PRESUMPTIVE BUSINESS JUDGMENT, SUBSTANTIVE GOOD FAITH, LITIGATION CONTROL: VINDICATING THE SOCIOECONOMIC MEANING OF *HARHEN V. BROWN*

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Presumptive Business Judgment, Substantive Good Faith, Litigation Control: Vindicating the Socioeconomic Meaning of *Harhen v. Brown*

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Not honesty alone, but the punctilio of an honor of the most sensitive is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned . . . . Only thus has the level of conduct of fiduciaries been kept at a level higher than that trodden by the crowd.[1]

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1. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (opinion by Judge Benjamin Cardozo).

I. INTRODUCTION

Whether corporate decisions are unbiased, informed, established in good faith, made in the best interest of shareholders, and hence presumptively valid, has spawned a recurring, contentious, and at times luminous debate among commentators and dyspepsia among judges from Delaware to Colorado and from New York to Tennessee. This matter becomes particularly poignant when shareholders file or threaten to file derivative actions, and when the corporation strives to control the litigation process by rejecting their demands through the determinations of pre-emptive board or special committee decisions. Derivative proceedings are generally commenced by minority shareholders to redress alleged injuries for breach of fiduciary duty. Shareholder derivative suits may provide both direct and indirect benefits.[2] Such suits may be a mechanism that helps provide proper monitoring of fiduciaries by shareholders. They may also be vehicles for mischief commenced largely for the benefit of entrepreneurial attorneys[3] that, under the current regulatory framework, poorly align the interests of attorney and client.[4] More importantly, it is equally imaginable that the interest of the corporation's shareholders and corporate litigation decisionmakers may also be poorly aligned. This may lead to directors not pursuing an appropriate and justifiable action, which achieves "norm management."[5] Furthermore, it is possible that the convergence of this dual misalignment of interest coupled with insufficient judicial scrutiny may result in the settlement of meritorious claims on terms that fail to vindicate legitimate shareholder interest in the proper monitoring of their agents and fail to deter future egregious misbehavior committed by management. Taken together, this result may enlarge agency[6] costs

2. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 56 (1991).

3. Perhaps "the single most salient characteristic of class and derivative litigation is the existence of 'entrepreneurial' plaintiffs' attorneys." Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 7-8 (1991).

4. *See id.* at 3 (stating that existing regulations often impair the interests of the clients they are designed to protect).

5. James D. Cox, *The Eighth Abraham Pomerantz Lecture: The Social Meaning of Shareholder Suits*, 65 BROOKLYN L. REV. 3, 7 (1999) ("The existence of shareholder suits, and their procedural requirements, are highly visible components of norm management for corporate law.").

6.

> An agency relationship can be seen as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decisionmaking authority to the agent. If both parties to the

associated with the proper operation of the corporation while vitiating the social meaning of such suits.[7] On the other hand, the notion of social meaning,[8] like the concept of social reality,[9] may be hauntingly attractive, yet potentially ineffable.

While the current regulatory framework contains a number of safeguards against frivolous litigation[10] by entrepreneurial attorneys and flagrant abuse of control by directors, the framework has nonetheless been deemed insufficient by opponents when it comes to precluding the filing of questionable cases, and as too constrained by those who wish to encourage and expand liability rules as a corporate governance mechanism. Current safeguards include the right of the shareholder to initiate litigation[11] (but not necessarily to control it),[12] the requirement of demand,[13] and the creation of shareholder litigation committees by the corporation, judicial review, and concurrence in any settlement.[14] This contentious and indeterminate[15] framework continues to raise

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> relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interest of the principal. The *principal* can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the *agent* to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions.

Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305-60 (1976).

7. *See generally* Cox, *supra* note 5, at 3-6 (explaining that the social meaning of such suits can be seen as a function of the expressive value enjoyed by all shareholder suits—its value consists not only of its ability to extract sanctions and to provide redress but also because it deters misconduct by others).

8. For a brief introduction to social norms and social meaning, see BRIAN BIX, JURISPRUDENCE: THEORY AND CONTEXT 196 (1999).

9. As used here, the concept of social reality refers to the possibility that there can be a coherent conception of what constitutes true, important, real, and universal explanations of human nature. On the other hand, if claims to truth "cannot be out there—cannot exist independently of the human mind"—then human nature and hence social reality cannot be universal, but merely elusive. RICHARD RORTY, CONTINGENCY, IRONY, AND SOLIDARITY 17-29 (1989).

10.

> The need for protection may arise because if "the suit on behalf of the corporation is successful, the corporation is required to pay the plaintiff shareholder's legal expenses, because the shareholder has benefited the other shareholders as a group. This legal rule seemingly solves the 'free rider' problem that would otherwise exist . . . if the individual shareholder who benefited the other shareholders had to bear all the costs of the action."

WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 195-96 (1996). Thus, the cost of monitoring management is equitably apportioned among all the stockholders. *Id.* Notably, if all the benefits of the litigation flow primarily to the plaintiff's attorney, then income is redistributed from the shareholders to lawyers.

11. *See* Sohland v. Baker, 141 A. 277, 282 (Del. 1927) (holding that the right of stockholders to litigate corporate rights is to prevent injustice); *see also* Zapata Corp. v. Maldonado, 430 A.2d 779, 782-783 (Del. 1980).

12. *Zapata*, 430 A.2d at 783.

13. The demand requirement can be seen as part of a framework in which the normal case demand is compelled but which also includes the possibility that the plaintiff may claim that demand was either wrongfully refused or excused. Grimes v. Donald, 673 A.2d 1207, 1215–20 (Del. 1996).

14. In addition, some jurisdictions also require the plaintiff to post a bond as security for expenses incurred. *See, e.g.*, Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949).

questions about: (A) the inability of plaintiff shareholders to monitor their attorney, which erodes the asserted value of the litigation paired with perhaps perverse incentives derived from indemnification rules, insurance exclusions, and the absence of internalized litigation cost in settlement;[16] (B) the difficulty of ascertaining whether decisions taken by corporate boards and special committees are in the best interest of the corporation, including the meaning of the often elusive term "good faith;" (C) the procedural rights that a plaintiff possesses or should possess in both a pretrial and special litigation committee context;[17] and (D) the appropriate standard of judicial review of corporate decisions to either discontinue derivative suits or refuse to commence them.

Significantly, the scope of judicial review is complicated by virtue of the fact that "few intracorporate transactions are not susceptible to differences of opinion" and by virtue of the fallibility of the courts.[18] Thus, the business judgment doctrine "presumes reasonable diligence and good faith"[19] and rests on the "prudent recognition that courts are ill-equipped and infrequently called on to evaluate what are and must be essentially business judgments."[20] Perforce, the "responsibilities vested in corporate directors . . . proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts."[21] Still, a debate persists as to whether courts should engage in both a procedural (largely deferential) or a substantive (largely an examination of the merits, the rationality, or the cost-benefits) of the committee or board's attempt to control the litigation. Indeed, this Article will focus much of its attention upon a recent Massachusetts Appeals Court case that amplifies this debate despite its more recent reversal by the Supreme Judicial Court of Massachusetts.[22]

A. Background

Several rather old British cases maintain that "the right to initiate proceedings in the name of the company belongs to the board of directors and the shareholders . . . do not have the right to control the board in the exercise of that power, save by removing them."[23] The cornerstone American case, *McKee v. Rogers*,[24] stands for the general proposition that "a stockholder cannot be permitted . . . to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the

15. "The primary cost of indeterminacy in corporate law is that it undermines the efficacy of the law in directing managerial behavior." Ehud Kamar, *Costs of Departures from Formalism: Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887, 892 (1999).

16. Romano, *supra* note 2, at 57.

17. For a discussion of special litigation committees, see Charles W. Murdock, *Corporate Governance—The Role of Special Litigation Committees*, 68 WASH. L. REV. 79 (1993).

18. *Id.* at 83 n.13.

19. Romano, *supra* note 2, at 56.

20. Murdock, *supra* note 17, at 91.

21. *Id.*

22. Harhen v. Brown, 710 N.E.2d 224 (Mass. App. Ct. 1999), *rev'd*, Harhen v. Brown, 730 N.E.2d 859 (Mass. 2000).

23. ROBIN HOLLINGTON, MINORITY SHAREHOLDERS' RIGHTS 11 (1994) (internal citations omitted).

24. McKee v. Rogers, 156 A. 191 (Del. Ch. 1931).

managing body refuses."[25] Nonetheless, shareholder derivative actions have been recognized in at least some American jurisdictions since the early part of the nineteenth century.[26] This is a striking exception to the majority rule principle of corporate law.[27] In addition to claiming compensation for breaches of fiduciary duties owed by officers or directors, derivative suits may potentially deter against future breaches. Significantly, both the imposition of private sanctions[28] and the social opprobrium attached to defendants of such suits[29] may act as deterrents.

Soon after recognizing the validity of such suits, "courts ruled that the successful plaintiff was entitled to recover attorneys' fees from the corporation on whose behalf the shareholder brought the suit."[30] Accordingly, derivative actions challenge majority rule and raise collective action problems,[31] as the benefits of such suits do not necessarily flow to all shareholders and in some cases to *any* shareholders.[32]

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25. *Id.* at 193; *see also* Zapata v. Maldonado, 430 A.2d 779 (Del. 1980) (recognizing the board's power to control litigation even where a majority of the board is tainted with "self-interest"); Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) (holding that derivative claims belong to the corporation itself and the decision to prosecute and control such cases lies within the judgment of the corporation's board of directors). More recently, courts have again held that the unconstrained use of shareholder suits could "undermine the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders." Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 530 (1984).

26. Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 1(1999).

27. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271 (1986). Shareholders with tiny investments and plaintiffs' attorneys have little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries, who ultimately bear the costs. Such cases may be pursued regardless of their effect on the value of the firm. *Id.* at 271-72.

28. To be sure, compensation may act as a deterrent. For an approach that seeks to distinguish between compensatory sanctions and their deterrence objectives, on the one hand, and enhanced sanction designed to deter, on the other hand, see Robert D. Cooter, *Punitive Damages, Social Norms, and Economic Analysis*, 60 LAW & CONTEMP. PROBS. 73 (1997).

29. Cox, *supra* note 5, at 5.

30. Loewenstein, *supra* note 26, at 1-2. Early cases required the creation of a common fund or pool of money from which attorney fees would be paid. *Id.* at 2. Recently, the courts have jettisoned this requirement. In the absence of a common fund, the courts have been willing to award attorneys' fees to the plaintiff if the derivative litigation resulted in a "substantial or common benefit" to the corporation, whether by judgment or settlement. *Id.* at 2. The "rationale for creating an exception to the normal American Rule that parties to litigation bear their own attorneys' fees was that in successful derivative litigation a whole class of people—the shareholders of the corporation—benefits from the successful litigation and, on general equity principles, should be called upon to bear a portion of the expense." *Id.* at 2 n.2 (citing Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 392 (1970)).

31.

> Shareholder derivative actions are not premised on collective action problems in the *litigation*. On the contrary, they presuppose the existence of a corporate form that is already organized to overcome such collective action problems. The corporation has standing and is fully competent to bring legal actions to redress injuries to its rights. The problem, rather, is with collective action *within* the corporate form itself. As scholars since Berle and Means have observed, corporate mangers typically have only a small ownership stake in the firms they manage. Thus, their interests deviate from those of shareholders: they may prefer to consume excessive perquisites or practice their golf whereas shareholders would want them to work diligently at maximizing profits.

Accordingly, collective action and the effects of free-riding, compounded by the relatively small value of claims, allow plaintiffs' attorneys in derivative cases to operate with nearly complete freedom from traditional forms of client monitoring.[33] The potential, if not actual, inefficacy of client monitoring in derivative suits, mirrored by a reduced role for bonding as a device for overcoming agency costs, and an inability to construct sufficient incentives structures to align the interests of plaintiffs' counsel with those of her clients, all give rise to current objections to shareholder derivative actions.[34] Such suits raise the possibility that even where the interests of management and shareholders are already properly aligned, litigation that results in abusive settlements may nonetheless occur. This may provide an incentive for future, improper litigation or abusive settlements while also raising the possibility of income redistribution from shareholders to attorneys. Other objections to shareholder derivative actions also exist.[35]

While a derivative suit is "neither the initial nor primary protection for shareholders against managerial misconduct,"[36] derivative actions, like other actions grounded in liability rules, act as an incentive for management to "engage in socially desirable conduct."[37] Indeed, "the derivative action may offer the only effective remedy in those circumstances where a control group has the ability to engage in self-dealing transactions with the corporation."[38] Furthermore, "Were there no competition in product markets, no market for corporate control, no governance by directors and shareholders, and no law of fiduciary obligations, corporate managers would not be constrained to maximize corporate profits. They would maximize their own utility."[39]

Macey & Miller, *supra* note 3, at 10 (emphasis added).

32. While the folklore of derivative actions tends to view these lawsuits disproportionately as nuisance actions brought to extort a small recovery, the validity of this view is difficult to assess. While a suit may sometimes be brought for its nuisance value because it can be more costly for the defendants to defend the action than it is for the plaintiff's attorney, the "greater problem may be the tendency for even meritorious actions to result in collusive settlements," despite the requirement that such settlements receive judicial approval. KLEIN & COFFEE, *supra* note 10, at 196-97. "Judges rarely reject fee petitions as part of a settlement" on the merits of the case because the alternative requires them to sift through myriad documents in order to complete the fee calculus or risk losing the settlement itself. Macey & Miller, *supra* note 3, at 48.

33. Macey & Miller, *supra* note 3, at 20.

34. *Id.* at 19-22. Bonding is a form of assurance given by the agent to the principal that she will carry out her duties faithfully. *Id.* at 16. Bonding mechanisms include the exclusive right to practice law and its concomitant excess income over other alternatives available to the lawyer. *Id.* at 16. Attorney malfeasance risks disbarment. Accordingly, the attorney's interest in maintaining the right to practice and right to earn monopoly profits operates as a bonding device. *Id.*

35. Other objections include the contention that the derivative "action is not duly authorized by the proper organs of the company," and "the minority [shareholder] is seeking to escape from the principle of majority rule." HOLLINGTON, *supra* note 23, at 11.

36. Murdock, *supra* note 17, at 83-84 n.13 (A "variety of social and market forces also operate to hold corporate fiduciaries accountable.").

37. Fischel & Bradley, *supra* note 27, at 261.

38. Murdock, *supra* note 17, at 83-84 n.13.

39. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 460 (5th ed. 1998) (internal citations omitted). Whether firms actually maximize profits is the subject of some controversy. For a perspective that instead focuses on maximizing behavior by all participants and that rejects the notion of profit-maximization to explain corporate behavior, see Jensen & Meckling, *supra* note 6, at 343.

In general, given the possible divergence of interest between managers and investors,[40] and given the persistent support for the suspect demand requirement,[41] proposals have been forwarded that would expand both the duty of care and the duty of loyalty, and thus expand the "potential legal liability which corporate managers face."[42] Other "proposals have focused on the need to strengthen the derivative suit" itself[43] and have encouraged the courts and legislatures to allow or require such derivative proceedings to be auctioned off to the highest bidder among potential plaintiffs' attorneys.[44] Overall, at least some courts have responded to critics by giving less deference in litigation to managers' decisions and by subjecting the business judgment rule to skepticism, especially with respect to decisions taken by special litigation committees.[45] Indeed, "The derivative suit exists because the real plaintiff, the corporation, is disabled by its board of directors' self-interest to terminate the derivative suit"[46] or to fail to commence the action. Allowing individuals animated by such self-interest to control the litigation without regulation and sufficient skepticism about

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40. The possibility of divergence between investors and managers arises out of an agency relationship. See Jensen & Meckling, *supra* note 6, for a discussion of agency costs.

41. The demand requirement acts to deter baseless suits. One source of the universal demand requirement may be the American Law Institute's corporate governance project. AMERICAN LAW INSTITUTE (ALI), PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.03 (1992) [hereinafter ALI PRINCIPLES (1992)]; *see also* AMERICAN LAW INSTITUTE (ALI), PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.03 (TENT. DRAFT 8, 1988) [hereinafter ALI PRINCIPLES (T.D. 1988)]. Suspicion is arguably justifiable for a number of reasons. First, the demand requirement can often be strictly enforced "even when there are serious reasons to doubt the board's objectivity." KLEIN & COFFEE, *supra* note 10, at 198; *see also* Aronson v. Lewis, 471 A.2d 805, 812 (Del. 1984) (discussing demand futility in relation to the business judgment rule). Second, in demand refused cases the plaintiff is not allowed discovery. Levine v. Smith, 591 A.2d 194, 210 (Del. 1991) (examining the effects of allowing discovery in demand refusal cases); KLEIN & COFFEE, *supra* note 10, at 198 n.119. *But see* Alford v. Shaw 398 S.E.2d 445, 454-55, (N.C. 1990) (allowing discovery on remand). Third, compelling "a shareholder to make demand on the board of directors before instituting suit is generally the death knell for a shareholder's derivative suit." Murdock, *supra* note 17, at 84 n.15. "[O]nce a demand has been made absent a wrongful refusal, the stockholders' ability to initiate a derivative suit is terminated." Speigel v. Buntrock, 571 A.2d 767, 775 (Del. 1990) (citing Stotland v. GAF Corp., 469 A.2d 421, 422 (Del. 1983)). "[W]hen a board refuses a demand, [often] the only issues to be examined are the good faith and reasonableness of its investigation." *Speigel*, 571 A.2d at 777. The attempt by a federal court to create a federal rule requiring shareholders to place a demand on directors before initiating any derivative action was rejected by the United States Supreme Court. Kamen v. Kemper Fin. Serv., Inc., 500 U.S. 90, 107 (1991). However, on remand it was held that Maryland would follow Delaware, and thus would require demand even where the directors participate in the transaction that the plaintiffs challenge. Kamen v. Kemper Fin. Servs., Inc., 939 F. 2d 458, 461 (7th Cir. 1991), *cert. denied*, 502 U.S. 974 (1991).

42. Fischel & Bradley, *supra* note 27, at 261.

43. *Id.* at 262.

44. Macey & Miller, *supra* note 3, at 6-8.

45. Murdock, *supra* note 17, at 84.

> If demand need not be made and suit is filed, as will generally be the case when the directors who were involved in the challenged decision still sit on the board, the typical response in recent years has been for the directors to appoint to the board two or three new ("independent") directors who constitute a special litigation committee with the task of determining whether the litigation against their fellow directors should go forward.

Id.

46. Cox, *supra* note 5, at 29.

motives would potentially increase agency costs and reduce even further the level of management and shareholder interest alignment.

B. The Current Regulatory Framework

1. Judicial Deference or Skepticism?

Turning from general considerations to more specific difficulties encountered within the current regulatory framework, one should note that pretrial devices such as requiring "the plaintiff to post a 'security for expenses' bond to cover the defendant's legal expenses if the action is unsuccessful;"[47] the requirement that the plaintiff must own shares contemporaneously at the time of the wrong; demand on the directors before bringing suit where directors do not face a conflict of interest in their decision;[48] or the introduction of special litigation committees after the litigation has been commenced, whether demand has been excused[49] or required, allow corporations to wrest control of the litigation away from shareholders and their attorneys or, at a minimum, inhibit the filing of what may be a meritorious action. Given that corporations, in the form of corporate managers, are commonly hostile to the litigation and given that "special committees almost invariably decide that the derivative action should be dismissed,"[50] doubt is especially warranted with respect to decisions taken by the special committees that can act to "shield director wrongdoing from judicial scrutiny."[51] Suspicion might also justifiably infect the viability of the business judgment rule and its accompanying presumptions, whether a majority or a minority of the board is implicated in self-interest. While one observer suggests that even suspicious courts are, at times, too deferential,[52] putatively skeptical courts such as the one in *Zapata*[53] assert, "Board members, owing a well-established fiduciary duty to the corporation, will not be allowed to cause a

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47. KLEIN & COFFEE, *supra* note 10, at 196-97.

48. From an economic perspective, the demand requirement appears to be a justifiable litigation control device. Macey & Miller, *supra* note 3, at 35; *see infra* text accompanying notes 189-194.

49. "Where . . . the directors are personally interested in and hostile to the litigation, they cannot be relied on to serve the best interests of the corporation." Macey & Miller, *supra* note 3, at 37. Where demand is excused, it is an admission by the court that the board cannot reliably decide the case. Special litigation committees allow corporations with unreliable boards to control the litigation. *See* KLEIN & COFFEE, *supra* note 10, at 198-99; *see also infra* text accompanying notes 208-226.

50. KLEIN & COFFEE, *supra* note 10, at 199; *see also* Murdock, *supra* note 17, at 84. "The existence of firm-specific investments may explain the reluctance of special litigation committees to sue corporate managers accused of wrongdoing." Fischel & Bradley, *supra* note 27, at 269. "The refusal to sue may result from a determination that there has been no wrongdoing or that the costs of litigating . . . exceed the likely benefits, or because the members of the committee have a conflict of interest." *Id.* at 269 n.20.

51. Murdock, *supra* note 17, at 82. Murdock argues against judicial deference to special litigation committee decisions when the underlying wrong involves a breach of the duty of loyalty. *Id.* at 86.

52. *See generally id.* at 95-96, 111-12.

53. Zapata v. Maldonado, 430 A.2d 779 (Del. 1980). Here, the court held that the two-step procedure designed to cure possible bias applied in demand-excused cases. *Id.* at 788-89. Demand-excused cases typically arise when a majority of the board is involved in a self-interested transaction. *See* KLEIN & COFFEE, *supra* note 10, at 198. Thus, demand is said to be required in Delaware unless the majority of the board is so directly self-interested in the challenged transaction that there is serious doubt that the business judgment rule would protect that transaction. *Zapata*, 430 A.2d at 784-89.

derivative suit to be dismissed when it would be a breach of their fiduciary duty."[54] Yet, that statement must be taken with some caution as *Zapata* seems to permit heightened court scrutiny of the sufficiency of the reasons advanced for dismissal only when demand on the board by the plaintiff would have been excused.[55] Despite this conclusion regarding special litigation determinations and despite whether demand has been excused, required, or wrongfully refused, plaintiffs' attorneys and plaintiffs may be compelled to cede control of the litigation to the business judgment of the board[56]—even where the board has been tainted by self-interest. One can surely argue that the *Zapata* decision, for all its asserted skepticism, merely amounts to a statement that the board's business judgment *should* control the litigation *except* where the board either fails to or cannot exercise such judgment.

Significantly, "Courts have differed as to the standard of review applicable, when demand is excused," [57] and when deference is sought for special committee decision. For instance, one deferential[58] court precludes an examination of the substantive basis of the committee's decision and provides a presumptive application of the business judgment rule whereby judicial review is constrained to an investigation of the good faith, independence, and adequacy of the committee's investigation.[59] While the burden of proof as to good faith remains on the corporation,[60] this approach raises the question: What is good faith in the context of the board's exercise of business judgment? While courts often refer to its proper conception, good faith is not always an ostensible entity. As one commentator asserts in a different context, "Entities which are not ostensible will have to be referred to allusively; what is unfamiliar will have to be described by means of some form of analogy with the familiar."[61] Deferential review likely means that simple subjective good faith is adequate. Consistent with that intuition, deferential review will likely also mean that asserted independence will offset claims of structural bias, and the adequacy of the committee's investigation will not be tested rigorously by the courts.

On the other hand, the North Carolina Supreme Court, in a decision which views corporate termination decisions with substantial suspicion, held that a special litigation committee's recommendation is not binding on the court, but that the court should look at the facts and circumstances to make its own judgment about the transaction.[62] This

54. *Zapata*, 430 A.2d at 783. The court goes on to state, "Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful." *Id.* at 784.

55. ALI PRINCIPLES (T.D. 1988), *supra* note 41, § 7.08 cmt. a. *But see* ALI PRINCIPLES (1992), *supra* note 41, at §§ 7.08-.10 cmt. a.

56. Macey & Miller, *supra* note 3, at 35-39.

57. KLEIN & COFFEE, *supra* note 10, at 200.

58. One observer argues that when "the court defers to the committee, the court will have effectively abdicated any role in overseeing corporate governance." Murdock, *supra* note 17, at 85.

59. Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979). Here, where four members of a fifteen-member board were named as defendants, the committee had the burden of showing that the investigation was carried out in good faith. *Id.* at 1002. While the relative weight given to the facts uncovered by the investigation seems beyond judicial review, half-hearted investigation would not likely be sheltered. *Id.* at 1002-03.

60. *See id.*

61. JOHN POLKINGHORNE, REASON AND REALITY: THE RELATIONSHIP BETWEEN SCIENCE AND THEOLOGY 20 (1991).

62. Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987).

suspicion is maintained regardless of whether demand should be required or excused.[63] Quite often, the basis for skepticism hinges on judicial concern for the often ineffable issue of structural bias. Yet an inquiry by the courts into the substantive decision taken by the committee (especially where the decision involves commercial questions as distinguished from whether the plaintiff is likely to prevail at trial or not), might permit courts that possess little business expertise to "emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee."[64] Indeed, the *Zapata* court "has been criticized for suggesting that a court can exercise its own 'business judgment.'"[65] Instead of implying the courts' commercial and business competence, *Zapata* should have focused on determining whether the decision of the special committee was "manifestly unreasonable" or "unsupported by the evidence."[66] This is the standard that courts commonly employ when reviewing judgments by other bodies. In any case, if "all judicial review of the merits of the committee's decision is foreclosed, there will be very few cases where a committee, once formed and put to work judging their peers, will conclude that the litigation should proceed."[67] Since even the *Zapata* approach has been criticized for providing too much deference,[68] one might be skeptical about this asserted skepticism.

In reality, it can be argued that the development of special litigation committees (coupled with judicial deference) and the avowed "expansion of situations in which demand must be made upon the boards of directors, have had a dramatically chilling effect upon shareholder derivative suits."[69] If true, this may inhibit the filing of meritorious suits while concurrently inhibiting the positive social meaning of such suits, by failing to subject fiduciary misconduct to the desirable level of public opprobrium.[70] Furthermore, it may be conceptually difficult to separate litigation control decisions, which are the result of the demand requirement, and those that are the function of special litigation committees. It is possible that special litigation committees effectively complement and reinvigorate an already robust demand requirement by allowing corporate litigation control decisions to take a more acceptable form—asserted independence grounded in the appearance of freedom from structural bias.

2. *The Settlement Question*

The current regulatory framework also implicates the settlement decision. In turning from judicial review of litigation committee decisions to settlements, it is important to reemphasize the context of demand excused cases. Where director self-interest exists, or where, for example, "the challenged conduct is so extreme that it is beyond the protection

63. *Id.* at 327-28; *see also* Alford v. Shaw, 398 S.E.2d 445, 460 (N.C. 1990) (affirming trial court's approval of the proposed settlement).

64. Murdock, *supra* note 17, at 92 (quoting *Auerbach*, 393 N.E.2d at 1002).

65. *Id.* at 94 (internal citation omitted).

66. *Id.* at 95.

67. *Id.* at 94 (quoting E. Norman Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions—An Analytical Framework for Litigation Strategy and Counseling Directors*, 37 BUS. LAW. 1247, 1273 (1982)).

68. *See id.* at 96.

69. Murdock, *supra* note 17, at 84.

70. *See generally* Cox, *supra* note 5, at 3-30.

of the business judgment rule or when a majority of the board's current members are either so connected to the challenged transaction or so financially dependent" on the targets of the suit, demand is said to be futile.[71] In such situations, allowing the corporation to control fully the litigation through the deployment of special committees vitiates the derivative action as a corporate control mechanism because such suits would conceivably be dismissed on terms favorable to the agents of the firm.[72] Hence, suspicion and a high degree of judicial scrutiny are particularly warranted when committees seek the termination of such derivative suits. Yet, when it comes to proposed settlements, judges are much less willing to rigorously scrutinize settlements that fail to provide an actual benefit to shareholders but which yield an arrangement that disposes of a case to the parties' satisfaction.[73] Such judicial timidity, often abetted by powerful incentives derived from indemnification rules and insurance exclusions,[74] is not cost free. On the contrary, judicial timidity may encourage the filing of "marginal and possibly frivolous claims," and "the party that was supposed to benefit from a successful derivative action—the corporation—often ends up paying the plaintiff's legal fees" and receiving little in return for the consumption of corporate resources deployed to litigate or to settle the claim.[75] Judicial timidity also has another cost: meritorious cases might be settled on terms favorable to the plaintiff's attorney without vindicating the shareholders' interests in proper monitoring and without litigation being seen as a positive social force nor as a deterrent against bad performance in the future.[76] This is compounded by virtue of the likelihood that a settlement does not entail personal expenditure by individual defendants.[77]

3. *The Absence of Pure Motives*

In summary, *both* corporate managers and plaintiffs' attorneys may have less-than-pure motives. Accordingly, courts have been called upon to wrestle with conflicting objectives that spring, in part, from the knotty problems associated with agency costs[78] in the context of derivative litigation. Like the *Zapata* court, other courts will be asked to choose a course of action which moves uneasily between deference toward the business judgment of the firm and the allowance of unbridled plaintiff (attorney) control of the litigation.[79] Such conflicts may be exacerbated by the willingness of courts to treat such cases like other private litigation cases. Given the relatively small financial stake which plaintiffs typically possess, that may be a mistake on both social and economic

71. *Id.* at 30.

72. *See* Macey & Miller, *supra* note 3, at 38-39.

73. *See* Loewenstein, *supra* note 26, at 6.

74. *See* Romano, *supra* note 2, at 57.

75. Loewenstein, *supra* note 26, at 6.

76. *See generally* Cox, *supra* note 5, at 1-44.

77. Romano, *supra* note 2, at 57. On the other hand, "if the claim is litigated there is some probability, however small, of [the individual defendant] being held liable with no reimbursement." *Id.*

78. *See generally* Macey & Miller, *supra* note 3, at 1-70. For an introduction to the separation of ownership and control which gives rise to an agency cost issue in its own right, see POSNER, *supra* note 39, at 451-53. The problems associated with inducing the agent to behave as if she were maximizing the principal's welfare is quite general and exists in all organizations and in all cooperative efforts. *See* Jensen & Meckling, *supra* note 6, at 351.

79. Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1980).

grounds.[80] While this Article will primarily consider how courts should resolve the potential conflicts that arise when management attempts to control the litigation, it is important to emphasize that courts must render decisions when it is possible that the motives of neither management nor plaintiffs' attorneys are free from conflict born of self-interest. Where a court enforces the demand requirement through a ratification of the board's decision to decline to litigate, allows discontinuance of a well-grounded suit after demand is excused, or allows disposition of such a proceeding through an uncritical settlement, its decision increases corporate agency costs by failing to find, where appropriate, substantial benefit to shareholders in the continuance of the litigation. Such a decision also demeans the social value of litigation by inhibiting the power of cases to compensate and act as deterrents. The problems inherent in the current regulatory framework have recently been illuminated in a number of jurisdictions,[81] including, most pertinently for our purposes, Massachusetts. In almost every case, the question that arises is whether, and under what circumstances, control of the litigation should be subject to corporate business judgment.

C. *Introducing* Harhen v. Brown

While the Massachusetts Appeals Court decision has been completely overruled by the Supreme Judicial Court,[82] the appeals court's conclusions in *Harhen v. Brown* remain intensely important. The case involves the conjunction of special litigation committee issues with the board's rejection of the plaintiff's demand to sue various individuals derivatively. Pretrial screening issues associated with the demand requirement must be considered along with the defensible level of judicial deference, if any, to board litigation control decisions. As we shall see, despite claims to the contrary,[83] these are not necessarily discrete issues. *Harhen* differs from the typical case in which demand is refused and the firm subsequently attempts to control the litigation through the special litigation process. As the *Harhen* court explains, there is a difference between

> the "discrete and quite different processes" involved in a special board committee formed to respond to stockholder demands and a special board

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80. *See* Macey & Miller, *supra* note 3, at 5. Macey and Miller note that because derivative litigation is often "dominated by entrepreneurial attorneys, the identified plaintiff [may simply be] a mere figurehead." *Id.* Accordingly, "[t]he named plaintiff does little . . . to monitor the attorney in order to ensure that representation is competent and zealous, or to align the interests of the attorney with those of the class or corporation." *Id.*

81. *See* Murdock, *supra* note 17, at 89-90 (discussing decisions by New York, Delaware, Illinois, Florida, Massachusetts, North Carolina, Alabama, Iowa, Minnesota, and Colorado courts).

82. Harhen v. Brown, 730 N.E.2d 859 (Mass. 2000) (overruling the appellate court's decision based on, among other grounds, the determination that in demand refused cases (1) if a corporation's board of directors with a majority of "disinterested" members refuses the shareholder's demand, the shareholder may only pursue the litigation if the demand was wrongfully refused and (2) the board's demand refusal is subject to deferential review in the form of the business judgment rule).

83. *See, e.g.*, Grimes v. Donald, 673 A.2d 1207, 1216 n.13 (Del. 1996).

> The use of a committee of the board formed to respond to a demand to sue or to advise the board on its duty in responding to such demand is not the same as the [special litigation committee] process contemplated by *Zapata*. These discrete and quite different processes must be kept separate.

Id.

> committee formed to respond to a derivative action.... [Thus] the complaint contains no allegations or intimations that the Hancock board of directors, or a committee of the board, ever voted to terminate the derivative action.[84]

This case also emphasizes the difficulty in differentiating the initial wrongdoing from the subsequent pretrial attempt by the firm to control the litigation. Significantly, the plaintiff may possess certain procedural rights in judicial proceedings, but often "lack[s] such rights in the special litigation context," as such committees often shield fiduciary wrongdoing from judicial scrutiny.[85]

In *Harhen v. Brown*, the trial court upheld a preemptive attempt by the board to control the litigation.[86] The trial judge dismissed the plaintiff's complaint for, among other reasons, the failure to allege particularized facts sufficient to overcome the "strong presumption of the business judgment rule." By doing so, the court "deferred totally to the business judgment of... [the special committee and the] board on all issues presented in the plaintiff's demand."[87]

The Massachusetts Appeals Court reversed. First, it disallowed the corporation's decision to rely on an unexplained and apparently unreflective decision of the special committee and to reject a demand that the firm sue its lobbyist and others for indemnification arising out of illegal lobbying activities. Some officers, directors and members of the management committee were charged with violations of their duties of care and loyalty in connection with these events. Importantly, the appeals court, by requiring a substantive conception of good faith, which requires the board to articulate a reasonable and principled decision free from structural bias, confirms the tentative, yet appealing, expansion of the content of the Massachusetts business judgment rule as applied to board or committee decisions that seek to terminate derivative litigation. Second, prior to this case "no Massachusetts appellate decision ha[d] considered the effect of a rejection of stockholder demand preceding a derivative action."[88] The court held that a "rejection of a demand letter was not the equivalent of a board decision to terminate the litigation."[89] Third, this decision implicates settlement and indemnification issues which arose *before* a derivative suit was threatened but which are the current basis for shareholder litigation, thus requiring scrutiny if the corporate decision to decline to seek reimbursement is to be sustainable.

Thus, the suit involves: (1) initial managerial misconduct in failing to properly direct the government relations department, which implicates the duty of care; (2) settlement through the payment of fines to federal and state government agencies at a cost to the company and at little or no cost to the managers, raising the possibility that similarly inclined fiduciaries will not be deterred (*i.e.*, general deterrence) because of the imposition of vicarious liability or some other device, which prevents or inhibits those most responsible for the wrong from paying the damages out of their own pockets and which also results in an absence of specific deterrence; (3) the possible self-interested

84. Harhen v. Brown, 710 N.E.2d 224, 232 (Mass. App. Ct. 1999).
85. Murdock, *supra* note 17, at 79.
86. *Harhen*, 710 N.E.2d at 224.
87. *Id.* at 226-27.
88. *Id.* at 234.
89. *Id.* at 232.

failure by the board to seek indemnification at a cost to the policyholders as well as at some potential cost to the public norms, which the civil litigation initiated by the government was designed to vindicate; and (4) the rejection of *Aronson v. Lewis*'s conclusion that the business judgment rule supplies a presumption that corporate decisions are unbiased, informed, and made in good faith.[90]

The Massachusetts Appeals Court in *Harhen* rejected the presumption that "corporate decisions are unbiased, informed, and made in good faith."[91] Instead, the court "appears to have held that refusals of shareholder demands by disinterested directors are presumptively suspect."[92] This decision reflects an expanded reconsideration of the business judgment rule in the context of shareholder derivative lawsuits. Of special interest is the requirement that Massachusetts' entities substantively and rationally justify decisions taken by apparently disinterested, but possibly structurally biased, directors before courts are entitled to ratify such decisions. Also, noteworthy is the conclusion that rejection of the demand letter was not the equivalent of a board decision to discontinue the litigation.[93]

This Article examines the *Harhen* case by establishing a policy framework which borrows contributions from a number of scholars. Over the next several sections, this Article will attempt to determine whether the Massachusetts Appeals Court decision (despite its reversal) can be justified or whether the decision must be seen as an unsustainable invitation to the courts to substitute their judgment for that of disinterested directors.[94]

Part II attempts to establish a defensible framework for evaluating judicial review by reference to the nature of the wrongdoing at issue; by explicating the nature of the social meaning of derivative suits, including judicial review of efforts by firms to control the litigation; and through the application of law and economics analysis. These considerations will not necessarily be reconcilable. Part III examines an earlier case, *Houle v. Low*,[95] that enlarged the scope of the Massachusetts business judgment rule as it relates to decisions to terminate shareholder derivative suits. *Houle* mandated the application of judicial skepticism to remove the taint of self-interest from such determinations.[96] Part IV examines the Massachusetts Appeals Court's application of *Houle v. Low* to its *Harhen v. Brown* decision. Part V addresses policy considerations, including an examination of the deterrence and compensatory value of derivative litigation, and law and economics to this holding. While the author will offer no meta-ethic on the deontology of shareholder litigation nor contend that liability rules are necessarily the best way to properly align divergent interests,[97] the author will argue that

90. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

91. THE HERITAGE FOUNDATION, THE INSIDER NO. 264, at 20 (1999); *see also Harhen*, 730 N.E.2d at 866-67.

92. THE HERITAGE FOUNDATION, *supra* note 91, at 20

93. *Harhen*, 710 N.E.2d at 232-35.

94. THE HERITAGE FOUNDATION, *supra* note 91, at 20.

95. 556 N.E.2d 51 (Mass. 1990).

96. *Id.* at 59 (Mass. 1990).

97. For an argument that shareholder litigation may fail this objective, see generally Fischel & Bradley, *supra* note 27, at 292-93; Romano, *supra* note 2, at 85. *But see* Charles J. Goetz, *A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven*, 71 CORNELL L. REV. 344, 348 (1986) (arguing that derivative suits constitute a credible deterrent to aberrant fiduciaries); Donald E. Schwartz, *In Praise of*

the decision taken by the appeals court in *Harhen* was, in fact, justifiable on the grounds that it has the potential to reduce firm-specific agency costs by encouraging meritorious claims which vindicate the social meaning of such suits by creating public deterrence effects in addition to providing private relief. This Article contends that the rules (however indeterminate) derived from this case should be expanded to encompass all (including settlement) decisions taken by special—either prelitigation or contemporaneous litigation—committees and the courts. While these rules were effectively overruled by the Supreme Judicial Court of Massachusetts, the Massachusetts Appeals Court assessment deserves consideration by other jurisdictions that are searching for a standard which properly declines to defer to either management or entrepreneurial attorneys.

II. A POLICY FRAMEWORK FOR ANALYSIS

Several policy issues confront any attempt to analyze judicial efforts to assemble a defensible review of board and special litigation committee decision making. The ability of shareholders to monitor fiduciaries, client monitoring of plaintiffs' attorneys, access to information, perverse and nonperverse incentives,[98] agency costs, compensation, public deterrence,[99] and the value of the potential relief available to the plaintiff are all part of the often inchoate calculus which may determine the appropriate liability rules for fiduciaries.[100] The current absence of a bright-line standard compels corporate actors who attempt to design their performance in accordance with the law to "assess—with some uncertainty—where the threshold of liability lies."[101] Legal indeterminacy may lead to less than socially optimal behavior coupled with a rise in risk to risk-averse fiduciaries, thus imposing a net cost on shareholders.[102] While an examination of all the potential policy issues which impact the appropriate approach is beyond the scope of this enterprise, several factors seem pertinent. They include the inherent nature of the fiduciaries' wrongdoing at issue, which may affect the appropriate level of judicial deference available; the social meaning or social importance of shareholder suits intertwined with the possible conflict between private compensation and the public deterrence value of such suits; and the measurable and theoretical impact of litigation control decisions on incentives to bring meritorious suits.

Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley, 71 CORNELL L. REV. 322, 343 (1986) (asserting that "liability rules are critical for the protection of investors' interests in a corporation").

98. For a discussion of perverse incentives created by allowing a party with only a nominal stake in the venture to determine corporate policy, see Fischel & Bradley, *supra* note 27, at 271-73.

99. For a discussion of the value of public deterrence, see Dan M. Kahan, *Social Influence, Social Meaning and Deterrence*, 83 VA. L. REV. 349 (1997).

100. Fischel and Bradley argue that an analysis of the factors on which the importance of liability depends illustrates the limited usefulness of liability rules as a governance mechanism, at least for public corporations. *See* Fischel & Bradley, *supra* note 27, at 264.

101. Kamar, *supra* note 15, at 888.

102. *Id.* at 889.

A. The Nature of the Wrongdoing: A Different Perspective on Zapata

In *Harhen v. Brown*,[103] the trial court and the Supreme Judicial Court of Massachusetts deferred totally to the business judgment of the special committee and the board. Accordingly, a gnarly consequential issue surrounds whether judicial deference toward either special committee or corporate decisions, if allowable at all, should depend on the nature of the underlying wrongdoing at issue. In recent derivative litigation,

> courts have analyzed the issues by recognizing two tiers of corporate decision making. The first tier involves the acts of directors, which give rise to the alleged wrongful conduct. The second tier is the decision of the special litigation committee or the corporation to decide whether the litigation based upon the first tier actions ought to be dismissed.[104]

In Professor Murdock's view,

> Courts thus far have focused strictly upon the second-tier decision. In one line of cases, if the directors making the second tier decision whether to continue or discontinue litigation against their fellow directors are not themselves implicated in the first-tier alleged wrongdoing, absolute deference is given to the second-tier decision on the basis of the business judgment rule. Another line of cases would permit the court some latitude in reviewing the substantive merits of the second-tier decision.[105]

Under this two-tier approach, management self-interest which implicates the duty of loyalty in the first tier, whether it directly implicates a majority of the board of directors or not, might be unjustifiably sheltered by the business judgment rule applied in the second tier. Thus, allowing corporate business judgment to be deployed affirmatively in a special committee context, to deflect the focus from the first-tier transgression, and to preclude substantive review.[106] Conversely, if the first-tier misconduct implicates the duty of care, judicial deference seems less controversial.[107] Yet, if "*Auerbach* . . . can be read as precluding any review of the substantive decision of the special litigation committee, [it] is simply bad law."[108] Given that there is a meaningful distinction between a duty of care and a duty of loyalty,[109] and that self-dealing is a more serious problem than management inefficiency,[110] Murdock's first-tier/second-tier analytical construct may be helpful in examining the sustainability of judicial deference in any duty of loyalty cases. Indeed, he contends that while the *Zapata*[111] technique can be justified when the underlying (first-tier) cause of action is predicated on a duty of care, "it cannot be justified when the defendant directors are charged with breaching their duty of loyalty

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103. 710 N.E.2d 224, 226 (Mass. App. Ct. 1999).

104. Murdock, *supra* note 17, at 85.

105. *Id.* Among other things, the *Auerbach* court held that the relative weights accorded the facts uncovered by the special committee investigation was beyond judicial review. Auerbach v. Bennett, 393 N.E.2d 994, 1003 (N.Y. 1979).

106. Murdock, *supra* note 17, at 95.

107. *Id.* at 85-86.

108. *Id.* at 95.

109. Goetz, *supra* note 97, at 350-51.

110. Schwartz, *supra* note 97, at 325.

111. *Zapata* was a duty of loyalty case. Zapata v. Maldonado, 430 A.2d 779, 780 (Del. 1980).

to the corporation."[112] Strong policy reasons support this distinction.[113] Some courts aver that the business judgment rule applies where some directors are charged with wrongdoing, so long as the remaining directors making the decision are disinterested (at least directly) and independent.[114] However, that conclusion fails to fully account for the impact of structural bias which is arguably more important where the alleged breach implicates the duty of loyalty rather than care.[115] There is "absolutely no reason to defer to the board of directors when the underlying first-tier violation involves a breach of the duty of loyalty, or self-dealing"[116] irrespective of whether a majority or minority are implicated by a conflict of interest and arguably irrespective of whether it is a demand excused, demand required, demand rejected, or special litigation committee decision. Skepticism, not deference, is required.

> Consistent with this view, the ALI distinguishes between the duty of care and the duty of loyalty and instructs the court to give greater deference to the board's justifications for dismissal in the former case, [unless it constitutes a knowing and culpable violation of the law] grounded in the belief that the historic function of the derivative action has been to monitor duty of loyalty violations.[117]

While it must be conceded that where the court declines to defer to the board's litigation control decision, the court's relative competence to take such a decision instead of the directors is placed at issue. This concern is largely misplaced. Indeed, while some observers assert that "[t]he very concept that courts have independent business judgment is, in fact, a contradiction of over 250 years of legal development,"[118] it can surely be argued that "judicial abdication of oversight of fiduciaries in situations involving self-dealing would be a contraction of over 500 years of legal development."[119] Courts then

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112. Murdock, *supra* note 17, at 96.

> If an independent and disinterested committee of the board reviews an operating decision by other directors and concludes that such decision or conduct did not involve self-dealing by the defendants and was rationally justified, and if a court, in a proceeding akin to summary judgment, concludes that the recommendation by the special litigation committee is supported by the record, then the litigation should be terminated.

Id.

113. *Id.* at 101. Policy reasons include the absence of external mechanisms which might hold fiduciaries accountable in duty of loyalty cases. On the other hand, in duty of care cases, any substantial deviation from sound business judgment will ultimately affect profits and market forces will hold managers accountable. *Id.*

114. Auerbach v. Bennet, 393 N.E.2d 994, 1000 (N.Y. App. Div. 1979).

115. Murdock, *supra* note 17, at 102.

> [More] caution should be taken before ousting the courts from jurisdiction over an alleged wrong in an area—duty of loyalty—in which they have been historically involved, in favor of a body—the special litigation committee—which has neither the competence nor the independence and disinterestedness of the courts in evaluating the alleged duty of loyalty violation.

Id.

116. *Id.* at 96.

117. KLEIN & COFFEE, *supra* note 10, at 199 n.125; *see also* ALI PRINCIPLES (T.D. 1988), *supra* note 41, § 7.08; ALI PRINCIPLES (1992), *supra* note 41, § 7.10.

118. Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Action: Viva* Zapata*?*, 37 BUS. LAW. 27, 63 (1981).

119. Murdock, *supra* note 17, at 98.

are likely to be more skilled than directors in recognizing such cases. Hence, judicial skepticism that leads to intense judicial scrutiny of the board's litigation-control decision is warranted where the underlying misconduct implicates the duty of loyalty.

> [D]ismissal of litigation is essentially a judicial function. Circumscribing the normal functioning of the courts ought to be done with caution. In duty of care cases, courts have recognized the limitations of their competence and authority vis-à-vis the competence of business decisionmakers to address the operational aspects of a business—thus, the business judgment rule.[120]

On the other hand, "No such disparity of competence exists in the duty of loyalty area."[121] One court aptly declares:

> The business judgment rule does not . . . protect business decisions that result from fraud or bad faith. The policy reasons for keeping a court from evaluating after the fact the wisdom of a particular decision do not apply when the issue is whether a party to that decision acted fraudulently or in bad faith. The assessment of fraud or bad faith is a function courts are accustomed to perform, and in performing it the courts do not intrude upon the process of business decision-making beyond assuring that those decisions are not improperly motivated.[122]

If this claim is correct, this author sees no reason to welcome the assertion made by some Delaware courts and accepted by other jurisdictions that there must be a clear distinction between a special committee action concerning the demand requirement and special committee decision making in response to a derivative action.[123] In both cases, dismissal of litigation ought to remain a judicial function; thus, assertions of business judgment where the transaction implicates the duty of loyalty warrant judicial skepticism, not deference, irrespective of whether it occurs as part of the screening function provided by the demand requirement or as part of a subsequent board attempt to control the litigation. Indeed, such an approach disallows presumptive attempts by both management and plaintiffs' attorneys to control the litigation.

