3,500,000, the hypothetical can be made more realistic simply by reducing the corporation's defense costs and raising the manager's gain from self-dealing by an offsetting amount. The result in the text stands as long as the corporation's total expected costs—in salary increases and litigation expenses—remains at $2,000,000, in contrast to the corporation's expected recoveries of $1,750,000.

In addition, it should be apparent that the distorted litigation incentives illustrated by these two examples do not depend on the particular contingency percentage chosen. A percentage higher than 20% would result in more value-increasing and more value-decreasing suits; a lower percentage would have the opposite effect. But whatever contingency percentage is in place, the possibility of discouraging value-increasing actions and encouraging value-decreasing ones remains.

33. Almost all public companies purchase standard D & O policies in two parts: one part to insure themselves against losses arising from indemnifiable expenses, and a second to insure their managers against non-indemnifiable liability costs. *See* Romano, *Aftermath*, *supra* note 7, at 1157-59. As a legal matter, the only personal liability costs that cannot be offset (by indemnification, insurance, or both) are those resulting from a formal adjudication

corporations pay indirectly for much of the expected cost of their managers' liability. To be sure, shareholders in the simple world of our model would prefer to compensate managers for their expected liability costs in the form of salary increases rather than subsidized insurance. Insurance is attractive only in the real world where managers are risk averse and courts sometimes err in imposing liability.[34] But the form of the ex ante cost imposed on the corporation by managers' prospective liability—whether payments to managers or insurers—leaves our conclusion unchanged. If the insurance premia paid by corporations roughly mirror the liability expenses of insurers, corporations cannot gain in any systematic sense when they recover from liability insurers.[35] And, obviously, corporations

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of breach of duty of loyalty. *See* Coffee, *Unfaithful Champion*, *supra* note 5, at 19-20. But since almost all recoveries in shareholder suits derive from settlements reached prior to an adjudication on the merits (even in duty of loyalty cases), insurers typically fund recoveries and "financial penalties are virtually never imposed on managers." Romano, *Shareholder Suit*, *supra* note 7, at 84; *accord* Alexander, *supra* note 5, at 550 (insurers provide 50%-80% of settlement funds in securities class actions). Thus, D & O insurance is the most straightforward mechanism for supplementing managers' compensation to offset liability. Indeed, one survey of large industrial and service corporations indicated that 88% of CEOs would not serve without D & O insurance coverage. *Id.* (citing 1988 Hendrick & Struggles annual survey of CEOs). Note too that managers' salaries appear to be unaffected by increases in D & O insurance premia. Romano, *Shareholder Suit*, *supra* note 7, at 84.

34. In the world of our model, risk neutral managers would be indifferent between full insurance or salary increases of the same expected value, but shareholders would prefer to increase salaries to offset managers' liability costs in order to preserve the deterrent value of damage awards against errant managers. By contrast, in a world of risk averse managers and legal error, it may be cheaper to offset managers' liability costs with insurance than with salary increases. Shareholder suits retain some deterrent value, even when insurers fund almost all recoveries from managers, if culpable managers face reputational losses or are privately sanctioned by their companies. Evidence of higher turnover rates among managers who are sued may suggest that some private sanctioning occurs in the wake of suits. *See* Romano, *Shareholder Suit*, *supra* note 7, at 78-79. To the extent that companies impose private penalties while simultaneously insuring managers against damage awards, they simply contract around the legal system as a disciplinary mechanism.

Note too that it is possible to contract around most civil liability for managerial misconduct despite both legal and contractual limitations on insuring such misconduct. The reason is that shareholder suits are rarely adjudicated and insurers routinely pay settlement costs. Nevertheless, insurance is nearly universal. Professor Alexander argues that D & O insurers have become highly successful in anticipating "non-merits-related" settlement costs, and simply pass these costs back to their corporate customers in the form of premia. Alexander, *supra* note 5, at 563-64.

35. Actual or potential litigation can substantially increase D & O insurance premia for particular corporations. Oesterle, *supra* note 10, at 563. Our own informal inquiries indicate that such increases are negotiated and vary with the circumstances of the litigation. More generally, evidence that increased liability raises insurance costs is apparent in the dramatic increases in premia that followed the doubling of shareholder suits between 1974-1984. *See* Romano, *Aftermath*, *supra* note 7, at 1157-59. Note also that to the extent that insurers cannot anticipate firm-specific liability costs, some firms gain and others lose from insured recoveries. But as shareholders are unlikely to know more than insurers about expected liability costs, whether a corporation wins or loses ex post in the insurance lottery has no bearing on shareholder valuation of expected corporate recoveries ex ante. For further discussion see *infra* note 95.

cannot gain when they must indemnify the liability expenses of their managers, even if they are insured against such indemnification costs.

Of course, insurance cannot cushion managers against all losses from suit, nor can it reimburse the illicit gains that managers forgo under threat of suit. The remaining question, then, is whether managers' salaries increase by the expected value of these uninsurable losses. Although managers who expect to spend time and energy defending themselves and their reputations in derivative suits probably will want some increase in salary as compensation, it is doubtful that salaries will rise to compensate managers for corrupt gains that they are denied by the threat of suit. There are several grounds for such skepticism.

First, only a minority of managers may be of the type that would engage in intentional misconduct. Were these managers to bargain openly about the benefits from misconduct that they would enjoy in the absence of the threat of derivative suits, they would reveal their dishonesty and thus invite unwelcome scrutiny or dismissal. Second, explicit bargaining about the benefits from misconduct might reflect badly on the corporation if, as seems likely, shareholders were to suspect the firm of tolerating immoral behavior that ought to be punished instead. Consequently, the corporation would probably avoid explicit bargaining about gains from misconduct. Third, opportunities for misconduct may be episodic, low-probability events. If so, managers who are not risk neutral would attach only small value to such opportunities. For example, the value a manager would attach to a two percent chance of making an extra $100,000 through misconduct might be only several hundred dollars, significantly less than its expected value of $2,000. Hence, even full salary adjustments to such opportunities would be small relative to their expected value. Together, we suspect, these three factors ordinarily prevent salaries from rising to offset the expected value of uninsured recoveries against managers.

We therefore believe that our model may overstate the ex ante costs to the corporation of imposing liability on managers. Shareholder suits can impose some costs on managers that should be counted as gains to corporations because they are not offset by corporate expenses; illicit gains to managers that are deterred by the prospect of suit may fall into this category, as may the occasional noninsurable monetary recoveries from managers. But in the real world, as in the model, corporations pay ex ante in insurance premia for the bulk of their own monetary recoveries from derivative suits. In any event, to the extent that our model overstates the ex ante costs to the corporation of imposing liability on managers (or of denying them illicit gains), litigation incentives are not necessarily less distorted in the real world. Rather, what follows is a shift in the form of distortion. Relative to the results we expect from the model, shareholders will bring value-decreasing suits less often, but they will fail to bring value-increasing suits more often (because the value to the corporation of deterrence is greater than it would be in the model).

B. MULTIPLE PERIODS, DETERRENCE, AND COMMITMENT TO BRING SUITS

In addition to the ex ante costs that potential suits against managers impose on corporations, the distorted litigation incentives modeled in Part II also turned on the point that shareholders considering suit in the wake of misconduct would not take into account the deterrent benefits of suit. Once misconduct had occurred there were no future deterrent benefits in our model, recall, because we assumed that the corporation was in business only for one period. But actual corporations persist longer, perhaps indefinitely. If we go beyond the model and recognize the possibility of subsequent managerial misconduct, what then are the future deterrent benefits from suit?

The answer is not straightforward. On one hand, a manager contemplating today whether he will be sued for misconduct in the future may well rationally believe that only the future costs and benefits of suit will govern shareholders' future decisions about suit—not the occurrence or nonoccurrence of suit today. If so, suit today will, in fact, have no future deterrence benefits relative to that manager.

On the other hand, a manager might believe that a future decision about suit will reflect not only the costs and benefits of suit at that time, but also the desire of shareholders to maintain their corporation's reputation for bringing suit whenever there is misconduct (presuming it has established such a reputation). If so, failure to sue today could damage this reputation and thus sacrifice future deterrence. Even if a litigious reputation will yield future deterrence gains, however, shareholders will not consider *past* opportunities to deter in deciding whether to sue today. For this reason, the chief qualitative conclusion from our model still stands. Because the reputational mechanism requires shareholders to invest in suit to earn future gains, it misses past opportunities to deter misconduct that a prior commitment to bring suit might have captured. Thus, not even the possible returns from a litigious reputation can fully align shareholder incentives to sue today with the litigation policy that would maximize deterrence gains.[36]

36. The distinction between past deterrence gains (which can only be captured through a prior commitment to bring suit) and future deterrence gains (which might be captured by a reputation for bringing suit) can be described as a distinction between less and more costly commitment devices. To see why, suppose that managers have a 10% probability of discovering a self-dealing opportunity in each period, but that such self-dealing could be deterred by the threat of suit. An optimal litigation policy would always dictate suit against self-dealing managers in order to deter misconduct costlessly and absolutely. By contrast, without a pre-existing commitment to sue, shareholders who were sensitive to reputational effects would only sue self-dealing managers today if the present value of future deterrence gains exceeded the net cost of suit (including reputational damage lasting well into the future). Because these future gains might not be realized for many periods and would have to be

This leads us to consider the issue of commitment to a policy of suit. Suppose shareholders could costlessly commit themselves to sue in certain named circumstances, such as when suit would deter misconduct. Informed shareholders with only investment interests at stake would then willingly commit themselves in advance to sue when and only when an action would result in an increase in corporate value. But without leadership from the board of directors or a low-cost way to bind all shareholders to the new litigation policy, shareholders could not make such a commitment. Even in the absence of legal impediments,[37] other obstacles—the costs of collective action, imperfect information, and the natural inclination of most shareholders to focus on immediate monetary benefits from suit—would likely preclude any binding agreement among shareholders.[38]

The ability of boards of directors to commit themselves to a policy of suit is somewhat different. Boards of directors play an important screening role in derivative litigation in many jurisdictions.[39] Moreover, it is plausible that boards, or at least some boards, are loyal to shareholder interests and wish to exercise their discretion over derivative litigation accordingly.[40] Yet in many states, existing law would not seem to allow the obvious device of a charter provision[41] committing boards to reject categorically value-decreasing actions.[42] Of course, loyal boards might still seek to

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discounted accordingly, shareholders would not sue today—and managers therefore would not be deterred today—unless the corporate losses from self-dealing were very large. The lesson, once again, is that because suits are costly and only future deterrence benefits result from suits brought to maintain a litigious reputation, shareholder incentives diverge from the optimal litigation policy, even when the reputational mechanism works perfectly.

