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## Corporate Governance in the Courtroom: An Empirical Analysis

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CORPORATE GOVERNANCE IN THE COURTROOM:  
AN EMPIRICAL ANALYSIS

JESSICA ERICKSON\*

ABSTRACT

*Conventional wisdom is that shareholder derivative suits are dead. Yet this death knell is decidedly premature. The current conception of shareholder derivative suits is based on an empirical record limited to suits filed in Delaware or on behalf of Delaware corporations, leaving suits outside this sphere in the shadows of corporate law scholarship. This Article aims to fill this gap by presenting the first empirical examination of shareholder derivative suits in the federal courts. Using an original, hand-collected data set, my study reveals that shareholder derivative suits are far from dead. Shareholders file more shareholder derivative suits than securities class actions, the area of corporate litigation that has received nearly all of the scholarly attention. By writing off shareholder derivative suits, scholars have missed the distinct role that these suits play in corporate law, particularly in the area of corporate governance. Unlike traditional litigation, remarkably few of the suits in my study ended with monetary payments. Instead, these suits more commonly ended with corporations agreeing to reform their own corporate governance practices, from the number of independent directors on their boards to the method by which they compensate their top executives. These settlements reflect the rise of a new type of shareholder activism, one that has gone undocumented in the legal literature. Corporate governance has moved into the*

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*courtroom, and this development has important, and potentially troubling, implications for corporate law.*

# TABLE OF CONTENTS

INTRODUCTION . . . . .	1752
I. STUDY DESIGN AND METHODOLOGY . . . . .	1756
II. EMPIRICAL ANALYSIS OF FEDERAL	
DERIVATIVE SUITS . . . . .	1760
A. <i>The Unseen Importance of Derivative Suits</i> . . . . .	1760
B. <i>Surveying the Complaints</i> . . . . .	1763
1. <i>Mapping the Complaints</i> . . . . .	1763
2. <i>Detailing the Parties</i> . . . . .	1765
a. <i>Derivative Plaintiffs</i> . . . . .	1765
b. <i>Plaintiff Corporations</i> . . . . .	1770
c. <i>Defendants</i> . . . . .	1771
3. <i>Analyzing the Allegations</i> . . . . .	1773
C. <i>Procedural Hurdles in Derivative Suits</i> . . . . .	1780
1. <i>Demand in the Federal Courts</i> . . . . .	1780
2. <i>Special Litigation Committees</i> . . . . .	1784
D. <i>Four Paths to Resolution</i> . . . . .	1787
1. <i>Judgment</i> . . . . .	1788
2. <i>Involuntary Dismissals</i> . . . . .	1789
3. <i>Voluntary Dismissals</i> . . . . .	1791
4. <i>Settlements</i> . . . . .	1794
a. <i>Private Company Settlements</i> . . . . .	1795
b. <i>Public Company Settlements</i> . . . . .	1798
III. ASSESSING CORPORATE GOVERNANCE IN THE	
COURTROOM . . . . .	1807
A. <i>The Promise of Redress</i> . . . . .	1807
B. <i>The Limits of Reform</i> . . . . .	1816
C. <i>The Possibility of Deterrence</i> . . . . .	1826
CONCLUSION . . . . .	1830

## INTRODUCTION

Conventional wisdom is that shareholder derivative suits play a small, and dwindling, role in corporate law. Once the cornerstone of corporate law,<sup>1</sup> these suits are now viewed as relics of an older time, rendered obsolete by more modern means of policing corporate misconduct such as high-stakes securities class actions, sweeping government investigations, and the stringent listing standards of the national stock exchanges. As the tools for monitoring corporate managers multiply, scholars have all but abandoned shareholder derivative suits. In the world of corporate law scholarship, shareholder derivative suits are not just “forgotten,”<sup>2</sup> they are “dead.”<sup>3</sup>

As a result, few scholars have deemed these suits worthy of empirical analysis. Over the last fifteen years, there have been just two studies of shareholder derivative suits.<sup>4</sup> Although both made crucial contributions to our understanding of these suits, the empirical focus in these studies was on suits filed in Delaware state court or on behalf of Delaware corporations.<sup>5</sup> There remains no comprehensive examination of shareholder derivative suits in the federal courts, where most corporate litigation is centered.

This dearth of empirical data comes at a particularly bad time. As the financial markets have experienced tremendous upheaval, corporate law has been besieged with calls for reform.<sup>6</sup> Scholars and

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1. See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (stating that shareholder derivative suits were the “chief regulator of corporate management”).

2. Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 389 (2008) (internal quotation marks omitted).

3. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1749 n.6 (2004) (stating that “[l]ike the proverbial cat, derivative suits have been pronounced dead on numerous occasions”); E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 142 (2000) (stating that commentators have proclaimed derivative suits “dead and gone and buried”).

4. See Davis, *supra* note 2; Thompson & Thomas, *supra* note 3.

5. See Davis, *supra* note 2, at 388-89; Thompson & Thomas, *supra* note 3, at 1749.

6. See, e.g., Lawrence A. Cunningham & David T. Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009) (evaluating proposals for reforming financial regulation); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 197-98 (2008) (proposing regulatory reforms to address systemic risk in the financial markets).

politicians alike have called for a restructuring of market regulations and renewed oversight of private litigation.<sup>7</sup> If shareholder derivative suits are to play any role in these efforts, it should not be based on an incomplete snapshot of this area of the law.