B. Toward a Coxian Conception of the Social Meaning of Corporate Litigation Decisions

While a major focus of this Article is the appropriate level of judicial deference to corporate litigation decisions, that question cannot be definitively separated from whether demand is or should be excused or required, whether the interests of plaintiffs' attorneys diverge or converge with those of their clients, whether shareholder litigation is an appropriate corporate control mechanism, and whether and how judicial review vindicates public norms. Accordingly, the social/public meaning of decisions to sustain

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120. *Id.* at 100.

121. *Id.*

122. *Id.* at 100-01 (quoting Rosenthal v. Rosenthal, 543 A. 2d 348, 353 (Me. 1988)).

123. *See* Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) (observing the distinction between special board committees formed to respond to stockholder demands and special board committees formed to respond to a derivative action); *see also* Harhen v. Brown, 710 N.E.2d 224, 232 (Mass. App. Ct. 1999) *But see Harhen*, 730 N.E.2d at 865-66 (viewing *Harhen v. Brown* as simply a demand refused case).

or reverse conclusions reached by special committees or the board will largely be a reflection of the comprehensive social meaning and social influence of shareholder suits themselves.

1. What is the Current Social Meaning of Shareholder Suits?

An atomistic conception of why people transgress social norms depends heavily on "when the expected utility of law-breaking exceeds the expected disutility of punishment."[124] This perspective demands that "the community should adopt the most cost-effective policies for raising the price of crime" and thus reduce crime to the optimal level.[125] It is possible that such an approach to deterrence in a civil/corporate setting will ignore both "the contribution that *social influence* makes to individuals' decisions to commit crimes" and "the role that the regulation of *social meaning* can play in determining the direction of social influence."[126] While it is possible that managers and directors do not decide to breach fiduciary duties in isolation, their decisions interact with and reinforce each other in a variety of ways.[127] Building on that intuition, it is possible that individuals are more likely to breach fiduciary duties when they perceive that such breaches are widespread. From this, these individuals then infer that the risk of being apprehended is low.[128] "They might also conclude that relatively little stigma or reputational cost attaches to" breaching one's fiduciary duty, "and if such behavior is common among their peers, they may view such behavior as status enhancing" while maintaining few moral aversions to such conduct.[129] The law relating to shareholder litigation generally, and special litigation committees in particular, may have the capacity to shape these perceptions by providing the investing public, consisting of actual and potential equity holders, with an expectation that certain kinds of behavior will be punished.

The law may also provide an avenue for shareholders to express their shared valuations of certain kinds of conduct. Directors and managers draw inferences from the behavior of other directors and managers. When the law regulates such behavior by accepting or refusing recommendations of special committees, it can either accentuate or mute these signals. The law then creates and shapes information and perceptions about the kinds of performance that shareholders hope for and value, as well as the kinds they

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124. Kahan, *supra* note 99, at 349.

125. *Id.*

126. *Id.* at 350.

127. *Id.* at 350.

128. *Id.* at 350.

129. Kahan, *supra* note 99, at 350. This builds on Kahan's intuition with respect to why people commit crimes. *Id.* at 350.

> The public expects criminal law to protect it from harm, but it also understands the kinds of things the law punishes, and how much, to express shared valuations. Individuals also draw such inferences from the behavior of other individuals; when the law regulates such behavior, it can either accentuate or mute these signals. By the regulation of *social meaning*, I refer to all of the ways in which the law creates and shapes information about the kinds of behavior that members of the public hope for and value, as well as the kinds they expect and fear.

Id. at 350-51; *see also* Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 907 (1996) (arguing that anomalies in human behavior are the result of social norms).

expect and dread.[130] A community that wishes to deter fiduciary misbehavior should concern itself not just with the effect of a particular regulation on the price of misconduct, but with the statement that those policies make about the public's attitudes toward fiduciary misbehavior.[131] In fact, cases proclaiming "fiduciary obligations teem with [moralizing] language of the kind found in Cardozo's famous opinion in *Meinhard v. Salmon*"[132] and elsewhere.[133] Significantly, the "phenomena of social influence and social meaning matter for deterrence."[134] As one observer remarks, "Lawyers and judges are explicitly trained to view fiduciaries . . . as a distinctive legal role, subject to legal norms that are more stringent than those applied to non-fiduciary legal roles."[135] Perforce, the social influence concept of deterrence and the social meaning concept of shareholder litigation yields a perspective that eludes standard economic analysis.[136] If true, the manager's role extends beyond her narrow, private contractual relationship with the firm and its equity holders[137] to a public role as a member of a community, which collaboratively produces benefits and imposes costs.

Shareholder litigation (including deference by courts to board decision making), like the concept of social reality,[138] has a public as well as a private role. The question of the social meaning and social influence of legal constructs inevitably must confront the possibility that "nihilism stands at the door" and that the very concept of truth represents "the solidification of old metaphors."[139] Whether shareholder litigation should be seen foundationally[140] and truly as a positive social force[141] is beyond the scope of this

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130. Kahan, *supra* note 99, at 350-51. While Kahan's focus is primarily criminal law, my debt should be obvious.

131. *Id.* at 351.

132. Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships 1999, at* http://www.legalessays.com (internal citations omitted) (last visited Feb. 2, 2001); Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928).

133. *But see* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 428 n.6 (1993) (claiming that morality is present in court opinions without establishing that ethics rather than economics best explain the legal rules).

134. Kahan, *supra* note 99, at 351.

135. Alexander, *supra* note 132, at 6.

136. *See* Kahan, *supra* note 99, at 351-67 (focusing on how social influence deters criminal behavior).

137. Jensen and Meckling emphasize the contractual nature of the manager's role in the firm. Jensen & Meckling, *supra* note 6, at 312-23.

138. *See, e.g.*, DAVID LYON, POSTMODERNITY 1-4 (1999). "One of the basic themes of postmodernism revolves around reality, or lack of reality, or a multiplicity of realities." *Id.* at 11.

139. *Id.* (internal citations omitted).

140. Foundationalism asserts, among other things, that science and analysis is built on a firm base of observable and verifiable facts. *See id.* at 10. For a defense of foundationalism, see EDWARD O. WILSON, CONSILIENCE: THE UNITY OF KNOWLEDGE (1998). Postmodernists reject the notion of a foundational or transcendent source for truth while simultaneously rejecting the notion of a determinate unique meaning for statements. BRIAN BIX, JURISPRUDENCE: THEORY AND CONTEXT 231 (1999). For a spirited challenge to foundationalism, see RICHARD RORTY, TRUTH AND PROGRESS: PHILOSOPHICAL PAPERS (1998) (suggesting, among other things, that knowledge, in the sense that it connotes "true beliefs which are considered useful nonrepresentational mental states as distinguished from accurate (and therefore useful) representations of reality" that actually correspond to reality, is seen as a difference which makes no difference in practice to pragmatic postmoderns). *Id.* at 20. *But see* DANIEL A. FARBER & SUZANNA SHERRY, BEYOND ALL REASON: THE RADICAL ASSAULT ON TRUTH IN AMERICAN LAW 27 (1997) (maintaining that since the Enlightenment, knowledge has been conceived of as a universally accessible concept). For a cautionary explication on the limits

Article. For present purposes, this author shall simply assume that it is. If this proposition is true, one might argue that the "higher the public esteem of the shareholder suit, the greater will be its deterrent value,"[142] independent of the deterrence generated by purely private sanctions. On the other hand, it must be conceded that an unreflective commitment to the enhancement of such suits in order to enlarge deterrence runs the risk of over-deterrence through over-enforcement[143] and hence runs the risk that such suits will be a force for negative social change and a source of shareholder alarm.

To be sure, Cox and others[144] accept "the well-documented tendency of individuals to make social choices by reference to the conduct of others."[145] Perforce, one might ask whether pretrial screening devices aimed at extirpating frivolous cases,[146] and indeed, whether any action connected with "the suit's commencement, prosecution [including judicial deference, if any, to board decision making] and settlement cause corporate managers . . . not involved in the suit to conform their future behavior to the normative standards invoked by the suit's plaintiff."[147] In other words, will managers "place the shareholders' and investors' interest[s] where they should be rather than irresponsibly discarding them?"[148] Such an undertaking proceeds beyond mere redress and private sanction for the misconduct of the manager or director at issue. It considers the deterrent effects (grounded in the social influence and the social meaning) of such litigation and judicial review of corporate litigation control decisions on those who may be currently innocent, yet undecided about future behavior or misbehavior. Given the power of social influence, derivative suits may plausibly shape the perceptions of corporate actors about their colleagues' beliefs and intentions about corporate opportunities, inside trading, and breaches of fiduciary duties.[149] Accordingly, corporate actors may refrain from breaching fiduciary duties even when the utility of such misconduct exceeds the direct disutility derived from merely private sanction.

Furthermore, a suit's deterrent effect depends partially on the nature of the complaint becoming public knowledge. The charges, and hence the power of the litigation to act as a deterrent, will be diluted "if the medium through which they are

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of human knowledge, human progress, and technique, see generally JACQUES ELLUL, THE TECHNOLOGICAL SOCIETY (John Wilkinson trans., 1964).

141. For a largely negative answer, see Fischel & Bradley, *supra* note 27, at 262-74.

142. Cox, *supra* note 5, at 4.

143. This risk is especially real in the context of shareholder derivative suits, which likely involve minimal plaintiff monitoring of attorney conduct. The attorney has an incentive to maximize the amount of legal fees recovered in light of the costs (time) expended. *See* Macey & Miller, *supra* note 3, at 12-26.

144. *See, e.g.*, Robert B. Cialdini et al., *A Focus Theory of Normative Conduct: A Theoretical Refinement and Reevaluation of the Role of Norms in Human Behavior*, *in* 24 ADVANCES IN EXPERIMENTAL SOC. PSYCHOL. 201, 221-23 (1991) (cited in Cox, *supra* note 5, at 4); Sunstein, *supra* note 129, at 905.

145. Cox, *supra* note 5, at 4-5. *See generally* Kahan, *supra* note 99 (examining social influences on criminal behavior).

146. Frivolous cases may be sorted out through (1) the contemporaneous ownership requirement, (2) security-for-expense statutes, (3) high pleading standards, (4) the demand requirement, (5) the use of summary proceedings, and (6) sanctions for abuse such as Rule 11. Loewenstein, *supra* note 26, at 17. Plaintiffs often settle cases (particularly the weakest) before clearing these hurdles. *Id.*

147. Cox, *supra* note 5, at 5.

148. *Id.*

149. This analogy is derived largely from Kahan's approach to criminal law. *See* Kahan, *supra* note 99, at 351.

asserted itself lacks a credible reputation."[150] Thus, charges of usurping corporate opportunities, self-dealing, and insider trading will fail to convey the desirable level of social condemnation for such misconduct if the charges are not seen as plausible.[151] "Shareholder suits will not affirm the social norms the suit's defendants allegedly violated if they are commonly understood to be frivolous."[152]

In fashioning social meaning through the production of social norms, leading commentators focus on the "ways the expressive value of an event, such as a sanction's imposition, can be influenced."[153] Possibilities include ambiguation,[154] tying,[155] inhibition,[156] and ritual.[157] Before inspecting the general conclusions derived from this framework, several examples illustrate the current regulatory framework's failings. Consider "inhibition" and "ritual." One "inhibition" which may limit the meaning of the derivative suit is the demand requirement. Despite the positive effect derived from the demand requirements' insistence that the plaintiff's charge be credible, in its contemporary formulation it often fails as a screening device because the court focuses on procedures and not on a rigorous examination of the good-faith refusal to commence suit.[158]

More generally, this analytical approach yields the following conclusions. First, the two major components of the mission of shareholder derivative suits are compensation of the injured and deterrence of misconduct.[159] Second, while some empirical evidence suggests that derivative suits provide little specific deterrence[160] or only provide "scant evidence" of indirect benefits as a backup corporate governance mechanism,[161] the empirical data does admit the possibility of deterrence.[162] In any case, neither a compensatory nor a deterrence mission necessarily remains at variance with the other

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150. Cox, *supra* note 5, at 6.

151. Conversely, judicial deference to board decision-making or the failure of the courts to ensure that substantive good faith has been exercised does not convey social condemnation for such misconduct.

152. Cox, *supra* note 5, at 6.

153. *Id.* at 8 (citing Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 948, 1009-34 (1995)).

154. Ambiguating refers to the tendency of courts to weaken the social meaning of shareholder suits by emphasizing private compensation, as opposed to society's condemnation, when evaluating such suits. *See id.* at 10-13.

155. Tying refers to the notion that courts frequently tie shareholder suits to a failing objective: compensation. This comes at the expense of deterrence. Since compensation is rarely forthcoming, such suits are derided. *Id.* at 13-16.

156. Inhibitions include: (1) the exclusions contained in insurance policies limiting compensation; (2) the "good faith" requirement contained in indemnification statutes; and (3) various pretrial procedures, including the demand requirement, which insists that the plaintiff's charges be credible, but, which may eliminate some meritorious suits. *See id.* at 20-27. Notably, vicarious liability that allows corporate managers to escape the personal consequences of misconduct may not provide appropriate disincentives for misbehavior. *See, e.g.*, POSNER, *supra* note 39, at 463-65 (addressing tort liability for corporate employees).

157. Cox, *supra* note 5, at 28-38. Ritual refers to the "procedural requirements that accompany the suits' initiation and settlement" and includes the adequacy of the plaintiff and weak incentives for attorneys and clients to aggressively pursue the derivative suit to trial. *Id.* at 28.

158. *Id.* at 23-24.

159. *Id.* at 8.

160. Romano, *supra* note 2, at 84-85.

161. *Id.* at 85.

162. *See id.*

because to hold one accountable to those harmed by the director or manager's misdeeds provides a disincentive for other similarly situated individuals. Still, a derivative action may possibly justify derivative actions as a general deterrent even where the total costs of such cases exceed their direct pecuniary benefits. "This is because most shareholders hold a portfolio of stocks, [and] they could benefit, because managers, both in the same corporation and in other corporations, might be deterred from future wrongful conduct by a few successful actions."[163] Despite this, shareholder suits are consistently dismissed when they neglect to serve compensatory ends even though the suit's successful prosecution would advance the goal of deterrence. Therefore, it is conceivable that "compensation is the prevailing objective of shareholder suits and deterrence its valuable byproduct."[164]

Accessible illustrations suggest that often deterrence norms have been sacrificed for compensation[165] and its focus on economic efficiency. This vindicates private interests at the expense of public norms,[166] despite the general moralizing tone which courts deploy in appraising such cases. Indeed, the courts' acceptance of compensation as the norm, as opposed to deterrence, implicates analysis of all forms of corporate decision-making including special litigation, prelitigation, and demand decisions. Thus enervated, their inspection vitiates the social meaning of the derivative suit. Importantly, shareholder-

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163. KLEIN & COFFEE, *supra* note 10, at 200-01. "Whether derivative actions in fact generate such a deterrent benefit today (particularly in view of the possibility of collusive settlements) is, however, an open question." *Id.* at 201.

164. Cox, *supra* note 5, at 8-9.

165. The requirement that the plaintiff demonstrate a "net loss" when the knowing violation of a criminal statute underlies the derivative claim underscores this conclusion. Despite the fact that directors or officers have knowingly engaged in an illegal act which deprives them of the presumption of propriety that normally accompanies the disinterested decisions of managers, they may nonetheless assert in their defense that in the absence of evidence that the corporation suffered a net loss through their illegal conduct, the suit must be dismissed. Accordingly, the plaintiff has the burden of establishing that "harm suffered by the corporation as a consequence of the misconduct exceeded the benefits" in order to prevail. *Id.* at 9. Perhaps skeptical courts, persuaded by this analysis, might be encouraged to reverse this process by shifting the burden to the corporation.

Additional illustrations that sustain the claim that compensation is the *sine qua non* of the corporate suit include the deployment of the "vicarious incapacity" principle, which implicates the contemporaneous ownership predicate to bringing a derivative claim. *Id.* at 9. Simply stated, the plaintiff must recover on the soundness of her own case, not on the infirmity of the defendant's case. This procedure fails deterrence norms by overemphasizing compensation. *Id.* at 9-10.

166. The court's preoccupation with the compensatory rather than the punitive aspects of shareholder suits ambiguates or vitiates

> the suits' expression of social values. . . . Because compensating the injured is a private matter, whereas deterrence is of public concern, the more squarely the courts place the objectives of shareholder suits in the compensatory sphere, the weaker the public perception will be that such suits are reflections of society's condemnation of the misconduct underlying the suit's charges.

Id. at 11. From this observation, it is a short peregrination to the conclusion that:

> To the extent that suits are perceived as addressing purely private injuries, instead of being understood to address violations of the public interest in ways that cause private harms, the public perception will be that derivative suits are but a subset of the standard commercial dispute between two warring financial interests.

Cox, *supra* note 5, at 11.

plaintiffs currently have a pitiable success rate in court and hence the deterrence effect, if any, of such suits may be reduced to the expected value of settlements, which may simply be attorneys' fees in some cases.[167] Despite the possibility that this very considerable failure rate may implicate the shareholder suits' value, and despite the possibility that a concern for deterrence amounts to adding a pile of arid bones onto an already limp instrument, truly skeptical courts committed to the revitalization of shareholder suits should be prepared to reverse this seductively attractive emphasis on compensatory recovery and ensure that deterrence norms and public concerns are highly valued as well[168] and thus provide an additional basis for shareholder success. This may provide sufficient additional incentives to plaintiffs' attorneys to pursue desirable actions in the future.[169]

C. Social Meaning in the Mirror of the Economics of Agency Costs and Litigation Control

In many firms, managers only possess a small financial stake in the enterprise while retaining an enormous interest in their own atomistic welfare, thus leading to conflicts between managers and shareholders. Where officers and directors are unwilling to constrain their self-interests, a representative shareholder may decide to bring suit for the benefit of the corporation. While an economic rationale for such litigation exists, it is still possible that such litigation is not "necessarily beneficial to either the putative plaintiffs or to society."[170] Despite this possibility, this author shall assume that plausible benefits can be found. Conceptually, plausible benefits could include compensation and its connection with an economic conception of deterrence premised on the notion that people behave rationally to maximize their own utility.[171] If this is the case, individuals breach fiduciary duties only when the expected utility exceeds its costs. In reality, such deterrence in a derivative suit context is largely compensation to injured shareholders in the form of a recovery to the corporation.

While earlier discussions of the social meaning of shareholder litigation seem to focus on the appropriate level of public condemnation of management misbehavior designed to vindicate public norms, agency cost considerations have litigation control implications which concede the possibility of misconduct by both management and

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167. Romano, *supra* note 2, at 84. In one study of derivative suit dispositions, most lawsuits (83 of 128) settled—that is of course unremarkable as most civil suits settle. *Id.* at 60. Shareholder-plaintiffs, however, have a particularly poor success rate in court. Their success rate was 6% of adjudicated cases, but plaintiffs actually won no judgments for damages or equitable relief in such successes. *Id.*

168. Cox, *supra* note 5, at 39-40. The social meaning might also be enhanced by ensuring that individual defendants who engage in misconduct actually contribute to the settlement and by allowing non-intervenors to appeal the settlement. *Id.* at 41-42.

169. Whatever the virtue of these conclusions, the settlement pattern implies that a significant proportion of such cases may be without merit. Romano, *supra* note 2, at 61. Settlements exhibit three striking features: (1) only half of all settlements have a monetary recovery, (2) awards are paid to attorneys far more frequently than to shareholders, and (3) in eight percent of the cases the *only* relief was attorneys' fees. *Id.* In light of this, the possibility emerges that a significant proportion of derivative litigation (judged from an economic perspective) is less than socially optimal.

170. Macey & Miller, *supra* note 3, at 11; *see* Fischel & Bradley, *supra* note 27, at 271-74.

171. For a discussion of economic deterrence in the context of criminal sanction, see Kahan, *supra* note 99, at 349.

plaintiffs' attorneys in the prosecution, termination, and settlement of the litigation. Such suits may be neither economically efficient nor financially worthwhile for shareholders. Despite that claim, it has been argued that such suits provide two social benefits: they forestall wealth-destroying managerial conduct and illuminate legal duties by producing legal precedents.[172] In any case, an inspection of both the economics of agency costs and litigation control standards may helpfully outline the parameters of a proper conception of the business judgment rule, and hence vindicate shareholder derivative suits as a corporate governance mechanism.

As alluded to earlier, the fundamental economic rationale for shareholder derivative suits is a function of the necessity of minimizing corporate agency costs grounded in the conviction that the interests of management deviate from those of shareholders.[173] This rationale is predicated in the separation of ownership from day-to-day control. Similarly, in prosecuting a derivative suit, there is a separation between the ownership of the litigation and its execution. The plaintiff's attorney allegedly acts as the agent of the client (the corporation) and accordingly is "charged with the duty to advance the client's interests zealously. . . ."[174] Zealous prosecution coupled with a judicial focus on norm management as informed by law and economic considerations of litigation control may serve the normative purpose of reducing firm-specific agency costs by shrinking the divergence in interests between management and shareholders.

To restate, interest divergence between managers and shareholders is likely to be mirrored by the possible divergence between attorney and client interest. This could be viewed as a largely circular and futile process, as the plaintiff's attorney is in essence the corporation's attorney whose remit is to limit the agency costs associated with the separation of ownership and management. Accordingly, minimizing plaintiff-attorney agency costs relative to the expected value of the benefits achieved or, put differently, maximizing the benefits to shareholders in relation to litigation costs should be an objective criterion for assessing the efficiency of derivative litigation. As conceived here, the reduction in interest divergence between attorney and client must primarily be viewed in teleological terms—it has or should have the instrumental objective of shrinking the divergence in interest between managers and shareholders. Given the possibility of interest divergence, monitoring by the principal, bonding by the agent, and devices which are designed to properly align the incentives of the agent more closely with those of the principal may, in general, diminish agency costs.[175] If true, judicial review of shareholder suits and the consequent allocation of control of the litigation bears on the optimal

172. *See generally* Kamar, *supra* note 15, at 887-90. In this view, insurance provides sufficient incentive for shareholders to bring suits by ensuring recovery without exacting too high a price in the form of excessive managerial timidity if they were faced with the prospect of paying damages solely through their own assets. *Id.* at 887-90; *see also* Paul G. Mahoney, *The First Thing We Do, Let's Pay All the Lawyers*, 66 U. CHI. L. REV., 922-28 (1999) (stating that insurance exists to help managers reduce liability and to ensure shareholders the ability to independently monitor management). Insurance may provide an additional benefit in the form of monitoring by liability companies of officers and directors. Kamar, *supra* note 15, at 889 n.7.

173. *See supra* page 106.

174. Macey & Miller, *supra* note 3, at 12.

175. *Id.* at 13. Macey and Miller build on Jensen and Meckling's observation that monitoring, the creation of sufficient incentives by the principal, and bonding by the agent are likely to reduce agency costs. *See id.*; *see also* Jensen & Meckling, *supra* note 6, at 343.

enforcement policy for corporate law[176] by contributing to the reduction or enhancement of agency costs while simultaneously vindicating or vitiating social norms associated with such suits. First, this Article examines plaintiff-attorney agency costs, which potentially undermine the viability of the derivative suit, and then inspects the allocation of control of the litigation process among the parties.

1. Attorney-Plaintiff Agency Costs in Small-Stake Litigation

In plaintiff-attorney and management-shareholder situations, agents often act cooperatively while simultaneously engaging in behavior that maximizes their benefit.[177] These relationships in turn affect questions of judicial deference and determinations of which party should control the litigation itself. Monitoring, bonding, and the invention of devices designed to align the incentives of the agent more closely with those of the principal can be seen as a viable, yet imperfect,[178] technique to reduce attorney-client agency costs where the client has a significant financial stake in the litigation. This analysis may prove ineffective where the plaintiff has only a small stake.[179] In fact, both attorneys and their clients may lack sufficient incentive to aggressively pursue the derivative action to trial.[180]

Thus, however appealing the general structure[181] of the attorney-client relationship may be, it fails radically in the context of large-scale, small-claim litigation. Given that

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176. From a strictly economic perspective, there is a debate as to whether optimal enforcement combines the highest sanctions defendants can bear with correspondingly low rates of enforcement or, because of the existence of legal indeterminacy in the corporate law, defendants pay less than the maximum they can bear and plaintiff—or, in shareholder suits, plaintiffs' attorneys—receive more than the defendant pays. For at least one view, see Kamar, *supra* note 15, at 889.