37. As a legal matter, shareholders could not commit their successors in an active trading market—or even their boards of directors—to a litigation policy, absent statutory leave to adopt a charter amendment doing just this. *See infra* note 42.

38. Further, under the contingent fee rule that now prevails, the shareholder-attorney teams most likely to bring suit have no interest in a value-maximizing litigation policy, because their own interests lie in obtaining fee awards. Professor Goetz optimistically speculates that the contingent fee rule may secure a beneficial commitment to suit that shareholders themselves otherwise could not agree upon. Goetz, *supra* note 8, at 348. But we have already demonstrated that such optimism is unwarranted. *See supra* notes 31-32 and accompanying text. Under the prevailing legal regime, only large long-term shareholders who respond to investment interests rather than fee awards would seem to have any incentive to commit to a value-increasing litigation policy.

39. *See* discussion *infra* Part IV.

40. We do not address the controversial issue of to what extent boards of directors can be loyal to shareholder interests in the context of derivative litigation. *See supra* note 6 (collecting sources).

41. *See* discussion of the use of charter provisions as screening devices *infra* Part VI.

42. Charter provisions altering the contours of manager liability are presently adopted pursuant to express statutory authorization. *See infra* note 65 and accompanying text (discussing DEL. CODE ANN. tit. 7, § 102(b)(7) (1974)); *cf.* BLOCK ET AL., *supra* note 2, at 109-24 (describing similar statutes adopted by 40 states since 1985). Of course, disinterested boards can provide limited protection from litigation in other ways: for example, by authorizing or ratifying suspect transactions. *See, e.g.,* REVISED MODEL BUSINESS CORPORATION ACT [hereinafter R.M.B.C.A.] §§ 8.61-8.62 (1991) (shareholders may not attack self-dealing transac-

commit themselves to facilitate only value-increasing litigation by amending the charter—or by establishing a reputation—to assure rewards for shareholder plaintiffs who brought suits with low recoveries but obvious deterrent benefits. We are skeptical, however, whether boards of directors would agree to encourage more shareholder litigation in this fashion. Shareholders might well be dubious about such a commitment,[43] which might be ineffective in any case, given that an adopting board could not assure the fidelity of future boards in enforcing it. In short, while loyal boards might in theory develop better litigation incentives than shareholder plaintiffs, in fact their incentives may not differ much from those of shareholders.

C. ALTERNATIVE LEGAL REGIMES

A final set of issues raised by our analysis of the misalignment of shareholder incentives to bring suit concerns the generality of our conclusions across alternative legal rules and modes of resolving litigation. Consider first whether any simple rule for compensating shareholder plaintiffs can avoid the problem of misaligned incentives. If a simple rule is understood to be one that rewards shareholder plaintiffs on the basis of corporate recoveries and litigation costs alone, then no such rule can avoid distorting litigation incentives. The reason is that, by their very nature, all such rules omit consideration of factors that bear importantly on whether a derivative suit is value-increasing, namely managers' personal gain from misconduct, managers' expected loss from suit, and the probability of detecting misconduct. Any rule that is constructed without reference to these deterrence considerations cannot possibly elicit value-increasing litigation decisions from plaintiffs in all circumstances.[44] This is not to say, of course, that there are no differences among simple plaintiff compensation regimes. Over a particular set of corporate situations, a contingent fee regime may outperform—that is, increase corporate value more often than—the benchmark regime (or vice versa), or a contingent fee regime

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tions approved by disinterested directors). But case-by-case ratification is no different, at least in principle, from screening derivative suits directly; it cannot establish a litigation commitment except through the reputational mechanism described above. In addition, whether disinterested directors could (or would) protect an obviously unfair transaction by ratifying it in order to thwart value-decreasing law suits is, to say the least, an open question.

43. Shareholders must understand the board's purpose for the board to retain shareholder support when it acts in ways that appear to be against shareholder interests (such as when the board allows a derivative suit for which expected recovery is less than litigation costs).

44. In Part V, *infra*, we propose a plaintiff compensation rule based on *all* factors bearing on the value of derivative litigation, including such factors as whether suits would deter certain behavior, and whether and to what extent suits would affect managerial salaries. Such a rule could be designed to induce suit if and only if a suit would enhance corporate value, because it would take all relevant factors into account.

paying a small amount may outperform one paying generously.[45] But such variations in relative performance will depend on the characteristics of the particular suits at hand; they will not be systematic.

Beyond plaintiff compensation rules, moreover, altering other features of the simple legal regime of our model would also leave our main results unaffected. For instance, if the model were extended to permit settlements (a plausible extension given that a high proportion of derivative suits settle[46]), our conclusions would remain qualitatively unaltered. The terms of settlement would reflect the same factors that motivate plaintiffs to bring suits in the first instance: litigation costs, potential recoveries, and the probability of prevailing. Hence, the incentives to bring derivative suits in scenarios recognizing settlement would remain the same, and litigation decisions would deviate from optimal in much the same fashion.[47] Similarly, treating penalties for misconduct or the potential corporate recovery as variables within the model (for example, by allowing courts to impose punitive damages) would also fail to correct plaintiffs' litigation incentives. To be sure, in a world without legal error or judgment-proof managers, draconian sanctions could deter all breaches of fiduciary duty, and the optimal plaintiff compensation rule would be simple indeed: courts would uniformly compensate plaintiffs with a sum large enough to induce all potential plaintiffs to bring suit upon discovering misconduct, which, because of the draconian rule, would never in fact arise. But in the real world, where legal error occurs and the personal assets of managers are limited, total deterrence is impossible. In the real world, not every derivative suit should be brought, and our analysis is necessary for determining when suits are valuable and when they are not.[48]

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45. *See supra* note 32.

46. Professor Romano reports that roughly two-thirds of her sample of shareholder suits settled, and that virtually all of the remaining third ended in dismissal or in a judgment for the defendants. Romano, *Shareholder Suit*, *supra* note 7, at 60; *cf. supra* note 15 (summarizing Romano's findings).

47. Again, we refer here to an extension of our model. A full account of the institutional factors that bear on the settlement of shareholder suits would also consider those factors that distort the litigation decision but go beyond our model, such as the settlement value of frivolous suits and the risk of collusive settlements between managers and plaintiffs' attorneys (that avoid findings of management liability in return for a sizeable cash settlement). *See supra* note 5 (citing relevant articles on frivolous suits). Because we focus on a logically distinct set of distortions in shareholder litigation, we do not provide a full account of the settlement process. We do believe, however, that a clear policy of increasing corporate value can mitigate distorted litigation incentives, whatever their source. *See infra* Part VI.B (discussing reform proposals).

48. We do not endorse judicial reluctance to award punitive damages in cases of corporate fiduciary breach. Indeed, we take no position on optimal damage awards in this article. Our only point here is that optimal damages, whatever they may be, are unlikely to be large enough to deter all misconduct and thus dispense with the possibility of value-decreasing suits. On a more practical level, judicial reluctance to award punitive damages in derivative suits may be understandable under the existing regime in which most suits settle, and in which corporations fund settlement or damage payments either indirectly (through settle-

IV. SCREENING DERIVATIVE SUITS

There is one aspect of actual legal regimes governing derivative suits that merits closer scrutiny because it may seem to bear indirectly on our results. This is the set of legal "screens" that determine whether derivative suits proceed or are dismissed to the plaintiffs' disadvantage in the early stages of litigation. Such screens, which range from provisions in corporate charters to state law structures requiring case-by-case evaluation by courts and boards of directors, interact with plaintiff compensation rules to shape the population of successful derivative suits.[49] Thus, the question arises: how far do these screens alter or offset the distorted litigation incentives analyzed in Part II? The short answer is, not very much. To see why, it is necessary to take a closer look at derivative suit practices.

A. SCREENING AT THE DEMAND STAGE

In all jurisdictions, derivative suits are subject to a "demand requirement," which requires would-be plaintiffs to choose between petitioning the corporation's board of directors to bring suit or, alternatively, persuading a court that demand is unnecessary under the law of the jurisdiction.[50] The demand requirement functions in a derivative suit to preserve the board of directors' control over what is nominally the corporation's own cause of action. If a plaintiff chooses to make demand, the board must then evaluate the action and decide whether to permit suit, reject suit, or assume control of the litigation itself. In many jurisdictions, a suit that the board rejects is thus over before judicial proceedings commence.[51]

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ment costs paid by insurers and passed back to the corporation in the form of increased premia) or directly (out of the corporate treasury). *See supra* note 33.

49. With the exception of charter provisions, which can insulate managers against some shareholder class actions, *see infra* note 65, the specialized screens addressed in this Part pertain to derivative suits alone and not to class actions.

50. This describes the law of virtually all states today. *See* ALI PRINCIPLES, *supra* note 4, at § 7.03 cmt. a (comparing present law with the requirements of § 7.03). By contrast, recent proposals to reform the law of derivative suits generally require all plaintiffs to make demand upon the board, but relax the circumstances in which courts may permit suits to proceed when the board rejects such demands. Thus, the R.M.B.C.A. provides that before derivative plaintiffs may bring suit, they must make demand upon the board to bring the suit in the name of the corporation; however, even if demand is rejected, derivative plaintiffs may still commence a suit if the alleged facts establish that (1) a majority of the board is not independent, or (2) that the board failed to conduct a "reasonable inquiry" in good faith into the substance of the proposed suit. *See* R.M.B.C.A. §§ 7.42-7.44 (1991). The proposed ALI procedure is similar, except that it is weighted against dismissal of actions alleging breach of duty of loyalty. *See* ALI PRINCIPLES, *supra* note 4, at §§ 7.03, 7.08-7.10.

51. The law varies by jurisdiction. *See* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 5.03 (1987) (surveying the demand requirements of various jurisdictions). Delaware, a leading jurisdiction in corporate law, views the demand requirement as a grant of power to corporate boards, allowing them to exercise their business judgment to dismiss suits that are not in the interest of the corporation. *Id.* Delaware law provides little room for plaintiffs to allege that a demand, once made, was "wrongfully

Many commentators argue that to allow corporate boards to screen suits in this fashion injects a powerful anti-plaintiff bias into the derivative mechanism because even independent directors are reluctant to permit suits against senior managers.[52] For present purposes, however, the issue of such "structural bias" on the part of the board is secondary. The analysis in Part III.B indicates that even a loyal board, whose sole objective is to maximize shareholder welfare, will likely face distorted incentives when screening derivative suits—precisely the same distorted incentives as those faced by the shareholder-plaintiff under the benchmark compensation regime—because it will naturally evaluate the derivative suit on an ex post basis (that is, in terms of only the suit's net expected recovery).[53] Thus, ironically, we cannot be certain that a loyal board will make better decisions than a biased board that reflexively rejects all demands.

