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The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Anaylsis

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SYMPOSIUM

THE ROLE OF LIABILITY RULES AND THE DERIVATIVE SUIT IN CORPORATE LAW: A THEORETICAL AND EMPIRICAL ANAYLSIS

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I
INTRODUCTION

Liability rules create incentives to engage in socially desirable conduct. Tort rules, for example, are beneficial because they create incentives for automobile drivers to drive more carefully than they otherwise would. This characteristic of liability rules has led many to argue that such rules should be more frequently utilized in the publicly-held corporation to minimize divergences of interest between managers and investors.[1] Proposals have included expanding both the duty of care and the duty of loyalty; these proposals would expand the potential legal liability which corporate managers face.

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1 *See, e.g.*, Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983) (criticizing overuse of business judgment rule and suggesting standards to guide judges in duty of care evaluations); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976) (comparing state and federal treatment of managers' fiduciary responsibility); March, *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966) (criticizing lenient judicial attitude toward conflict of interest transactions); Vagts, *Challenges to Executive Compensation: For the Market or the Courts?*, 8 J. CORP. L. 231 (1983) (suggesting that courts monitor executive compensation agreements). Many of these proposals are adopted in some form in the AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 1, 1982; Tent. Draft No. 2, 1984; Tent. Draft. No. 3, 1984; Tent. Draft No. 4, 1985; Council Draft No. 5, 1985; Discussion Draft No. 1, 1985) (Council Draft No. 5 is a preliminary draft and has not been approved by the Council or membership of the ALI) [hereinafter cited as ALI PROJECT].

Related proposals have focused on the need to strengthen the derivative suit.[2] Proponents claim that the derivative suit, a suit brought by a shareholder on behalf of the corporation, is essential to enforce the fiduciary duties of care and loyalty. Absent such an enforcement mechanism, the argument runs, corporate managers could engage in wrongdoing with impunity so long as they decline to sue themselves.

Recent controversy has centered on the scope of judicial review to be applied to decisions by special litigation committees to terminate derivative suits against directors. Because the members of these committees are chosen by the same directors who are named in the derivative suit, some courts have held that the committee's decision to terminate a derivative suit should be subject to close judicial review.[3] Reducing the ability of directors or their agents to terminate derivative suits, like expanding the scope of the duties of care and loyalty, would increase directors' potential legal liability.

The underlying premise of these proposals is that greater legal liability will reduce agency costs by more closely aliguing the interests of managers and investors. The validity of this premise, however, is far from obvious. First, existing evidence suggests that the widespread assumption that corporate managers systematically act in ways contrary to investors' best interests is without foundation.[4] Thus, there may be no problem that needs to be addressed by expanding directors' legal liability.[5]

Second, liability rules create both costs and benefits; as a result,

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2 *See, e.g.*, Buxbaum, *Conflict-of-Interest Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CALIF. L. REV. 1122 (1980) (suggesting standards for courts to use in deciding whether directors' refusal to sue should terminate derivative suits); Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981) (proposing legislation that would decrease Board of Directors' powers to terminate derivative suits); Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1985) (noting that too many purposes weaken derivative suits); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96 (1980) (proposing state court actions to strengthen derivative suits); Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983) (recommending removal of impediments to derivative suits enforcing the fiduciary duty of loyalty).

3 *See, e.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982) (holding that business judgment rule does not apply when special litigation committee recommends terminating derivative suit), *cert. denied*, 460 U.S. 1051 (1983); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (abandoning business judgment rule and adopting balancing test for reviewing board or committee terminations of derivative suits). At least one commentator has suggested that special litigation committees could cause the "death" of derivative suits. *See* Dent, *supra* note 2.

4 For a comprehensive summary of the evidence, see Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984).

5 See Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982), for a general discussion of this point.

their imposition may not be desirable. In many situations, liability rules play little or no role in creating incentives for beneficial conduct. For example, elected officials, regulators, judges, and other types of government officials are relatively unaffected by liability rules.[6] Although public officials are probably the best known example in which the significance of liability rules is minimal, other examples exist. Most significant for our purposes, certain types of contracts depend on mechanisms other than liability rules for enforcement.[7]

The value of liability rules in assuring contractual performance depends on a number of factors which are discussed in Part II. Analysis of these factors suggests that liability rules play a relatively minor role in assuring contractual performance by corporate managers in publicly-held corporations. Part II also demonstrates that the problems with liability rules are aggravated when enforcement is by derivative suit (rather than an action by the corporation acting through its directors) because of the poor incentives that small shareholders and their attorneys have to maximize the value of the firm.

After briefly surveying alternative governance mechanisms for publicly-held corporations in Part III, Part IV reports the results of an empirical study we conducted of derivative suits. Proposals to expand the scope of fiduciary duties and strengthen the derivative suit necessarily assume that liability rules are highly valued by investors as a governance mechanism. Part IV demonstrates, however, that this assumption is not supported by the existing evidence.

Part V then discusses a variety of doctrines in corporate law. We argne that the effect of these doctrines is primarily to displace the operation of liability rules. Thus, corporate law is in the main consistent with our conclusion that liability rules play a minor role in assuring contractual performance in publicly-held corporations. Finally, Part VI applies the analysis in preceding sections to the most recent draft of the chapter on remedies of the American Law Institute Project on Corporate Governance.[8] Part VII is a conclusion.

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6 *See, e.g.,* P. SCHUCK, SUING GOVERNMENT (1983); Ackerman, *Bureaucratic Control and Imperfect Information* (Colum. Working Paper 1984); Mashaw, *Civil Liability of Government Officers: Property Rights and Official Accountability,* 42 LAW & CONTEMP. PROBS. 8 (1978).

7 *See, e.g.,* Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance,* 89 J. POL. ECON. 615 (1981); Knoeber, *An Alternative Mechanism to Assure Contractual Reliability,* 12 J. LEGAL STUD. 333 (1983); Macaulay, *Non-Contractual Relations in Business: A Preliminary Study,* 28 AM. SOC. REV. 55 (1963); Telser, *A Theory of Self-Enforcing Agreements,* 53 J. BUS. L. 27 (1980); Williamson, *Credible Commitments: Using Hostages to Support Exchange,* 73 AM. ECON. REV. 519 (1983). *See also* Ellickson, *Of Coase, Cattle and Cooperation: Dispute Resolution Among Neighbors in Shasta County* (draft 1984).

8 ALI PROJECT, *supra* note 1, Council Draft No. 5.

II
Liability Rules as a Governance Mechanism

Liability rules are a method of assuring contractual performance. But they are not the only method. Recent work has demonstrated that the importance of liability rules in assuring contractual performance varies dramatically in different contexts.[9] Where liability rules are likely to be ineffective, parties have incentives to adopt alternative governance structures to assure contractual performance.

A. The Limits of Liability Rules in Reducing Agency Costs in Publicly-Held Corporations

The importance of liability rules in assuring contractual performance depends on a variety of factors: the ability to negotiate, draft, and enforce complete (state contingent) contracts at a low cost; whether repeat transactions are contemplated; the efficiency of information markets; the extent to which gains from a contractual arrangement depend on a long-term relationship; the gains from breach; and comparative risk bearing ability. Analysis of these factors illustrates the limited usefulness of liability rules as a governance mechanism in the public corporation.

1. *The Cost of Contracting*

Contracts define the performance obligations of respective parties and provide a basis for remedies if an obligation is not fulfilled. Because the issue of whether a given act constitutes a breach of the performance obligation is commonly in doubt, and remedies are generally not self-executing, resolution of contractual disputes typically requires the intervention of a third party such as a court.

The role of contracts and the remedies for breach illustrate the limitations of liability rules. In some situations, specifying performance obligations ex ante is very difficult (costly) because future contingencies are often unforeseeable. Even if future contingencies are foreseeable, defining the appropriate responses to them may be impossible. Furthermore, assuming that performance obligations can be specified at the outset, enforcement may be costly ex post. For example, monitoring costs will be high whenever it is difficult to distinguish poor performance of the agent from other possible causes of a bad outcome (i.e., poor performance of other agents, adverse market movements, or other random events). The probability that a court will misinterpret the intent of the parties may also make reliance on liability rules an undesirable method of assuring contractual

9 *See* authorities cited *supra* note 7.

performance. When the costs of contracting—the combination of negotiating, monitoring, and error costs—are high, parties have incentives to devise methods other than liability rules to assure contractual performance.

The high costs of contracting preclude writing contracts that completely define the duties of corporate managers. As noted, identifying all possible contingencies as well as appropriate responses is highly impractical because the direct costs of negotiating and drafting such contracts would be prohibitive. More importantly, attempts to define in advance what managers should do in light of certain contingencies may simply prove to be wrong in light of new information and expertise. Thus, the direct and indirect costs of defining all possible future contingencies that might affect managers' decisionmaking (i.e., changes in interest rates, changes in demand for the firm's products, new technologies, and so forth), as well as responses to these contingencies, make defining adequate performance impossible.[10]

Monitoring costs also make heavy reliance on liability rules impractical as a method of assuring contractual performance. Because managers work in teams and their performance is affected by random events such as market movements, monitoring the effort or output of any individual manager is very costly. It is difficult, for example, to imagine using liability rules as a remedy for lack of effort by managers, even though this phenomenon represents perhaps the single largest source of agency costs.