177. Jensen & Meckling, *supra* note 6, at 333.

178. *Id.* at 343 (stating it is generally impossible for the principal or the agent at zero costs to ensure that the agent will make optimal decisions from the principal's perspective).

179. Macey & Miller, *supra* note 3, at 20-25.

180. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 671-77 (1986) (examining ways in which private enforcement both encourages and discourages class and derivative actions).

181. The general structure depends on monitoring, bonding, and incentives. Macey & Miller, *supra* note 3, at 13. Where the plaintiff has a large financial stake in the litigation, monitoring, bonding, and incentive structures may be sufficient. The "effectiveness of monitoring depends on the observability of the agent's performance." *Id.* Monitoring costs will be slight when the principal can readily observe the agent's performance so that she can reliably and cheaply determine the marginal product of the agent's conduct. *Id.* Because much of the attorney's work is performed outside of the client's supervision and beyond the client's expertise, the possibility that the attorney will shirk her duty or abuse her trust remains. *Id.* at 14. Admission and retention rules of bar membership carry some assurance that the attorney has the propensity and competency to act faithfully on behalf of the client. *Id.* Codes of attorney ethics require the lawyer to keep the client reasonably informed and to abide by the client's decisions on important matters such as whether to accept settlement. Macey & Miller, *supra* note 3, at 14-15. On the other hand, conduct which strays from the attorney's ethical obligations is unlikely to result in sanctions unless the client discovers them. *Id.* at 15. Like the traditional lawsuit, plaintiff monitoring in derivative cases is likely to be too costly and therefore incomplete. *Id.* (discussing deficiencies of clients' monitoring of attorneys in litigation).

When monitoring costs are high, the optimal strategy may be for the agent to engage in bonding to assure the principal that she will perform faithfully. *Id.* at 15-16. Bonding devices include the attorney's interest in maintaining the right to practice law and thus earn monopoly rents, and the lawyer's interest and investment in her reputation. *Id.* at 16-17.

plaintiffs in shareholder derivative suits often possess claims that are so minor that the litigation remains a matter of unimportance, plaintiffs seem plainly incapable of elementary monitoring in the context of derivative litigation. In addition, standard bonding and incentive techniques are much less effective in such suits. Indeed, incentive effects in derivative litigation may lead attorneys to minimize the relief to their clients so long as the attorney fees are relatively high in relation to effort.[182] Accordingly, given the combined effect of these issues, the effectiveness of derivative litigation itself can be placed at issue.

It must also be conceded, given the monitoring difficulties, the inefficacy of bonding, and the absence of proper incentives, that collusive settlements are an attractive vehicle for plaintiffs' attorneys to reduce their risk when prosecuting derivative suits. Incentive problems tend to arise irrespective of whether the attorney is compensated through the common fund approach or through the lodestar method.[183] Given these incentive problems, it is doubtful that plaintiffs' counsel can necessarily be relied upon to vindicate either the compensatory or deterrent value, if any, of shareholder derivative suits.

Given this conclusion, the agency cost issues associated with the divergence in interests between attorney and client might fatally diminish the viability of shareholder

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The incentive structures in the attorney-client relationship act as partial, but often incomplete, substitutes for adequate client monitoring and attorney bonding. Macey & Miller, *supra* note 3, at 17. While the standard hourly fee may eliminate an incentive, because the lawyer might have to work insufficient hours on the case, the hourly fee also gives rise to the opportunity for opportunism by attorneys. *Id.* On the other hand, the contingent fee partially aligns the interests of lawyer and client by giving the lawyer an economic interest in the outcome of the case. *Id.* This resultant sharing of risk may benefit both parties. *Id.* That conclusion must be tempered by noting that the contingent fee also gives the attorney an incentive to pay insufficient attention to cases where the marginal return to her time is low relative to other cases in her portfolio, and an incentive to settle early for a lower amount than she could obtain for the client by putting forth more time and effort. *Id.* at 17-18.

Lastly, monitoring, bonding, and incentive structures all consume scarce economic resources. Macey & Miller, *supra* note 3, at 19. Such devices will likely only be utilized up to the point at which "the marginal cost of overcoming the misalignment of interests between principal and agent equals the marginal cost of the misalignment itself." *Id.* at 19.

182. *See id.* at 3-7, 22-27 (discussing manners in which derivative litigation impairs normal attorney incentives). The absence of a real client impairs the incentive of the lawyer for the class and, by analogy, for the corporation to press the lawsuit to a successful conclusion. *See* Posner, *supra* note 39, at 627.

183. Plaintiffs' attorneys who are compensated under the lodestar approach can reduce risk by "reaching an understanding with defense counsel early on about the contours of the eventual settlement. Then they can expend a mutually acceptable number of additional hours on the case, charging them against the settlement fund under the lodestar calculation." Macey & Miller, *supra* note 3, at 23. The disutility of the method

> represents an essentially meaningless exercise that ties up the resources of plaintiffs' counsel, defense counsel, and others such as witnesses who must submit to depositions that all parties understand will never be used in court. The principal losers are members of the plaintiff class who must pay over part of their recovery to counsel for work that serves no purpose other than to justify an enhanced attorney's fee.

Id. Similarly, where the attorney is compensated under the common fund method, incentive problems will also arise, which suggests that the attorney may pursue the claim with less than full effort, despite the possibility that admission and the retention rules of bar membership carry some assurance that the attorney has the propensity and competency to act faithfully on behalf of the client. *Id.* at 25 (advancing the proposition that the common fund approach creates incentive for attorney to proceed with less than maximum effort).

derivative suits as a method of ensuring adequate performance by fiduciaries. Indeed, one set of observers asserts that "monitoring costs . . . make heavy reliance on liability rules impractical as a method of assuring [proper fiduciary] performance."[184] Instead, they assert that "[b]ecause 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."[185] Accordingly, at least some skepticism seems warranted with respect to the performance of attorneys in a derivative litigation context. Conversely, ensuring the viability of longshot suits that can withstand cost-benefit analysis should guide judicial decision making which seeks to sustain the possible benefits of derivative litigation. Judicial efforts aimed at chilling frivolous litigation may be potentially overbroad. We should be cognizant that uncritical adherence to prelitigation screening or corporate litigation control devices or acceptance of abusive settlements may inhibit future litigation that might benefit shareholders.[186] In addition, because of the existence of transaction costs, room for improving incentives to bring meritorious suits without simultaneously contributing to massive wealth transfers from plaintiffs to attorney is rather severely constrained.[187] Accordingly, the possibility remains that construction of an idealized attorney-plaintiff framework will remain difficult.

2. *The Litigation Control Determination*

As described earlier, the derivative litigation control problem is derived from the fact that the real client in interest—the corporation—is under the control of parties who are typically hostile to the litigation.[188] Free rein by corporate agents would likely vitiate the derivative action as a corporate control mechanism, as they would routinely cause the suits to be dismissed or compromised on terms favorable to them, but not necessarily favorable to the shareholder or the corporation.[189] It is questionable whether the current regulatory regime appropriately divides control of the litigation between the plaintiff's counsel and the corporation. Two devices, grounded in the corporate business judgment rule, regularly arise and require examination: demand on directors before the litigation, and special litigation committees after the commencement of the suit. This approach seems especially warranted given that *Harhen* involves both the demand requirement, and a special prelitigation committee determination.[190]

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184. Fischel & Bradley, *supra* note 27, at 265.

185. *Id.* Hence, the use of liability as a remedy for lack of effort by managers may fail, despite the fact that "this phenomenon represents perhaps the single largest source of agency costs." *Id.*

186. *See* KLEIN & COFFEE, *supra* note 10, at 197 ("In recent years, because of these barriers, plaintiffs' attorneys appear to have become less willing to undertake the often considerable time and expense incident to derivative litigation.").

187. *See* Macey & Miller, *supra* note 3, at 60-61 (examining potential impacts of the current systems of attorney compensation on derivative litigation).

188. *See supra* Part I.B.

189. Macey & Miller, *supra* note 3, at 34.

190. Where the suit satisfies the demand requirement, the shareholder suit "can more easily be understood to reflect a public condemnation of the conduct that is the subject of the suit." Cox, *supra* note 5, at 24 (footnote omitted). The court's involvement at an early stage in the facts supporting the derivative complaint constitutes a powerful pretrial screening mechanism that has a positive winnowing effect so that suits which comply with these pretrial demands enjoy greater merit than if such requirements did not exist. *Id.*

While pretrial procedures that lead to the dismissal of baseless suits nurture social meaning by insisting that when charges are brought they must be credible and thus create positive deterrent effects,[191] economic considerations sustain this conclusion. For instance, from the standpoint of economic analysis, the demand requirement is defensible. The demand requirement consists of at least three iterations: (1) an almost universal demand requirement that often leads to a rejection by the board; (2) if demand is rejected, plaintiffs are allowed to demonstrate that the rejection is wrongful under certain circumstances; and (3) under certain circumstances, the plaintiff is allowed to allege that demand is futile. Theoretically, the demand requirement creates a balanced environment, which screens out baseless suits while allowing those that contribute to the reduction of firm-specific agency costs to survive.[192] Where the directors are not personally involved with the litigation, demand should be required because (1) the directors have a greater stake (both financially and in terms of their reputations) vested in the corporation than plaintiffs' attorneys and hence, their interests are likely to be aligned with those of the shareholders; (2) directors possess far greater expertise to evaluate the corporation and its affairs than do plaintiffs' attorneys and may justifiably conclude that the corporation and the defendant can adjust their relationship appropriately without litigation; and (3) the directors are chosen by shareholders, whereas plaintiffs' attorneys are volunteers.[193] Thus, in normal cases, the corporation's decision to control the litigation should be sustained unless the directors failed to make an informed business judgment[194] or rejected demand out of self-interest. The demand requirement remains defensible despite the possible cost in the form of reduced information flow to corporate directors.[195] On the other hand, by sustaining the demand requirement and by invoking a procedural version of the business judgment rule, the court, in effect, requires the plaintiff to concede control of the litigation to the business judgment of the board. While the shareholder can plead futility after the fact or wrongful refusal of demand, once demand is made and refused, the court often presumes, subject to rebuttal, that directors are disinterested and independent. In Delaware, because the plaintiff is not entitled to

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191. *Id.* at 20-23.

192.

> The jurisprudence of *Aronson* and its progeny is designed to create a balanced environment which will: (1) on the one hand, deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms; and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule.

Grimes v. Donald, 673 A.2d 1207, 1217 (Del. 1996) (footnotes omitted).

193. Macey & Miller, *supra* note 3, at 35-36.

194. *Id.* at 36; *see also supra* note 41 and accompanying text.

195. If plaintiffs' attorneys expect the corporation to take over the litigation, outside attorneys are less likely to research potential corporate causes of action. While this cost might be slight, valid cases may not be pursued by anyone. On the other hand, "the existence of a potential plaintiff . . . will benefit the corporation because directors can use the threat of litigation in order to extract larger concessions from potential defendants." Macey & Miller, *supra* note 3, at 36. The current regulatory system fails to provide a reliable means by which potential derivative plaintiffs can be compensated for their services to the corporation in threatening litigation, thus likely reducing the frequency that such service will be provided. *Id.*

discovery in demand refused cases, it is extremely doubtful that the plaintiff can plead particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.[196]

Where demand is refused, this directoral determination is normally final unless the shareholder can show that the directors did not act out of informed business judgment.[197] This process should be reversed. In cases where the underlying wrong implicates a potential breach of loyalty, the possibility exists that structural bias may infect an allegedly independent good faith rejection. If true, meritorious suits which have the capacity to reduce the divergence in interest between management and shareholders may not be brought if tainted demand rejections are allowed. Maintaining the vitality of the demand requirement in these cases without dissuading plaintiffs' attorneys from initiating meritorious claims can best be accommodated by placing the burden of proving informed business judgment on the party with the most access to information—the corporation. Nondeferential courts should demand more than subjective good faith before sustaining business judgment as a defense to the plaintiff's allegation that demand was either wrongfully refused or excused. These adjustments will likely enhance the credibility of shareholder derivative litigation and may enhance its economic justification as well.

Similarly, the burden of showing futility has generally been placed on the shareholder who asserts it. Where the directors are personally interested in and hostile to the litigation, a rigid demand requirement might well be counterproductive as well-informed and self-interested directors could use their powers under the demand rule to derail the litigation.[198] Historically, demand appears to have been "usually excused if the complaint alleged misconduct by any of the board's members."[199] The law has undergone a shift so that in Delaware and a number of other jurisdictions, the plaintiff must allege that a majority of the board personally profited from the challenged transaction or was otherwise disabled.[200] Today, demand is thus typically excused when "the plaintiffs' well-pleaded allegations, taken as true, raise a reasonable doubt as to (1) the disinterestedness or independence of a majority of the board, or (2) the directors' exercise of proper business judgment in approving the transaction."[201] Conceivably, this approach might be defensible as the court

> carve[s] out a limited territory in which the benefits of director demand are outweighed by the possibility that interested directors will abuse their rights under the demand requirement to the detriment of the corporation. In these situations, it is better for the litigation to be turned over to the derivative plaintiffs' attorney for zealous prosecution.[202]

While this procedure is defensible where the underlying wrong involves an alleged breach of the duty of care (of the typical kind),[203] it is insufficient. By requiring the

196. Levine v. Smith, 591 A.2d 194, 197 (Del. 1991).
197. Macey & Miller, *supra* note 3, at 36.
198. *Id.* at 37.
199. KLEIN & COFFEE, *supra* note 10, at 198.
200. *Id.*
201. Macey & Miller, *supra* note 3, at 37.
202. *Id.* (footnote omitted).
203. This analysis may not necessarily apply where the breach of the duty of care involves knowing culpability. *See infra* text accompanying notes 369-373.

plaintiff to come forward with evidence, this process places the burden on the plaintiff, who is likely to have little access to information. This seems indefensible, especially where the possible taint of structural bias also exists. In such cases, meritorious suits will fail to be brought and abusive settlements will likely be sought. Like wrongful rejection of demand cases, courts should view with skepticism corporate attempts to preclude the plaintiff from demonstrating demand futility where self-interest implicates possible structural bias. Again, reversing the burden in these cases by requiring the corporation to demonstrate that demand was not excused would arguably provide the proper incentive for plaintiffs' attorneys. Admittedly, such an approach amounts to a repudiation of *Aronson v. Lewis*,[204] where the Delaware Supreme Court sustained the demand requirement against an assertion of futility despite an allegation of self-dealing by the CEO, founder, and controlling (forty-seven percent) stockholder, who allegedly had personally selected the other directors, on the grounds that plaintiff had not shown that demand on the directors would have been futile. Further, as the North Carolina Supreme Court helpfully implies, the demand required, demand excused, and demand wrongfully rejected distinction may be unworkable.[205] Instead, it

> held that a derivative action may not be dismissed without a judicial judgment that the action will not benefit the corporation, regardless of whether demand would be required or excused. Similarly, the American Law Institute has recommended . . . that demand be required in virtually all cases but that the court not dismiss any derivative action without first substantively reviewing the board's justification for dismissal.[206]

Defensible substantive review likely requires objective, as opposed to subjective, good faith.[207] Such a modified procedure coupled with placement of the burden of proof on the corporation when the taint of structural bias exists is surely justifiable.

These modifications will likely reduce the threat of structural bias and reduce the level of deference to board decision-making that surrounds the demand requirement and its progeny. Under currently favored methods where demand is wrongfully refused or where demand is excused, the stockholder is normally allowed to control the initial prosecution of the litigation,[208] subject of course to the probability that the board will

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204. 473 A.2d 805 (Del. 1984).

205. Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987).

206. KLEIN & COFFEE, *supra* note 10, at 199.

207. When the majority of the directors are found to be sufficiently disinterested, most courts accept their good faith conclusion that the suit should be dismissed. Cox, *supra* note 5, at 23. But whatever the content of board good faith in a demand context, it is, however, rarely subjected to a searching scrutiny. *Id.* This may have implications for the social meaning of the demand requirement.

> If good faith were determined through a searching inquiry of the directors' reason for urging the suit's dismissal—their legal conclusions and the facts that support them—then the good faith standard would permit the court to evaluate preliminarily the claims raised in the derivative suit. . . . [H]owever, courts avoid this inquiry and focus their attention upon the procedures the directors pursued, rather than the reasoning invoked, in supporting their dismissal recommendation.

Id.

208. *Aronson*, 473 A.2d at 811-12.

reassert its authority over the derivative claim via special litigation committees.[209] Corporate control of litigation through such committees should not be accepted automatically. If the underlying misconduct that disables the board from either rejecting the suit (self-interest by the majority or self-interest by a significant minority of the board in the challenged transaction, for instance) or ensures that such rejection is wrongful can be cured by the creation of a special litigation committee, structural bias may still loom below the surface. Again, placing the burden on the corporation to justify its attempt to discontinue the litigation and testing that decision objectively[210] in a nondeferential manner is one way to maintain the credibility of such suits and to provide sufficient economic incentives to plaintiffs' attorneys to bring such suits in the future. This approach differs from *Auerbach*, which disallows judicial review of the substantive basis of the committee's decision so long as the members are technically independent.[211] Instead, review is largely procedural and limited to good faith, independence, and adequacy of investigation.[212] While *Zapata*, a demand excused case,[213] and *Alford*,[214]

209. Macey & Miller, *supra* note 3, at 37. Special litigation committees allow corporations whose boards are unreliable to control the litigation. Where the board is unreliable, special litigation committees allow the board to terminate the litigation in most instances on grounds that the litigation is not in the best interest of the corporation. KLEIN & COFFEE, *supra* note 10, at 197. Courts have split over whether to respect a determination by allegedly disinterested directors that the litigation should be terminated. KLEIN & COFFEE, *supra* note 10, at 197. A variety of tests assess whether the special litigation may be allowed to terminate the litigation. *See, e.g.*, Zapata v. Maldonado, 430 A.2d 779 (Del. 1981); Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987) (holding that a case cannot be dismissed without a, discretionary in the former case and mandatory in the latter, judicial determination that the action will not benefit the corporation after an inquiry into the independence, good faith, and sufficiency of the investigation); Greenfield v. Hamilton Oil Corp., 760 P.2d 664 (Colo. Ct. App. 1988) (refusing to accept recommendation of special litigation committee appointed by defendant directors); Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709 (Iowa 1983) (concluding that where the majority of directors are parties to a derivative action, they may not confer upon a special committee the power to bind the corporation as to its conduct of the litigation because of the risk of structural bias, but corporations may apply to court for the appointment of a special panel to make an investigation and to report on the pursuit or the dismissal of the stockholder's derivative action); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (stating that the court may review the independence, sufficiency of investigation, and the good faith of the committee, but not examine the merits of the decision).

210. As used here, "objectively" refers to the establishment beyond peradventure of good sound reasons for the board's decision.

211. KLEIN & COFFEE, *supra* note 10, at 200.

212. *Id.*

213. 430 A.2d 779 (Del. 1987). The plaintiff successfully alleged that demand on the board would be futile because all directors were named as defendants and allegedly participated in the acts specified. *Id.*

214. 398 S.E.2d 445 (N.C. 1990). Here, the trial court is required by statute "to approve or disapprove any proposed discontinuance, settlement, dismissal or compromise" of the shareholders' derivative action. *Id.* at 452. First, the trial court must decide whether qualified, independent, disinterested decision-makers who in good faith thoroughly investigated and evaluated the claims in the complaint reached the proposal for disposition of the case. *Id.* The trial judge may allow discovery and hear evidence, and the burden is on the movant, usually the corporation, to prove the independence, disinterestedness, and appropriate qualifications of the committee and the reasonableness of its investigation. *Id.* Second, the trial court must then exercise its own independent business judgment as to whether the case is to be discontinued, dismissed, compromised, or settled. *Id.* at 452-453. The court is compelled to balance legitimate corporate claims as brought forward in the suit against the corporation's bests interests as determined in part by the committee. *Alford*, 398 S.E.2d at 453. The court must also consider "'such ethical, commercial, promotional, public relations and fiscal factors as may be involved in a given situation.'" *Id.* at 453 (quoting Kaplan v. Wyatt, 484 A.2d 501, 509 (Del. Ch. 1984)). The corporation, as the party seeking final disposition of the case, has a burden of going forward with evidence and

also a demand excused case, but is less deferential than *Zapata*, either allow[215] or require judicial review of purely commercial considerations which may be pertinent to the litigation, the question arises as to whether even this approach is defensible.

Zapata and its progeny demonstrate a sensitivity to the possibility that sham committees of outside directors, under the influence (i.e., structural bias) of corporate insiders, might terminate suits that are in the best interests of the firm.[216] Hence, courts that find *Zapata* persuasive are allowed, but not necessarily required, to exercise their own business judgment in reviewing decisions taken by special committees with the burden of proof on the corporation. The procedure for allocating litigation authority between the directors' and plaintiffs' attorneys amounts to an accommodation of competing considerations in light of the underlying economic rationale for derivative litigation, given the agency problems that confront plaintiff-shareholders and their attorneys. But this method may not be defensible. First, the *Zapata* procedure fails to articulate the substantive standard that a trial court should apply in exercising its own business judgment and leads to indeterminacy. Hence, trial courts "find the *Zapata* test a convenient means for disposing of cases on the merits, even though conceptually the business judgment analysis should not reflect the court's evaluation of the case on the merits but rather whether the control of the litigation should be left in the derivative plaintiff's attorney's hands."[217] Second, it is far from clear that the trial court can exercise business judgment because trial judges lack the experience necessary to engage in a reasoned examination of commercial considerations. Given these deficiencies, the court's business judgment might well bias the analysis in favor of management,[218] leading to deference. In light of these deficiencies, one set of observers asserts, "A more appropriate rule for evaluating the recommendations of special litigation committees [might] be crafted using the common jurisprudential devices of substantive standards and burdens of proof."[219]

The substantive standard technique could assist judicial review that aims to be both skeptical and nondeferential. The "substantive standard method would examine whether the benefits to the corporation of continuing the litigation exceed the costs of doing

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showing that maintaining the action is "more likely than not to be against the interests of the corporation." *Id.* at 453 (quoting Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983)). The shareholders bringing the suit are also entitled to present evidence and arguments as to their contentions. *Id.* at 453. Whether a court can properly weigh commercial, promotional, public relations, and fiscal factors, which bear on the decision to continue or discontinue the litigation, is the subject of some dispute. *See, e.g.*, Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva* Zapata*?*, 37 BUS. LAW 27, 63 (1981).

215. Delaware courts following *Zapata* leave it to "the discretion of the trial court whether or not to engage in substantive review of special committee justifications for dismissal in a demand excused context." KLEIN & COFFEE, *supra* note 10, at 200 (quoting Zapata v. Maldonado, 430 A.2d 779, 788 (Del. 1980)).

216. Macey & Miller, *supra* note 3, at 39.

217. *Id.* It seems doubtful that Macey and Miller are necessarily correct. In order for a court to decide whether to leave the litigation in the hands of the plaintiff's attorney, some assessment of the likelihood of success on the merits of the plaintiff's claim must be made in order to enter into some form of cost benefit analysis. For additional discussion of cost benefit in the context of *Houle*, see *infra* text accompanying notes 426-429.