In addition, because boards of directors seldom accept suits on demand, trial courts also play an important screening role at the demand stage by certifying some suits as "demand excused," and therefore beyond the board's power to dismiss.[54] The screening criteria used by the courts, however, bear only an attenuated relationship to the value of derivative actions. The most frequent justification for excusing demand is evidence that the board is financially interested in the litigation or dominated by a party with interests adverse to those of other shareholders.[55] Here, demand is excused to control biased decisionmaking by the board. This mechanism enhances the legitimacy of the demand doctrine, but it does not correct the distorted incentives identified in our model. Instead, it merely removes the board as a screen, leaving the selection of which demand excused suits will be litigated entirely to the plaintiff compensation scheme—in most cases to the contingent fee regime.

A second criterion that some courts employ in excusing demand appears to relate to the quality of the suit, that is, to the probability that a suit can succeed on its merits. Specifically, recent Delaware doctrine, although not entirely clear, appears to establish a threshold quality level above which a

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refused" by the board, because courts deem plaintiffs who have made a demand as having waived their rights to challenge the impartiality of the board. Levine v. Smith, 591 A.2d 194, 212 (Del. 1991). As a consequence, Delaware practioners avoid making demand, leaving most derivative suits to be screened by the Court of Chancery. By contrast, the R.M.B.C.A. and ALI impose a universal demand requirement that would assure that most suits are screened by both boards and courts. *See supra* note 50.

52. *See, e.g.,* Dent, *supra* note 6, at 97.

53. *See supra* Part III.B. Recall also the difficulty that a loyal board would have, at least in the absence of a charter amendment, in committing to a policy of permitting suit when and only when suit would increase corporate value.

54. *See, e.g.,* Rales v. Blasband, 634 A.2d 927 (Del. 1993); BLOCK ET AL., *supra* note 2, at 733-36 (overview of demand futility doctrine).

55. *See* ALI PRINCIPLES, *supra* note 4, at § 7.03 cmt. d (discussing several justifications for excuse of the demand requirement, the inherent problems with these justifications, and possible solutions).

suit can escape board screening, notwithstanding the absence of obvious bias on the part of the board.[56] Such a quality screen (if this is indeed the effect of Delaware doctrine) finds some support in our model, since, all else being equal, a suit that is more likely to succeed is also more likely to increase corporate value, either as a deterrent or as a vehicle for recovery. On the assumption that the Delaware standard is used only to exclude strike suits that exploit asymmetrical litigation costs or the risk of legal error to extract settlements, this doctrine is clearly beneficial. By definition, such suits cannot contribute to corporate value and can only generate litigation costs. Thus, eliminating these suits improves litigation incentives, even if it still permits shareholders to bring some value-decreasing but meritorious suits.[57]

B. SCREENING AT THE SPECIAL LITIGATION COMMITTEE STAGE

The demand stage is not the only point in the litigation process at which a derivative suit may be excluded. Many jurisdictions also permit screening even after demand is excused if a "special litigation committee" of independent directors petitions the court to dismiss a suit.[58] In most of these jurisdictions, however, the court rather than the committee or the board ultimately decides whether a suit will be permitted to continue.[59]

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56. This point is not recognized by the Delaware cases, which treat the judicial power to excuse demand solely as a safeguard against biased decisionmaking by the board. *See Rales*, 634 A.2d at 927. Nevertheless, the structure of Delaware's test for excusing demand invites implicit screening for quality. Under this test, the chancery court must ask: "(1) whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts, and, if not (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment." Levine v. Smith, 591 A.2d 194, 205 (Del. 1991). The second prong of this test excuses demand nothwithstanding the apparent disinterestedness of the board when allegations of past misconduct seem sufficiently plausible. The justification is that a board's past behavior can itself indicate bias. *Rales*, 634 A.2d at 936. But the effect is to excuse demand whenever misconduct seems likely on the face of the complaint (except in the odd case where, due to turnover or otherwise, the directors who presided over the alleged misconduct differ from those who would receive demand). *See id.* at 933-34; ALI PRINCIPLES, *supra* note 4, at § 7.03, Reporter's Note 5 (collecting cases). Casual empiricism suggests that the Delaware courts often excuse demand where there is a strong prima facie case of fiduciary breach.

57. In fact, the Delaware doctrine probably cuts deeper than simply excluding frivolous suits. An informal survey of Delaware Chancery Court rulings over the past year yields only one example where demand was excused (out of five demand-excused cases) without a showing of reasonable doubt about the disinterestedness of the board. *See* Andreae v. Andreae, No. CIV.A.11905, 1992 WL 43924, at *4 (Del. Ch. Mar. 5, 1992). Thus, rather than acting as a simple quality screen, the net effect of Delaware's demand-excused test may be overdeterrence of shareholder litigation.

58. *See, e.g.*, BLOCK ET AL., *supra* note 2, at 851-62 (reviewing special litigation committee doctrine).

59. *See, e.g., id.* at 863-91 (indicating more jurisdictions follow Delaware approach of permitting court to exercise its own business judgment in reviewing special litigation committee report).

The case law offers two classic decision rules for a court to follow in passing on a special litigation committee's motion to dismiss derivative litigation. The first, formulated by Judge Ralph Winter, is a detailed ex post cost-benefit analysis of precisely the sort that a shareholder would make under our benchmark regime: balancing the expected value of recovery against the legal costs of continuing the suit.[60] Commentators have endorsed this rule for its relative clarity and apparent coincidence with shareholder interests.[61] But as we explained in Part II, the Winter rule only considers shareholder interests on an ex post basis. Thus, from the perspective of increasing corporate value, the rule is subject to the same distortions as the shareholder's litigation decision under the benchmark compensation regime.

The second rule, adopted by the Delaware Supreme Court, allows judges to consider not only the ex post value of a suit but also matters of public policy, which presumably includes a suit's potential deterrent value.[62] In principle, the Delaware rule might do better than the Winter rule by not excluding suits with obvious deterrent value simply because their expected recovery is small. And even if judges estimate the deterrence benefit of a suit solely in terms of the harmfulness of managerial misconduct—as we suspect often happens—introducing deterrence into the judicial calculus is a step in the right direction. It stops well short of optimal screening, however, because the value of the deterrence benefit conferred by suit depends on the prospects for deterrence as well as the magnitude

60. Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982). Judge Winter framed the test as follows: "Where the court determines that 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, it should dismiss the case." *Id.* Much of the attraction of the *Joy* test lies in Judge Winter's painstaking inventory of the ex post costs and benefits associated with derivative actions.

61. *See* Macey & Miller, *supra* note 5, at 39-40 (apparently endorsing the Winter rule). Professor Joel Seligman also adopted a "refined" version of the Winter rule in passing on derivative litigation under a unique Michigan statute that permits a court to vest screening authority in a "disinterested person." *See* Joel Seligman, *The Disinterested Person: An Alternative Approach to Shareholder Derivative Litigation,* 55 LAW & CONTEMP. PROBS. 357, 362-76 (1992).

62. Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981). The *Zapata* opinion rejects the conventional view that a derivative action can be treated as a simple matter of business judgment by the board (or by a court), much as the board might consider a corporate investment project or other business opportunity. *Id.* Our analysis supports *Zapata* here: a derivative suit is unlike an investment project because it cannot be valued solely on the basis of its ex post costs and benefits. Yet, *Zapata* does not appear to rely on our argument to support its conclusion. Instead, it relies on the different claim that there are positive externalities associated with derivative litigation ("matters of law and public policy in addition to the corporation's best interests"). *Id.* at 789. We understand this phrase to refer to the possibility of deterrence externality or spillover that benefits other corporations. See *infra* note 64 (examining the claim of a positive "deterrence externality" associated with shareholder suits).

of the harm that deterrence might avert.[63] Thus, explicit legal weighing of the deterrence objective still distorts the litigation decision insofar as it fails to consider the likelihood of deterrence.[64]

C. SCREENING BY CHARTER PROVISION AND STATUTORY EXCLUSION

Finally, a third form of legal screen on derivative suits exists in many jurisdictions: corporate charter provisions or statutory exclusions that discourage plaintiffs from bringing specific suits, usually those intended to recover monetary damages from managers for breach of the duty of care.[65]

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63. Moreover, the second rule also fails to consider the effect of derivative suits on both corporate wages and liability insurance bills.

64. Another feature of the legal treatment of the deterrence concept deserves mention here. A widespread assumption that seems implicit in *Zapata*, see *supra* note 62, and explicit in the ALI PRINCIPLES, is that a derivative suit can generate a net social benefit by deterring misconduct elsewhere, even though it imposes a net cost on the corporation whose managers are sued. *See* ALI PRINCIPLES, *supra* note 4, Part VII, Intro. Note, Rept.'s Note 2. This assumption is obviously correct in the case of bombshell suits that alter managers' perceptions about actionable conduct. Perhaps the best example is Smith v. Van Gorkom, 488 A.2d 858 (Del. 1988) (class action holding an entire board of experienced directors liable for breach of duty of care).

But it is important to understand the collective deterrent benefits that bombshell suits confer. They enhance deterrence by revealing new information about expected sanctions, i.e., information about the probability of suit or the sanction attaching to particular misconduct. (By contrast, routine actions that merely confirm managers' expectations about the vulnerability of misconduct to suit yield no collective benefits.) Viewed after misconduct has occurred, the cost of a bombshell suit may or may not exceed its private deterrent benefit for the company whose managers are sued (depending, for example, on the frequency of opportunities to engage in the misconduct at issue). Indeed, this company's cost-benefit analysis, after it learns of the suit, resembles that of directors who must decide whether to allow an uneconomical suit in order to establish a reputation with future deterrent value. *See supra* note 36. But this suit is clearly value increasing from the ex ante perspective of this same company, i.e., before it learns that it must pay the price of announcing the new deterrence calculus. Ex ante, the unlucky company faces only the negligible expected cost of suit, while it enjoys the suit's collective deterrent benefit. Thus, this company would commit to bring the suit ex ante, even though it might be reluctant to permit the suit ex post. The analysis of the deterrent benefit is similar, whether we address litigation policy at a single company or, as with bombshell suits, across all companies.