This Article aims to bridge that gap by presenting the first empirical analysis of shareholder derivative suits in the federal courts. My study is based on a hand-collected and original dataset of full case records from complaint through final judgment.<sup>8</sup> In contrast, many studies of litigation examine only reported decisions available through Westlaw or Lexis.<sup>9</sup> As others have recognized, such studies suffer from a selection bias because fewer than 5 percent of decisions are available through these databases.<sup>10</sup> Moreover, neither Westlaw nor Lexis allows scholars to track entire case records, which means that most litigation research is based on a single snapshot of the studied cases rather than a comprehensive review of the entire case record.<sup>11</sup> As scholars are increasingly

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7. See, e.g., Stephen J. Choi & Linda J. Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465, 468 (outlining an approach to address securities class actions filed against foreign corporations); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1354-58 (2008) (proposing reform of securities class actions that would allow the Securities and Exchange Commission to serve as a gatekeeper).

8. Scholars have recognized the value of using full case records as the basis of research. See David A. Hoffman et al., *Docketology, District Courts, and Doctrine*, 85 WASH. U. L. REV. 681, 684-85 (2007) (describing the growing legal movement in conducting empirical research using full case records); see also Margo Schlanger & Denise Lieberman, *Using Court Records for Research, Teaching, and Policymaking: The Civil Rights Litigation Clearinghouse*, 75 UMKC L. REV. 155, 163-68 (2006) (explaining the significant problems with traditional litigation research and concluding that “[i]n short, for anyone who hopes to understand litigation ... one specific litigation or an entire field of litigation ... there is no substitute for court records”).

9. See Hoffman et al., *supra* note 8, at 686.

10. See *id.* at 727 (“An astonishingly low 3% of all orders are available on [Westlaw or Lexis] databases; more than 80% of difficult orders are similarly ‘hidden’ without explanation.”); Schlanger & Lieberman, *supra* note 8, at 165 (explaining that “there is now voluminous evidence that [judges] choose to devote the time to fully developed opinion writing in nonrepresentative ways”).

11. See Schlanger & Lieberman, *supra* note 8, at 163.

recognizing,<sup>12</sup> litigation research must be done on the ground, studying case records from start to finish.

From this in-depth examination of shareholder derivative suits, three important conclusions emerge. First, contrary to the conventional wisdom, shareholder derivative suits are anything but dead. Shareholders actually file more shareholder derivative suits than securities class actions,<sup>13</sup> the area of shareholder litigation that has received nearly all of the scholarly attention.<sup>14</sup> Corporate law scholarship has missed this fact because most shareholder derivative suits are filed in *federal* court and nearly half are filed on behalf of companies incorporated *outside of* Delaware.<sup>15</sup>

Second, corporate governance reform has moved into the courtroom. Remarkably few of the suits in my study ended with the corporation receiving a meaningful financial benefit. Instead, shareholder derivative suits more commonly end with the parties agreeing to corporate governance settlements. In these settlements, corporations agree to reform their corporate governance practices, from the number of independent directors on their boards to the method by which they compensate their top executives. These

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12. Over the past several years, a number of prominent studies have been published examining full case records in discrete areas of the law. *See, e.g.*, James D. Cox et al., *There Are Plaintiffs and ... There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355 (2008); Theodore Eisenberg & Charlotte Lanvers, *What is the Settlement Rate and Why Should We Care?*, 6 J. EMPIRICAL LEGAL STUD. 111 (2009); Margo Schlanger, *Inmate Litigation*, 116 HARV. L. REV. 1555 (2003); David L. Schwartz, *Practice Makes Perfect? An Empirical Study of Claim Construction Reversal Rates in Patent Cases*, 107 MICH. L. REV. 223 (2008); Adam Winkler, *Fatal in Theory and Strict in Fact: An Empirical Analysis of Strict Scrutiny in the Federal Courts*, 59 VAND. L. REV. 793 (2006); Ronald F. Wright, *Trial Distortion and the End of Innocence in Federal Criminal Justice*, 154 U. PA. L. REV. 79 (2005).

13. *See infra* Part II.A.

14. There have been dozens, if not hundreds, of empirical studies analyzing securities class actions over the last fifteen years. *See, e.g.*, Stephen J. Choi et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869 (2005); James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587 (2006) [hereinafter Cox & Thomas, *Does the Plaintiff Matter?*]; James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions To Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411 (2005); Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J.L. & ECON. 365 (2006).

15. *See infra* Part II.A.

settlements have not been studied at all in the legal literature. The rise of shareholder activism in the courtroom has simply flown under the radar of corporate law scholarship.

Third, there is significant reason to question the wisdom of corporate governance's move from the boardroom into the courtroom. Drawing on business and finance literature, this Article demonstrates that corporate governance settlements often fail to live up to their potential because they include reforms that are unlikely to benefit corporations or their shareholders.<sup>16</sup> Yet despite the minimal benefits to corporations, the plaintiffs' attorneys studied still received substantial fees, confirming the view that "[t]he real incentive" to file shareholder derivative suits "is usually not the hope of return to the corporation, but the hope of handsome fees to be recovered by plaintiffs' counsel."<sup>17</sup> By writing off shareholder derivative suits, scholars have missed the problematic role that these suits continue to play in corporate law.