The problem of error costs is similar. Courts have as much difficulty as other agents in measuring managers' efforts or output. Moreover, the difficulties faced by a court are complicated by sample bias. Because most lawsuits follow poor outcomes, courts naturally tend to assume that such outcomes are a product of bad actions. This bias can be a source of substantial error costs and can greatly discourage any risk taking by managers. Managers have a

10 It is interesting to compare firms' contracts with bondholders' and shareholders'. Because bondholders are promised a fixed return, bondholders' contracts often contain detailed provisions limiting managers' discretion to take actions that might jeopardize payment of the promised return. Contracts with shareholders are far less detailed and commonly consist of only the relatively general corporate charter, by-laws, and other internal documents. Even the more detailed contracts between the firm and bondholders do not specifically constrain the firm's production/investment decisions. From the perspective of the firm's bondholders, the ideal performance contract would require the firm's management to accept all positive net present value projects and reject all negative net present value projects. Obviously, such a contract would be far too costly to write and enforce. Consequently, bond contracts typically only deal with the firm's future financing and dividend decisions. They rarely, if ever, place specific contractual restrictions on the firm's production/investment decisions. *See* Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants,* 7 J. FIN. ECON. 117 (1979).

tendency to avoid risk because they cannot diversify the value of their human capital. Shareholders, however, can better diversify risk because of their access to capital markets; therefore, they want to create incentives for managers to accept all positive net present value projects, even those that are risky. By definition, however, risky projects can have poor outcomes; if managers are sued whenever decisions that were optimal ex ante turn out poorly ex post, they will tend to avoid risky projects. This result—reinforcement of managers' tendency to avoid risk—may be precisely what the parties to the initial agreement sought to avoid.

Because of these costs of contracting, traditional breach of contract remedies play no role in assuring the contractual performance of corporate managers. As a substitute for breach of contract remedies, corporate law has developed the fiduciary principle. Best understood as an implied term in the agency agreement that managers act to further shareholders' presumptive goal of wealth maximization, the fiduciary principle lowers the costs of contracting.[11] The extreme generality of the fiduciary principle, however, limits its application to the most extreme cases.[12]

2. *Whether Repeat Transactions Are Contemplated*

Poor performance is a rational strategy if the present gains exceed the present value of future costs. The relationship between present gains and future costs depends in large part on the likelihood of repeat transactions. The lower the probability of repeat transactions, the greater the incentive to perform poorly.

Itinerant street vendors illustrate the classic situation in which repeat transactions are not anticipated. Because such vendors typically have no brand name to protect and seldom engage in multiple transactions with the same buyer, they have strong incentives to misrepresent product quality in order to obtain a higher price; the present value of future costs of such conduct is likely to be small. Thus, poor performance in current periods to achieve even small gains is a rational strategy. At the opposite extreme is a seller of high quality products where quality is continually monitored by a well-known rating agency or consumer magazine. Here the present value of future costs caused by misrepresenting product quality is likely to be large because of the adverse consequences to the seller's reputation.

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11 For a general discussion of the fiduciary principle, see Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982). For a similar analysis of standard form terms that reduce the costs of contracting in other types of principal-agent relationships, see Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

12 As we discuss in Part IV, other doctrines of corporate law limit the scope of the fiduciary principle even further.

This contraint, resulting from the prospect of repeat transactions, decreases the importance of liability rules as a method of assuring contractual performance.

Managers of public corporations are repeat players in several respects. Even if managers need not regularly tap capital markets to raise funds, their wealth is tied to the value of the firm which is monitored continuously. Moreover, because managers realize that their performance determines their value in labor markets, they must balance any gains from poor performance, including self-dealing, against foregone compensation in future periods. As the present value of foregone compensation in future periods increases relative to the current gains from poor performance, liability rules become less important in assuring contractual performance.[13]

3. *The Efficiency of Information Markets*

Whether poor performance in current periods is a rational strategy also depends on the efficiency of information markets. Where such markets are relatively inefficient, the probability of poor performance increases. For example, poor performance by a doctor may cause a patient to go elsewhere, assuming the patient does not equate the bad result with bad luck; this prospect gives doctors some incentive to perform well. This incentive is weakened, however, by the absence of an efficient information market whereby results of performance are reflected in prices. Disappointed patients cannot sell shares in a doctor to communicate information to the market.

Managers of public corporations face a very different type of information market. Indeed, few information markets are as efficient as capital markets where a firm's securities are publicly traded. Poor performance in efficient capital markets will have several significant consequences. First, investors (both informed and uninformed) will pay less for shares. The more investors believe that their dollars will be used by those in control of firms in ways inconsistent with maximizing the value of the firm, the less they will pay for shares. To minimize this rational fear of investors, those in control have incentives to adopt governance mechanisms that limit their discretion to benefit at investors' expense.[14]

Second, accurate price signals in capital markets contribute to

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[13] Thus, poor performance is likely to be more profitable for older than for younger workers. Agreements providing for a lump sum payment upon retirement assuming satisfactory performance can reduce the risk that older workers will perform poorly, however.

[14] *See* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

the efficiency of labor markets. Share price information provides a relatively low cost method of evaluating the performance of corporate managers. Such information can be used to set managers' compensation within the firm as well as to measure their opportunity wage in external labor markets.

Finally, efficient capital markets facilitate the operation of the market for corporate control. The market for corporate control provides managers with an incentive to perform well and thus keep share prices high, as well as a device for displacing management teams who perform poorly.[15] The efficient operation of the capital, labor, and takeover markets all raise the future costs of poor performance, thereby helping to assure contractual performance.

4. *The Extent to Which Anticipated Gains Depend on a Long Term Relationship*

The gains from exchange in many contracts do not depend on the identity of the other party. If *A* purchases wheat from *B* and then *B* refuses to perform, *A* can probably purchase wheat of identical quality from *C* without difficulty. Neither party in the above example has a specific investment in the particular transaction, and the gains from exchange thus do not depend on the continued presence of either party.

But not all contracts are of this type. Assume *A* contracts with *B* for the construction of a nuclear power plant. At the time the contract was entered into *B* was one of many contractors with the necessary expertise. Over time, however, it is likely that *B* will acquire certain skills and expertise that are specialized to this particular transaction. Other contractors who were once close to perfect substitutes for *B* now are decidedly inferior because they have not made the same transaction-specific investment.[16]

Now assume *B* breaches some term of the agreement. *A* is in a bind. If *A* fires *B* or causes *B* to walk off the job by suing *B*, the cost and expense of the plant might go up substantially because some other contractor will now need to acquire the transaction-specific skills of *B*. *A* might well conclude that it is better off by continuing the deal with *B*, the breaching party, and avoiding these costs.[17]

15 For a discussion of the relationship between efficient capital markets and the takeover mechanism, see Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

16 For a sampling of the literature on transaction-specific investments, see Goetz & Scott, *supra* note 11; Williamson, *supra* note 7; Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. LAW & ECON. 233 (1979).

17 For this reason, contract law has developed the principle that sometimes the

Of course, it is likely that *A* anticipated the risk that *B* might behave opportunistically and the relative ineffectiveness of litigation in resolving disputes. In this event, *A* might have insisted on other mechanisms to give *B* incentives to perform and resolve disputes should they occur. Examples of the former are performance bonds and incentive clauses with lump sum payments upon completion by a satisfactory time; an example of the latter is one of compulsory arbitration. Ex ante, both parties benefit from the lowest cost method of assuring contractual performance which will frequently not be litigation. Indeed, one of the striking findings of those who have studied contracts where transaction-specific investments are common is how rarely litigation is actually used to enforce contractual obligations.[18] Other governance mechanisms are far more important in assuring contractual performance.

Contracts involving labor have long been recognized as having the potential for firm or transaction-specific investments. Corporate managers will frequently possess expertise and skills that are specialized to a particular firm. Replacement of such individuals is costly because their replacements will lack equivalent firm-specific expertise. To avoid imposition of these costs, the parties at the time of the initial agreement may emphasize other methods of assuring contractual performance than the threat of termination. Similarly, once breach has occurred, the nonbreaching party (assuming breach can be defined) may view termination only as a remedy of last resort.

In many cases, litigation will have the same undesirable consequences as termination because of its disruptive effects on ongoing relationships.[19] Thus litigation, like termination, will frequently be deemphasized as a governance mechanism at the time of agreement, and avoided by the nonbreaching party after a breach has occurred.

The existence of firm-specific investments may explain the observed reluctance of special litigation committees to sue corporate managers accused of wrongdoing.[20] Even if those accused are no

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nonbreaching party has a duty to continue to deal with the breaching party in order to mitigate damages. *See* Goetz & Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation,* 69 VA. L. REV. 967 (1983); Muris, *Opportunistic Behavior and the Law of Contracts,* 65 MINN. L. REV. 521 (1981).

18 *See* Ellickson, *supra* note 7; Goldberg & Erickson, *Long-Term Contracts for Petroleum Coke,* (U.C.D. Working Paper 1982); Joskow, *Vertical Integration and Long Term Contracts: The Case of Mine-Mouth Coal Power Plants,* (M.I.T. Working Paper 1984); Macaulay, *supra* note 7.

19 *See* Williamson, *supra* note 7.

20 Of course, other explanations for a special litigation committee's refusal to sue also exist. The refusal to sue may result from a determination that there has been no wrongdoing or that the costs of litigating (including error and other indirect costs) exceed the likely benefits, or because the members of the committee have a conflict of interest. We discuss the conflict of interest aspect of decisionmaking by special litigation committees in Part II B below. For a further discussion of the issue, see Dent, *supra* note

longer with the firm, those acting on behalf of the firm can rationally be concerned with the effect of litigation on others who remain. The greater the threat of litigation, the less willing those who remain with the firm will be to make firm-specific investments of human capital.