65. For example, a recent addition to the Delaware statute permits corporations to adopt charter amendments eliminating the personal liability of directors "to the corporation or its stockholders for monetary damages" for most breaches of the duty of care. DEL. CODE. ANN. tit. 12, § 102(b)(7) (1993). Other states have gone further by denying shareholders standing to bring actions for breach of the duty of care. For empirical studies suggesting that these liability limits have had little effect on corporate value, see Janjigian & Bolster, *supra* note 7, at 53 and Romano, *Aftermath*, *supra* note 7, at 1188-89. *But see* Michael Bradley & Cindy A. Schipiani, *The Economic Importance of the Business Judgment Rule: An Empirical Investigation of the Trans Union Decision and Subsequent Delaware Legislation, in* THE BATTLE FOR CORPORATE CONTROL 105 (Arnold N. Sametz ed., 1991) (finding that the passage of § 102(b)(7) actually lowered the value of Delaware corporations). Bradley and Schipiani's analysis is critiqued by William T. Allen, *Law and Markets as Social Products: Comments on Chapter 7, in* THE BATTLE FOR CORPORATE CONTROL, *supra*, at 147, and Ronald J. Gilson, *The Law and Finance of the Business Judgment Rule: Comments on Chapters 6 and 7, in* THE BATTLE FOR CORPORATE CONTROL, *supra*, at 157.

At first glance, such blanket screening based on the substantive character of alleged wrongdoing would seem to be unrelated to the ex ante criteria for bringing suit set forth in our model. There is a case, however, for excluding duty of care actions, based on the assumptions of our model and on the additional—but not implausible—conjecture that the risk of legal error is far greater in duty of care actions alleging negligence or gross negligence than in duty of loyalty actions accusing managers of explicit cheating.[66]

A significant risk of legal error obscures the connection between liability and managerial behavior, and thus may mean that duty of care actions will confer little deterrent benefit.[67] If these actions do not deter negligent conduct, it follows that they are likely to cost corporations more—in indemnity payments, insurance premia, and possibly even salaries—than the amount of the recoveries that they produce. The reason for this dynamic, as our model predicts, is that managers will wish to be compensated ex ante for their expected liability. Thus, the value paid by the corporation in the form of indemnity rights and insurance premia is likely to equal the corporation's expected recoveries from managers *before* considering litigation costs. But since the corporation bears litigation costs, the corporation is therefore likely to pay more ex ante than it can expect to recover in these actions.[68]

Perversely, then, a blanket restriction on the permissible subject matter of derivative suits may come closer to embodying the lessons of our model

66. This conjecture is frequently made. *See, e.g.,* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 103 (1991); Harold Demsetz, *A Commentary on Liability Rules and the Derivative Suit in Corporate Law,* 71 CORNELL L. REV. 352, 356 (1986). The reason for expecting a significant risk of legal error in duty of care suits is closely linked to the justification for the business judgment defense: when business decisions go awry, courts find it difficult to distinguish between bad luck and bad judgment. *See* Ronald J. Gilson, Executive Compensation and Corporate Governance: An Academic Perspective 26 (Nov. 1992) (unpublished paper, on file with the authors). By contrast, management decisions in duty of loyalty cases, if shown to involve opportunities for personal gain at corporate expense, are a priori less likely to be innocent. We are grateful to Professor Ronald Gilson for his insight on this point.

67. Duty of care actions might also fail to deter because corporations can insure or indemnify for all liabilities arising from such actions. *See supra* note 33. Yet how much this matters is an open question. On one hand, duty of care actions presumably impose nonmonetary costs on defendants, such as injury to reputation. On the other hand, almost all nonfrivolous shareholder suits settle and thus are insurable in fact even when they allege misconduct that, if actually established, would not be insurable. *See supra* note 15.

68. Whether the corporation recovers more ex post than it has paid ex ante depends largely on the accuracy with which insurers anticipate liability risks. *See supra* note 35. Note, however, that even in the absence of deterrence, a real expected gain to the corporation results when a duty of care action thwarts a prospective harm, such as a hastily-approved merger. In this case the corporation recovers a benefit for which it has not had to pay beforehand. This observation supports Delaware's decision to retain equitable relief in duty of care actions against directors, even while permitting corporations to eliminate monetary liability in such actions. *See supra* note 65.

than any of the more particularized forms of screening now employed by boards and courts. This is not to say, however, that we wholeheartedly endorse a ban on duty of care suits. The assumption that error risks are very large in these actions remains a conjecture. Moreover, the assumption is surely wrong for some duty of care actions, even if it is correct for many others. For example, there is little risk of error in allowing a court to pass on the care of a director who completely fails to inform himself about a patently disastrous transaction, even if the adjudication of directors' care in approving transactions generally poses a significant risk of error. It follows that a blanket ban on duty of care suits can find support in our analysis only as a crude corrective to distorted shareholder litigation incentives.

V. OTHER CLASSES OF SHAREHOLDER SUITS

Thus far we have examined what is generally taken to be the most prominent class of shareholder suits: derivative actions against corporate officers and directors. As we noted at the outset, however, other classes of shareholder suits are also important.[69] First, in some circumstances shareholders may bring class actions to enforce the fiduciary duties of officers and directors directly, and in doing so avoid most of the screening procedures sketched in Part IV.[70] Second, shareholders may bring class actions against both the corporation and its officers and directors to enforce disclosure obligations arising under federal securities laws.[71] Third, minority shareholders may sue controlling shareholders,[72] in either derivative or class actions, alleging breach of fiduciary duty or violations of the securities laws. In this Part, we demonstrate that the main results of our model are not unique to derivative suits, but extend to these other types of shareholder litigation as well.

A. CLASS ACTIONS ALLEGING BREACH OF FIDUCIARY DUTIES

Our analysis extends most obviously to shareholder class actions alleging that managers have directly injured shareholders by breaching their fidu-

69. In Professor Romano's sample, the average recovery in derivative suits with a monetary settlement ($6,000,000) was about half the recovery in shareholder class actions ($11,000,000). Romano, *Shareholder Suit*, *supra* note 7, at 61.

70. *See supra* note 4 (distinguishing direct and derivative actions). Because shareholder class actions are direct suits, corporate boards have no authority to request their dismissal.

71. One common basis for such actions is Rule 10b-5, which permits actions by investors trading in reliance on corporate misrepresentations or omissions. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1993). Another basis is Rule 14a-9, which bars misrepresentations and omissions in proxy materials. SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1993).

72. A controlling shareholder dominates the election of directors with a 51% stake or a smaller stake that gives de facto control over the business affairs of the corporation. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987). "Minority shareholders" are the remaining shareholders in a controlled corporation. Controlling shareholders owe fiduciary duties to corporations and minority shareholders. BLOCK ET AL., *supra* note 2, at 151-57.

ciary duties.[73] The major legal differences between such actions and derivative suits (the absence of procedural screens and the right of shareholders to recover directly) are irrelevant to our conclusions. As in the case of derivative suits, shareholders should want to bring such class actions when and only when the litigation will increase the value of shareholdings as measured by deterrence benefits, plus expected recoveries, minus litigation expenses, ex ante salaries, and insurance premium adjustments. But shareholders will instead tend to bring class actions on the basis of only expected recoveries net of litigation costs.[74]

B. CLASS ACTIONS ALLEGING SECURITIES VIOLATIONS

A shift in the legal theory of shareholder suits against managers—from a fiduciary claim to an alleged violation of the securities acts—has no implications for our analysis. Thus, shareholder class actions asserting securities law violations are also subject to the distorted incentives identified in our model. This point is particularly obvious when all shareholders are potential members of the plaintiff class—for example, when the corporation and its directors have distributed misleading proxy materials prior to a merger vote, in violation of SEC Rule 14a-9.[75] Presumably, shareholders would wish to bring only those actions that will increase the value of shareholdings. Just as in the case of actions alleging fiduciary breach, however, shareholder incentives to sue will be keyed to ex post recoveries, and will not reflect either the deterrence benefits or the ex ante salary costs of suit.

The same logic applies to shareholder actions charging that the corporation and its managers caused trading losses by issuing misleading information (that is, they committed a "fraud on the market" in violation of SEC Rule 10b-5).[76] On an ex post basis, such suits only benefit investors who have traded on distorted market prices (as opposed to all shareholders), and they are obviously motivated by the prospect of obtaining large recoveries for these traders and their attorneys. Yet this incentive to sue is distorted because it neglects the corporate costs of suit that all shareholders bear ex ante. Before a misrepresentation is discovered, all sharehold-

73. The classic example is Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), which held an entire corporate board personally liable for gross negligence in considering a merger proposal.

74. The problem of distorted incentives to bring class actions may be worse than the distortions in derivative suits because in a class action, unlike a derivative action, there is no opportunity for the board to exclude value-decreasing actions.

75. 17 C.F.R. § 270.14a-9 (1993).

76. The best known example involves a misrepresentation of good news that was arguably intended to benefit the corporation and all of its shareholders. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988) (class action against corporation and its directors for falsely denying merger negotiations). But the overwhelming majority of cases involve managers who lie out of self-interest about bad news that might put their own positions at risk. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 724-27 (1992) (surveying 111 fraud-on-the-market cases).

ers, including those who have purchased or sold their shares after the misrepresentation occurred, would prefer potential plaintiffs to bring suit only when its deterrence value exceeds its corporate costs.[77] That this may not happen much of the time is graphically indicated by fraud-on-the-market cases[78] in which the sole defendant is the corporation itself.[79] Because these suits abandon even the pretense of deterring managers, they are unlikely to accomplish anything more from an ex ante perspective than to impose litigation costs on the corporation and its shareholders.[80]

C. SHAREHOLDER ACTIONS AGAINST CONTROLLING SHAREHOLDERS

Finally, suits brought by minority shareholders against controlling shareholders are also subject to distorted incentives.[81] Just as in other classes of shareholder litigation, minority shareholders considering suit against a control group are likely to rely solely on net expected recoveries in deciding whether to sue. They will thus overlook ex ante gains from deterring behavior that would lower the value of their shareholdings, as well as litigation costs that they do not bear. In addition, minority shareholders will overlook the ex ante costs of suit. Of course, suits against control groups may not impose ex ante costs on the corporation in the form of salary adjustments. But these suits will have an analogous negative effect on share value by making shares less valuable to investors who expect to reap the benefits of being a member of a control group.

In Note 6 of the Appendix we later examine how minority shareholders may either bring a value-decreasing suit or fail to bring a value-increasing suit, on the simplifying assumption that all shareholders face identical prospects of organizing a control group able to extract private gains from

77. By hypothesis, purchasers and sellers of shares do not know at the moment of transacting whether they are transacting at a distorted market price. At that moment they will prefer to allow only those suits that add value for all shareholders, in order to obtain the top price for their shares (if the seller) or the top value for their price (if the buyer).

78. "Fraud on the market" occurs when corporate managers manipulate stock prices by making misleading statements in violation of SEC Rule 10b-5. *See, e.g.*, *Basic*, 485 U.S. at 241-49 (1988).

79. Professors Arlen and Carney report that corporate issuers were the sole defendants in 9% of their sample of 111 cases. Arlen & Carney, *supra* note 76, at 727. Of course, the distinction between corporate and individual defendants is artificial to the extent that recoveries from managers are, in reality, insurance settlements that are indirectly funded by corporations. *See supra* note 35.