218. Macey & Miller, *supra* note 3, at 39.

219. *Id.*

so."[220] It is asserted that such an approach is quite different from a determination of the merits of the case, thus allowing the case to continue despite the relatively low probability of success on the merits.[221] Whether there is an indisputable separation between an assessment of the costs of the litigation and the expected value of its continuance on the one hand, and a determination of the merits of the case on the other, is surely a debatable proposition.[222] In any case, a lucid application of the substantive standard approach may depend on difficult questions of proof and complex factual inferences. Much will turn on the burden of proof required.[223] While the special litigation committee is ostensibly independent, even independent directors will often maintain ties with the defendant directors.[224] Accordingly, continued prosecution of the litigation by "the plaintiffs' attorney demonstrates in a highly reliable way that the suit has favorable prospects for generating value for the corporation,"[225] and hence, implying a probability that the litigation is in the firm's best interest. Thus, the burden should be on those parties seeking to demonstrate that it is not.[226] The substantive standard method, coupled with the corporate defendants' burden of proof when the underlying misconduct implicates a breach of loyalty irrespective of whether the alleged breach implicates a majority of the board, would likely reduce the ability of directors or their agents to terminate derivative suits. Additionally, similar to proposals aimed at expanding the scope of the duties of care and loyalty, the substantive standard method would on average increase directors' potential legal liability[227] and reduce the possibility that litigation control was infected by structural bias. This technique is also cognizant of the fact that the plaintiffs' attorney's interest may diverge from the real client in interest—the corporation.

Perforce, this method does not "automatically result in the placement in the hands of the litigating stockholder [attorney] sole control of the corporate right throughout the litigation."[228] Instead, the determination of the litigation committee is simply subjected to rigorous, nondeferential scrutiny *before* the corporation can resume control of the lawsuit. This method may helpfully vindicate the social meaning of shareholder litigation by allowing difficult, longshot cases to proceed, thus vindicating deterrence norms. Similarly, compensation norms may also be vindicated as the expected value of the

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220. *Id.* at 40. For example, if the corporation has only a 10% chance of victory but stands to win a net judgment (after deducting appropriate costs including the plaintiff's attorney fees) of $10 million, the derivative suit should be allowed to continue if the costs of continuing the litigation exceed $1 million. Significantly, the appropriate measure of costs to the corporation exclude plaintiffs' attorney's fees, the major component of expenses in most standard litigation settings, because no fees will be owed if the case fails and the fees in the event of success are already included in the calculation. *Id.*

221. *Id.*

222. *See infra* text accompanying notes 426-429.

223. Macey & Miller, *supra* note 3, at 40.

224. For a discussion of the ties between dependent and independent directors, see James D. Cox and Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 103-04 (1985). There seems to be a "substantial mutuality of interests between all directors of a corporation—both inside (management) and outside (independent). . . . '[T]wo-thirds of outside directors in America are themselves chief executives of other companies.'" Murdock, *supra* note 17, at 82 (citation omitted).

225. Macey & Miller, *supra* note 3, at 40.

226. *Id.*

227. Fischel & Bradley, *supra* note 27, at 262.

228. Zapata v. Maldonado, 430 A.2d 779, 784-85 (Del. 1980).

benefits of the suit to the corporation exceed its costs, despite the low probability of success on the merits. Meritorious suits cannot be peremptorily discontinued by those potentially infected with structural bias, thus providing an appropriate incentive to attorneys to bring litigation that vindicates derivative suits as corporate governance vehicles. On the other hand, inappropriate suits will not be continued where no direct or indirect benefits accrue to shareholders. This procedure maintains social norms by increasing the probability that fiduciary misconduct will be subjected to substantial compensation while possibly providing general and specific deterrence.[229] Such an approach should arguably be extended to encompass judicial review of demand futility and demand refusals by boards of directors or special committees as well.

To restate, while the demand requirement may be the principal pretrial means for involving the alleged client—the corporation—in the litigation control decision, even when demand is excused as futile, that conclusion fails to preclude corporate managers from reentering the litigation later via a special litigation committee consisting of allegedly impartial directors.[230] Both vehicles for controlling litigation should, in the presence of *potential* structural bias, be subject to skepticism. Nondeferential skepticism requires an articulated and rational basis for attempts to refuse, discontinue, or otherwise impede the litigation, as well as an assessment of the cost of the litigation in light of its benefits.

3. *Judicial Supervision of Settlements*

Given that most derivative cases settle prior to judgment, the problem of agency costs must be confronted here. Plaintiffs' attorneys and corporate defendants may face a severe conflict of interest in settling derivative litigation brought, theoretically, to vindicate corporate governance norms. Abusive settlements undermine those norms. The regulatory response to this conflict is to require judicial scrutiny of proposed settlements. On the other hand, scrutiny and the plaintiffs' interest may be highly compromised in light of the judge's powerful interest in approving settlements, the possibility that trial courts lack sufficient information to make informed judgments on the fairness of the settlement, and the fact that settlements tend to devolve into "pep rallies" jointly orchestrated by plaintiff's counsel and defense counsel without the presence of objections from intervenors.[231] Indemnification rules, insurance exclusions, and the possibility that neither party internalizes litigation costs constitute powerful incentives to compromise the alleged objective of the litigation[232]—the maintenance of derivative suits as a

229. This approach likely undercuts Cox's assertion that the social meaning of shareholder litigation depends crucially on whether the plaintiff has an adequate financial stake in the corporation. *But see* Cox, *supra* note 5, at 41.

230. *Id.* at 38.

231. Macey & Miller, *supra* note 3, at 45-47.

232. Romano, *supra* note 2, at 57.

> The combination of differential indemnification rights, insurance policy exclusions, and plaintiffs' counsel as the real party in interest creates powerful incentives for settlement. . . . With a settlement, attorneys' fees will be recovered, as defendants routinely agree not to oppose petitions for fees, and, in any event, the benefit the plaintiff has conferred on the firm will be recognized in the settlement. If a claim is litigated, however, there is some probability that the plaintiff will lose. The plaintiff's attorney thus also has a powerful incentive to settle. Because D

corporate governance mechanism. On the other hand, one leading observer suggests that it is precisely the promise of insurance payments (which may be a component of settlement negotiations) which catalyzes the plaintiff's attorney into action and without which an insufficient number of derivative suits might be brought.[233] Without insurance, managerial timidity may increase and impose a cost on shareholders in the form of lower returns on capital.[234] Without the protection offered by insurance, it is argued, managers will unduly avoid risks to the detriment of overall corporate returns by foregoing efficient transactions.[235] Whether this perspective is persuasive is debatable.[236] On balance however, this Article asserts that deterrence norms attached to both private and public values and cost internalization values connected to economic efficiency will likely be served by ensuring that active wrongdoers bear at least a portion of the cost.

In addition, the adoption of Professor Cox's proposal requiring courts to allow individuals and groups with a substantial stake in the corporations to intervene at the settlement stage might helpfully limit abusive settlements. Independent review assisted by intervenors might constrain excessive fees by comparing such fees to the benefits achieved and, therefore, provide an incentive which likely corresponds to the need for public condemnation. This is, however, only a tentative recommendation. Intervenors or the courts could insist that courts reconsider the current policy of approving attorneys' fees in derivative settlements unless the settlement either generates a common fund out of which fees were paid, produces an intangible benefit (perhaps including deterrence) reasonably susceptible of valuation, or reflects a strong nexus between the relief sought in the complaint and the relief obtained that perhaps vindicates compensation norms.[237] Further, courts must act with awareness that stringent limitations on attorneys' fees might overly deter meritorious litigation or inhibit unabusive settlements.[238]

D. Developing a Defensible Policy Framework for Judicial Review of Shareholder Derivative Control

The underlying premise of many proposals aimed at strengthening the derivative suit is the premise "that greater liability will reduce agency costs by more closely aligning the interests of managers and investors."[239] For at least one set of observers, this premise is

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> & O [Directors and Officers] insurers reimburse both sides' expenses in a settlement, unlike other civil litigation, in shareholder suits neither party internalizes litigation costs.

Id.

233. Kamar, *supra* note 15, at 908-09. This, of course, assumes the indeterminacy of corporate law. *See generally id.*

234. Managerial timidity might increase if managers were held personally liable for their fiduciary duty breaches. *See generally id.* at 907-10.

235. *Id.* at 889.

236. *See generally* Mahoney, *supra* note 172, at 922-32.

237. Loewenstein, *supra* note 26, at 6-26. Under current practice, the "value of the 'benefit' obtained by 'successful' plaintiffs has often been insubstantial, especially when viewed in light of the fees sought by the plaintiff's counsel." *Id.* at 3-4.

238. For a perspective on this issue, see *id.* at 25-26.

239. Fischel & Bradley, *supra* note 27, at 262. Fischel and Bradley suggest that the "widespread assumption that corporate managers systematically act in ways contrary to the investor's best interests is without foundation." *Id.* Hence, there is no problem that needs to be addressed by expanding directors' legal liability. *Id.*

dubious in that it ignores the reality that liability rules create both costs and benefits, calling into question the desirability of shareholder derivative actions.[240] Not all rules will properly align the interests of management and shareholder, but it is possible to posit some legal rule or set of rules that provide benefits which exceed their costs. That intuition should inform judicial decisions. In addition, this Article strives to go beyond mere concern for the deviation in the economic interests between investors and managers, which is the subject of these suits, as it is refused, allowed to proceed, discontinued, or settled. Instead, it pertains to the notion that some rules may vindicate not simply the economic interests of shareholders, but society and the shareholder community generally.

With that in mind, the nature of the underlying wrongdoing logically and defensibly influences the amount of judicial deference allowable for special committees and perhaps even all litigation control decisions. Despite the argument of some observers that the distinction between fiduciary duties is artificial,[241] there is certainly an argument for less deference and intensified scrutiny when the initial wrong involves a breach of the duty of loyalty or assertions of self-interested behavior. Where self-interest is implicated, intensified scrutiny increases the probability that such misbehavior will be subject to sanction by increasing the incentive for attorneys to research such cases and by increasing the certainty of punishment. Heightened certainty of punishment[242] may positively change corporate norms and these benefits may outweigh the increased consumption of judicial resources required. Greater deference—when the alleged breach involves a typical duty of care, as opposed to one involving either dishonesty or self-interest—is arguably consistent with positive inhibitions observed in both insurance and indemnification statutes,[243] and is less likely to be tainted by structural bias. This concern for structural bias extends beyond *Zapata's* evident concern, where a majority of the directors are implicated in the transaction and suggests the possibility of an infected process, despite the absence of proof that a majority of the board or any members of the special committee were directly implicated in the challenged activity.

While standard economic analysis might suggest that raising the price of fiduciary misconduct might be sufficient to reduce its frequency to an appropriate level, a social influence view might argue that the deterrent effects of shareholder suits cannot be limited solely to price effects.[244] It is possible that by increasing the positive social influence effects of derivative suits, the level of fiduciary misconduct may be reduced without increasing the price effects through higher compensation. Therefore, a more robust conception of shareholder suits, which admits a formal role for the regulation and the vindication of social meaning, and the public opprobrium and their role in affecting the direction and frequency of future corporate misconduct seems justifiable. Heightened public esteem derived from rigorous adherence to the need for public condemnation for

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240. *Id.* at 262-63.

241. *Id.* at 290-91. *But see* Goetz, *supra* note 97, at 350-51 (stating that there is a difference in the ability of judges to identify a failure of loyalty as opposed to one of care).

242. "The standard economic conception of deterrence treats severity of punishment and certainty of conviction as interchangeable components of the price of crime. . . . The social influence conception challenges this prescription." Kahan, *supra* note 99, at 378. It is possible that high certainty operating through social influence is highly beneficial to deterrence norms. *See id.* at 377-82.

243. Cox, *supra* note 5, at 25-26.

244. *See* Kahan, *supra* note 99, at 377-78.

corporate misconduct courts may obviate some future suits by revitalizing deterrence considerations. While an earlier subsection presents a rather opaque picture of forces that often enervate the social meaning of shareholder suits and confirm them as vehicles that often fail to affirm desirable norms, the judicial role in vindicating social norms should be part of the calculus. Despite the vulnerability of the derivative suit to assault on grounds that it either leads to frivolous litigation or fails to fulfill its compensatory mission,[245] judges should consider reversing the current elevation of compensation over deterrence when defining the mission of the derivative suit.[246] Given that shareholders receive a paltry recovery on a per-share basis[247] and that nonpecuniary forms of relief may be cosmetic,[248] tying the measure of shareholders' suits, to their compensatory functions might call such litigation into question. Courts should therefore ensure that real compensation occurs when possible. They should also be reluctant to dismiss suits when they fail to serve compensatory ends unless such suits fail to serve deterrence goals attached to public values, and warrant that nonpecuniary forms of relief, when granted, are substantive and not simply cosmetic. Because shareholder suits are a risky business, plaintiffs' attorneys demand large rewards. If, as is likely, the overall incentives of shareholder suits will continue to cause them to be lawyer-driven, then one could argue that "the role of the law should be to direct the suits in such a way as to increase their stature."[249] Professor Cox's contention that by requiring the suit's representative to be adequate in terms of her financial stake, society would ensure that adequate representation of the public interest underlying the creation of this cause of action[250] is debatable.[251] In the absence of additional and compelling evidence, it should largely be rejected.[252] On the other hand, his recommendation that the public status of shareholder suits might be enhanced by allowing nonintervening shareholders greater rights to review and appeal settlements,[253] or the alternative recommendation by others that courts should consider the appointment of a *guardian ad litem* to represent shareholders[254] in order to dissuade collusive or abusive settlements,[255] have merit.[256]

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245. Two leading studies conclude that derivative suits yield no significant wealth effects. Cox, *supra* note 5, at 14. *See generally* Fischel & Bradley, *supra* note 27; Romano, *supra* note 2, at 55-85.

246. Cox, *supra* note 5, at 39.

247. In fact, given that the standard recovery represents a small amount on a per share basis, the conclusion that such suits are always an important monitoring device that curbs managerial malfeasance becomes improbable. One observer concludes that many shareholder suits remain skittish and the prime beneficiaries of such proceedings are attorneys. Romano, *supra* note 2, at 61, 65. But such a conclusion cannot be accepted uncritically if derivative litigation produces indirect and perhaps unmeasured benefits.

248. *Id.* at 63.

249. Cox, *supra* note 5, at 41.

250. *Id.*

251. *See* Macey & Miller, *supra* note 3, at 61 (asserting that "named plaintiffs are—or should be—largely irrelevant in large-scale, small-claim cases and should be eliminated. Plaintiffs' attorneys should be allowed to file 'Jane Doe' . . . complaints on behalf of unnamed . . . shareholders.").

252. For example, if courts emphasize the adequacy of the plaintiff in determining whether to allow the suit to continue, fewer meritorious suits may be brought, thus vitiating the compensatory and deterrence value of such suits. It is doubtful that such results vindicate the social meaning of derivative litigation, nor does it provide desirable social influence to deter future fiduciary misbehavior.

253. Cox, *supra* note 5, at 42-44.

254. *See* Macey & Miller, *supra* note 3, at 47-48.

255. Cox, *supra* note 5, at 43-44.

Additionally, an informed evaluation of judicial behavior must be cognizant of the economic advantages which accrue when firm-specific agency costs are reduced, and therefore, conclusions about who should control the litigation should be informed by its economic effects on incentives for shareholders or plaintiff's attorneys to bring appropriate suits in the future. Enforcement of the demand requirement where directors are not personally involved with the litigation is defensible on numerous grounds, unless it can be shown that they did not act out of informed business judgment. In addition to its economic justification, the enforcement of the demand requirement enhances the credibility of suits. Where demand is excused, public values are vindicated by ensuring that the conduct that is the subject of suit reflects public condemnation.[257] On the other hand, because the plaintiff must often plead sufficient facts with particularity to excuse demand, meritorious litigation may be unjustifiably compromised with both economic and social costs. While some courts or observers might be disinclined to require that the exercise of business judgment at the demand refusal stage embrace a substantive good faith component, this author doubts that the mere exercise of subjective good faith[258] constitutes a defensible exercise of corporate business judgment.

One observer notes that even the *Auerbach* court recognized that trial courts could scrutinize corporate litigation control decisions to ensure that the decision was not a whitewash, but failed to recognize that judicial scrutiny of the decision itself, and not simply the procedures followed, is necessary to preclude a whitewash.[259] Accordingly, courts should go beyond a mere procedural and largely deferential[260] inquiry and insist that an allegedly good faith decision to refuse demand or to otherwise discontinue litigation be subjected to a substantive test. That would compel the court to inquire into the directors' reasons for rejecting demand.[261] It would require the court to determine whether there was an informed and comprehensive exercise of judgment. At a minimum this should allow the court to "evaluate preliminarily the claims raised in the derivative suit"[262] instead of focusing merely on proper procedures.[263] This would also subject good faith to a requirement that it be exercised transparently and rationally in compliance with the ALI recommendations, coupled with an insistence that potential breaches of loyalty may infect and thus corrode the entire litigation control process, even if a majority

256. In order to overcome possible intervenor skepticism, plaintiffs' attorneys would have an incentive to ensure that the value of the settlement exceeds its costs in terms of attorney's fees. Attorneys could demonstrate that the compensation received by shareholders and the corporation exceeds its pecuniary benefits. They could also attempt to show that the deterrence value of the suit exceeds its monetary costs. Still, this recommendation should be taken with some care because fees are an incentive to bring derivative litigation. If the attorney faces a daunting gauntlet, she may fail to bring or discontinue meritorious suits simply because of the difficulty of proving that her fees are justifiable. This also has a cost: fewer meritorious suits might be brought.

257. Cox, *supra* note 5, at 24.

258. For an argument that we can punish defendants whose actions evince their lack of desirable values and motivations, even if their actions were taken in subjective good faith, see John T. Parry, *The Virtue of Necessity: Reshaping Culpability and the Rule of Law*, 36 HOUS. L. REV. 397 (1999).

259. Murdock, *supra* note 17, at 95.

260. *See* Macey & Miller, *supra* note 3, at 36 n.106 (citing Kamen v. Kemper Fin. Serv., Inc., 908 F.2d 1338, 1343-44 (7th Cir. 1990), *cert. granted*, 498 U.S. 997 (1990)) ("no special deference owed to directors' decision in demand-refused cases").

261. Cox, *supra* note 5, at 23-24.

262. *Id.* at 23.

263. *Id.*

of the board has not been implicated in the alleged wrongdoing.[264] Where the underlying wrong implicates self-interest or structural bias of any variety, the burden of proof as to good faith, independence, and the adequacy of the investigation should remain on the directors even though less than a majority of the board has been implicated in a conflict of interest. "Since the continuation of the suit is dependent, in large measure, upon the motives and actions of the defendants and the special litigation committee [or the board], and since knowledge of these matters is 'peculiarly in the possession of the defendants themselves,'"[265] transparency demands that summary judgment or the confirmation of a demand refusal by courts should not be granted without disclosure proceedings.[266] To the contrary, some observers suggest that concern for structural bias may simply be a form of the Nirvana fallacy,[267] which compares imperfect enforcement with its mythical alternative—perfect enforcement.[268] Nonetheless, it is possible to conclude that the court's reliance on tainted decisions diminishes the social meaning of derivative lawsuits, as the court may fail to deploy a "formal mechanism for assessing the suit's merits."[269] If courts were to insist that the corporate litigation control decision be rationally or substantively justified without necessarily engaging in an examination of the best interests of the firm (including commercial considerations), or if the court were to formally review the suit's merits in addition to ensuring that proper procedures were adhered to, then public norms associated with shareholder litigation, and hence the social meaning of such litigation, might be enhanced. The public and deterrent effects of such litigation might also be increased by tweaking incentives. For instance, the court might consider increasing the fees awarded to plaintiffs' counsel when they have secured a nontrivial contribution from defendants to the settlement that vindicates public norms.[270]

In addition, the proposed framework might vindicate the cost-benefit calculus championed by many observers.[271] Requiring courts to exercise a substantive standard complements the substantive conception of good faith. When assessing the utility of litigation, they insist that the benefits to the corporation of continuing the litigation exceed its costs. This substantive standard approach should be retained despite its possible effects in causing suits, which primarily retain a deterrence and not a compensatory value, to be dismissed. This possibility should be dealt with by refurbishing the cost-benefit calculus to include the court's assessment of deterrence benefits associated with the litigation.

"Moreover, litigation rules must be assessed in light of their probable effect on primary conduct. If defendants know that they can probably keep their wrongful gains, then more individuals will be induced to engage in socially undesirable actions."[272]

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264. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), has often been cited for the proposition that *only* where a majority of the board is directly infected with self-interest, will demand be excused. *See, e.g.*, McCall v. Scott, 239 F.3d 808 (6th Cir. 2001).

265. Auerbach v. Bennett, 393 N.E.2d 994, 1004 (N.Y. 1979) (Cooke, J., dissenting) (quoting Terranova v Emil, 20 N.Y.2d 493, 496-497 (1967)).

266. *Id.*

267. Fischel & Bradley, *supra* note 27, at 273.

268. *Id.*

269. Cox, *supra* note 5, at 24.

270. *Id.* at 40.

271. Macey & Miller, *supra* note 3, at 39-41.

272. *Id.* at 61.

Accordingly, we should be concerned with perverse incentives, which cause attorneys to engage in abusive settlement not simply because of its effect on their client but because of its effects on other future conduct by lawyers who might fail to bring a suit that vindicates economic or social values, or possibly both. Courts committed to maintaining the vitality of derivative litigation must be cognizant of the agency cost issues associated with the likely divergence in interests between attorney and client. Courts dedicated to improved efficiency must insist that shareholders' and not plaintiffs' attorneys' interests are vindicated by insisting that a real benefit, either compensatory or deterrence, is derived from the litigation. Yet, courts cannot overemphasize plaintiff-attorney agency costs, because they pose a risk that attorneys may become reluctant to bring such suits at all. But assuming the foregoing policy framework sets the right, though messy and indeterminate,[273] balance, the complete justification for shareholder derivative suits as a corporate control mechanism will find its entire rationalization elsewhere.

While it remains possible that poor incentives, lack of expertise by small shareholders and their attorneys, lack of business expertise by judges, and strategic behavior challenge the logic of derivative actions as an adequate corporate control mechanism,[274] if enforced, this policy framework would enhance the socioeconomic meaning of shareholder litigation. Despite potential conflicts between economic considerations and deterrence concerns attached to public values, this scaffold may revitalize shareholder derivative suits as an appropriate corporate governance vehicle. Failure to consider this perspective might undesirably discount the value of public condemnation of corporate misbehavior by allowing such conduct to escape attempts to ensure accountability, while simultaneously failing to ensure that the compensatory and the economic efficiency value of such suits are maintained. Lastly, given the weak incentives to pursue the complaint or defense aggressively, settlement may be the natural outcome of most derivative litigation.[275] One way to discourage abusive settlements is to reinvigorate derivative actions grounded in real compensation, real deterrence, and real cost-benefit analysis. Nondeferential review embodied in this framework may provide a way forward.

III. HOW MUCH JUDICIAL OVERSIGHT IS REQUIRED? EXPANDING THE CONTENT OF THE BUSINESS JUDGMENT RULE AS APPLIED TO LITIGATION COMMITTEES: *HOULE V. LOW*

Factually, *Houle v. Low*[276] arose out of a decision to exclude the plaintiff from participating in a new surgical venture formed by his coshareholders in an ophthalmology clinic.[277] Like the plaintiff in *Meinhard v. Salmon*,[278] he brought suits for fraud, breach of fiduciary duty, and misappropriation of corporate opportunities. He brings both a derivative and direct action against shareholders and officers of the original corporation.

273. Legal certainty may be important for legal planning. Accordingly, it has been argued that "indeterminacy leads managerial behavior to diverge from the social optimum and exposes corporate fiduciaries to socially costly sanctions." Kamar, *supra* note 15, at 891-92.

274. Fischel & Bradley, *supra* note 27, at 271-74.

275. Cox, *supra* note 5, at 34.

276. 556 N.E.2d 51 (Mass. 1990).

277. *Id.* at 52.

278. 164 N.E. 595 (N.Y. 1928).

The plaintiff, Houle, averred that it would be futile to make demand on the directors or the shareholders of Eye Health, since a majority of the directors and shareholders were interested defendants. Conceding the futility of demand the directors of Eye Health appointed Dr. Shelley G. McKee to serve as its "special litigation committee" and to recommend a course of conduct.