5. *The Gains from Breach*

The larger the potential gains from breach, the more important, all else equal, are liability rules. Thus the spectre of civil liability (and/or imposition of criminal penalties) is probably a useful deterrent to large one-shot frauds. Because one-shot frauds can occur in publicly-held corporations, use of liability rules in this narrow class of cases is probably desirable.[21]

6. *Relative Attitudes Toward Risk*

If information were costless, liability would be imposed against an agent only if his conduct fell below a given standard of performance. Because information is costly, however, the possibility exists that a poor outcome will be equated with poor performance. If agents are penalized for poor outcomes, as well as poor performance, they will tend to undertake lower risk projects. This tendency to cause agents to behave in a more risk-averse manner is itself a potentially large cost of liability rules as a governance mechanism in contractual situations where principals want agents to behave in a more risk-neutral manner.[22]

As we have discussed, the publicly-held corporation where shareholders are specialized risk bearers is a classic example of this cost of liability rules.[23] Such rules in a world of costly information have the effect of transferring risk from more efficient to less efficient risk bearers (shareholders to managers); thus the rules reduce the benefits of the specialization of function in public corporations.[24]

2; Comment, *Special Litigation Committees—An Expanding and Potent Threat to Shareholder Derivative Suits,* 2 CARDOZO L. REV. 169 (1980); Note, *The Business Judgment Rule in Derivative Suits Against Directors,* 65 CORNELL L. REV. 600 (1980).

21 It is important to understand, however, that liability rules are not the only deterrent to large one-shot frauds. For example, requiring managers to own shares in the firm decreases the probability of fraudulent acts because managers must then bear more of the costs of their actions. *See infra* text accompanying notes 38-41.

22 *See* Sykes, *The Economics of Vicarious Liability,* 93 YALE L.J. 1231, 1235 (1984) (noting that "[e]mpirically, principals are usually better risk bearers than their agents").

23 We do not suggest that managers should bear no risk. As we discuss in Part III below, compensation agreements typically link manager wealth with firm performance to provide managers with incentives to maximize the value of the firm. Thus, some firms may, for incentive reasons, cause managers to bear more risk than is ordinarily optimal.

24 For an excellent analysis of this differential risk-bearing ability in the context of

B. Special Problems of the Derivative Suit

The problems associated with the use of liability rules as a corporate governance mechanism are exacerbated when the parties charged with enforcement have poor incentives to make correct decisions. This is obviously true when members of a board allegedly involved in wrongdoing must decide whether to sue themselves. Indeed, skepticism of directors who have been asked to sue themselves, or of persons named by the directors to make this decision (special litigation committees), seems to be the most common rationale for the need to toughen the derivative suit.[25] What this argument overlooks, however, is that individual shareholders and their attorneys who bring suit on behalf of the corporation also have very poor incentives to maximize shareholders' wealth.

The voting rules in corporate law, which we discuss more fully below, ensure that shareholders with the largest economic stake in a venture have the greatest effect on corporate policy. Because shareholders with the largest stakes will gain the most from good performance and bear most of the costs of bad performance, they have the best incentives to maximize the value of the firm. Small minorities have no power to act on behalf of the corporation or thwart the will of the majority. Minority shareholders' relative lack of power does not disadvantage them, however, because they too benefit from a system that gives decisionmaking authority to those parties with the best incentives to maximize the value of the firm.

The derivative suit is a striking exception to this fundamental principle of corporate law. Shareholders with tiny investments can bring derivative actions on behalf of a corporation. Because of his small stake in the venture, the complaining shareholder (or his attorney) has very little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries, who ultimately bear the costs. If the action appears to be a positive net value project because of the possible recovery of attorneys' fees,[26] an attorney

suits by third parties against the corporation, see Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls,* 93 YALE L.J. 857 (1984).

25 *See* Buxbaum, *supra* note 2, at 1127; Coffee & Schwartz, *supra* note 2, at 283; Dent, *supra* note 2, at 110-18; Scott, *supra* note 2, at 940.

26 Shareholders who own small stakes in the firm have little incentive to bring a derivative suit because the benefits of the suit accrue to shareholders according to the size of their holdings, not their efforts in bringing the action. This suggests that the real party in interest is the attorney. The prospect of attorneys' fees overcomes the collective action problem faced by shareholders. But a legal rnle that relies on private attorneys general for enforcement involves substantial costs. If everyone has the right to sue (what a private attorney general system means), high transaction costs prevent value-increasing exchanges and encourage opportunistic behavior. This is the economic justification for the legal doctrine of standing. *See* Jensen, Meckling & Holderness, *Analysis of Alternative Standing Doctrines,* (U. Rochester Working Paper 1984).

will pursue it regardless of its effect on the value of the firm.[27]

Sometimes this perverse incentive created by allowing a party with only a nominal stake in the venture to determine corporate policy is obvious. The spate of derivative suits in the 1970s challenging the making of foreign payments notwithstanding the profitability of the practice illustrates the divergence of interests between a derivative plaintiff and shareholders as a class. Sometimes the perverse incentive is less obvious but no less real. Consider the situation of a negotiated merger at a premium over the market price. State corporation statutes typically require a majority, or at most two-thirds, of shareholders to approve merger transactions. Unanimous consent of shareholders is not required because a unanimity requirement would, among other problems, create incentives for shareholders to behave strategically. Any shareholder, even if convinced the merger was beneficial and the terms fair, could rationally decide to refuse consent. Such a shareholder would reason that the cost imposed on all other shareholders (the premium foregone) would force the corporation to "buy" the shareholder's approval with some type of side payment. Such behavior would be privately rational but wealth reducing for shareholders as a whole. In addition to resources wasted in haggling over the division of gains, some value increasing transactions would be abandoned altogether or never started under a unanimity rule because of the strategic power of minorities.

Thus, shareholder suits create a risk of strategic behavior by minorities.[28] The shareholder who is unable to blackmail other shareholders due to the absence of a unanimity rule can attempt to accomplish the same objective by alleging in a suit that some aspect of the terms or disclosure in connection with the merger was inadequate. Once again, the hope would be that the potential loss inflicted on other shareholders (the nominal beneficiaries of the action) in the form of direct and indirect litigation costs as well as the possible loss of the premium would enable the shareholder (or

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27 This suggests that the method of compensating attorneys and assessing costs is crucially important in minimizing conflicts of interest between attorneys and investors, the supposed beneficiaries of the action. *See* Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983). We do not discuss this issue here. For our purposes, recognizing that no system of awarding attorneys' fees or assessing costs is perfect is sufficient. The value of managers' time, for example, will never be compensated for, no matter how frivolous the action. Thus, our major point, that the imperfect incentives of directors and their agents should not be compared with a hypothetical system of perfect enforcement, is unaffected by the choice of rule regarding attorneys' fees.

28 It is important to recognize that share ownership is not immutable. A shareholder who believed that the value of the firm would increase after the filing of a lawsuit could aggregate a large block of shares in the same manner as a prospective bidder for control. Casual empiricism suggests, however, that complaining shareholders do not aggregate shares before filing suit; they typically have only a nominal interest in the firm.

his attorney) to capture a disproportionate share of the gains.[29]

In addition to this problem of perverse incentives, there is also the problem of access to information and expertise. Managers, not small shareholders or plaintiffs' attorneys, direct the corporations' affairs. What looks like a hasty decision by corporate managers may simply reflect their knowledge of the subject and their desire to avoid the expense of hiring outside experts. For instance, a seemingly self-interested decision to accelerate the exercise of a stock option may well be the most efficient method of awarding an increase in compensation. Thus, even when shareholders and their attorneys have proper motives, their lack of expertise and access to relevant information will frequently make it difficult for them to determine which management actions are inconsistent with maximizing the value of the firm.

The poor incentives and lack of expertise of small shareholders and their attorneys would be less important if courts were skilled at recognizing suits that do not increase the value of the firm. Unfortunately, judges also lack business expertise and strong incentives to maximize the value of the firm. A manager who makes bad business decisions is likely to have his wealth reduced or be fired; judges who make bad business decisions will continue in office with the same salary as before. Moreover, it is important to recognize that judges, no matter how competent, cannot eliminate the problems created by the ability of small shareholders and their attorneys to sue. So long as the full costs of the suit are not assessed (including the value of managers' time), the threat of strategic behavior will exist.

Our point is not that all derivative suits are either strategically motivated or frivolous. Rather, our point is that there are real costs to the derivative suit because of the risk of strategic behavior and uninformed decisionmaking. It is thus incorrect to conclude that the "structural bias" of the board—the alleged reluctance of managers who are named as wrongdoers or special litigation committees appointed by such managers to take proper action[30]—demonstrates the need for more vigorous enforcement of derivative suits. This argument represents a form of the Nirvana fallacy: it compares imperfect incentives of corporate managers and their agents with a mythical perfect enforcement scheme and concludes, not surprisingly, that perfect enforcement dominates. But the relevant ques-

29 For a discussion of the problem of strategic use of litigation in the merger context, see Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law,* 76 Nw. U.L. Rev. 913, 923-41 (1982); Fischel, *The Appraisal Remedy in Corporate Law,* 1983 Am. B. Found. Research J. 875, 898-901.

30 The directors' choice of the special litigation committee's members is not as unusual as some critics suggest. Directors, for example, also choose the accounting firm that monitors the firm.

tion is which of two very imperfect classes of decisionmakers—managers allegedly involved in wrongdoing or individuals named by them to serve on special litigation committees on the one hand or shareholders with a small economic stake in the venture represented by plaintiffs' attorneys and judges on the other hand—is more likely to make decisions that increase the value of the firm. Alternatively, in light of the imperfections of both classes of decisionmakers and the limits of the liability rules discussed above, firms have incentives to create alternative methods of assuring contractual performance.

III
ALTERNATIVE METHODS OF ASSURING CONTRACTUAL PEFORMANCE

The role of liability rules as a governance mechanism can be analyzed only in comparison with other governance mechanisms. We discuss some of the alternative governance mechanisms to liability rules below.

A. Freely Transferable Shares with Votes Attached

Under modern enabling legislation, individuals who form corporations have wide latitude in determining how they should be structured. It would be possible, for example, for each shareholder to have an equal number of votes (or no votes) or to restrict shareholders' ability to sell their shares. With rare exception, however, votes in public corporations are apportioned by shares, not shareholders, and shares are freely transferable.