80. Although it might be argued that corporate liability deters misrepresentations by managers indirectly (by encouraging private disciplinary measures), the case for such "gatekeeper" enforcement seems weak here. Like illicit self-dealing, market fraud usually benefits managers at the expense of investors and of the corporation. Arlen & Carney, *supra* note 76, at 727. Thus, sanctioning managers directly seems far more likely to deter market fraud than imposing additional costs on corporations and their shareholders. Professors Arlen and Carney develop this point forcefully. *See id.* at 704-17.

81. These may be derivative suits alleging self-dealing or class actions challenging cashout mergers. *E.g.,* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

the corporation. In such a case, all shareholders would agree ex ante that suits against control groups should be brought if and only if they would tend to increase share value. But shareholders who find themselves in the minority position ex post will sometimes fail to bring suit against control groups when this would increase share value by spurring deterrence. Minority shareholders will also sometimes bring suit even when this will ultimately decrease share value, because the recoveries obtained are offset by lowered share value due to reduced profits for control groups.

In the real world, of course, shareholders generally do not face equal prospects of joining a control group. Nevertheless, the ex ante costs and benefits of suit are similar for all shareholders, even for those who expect never to participate directly in the diversionary gains of a control group. This is obvious with respect to the ex ante benefit of suit, deterring diversion by a control group. To some extent, it is also evident with regard to the ex ante cost of suit, because the prospective gains and losses of the control group will inevitably affect demand for all shares in the corporation—and thus, through the market, affect the value of non-controlling shares as well.[82]

D. SUMMARY

This discussion demonstrates that the distortion in litigation incentives is not a special characteristic of derivative suits against corporate managers. Rather, it is an endemic feature of all shareholder litigation against corporations, managers, and controlling shareholders in which there is a relationship between the parties that shifts the costs of prospective liability, in whole or in part, from defendants to plaintiffs prior to suit.[83]

82. For example, the litigation risks of control shareholders will lower the price that control groups will pay to purchase minority stakes.

83. A different scenario is presented by class actions following public offerings of securities. This popular genre of suits accuses corporate issuers—and often their managers, underwriters, and accountants—of making misrepresentions while issuing new securities. Imposing liability here, as for most other classes of securities fraud, should in theory reduce the information costs of investors, and thus increase the net value of securities. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 602-05 (1984) (discussing market-based techniques for reducing information costs). Nevertheless, shareholders face distorted incentives to bring such suits because they are likely to consider only ex post net recoveries in deciding whether to sue, while neglecting the deterrent benefits and ex ante costs of suing.

Unlike the shareholder actions considered in the text, however, value-decreasing suits against new issuers are more likely to impose costs on the issuers than on the purchasers of securities. Issuers feel the ex ante effects of distorted litigation incentives, such as higher underwriting fees and foregone deterrence benefits, before their securities are distributed, yet they cannot recoup these costs by raising securities prices because investors have many alternative investment opportunities. In theory, then, issuers should attempt to lower their cost of capital by binding the purchasers of their securities to bring suit when and only when it is value-increasing (although any effort to do this would likely run afoul of the securities acts). *E.g.*, 15 U.S.C. § 77k (1993) (Section 11 of the Securities Act of 1933, as amended).

VI. THE PROSPECTS FOR REFORM

As a logical matter, a variety of law reform strategies might ameliorate the misalignment of shareholder incentives to bring suit that we have identified.[84] In this Part, we explore one such strategy that looks to the courts to improve shareholders' incentives to bring suit by altering the plaintiffs' (or, more realistically, the plaintiffs' attorney's) compensation rule. Our purpose in selecting this reform—one that closely follows existing law—is illustrative rather than prescriptive: we wish to demonstrate the kind of implications our analysis carries by briefly sketching how a different rule for awarding attorney fees might improve litigation incentives. We have not canvassed alternative reform strategies, and we focus only on derivative suits (as in Parts II-IV). Nevertheless, we suspect that other possible reforms and classes of shareholder suits raise fundamentally similar issues of policy and administration.

A. COMPENSATING PLAINTIFFS FOR INCREASING CORPORATE VALUE

Consider first the introduction of a plaintiff compensation rule that would lead shareholders to sue if and only if suit would increase corporate value. Unlike the rules considered in Part II, this rule would fully reflect deterrence benefits and manager-related liability costs. It could be adopted by statute or, with legislative leave, by amending corporate charters. In theory, moreover, the rule would be easy to frame: courts would be instructed to award attorney fees to plaintiffs in shareholder suits only after determining that these actions were likely to increase corporate value, based on the analysis set forth in Parts II and III.[85] In principle, such a rule would attract only value-increasing suits, even without screening by courts or corporate boards.

At first glance, such a plaintiff compensation rule might appear to be doomed by the difficulty of the task that the courts must perform in valuing shareholder suits. Shareholder litigation is already hard to value;[86] assess-

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Professor Alexander's study provides further discussion of the institutional context and agency problems attending suits against new issuers of securities. *See* Alexander, *supra* note 5, at 524-68.

84. Strategies to mitigate the effects of distorted litigation incentives can differ by method (altering plaintiffs' incentives directly verses screening value-decreasing suits) and by administrator (boards versus courts or even agencies). In this Part, we sketch a judicially-administered effort to alter plaintiffs' incentive by revising the rule for awarding attorney fees. More radical strategies, based on very different background assumptions, might range from permitting boards of directors complete discretion to frame and administer litigation policy to vesting such discretion in an expert agency. We make no effort here to review the many alternatives to our illustrative proposal.

85. In the case of a class action, the parallel threshold for a fee award would be that the action was "investment value increasing" for the class members.

86. Derivative suits today must be valued after settlements, adjudications to establish fee awards, and decisions to pass on motions to dismiss by special litigation committees. On the difficulties of valuation in the last context, see Seligman, *supra* note 61, at 410-14.

ing its costs and benefits from an ex ante perspective would seem to be harder still. On closer inspection, however, assessing the value of shareholder suits divides readily into component tasks that fall well within the scope of judicial competence. As an initial matter, there are two distinct grounds for awarding attorney fees under a compensation rule that rewards increases in corporation value: deterrence of misconduct or generation of net recoveries. Fee requests on these two grounds can be analyzed sequentially. A court should first ask whether deterrence justifies a fee award, and only then—if a deterrence rationale is lacking—inquire into whether the suit's net recovery supports an award.

1. Awarding Fees on Deterrence Grounds

In considering whether to award fees on deterrence grounds (the first step in the sequential analysis), a court should treat an affirmative decision to award fees as creating a judicial commitment to induce suit against similar misconduct in the future—or, alternatively, as implementing a judicial commitment made in the past.[87] Such a commitment would be worthwhile whenever the prospect of suit is likely to deter misconduct, because deterrence almost always increases corporate value under our analysis.[88] Hence, to award or withhold fees on a deterrence rationale, courts need only make an up-or-down judgment about the likelihood of deterrence. Although this decision could not be made with mathematical precision, we expect that courts would learn over time that some types of suits—even if uneconomic in the immediate sense that they fail to recover their costs—ultimately result in beneficial deterrence of harmful misconduct. Presumably, a court in evaluating a suit's deterrence prospects would look chiefly to the penalties that it imposes on wrongdoers and the probability that shareholders could detect similar misconduct. Thus, settlements reached without evidence of wrongdoing or that impose no obvious costs on defending managers would be poor candidates for fee awards, as would suits targeting misconduct that shareholders are inherently unlikely to detect.[89] By contrast, misconduct such as self-dealing that is widely known

87. Whether a fee award creates or implements a commitment to induce suit depends on whether courts have previously awarded fees in suits against similar misconduct. Presumably pressure to grant fees is greater when there is precedent for doing so. Against the backdrop of past fee awards, a judicial decision to award fees again not only deters future misconduct, but also pays for past deterrence and underwrites the broader credibility of judicial commitments. *Cf. supra* note 36 and accompanying text (distinguishing the benefits of making and enforcing shareholder commitments to sue).

88. Of course, after misconduct is discovered, the costs of suit may well exceed its deterrent benefits for the company where suit is brought. But even for this company, deterrent benefits should be evaluated on an ex ante basis, when the company faces only the expected costs of litigation rather than the much larger actual costs of suit. *See supra* note 64.

89. Much serious misconduct by corporate managers—including bribery, kickbacks, and insider trading—is often inherently unlikely to be detected by shareholders acting alone. Shareholder suits involving these forms of wrongdoing often "piggyback" on governmental

or can be discovered by close analysis of the public record (including SEC disclosure documents)[90] is presumptively subject to detection and therefore to deterrence—provided that suit imposes genuine penalties on the managers at fault.[91]

After a judicial finding that a suit is likely to confer significant deterrent benefits, attorney fees should ordinarily follow without further analysis. This is because the corporate gain from deterring recurrent misconduct would almost always exceed the cost of a judicial commitment to induce suit. Correlatively, in setting the amount of a plaintiff's fee award, a court would not need to value the full extent of the deterrent benefit, beyond determining that it exceeded the costs of the litigation at hand, since any fee large enough to induce suit against similar misconduct would suffice to generate the benefit. A sensible way to set fees in such a case would simply be to award the plaintiff's attorney a sum designed to assure future attorneys a reasonable return on the cost of bringing a similar suit. For this purpose, the familiar lodestar method of fee calculation presently used to set fees in class actions for federal securities violations would be an appropriate measure of attorney fees.[92]

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or internal corporate investigations. *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (derivative suit targeting corrupt practices follows internal corporate investigation). In these cases, the deterrence inquiry must ask whether the *additional* sanction imposed by a shareholder suit—beyond the penalties that wrongdoers face from the original investigation—substantially enhances the prospects for deterrence. When this seems unlikely, as when shareholder suits piggyback on criminal or SEC investigations, attorney fees can only be justified by positive net corporate recoveries. By contrast, shareholder suits against hard-to-detect misconduct may well deter misconduct (and hence merit fees on deterrence grounds) when punitive damages result or when—in a reversal of the common pattern—public enforcement proceedings follow in the wake of shareholder allegations.

90. For example, Item 404 of Regulation S-K requires detailed disclosure of direct and indirect self-dealing transactions. This disclosure is also incorporated by reference in Item 13 of the Form 10-K annual report, which must be completed by public companies registered under the 1934 Act.