This Article proceeds in three parts. Part I explains the design and methodology of the study. Part II sets out the empirical results of the study, examining the shareholders who file derivative suits, the companies named in the suits, the types of claims alleged, and, most importantly, the resolution of these suits. Part III adds a normative component, drawing on business and finance scholarship to evaluate corporate governance settlements and concluding that many of these settlements do little to enhance corporate value. In the end, "corporate governance at gunpoint" may not be the best strategy for reform.<sup>18</sup>

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16. See *infra* Part III.A.

17. *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982).

18. See William S. Lerach, *Achieving Corporate Governance Enhancements Through Litigation*, 24 T. JEFFERSON L. REV. 1, 8 (2001) (internal quotation marks omitted). William S. Lerach, the (in)famous plaintiffs' attorney, used this term in describing corporate governance settlements, adding that "oftentimes more is obtained with a kind word and a gun, than a kind word alone!" *Id.* Mr. Lerach was recently released from prison after serving time for providing kickbacks to clients. See Joe Nocera, *Serving Time, but Lacking Remorse*, N.Y. TIMES, June 7, 2008, at C1.



## I. STUDY DESIGN AND METHODOLOGY

This Part explains the methodology of the study and provides an overview of its significance and limitations. Before turning to this discussion, however, a brief explanation of the role of derivative suits and securities class actions in corporate law is warranted. Derivative suits and securities class actions are the procedural mechanisms to enforce two different branches of corporate law.

Derivative suits are the procedural mechanism to enforce state fiduciary duty law.<sup>19</sup> In a derivative suit, the corporation is the functional plaintiff—that is, the real party in interest—and the allegations are that the corporation’s current or former officers and directors breached their fiduciary duties to the corporation.<sup>20</sup> Any recovery in a derivative suit is returned to the corporation.<sup>21</sup> In a derivative suit, despite the fact that the suit is brought in its name, the corporation’s role is limited because shareholders, whom I will call derivative plaintiffs, file these suits on behalf of corporations.<sup>22</sup> The law gives shareholders this power because corporate officers and directors, who normally decide whether corporations should file lawsuits, are often implicated in the alleged wrongdoing and cannot be trusted to make unbiased decisions regarding the merits of these suits.<sup>23</sup>

Securities class actions are the procedural mechanism to enforce the federal securities laws.<sup>24</sup> In a securities class action, the plaintiffs are shareholders alleging that a corporation and its individual officers and directors violated the federal securities laws by making false or misleading public statements.<sup>25</sup> Any recovery in the lawsuit goes to the corporation’s shareholders.<sup>26</sup>

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19. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

20. See *Joy*, 692 F.2d at 887.

21. See *id.*

22. See *Aronson*, 473 A.2d at 811.

23. See *id.*

24. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860 (2003).

25. See *id.* at 870-72.

26. See *id.* at 863-64, 883.

Although derivative suits and securities class actions are both key procedural tools in corporate law, scholars have focused nearly all of their attention on securities class actions, studying these suits from every angle.<sup>27</sup> As a result, scholars now know almost everything there is to know about securities class actions, but next to nothing about derivative suits.<sup>28</sup> The time has come to explore the unexplored side of shareholder litigation.

To understand the role of derivative suits in the federal courts, this study examined the full case records of derivative suits filed in federal district courts over a twelve-month period in 2005 and 2006.<sup>29</sup> The cases were identified by searching the “Dockets” database in Westlaw, which includes the dockets of cases in the federal district courts.<sup>30</sup> The search was limited to dockets that included any variation of the term “derivative.”<sup>31</sup>

This search produced a list of 478 cases. I then culled from this list cases that were not shareholder derivative suits, cases that were filed before the relevant time period, duplicate cases, and cases that were filed under seal. Two hundred ninety-one cases remained after these suits were culled from the study. I then culled an additional 109 cases that were consolidated by court order. If a suit from my study was consolidated with other suits, I tracked the consolidated suit, even if some of the constituent suits that made up the consolidated suit were not filed during the relevant time period. On the other hand, if two or more suits were filed on behalf of a single plaintiff corporation, but these suits were not consolidated,

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27. See *supra* note 14.

28. Scholars have been calling for additional empirical data regarding derivative suits for decades, noting that existing data is sparse and “reveals a focus on only a few of the wide range of possible questions that might be addressed.” Bryant G. Garth et al., *Empirical Research and the Shareholder Derivative Suit: Toward a Better Informed Debate*, 48 LAW & CONTEMP. PROBS. 137, 149 (1985).

29. The twelve-month period was July 1, 2005 through June 30, 2006. The start date was chosen because most districts had adopted electronic case filing by the middle of 2005, allowing electronic access to nearly all of the case records. The end date was chosen to allow sufficient time for most of the cases in the study to reach final judgment.