Recall that a majority of courts confronted by a "special litigation committee issue have determined that the use of such committees is permissible"[279] while differing on the proper degree of judicial oversight required.[280] Lurking in the background is the issue of structural bias[281] grounded in a substantial mutuality of interests among all directors—both inside and outside (e.g., those allegedly independent).[282] This leads some courts to spurn decisions taken by special litigation committees.[283] Similarly, the *Houle* court notes that "[t]he potential for structural bias[284] on the part of a litigation committee appointed by directors who are parties to derivative actions is sufficiently great and sufficiently difficult of precise proof in an individual case" to cause courts to be dubious of the decision reached.[285] At least one "court adopted a prophylactic rule, prohibiting the use of special litigation committees, at least in cases where a majority of directors are named as defendants in a derivative suit."[286]

When special litigation committees are allowed, the extent of judicial oversight over deliberations and conclusions of special litigation committees varies from the cursory and procedural[287] to a more robust approach,[288] which requires a procedural and allows but

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279. *Houle*, 556 N.E.2d at 54; *see* Zapata v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979); Alford v. Shaw, 398 S.E.2d 445, 454-55 (N.C. 1990)

280. *Houle*, 556 N.E.2d at 54.

281. For a discussion of structural bias and its impact on allegedly independent directors, see Cox & Munsinger, *supra* note 224, at 84-85. *See also Zapata*, 430 A.2d at 787.

282. *See* Murdock, *supra* note 17, at 82.

283. *See, e.g.*, Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 715-18 (Iowa 1983) The court was concerned with the anomalous situation where a majority of the directors, because they were named as defendants, could not terminate a derivative action, yet could appoint a committee of their choosing which would have that power. *See Houle*, 556 N.E.2d at 54.

284. "Several psychological mechanisms can be expected to generate subtle, but powerful biases which result in the independent directors' reaching a decision insulating colleagues on the board from legal sanctions." Cox & Munsinger, *supra* note 224, at 85.

285. *Houle*, 556 N.E.2d at 54.

286. *Id.* (citing Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 718 (Iowa 1983)).

287. Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) (stating that "the decision whether to, and to what extent, to explore and prosecute such claims lies within the judgment and control of the corporation's board of directors" and if the committee engages in an adequate and independent investigation, courts should not generally interfere—in addition, the plaintiff has the burden of proof in attacking the adequacy and independence of the investigation). *See also* Gaines v. Haughton, 645 F.2d 761, 770-72 (9th Cir. 1981) (applying California law), *cert denied*, 454 U.S. 1145 (1982); Genzer v. Cunningham, 498 F. Supp. 682, 686-89 (E.D. Mich 1980) (applying Michigan law); Black v. NuAire, Inc., 426 N.W.2d 203, 210 (Minn. Ct. App. 1988) (following *Auerbach*).

288. *Zapata*, 430 A.2d 779, 779 (Del. 1981). The reviewing court must scrutinize the independence, good faith, and procedures used by a special litigation committee with the corporation retaining the burden of proof on this issue, but the court at its discretion should extend this limited review by application of the court's own independent business judgment in order "to thwart instances where the corporate actions meet the criteria in step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest." *Id.* at 788-89. For a case which re-emphasizes that the corporation shoulders the burden of proof with respect to the

does not require a substantive review.[289] While the *Houle* court held that special litigation committees are viable and, once formed, the decision to dismiss is removed from the sphere of the interested directors' control, the court asserts that the "real danger of taint lies in whether the particular committee chosen is independent and unbiased."[290] The primary purpose of judicial scrutiny, therefore, is to purge the danger of taint and reject blanket rules.[291] While special litigation committees are valid in Massachusetts, their value "is coextensive with the extent to which that committee truly exercises business judgment."[292] In order to ensure that real business judgment is wielded, "a great deal of judicial oversight is necessary in each case."[293] Citing the American Law Institute (ALI),[294] the court insists that, at a minimum, the asserted business judgment must in every case demonstrate independence, lack of bias, and good faith.[295] The absence of any one of these elements, while not necessarily fatal in form, may be fatal in fact. Furthermore, it concludes that the burden of proving these procedural requirements must rest on the party with the greatest access to information and the party capable of making that proof—the corporation itself.[296] Deploying tenable business judgment includes, but is not limited to, an assessment of the merits of the plaintiff's claim. The fact that demand is excused "does not extinguish the substantive principle that the decision as to what is in the corporation's best interest is a matter of business judgment," which may include commercial considerations.[297]

In *Houle*, the plaintiff effectively demolishes the special committee's validity by referring to her inexperience, the closeness of her professional association with the defendants, her business connections with the defendants, and to her dependency on them for the future economic success of the sole member committee.[298] Thus, intensive court

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independence and good faith of the committee and the bases for supporting its conclusions, see *Robert Strougo v. Juris Padegs*, 27 F. Supp. 2d 442, 447-49 (S.D.N.Y. 1998).

289. Whatever this means, it should be clear that while "jurisdictions differ on the proper degree of judicial oversight required but agree that the propriety of accepting a special litigation committee decision can be determined on a case-by-case basis." *Houle*, 556 N.E.2d at 54.

290. *Id.* at 57.

291. *Id.*

292. *Id.* at 58.

293. *Id.*

294. The ALI formulation requires (1) that the trial judge, in the first step, evaluate the independence of the committee members and the procedures utilized; (2) that the decision of the special committee be based on an adequately informed evaluation; (3) that the committee have two or more members; (4) that the committee be capable of objective judgment; (5) that the committee be assisted by counsel; and (6) that the committee submit a written report to the judge. The second step requires the judge to determine that dismissal was in the best interests of the corporation. *Houle*, 556 N.E.2d at 56 (citing ALI PRINCIPLES (T.D. 1988), *supra* note 41, at § 7.08). In other words, the judge must look at (1) the likelihood of a judgment in the plaintiff's favor, (2) the expected recovery as compared to the out-of pocket costs, (3) whether the corporation took corrective action, and (4) whether the balance of corporate interests warrants dismissal. *Id* at 56-57 (citing ALI PRINCIPLES (T.D. 1988), *supra* note 41, at §§ 7.06-7.10); *see also* ALI PRINCIPLES, *supra* note 41, at § 7.10 at 725-66 (1994). Dismissal is not warranted when it would permit any defendant who has control of the corporation to retain a significant improper benefit. *Houle*, 556 N.E.2d at 56-57 (citing ALI PRINCIPLES (T.D. 1988), *supra* note 41, at §§ 7.06-7.10).

295. *Houle*, 556 N.E.2d at 56.

296. *Id.* at 58.

297. *Id.* at 57.

298. *See id.* at 58.

scrutiny of her independence and the good faith of the special committee is required.[299] The court accepts that "typically there are relationships among directors that call for scrutiny of the independence of members of a litigation committee."[300] Here, the relationship is particularly suspect because the sole member of the special committee "is not an independent, outside director."[301] Instead, she is utterly dependent on those whom she is called upon to judge. While these factors taken together will not alone disqualify her, such factors must be weighed in deciding whether the corporation is capable of sustaining its burden of proof that the committee was "independent and unbiased."[302] The Supreme Judicial Court of Massachusetts concludes on the evidence before it that there is a dispute as to whether the Eye Health special committee was in fact independent and unbiased.[303]

Even if the corporation could have sustained its burden with respect to independence and bias, the existence of facts suggesting the possibility that the director's loyalty to the corporation is in conflict with her own self-interest, coupled with the possibility of structural bias precipitates substantial suspicion in this case. The possibility of structural bias "recognized by so many courts and commentators" requires that a reviewing judge "go beyond establishing the committee's independence, good faith and the adequacy of its investigation."[304] "The judge must determine, on the basis of the evidence presented, whether the committee reached a reasonable and principled decision."[305] In a conclusion which anticipates the reasoning of other commentators,[306] and which departs at least marginally from *Zapata*, the Supreme Judicial Court of Massachusetts requires[307] the reviewing judge to examine the

> likelihood of a judgment in the plaintiff's favor, the expected recovery as compared to out-of-pocket costs, whether the corporation itself took corrective action, whether the balance of corporate interests warrants dismissal, and whether the dismissal would allow any defendant who has control of the corporation to retain a significant improper benefit.[308]

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299. *Id.* at 59.

300. *Houle*, 556 N.E.2d at 58.

301. *Id.* at 58.

302. *Id.*

303. *Id.*

304. *Id.* at 59.

305. *Houle*, 556 N.E.2d at 59.

306. Macey & Miller, *supra* note 3, at 39-40 (stating that "the appropriate substantive standard is whether the benefits to the corporation of continuing the litigation exceed the costs of doing so").

307. The court envisions a judicial inquiry that:

> will allow the special litigation committee to point out to the judge on what factors it relied and why those factors support its decision. The test will also allow the derivative plaintiff to point out factors not considered by the committee or why those relied upon by the committee do not support its conclusion. Such a limited review by the judge will avoid the problem in the second level of the *Zapata* test, which requires the judge to exercise his or her own business judgment. The courts are better able to determine the merits of a law suit than whether a decision is correct based on a subjective evaluation of the business policies involved.

Houle, 556 N.E.2d at 59.

308. *Id.*; *see also* ALI PRINCIPLES (T.D. 1988), *supra* note 41, § 7.08; ALI PRINCIPLES (1992), *supra* note 41, § 7.10 cmt. g.

Proof that the committee decision was independent and that it conducted a thorough investigation will not preclude the court from concluding otherwise.[309] Additionally, judges will avoid basing their decisions, as perhaps *Zapata* requires, "on a subjective evaluation of the business policies involved."[310] Importantly, "courts are better able to determine the merits of a law suit than whether a decision [to discontinue] is correct based on a subjective evaluation of the business policies involved."[311]

In summary, the *Houle* court requires at least three things. First, each participant on the board or committee designated to render a decision about the litigation must be unbiased and independent—that is, lacking any structural or inherent bias in favor of the defendant members of the board.[312] This approach goes beyond the simple requirement that the director lack a direct financial interest in the matter. Second, in order to warrant that the board or committee acts in the best interest of the corporation, the decisionmaker must conduct a thorough and careful analysis regarding the plaintiff's suit and must express his or her conclusions in a reasonable and principled decision that transcends the parameters of mere subjective good faith.[313] Third, the trial judge, in her review of the decision, shall ascertain whether, on the basis of the evidence presented, the committee has reached a reasonable and principled decision allowing due respect for good faith, if any,[314] and after assessing, among other things, the likelihood that the plaintiff would prevail weighed against the costs of the litigation.[315] This implies that Massachusetts requires the corporate decisionmaker to go beyond mere procedural analysis. Sustainable and defensible conclusions must be reached. Such an approach protects truly independent, unbiased, and fully informed decisions without the necessity of requiring the court to deploy its inexperienced commercial judgment.

The court's overt concern with structural bias warrants that undeniably true, as opposed to sham, independence determines the litigation control decision. This improves the credibility of a corporate decision not to pursue a claim, thus enhancing the social meaning through appropriate public condemnation of cases in which the alleged misconduct continues to trial, judgment, or nonabusive settlement. On the other hand, a decision about the likelihood of success on the merits requires some judicial assessment of the actual merits of the claim. In any case, the *Houle* court determines that the business judgment rule cannot be invoked to give presumptive effect to decisions taken by special committees or the board to terminate shareholder derivative litigation. While the court concedes that the procedural requirements of demand excusal in a given case do not extinguish the substantive principle that the decision as to what is in the corporation's best interest is a matter of business judgment,[316] and while interested directors can create a committee which has the power to determine the fate of the litigation, the taint of bias

309. *Houle*, 556 N.E.2d at 59.

310. *Id.*

311. *Id.* The court concludes that the distinction between close corporations and a public one does not lead to a different standard of review. *Id.* at 59 n.11.

312. *Id.* at 57-58.

313. *Houle*, 556 N.E.2d at 59; *see also* Harhen v. Brown, 710 N.E.2d 224, 234 (Mass. App. Ct. 1999) (summarizing *Houle*, 556 N.E.2d at 51).

314. *See also Harhen*, 710 N.E.2d at 235 (summarizing *Houle*, 556 N.E.2d at 51).

315. *Houle*, 556 N.E.2d at 59.

316. *Id.* at 57.

must be removed.[317] Precluding the presumptive effect of the business judgment rule, where the underlying misconduct involves an alleged breach of loyalty or self-interest, provides appropriate incentives to plaintiffs' attorneys to act in future cases. Equally important, this decision incorporates a cost-benefit calculus as part of the court's assessment, thus vindicating the compensatory norms associated with the litigation while ensuring that the suit retains the possibility of being efficient from the perspective of the corporation, the real client in interest.

IV. SUBSTANTIVE GOOD FAITH, BUSINESS JUDGMENT, AND LITIGATION CONTROL: *HARHEN V. BROWN*

Factually, *Harhen*[318] echoes *Auerbach*[319] in that payments were made in breach of the duty of care, but it differs from *Auerbach* in that the reimbursement of expenses incurred by the defendants in *Harhen* implicate indemnification and settlement issues that are derived from public intervention and give rise to a possible breach of loyalty. Secondly, while John Hancock is a mutual insurance company, the common law and pertinent statutes applicable to corporations apply.[320] Loretta Harhen, a policyholder of John Hancock Mutual Life Insurance company (Hancock) brought a derivative action against certain director and senior officers who were all members of the company's management committee; Raeburn Hathaway, a vice-president of Hancock and head of its government relations department; F. William Sawyer,[321] the senior registered lobbyist for Hancock; and John Hancock as the nominal defendant.

First, the alleged misconduct must be seen against a fairly extensive and very conclusive record which was derived from federal and state proceedings commenced against Hancock in 1994 coupled with Hancock's admissions of violations of the law.[322] Second, it is imperative to establish that the independence, such as it is, to which the Board of Directors refers is largely provided by a decision taken by an allegedly independent special committee that consisted of two directors, which met and rendered its decision *before* any lawsuit was filed by the plaintiff.[323] Accordingly, it might plausibly be argued that the board never actually rejected the plaintiff's pre-suit demand.

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317. *Id.*

318. *Harhen*, 710 N.E.2d at 226-27.

319. 393 N.E.2d 994 (N.Y. 1979).

320. MASS. GEN. LAWS ANN. ch. 175, § 30(a)(1) (West 1998) (as amended by Massachusetts Acts of the General Court 1970, ch. 876, § 7) (providing that the general principles of law relative to the power, duties, and liability of corporations shall apply to all incorporated domestic companies). This provision applies to insurance companies. *Harhen*, 710 N.E.2d at 233-34. While policyholders, unlike stockholders in a corporation, do not have an ownership interest that can be transferred to others, they nevertheless have a financial interest in the mutual insurance company through their right to participate in the annual surplus of the company. *Id.* at 235 n.14. Because of this right, a policyholder may sue on behalf of himself and all others similarly situated for a misapplication or misappropriation of funds. *See* 18 JOHN ALAN APPLEMAN, INSURANCE LAW AND PRACTICE § 10060 (1945); Clifford v. Metro. Life Ins. Co., 34 N.Y.S.2d 693, 695 (N.Y. App. Div. 1942).

321. Sawyer was a licensed attorney and was responsible for maintaining Hancock's good relations with members of the Massachusetts Legislature. *Harhen*, 710 N.E.2d at 226.

322. *Id.* at 229-31.

323. *Id.* at 232 (logically the vote to terminate the litiagation could only occur after the derivative suit was filed).

While the Superior Court dismissed the action on grounds that the complaint lacked the required specificity on the issue of bias and lack of independence of the board appointed special committee,[324] the most important corporate[325] defense is grounded in the alleged presumptive force of the business judgment rule.[326] Third, the plaintiff presented the defendant with a cosmetic settlement offer which the defendant said that it was prepared to accept. However, the defendant stated it was not ready to act upon plaintiff's proposals for amendments to Hancock's bylaws.

A. Alleged Company Violations

Sawyer, a licensed attorney responsible for maintaining Hancock's good relations with members of the Massachusetts Legislature, engaged in a full panoply of entertainment activities subject to the approval of Hathaway, the head of the government relations department.[327] Hathaway reported directly to the president of Hancock.[328] Hancock's management committee, which consisted of Brown, Morton, D'Alessandro, and Hathaway, was responsible for overseeing all aspects of Hancock's operations, including government relations.[329] They were kept informed of Sawyer's activities and, according to plaintiff's allegations, knew or should have known of Sawyer's illegal activities.[330] In fact, one member of the management committee reviewed Sawyer's

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324. *Id.*

325. Strictly speaking, Hancock is a mutual company.

326. The Hancock defendants (Brown, Morton, and D'Alessandro) moved to dismiss the complaint because

> (i) the complaint fail[ed] to allege particularized facts sufficient to overcome the strong presumption of the business judgment rule, and (ii) the complaint fail[ed] to state any claim upon which relief may be granted. Hathaway moved to dismiss on the grounds that the complaint [was] time -barred and fail[ed] to state a claim upon which relief [could] be granted.

Id. at 226 (internal citations omitted).

Sawyer moved to dismiss pursuant to Massachusetts Rule of Civil Procedure 12. *Id.* Sawyer argued that a demand on all other policyholders is required before this action could proceed. *Harhen*, 710 N.E.2d at 228-30. Hancock has approximately seven million policyholders in all fifty states. *Id.* at 227.

The presumptive effect of the business judgment rule was found persuasive by the Supreme Judicial Court of Massachusetts. Among other things, this court states that (1) if the plaintiff chooses to make demand, the board may determine that no action is appropriate at that time; (2) in a demand refused case, because it is presumed that a disinterested board of directors acts in good faith towards all the corporation's members, a disinterested board that has refused a plaintiff's pre-suit demand is entitled to the protection of the business judgment rule; (3) given the absence of bad faith here and given the presence of disinterested directors and the reasonableness of its investigation; and (4) the plaintiff's action was properly dismissed. *Harhen*, 730 N.E.2d at 865-68 (Mass. 2000).

327. *Harhen*, 710 N.E.2d at 228-30.

328. The position of the president of Hancock was filled at various times by the named defendants: Brown, D'Alessandro, and Morton. *Id.* at 227-28.

329. *Id.* at 226-28

330. Sawyer violated Hancock's gift policy. The policy forbid making gifts in excess of $50 on any single occasion gifts with an aggregate value of $100 in any calendar year to persons with whom the company has or is likely to have any business dealings. *Id.* at 228. For instance, Hancock maintained corporate boxes at Boston Garden, Foxboro Stadium, and Fenway Park. *Id.* Tickets were made available to persons selected by board members, senior management, and Hathaway and Sawyer. *Harhen*, 710 N.E.2d at 228. Records show numerous charges by Sawyer and the government relations department revealing alleged per se violations of the lobbying law. *Id.* at 228-29. Further, in 1982, Sawyer was granted permission to take the then chairman of the Legislature's Joint Insurance Committee and his wife to the Superbowl at a cost far in excess of the legal limit.

records "which included the identity of each legislator entertained on each of many occasions and approved payment of these expenses."[331] The plaintiff further alleged that the individual defendant directors, as members of the management committee, neglected to take any action to assure Sawyer's compliance with the law.[332] Furthermore, the firm's management committee authorized the use of Hancock's funds in connection with Sawyer's illegal lobbying activities[333]—all in violation of Hancock's own policy. Additionally, the plaintiff alleged that "no steps were taken by the management committee or the board to ensure that box seats, tickets, meals and other gifts of various sorts were not in violation of Massachusetts laws,"[334] and that the corporate defendants as directors and senior officers *controlled* the decisions of the board not to seek reimbursement from the culpable parties of costs and expenses incurred by the company.[335]

In fact, in 1994, as a result of federal and state proceedings against Hancock, the company admitted violating the law.[336] The company violated Massachusetts law by giving gratuities valued at more than $50 on more than three hundred occasions to Massachusetts legislators as part of an alleged scheme to defraud the public of its right to honest service from public officials.[337] It paid a fine in the amount of $900,000 to the federal government in settlement of a civil complaint.[338] At the same time, pursuant to proceedings brought by the State Ethics Commission (the Commission), Hancock entered into an eighteen-page disposition agreement, in which Hancock admitted that it had given gratuities in excess of $50 to Massachusetts legislators on numerous occasions, and that Hancock's legal department had repeatedly warned the government relations department of statutory limits on gifts.[339] Hence, from these admissions, knowledge or constructive knowledge of the violations must be conclusively presumed. The Commission imposed a civil fine of $110,000 and required semiannual written reports of all expenditures made by Hancock directly or indirectly involving any Massachusetts state, county, or municipal employee.[340] Hancock waived all rights to contest the findings of fact, conclusions of

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Id. While Sawyer was convicted, he was granted a Writ of Error, *Coram Nobis*, and his conviction of November 27, 1996 was vacated and his record was expunged. U.S. v. Sawyer, 74 F. Supp. 2d 88 (D. Mass. 1999).

331. *Harhen*, 710 N.E.2d at 228.

332. *Id.* at 231.

333. *Id.* at 227-28.

334. *Id.* at 229.

335. *Id.* at 230.

336. *Harhen*, 710 N.E.2d at 229.

337. *Id.*

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> The settlement agreement between Hancock and the United States Attorney's Office stated that "Hancock publicly acknowledged that certain lobbying activities by members of the Government Relations Department violated Massachusetts law . . . [and] Hancock agreed to reorganize its government relations department . . . [and] agreed to implement new auditing procedures for its government relations department."

Id.

339. *Id.*

340. *Id.* at 230.

law, and terms and conditions contained in the agreement in "any related administrative or judicial proceeding to which the Commission is or may be a party."[341]

In addition to the $1,010,000 in fines paid by Hancock to federal and state authorities, the complaint alleged that Hancock paid $1.2 million in legal fees indemnifying Sawyer for his expenses in defending federal criminal charges arising out of the same lobbying violations that Hancock admitted to in its disposition agreement.[342] In total, the plaintiff asserted that the entire "direct costs incurred by Hancock in this matter exceeded $4 million."[343] Importantly, it was maintained that members of the management committee controlled the company's decision "not to seek reimbursement from the culpable parties of costs and expenses incurred by Hancock" because "investigations of illegal conduct could ultimately lead to findings of their own culpability."[344] They were therefore placed "in a position of a conflict of interest."[345] Thus, while Sawyer's initial misconduct implicates the duty of care on the part of his supervisors, the decision to decline to seek reimbursement from Sawyer and all the culpable parties of the costs and expenses incurred by Hancock implicates a breach of the duty of loyalty. The third tier of alleged wrongdoing arises from Hancock's refusal to accept a request from a policyholder to seek reimbursement from the alleged culpable officers and employees.

B. Demand Refusal by Hancock

While the trial court's and the court of appeal's holdings are largely focused on whether the board can control the litigation through a special committee, this case can also be dissected as a demand refusal case. The screening function provided by strict adherence to the demand requirement at issue along with the ability of the firm to control the litigation through special committee determinations. This bears on *both* the pretrial demand requirement and on the ability of the firm to control the litigation (assuming the firm has neglected to refuse plaintiff's demand that it sue its fiduciaries). Hence it is only with difficulty that the response to a pre-suit demand can be kept distinct from the functions of a special committee after the litigation is filed.

Recall that *Houle* involved a demand excused case where the plaintiff successfully averred that it would be futile to make a demand given that a majority of the board were defendants.[346] Massachusetts Rule 23.1 "includes a pre-suit demand requirement that, unlike courts in Delaware is strongly enforced."[347] In *Harhen*, unlike *Houle*, less than a majority (three of twenty directors) of the Hancock board at the time of the plaintiff's

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341. *Harhen*, 710 N.E.2d at 230.

342. *Id.* at 230.

343. *Id.*

344. *Id.* Apparently, the Supreme Judicial Court of Massachusetts, in rejecting the plaintiff's complaint, fails to directly deal with this allegation. The Court was persuaded that the plaintiff must affirmatively demonstrate that either a majority of the board or a majority of the special litigation committee must have engaged in an interested transaction as defined by the ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 1.15, 1.23 (1994). *Harhen*, 730 N.E.2d at 866-68.

345. *Harhen*, 710 N.E.2d at 230. Again, the Supreme Judicial Court apparently finds no such conflict of interest. *Harhen*, 730 N.E.2d at 866-68.

346. *Houle*, 556 N.E.2d at 53.

347. Harhen v. Brown, No. 97-1522, 1997 Mass. Super. LEXIS 145, at *8-*9 (Aug. 18, 1997).

demand were named as defendants plus two former executive employees.[348] The absence of evidence that either a majority of the board or the special litigation committee were subject to a direct conflict of interest fails to prevent this court from questioning the independence of the litigation control decision.