The rationale for this fundamental aspect of corporate structure is clear. The principle of one share-one vote enables those with the largest stake in the venture to have the greatest impact on the firm's decisionmaking. Because such parties will reap more of the benefits of good performance and bear more of the costs if things turn out poorly, they have better incentives to maximize the value of the firm than do those with a smaller stake in the venture. Small shareholders are also better off if those with the best incentives to maximize the value of the firm are given that authority. The voting rules adopted by most corporations, in sum, have the effect of reducing agency costs to the benefit of all shareholders regardless of the size of their investment.[31]

The absence of restrictions on alienability in public corporations also has the effect of reducing agency costs by facilitating the

[31] For a more general discussion, see Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983). For an analysis of why some firms have deviated from the one share-one vote rule, see DeAngelo & DeAngelo, *Managerial Ownership of Voting Rights*, 14 J. FIN. ECON. 33 (1985).

formation of control blocs and transfers of control. As an increasingly impressive body of evidence demonstrates, both the formation of control blocs which decrease the costs of monitoring and transfer of control which moves assets to higher valued uses increase the value of investments and are thus beneficial for shareholders.[32]

B. Internal and External Monitoring

The separation of the management and risk-bearing functions in public corporations allows investors to capture the benefits of specialization of function but exposes them to the risk that their funds will be used for managers' personal benefit. Investors will discount the price they are willing to pay for shares accordingly. To minimize the size of this discount, those who raise capital have incentives to establish institutional arrangements whereby the performance of managers is continually monitored. Such monitoring arrangements reduce the probability of managerial misconduct.

Monitoring arrangements take a variety of forms. Inside directors of a corporation monitor the officers; top managers monitor lower level managers, and vice-versa.[33] The increasing use of independent directors in public corporations also can be viewed as an institutional response to the demand by investors for greater internal monitoring. Similarly, the much-maligned special litigation committee formed in response to a derivative suit can be analyzed in the same manner. Examples of external monitoring include selling securities through investment bankers,[34] using independent third party accountants to certify financial statements,[35] listing securities on a stock exchange,[36] and regnlarly paying dividends to ensure continual availability of funds in the capital markets.[37] External labor markets and the market for corporate control also act as monitors of managerial performance.

C. Managerial Stock Ownership and Executive Compensation Agreements

An additional method to reduce agency costs is to tie manage-

32 The evidence is summarized in Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence,* 11 J. FIN. ECON. 5 (1983).

33 Fama, *Agency Problems and the Theory of the Firm,* 88 J. POL. ECON. 288 (1980). *See also* Fama & Jensen, *Separation of Ownership and Control,* 26 J. L. & ECON. 301 (1983).

34 Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 VA. L. REV. 669, 675 (1984); Gilson & Kraakman, *The Mechanisms of Market Efficiency,* 70 VA. L. REV. 549, 613-22 (1984).

35 Watts & Zimmerman, *Agency Problems, Auditors, and the Theory of the Firm: Some Evidence,* 26 J. L. & ECON. 613, 630-33 (1983).

36 *See generally* Gilson & Kraakman, *supra* note 34, at 565-92.

37 Easterbrook, *Two Agency-Cost Explanations of Dividends,* 74 AM. ECON. REV. 650 (1984).

rial compensation to firm performance. Extensive evidence indicates that managers own a surprisingly large amount of their firm's outstanding securities, both in absolute and percentage terms;[38] furthermore, other important types of compensation such as stock options or phantom stock also link compensation to firm performance.[39] When all aspects of managerial compensation are taken into account (stock based measures of compensation as well as salaries, bonuses, etc.), the evidence suggests that changes in managerial wealth are closely tied to changes in the value of the firm.[40] Thus, compensation schemes tend to align managerial incentives with those of investors.[41]

Of course, we do not claim that these governance mechanisms operate without cost or reduce agency costs to zero.[42] Because managers work in teams, the marginal product of each manager is impossible to measure. No matter how effective the contractual and market mechanisms are, some shirking is inevitable. Thus, liability rules enforced by derivative suits may operate simply as an additional, albeit imperfect, governance mechanism. The theory of contract enforcement discussed above, however, suggests that liability rules enforced by derivative suits play only a minor role in enforcing the express and implied agreements between managers of public corporations and residual claimants.[43] Moreover, our own empirical study, described below, provides no support for the hypothesis that shareholders value liability rules as a governance mechanism.

38 *See, e.g.*, Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. 375, 387-90 (1983).

39 *See, e.g.*, Murphy, *Corporate Performance and Managerial Renumeration*, 7 J. ACCT. & ECON. 11 (1985).

40 *See, e.g.*, Benston, *The Self-Serving Management Hypothesis: Some Evidence*, 7 J. ACCT. & ECON. 67 (1985).

41 For a more complete summary of compensation studies, see Easterbrook, *supra* note 4.

42 Nor do we claim that the importance of these alternative governance mechanisms, either singly or in combination, is the same for all firms. Some firms will rely more on independent directors; others on the market for corporate control; still others might make takeovers more difficult but require managers to have a large percentage of their wealth tied up in their firm.

43 Significantly, states such as Delaware that have dominated in the competition for corporate charters have legal rules which minimize, not maximize, managers' potential legal liability. For a discussion of the relationship between Delaware law and shareholders' wealth, see R. WINTER, GOVERNMENT AND THE CORPORATION (1978). *See also* Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J. L. & ECON. 179 (1985); Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985); Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. 259 (1980); Fischel, *supra* note 29; Romano, *Some Pieces of the Incorporation Puzzle* (Stan. L. & Econ. Program Working Paper No. 19 (1984)). There is some evidence that the threat of legal liability of managers is increasing in Delaware. *See infra* note 51.

IV
Empirical Analysis of the Wealth Effects of Derivative Stockholder Suits

In this section we examine the change in the market price of the common stock of firms involved in derivative stockholder suits.[44] Our purpose is to determine whether such litigation is in the interest of the firm's stockholders.

Our initial intent was to examine the stock market's response to the various stages of a derivative action: the initial filing of the complaint, the meeting of demand requirements, the rulings of special litigation committees, and the final resolution of the issue. However, because of the paucity of publicly available data concerning these events, such a comprehensive study was beyond the scope of this inquiry.[45]

That the financial press fails to report the events surrounding derivative actions indicates, prima facie, that such litigation has little or no effect on the market price of the firm's securities; if efficient pricing of the firm's equity depended on these events, surely the financial press would publish their occurrence. Because such litigation presumably has no material effect on their wealth, investors have little demand for information on derivative litigation.

Unable to find either filing dates or settlement dates from the financial press, we turned our attention to derivative suits in which the firm's management sought to have court intervention halt the litigation.[46] In two situations a court will dismiss a derivative suit: if the stockholder/plaintiff has failed to make sufficient demand on the firm's management,[47] or if a special litigation committee, appointed by the firm's management, decides that the suit is not in the corporation's best interests.[48]

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44 The raw data and results of this empirical analysis can be found in the Appendix, *infra*.

45 None of the major financial publications systematically covers stockholder derivative suits. Indeed, a computer search of *Barrons, Business Week, The New York Times,* and *The Wall Street Journal* over the past six years failed to turn up any of the recent landmark cases in derivative stockholder litigation.

46 The facts and decisions in these cases are contained in the LEXIS and the West's Federal Practice and Decennial Digest data bases.

47 *See In re* Kaufman Mutual Funds, 479 F.2d 257 (1st Cir. 1973); Aronson v. Lewis, 473 A.2d 805, 808 (Del. 1984). *See also* Note, *Demand on Directors and Shareholders as a Prerequisite to the Derivative Suit,* 73 Harv. L. Rev. 746 (1960); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. Chi. L. Rev. 168 (1976).

48 See Burks v. Lasker, 441 U.S. 471 (1979), in which the Court held that the Investment Company Act of 1940, 15 U.S.C. § 80(a)(1) et seq., and the Investment Advisors Act of 1940, 15 U.S.C. § 80(b)(1) et seq., did not require state or federal courts to absolutely forbid termination by corporate directors of nonfrivolous derivative suits. Since then, a number of courts have upheld the right of disinterested directors to terminate derivative suits which are contrary to the firm's best interests. *See, e.g.,* Abramowitz

Our sample of derivative suits consists of those halted by court action and those challenged by the firm's management but not dismissed by the courts. Table 1 lists the cases that courts dismissed because the plaintiff failed to make sufficient demand on the firm's management. Table 2 lists those suits that were dismissed because of the decision of a special litigation committee. Table 3 lists the cases in which the court excused demand and allowed the litigation to proceed. Finally, Table 4 contains the cases in which the courts ruled that the business judgment rule did not apply and thus vitiated the decision of a special litigation committee to terminate the suit.

Our ultimate objective is to assess the effect of a derivative suit on the wealth of a corporation's stockholders. However, because of the data limitations discussed above, we are limited to examining only the market reaction to judicial decisions of whether to terminate or allow a derivative suit to continue. Obviously, for there to be any market reaction to these decisions, they must not have been fully anticipated by market participants. In other words, the court decisions in our sample must have significantly changed the probability that one side or the other would ultimately prevail in the suit; otherwise, we would be studying a nonevent and would find no market reaction to these court decisions.

Given this assumption, if derivative suits are, on average, in the interests of the firm's stockholders, the market price of the firm's shares should rise if the court allows the suit to proceed and fall if the court dismisses it. A successful derivative suit might increase the value of the firm's equity for two reasons. First, in most derivative suits, money is in dispute. Presumably, if the plaintiff prevails, this money will flow back into the firm and be claimed by its equityholders. Second, if the potential of a derivative suit deters managerial malfeasance, then a successful suit should improve the extent to which the firm is run in the interests of its stockholders. A successful suit might put the firm's management on notice that they are being monitored more closely, and this monitoring in turn will better align managerial behavior with stockholder interests. Thus, the price of the firm's stock should increase when a court rules that the derivative suit should proceed, reflecting the expectation of a reduction in agency costs from increased monitoring.