91. Recall that most shareholder suits settle today, and that corporate recoveries from settlement are usually paid by insurers rather than defending managers. *See supra* note 15. At first glance, requiring settlements to penalize defending managers as a condition for deterrence-based fee awards might seem to discourage settlement needlessly and to ignore the possibility that some suits deter by imposing invisible sanctions, such as reputational injury. Notwithstanding these objections, conditioning fee awards on visible penalties makes sense for two reasons: (1) it would lower litigation costs by discouraging suits that cannot deter, and (2) it would discourage plaintiffs from dissipating the deterrent value of other suits through a sweetheart settlement. Settlements would still occur under such a "visible penalty rule" when managers agreed to pay part of the settlement price or to accept an equivalent penalty. *See infra* text accompanying notes 103-04. Nonetheless, this rule would significantly change settlement expectations on both sides of the corporate bar—very much for the better, we predict.

92. *See supra* note 31 (lodestar formula). Of course, the lodestar formula imposes difficulties of its own. Lodestar fees, which are awarded after a suit is adjudicated or settled, must be inflated by the court to induce attorneys to take promising but risky cases ex ante. To pick the right multiplier, the court must estimate both the optimal amount of effort required by a suit and the suit's risk of failure despite this effort. *See* Lynk, *supra* note 31, at 189-93.

2. Awarding Fees on the Basis of Net Recoveries

Even if a suit seemed unlikely to deter misconduct, a court would still award attorney fees under a value-based compensation rule upon finding that the suit produced a positive net recovery for the corporation. As with the deterrence inquiry, this inquiry would not be burdensome for the court to administer. A suit without deterrent value only benefits the corporation through its gross recovery, while its costs include both litigation expenses and increases in insurance or salary costs that are associated with managers' liability. Consequently, a court could calculate a corporation's net recovery by merely adjusting gross recovery downward to reflect the manager-related costs of liability and litigation expenses.

As a practical matter, the necessary adjustment of an action's gross recovery could proceed in two steps. The first step would be to subtract the manager-related costs of liability. In the world of our model, some combination of salary increases, indemnification, and insurance fully offset managers' expected costs of liability. Hence, judgments against managers or their insurers should never qualify as corporate "benefits" for purposes of setting fee awards.[93] Of course, this exclusion would be overbroad in the real world, where direct recoveries from managers are not anticipated by salary levels and, therefore, may be treated as true corporate benefits.[94] However, the same cannot be said for shareholder recoveries that are funded by insurers or, in cases of indemnification, by corporations themselves. A value-based compensation rule must therefore recognize that these recoveries impose real costs on corporations. In particular, as long as director and officer insurance premia fairly reflect the expected payouts of insurers, the simplest way for a court to account for the corporate costs of liability insurance when assessing a fee award is to subtract all payments made by insurers from the gross recovery.[95] In practice, this procedure

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Estimating effort and risk in the deterrence context introduces further complications. Very risky suits involving unsettled law or facts may not be plausible deterrents, and thus may not merit any attorney fees. Similarly, whether a suit deters may depend on how much effort the court will compensate, as when more investigation increases the detection of misconduct, and hence the deterrent value of suit.

These calculations are not easy. Indeed, applying the lodestar formula may be more difficult than resolving our primary question, i.e., determining when fee awards are merited at all. But unlike the fee rule that we discuss, the lodestar formula is a familiar aspect of securities litigation. Invoking it does not invite a novel judicial burden. *But cf.* Burlington v. Dague, 112 S.Ct. 2638 (1992) (disapproving application of multipliers in lodestar formula in environmental action).

93. The justification, as we have argued in Part II, is that recoveries from managers are offset by salary adjustments and therefore such recoveries do not benefit the corporation at all.

94. We have qualified the salary assumptions made in our model. *See supra* text accompanying notes 35-36.

95. As Professor Oesterle has argued, corporate recoveries from insurers that are offset by increased insurance premia constitute a "farcical triangle." Oesterle, *supra* note 10, at 571. Although insurance premia may rise to reflect claims filed against a corporation's managers

would generally yield the same result as excluding all recoveries from managers and their insurers, because insurers fund most recoveries paid out in shareholder suits.[96]

Finally, after adjusting the gross corporate recovery to reflect insurance and indemnification costs, courts should subtract all relevant litigation costs to obtain the net corporate recovery. These costs would include not only corporate legal costs and the expense of managers' time and effort devoted to defense, but also the prospective cost of paying fee awards to plaintiffs' attorneys. In the absence of deterrence, plaintiffs' attorneys should receive fee awards only if positive corporate value remains after subtracting all litigation costs from adjusted corporate recoveries.[97] When this condition is satisfied, courts could set the size of fees either as a percentage of the adjusted corporate recovery or, following the lodestar formula, as a reasonable return on plaintiffs' investment in litigation.[98]

B. FEE REFORM, AGENCY PROBLEMS, AND D & O INSURANCE

A proposal to award attorney fees only when suits appear to be value-increasing addresses incentive problems in shareholder litigation that are logically distinct from the agency problems widely discussed in the literature.[99] Thus, awarding fees as we propose would not directly bar either frivolous suits or sweetheart settlements. But a revised fee rule might plausibly mitigate both agency problems by altering the incentives of plaintiffs' attorneys. Frivolous suits that produced, at most, small insurance settlements would yield no net recoveries under our analysis, and hence no fee awards.[100] Similarly, sweetheart settlements of meritorious suits that

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ex post, how accurately premia reflect liability risks ex ante is less certain. To the extent that premia do not reflect liability risks accurately, recoveries from insurers might benefit some corporations ex post, at a commensurate cost to the entire pool of insured corporations. But the case for excluding insurance recoveries in valuing shareholder suits does not depend on how accurately insurance premia reflect firm-specific liability risks. Shareholders are unlikely to assess liability risks more accurately than insurers. Thus, when shareholders weigh insurance costs against expected recoveries ex ante, they will prefer to bar suits that cost the insurance pool more than they recover on behalf of individual corporations.

96. Even apart from the theoretical claim that salaries reflect liability ex ante, the evidence that insurers—and not managers—fund most recoveries graphically demonstrates that recovery dollars are, for the most part, merely recycled corporate dollars. *See supra* note 18.

97. Courts should only debit reasonable litigation costs in calculating net corporate recoveries to prevent companies from overinvesting in legal defenses in order to reduce fee awards.

98. The lodestar formula remains the more attractive measure of fees as a matter of theory. *See* Lynk, *supra* note 31, at 191-95 (percentage-of-recovery formula for calculating fees skews incentives of plaintiffs' lawyers).

99. *See supra* note 5 (collecting sources).

100. Whether structural reforms undertaken to settle shareholder litigation yield net benefits for shareholders would be a more difficult issue to resolve. We share Professor Romano's suspicion that structural reforms tend to be cosmetic rather than value increasing. *See* Romano, *Shareholder Suit*, *supra* note 7, at 63.

induced insurers to fund large settlements without penalizing managers would generate neither deterrent benefits nor net corporate recoveries. As a consequence, plaintiffs' attorneys would reject such settlements. Under our proposal, they could earn fees only by imposing real penalties on errant managers or obtaining uninsured recoveries, whether by going to trial or by negotiating settlements to the same effect.[101]

Commentators frequently observe that the agency problems endemic to shareholder litigation are closely linked to prevailing settlement and insurance practices. Boards settle dubious suits (and hence lawyers bring them) not only to avoid legal costs and the outside risk of personal liability, but also because insurance funding disguises the true costs of settlement.[102] Similarly, easy access to insurance funds permits culpable managers to buy off strong shareholder claims at little visible cost to their companies. In effect, our proposal for fee reform would limit both uses of insurance funds by forcing plaintiffs' attorneys to reject settlements that provided for insurer contributions and little else.

Of course, viewing our proposal as a constraint on D & O insurance raises substantive questions about how much liability risk managers should bear. At one extreme, it is logically possible—although highly unlikely—that restricting fee awards does not go far enough: D & O insurance itself should be limited, or even prohibited outright, to maximize deterrent benefits and net recoveries from shareholder suits.[103] At the opposite extreme, it is also possible that constraining D & O insurance in even the minimal and indirect fashion that we suggest would impose too much risk on managers. Again, however, we are skeptical.

Although our proposed reform of fee awards might well increase managers' liability risk, two considerations suggest that this effect would be small relative to the potential deterrent and recovery benefits of suit. First, limiting fee awards to value-increasing actions would eliminate the incentive to bring large numbers of weak or dubious suits. Second, companies would continue to retain considerable control over legal risk under our proposal. They could choose to litigate derivative actions or to settle on

101. Recall that D & O insurance will not cover actual judgments against managers for breaches of the duty of loyalty or for securities fraud. *See supra* note 33.

102. *See* Alexander, *supra* note 5, at 550 (the insurance and indemnification system may be the single most important factor in decoupling settlements from the merits of securities class actions). Lax settlement practices appear to create a significant moral hazard by permitting settling companies to shift costs to the pool of insured companies.

103. We are highly skeptical of this view. In a world of legal error, strike suits, and soft-edged corporate and securities laws, a ban on D & O insurance would impose crushing risk on officers and directors. It would presumably raise compensation levels and force many managers (notably the risk averse and the wealthy) out of service entirely. Indeed, in one survey, 88% of directors reported that they would not continue to serve without D & O insurance coverage. *See supra* note 33. Thus, we suspect that the aggregate costs of barring D & O insurance would far outweigh the deterrent and recovery benefits that might accrue to corporations as a result.

terms that combined insurance contributions with value-increasing measures. For example, a plausible settlement might impose private penalties on suspect managers (such as dismissal or demotion) but rely on insurers to pay monetary claims. These terms could generate a deterrent benefit (and hence fees for plaintiff's attorney) but would nonetheless limit the risks of defending managers by shielding them from massive damage claims.[104]

C. ALTERNATIVE REFORM STRATEGIES

A full evaluation of our proposal to link fee awards to the value of derivative litigation would obviously require more study, especially of prevailing insurance and settlement practices. Our goal in this paper is less ambitious: We merely wish to describe in plausible detail one genre of reform suggested by our analysis of distorted litigation incentives. Other reform strategies that find support in our analysis are possible as well. In particular, lawmakers who wished to mitigate distorted litigation incentives might also look to the reform of the screening doctrines examined in Part IV, such as the demand requirement and review of special litigation committee recommendations.

Even without pursuing the matter in detail, it is easy to suggest what legal screens on shareholder suits ought to accomplish in our view: namely, identifying and culling only those actions that appear likely to decrease corporate value. This means that our analysis is clearly relevant when courts are called upon to perform this very task, as when they must pass upon the recommendations of a special litigation committee to dismiss a suit.[105] In this circumstance, we would argue, judges should conduct much the same two-step inquiry that we propose for awarding fees. That is, courts should ask whether the suit is a plausible deterrent and, if not, whether it is likely to yield any recovery net of litigation costs and payments made by the corporation or its insurers. To be sure, such an inquiry will often be inconclusive before the settlement or adjudication of a case. But that is the nature of a legal screen. Where the strength of plaintiff's case indicates a real possibility of ultimately increasing corporate value, there is little justification for culling the suit.