In April 1999, "the plaintiff delivered a twelve-page letter to the board of directors" which carefully recapitulated the events at issue.[349] The letter alleged the responsibility of the directors and senior management for those events and "concluded with thirteen demands, including the demand that Hancock seek reimbursement from the responsible officers and directors for all costs and expenses arising out the unlawful activities of the employees of the government relations department of Hancock."[350] The board delegated the letter to a special committee consisting of two directors for "such action as the committee deems appropriate."[351] Conceptually, a "demand requirement gives the board the opportunity to do one of several things: (1) take corrective actions, or enter into a settlement with the defendant, thereby avoiding the need for the lawsuit; (2) bring the requested action; (3) permit the plaintiff to proceed in its place; or (4) reject the requested action as not in the corporation's best interest."[352] However, the committee responded in superficial fashion by stating, "we have carefully reviewed the actions of the Company, its Board of Directors and Officers in the handling of the Sawyer matter, and find that the investigation of the matter and the action taken in response were entirely appropriate."[353] No additional information was provided, thus raising the issue as to whether its response was both wrongful and unavailing, despite Hancock's claim that "its unbiased business decision [was] conclusive."[354] A few weeks later, plaintiff's counsel met with two senior Hancock employees, who indicated that they were prepared to receive the plaintiff's proposals for amendments to the Hancock bylaws but "they flatly and repeatedly refused to discuss or answer any questions or provide any information whatsoever on the matters" that were described in the demand letter.[355] Hancock argued that demand was rejected; "the business judgment rule supplies a presumption that corporate decisions [to either reject demand or to discontinue the litigation] are unbiased, informed and made in good faith," and in the absence of an affirmative showing that a majority of the board or

348. *Harhen*, 710 N.E.2d at 227.

349. *Id.* at 231. The absence of such evidence eventually proved fatal. *See Harhen*, 730 N.E.2d at 866-68.

350. *Harhen*, 710 N.E.2d at 231.

351. *Id.* (internal citations omitted). This approach avoids the apparent error of the defendant corporation in *Greenfield v. Hamilton*, 760 P.2d 664 (Colo. Ct. App. 1988). There, the special committee was simply charged with providing a recommendation to the board of directors where a majority was named as defendants in the derivative suit. *Id.* at 668. Where putative wrongdoers retain the ultimate decision, the Colorado Court of Appeals was disinclined to even consider granting deference. *Id.*

352. KLEIN & COFFEE, *supra* note 10, at 197. For an empirical assessment of the responses of boards of directors, see James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959. "Plaintiffs seldom make demand, preferring instead to argue that demand was excused." KLEIN & COFFEE, *supra* note 10, at 198. One reason for this, under Delaware law, is that "the making of demand concedes that a business judgment test applies to the board's decision to reject demand," which may presumptively preclude spirited judicial review. *Id.*; *see also* Levine v. Smith, 591 A.2d 194 (Del. 1991) (explaining that a plaintiff is not allowed discovery in demand-refused cases under Delaware law).

353. *Harhen*, 710 N.E.2d at 231 (internal citations omitted).

354. *Id.* at 232 (alteration in original).

355. *Id.* at 231.

committee is subject to a conflict of interest, the business decision to decline to bring suit is protected by the business judgment rule.[356]

The court of appeals disagreed. It concluded "that the pleading requirements of the Massachusetts Rule of Civil Procedure 23.1, which requires that the complaint must allege with particularity the efforts made by the plaintiff to obtain the action she desires from the directors were satisfied."[357] Moreover, since "the special committee responded to . . . and rejected [plaintiff's] demands without explanation approximately six months before [the plaintiff filed her action,] . . . the rejection of the demand letter [by the special committee] was not the equivalent of a board decision to terminate the derivative action."[358] Thus, the court implied that the alleged decision to reject demand, if that is what was intended, did not occur by virtue of the special committee's refusal to discuss the plaintiff's demands—instead there is simply a putative rejection of stockholder demand which preceded the derivative action. In reality, this court seems to hold that there was both an attempted litigation control decision via a special committee and an attempted rejection of plaintiff's demand. Both attempts fail. Whatever the appellate decision means, its attempt to separate the initial demand response from the subsequent litigation control decision illustrates that they are not necessarily distinguishable. In fact, litigation control, whether it occurs before the suit is brought as part of the screening process or after, can be seen as part of a category of responses toward which skepticism is arguably appropriate.

But assuming that there is simply an attempted rejection of demand by the special committee or the board, this court insists that screening decisions must be grounded in action by "independent directors 'capable . . . of *objective* judgment'"[359] coupled with "'specific reasons' for doing so."[360] If both of these elements exist, then the plaintiff must plead with particularity facts which demonstrate that the statements in the corporation's reply to the complaint are not correct or that "disinterested directors could not reasonably have determined that rejection of the demand was in the best interests of the corporation."[361] Because the plaintiff, Loretta Harhen, did not receive any

356. *Id.* (internal citations omitted).

357. *Id.* at 231.

358. *Harhen*, 710 N.E.2d at 232. The court in essence asserts that the special committee decision constitutes an attempted rejection of the demand to sue but its decision does not necessarily control the litigation.

359. *Id.* at 234 (quoting ALI PRINCIPLES (1992), *supra* note 41, § 7.04) (emphasis added).

360. *Id.* (citing ALI PRINCIPLES (1992), *supra* note 41, § 7.04).

361. *Id.* First, while the "special committee responded to the plaintiff's demands on September 13, 1996, and rejected those demands substantially without explanation approximately six months before this action was filed . . . the rejection of the demand letter was not the equivalent of a board decision to terminate this derivative action." *Id.* at 232. Second, assuming that the committee's September 13, 1996 reply to the plaintiff's demand letter was equivalent to action by the board, Hancock's defense remains deficient.

> The plaintiff's twelve-page demand letter alleges . . . (i) years of knowing, deliberate, illegal lobbying activity of Hancock's government relations department headed by Sawyer; (ii) the complicity of Hathaway, an officer of Hancock and member of the management committee, in approving the expenses of Sawyer while knowing that the expenditures were for an unlawful purpose; and (iii) that Brown, Morton and D'Alessandro, as directors, senior officers, and members of the management committee, either knew, or should have known, of Sawyer's illegal lobbying expenditures and activities, and (iv) the damage to Hancock in fines paid and reimbursement of Sawyer's legal fees.

information to determine whether her demand was wrongfully refused, the special committee's response to the plaintiff's demand either remains ineffectual or fails to reject the suit.[362] Furthermore, since the plaintiff alleges a conflict of interest among culpable parties, the business judgment rule does not apply.[363]

Deprived of the presumptive effect of the business judgment rule in the context of the firm's response to the plaintiff's demands and "[b]ased on the allegations of the complaint, reinforced and supplemented by the admissions and findings of fact in the settlement agreement and the disposition agreement," the Massachusetts Appeals Court had little difficulty concluding that the plaintiff's complaint, if true, sufficiently alleged and established the following:

> that defendant Sawyer engaged in illegal lobbying activities . . . ; that the defendant Hathaway assisted and approved Sawyer's illegal activities; that the Hancock [directors and senior officers] (i) violated their duty of care in failing . . . properly to direct and manage the affairs of Hancock so that the illegal activities of Sawyer and the government relations department . . . would not have occurred or persisted and (ii) violated their duty of loyalty to Hancock by reason of the decisions of the [management committee] not to seek reimbursement from the culpable parties because of their own conflict of interest,[364] . . . and by seeing to it that the fines paid to Federal and State authorities were from corporate assets, thereby wasting those assets.[365]

Next, the Appeals Court is required to decide whether the business judgment rule presumptions apply to the attempt to control the litigation after the suit is filed.

Harhen, 710 N.E.2d at 233. In response to this letter, the Hancock special committee, and hence the board, dismissed the letter without any indication that it was to be taken seriously. *Id.* at 232-33.

362. *Id.* at 234. "A stockholder who makes a serious demand and receives only a peremptory refusal has the right to . . . obtain the relevant corporate records . . . to determine whether or not there is a basis to assert that demand was wrongfully refused." Grimes v. Donald, 673 A.2d 1207, 1218 (Del. Super. Ct. 1996). Without relevant corporate records, and without attempting to address plaintiff's demands, Hancock failed to reject the demand as the uncontroverted facts eviscerate its position.

> [G]iven Hancock's admission in the settlement agreement with Federal authorities that 'certain lobbying activities by members of [Hancock's] Government Relations Department violated Massachusetts law,' and the payment of fines in excess of one million dollars, there was a need to explore the events that culminated in the Federal and State proceedings, and to identify those directors, officers, or employees, if any, responsible for permitting Sawyer's illegal activities to continue openly for years, and, if identified, to decide what should be done (or not done), and why. None of that information was forthcoming.

Harhen, 710 N.E.2d at 233-34. *But see Harhen*, 730 N.E.2d at 867 (stating that lengthy explanations of a demand refusal are not required).

363. *Harhen*, 710 N.E.2d at 231.

364. The business judgment rule fails to protect violations of the duty of loyalty, for example, where a conflict of interest exists. *See* Starr v. Fordham, 648 N.E.2d 1261, 1266 (Mass. App. Ct. 1995).

365. *Harhen*, 710 N.E.2d at 231.

C. Appellate Analysis of Hancock's Attempt to Control the Litigation

Citing the Supreme Court of Delaware, the Massachusetts Appeals Court asserts that it is important to recognize "the 'discrete and quite different processes'[366] involved in a special board committee formed to respond to stockholder demands and a special board committee formed to respond to a derivative action."[367] While this proposition remains dubious, the court's overall analysis of Hancock's attempt to control the litigation is largely sound. The *Harhen* court notes there is no evidence that the board of directors or a special committee *ever* voted to terminate the derivative action. Logically, such a vote "could only occur after the commencement of the derivative action on March 21, 1997."[368] "Since there is nothing in the complaint regarding a 'business decision' by the board or committee to terminate this action, the business judgment rule offers no protection at this stage of the proceedings."[369] In order for Hancock's directors and senior management to be shielded by the business judgment rule, "a decision must have consciously been made and judgment must . . . have been exercised."[370] That perspective is congruent with the ALI's most recent formulation that the business judgment rule does not apply to nondecisional conduct or to decisions that involve knowing and culpable illegality.[371] "There is no merit, then, to the argument that the board's decision is conclusive on the motion to dismiss" the plaintiff's action.[372] Further, the special committee was not created to "address pending litigation."[373]

More importantly, even if the demand requirement analysis can be seen as independent from a post-demand attempt to control the litigation, Hancock's argument also fails. In a decision which vindicates *Miller v. Register*,[374] and directly relies on *Houle v. Low*,[375] the Massachusetts Appeals Court concludes that termination of the action can be ruled out *even if* "(i) there was a majority of the board or committee that voted in favor of the termination, (ii) that majority was independent and disinterested, and (iii) the Hancock defendants did not assist or participate either in the debate or the vote to terminate this action."[376]

The burden of proof as to "(i) whether the committee was independent and unbiased, and if so (ii) whether the committee, after thorough investigation, came to the conclusion that the corporation's best interest called for the termination of the derivative action and this conclusion 'was a reasonable and principled decision,'"[377] remains on the corporation. Moreover, the *Harhen* court insists that a principled decision includes a *good*

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366. *See Grimes*, 673 A.2d at 1216 n.13, 1218 (noting that it is "important that the demand process be meaningful").

367. *Harhen*, 710 N.E.2d at 232.

368. *Id.*

369. *Id.* (citing ALI PRINCIPLES (1992), *supra* note 41, § 4.01 cmt c (stating that the business judgment rule "affords protection only to 'business judgment'")).

370. ALI PRINCIPLES (1992), *supra* note 41, § 4.01(c) cmt. c.

371. *Id.* §7.04 cmt. d(4).

372. *Harhen*, 710 N.E.2d at 233.

373. *Id.* at 233 n.11.

374. 336 N.W.2d 709 (Iowa 1983) (the court remains skeptical of the ability of the board to evaluate its members).

375. 556 N.E.2d 51 (Mass. App. Ct. 1990); *see Harhen*, 710 N.E.2d at 234.

376. *Harhen*, 710 N.E.2d at 234.

377. *Id.* (quoting *Houle*, 556 N.E.2d at 60).

faith component which is a settled element of the business judgment rule.[378] Echoing *Zapata*, and stating obvious concern for the possibility of structural bias, the court accepts that it has an obligation to deal "fairly and competently with those seeking relief" and it will not do to permit the foreclosure of relief merely at the ungrounded request of "those who are, or may be, in league with the wrongdoers. . . ."[379] Courts, therefore, have been called upon to resolve conflicting concerns involving the right of the corporation to control the litigation and the possibility that by doing so, the litigation might be extirpated—absorbed by the odor of management self-interest, and poignantly assisted by structural bias among the putative decisionmakers. While corporate representatives retain the power to terminate derivative litigation as a matter of sound business judgment,[380] exercise of the power is subject to certain conditions. *Houle* requires that court inspection of a decision to terminate derivative litigation allegedly justified by convincing business judgment, to insist that (1) each individual serving on the board or committee must be unbiased and independent, that is, free from any *structural* or inherent bias; (2) the decisionmaker must conduct a thorough and careful analysis regarding the plaintiff's suit for demand and express its conclusions in a reasonable and principled decision; and (3) the trial judge must in her review of the decision determine whether on the basis of the evidence presented, the committee reached a *reasonable and principled* decision. The court must create a "balanced environment" which deters baseless suits (entrepreneurial attorney mischief) on the one hand, and on the other hand permits suit by stockholders who are able to articulate particularized facts warranting relief (ensuring that management interest is sufficiently aligned with those of the shareholders by encouraging meritorious suits).[381] The business judgment rule cannot be invoked to obstruct the court's balanced yet tangible inspection. In addition, the special committee or the board is required to conduct a review that demonstrates substantive, not merely subjective, good faith. This decision must be seen as a rejection of *Aronson v. Lewis*,[382] which means that Massachusetts rejects the presumption that corporate decisions are unbiased, informed, and made in good faith.[383] This conclusion can also be seen as congruent with *Maher v.*

378. On the other hand, the Supreme Judicial Court of Massachusetts argues that the heightened standard of review derived from *Houle v. Low* does "not alter the application of the business judgment rule to cases in which the plaintiff makes demand on a board composed of a majority of disinterested directors" and then the plaintiff "claims that demand was wrongfully refused." *Harhen*, 730 N.E.2d at 867.

379. *Harhen*, 710 N.E.2d at 234. On the other hand, the court admits that "whether a corporation should pursue a given lawsuit involves factors other than the merits of the claim, [i]t is often a question of business policy," and it will not always be in the best interest of the corporation to insist on its rights. *Id.* Perforce, the court accepts the notion that it might be possible for the parties to adjust their performance over time without the assistance of litigation. Furthermore, there may be a range of director or senior officer decision-making which may fall short of full performance of the duty of care, but may nevertheless be seen by an independent observer as a decision which the director or senior officer in good faith reasonably believed was in the best interest of the corporation. *Id.* at 235 (citing *Houle*, 556 N.E.2d at 58).

380. *Id.* at 235 (citing *Houle*, 556 N.E.2d at 59 n.10).

381. *Id.* at 236 (citing Grimes v. Donald, 673 A.2d 1207, 1217 (Del. 1996)).

382. 473 A.2d 805 (Del. 1984) (corporate decision to reject demand presumed to be objectively unbiased and in good faith despite evidence which shows that defendant director controlled the company); *see also* KLEIN & COFFEE, *supra* note 10, at 198.

383. *Id.* at 812.

Zapata's ultimate rejection of boiler-plated corporate reasoning unsupported by the facts.[384]

In applying this rule to the facts, the *Harhen* court effortlessly established that whatever the basis of the special prelitigation committee conclusion, its decision was not free from attack. On the contrary, "Because neither the board nor the special committee has articulated a reasonable and principled decision regarding this litigation, there is no occasion to invoke the business judgment rule to protect either the board or the committee."[385] Second, since the Hancock defendants were entangled with the illegal lobbying efforts of Sawyer, the court had occasion to reemphasize its conclusions about the necessity of "substantive good faith" as a predicate for business judgment. While typical courts may view a challenge to the good faith component of the corporate litigation control decisions as the plaintiff's dying hope,[386] this court suggests that good faith may be difficult to sustain where a conflict of interest that gives rise to structural bias exists. Furthermore "an essential element of the business judgment rule is that a director or officer making the business decision 'rationally believes that the business judgment is in the best interests of the corporation.'"[387] Accordingly, the Hancock defendants and Hathaway were so purposefully and knowingly involved with Sawyer so that they could not have rationally believed that Sawyer's illegal acts were in the best interest of the corporation, shielding their decision through the business judgment rule in the form of a special committee decision became implausible. Effectively, the special committee of the board became infected with structural bias in favor of the defendant members of the management committee. Bias led them to accept the contention that despite Hancock's knowing involvement with Sawyer's illegal conduct, such misconduct was still in the best interest of the firm. Bias eviscerates good faith, which is an obligatory predicate to the defendant's claim that the alleged misconduct was in the best interest of Hancock.[388] The special committee's determination is not entitled to be sheltered. The court avers that the "Massachusetts business judgment rule applicable to individual business decisions of directors and officers, like the business judgment rule described in Principles of Corporate Governance [section] 4.01(c), . . . is rooted in the idea that 'action [by directors] taken in good faith, even though wanting in sound judgment does not involve them in personal liability.'"[389] The court demands a substantively rational decision *before* the good faith necessary to produce tenable business judgment can be found. A decision taken that is objectively irrational and so removed from reality cannot be sustained on the "'basis that it was made in subjective good faith.'"[390] "Absent some basis in reason, action could hardly be in good faith even apart from ulterior motive."[391] Absence of subjective "bad motives" is insufficient to

384. *See* Maher v. Zapata Corp., 490 F. Supp. 348, 350-51 (S.D. Tex. 1980); Murdock, *supra* note 17, at 97 n.99 and accompanying text.

385. *Harhen*, 710 N.E.2d at 810.

386. Murdock, *supra* note 17, at 111.

387. *Harhen*, 710 N.E.2d at 236 (quoting ALI PRINCIPLES (1992), *supra* note 41, § 4.01(C)(3) (1992)).

388. *Id.* at 236.

389. *Id.* at 236 (internal footnote omitted) (quoting Sagalyn v. Meekins, Packard & Wheat, Inc., 193 N.E. 769, 771 (Mass. 1935)).

390. *Id.* at 236 (quoting ALI PRINCIPLES (1992), *supra* note 41, § 4.01)).

391. *Id.* at 236 (quoting Sam Wong & Son v. N.Y. Mercantile Exch., 735 F.2d 653, 678 n.32 (2d Cir. 1984)).

sustain a claim of good faith.[392] Accordingly, decisions that are not based on the rational belief that the resolution is in the best interest of the corporation will not be allowed into the safe harbor of presumptive validity called business judgment. The burden of proving the absence of bias and that the decision meets the reasonable and principled standard remains on the corporation, especially where the facts raise an issue of personal advantage or where there is a conflict of interest.[393]

Here, the presumptive application of the business judgment rule is unavailable. First, there is a possible breach of the duty of loyalty, and the very presence of self-interest precludes the presumptive application of business judgment. Business judgment also requires some basis in reason for the decision taken. That is absent in this case. Given that the defendants engaged in a knowing and culpable violation of the law, it is extremely doubtful that the special committee decision can be sustainable, unless one can plausibly argue that wilful violations of law are in the company's best interest. Board or committee decisions infected by possible bias or grounded in the absence of reason which eviscerate good faith must be subject to skepticism. Such skepticism attempts to balance the divergence in interests between plaintiffs and attorneys with an equal skepticism for the divergence of interests between management and shareholders.[394]

D. Exculpation, Indemnification, and Settlement

Hancock argues that the indemnification of Hathaway and Sawyer is required by its bylaws, which compels compensation of directors and officers for expenses incurred in defending any civil or criminal action.[395] In reality, there is a question as to whether there is any obligation to indemnify Sawyer since he is neither a director nor officer as required by the relevant bylaws.[396] More apparent, given his guilty plea, it is doubtful that he can claim that he "acted 'in good faith in the reasonable belief that his actions were in the best interest of Hancock'"[397] as mandated by the indemnification provisions. In addition, Massachusetts law requires that before exculpatory clauses can be adopted to authorize indemnification, there must be a favorable vote by the members of the mutual company.[398] That is lacking here.[399] Assuming *arguendo* the validity of Hancock's exculpatory provisions, Massachusetts law disallows the elimination or limitation of personal liability of directors for breach of fiduciary duties, "for breach of duty of loyalty . . . and acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."[400] Because Brown, Morton, D'Alessandro,

392. *Id.* at 236.

393. *Harlen*, 710 N.E.2d at 237 n.18 (citing *Sagalyn*, 193 N.E. at 771).

394. On the other hand, where the underlying wrong involved a typical breach of the duty of care, the court reverses the burden and required the plaintiff to establish a violation of the law and then establish that the corporate defendant failed to comply with section 4.01(c) of the ALI Principles, including the requirement of good faith. *See* ALI PRINCIPLES (1992), *supra* note 41, § 4.01(c). Assuming that this case could be plausibly characterized as a breach of the duty of care, it would nonetheless be atypical since there was arguably a knowing and culpable breach of the requisite standard of care. *See infra* text accompanying notes 411-412.

395. *Harhen*, 710 N.E.2d at 237.

396. *Id.* at 237 n.22.

397. *Id.* (internal citations omitted).

398. *Id.*

399. *Id.* at 238.

400. *Harhen*, 710 N.E.2d at 237.

and Hathaway are all senior officers as well as directors, and since the claims arise out of performance failures as officers and members of the management committee, the exculpatory clause is not available to them.[401] One can conclude that indemnification and exculpation should not remain available for all of the alleged wrongdoers in *Harhen* for a variety of reasons.

V. TOWARD A CRITICAL ANALYSIS OF *HARHEN V. BROWN*

While the case has not yet completed the litigation gauntlet, the implications of the decision bear analysis by courts and commentators who seek to appropriately balance the divergence in interests between management and shareholders on the one hand, and attorneys and plaintiffs on the other. While it is imperative to establish the nature of the underlying wrong when assessing the amount of judicial deference allowable for corporate decisionmaking, *Harhen* provides at least two possibilities—finding of a breach of care or a breach of loyalty. First, if the nature of the underlying wrong includes all the activities culminating in the refusal to seek reimbursement from active participants in the misbehavior, then self-interest becomes evident. While only a fraction of the board is implicated in the misconduct, the scent of structural bias is apparent. The chairman of the board of directors, the president, and former and current members of the management committee are all tangibly implicated. Social-psychological mechanisms may generate bias in directors' assessment of the shareholder's derivative action.[402] Such mechanisms include: (1) "the independent directors' prior associations with the defendants and their common cultural and social heritages;" (2) "biases established by appointment of members to the board or special litigation committee;" and (3) "control of pecuniary or non-pecuniary rewards made available to the independent directors by the defendant members of the board of directors."[403] Additionally, a derivative action may invoke a response of group loyalty that compels an independent and even "maverick" director to close ranks and protect her colleagues[404] as she subconsciously[405] murmurs "there but for the grace of God go I."[406]

Given that the underlying claim (the failure to compel reimbursement) implicates a breach of the duty of loyalty, and in light of the apparent possibility of structural bias and despite the absence of evidence implicating a majority of the board of directors, the court justifiably declines to conclude that asserted business judgment warrants deference. While *Houle v. Low* concedes "the power of a corporate representative to terminate derivative litigation as a matter of sound business judgment,"[407] it also requires that each individual serving on the committee designated to render the decision be free from both inherent or structural bias.[408] The principal function of the board of directors is the "selection of the chief executive officer and concurrence with the CEO's selection of the

401. *Id.* at 238.

402. Cox & Munsinger, *supra* note 224, at 84-85.

403. *Id.*

404. John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 283 (1981).

405. Zapata v. Maldonado, 430 A.2d 779, 787 (Del. 1980).

406. *Id.*

407. *Harhen*, 710 N.E.2d at 235.