30. Specifically, the “Dockets — U.S. District Courts Combined” database includes “comprehensive full docket coverage [beginning in] January 2000.” Westlaw Database Directory, <http://directory.westlaw.com/scope/default.asp?db=Dock-DCT-ALL&RS=WDIR2.0&VR=2.0> (last visited Feb. 15, 2010).

31. The search used was “derivativ! & da(aft 6/30/2005 & bef 7/1/2006).”

I tracked each suit separately. This sorting process led to a total population of 182 cases.<sup>32</sup>

I then reviewed the entire case record, from original complaint to final judgment, for all 182 suits using the Public Access to Court Electronic Records (PACER) system.<sup>33</sup> Data from the case records were coded into a specially designed database.<sup>34</sup> I coded more than 200 variables for each suit. These variables included nearly every substantive aspect of the suits, from the parties, to the claims, to the motions and orders and ultimate resolution of the suits. This in-depth review makes this study the most comprehensive examination of derivative suits that has ever been conducted.

This search methodology has certain limitations. First, although the search likely uncovered nearly all derivative suits filed in federal court during the relevant time period, it is impossible to guarantee that the search uncovered all such cases. This limitation is unavoidable in litigation research. The documents in the PACER system are not text searchable and, therefore, there is no perfect way to capture all cases of a given type. Nonetheless, unlike the dockets of other types of cases, the dockets of derivative suits typically note that the case is a derivative suit on the docket itself, usually by specifying that the shareholder sued *derivatively* on behalf of the plaintiff corporation. Accordingly, a search of the dockets database likely uncovered most, if not all, of the federal derivative suits filed during the relevant time period.

Second, the dataset includes a number of cases that may not reflect the typical derivative suit. Specifically, 40 of the 182 cases

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32. Ten cases from the list were sealed and were therefore excluded from the study. I was unable to confirm whether these suits were derivative suits. In addition, the record from one derivative suit was not available on PACER, and I could not obtain hard copies of the record because it was in chambers.

33. I obtained nearly all of the case records from PACER. A few districts did not provide electronic access to case filings at the start of the survey period. I worked with a copy service in these districts to obtain hard copies of the case records.

34. I used several standard procedures to ensure the accuracy of the data. All coders received comprehensive training and a detailed code book to assist in their coding. Coders also noted any unusual cases or situations. I then individually reviewed the coding in each case. After all of the cases were coded, I had twenty-five cases recoded without reference to the prior coding. I compared the coding and resolved any discrepancies. The data were 94 percent accurate. If the plaintiff filed more than one complaint in the case, coding was based on the last filed complaint.

(22 percent) involved allegations that the defendants backdated or otherwise repriced stock options. A company backdates stock options when it dates stock options prior to the date that the company actually granted the options. By backdating stock options, companies can manipulate, and generally increase, the value of these options, a practice that often violates accounting and tax rules and can make the company's public disclosures false or misleading.<sup>35</sup> These suits occupied the front pages of newspapers when the scandal broke,<sup>36</sup> but they are different in several important ways from the other suits in the study. Specifically, these suits, which I will call stock option suits, were filed exclusively against large public companies, they disproportionately settled, and these settlements resulted in more value for the plaintiff corporations than the settlements in many of the other suits.<sup>37</sup>

Despite their unique characteristics, these suits reflect an important facet of shareholder litigation. In any given year, most derivative suits are what I term "classic" derivative suits. These suits turn on traditional allegations of corporate wrongdoing, including accounting irregularities, false public statements, or abuse of control by a controlling shareholder. A significant number of derivative suits, however, are more episodic, reflecting the financial crisis du jour. In 2003-2004, for example, derivative plaintiffs set their sights on mutual funds, alleging that these funds had engaged in illegal "market timing" by allowing key clients to profit by placing trades after business hours.<sup>38</sup> In 2005-2006, the time period covered by this study, these episodic suits focused on stock option backdating. From 2008 to the present, there has been

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35. See Charles Forelle, *As Companies Probe Backdating, More Top Officials Take a Fall*, WALL ST. J., Oct. 12, 2006, at A1.

36. See, e.g., Eric Dash, *2 Are Charged in Criminal Case on Stock Options*, N.Y. TIMES, July 21, 2006, at A1; Forelle, *supra* note 35, at A1; Mark Maremont, *Authorities Probe Improper Backdating of Options*, WALL ST. J., Nov. 11, 2005, at A1.

37. See *infra* Part II.D.4.b, tbl.2.

38. See James N. Benedict et al., *The Aftermath of the Mutual Fund Crisis*, 38 REV. OF SEC. & COMMODITIES REG. 261, 261 (2005) ("Beginning in 2003, ... the plaintiffs' bar set its sights on mutual funds, filing over five hundred private class actions and derivative suits against mutual fund advisors.").

an explosion of derivative suits relating to the subprime lending crisis and the resulting credit crunch.<sup>39</sup>

A study of derivative suits that did not include these episodic suits would miss an important facet of shareholder litigation. I have accordingly included both types of suits in my study but noted below when the stock option suits differ significantly from the classic suits. With these points in mind, we turn to the findings of the study.