By similar logic, the termination of a derivative suit might signal to the market the court's unwillingness or inability to prevent the firm's management from expropriating the wealth of the firm's equityholders. As a result, market participants may view the court's de-

v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981), *aff'd*, 672 F.2d 1025 (2d Cir. 1982) (Delaware law permits termination by disinterested directors of suit alleging impropriety of other board members).

cision to terminate a derivative suit as having given the firm's management a "license to steal." Thus, the termination of a derivative suit should decrease the value of the firm's shares by the discounted value of the increase in agency costs arising from the increased discretion that the court's decision gives the firm's management.

Derivative suits may, on the other hand, reduce net stockholder wealth. The litigation costs imposed on the firm may well exceed the damages awarded even in successful suits. Some derivative suits are based on public policy issues and, if won, clearly will reduce stockholder wealth. For example, suits motivated by environmental concerns or brought to halt the payment of bribes to foreign officials would, if successful, undoubtedly decrease the wealth of the firm's equityholders. Finally, some argue that the derivative suit is designed primarily to enhance the welfare of the plaintiffs, or the plaintiffs' counsel, and not the welfare of the firm's equityholders in general. Based on these considerations, the termination of a derivative suit might well increase the price of the firm's equity, and a continuance might decrease its market price.

Stock returns are taken from the data base compiled by the Center for Research in Security Prices (CRSP) of the Graduate School of Business of the University of Chicago. Because of the limitations of this data base, we are able to analyze only those cases involving firms listed on either the American or New York Stock Exchanges at the time of the decision and decisions rendered between July 2, 1962, and December 31, 1983. Tables 1 through 4 list only those observations that meet this CRSP-imposed criteria.

To estimate the stock price reaction (wealth effect) of the termination or continuation of a derivative suit, we performed a standard event-study analysis on the firms named in the cases listed in Tables 1 through 4. Specifically, we calculated a daily abnormal return to the shares of each firm in the sample according to the formula:

$$AR_{i,t} = R_{i,t} - [\alpha_i + \beta_i R_{m,t}] \qquad (1)$$

where

$AR_{i,t}$ = the abnormal return to the equity of firm i on day t
$R_{i,t}$ = the realized return to the equity of firm i on day t
$R_{m,t}$ = the realized return to the market portfolio on day t
α_i, β_i = market model parameters estimated over event days $t = -280$ through $t = -41$, where $t = 0$ is the decision date.

The abnormal return defined in Equation 1 measures the market's reaction to an event that is specific to firm *i* occurring on day *t*. The bracketed expression in Equation 1 is the expected return to security *i* on day *t*, given the realized return to the market portfolio on day *t* ($R_{m,t}$). Thus, the difference between the expected return given by the so-called market model (the bracketed expression in Equation 1) and the realized return to a share of firm *i* on day *t* is an estimate of the abnormal return to this security and is attributable to some firm-specific event. $AR_{i,t}$ represents this abnormal return estimate in Equation 1.[49]

To estimate the average share price reaction to a court's decision to terminate or permit a derivative suit, we grouped the daily abnormal returns to each of the relevant firms into equally weighted event-time portfolios. Algebraically, the abnormal return to each "test" portfolio on each event day *t* was calculated according to the following formula:

$$AR_{p,t} = \frac{1}{N} \sum_{i=1}^{N} AR_{i,t} \qquad (2)$$

where

$AR_{p,t}$ = the abnormal return to portfolio *p* on event day *t*
$AR_{i,t}$ = the abnormal return to security *i* on event day *t*
N = the number of firms in the portfolio

The standard deviation of the abnormal return to each portfolio is taken from the abnormal returns calculated over the test period (from $t = -280$ through $t = -41$, where $t = 0$ is the decision date).

The results of our analysis of the wealth impact of a court decision to terminate a derivative stockholder suit are reported in Table 5. In the first row of the table, we report the average abnormal return to the stockholders of fourteen firms having suits dismissed for failure to meet demand requirements. We report the average abnormal return (AR_p) on the decision day, the cumulative average abnormal return (CAR_p) from the decision day through the following day, and the CAR_p from the decision day through the following four days (defined in the table as the decision week). The data show that while the point estimates of the average abnormal returns for each of the three time periods reported are all negative, none are statistically significant. The absolute values of all the t-statistics are less than 1.96, which is the critical value for significance at the $\alpha = .05$ level. Based on these statistics, we conclude that the termination of a derivative suit for failure to meet demand requirements does not significantly affect the wealth of the firm's stockholders.

The results for the sample of eighteen court-ordered terminations based on rulings of special litigation committees, reported in the second row of Table 5, suggest the same conclusion. None of

49 *See* E. FAMA, FOUNDATIONS OF FINANCE (1976) (providing, in chapters 3-5, extensive discussion of use of market model in empirical work).

the point estimates of the average abnormal returns diverges significantly from zero. Indeed, the point estimate of the average abnormal return over the decision week is positive.

The only indication of a nonzero wealth effect from a court-ordered termination is given by the abnormal return to the portfolio of the entire sample on the decision day ($AR_p = -0.69\%$, $t = -2.13$). However, neither the two-day CAR_p nor the five-day CAR_p to this portfolio differs significantly from zero.

The average abnormal returns to the stockholders of firms having derivative suits challenged by their management but not dismissed by court action are reported in Table 6. The first row reports the returns to the stockholders of the ten firms in the sample for which demand requirements were met or demand was excused. The data show that although the point estimates of the average abnormal returns for each time period reported are positive, none diverges significantly from zero. This data is consistent with our earlier conclusion that a court decision regarding the potential termination of a derivative suit has no material effect on the wealth of the firm's stockholders.

In the second row of Table 6, we report the average abnormal returns to the six firms in the sample involved in suits that were challenged by management but not dismissed because the courts ruled that the business judgment rule did not apply. The abnormal return to this portfolio on the decision day does not differ significantly from zero. However, the two-day cumulative abnormal return to this portfolio is significantly positive ($CAR_p = 2.26\%$, $t = 2.25$). Thus, for these six firms, the failure of the courts to dismiss the suit had a small, albeit significant, positive wealth effect. Still, the cumulative abnormal return for the decision week is not significantly different from zero.

Summarizing the results in Tables 5 and 6, we find that neither termination nor continuation of a derivative stockholder suit has a significant effect on the wealth of the firm's stockholders. However, the data show that the majority of the point estimates of the abnormal returns to the firms that have suits terminated are negative and the majority of those to the firms that do not have their suits terminated are positive. In general, however, these point estimates are not statistically different from zero.

The above results do not clearly indicate whether a derivative suit increases the wealth of the firm's stockholders. On the one hand, the majority of the point estimates indicate that derivative suits, if allowed to proceed, increase stockholder wealth; this result implies that such suits are a material check on managerial behavior. On the other hand, the wealth effects are not strong (i.e., they are not statistically significant). The statistical insignificance of the results, however, may be due to our small sample (large standard error estimates) or the possibility that market participants had already anticipated most of the effects of the decisions in our study and factored them into market prices. Nonetheless, we present our results, offer our interpretations, and await further research on the wealth-effects of derivative stockholder suits.

The results reported in this section show that a successful derivative suit, on average, has a slight positive effect on the wealth of the firm's stockholders; a court's termination of such a suit has a slight negative effect on shareholder wealth. However, the insignificant magnitude of these wealth-effects suggests that such litigation does not have a material impact on the ongoing relations between the firm's management and its stockholders. The slight wealth-effects evident in our empirical results are attributable to the fact that stockholders will realize a gain if the suit is successful. These results do not, however, indicate that the outcomes of the suits under study materially affect the extent to which the managers of these firms act in the interest of their stockholders. In other words, our results indicate that derivative suits are not an important monitoring device to curb managerial malfeasance. If derivative suits were effective monitors we would expect a much greater market reaction to the court decisions in this study.

To buttress this interpretation, we separated from our sample those cases in which the derivative suit explicitly charged breach of the duty of loyalty by the firm's management. Presumably, if derivative suits discipline corporate managers' behavior, these cases would have the greatest wealth effects. Table 7 reports the results of our analysis of the breach of duty of loyalty cases: eleven cases were dismissed, and six were allowed to proceed.[50] The point estimates of the abnormal returns are negative for the terminations and positive for the cases allowed to proceed; but, again, none significantly differs from zero. Thus, the wealth-effects of cases explicitly charging breach of the duty of loyalty are not significantly different from the wealth effects of our overall sample.

As in all empirical analyses, one must be careful not to carry the interpretation of the results too far; this admonition is particularly relevant for the data reported in this section. Our results are based on a very small sample, include only cases that were challenged by the firm's management, and measure the market's reaction to only one stage in the entire derivative suit process. A more definitive assessment of the empirical effects of derivative suits must await a

50 The firms included in these two samples are indicated by an "x" in the right column in Tables 1 through 4.

more comprehensive study which includes a larger sample and measures returns over the various stages of the suit.

V
THE ROLE OF LIABILITY RULES IN CORPORATE LAW

Our conclusion that liability rules are relatively unimportant in assuring contractual performance in public corporations appears inconsistent with certain principles in corporate law, particularly the duties of loyalty and care which can be enforced by derivative suit. This inconsistency, however, is less serious than it might appear. First, the very generality of fiduciary duties, as discussed above, limits their application to relatively egregious cases. Moreover, other principles of corporate law, such as the business judgment rule, the substitution of procedural for substantive review of conflict of interest transactions, the liberal rules concerning indemnification and insurance, the exclusivity of the appraisal remedy, and the limitations on derivative suits, reduce the scope of liability rules. We describe the significance of these aspects of corporate law below[51] and conclude the section with a brief discussion of the inferences to be drawn from the derivative suit's survival.