Attempting to cull value-decreasing suits at the outset of litigation—at the point of demand on the board of directors in a derivative action—is likely to be still less conclusive than screening at later points in the litigation. Yet, the two-step analysis we propose may have a role to play even here. In particular, it might be possible to determine early on that

104. To the extent that managers already face private penalties in the wake of shareholder suits, settlements along these lines would simply formalize an existing practice. *See supra* note 34 (management turnover increases following shareholder suits).

105. *See supra* text accompanying notes 58-64.

some suits have no plausible deterrent benefit,[106] in which case a small expected recovery relative to litigation and insurance costs would justify dismissal.

Thus, our approach is no less suited to crafting screening rules than it is to allocating attorney fees. Perhaps the real difficulty in proposing to screen derivative suits based on their contributions to corporate value lies less in the logic of screening than in the issue of who screens: corporate boards or trial courts? Here, the arguments on both sides track the familiar debate over the reach of the demand requirement.[107] On one hand, screening by independent directors is likely to be cheaper and better informed as to the facts than screening by judges; on the other hand, screening by courts is likely to be better informed about the law and less prone to structural bias than screening by boards. The difficulty of balancing these relative institutional competencies may be a good reason to begin correcting shareholders' distorted litigation incentives by rethinking fee awards rather than by rewriting the screening rules.[108]

D. A FINAL NOTE ON THE DIFFICULTY OF VALUING SUITS

The proposed reform regime that we have sketched in this Part closely parallels the one that already regulates derivative suits and could be adapted for use in many shareholder class actions. The only real novelty in our proposal concerns the substantive standard at the core of the compensation rule: suits ought to be judged and plaintiffs rewarded on the basis of the value that they create for corporations, rather than on the basis of the gross corporate recovery that they generate. As a practical matter, then, the merits of our proposal might seem to turn on how accurately courts, boards, and litigants can estimate the value of suits, as we have developed this concept.

But this assessment would put our proposals to too hard a test. Our analysis requires valuation for purposes of screening suits or awarding fees only when shareholder actions appear unlikely to deter misconduct. By definition, such suits do not confer hard-to-value deterrent benefits and, as

106. For example, we would be skeptical of complaints that lacked specific allegations of misconduct or that "piggybacked" on extraordinary investigations by third parties, since the wrongdoing alleged in these complaints would be presumptively difficult to detect or deter a second time. In this connection, it might be argued that Delaware's requirement that misconduct be pleaded "with specificity" in derivative actions excludes not only frivolous suits but also actions without plausible deterrent value. *See supra* note 56 (Delaware's demand excused test).

107. *See supra* note 6 (collecting sources).

108. Note also that our proposed reforms do not preclude different measures aimed at ameliorating the agency problems in shareholder litigation, such as restructuring fee awards or even auctioning suits to the highest bidder. *See, e.g.,* Macey & Miller, *supra* note 5; Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Suits*, 87 NW. U. L. REV. 423 (1993); Jonathan R. Macey & Geoffrey P. Miller, *Auctioning Class Action and Derivative Suits: A Rejoinder*, 87 NW. U. L. REV. 458 (1993).

we have suggested, there is a simple method for registering their manager-related costs: namely, disqualifying payments by insurers as corporate benefits. By contrast, the important class of suits with genuine deterrent potential may not require explicit valuation at all, but only an up-or-down decision on their ability to deter. We know that this decision cannot be made with great accuracy—perhaps not even with the level of accuracy that courts now achieve in estimating the potential recovery value of suits. Nevertheless, accuracy is not needed to justify reform. The choice is not between a more or less accurate measure of value, but between a distorted standard for evaluating shareholder suits and a true one. Surely the legal regime governing shareholder suits should not prescribe the wrong standard, simply because the right one is hard to apply.

VII. CONCLUSION

Legal rules that compensate plaintiffs and their attorneys on the basis of recoveries from suits introduce a fundamental distortion in the decision to bring suit. In some cases, these rules create too weak an inducement to sue because they fail to reflect the deterrent benefits of a decision to bring suit. In other cases, these rules create too strong an incentive to sue because they fail to reflect the implicit costs, especially increases in liability insurance premia, imposed by prospective liability. At present, there is little in the legal regulation of shareholder suits to correct the distorted incentives created by plaintiff compensation rules. But law reform, in the guise of a new compensation rule and a new legal screen on shareholder suits, might do much to correct these distorted incentives.

APPENDIX

In this Appendix, we set forth and briefly analyze the model of shareholder derivative suits that we discuss in the text. In paragraph 6 below we also sketch a model of shareholder suits against control groups.

1. *Basic assumptions*. A risk-neutral manager of a corporation may decide to violate a duty and, if so, may be discovered. If he is discovered, risk-neutral shareholders may sue. In a shareholder suit that succeeds, the corporation will obtain an award and the manager will lose an amount. The manager's expected salary, net of any expected losses from such awards, must equal his reservation salary (interpreted, for example, as the value of his opportunities elsewhere). Let:

g = the gain to the manager from violation of his duty;
h = the harm to the corporation if the manager violates his duty;
p = the probability that shareholders will detect a violation;
q = the probability that a shareholder suit would succeed if brought;
c_π = the cost of bringing a suit;
c_δ = the cost of defending against a suit;
r = the loss to the manager if he loses a suit;

d = the damage award that the corporation will obtain if the shareholder suit succeeds;
v = the value of the corporation, exclusive of the manager's salary, the losses associated with violations of duty, and litigation costs;
w^* = the reservation salary of the manager; and
w = the actual salary of the manager.

We make several assumptions and comments about these variables:

(i) $g < h$. The gain to the manager from violation of a duty is less than the harm this causes to the corporation. (For instance, the manager may obtain a benefit when he orders the corporation to make a purchase that is exceeded by the loss the corporation suffers due to the purchase.) The quantity $h - g$ is the *inefficiency* created by a violation of duty.

(ii) $g < r$. The gain to the manager is less than his loss if he loses a suit. The justification for this assumption is that otherwise the manager would not be deterred from violating his duty even if he would be sued and lose with certainty. (The loss r may be interpreted as including the damage to reputation the manager suffers as well as the judgment he must pay if he loses a suit.)

(iii) w plus expected gains from violations minus expected losses from losing suits just equals w^*. This is the assumption that the expected net salary equals the reservation salary.

We also assume that the object of shareholders is to maximize the net value of the corporation: the value of the corporation less any litigation expenses they themselves have to bear. Shareholders may bring suit to achieve this goal.

2. *Effect of suit on managerial behavior and net corporate value.* We consider two situations here: (1) situations where suit will not be brought if the manager commits a violation, and (2) situations where suit will be brought if he does so and is detected. The manager is presumed to know whether or not suits would be brought.

If shareholders will not bring suit, the manager will clearly commit a violation, so the total salary of the manager will be $w + g$. Because (by assumption (iii)) $w + g = w^*$, then also $w = w^* - g$. Hence, the value of the corporation will be

$$v - h - (w^* - g). \tag{1}$$

If shareholders will bring suits whenever the manager commits a violation and is detected, the manager will commit a violation if and only if[109]

$$g > pqr. \tag{2}$$

109. In order to preserve the simplicity of our exposition, we do not comment on cases in which the manager is indifferent.

If (2) does not hold, the manager will be deterred from committing a violation, so his salary will be w^* and the value of the corporation will be

$$v - w^*. \tag{3}$$

If (2) holds, the manager will commit a violation, and shareholder suits will be brought with a probability of p and will be won with a probability of q. Thus, the total salary of the manager will be $w + g - pqr = w^*$, so that $w = w^* - g + pqr$. Hence, the net value of the corporation will be

$$v - h - (w^* - g + pqr) + pqd - p(c_\pi + c_\delta). \tag{4}$$

The last term is explained by the fact that when suit is brought, c_δ is borne by the corporation and c_π by the shareholders.

3. *When suit increases and decreases net corporate value.* From what we have just observed, we can conclude several things. First, *suit raises net corporate value when the prospect of suit deters violations.* When violations are deterred, that is, when (2) does not hold, the value of the corporation is $v - w^*$, rather than $v - h - (w^* - g) = v - w^* - (h - g)$. Thus, the increase in corporate value from deterrence equals $h - g$, the inefficiency caused by a violation. The reason for this result is that when violations are deterred, the corporation prevents harm of h but has to raise the manager's salary by g, for a net gain of $h - g$.

Second, *suit also raises net corporate value even if violations are not deterred, provided that the expected recovery from suit exceeds the manager's expected loss plus total litigation costs.* Specifically, suppose that (2) holds—violations are not deterred—and assume that net corporate value rises due to suit, that is, (4) exceeds (1). The condition that (4) exceeds (1) can be expressed as

$$qd > qr + c_\pi + c_\delta, \tag{5}$$

which demonstrates this claim. The explanation for this is that the corporation gains qd from suit, but loses the amount of litigation costs and the amount by which it must raise the manager's salary, qr.

Third, it follows from the preceding paragraph that *suit lowers net corporate value when it does not deter violations and also fails to result in an expected recovery that exceeds the manager's expected loss plus total litigation costs.*

4. *When shareholders will decide to bring suit.* We now examine when suit will actually be brought by shareholders. This depends on the incentives shareholders face at the point when they have detected a violation by a manager. We examine two cases.

(a) *Benchmark case: where shareholders pay their pro rata fraction of litigation costs to bring suit.* In this regime, a shareholder owning fraction f of the corporation pays fc_π to bring suit (the other shareholders pay the balance). The shareholder obtains a benefit of $f(qd - c_\delta)$ from suit. Hence, a shareholder will bring suit if and only if $c_\pi < qd - c_\delta$ or, equivalently, if and only if the expected recovery exceeds total litigation costs,

$$qd > c_\pi + c_\delta. \tag{6}$$

This condition is different from those determining when suit increases net corporate value (which involve, among other factors, deterrence and compensating adjustments to the manager's wage). In particular, *shareholders might not bring suit even when its prospect would deter violations and thus increase net corporate value.* This would occur when (6) does not hold and (2) does not hold. (This is obviously possible. When (2) does not hold, it is always possible to choose litigation costs high enough that (6) does not hold.) Also, *shareholders might bring suit even when it would lower net corporate value.* This would occur when (6) holds and (2) holds, but (5) does not. (For example, suppose that $p = .5$, $q = .8$, $d = 300$, $r = 200$, $c_\pi + c_\delta = 200$, and $g = 150$.) *If, however, suit increases net corporate value when it does not deter violations, shareholders will bring suit* because (5) implies (6).