## II. EMPIRICAL ANALYSIS OF FEDERAL DERIVATIVE SUITS

This Part sets out the results of the study. These results demonstrate that derivative suits are a much bigger player in the world of shareholder litigation than scholars have recognized. The study also uncovers the sharp resemblance between derivative suits and other types of shareholder litigation, a resemblance that has gone unnoticed in the legal literature. The results are divided into four sections. The first section analyzes the number of derivative suits in the federal courts, highlighting the long-overlooked role of these suits in corporate law. The next three sections proceed chronologically through the lifecycle of litigation. The second section focuses on the complaints, analyzing the parties on both sides of the litigation as well as their allegations. The third section focuses on the procedural hurdles in derivative suits, hurdles that waylay many shareholders in their effort to vindicate corporate claims. The final section focuses on the resolution of derivative suits, providing a foundation for the reevaluation of the role of derivative suits in countering corporate misconduct.

### *A. The Unseen Importance of Derivative Suits*

An initial look at the data demonstrates that derivative suits play a far larger role in corporate law than previous empirical studies have recognized. Conventional wisdom is that derivative suits are

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39. See Subprime-Related Derivative Lawsuits: The List, The D&O Diary, <http://www.dandodiary.com/2008/04/articles/subprime-litigation/subprimere-lated-derivative-lawsuits-the-list/index.html> (Apr. 8, 2008) (listing twenty-eight derivative suits filed in 2007 through 2009 related to subprime lending and the credit crisis).

bit players in corporate law,<sup>40</sup> and this view has been confirmed by the few empirical studies in this area.<sup>41</sup> In their study of derivative suits filed in the Delaware Court of Chancery in 1999 and 2000, Randall Thomas and Robert Thompson found that shareholders filed approximately forty derivative suits per year during this time period.<sup>42</sup> The other major study of derivative suits over the last fifteen years, conducted by Kenneth Davis, examined reported decisions of derivative suits available on Westlaw and Lexis.<sup>43</sup> This study examined a total of 294 suits filed over more than seven years, or again approximately 40 suits per year.<sup>44</sup> Thus, the existing empirical literature has unearthed a relatively small number of derivative suits, leading scholars to conclude that “the number of derivative suits has declined markedly in recent years.”<sup>45</sup>

My study found that derivative suits have not disappeared—they have simply moved into the federal courts. During the twelve-month period covered by my study, shareholders filed a total of 182

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40. See, e.g., Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1492 (2006) (“Derivative suits have been eclipsed in recent years by [other] form[s] of representative litigation.”); Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1473 n.164 (2006) (stating that empirical studies of derivative suits have found that these suits “are not performing a large role in corporate governance”).

41. There have been only two studies of derivative suits over the past fifteen years. Davis, *supra* note 2; Thompson & Thomas, *supra* note 3. In addition, there were a handful of studies conducted prior to the mid-1990s, all of which have received considerable attention in the academy. To review these prior studies, see Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, J.L. ECON. & ORG., Spring 1991, at 55, 64; Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542 (1980); Thomas M. Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U. L. REV. 306 (1980); FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS’ DERIVATIVE SUITS (1944).

42. See Thompson & Thomas, *supra* note 3, at 1762. This number reflects the number of “lead cases,” rather than complaints, filed in the Delaware Court of Chancery in 1999 and 2000. See *id.* The number of lead cases refers to the number of cases remaining after all cases arising out of the same controversy have been consolidated, a similar metric to the one used in my study. *Id.*

43. See Davis, *supra* note 2, at 418 n.162.

44. See *id.* at 418.

45. See Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 305 (2008).

suits in the federal courts.<sup>46</sup> This figure is more than four times higher than the number of derivative suits found by prior studies and more than four times higher than the number of derivative suits filed in the Delaware Court of Chancery.<sup>47</sup> The federal courts are now the center of a significant percentage of corporate litigation, a fact that the focus on state courts has caused scholars to miss.

Even more importantly, my study reveals that derivative suits may well outnumber other types of shareholder litigation, a finding that is again directly contrary to the conventional wisdom. The relatively low number of derivative suits found in prior studies has led scholars to conclude that, “compared to federal securities class actions, or to state court acquisition-oriented class actions, derivative suits are running a weak third in terms of their importance to shareholders.”<sup>48</sup> My study challenges this conclusion. Adding the 182 suits in my study to the approximately 40 suits filed per year in the Delaware Court of Chancery yields an approximate estimate of more than 220 derivative suits filed each year.<sup>49</sup> Moreover, this number does not include derivative suits that are filed in other state courts—suits that are currently beyond the reach of litigation researchers because few state court dockets are searchable. In contrast, shareholders on average file fewer than 200 securities

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46. A note of clarification is important here. As explained in the discussion of methodology above, my study included all derivative suits in which any of the constituent suits were filed during the twelve-month period at issue. *See supra* note 29 and accompanying text. A relatively small number of these consolidated suits included constituent suits that were filed before and/or after the relevant time period. I am not claiming that shareholders file exactly 182 derivative suits per year, a claim that would not account for the potential double-counting of consolidated suits or the inevitable variation in litigation from year to year. My point is that shareholders file far more derivative suits than prior studies have recognized.

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

48. *See* Thomas, *supra* note 45, at 305.