A. The Business Judgment Rule

Although formulations of the business judgment rule vary,[52] the rule's effect is relatively straightforward. The rule precludes judicial review of the merits of managerial decisions in a wide variety of situations. It is commonly assumed that the rule's scope is limited to transactions that do not involve conflicts of interest. In practice, however, the rule's scope is much broader. Courts have applied the rule to transactions between parent corporations and their subsidiaries,[53] compensation decisions within a firm,[54] deci-

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51 In so doing, we recognize that our discussion suggests that corporate law is more uniform than it actually is. Different jurisdictions have different rules and sometimes different rules exist within the same jurisdiction. Moreover, a recent decision by the Delaware Supreme Court, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), is a striking counter-example to our principal conclusion in this section that various doctrines of corporate law reflect the relative unimportance of liability rules in assuring contractual performance. Notwithstanding these caveats, we feel that the discussion below captures the essence of corporate law. The *Van Gorkom* case is criticized in Fischel, *The Business Judgment Rule and the Trans-Union Case,* 40 BUS. LAW 1437 (1985).

52 *Compare* Veasey & Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law,* 35 BUS. LAW. 919 (1980), *with* Arsht & Hinsey, *Codified Standard—Same Harbor but Charted Channel: A Response,* 35 BUS. LAW. 947 (1980).

53 *See, e.g.,* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

54 *See, e.g.,* Heller v. Boylan, 29 N.Y.S.2d 653 (N.Y. Sup. Ct. 1941).

sions to resist takeover attempts,[55] and decisions to terminate derivative suits.[56] The rule thus immunizes a wide range of corporate conduct from anything more than cursory judicial review.

The business judgment rule implicitly recognizes the concepts we have discussed: (1) the specialization of function in public corporations whereby managers are entrusted to make business decisions and shareholders rather than managers bear business risks; (2) the poor incentives of shareholders and their attorneys to maximize the value of the firm; and (3) the availability of alternative mechanisms for assuring contractual performance. Because it restricts the scope of judicial review, the business judgment rule reflects the limits of liability rules in assuring contractual performance of managers in public corporations.

B. The Substitution of Procedural for Substantive Review of Conflict of Interest Transactions

By acting as monitors for investors, independent or disinterested directors act as a substitute for liability rules in assuring contractual performance. Corporate law has recognized this monitoring function by allowing such directors to validate transactions that would otherwise be tainted by conflict of interest. Thus, a decision to resist a tender offer,[57] dismiss a derivative suit,[58] enter into a transaction with an interested director,[59] or negotiate a merger with a related entity[60] may be subject to a lower standard of judicial review if it is made by disinterested directors. These decisions allow firms to opt out of stricter standards of judicial review by adopting alternative governance mechanisms. Similarly, the much-maligned special litigation committee also can be viewed as a contractual attempt by firms to opt out of liability rules enforced by shareholder litigation as a governance mechanism.

C. Liberal Rights of Indemnification and Insurance

Corporate law provides firms with broad flexibility in deciding whether to provide indemnification or insurance to managers for ex-

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55 *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

56 *See, e.g.*, Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); Roberts v. Alabama Power Co., 404 So. 2d 629 (Ala. 1981).

57 *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

58 *See, e.g.*, Zapata v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

59 *See, e.g.*, Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971).

60 *See, e.g*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

penses incurred in litigation.[61] Firms commonly indemnify and/or insure corporate officers against litigation expenses and certain types of judgments. This contractual response, which many have criticized,[62] can be explained along the lines we have suggested. Indemnification and insurance allow firms to contract around liability rules in certain circumstances.

Public corporations are structured to transfer most business risk to security holders who have access to capital markets and thus have a comparative advantage in bearing risk. The threat of litigation if a particular decision turns out poorly, however, has the effect of transferring the risk from security holders to managers who are far less efficient risk bearers. Managers must be compensated for bearing this risk which, by definition, is more efficiently borne by security holders. The individual shareholder or his attorney who owns only a nominal percentage of outstanding shares has no incentive to take this (or any other) cost into account when deciding whether to sue because other shareholders bear the cost. Indemnification and/or insurance allows the firm to undo this inefficient risk-bearing scheme by shifting risk to security holders of the firm or an insurance company, both superior risk bearers. As such, one major cost of liability rules—inefficient risk shifting—is minimized by legal rules which allow widespread use of indemnification and insurance.

D. The Exclusivity of the Appraisal Remedy

Mergers and other fundamental corporate changes have long been major sources of litigation. Corporate law reduces the cost of litigation in connection with mergers by often making appraisal—a procedure by which shareholders dissatisfied with the terms of a merger may obtain a judicial determination of the value of their shares—the exclusive remedy.[63]

Although appraisal is itself a type of litigation, the costs of lia-

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61 *See, e.g.,* DEL. CODE ANN. tit. 8, § 145(f) (1983) ("The indemnification provided by this section shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise . . . ."). Corporations can also purchase insurance for directors even where indemnification is prohibited. *Id.* § 145(g).

62 *See, e.g.,* J. BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE (1981). Bishop and others have argued that indemnification and insurance erode the deterrent effect of liability rules. As Charles Goetz points out, however, insurers may be superior monitors of managerial misconduct. Goetz, *A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven,* 71 CORNELL L. REV. 344, 349 (1986). *See also* Holderness, *Protection of Corporate Directors and Officers: A Theory of Liability Insurance and Indemnification,* (MERC Working Paper 84-13).

63 For a fuller discussion of the appraisal remedy, see Fischel, *The Appraisal Remedy in Corporate Law, supra* note 29.

bility rules as a method of assuring contractual performance that we have discussed are largely absent in appraisal proceedings. This is true for two reasons. First, appraisal does not involve a threat of personal liability against directors. Thus there is no inefficient risk shifting created by the appraisal remedy. Second, the incentive to utilize the appraisal remedy strategically is much weaker than in suits attempting to impose liability on corporate managers. Shareholders who seek appraisal receive the value fixed by a court. This value may be more or less than the value received by shareholders from the transaction being dissented from. The prospect of receiving less in an appraisal proceeding than by going along with the transaction and not seeking appraisal is a meaningful check on the strategic use of litigation. Moreover, appraisal is, by definition, a post-transaction remedy; it cannot be used to enjoin, or threaten to enjoin, a value-increasing transaction. Because of the availability of appraisal, remedies which might otherwise exist such as suits against directors personally are not available.

E. Restrictions on the Ability to Bring Derivative Suits

A final set of legal rules which act to minimize the cost of liability rules is restrictions on the ability to bring derivative suits. The demand on directors requirement, the contemporaneous ownership rule, security for expenses statutes, and, perhaps most importantly, the ability of directors to dismiss derivative suits all limit the ability of shareholders and their attorneys to bring derivative suits.[64] The rationale of these restrictions is that the costs of liability rules enforced by those with a small economic stake in the venture outweigh the benefits unless limitations are imposed to reduce these costs.[65] Once again, the effect of this set of legal rules is to deemphasize the role of liability rules in assuring contractual performance.

F. The Survival of the Derivative Suit

Notwithstanding the substantive limitations on the scope of liability rules and the procedural barriers to derivative suits, derivative suits are still a part of corporate law. This survival of the derivative suit suggests it has some value. The most likely explanation for the

64 Many of these restrictions on the ability to bring derivative suits are criticized in Coffee & Schwartz, *supra* note 2.

65 Security for expenses statutes are explicitly based on this premise. Commentators frequently criticize these statutes on the ground that they deter both meritorious and frivolous suits. *See, e.g.,* Geviertz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits,* 46 U. PITT. L. REV. 265 (1985). Nonetheless, suits brought by those with a trivial stake in the firm are more likely to be frivolous than suits brought by large shareholders. Thus, a strong argument could be made that these statutes should be strengthened, not eliminated.

survival of the the derivative suit is its role in deterring large one-shot frauds. If there were no such thing as a derivative suit (we ignore here the criminal law), managers could decide, at least in theory, to distribute all of their firm's assets to themselves.[66] Perhaps the derivative suit also plays a useful role in deterring other egregious derelictions by corporate managers. But these limited, albeit important, justifications for the derivative suit in no way suggest that such suits should be brought more frequently or that legal rules that discourage their incidence are detrimental to investors.

VI
THE ANALYSIS OF DERIVATIVE SUITS IN THE ALI PROJECT

The drafters of the ALI project recently circulated their revised chapter on derivative suits. Much of the discussion of derivative suits demonstrates an awareness of relevant economic principles and evidence that other sections of the project have lacked.[67] Thus, the chapter begins with the statement that "it must be recognized that the derivative action is neither the initial nor primary protection for shareholders against managerial misconduct."[68] Similarly, the draft recognizes that "private enforcement of law should not be idealized" and that "[e]xperience suggests that the social costs associated with intracorporate litigation can sometimes outweigh their benefits."[69] The discussion also acknowledges that the existing empirical evidence sheds little light on the value of derivative suits.[70] Moreover, much of the analysis and criticism of aspects of current law appears to be perceptive and convincing.[71]

For all of this, the drafters deserve credit. Indeed, our primary criticisms of the section on derivative suits focus on the drafters' failure to appreciate the logical implications of their own premises. We discuss these criticisms below.[72]

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66 One-shot frauds can take various forms. For example, a decision to destroy all of a firm's assets in response to a hostile takeover attempt is a type of one-shot fraud.

67 For a critique of an earlier version of the ALI Project, see Fischel, *supra* note 5.

68 ALI PROJECT, *supra* note 1, Draft No. 5, at 2.

69 *Id.* at 3.

70 *Id.* at 5-7. Studies to date have focused on the frequency of derivative suits, their rate of settlement, and amounts of recovery. *See, e.g.*, Jones, *An Empirical Evaluation of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U.L. REV. 306 (1980). The problem with this type of study is that there is no way to interpret the data without a theory of the role of liability rules enforced by shareholder litigation as well as the evidence on the effect of such suits on shareholders' wealth.