(b) *Contingency fees: where shareholders (and their lawyers) obtain a percentage α of the recovery d, but bear their litigation costs c_π.* Here, a shareholder who owns fraction f of the corporation will bear total litigation costs of $c_\pi + fc_\delta$ and obtain an expected recovery of $q\alpha d + q(1 - \alpha)fd$, since the corporation obtains $(1 - \alpha)d$ if the suit is won. Accordingly, a shareholder will sue if and only if

$$q\alpha d + q(1 - \alpha)fd > c_\pi + fc_\delta. \tag{7}$$

This condition is, like (6), different from those determining when suit increases net corporate value. *Shareholders might not bring suit despite the fact that its prospect would deter violations and increase net corporate value.* This would occur when (7) does not hold and (2) does not hold. (That this is possible is shown by the fact that when (2) does not hold, it is always possible to choose litigation costs high enough that (7) does not hold.) Also, *shareholders might bring suit when it would lower net corporate value.* This would occur when (7) holds and (2) holds, but (5) does not. (For example, suppose that $p = .5$, $q = .8$, $d = 300$, $r = 200$, $c_\pi = 40$, $c_\delta = 160$, $f = .01$, $g = 150$, and $\alpha = .3$.) Furthermore, *suit might not be brought when it would raise net corporate value but not deter violations.* This would occur when (7) does not hold and (2) and (5) hold. (Suppose that $p = .5$, $q = .8$, $d = 500$, $r = 180$, $c_\pi = 100$, $c_\delta = 100$, $f = .01$, $g = 150$, and $\alpha = .1$.)

5. *Remarks.* (a) One could introduce the possibility of erroneous convictions for violations into the model in the following way. Suppose that if the manager does not violate his duty, there is a probability p_e that he will be

seen as having violated his duty and that he will then, if sued, be found liable with probability t. In this case (we omit details), suit will be less likely to raise corporate value, and when it does, will raise it by a lesser degree. The reasons are as follows. First, deterrence will be diluted, because the manager will no longer definitely escape liability by not violating his duty. Second, there will be a greater frequency of suit, and thus more litigation costs. Third, if shareholders bring suits when the manager did not commit a violation, it can only result in a decline in corporate value, assuming that the loss to the manager is at least equal to the recovery of the corporation.

(b) The logic of this analysis suggests that no simple scheme regulating shareholder litigation—one that does not take into account the deterrence value of suits and their effect on managers' salaries—exists that will effectively limit litigation to those suits that raise net corporate value.

6. *Shareholder suits against control groups.* The model examined above can be modified to allow study of shareholder suits against control groups rather than managers. For simplicity, suppose that there are n shareholders, each holding $1/n$ of corporate value, and that one randomly selected shareholder will constitute a control group with an opportunity to divert resources to itself. We will assume that the variables are defined as before, except that here there is no manager (and thus no wage w or w^*), that g is now the diversionary gain to the control group from a violation, and that h is the harm to corporate value caused by a violation. Assume that the object of shareholders is to maximize their expected corporate value.

Now let us sketch the analysis of this model. First, consider the effect of possible suit on control group behavior and expected shareholder value: If shareholders will not bring suit, then the control group will commit a violation. Specifically, if the control group does not commit a violation, the value of the firm will be v, so that each share will be worth v/n. If the control group does commit a violation, it will obtain g for itself and cause harm h, so the share value will be $v/n - h/n - g/n$. Accordingly, the control group will commit a violation if $g + v/n - h/n - g/n > v/n$, or if $[(n-1)/n]g > h/n$, which we will assume holds. Because each person has a $1/n$ chance of being in the control group and gaining g, the expected shareholder value is

$$(v/n - h/n - g/n) + g/n = v/n - h/n. \quad (8)$$

This makes sense because, although the diversion carried out by the control group is a mere transfer and does not hurt shareholders ex ante, it does cause a loss of corporate value of h. If shareholders will bring suits whenever the control group commits a violation and is detected, the control group may or may not be deterred (as will be described below). If the prospect of suit deters the control group, the value of the firm will be v, so the share value will be v/n. If the control group is not deterred, expected shareholder value will be

$$v/n - h/n + [pq(d - r)/n] - [p(c_\pi + c_\delta)/n]. \qquad (9)$$

The explanation is that the total value of the firm will be $v - h$ (since there will be a violation) plus $pqd - pqr$ (the firm will recover d and the control group will lose r, with probability pq) minus expected litigation costs.

Next, consider when suit increases and when it decreases expected shareholder value. Expected value will be raised when the prospect of suit deters violations, for then expected value will be v/n rather than $v/n - h/n$. Suit may also raise expected value when violations are not deterred. In that case, suit raises value if (9) exceeds $v/n - h/n$, which is to say, if $qd > qr + c_\pi + c_\delta$, which is (5). The explanation is that the corporation gains qd from suit but loses because litigation costs must be incurred and because the control group loses qr. If (5) does not hold and suit does not deter violations, suit will lower expected shareholder value.

Last, consider when suit will actually be brought, assuming the benchmark case, where shareholders each pay their pro rata fraction of litigation costs to bring suit and benefit pro rata as well. A shareholder will bring suit if and only if $c_\pi/n < (qd - c_\delta)/n$ or, equivalently, if and only if $qd > c_\pi + c_\delta$, which is (6). Now when will the prospect of suit deter? If the control group does not commit a violation, each share will be worth v/n. If the control group does commit a violation and will be sued with probability p, each share will be worth $1/n[v - h - g - p(c_\pi + c_\delta) + pqd]$; but, in addition, the control group will obtain g and lose pqr. Hence, the control group will be deterred if

$$[(n - 1)/n]g + pqd/n < pqr + p(c_\pi + c_\delta)/n + h/n. \qquad (10)$$

It is clear that suit may not be brought when it would deter and raise expected shareholder value; that is, (6) may not hold even though (10) does hold. It is also apparent that suit might be brought when it would not raise expected value; in particular, (6) might hold even though (10) and (5) do not hold.

Comment

The *Georgetown Law Journal* has asked me to state why I have chosen not to comply with its policy concerning use of gender-neutral language[1] in my article (with co-authors[2]), "When Are Shareholder Suits in Shareholder Interests?"

(As an aside, I observe that the true policy of the *Journal* is not one of gender-neutrality. The *Journal* is apparently happy to publish articles that use "she," "her," and "hers," to the exclusion of "he," "him," and "his".[3])

I should think that the general considerations that might lead a person generally to use the male pronoun forms are obvious (my own reasons are not the *Journal*'s business) and include the following. First, a person might find writing that scrupulously avoids use of "he," "him," and "his" to be stilted and unnatural, upsetting to our aesthetic sensibilities (which have been molded by use of the male pronoun forms in our language and literature). Second, a person might well believe that use of gender-neutral language carries a particular political connotation (for example, pro-affirmative action for women) and not wish to be associated with it.

Of course, there are opposing considerations as well. A person might favor the political connotation to use of gender-neutral language. Moreover, and notably, a person might believe that by changing English usage, we may beneficially influence consciousness about the proper role of women in society.

Different individuals will make different choices about their use of gender-neutral and gender-specific language, as illustrated by mine and the *Journal*'s.

I hasten to add, however, that even if my decision about gender and language were that of the *Journal*, I would be concerned about the policy of the *Journal*—for the reason that it imposes a constraint on authors' freedom of expression.

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1. The *Journal* prefaces each issue with a page including this statement: "As a matter of policy, *The Georgetown Law Journal* encourages use of gender-neutral language." In my case, the *Journal* first changed all male pronoun forms to female (so the language was not gender-neutral but gender specific); then, when I amended their changes, the *Journal* asked me rather firmly to include an explanation in my article about my deviation from its desired practice. I responded that inclusion of such an explanation would be incongruous in an article about derivative suits and would be out of keeping with scholarly enterprise. As an alternative, I suggested that I write a statement separate from the article. I do not know how the *Journal* would seek to encourage use of gender-neutral language by others, but, as far as I am concerned, I faced a policy best characterized as a requirement either to comply or to publish an explanation. I therefore will take slight license below and refer to the *Journal* policy as a requirement.
2. They do not share my views on the matters in question here.
3. For example, in the April, 1994, issue of the *Journal*, two of the publications (those by Beckett and by Padden) use only female pronouns (except, of course, in reference to a named male person, like Sir Walter Raleigh); none of the publications do the reverse.

And this matter of limiting authors' freedom of expression should be viewed in a general light. The issue of gender-neutral language is not singular in nature. At another time or place, it is easy to envision individuals finding it just as important to purge writing of words or ideas deemed detrimental or offensive to groups other than women (for example, blacks, homosexuals, immigrants, the poor—or even men) as cleansing writing of "he," "him," and "his" now is apparently important to the *Journal*.[4] We have only to consider the recent experience with speech codes on the college campus to appreciate that there is a natural tendency for controls over freedom of expression to increase in scope.

The evils of a world in which authors face requirements about how and what they can write—these evils being a flow of work that is reduced and distorted in content, and a situation rife with opportunity for abuse by those with censorial authority—should not need amplification.

The *Journal*, being a scholarly publication affiliated with a university, has a special duty to guard against these evils, to uphold and foster freedom of expression. The identity of universities as social institutions dedicated to scholarship (among their other purposes) is threatened by such policies as the *Journal*'s.

In consequence, I find the policy of the *Journal* to be ill-advised and believe that it should be dropped.

—Steven Shavell

4. The *Journal* might ask itself on what basis it could object to a decision by another law review (or even to a future decision by the *Journal*) to proscribe language detrimental to any named group (such as men).

From the Editor

The *Georgetown Law Journal* does have a policy encouraging the use of gender-neutral language. It is also *Journal* policy, however, to respect our authors' voices and styles. Thus, we have acceded to Professor Shavell's wish to use exclusively male pronouns in the preceding article. We have also agreed to publish his response to our editorial policy.

Readers may judge for themselves the arguments made by Professor Shavell. Nevertheless, it is important to highlight his implicit but unacknowledged assumption that the use of exclusively male pronouns is neutral or natural—an assumption we do not share.

Language matters. The use of only male pronouns may imply a world populated solely by men, or that certain roles or spheres are reserved solely for men or for women. Women have long been excluded from the practice of law and the powerful positions within this discipline—and hence the pages of law reviews. Against the backdrop of this history, the use of only male pronouns is not a neutral exercise; rather, it is a political choice.

The *Georgetown Law Journal* encourages the use of language that reflects the presence of both genders. Authors may help us accomplish this goal in many ways, including alternating male and female pronouns—an option that was offered to but rejected by Professor Shavell.

Although the Editors of Volume 83 of the *Journal* disagree with Professor Shavell's position, we are happy that this issue is being debated in the pages of this law review. Important issues of gender equality must be discussed, not shunted aside.