49. This number is an estimate, as the precise number of derivative suits undoubtedly varies each year. My data are from a single twelve-month period, while the forty suits Thompson and Thomas studied were from an earlier two-year time period. *See* Thompson & Thomas, *supra* note 3, at 1762. Nonetheless, the number of derivative suits is significant and likely exceeds the number of securities class actions filed each year, especially when one considers the number of derivative suits filed in states other than Delaware that are not included in these figures.

class actions per year, fewer than the number of derivative suits.<sup>50</sup> Shareholders file approximately 110 state court acquisition-oriented class actions each year, again fewer than the number of derivative suits.<sup>51</sup>

As this comparison demonstrates, the sheer numbers do not justify the scholarly neglect of derivative suits. Scholars have written off derivative suits based on the small number of these suits in the Delaware Court of Chancery, overlooking the fact that derivative suits have moved into the federal courts. Derivative suits are not dead. Shareholders are still filing them and corporations are still fighting them—the legal academy simply has not known it.

This insight, however, is only the start of the inquiry. Once it is clear that derivative suits are a much more important part of shareholder litigation than previously recognized, the next question is what role these suits play. This question requires an in-depth examination of the suits themselves—an examination conducted in light of empirical evidence from other types of shareholder litigation. We begin this inquiry by looking at the various parties involved in the litigation, from the shareholders to the corporations to the individual officers and directors.

### *B. Surveying the Complaints*

My analysis of shareholder derivative suits begins at the beginning of the suits themselves. I first explore the geography of shareholder litigation. I then turn to the complaints, examining the shareholders who typically file these suits and their allegations.

#### *1. Mapping the Complaints*

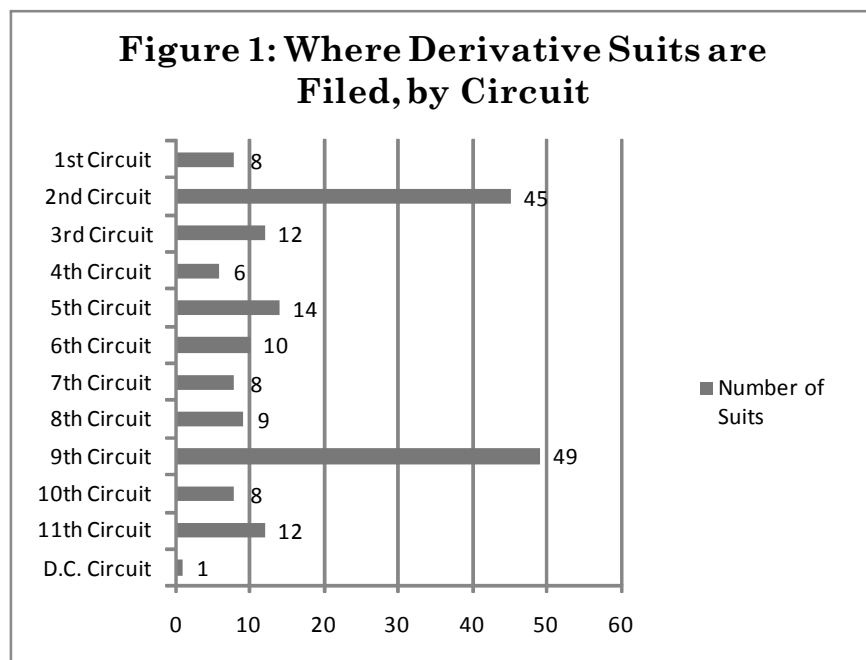
The suits in my study were spread throughout the federal courts, with at least one suit filed in every judicial circuit. As the figure below indicates, however, a disproportionate number of suits were filed in district courts in the Second and Ninth Circuits.

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50. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS: 2006: A YEAR IN REVIEW 2-3 (2007), available at <http://securities.cornerstone.com/pdfs/YIR2006.pdf> [hereinafter CORNERSTONE 2006 FILINGS].

51. See Thompson & Thomas, *supra* note 3, at 1762.





In all, 26.7 percent of the suits were filed in the Ninth Circuit, while 24.7 percent were filed in the Second Circuit.<sup>52</sup> These percentages are nearly twice the percentages of civil cases filed in each of these two circuits more generally.<sup>53</sup> The concentration of suits in these two circuits is not especially surprising. District courts in New York and California have traditionally been hotbeds of corporate litigation, as empirical studies of securities class actions have demonstrated.<sup>54</sup>

52. The prevalence of suits in the Ninth Circuit is partially explained by the large number of stock option suits. Of the 40 such suits, 29 (72.5 percent) were filed in the Ninth Circuit. If the stock option cases are removed from the sample, the Second and Ninth Circuits still remain the dominant circuits, but the percentage of cases filed in the Ninth Circuit falls to 14 percent, while the percentage of cases filed in the Second Circuit rises to 29.6 percent.

53. See JAMES C. DUFF, ANNUAL REPORT OF THE DIRECTOR: JUDICIAL BUSINESS OF THE UNITED STATES COURTS 139 tbl.C (2007), available at <http://www.uscourts.gov/judbus2007/JudicialBusinesspdfversion.pdf> (noting that, in 2007, approximately 10 percent of civil cases were filed in district courts in the Second Circuit, while approximately 15 percent of civil cases were filed in district courts in the Ninth Circuit).