71 *See, e.g.*, ALI PROJECT, *supra* note 1, Council Draft No. 5, § 7.03, at 45-58 (discussing rationale and judicial interpretation of demand on directors requirement).

72 We make no attempt to be comprehensive; we do not discuss, for example, the sections on attorneys' fees because that subject is sufficiently complex to warrant its own paper.

A. The Analysis of the Relationship Between Agency Costs and Derivative Suits

The drafters' economic analysis of derivative suits focuses on the separation of the management from risk-bearing functions in public corporations. The drafters argue that "the self-regarding manager may sometimes find it both possible and profitable to divert income or assets from the corporation to himself."[73] Although monitoring mechanisms exist, the drafters note that "none of these techniques is costless."[74] Thus, "there is a minimum level of exposure to losses caused by managerial misbehavior that rational shareholders must accept . . . ."[75] Moreover, "[b]ecause only imperfect information is available to the stock market about the agency cost associated with any given firm, an efficient market will . . . discount the value of each firm by an average agency cost factor."[76] The drafters thus conclude that "the most important claim that can be made for the derivative action is that it can reduce average agency costs."[77]

This reasoning is muddled. Using the existence of agency costs as a justification for derivative suits is another classic example of a Nirvana fallacy. As we have emphasized, liability rules enforced by derivative suits impose costs of their own; these costs cannot be ignored in analyzing the effect of such suits on shareholders' wealth.[78] In other words, the existence of agency costs tells nothing about the desirability of using derivative suits to enforce liability rules.

The related argument about average agency costs is also flawed. To the extent the drafters claim that the inability of high quality firms to distinguish themselves from low quality firms will lead to a lemons market where all firms will degrade product quality,[79] the argument is clearly false. No basis exists for assuming the market for corporate securities is a lemons market. The combination of firms' actions in communicating information about themselves, monitoring by informational and financial intermediaries, and antifraud rules all enable investors to distinguish firms of differing quality.[80] That information is costly does suggest that high

73 ALI PROJECT, *supra* note 1, Council Draft No. 5, at 8.

74 *Id.* at 9.

75 *Id.*

76 *Id.*

77 *Id.*

78 *See supra* notes 6-7 and accompanying text.

79 The drafters cite Ackerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970), for their proposition regarding average agency costs; apparently they intend to compare the market for corporate securities to a lemons market. ALI PROJECT, *supra* note 1, Council Draft No. 5, at 9.

80 For a more complete discussion of the methods used by high quality firms to distinguish themselves, see Easterbrook & Fischel, *supra* note 34.

quality firms will not be able to distinguish themselves perfectly. But there is no reason to believe that the derivative suit will have any effect on this "problem." Plaintiffs' attorneys are not likely to have any comparative advantage in identifying mispriced securities; even if they did, any resulting benefits would have to be balanced against the costs of liability rules enforced by derivative suits.

Ultimately, the effect of derivative suits on shareholders' wealth must be determined empirically. As summarized in Part III, we find no evidence that investors value derivative suits highly as a cost-effective method of reducing agency costs.

B. The Relationship Between the Derivative Suit and Governmental Control Over Corporate Activities

The drafters allege that the reduced need for public enforcement is another benefit of the derivative suit. "Over the long run," the drafters claim, "the availability of private enforcement should reduce the need for public enforcement and bureaucratic oversight of corporate conduct."[81] Moreover, "[a]bsent [such a] remedy, public agencies might be compelled to increase the regulatory oversight they exercise over the private corporation."[82]

This claim has two serious difficulties. First, private enforcement is not always desirable; indeed, in some situations, no enforcement is optimal. Neither public nor private enforcement, for example, would solve the "problem" of excess consumption of leisure time. In other situations, public enforcement might be preferable to private enforcement—criminal law being one prominent example.[83] Absent some notion of the nature and magnitude of the problem sought to be remedied by the derivative suit or public enforcement, as well as the relative costs of different remedies, making any meaningful statement about the desirability of private, public, or no enforcement is simply impossible.

The analysis also fails to distingnish between social and private benefit. Shareholders do not bear the costs of public enforcement. Moreover, public enforcement is commonly directed at activities, such as political payments and pollution, that benefit shareholders of particular firms. Substituting public enforcement with derivative suits forces shareholders, the supposed beneficiaries of such actions, to bear the direct costs of enforcement as well as the indirect costs of profitable opportunities foregone.

81 ALI PROJECT, *supra* note 1, Council Draft No. 5, at 3.

82 *Id.*

83 On the distinction between private and public enforcement, see, e.g., Landes & Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1975).

C. Regulatory Bias

Current legal rules concerning derivative suits are highly varied. Some jurisdictions impose procedural barriers to the filing of derivative suits such as security for expenses statutes, others do not;[84] some jurisdictions make it relatively easy for directors to dismiss a derivative suit, others less easy, still others virtually impossible.[85] The reporters apparently view this diversity of legal rules as a problem. The Reporter's Notes following specific sections repeatedly discuss why one particular legal rule is preferable to another or why a compromise is desirable. Moreover, there is no suggestion that a particular firm could opt out of a proposed legal rule—that a firm could, for example, go public with a charter provision stating that a special litigation committee's decision with respect to whether a derivative suit should proceed is final.[86]

The fundamental problem with the approach of the drafters is that there is no theory or evidence demonstrating that the legal rules proposed are superior in any way to the alternative rules that are rejected. In light of the total absence of any support for the legal rules proposed, the preferable approach is to allow firms maximum flexibility in choosing what legal rules to be governed by. Competitive solutions are most beneficial when the optimal rule is unclear or where optimal rules may be different for different firms. It is perfectly plausible, for example, that derivative suits create net benefits for some firms but net costs for others. Any attempt to formulate a single legal rule for all firms, therefore, is likely to be unproductive.

D. The Distinction Between the Duty of Care and the Duty of Loyalty

Various sections in the chapter on derivative suits draw a sharp

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84 *Compare* N.Y. BUS. CORP. LAW § 627 (McKinney 1983) (requiring plaintiffs in derivative actions to post security for expenses) *with* DEL. CODE ANN. tit. 8, § 327 (1983) (no requirement of security for expenses).

85 *Compare* Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) (decision by independent members of special litigation committee to terminate derivative suit subjected to scrutiny under business judgment rule), *with* Miller v. Register & Tribune Syndicate, 336 N.W.2d 709 (Iowa 1983) (directors named as defendants cannot create special litigation committee to study whether derivative suit should be dismissed), *and* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (intermediate standard).

86 This refusal to permit a corporation to minimize the scope of liability rules enforced by derivative suit contractually is particularly surprising since the drafters do allow corporations flexibility to draft more onerous provisions than the project recommends. *See* ALI PROJECT, *supra* note 1, Council Draft No. 5, § 7.17(a), at 204-05 (limitations on liability for duty of care violations unless corporation specifies otherwise).

distinction between the duty of care and the duty of loyalty.[87] Potential liability of defendants is greater for duty of loyalty violations,[88] and it is more difficult to dismiss an action based on alleged violations of the duty of loyalty.[89] The rationale for these distinctions is that "alternative mechanisms, such as the market, peer pressure and public disclosure, will normally ensure adequate compliance with the duty of care without substantial reliance being placed on litigation . . . . [A] litigation remedy should not be extensively utilized when other mechanisms of accountability seem likely to be adequate."[90]

The distinction drawn between the duty of care and the duty of loyalty is not at all clear. For example, there is no difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty). Both are examples of agency costs (conflicts of interest in an economic sense) that reduce shareholders' wealth. Moreover, with the possible exception of large one-shot frauds, a clear breach of the duty of loyalty, where derivative suits or the criminal law are necessary as a deterrent, it is far from obvious that alternative mechanisms such as public disclosure, peer pressure or market forces deter shirking more effectively than cheating. It is just as, or perhaps more, plausible to make the opposite argument. Monitoring compensation agreements, for example, is likely to be less costly than monitoring effort. Indeed, the opportunity cost of excess leisure and not working hard is probably the single largest source of agency costs. Finally, there is once again no evidence in support of the sharp distinction drawn by the drafters. Investors, as demonstrated in Part IV above, do not value suits based on the duty of loyalty any more than other types of suits.

E. The Significance of Diversification

The drafters emphasize the existence of diversification as a justification for derivative suits. "[B]ecause most shareholders hold a diversified portfolio of securities," it is claimed, "the fact that costs in an individual derivative action may exceed the recovery to the

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87 Kenneth Scott has proposed eliminating derivative suits for duty of care violations while strengthening such suits for alleged violations of the duty of loyalty. *See* Scott, *supra* note 2; *see also* Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project,* 70 CORNELL L. REV. 1 (1984) (accord).

88 *See* ALI PROJECT, *supra* note 1, Council Draft No. 5, § 7.17(b) (ceiling on liability for duty of care violations).

89 *See id.* § 7.08(c) (court should not dismiss derivative suit based on duty of loyalty violation if defendant retains "improper" benefit).

90 *Id.* § 7.17 comment c, at 206-07.

corporation is not necessarily adverse to their interests, if there is a generic benefit to their broader interests as diversified shareholders in the form of enhanced deterrence against unfair self-dealing."[91] The argument, in other words, is that the deterrent effect of liability rules to shareholders as a class justifies derivative actions even if shareholders of the firm on whose behalf the suit is brought experience reductions in wealth. It is difficult to assess this argument because it is by definition impossible to test. But there are reasons for skepticism. The claim implies that derivative suits are of major interest to investors and thus should be widely reported. The facts, however, are the opposite, as discussed in Part IV above. Moreover, the relevant issue is not deterrence but the costs of increased deterrence. Shareholders, whether or not diversified, do not benefit from legal rules that allow derivative suits to be brought in situations where the costs (direct and indirect) of doing so exceed the benefits. Finally, there is no possible way for the directors of a particular firm or a court to determine the value of a precedent to investors of other firms.[92] Indeed, such value might be negative in light of the costs of liability rules enforced by derivative suit. The existence of diversification, in sum, does not provide a convincing rationale for forcing investors of a particular firm to subsidize the maintenance of a derivative suit that reduces the firm's value.