408. *Id.*

company's top management team."[409] But given that defendant Brown is both the chairman of the board and chief executive officer of Hancock, and since defendants Morton and D'Alessandro are directors and senior officers, it is possible that an ostensibly independent committee will maintain ties with the defendants and raises the likelihood that structural bias is present in this case. While it may be "proper for courts to accord some deference to independent directors who evaluated the business judgments which are challenged in [typical] duty of care cases . . . courts, and not directors, have experience in assessing the type of wrongdoing which is challenged in duty of loyalty cases."[410] Thus, the *Harhen* court's unwillingness to defer to the business judgment of the special committee evinces a transparent concern for the possibility that structural bias may corrupt the entire litigation process—it also vindicates five-hundred years of legal development which sustains judicial concern for self-dealing. Public values attached to this derivative suit are accordingly vindicated, as potential breaches of loyalty command greater scrutiny and a larger investment of judicial (public) resources.

Second, if the nature of the underlying wrong is conceived of simply as a failure to comply with both state and federal gift rules coupled with a failure to sufficiently supervise active offenders, it is doubtful that the alleged misconduct falls within any breach of loyalty category. Sawyer, with the concurrence of the management committee, was attempting to maximize his firm's influence with the state legislature by giving gifts which exceeded the pertinent limits. One could possibly argue that Sawyer's misconduct was in the best interest of the firm, although the firm effectively concedes otherwise in separate state and federal litigation. Consistent with the view that the underlying breach involves a breach of the duty of care, one might argue that corporate litigation control decisions should be greeted with greater judicial deference. On the other hand, the ALI advocates greater judicial deference to corporate justifications regarding a breach of the duty of care only where the conduct of the defendant did not involve a knowing and culpable violation of the law.[411] Because Hancock's own legal department and the firm's admissions to both state and federal authorities imply a knowing and culpable violation of the law, even if this case can be characterized as a breach of care case, judicial deference is not warranted. If the court had treated this case as a typical breach of care case, then the result might have been different. For instance, if the first tier wrongdoing was conceived merely as implicating the duty of care, and if the plaintiff was required to demonstrate a "net loss" when a knowing violation of a civil statute underlies her claim, she might have lost. If, despite the fact that directors or officers knowingly engaged in an illegal act which deprives them of the presumption of propriety that normally accompanies the disinterested decisions of managers, they could nonetheless assert in their defense that in the absence of evidence that the corporation suffered a net loss through their illegal conduct, then the suit must be dismissed.

Typically, in order to prevail, the plaintiff in such cases has the burden of establishing that "the harm suffered by the corporation as a consequence of the misconduct exceeded the benefits."[412] While Loretta Harhen can adduce compelling

409. *Harhen*, 710 N.E.2d at 230 n.7 (quoting *The Business Roundtable Corporate Governance and American Competitiveness*, 46 BUS. LAW 241, 246 (1990)).

410. Murdock, *supra* note 17, at 86.

411. ALI PRINCIPLES (1992), *supra* note 41, § 7.10(a)(2); *see also id.* cmt. (e).

412. Cox, *supra* note 5, at 9.

evidence that the firm incurred a tangible loss (fines and other expenses), she cannot necessarily establish that the costs incurred by the firm because of the failure to adequately supervise Sawyer constitutes misconduct that exceeded its benefits. By effectively implicating a breach of duty of loyalty in the wrongdoing via indemnification, by allowing the plaintiff to continue the litigation, and by declining to require Ms. Harhen to effectively show that the costs of the misconduct exceed its benefits, the court vindicates deterrence norms. This arguably increases the public condemnation attributable to the wrongdoing. Moreover, by rejecting Hancock's contention that Loretta Harhen must necessarily allege particularized facts sufficient to overcome the alleged presumptive effect of the business judgment rule, and by requiring the defendants to present evidence which supports a reasonable and principled decision where there is evidence of structural bias, the Massachusetts Appeals Court places both the burden of going forward with evidence and the burden of proof on the corporation.

On the other hand, the court declares that

> if independent directors "capable . . . of objective judgment" reject the demands and provide "specific reasons" for doing so, then the complaint may be dismissed without further proceedings unless the complaint pleads, with particularity, facts that "raise a significant prospect" that the statements in the reply are not correct, are legally insufficient or that "disinterested directors could not reasonably have determined that rejection of the demand was in the best interests of the corporation."[413]

Because potential structural bias is present, the defendants are required to come forward with evidence and proof in order to defeat the complaint. This technique seems consistent with the burden of proof component of the substantive standard approach when a breach of loyalty is implicated.[414] Thus, this judgment is congruent with the view that the burden should remain on the party with the greatest access to information. Even if conclusive disinterest could be found, the Massachusetts Appeals Court places the burden of proving good faith as part of a reasonable and principled corporate decision and also proving an absence of bias on the corporation.[415] In other words, a searching inquiry of the directors' reasons for rejecting demand is required. This method not only enhances the public reputation of the demand requirement as a credible screening device, it enhances the social meaning of derivative litigation by ensuring that only credible demand refusals are ratified by the court. Perforce, cases that can withstand the demand requirement enhance the public condemnation that justifiably accrues to the defendants.

Further, by rejecting the presumptive effect of the business judgment rule in the context of the demand requirement, this case arguably subjects the alleged misconduct engaged in by fiduciaries to public condemnation and thus embraces deterrence norms, even though one could argue that this case might reasonably be characterized in other

413. *Harhen*, 710 N.E.2d at 234 (quoting ALI PRINCIPLES (1992), *supra* note 41, § 7.04 (1992)).

414. *See supra* Part II.

415. *Harhen*, 710 N.E.2d at 236 n.17. Later, the court states that "when the facts raise an issue of 'personal advantage' . . . or a 'conflict of interest,' the burden is on the director to prove good faith." *Id.* at 811 (internal citations omitted).

jurisdictions as a demand required case.[416] In fact, one can argue that it is precisely the rejection of this presumption that constitutes *Harhen*'s contribution to public condemnation and its vindication of social meaning. While the *Harhen* trial court agrees with *Houle v. Low*'s mandate

> to conduct a preliminary hearing to study the make-up of the committee and what it may have reviewed, [the *Harlen* trial court argues it should] only to apply when the allegations in the complaint demonstrate with specificity that the committee lacked independence, or was biased and that its review was inappropriately sparse. A Court must begin with the presumption of propriety in the board's action in the absence of clear allegations to the contrary.[417]

The Massachusetts Appeals Court declines this conclusion and refuses to defer to board decisionmaking when potential structural bias exists. This sends a message to fiduciaries who are currently undecided about their future course of conduct that misconduct may be subject to sanction even where a majority of the board or the special litigation committee, free from direct allegations of bias, approve the challenged transaction. Also, by refusing to accept uncritically the assertion that special committees are intrinsically independent, and by requiring an informed business judgment, which includes an implicit examination of the costs of the litigation in relation to its benefits, the court helpfully confirms the expansion of the content of the business judgment rule. The court additionally guarantees that the good faith component of the business judgment rule will be subject to substantive, as opposed to peremptory, analysis. In fact, one can argue that it is precisely the rejection of the presumptive application of the business judgment rule and the indispensability of substantive good faith that constitute the court's most important contribution to the value of public condemnation and general deterrence. Moreover, this approach may enhance the vindication of compensatory norms, as plaintiffs' attorneys will have sufficient incentives to bring meritorious actions grounded in the knowledge that meritorious claims will not necessarily be placed in the control of the corporation, and frivolous actions will not necessarily result in fees that exceed the benefits to shareholders and the corporation.

Given the possibility that many corporate managers operate with at least some confidence that insurance coverage, indemnity provisions, or vicarious liability rules protect wrongdoers from bearing the costs which are imposed on the shareholders, courts committed to vindicating the social meaning of shareholder derivative suits should insist that those who engage in misconduct actually pay the fines or penalties.[418] This helps ensure that those who are most responsible for violating fiduciary standards compensate those they have harmed from their own funds, thereby sending the correct public message

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416. Where less than a majority of the directors are directly implicated in the challenged transaction, many jurisdictions (notably Delaware) require the plaintiff to place a demand on the board. KLEIN & COFFEE, *supra* note 10, at 198. Because less than a majority of the Hancock board is directly implicated, it is very likely that a Delaware court would require the plaintiff to cede control of this case to the firm. *See supra* note 41 and accompanying text.

417. Harhen v. Brown, 1997 Mass. Super. LEXIS 145, at *7-*8 (Aug. 18, 1997).

418. In reality, "in most states, payments in settlement or judgment of a derivative suit cannot be reimbursed, and indemnification is instead limited to legal expenses. However, all states permit corporations to purchase D & O (directors and officers) liability insurance for their executives, and policies can cover losses that cannot be indemnified." Romano, *supra* note 2, at 57.

to other potential wrongdoers. Here, by suggesting that the board's failure to require active wrongdoers to reimburse the firm constitutes a recoverable derivative claim, the Massachusetts Appeals Court sends a message that noncompliance with statutory rules governing gifts to public officials violates public norms. Robust enforcement of the corporation's right of reimbursement in this case, like the enforcement of standard insurance exclusions and the good faith requirement of state indemnification statutes in the case of settlement, help invest judicial decisions with meaning and signify to the shareholder community that judges, as public officials who are representatives of the community, care about fiduciary duty violations. If those who actively engage in misconduct are required to reimburse their firms, the outcome may deter future wrongdoers, as well as ensure that compensatory norms are maintained. Plaintiffs can then look to both the corporation and to active wrongdoers for compensation, thus increasing the likelihood that the expected value of the lawsuit exceeds its costs. Because there is little "utility for shareholders in suing corporate fiduciaries for damages when fiduciaries pay most of these damages using funds provided by shareholders,"[419] allowing officer liability insurance, like officer indemnification, may seem both circular and futile. This may send the wrong social message to other potential wrongdoers.[420] Requiring wrongdoers to indemnify the company will increase the possibility that the costs of litigation will be internalized, unlike many cases which end in settlement based on typical D & O insurance policies.[421] It will also encourage companies confronted by fiduciary misbehavior in the future to decline to indemnify wrongdoers unless it can be affirmatively shown that their misconduct was in the best interest of the firm.

One commentator suggests the optimality of insurance, indemnification, and reimbursement rules which enable the active wrongdoer to possibly escape repaying her employer.[422] It can be argued, however, that policy approaches which require repayment send a powerful message to plaintiffs' attorneys, the shareholder community, and officers and directors that the objectives of the suit as a corporate governance mechanism will not be compromised by uncritical courts. This ensures that derivative suits maintain their compensatory function and also provide general and specific deterrence to those who are currently undecided about their future course of conduct. This conclusion is warranted, since Hancock's public acknowledgment that the lobbying activities of its government relations department violated Massachusetts law amounts to an admission that it failed to adhere to public norms.

Considering that "the defendants' involvement with Sawyer, if any, was so purposeful and knowing that the defendants could not rationally have believed that that

419. Kamar, *supra* note 15, at 887-88. Kamar argues to the contrary that insurance and indemnification in the context of shareholder litigation are defensible. *See generally id.*

420. This situation would provide less of a puzzle if the costs of insurance or indemnification were deducted from the pay of directors or officers. Mahoney, *supra* note 172, at 923. Notably, even if insurance remains unavailable, the presence of vicarious liability likely means "the active wrongdoers rarely contribute toward the suit's settlement." Cox, *supra* note 5, at 25.

421. *See supra* note 412. On the other hand, some D & O insurance policies and state indemnification statutes exclude awards arising from an officer's or director's knowing, willful, or lack of good faith misbehavior. Cox, *supra* note 5, at 25.

422. *See* Kamar, *supra* note 15, at 913-14 (contending that liability insurance and indemnification as practiced today is not necessarily efficient).

involvement, and Sawyer's illegal activities, were in the best interests of Hancock,"[423] the claim of good faith is merely an assertion of subjective good faith. Subjective good faith is indefensible where it is objectively irrational and so removed from the realm of reason.[424] Even *Zapata* states:

> [Where] the Court determines either that the committee is not independent *or* has not shown reasonable bases for its conclusions, or if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion [to terminate the litigation].[425]

"Absent some basis in reason, action could hardly be in good faith"[426] and as a result, the special committee in *Harhen* has tendered an unjustifiable conclusion. When, as here, "the facts raise an issue of 'personal advantage' or a conflict of interest, the burden is on the director to prove good faith."[427] That burden has not been met.

On the other hand, the Massachusetts Appeals Court's conclusions must be subject to two caveats. First, it encourages but fails to explicitly emphasize a cost-benefit calculus as commended by the substantive standard method. If a special committee or a board can demonstrate objective good faith in the absence of an assessment of the benefits and costs of the litigation, then the *Harhen* court's analysis seems deficient. Let us assume, for instance, that there is a ten percent chance that the plaintiff will prevail on the merits of her claim and that the costs of the litigation to the corporation will be less than $400,000. After calculating the expected value, this litigation appears to be cost justified because the amount of fines and expenses that John Hancock has incurred exceeds $4 million.[428] Accordingly, one could argue that compensatory norms are not fully implicated by the court's analysis, as the court does not explicitly require that the firm's decisionmaker consider whether the direct benefits of the litigation exceed its costs. That conclusion should be taken with some caution. Hancock's decision not to pursue this action must be examined in light of several pre-existing admissions of liability and the pressure of federal and state proceedings. One can clearly argue that substantive good faith enforced in this context will skew the court's analysis in favor of prosecution of the wrongdoer. That would ensure that compensatory norms are vindicated, at least in this case. Second, while the effect of its decision complements the social meaning of shareholder suits, the court does not explicitly focus on the value of deterrence attached to public values. Yet, it must be conceded—if this decision had been sustained—that the Massachusetts Appeal's Court holding would provide a deterrent effect to those who might be undecided about their future conduct, as meritorious suits would likely survive the Massachusetts Appeals Court's nondeferential review.

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423. *Harhen*, 710 N.E.2d at 236.

424. *Id.* at 811 (citing ALI PRINCIPLES (1992), *supra* note 41, § 4.01(C)).

425. Zapata v. Maldonado, 430 A.2d 779, 789 (Del. 1980).

426. *Harhen*, 710 N.E.2d at 236 (citing Sam Wong & Son v. N.Y. Mercantile. Exch., 735 F.2d 653, 678 n.32 (2d Cir. 1984)).

427. *Harhen*, 710 N.E.2d at 237 n.18 (internal citations omitted).

428. The appropriate measure of costs to the corporation exclude plaintiffs' attorney's fees, because under Macey and Miller's analysis "no fees will be owed if the case fails." Macey & Miller, *supra* note 3, at 40.

Despite these caveats, (1) by placing the burden on the directors to prove good faith; (2) by disallowing the presumption of propriety where there is plausible but not necessarily proven evidence of structural bias; (3) by ensuring that deterrence norms are, at least, in effect valued, by creating a scaffold in which compensatory norms can be maintained; (4) by ensuring greater judicial review and skepticism where the first-tier wrongdoing implicates the duty of loyalty; and (5) by precluding either management or plaintiffs' attorneys from necessarily controlling the litigation, the Massachusetts Appeals Court contributes to the vindication of shareholder derivative litigation as a corporate governance mechanism. By obstructing certain behavior, society can positively reinforce a favored social meaning.[429] By obstructing irrational and potentially biased attempts to control the fate of shareholder litigation, judges reinforce derivative suits as a device that is suffused with social meaning. Deference to the litigants' position contributes to derivative suits being seen as merely having a private role.[430] The absence of deference to either litigant contributes to such suits having both a private and public role as the court breathes life into the moralizing language attached to fiduciary duty breaches. It will be up to directors, special committees, and the corporation to overcome judicial skepticism by an affirmative showing that the decision to discontinue the litigation was in good faith, that is, there was an informed judgment. On the other hand, this court seems to avoid the potential pitfalls accompanying the judgment of the Supreme Court of North Carolina requiring the trial court to utilize its commercial and business judgment in deciding the best interest of the corporation. Avoidance occurs because the *Harhen* appeals court contemplates a rigorous appraisal of the board's conclusion that discontinuance is in the best interest of the firm. This approach prevents the emasculation of the board's judgment, which occurs when an inexperienced trial court is required to weigh commercial, public relations, and promotional and physical facts in deciding whether the litigation should continue. It also eludes the pitfalls attached to entrepreneurial attorney control.

The persuasive appeal of the *Harhen* holding lies in the fact that lawsuits are only allowed to proceed where there is an informed judgment unaffected by structural bias. This decision vindicates the structural bias concerns of the *Miller v. Register*[431] court, yet enables Massachusetts directors (even though directly implicated) to participate in the litigation control process by selecting a committee to consider demand or to discontinue the litigation. At least theoretically, Massachusetts' firms, unlike Iowa's, can still control the litigation even where a majority of the board is tainted by bias.

Conversely, the Massachusetts Appeals Court decision might be seen as an expansion of *Miller* in that the court believes that directors who are not directly implicated in wrongdoing can nonetheless be biased against derivative suits which implicate fellow directors. When the board takes the time to carefully and rigorously examine the transaction, and it overcomes bias with a demonstrably independent decision, the board's attempt to control the litigation will likely be ratified by the court. The Massachusetts Appeals Court approach applies irrespective of whether the corporate

429. Cox, *supra* note 5, at 20 (citing Lessig, *supra* note 153, at 1013, 1032 (arguing that failure to inhibit certain behaviors would reinforce negative social meanings).

430. This seems particularly true with respect to settlements. *See* Cox, *supra* note 5, at 12.

431. 336 N.W.2d 709 (Iowa 1983) (the court remains skeptical of attempts by interested directors to vote to elect members of the special litigation committee).

decision involves any permutations connected to the demand requirement or to subsequent attempts to control the litigation. While giving lip service to the old demand required/demand excused distinction derived from *Zapata* and its progeny, the court seems disinclined to reify it.

The *Harhen* court's most important conclusion is that the presence of potential structural bias deprives the litigation control decision of the presumption of propriety. On the whole, this court's approach largely prevents enmeshing shareholder derivative litigation in a ritual[432] that demeans the social value of shareholder litigation by deferring too quickly to the business judgment of management. On the whole, this approach provides sufficient incentives for meritorious suits to go forward without necessarily handing litigation control to entrepreneurial attorneys. The absence of deference decreases the likelihood that the plaintiffs' attorney will expect the corporation to take over the litigation—thus increasing the likelihood that they will research potential meritorious causes of action.[433] Nondeferential review sustains the notion that derivative litigation may have a role that extends beyond an atomistic conception of why corporate actors engage in misconduct by creating a framework in which public concerns can be vindicated. That may positively affect the portfolio of stocks that an investor holds, even where the managers of the firms in which she holds the equity interests are not themselves the subject of litigation. If the courts and other jurisdictions continue to extend the logic of this case to encompass a nondeferential approach to the litigants' position in the context of settlement, abusive settlements[434] might be discouraged as well. In fact, nondeferential review at the screening or special committee stage of the litigation is likely to vitiate the possibility of future abusive settlements.[435]

Still, this framework must confront the possibility that it remains inescapably indeterminate. Whether optimal enforcement of the norms of corporate law requires high sanctions and low rates of enforcement or high certainty with moderate sanctions, or whether it warrants a posture whereby "defendants pay less than the maximum they can bear and plaintiffs—or, in shareholder suits, plaintiffs' attorneys—receive more than the defendant pays," is subject to some dispute.[436] "The combination of less than maximum sanctions and high rates of enforcement is optimal" because litigation can reduce legal uncertainty.[437] "[A]s decided cases accumulate, the interpretation and proper application

432. Cox, *supra* note 5, at 28. Rituals may either "support or weaken a particular social meaning." *Id.*

433. Macey & Miller, *supra* note 3, at 36-37.

434. The social meaning of shareholder suits "may easily lose their public character through weaknesses in the settlement process." Cox, *supra* note 5, at 31. Thus, the settlement ritual may prevent the shareholder suit from securing an honored position as a mechanism for vindicating public norms. Cox, *supra* note 5, at 31. While settlement remains an important ritual in the life and image of the shareholder suit, it may be a ritual which confirms all that is wrong with the shareholder suit: settlement procedures nurture and reinforce attorney-driven tendencies at the expense of public condemnation. *Id.* at 38. Judicial deference is therefore hardly warranted. Instead, judicial suspicion seems necessary.

435. Numerous commentators have catalogued the weak incentives for attorneys and their clients to aggressively pursue representative suits to trial. Coffee, *supra* note 180, at 671-77.

436. Kamar, *supra* note 15, at 889. For an argument that optimal enforcement combines the highest sanctions defendants can bear with low rates of enforcement, see Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). Exceptions arise from among other things, including income level, nonmonetary sanctions, and risk aversion. Kamar, *supra* note 15, at 889 n.5.

437. Kamar, *supra* note 15, at 890.

of fiduciary standards become clearer, [thus] allowing directors and officers to estimate more accurately and thus to behave closer to the social optimum."[438] Indeterminancy must be assessed against an awareness that adjudication uses public resources that employ public officials chosen by a process in which the public participates.[439] These officials possess

> a power defined and conferred by public law not by private agreement. Their job is not to maximize the ends of private parties . . . but to explicate and give force to the values embodied in authoritative texts such as the Constitution and statutes: to interpret those values and to bring reality to accord with them.[440]

Indeterminancy must also be assessed against the possibility that perhaps there is really no "single" business judgment rule.[441] However indeterminate and incomplete, the public officials in this case offer the possibility that shareholder derivative suits can vindicate social norms without necessarily compromising economic ones. The *Harhen* appeals court rightly indicates that neither the interests of management and shareholders on the one hand, nor attorney and client on the other, are necessarily congruent. Yet it also endeavors to secure the survival of meritorious suits and the evisceration of frivolous ones. Despite its reversal by the Supreme Judicial Court, the Massachusetts Appeals Court examination supplies an attractive praxis for other jurisdictions that are currently grappling with how to appropriately balance the divergent interests that characterize shareholder derivative litigation in the United States.

VI. CONCLUSION

An organization like a corporation or a mutual insurance company is simply the venue for a nexus of contracts which may be written or unwritten. These agreements specify the rights of each agent in the organization, invent performance criteria on which they are judged, and create incentives and financial rewards. These contracts, in combination with production techniques and external legal constraints, help determine the costs of delivering the service or product.[442] Typically, these organizations involve the separation of ownership from control and thus raise agency costs issues. This separation of ownership is not costless[443] and can be minimized, but not eliminated, by monitoring via directors, shareholders, auditors, insurers, and sometimes public entities. A backup device is also available—shareholder derivative suits. But this device raises its own questions about the divergence in interests between entrepreneurial plaintiffs' attorneys and their clients. Shareholders with tiny investments and their agents may have "little incentive to consider the effect of a legal action on other shareholders—the

438. *Id.*

439. Cox, *supra* note 5, at 12 (citing Owen Fiss, *Against Settlement*, 93 YALE L.J. 1075 (1984)).

440. *Id.* at 12.

441. *See* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287 (1993-94).

442. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 25 J. L. & ECON. 301, 302 (1983).

443. Frank H. Easterbrook & Daniel Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94 (1985).

supposed beneficiaries, who ultimately bear the costs."[444] While it is possible that shareholder derivative suits fail their corporate governance function, there is at least some evidence that such suits constitute a credible menace to aberrant directors and officers.[445] Further, American corporate law is far from an exact science. It is a set of loosely defined guidelines made tangible by after-the-fact court judgments. Their message remains apparent: fiduciaries must do their utmost to promote shareholder interests.[446]

The Massachusetts Appeals Court decision in *Harhen* contributes to the view that courts enjoy a relative advantage in competence vis-à-vis business decisionmakers when and if the underlying misconduct implicates either self-interest or a knowing and culpable violation of the duty of care. If this framework is applied irrespective of whether demand is required, refused, or excused, or whether the decision is a function of special litigation committee deliberations, or whether the court is considering settlement, the litigants' position will deservedly receive a healthy dose of skepticism—something that all parties should expect when they come to the table with less than incontestably pure motives. This framework vindicates the notion that the business judgment rule is primarily a defensive rule, ripe for deployment when the duty of care is placed in issue. *Harhen* suggests that when firms attempt to deploy the business judgment rule offensively to shield underlying transactions, thus implicating self-interest, judicial deference may potentially amount to an abdication of both the public and the court's role in corporate governance.

444. Fischel & Bradley, *supra* note 27, at 271-72. *But see* Schwartz, *supra* note 97, at 343 (stating that a sound theoretical base supports the imposition of liability rules on fiduciary misconduct).

445. Goetz, *supra* note 97, at 348.

446. Kamar, *supra* note 15, at 891.