54. Between 1997 and 2007, nearly half of all securities class actions were filed in these

## 2. *Detailing the Parties*

### a. *Derivative Plaintiffs*

Turning to the derivative complaints, the first question is who are the shareholders who are filing these lawsuits? My study found that derivative plaintiffs are rarely corporate insiders. Only 15 of the 182 cases (8.2 percent) involved a derivative plaintiff who also served as a director or officer of the plaintiff corporation, and all 15 involved private companies. Moreover, although derivative plaintiffs rarely disclosed their precise ownership interest in the plaintiff corporations, few shareholders appeared to own a significant stake in these corporations. Accordingly, even if they were victorious, their individual recoveries were minimal. What then is their motivation for filing these lawsuits?

The answer turns on the role of institutional investors and other activist investors in shareholder litigation. Institutional investors have long been the preferred plaintiffs in shareholder litigation, as the example of securities class actions makes clear. Prior to 1995, securities class actions were widely viewed as a prime example of lawyer-driven litigation, with shareholders playing little or no role in directing the litigation.<sup>55</sup> Corporations were often forced to pay nuisance settlements rather than incur the high costs of litigation, a phenomenon that Congress concluded would “wreak havoc on our Nation's boardrooms and deter capital formation.”<sup>56</sup> Congress sought to end these practices by enacting the Private Securities Litigation Reform Act of 1995, or PSLRA.<sup>57</sup> The PSLRA encouraged institutional investors, such as banks or other financial institutions,

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two circuits, roughly the same percentage as the derivative suits in my study. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2008: A YEAR IN REVIEW 20 (2009), available at <http://securities.cornerstone.com/pdfs/YIR2008.pdf>.

55. See William B. Rubenstein, *A Transactional Model of Adjudication*, 89 GEO. L.J. 371, 397-98 (2001) (“The common thread [behind the 1995 reform of the federal securities fraud laws] was distrust for the plaintiffs' securities bar, characterized repeatedly by the sound-bite provided, perhaps accidentally, by a prominent plaintiffs' attorney: ‘I have the greatest practice of law in the world. I have no clients.’” (footnote omitted)).

56. S. REP. NO. 104-98, at 10 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 689.

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

to serve as lead plaintiffs by creating a strong presumption that the lead plaintiff in a securities class action should be the shareholder applicant with the largest financial stake.<sup>58</sup> Congress hoped that institutional investors, who have to answer to their own constituencies, would pursue more meritorious litigation and therefore end the abuses that had plagued this area of the law.<sup>59</sup>

By and large, however, the empirical evidence has not borne out these expectations. In a study of 260 post-PSLRA settlements between 1995 and 2002, James D. Cox and Randall S. Thomas found that the PSLRA did increase the percentage of institutional investors serving as lead plaintiffs, but their influence has not lived up to the heady congressional expectations of the 1990s.<sup>60</sup> Approximately 40 percent of the post-PSLRA cases included at least one institutional plaintiff,<sup>61</sup> up from less than 10 percent before the enactment of the PSLRA.<sup>62</sup> Only 17.6 percent of the total study, however, included a financial institution—the classic institutional investor envisioned by Congress<sup>63</sup>—as a plaintiff.<sup>64</sup> Moreover, these financial institutions were not banks or mutual funds, but rather public or labor pension/retirement funds.<sup>65</sup> The study found, however, that the presence of institutions as lead plaintiffs in securities class actions had a small, but measurable, impact on settlement value, raising settlements 0.04 percent for every 1 percent increase in provable losses.<sup>66</sup>

Derivative suits, by contrast, have largely escaped legislative scrutiny. There are no statutes comparable to the PSLRA's lead plaintiff provisions encouraging institutional investors to file derivative suits. Surprisingly, however, institutional investors are still quite common in federal derivative suits.<sup>67</sup> Of the 141

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58. 15 U.S.C. § 78u-4(a)(3)(B)(iii) (2006).

59. S. REP. NO. 104-98, at 11 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 690.

60. Cox & Thomas, *Does the Plaintiff Matter?*, supra note 14, at 1587-92.

61. See *id.* at 1623-24. For the purposes of this discussion, an "institutional investor" includes any investor who is not a natural person. I have therefore included in this 40 percent figure plaintiffs that Cox and Thomas categorize as either institutions or entities.

62. See *id.* at 1590.

63. See *id.* at 1596-97 & n.140.

64. See *id.* at 1623-24 & n.139.

65. See *id.* at 1610, 1620.

66. See *id.* at 1636.

67. Professors Cox and Thomas calculated the percentage of institutional investors

derivative suits filed on behalf of public companies, 47 (33.3 percent) involved some kind of institutional plaintiff.<sup>68</sup> Moreover, in 27 of these cases (19.1 percent of the public company suits), there was at least one financial institution named as a plaintiff, a greater percentage than Cox and Thomas found in their study of securities class actions. Once again, these financial institutions were almost all public or labor pension/retirement funds, rather than more traditional financial institutions such as banks or mutual funds.<sup>69</sup> These figures demonstrate that financial institutions such as pension and retirement funds are actually more common as plaintiffs in federal derivative suits than securities class actions, at least during the period covered by this study. This fact is counter-intuitive, given that securities class actions tend to draw far higher settlement awards and thus return more bang for the buck for investors willing to lend their name to the suits.