VII
CONCLUSION

Many analyses of corporate law assume that liability rules enforced by derivative suits play a fundamental role in aligning the interests of managers and investors. We have shown that this widespread assumption is not supported by either the theory of liability rules, the available empirical evidence, or the structure of corporate law. Proposals to reform corporate law which rest on this assumption are thus highly suspect.

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91 *Id.*, reporter's note, at 9; *see also id.* § 7.08(a)(4) (derivative suit should not be dismissed if dismissal would "frustrate any legal rule that operates for the protection of shareholders").

92 On the more general question of the relationship between private and social benefits from litigation, see Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System,* 11 J. LEGAL STUD. 333 (1982).

APPENDIX

TABLE 1

Cases Dismissed for Failure to Meet Demand Requirements

Case (company if not named)	Decision Date	Breach of Duty of Loyalty
Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).	07/18/78	
Elfenbein v. Gulf & Western Indus., 590 F.2d 445 (2d Cir. 1978).	12/21/78	
Greenspun v. Del E. Webb Corp., 634 F.2d 1204 (9th Cir. 1980).	02/29/80	x
Haber v. Bell (Oneok Corp.), 465 A.2d 353 (Del. Ch. 1983).	06/13/83	x
Kemper v. American Broadcasting Co., 365 F. Supp. 1272 (S.D. Ohio 1973).	09/27/73	
Laufer v. Olla Indus., 96 F.R.D. 230 (S.D.N.Y. 1982), *aff'd*, 729 F.2d 144 (2d Cir. 1983).	12/29/82	
Laufer v. Olla Indus., 729 F.2d 1444 (2d Cir. 1983).	04/29/83	
Lewis v. Graves (McDermott), 701 F.2d 245 (2d Cir. 1983).	02/28/83	x
Mills v. Esmark, Inc., 91 F.R.D. 70 (N.D. Ill. 1981).	06/18/81	x
Shlensky v. Dorsey (Gulf Oil), 574 F.2d 131 (3d Cir. 1978).	03/06/78	
Smachlo v. Birkelo (Burlington Northern), 576 F. Supp. 1439 (D.Del. 1983).	12/27/83	x
Stotland v. GAF Corp., Del. Ch. Civ. Action No. 6876, Longoliardi, V.C. (Sept. 1 1983).	07/01/83	x
Stotland v. GAF Corp., 469 A.2d 421 (Del. 1983).	12/05/83	
Tanjer v. Sharon Steel Corp., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,915 (S.D.N.Y. 1979).	06/22/79	

TABLE 2

Cases Dismissed Based on Rulings by Special Litigation Committees

Case (company if not named)	Decision Date	Breach of Duty of Loyalty
Abbey v. Control Data Corp., 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979).	12/07/78	
Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982).	09/07/82	x
Abramowitz v. Posner (NFV), 513 F. Supp. 120 (S.D.N.Y. 1981), *aff'd*, 672 F.2d 1025 (2d Cir. 1982).	02/09/82	x
Ash v. IBM, 353 F.2d 491 (3d Cir. 1965).	11/17/65	
Auerbach v. Bennet (GTE), 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).	07/09/79	
Burke v. Gulf, Mobile and Ohio R.R., 324 F. Supp. 1125 (S.D. Ala. 1971).	03/30/71	
Gaines v. Haughten (Lockheed Aircraft Corp.), 645 F.2d 761 (9th Cir. 1981).	05/18/81	
Genzer v. Cunningham (Burroughs), 498 F. Supp. 682 (E.D. Mich. 1980).	09/26/80	x
Issner v. Aldrich (National Distillers & Chem. Corp.), 254 F. Supp. 696 (D. Del. 1966).	05/18/66	x
Lewis v. Anderson (Disney), 615 F.2d 778 (9th Cir. 1980).	10/29/79	x
Maldonaldo v. Flynn (Zapata), 485 F. Supp. 274 (S.D.N.Y. 1980).	01/24/80	
Meer v. United Brands Co., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,794 (S.D.N.Y. 1979).	02/21/79	
Mills v. Esmark, Inc., 544 F. Supp. 1275 (N.D. Ill. 1982).	08/16/82	
Mills v. Esmark, Inc., 573 F. Supp. 169 (N.D. Ill. 1983).	09/06/83	
Parkoff v. GTE, 74 A.D.2d 762, 425 N.Y.S.2d 599 (1980).	03/11/80	
Rosengarten v. ITT Corp., 466 F. Supp. 817 (S.D.N.Y. 1979).	02/29/79	
Stein v. Bailey (McDermott), 531 F. Supp. 684 (S.D.N.Y. 1982).	02/04/82	
Zapata v. Maldonado, 430 A.2d 779 (Del. 1981).	05/13/81	

TABLE 3

Cases Not Dismissed for Failure to Meet Demand Requirement
Demand Excused

Case (company if not named)	Decision Date	Breach of Duty of Loyalty
Altman v. Place (I.U. Int'l Corp.), 63 A.D.2d 639, 405 N.Y.S.2d 257 (1978).	05/25/78	x
Barr v. Wackman (Talcott Nat'l Corp.), 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975).	04/01/75	x
Bergstein v. Texas Int'l Co., 453 A.2d 467 (Del. 1982).	10/12/82	
Fradkin v. Ernst (Mohawk Rubber Co.), 571 F. Supp. 829 (N.D. Ohio 1983).	09/01/83	
General Elec. Co. v. Bucyrus-Erie Co., 563 F. Supp. 970 (S.D.N.Y. 1983).	01/28/83	
In re Caesar's Palace Sec. Litig., 360 F. Supp. 366 (S.D.N.Y. 1973) (Lum's Inc. changed by time of suit to Caesar's World).	05/23/73	
Kaufman v. Beal, Del. Ch. Civil Action No. 6485, Hartnett, V. C. (Feb. 25, 1983).	02/25/83	x
Lewis v. Curtis (Hammermill Paper Co.), 671 F.2d 779 (3d Cir. 1982).	03/03/82	x
Siegel v. Merrick (Twentieth Century Fox), 84 F.R.D. 106 (S.D.N.Y. 1979).	10/24/79	
Tarlov v. Paine Webber Cashfund, Inc., 559 F. Supp. 429 (D. Conn. 1983).	03/15/83	

TABLE 4

Cases Not Dismissed Contrary to Recommendation by Special Litigation Committee: Business Judgment Rule Does Not Apply

Case (company if not named)	Decision Date	Breach of Duty of Loyalty
Byers v. Baxter (Allied Chemicals Corp.), 69 A.D.2d 343, 419 N.Y.S.2d 497 (1979).	06/26/79	
Galef v. Alexander (TRW), 615 F.2d 51 (2d Cir. 1980).	01/22/80	
Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976).	07/30/76	x
Levy v. Sterling Drug Co., N.Y.L.J., Nov. 23, 1977, at 10, col. 3 (N.Y. A.D. 1977).	11/23/77	
Maldonado v. Flynn (Zapata), 413 A.2d 1251 (Del. Ch. 1980).	03/18/80	x
Maher v. Zapata, 490 F. Supp. 348 (S.D. Tex. 1980).	05/27/80	

TABLE 5

Average Abnormal Returns to the Stockholders of Firms Having Derivative Suits Dismissed by Court Action

		% Abnormal Return (t-statistic, % Negative)		
Reason for Dismissal	Number of Firms	Decision Day	Decision Day Plus One Day After	Decision Week*
Demand Requirements Not Met	14	−0.679 (−1.34,64)	−1.365 (−1.90,88)	−1.091 (−0.96,79)
Ruling of Special Litigation Committee	18	−0.698 (−1.72,61)	−0.092 (−0.16,61)	0.475 (0.51,67)
TOTAL	32	−0.690 (−2.13,63)	−0.650 (−1.42,73)	−0.190 (−0.26,72)

$t = 1.96$ at $\alpha = .05$
$t = 2.34$ at $\alpha = .01$
*Decision Day Plus Four Days After

TABLE 6

Average Abnormal Returns to the Stockholders of Firms Having Derivative Suits Challenged by Management But Not Dismissed by Court Action

		% Abnormal Return (t-statistic, % Negative)		
Reason for Challenge (Reason Dismissal Refused)	Number of Firms	Decision Day	Decision Day Plus One Day After	Decision Week*
Demand Requirements Not Met (Demand Excused)	10	1.063 (1.10,40)	1.513 (1.11,30)	1.034 (0.480,60)
Ruling of Special Litigation Committee (Business Judgment Rule Does Not Apply)	6	1.122 (1.58,33)	2.263 (2.25,33)	2.550 (1.61,20)
TOTAL	16	1.085 (1.76,38)	1.794 (2.06,31)	1.602 (1.16,50)

$t = 1.96$ at $\alpha = .05$
$t = 2.34$ at $\alpha = .01$
*Decision Day Plus Four Days After

TABLE 7

Average Abnormal Returns to the Stockholders of Firms Involved in Derivative Suits Charging Breach of Duty of Loyalty

		% Abnormal Return (t-statistic, % Negative)		
	Number of Firms	Decision Day	Decision Day Plus One Day After	Decision Week*
Suit Dismissed by Court Action	11	−0.759 (−1.16,55)	−0.547 (−0.59,64)	−1.261 (−0.86,73)
Suit Challenged by Management But Not Dismissed b Court	6	1.00 (0.80,33) y	0.078 (0.044,50) y	1.246 (0.45,50)

$t = 1.96$ at $\alpha = .05$
$t = 2.34$ at $\alpha = .01$
*Decision Day Plus Four Days After