A further examination of the data, however, indicates that institutional investors were far more likely to serve as plaintiffs in the stock option suits than in the more classic derivative suits in my study. Financial institutions served as plaintiffs in 37.5 percent of the stock option cases, but only 11.9 percent of the classic public company derivative suits. As explained in more detail below in Part II.D, these cases are the most meritorious suits in the study, at least if merit is determined by the relief obtained by the plaintiff corporation.<sup>70</sup> Accordingly, it appears that, just as in securities class

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serving as lead plaintiffs. *See id.* at 1618-19. Courts appoint lead plaintiffs in derivative suits less frequently (43 of the 141 public company cases, or 30.5 percent, and none of the private company suits), and as a result, my study measured whether any institutional shareholder served as a plaintiff in the suit, even if there were other noninstitutional shareholders in the suits as well.

68. On the private company side, none of the suits in the sample involved a public pension fund or other financial institution. Eleven of the 41 private company suits (26.8 percent) did include one or more other institutional plaintiffs.

69. Only one mutual fund served as a plaintiff in my study, and no banks served as plaintiffs. For an explanation of why banks and mutual funds are resistant to serve as plaintiffs in securities litigation, see Cox & Thomas, *Does the Plaintiff Matter?*, *supra* note 14, at 1602-10, which explains that these institutions typically "are not eager to become, or to align themselves with, antagonists of their clientele." The same reasoning likely applies in derivative suits.

70. Of course, one other measure of merit is the percentage of potential and/or claimed damages obtained by the derivative plaintiff. The derivative plaintiffs in my study rarely placed an exact dollar amount on the damages that they sought, nor were these damages

actions, institutional investors in derivative suits are drawn to the bigger, higher-quality cases.

Derivative suits also have their fair share of repeat players, another characteristic common in securities class actions. The vast majority of plaintiffs in my study appeared in only one of the study cases. Twenty-one plaintiffs, however, appeared in more than one. Of these twenty-one repeat players, eighteen appeared in two cases, three appeared in three cases, and one plaintiff (the Alaska Electrical Pension Fund) appeared in five cases. All of these repeat players appeared in public company suits.

Interestingly, several shareholders in my study have made frequent appearances in the world of shareholder litigation even outside the time period covered by my study. Steven Staehr filed just one suit in my study, but according to the *Wall Street Journal*, he is a “frequent filer” of shareholder derivative suits and has filed “at least seven other shareholder suits” over the past five years.<sup>71</sup> Another plaintiff, Robert L. Garber, who filed two suits in my study, testified in a deposition last year in New York federal court that he has filed more than twenty-five shareholder derivative suits.<sup>72</sup> Following his deposition, the court determined that Mr. Garber was “appallingly ignorant of the many derivative actions that have been filed in his name”<sup>73</sup> because he did “not exert himself to become informed about the litigations in which he serves as named plaintiff unless his performance is being closely examined.” The court also noted that Mr. Garber’s law firm “initiated this litigation and entirely controlled it.”<sup>74</sup> As the court noted, “[t]he very abuses that led to the reform embodied by the PSLRA permeate the world of derivative litigation as well.”<sup>75</sup>

There were even more repeat players among the law firms involved in the suits. My study reveals that a fairly small group of plaintiffs’ law firms file the vast majority of the suits. Three

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readily ascertainable.

71. Nathan Koppel, *Some Shareholder Plaintiffs Have Little at Stake*, WALL ST. J., Mar. 26, 2009, at A9.

72. *In re JPMorgan Chase & Co. S’holder Deriv. Litig.*, No. 08 Civ. 974(DLC), 2008 WL 4298588, at \*9 (S.D.N.Y. Sept. 19, 2008).

73. *Id.*

74. *Id.* at \*8.

75. *Id.* at \*10.

firms—Coughlin Stoia Geller Rudman & Robbins, Robbins Umeda & Fink, and Federman & Sherwood—each appeared in more than thirty of the suits. Three other firms appeared in ten or more of the lawsuits.<sup>76</sup> Indeed, the ten most common plaintiffs' firms in the study were involved in nearly 75 percent of the public company suits.<sup>77</sup> None of these firms was involved in any of the private company suits. These figures reveal a cadre of plaintiffs' firms responsible for a significant percentage of derivative suits filed on behalf of public companies.

This phenomenon will not surprise those familiar with other types of shareholder litigation because securities class actions are also dominated by a small group of law firms.<sup>78</sup> What may be surprising, however, is how little overlap there is between the law firms involved in derivative suits and the law firms involved in securities class actions. Only two of the ten most represented law firms in my study appeared as one of the top ten plaintiffs' law firms in securities class actions in 2006, 2007, or 2008.<sup>79</sup> Many of these firms file securities class actions but are much smaller players in this category of suits,<sup>80</sup> suggesting that derivative suits may serve as a launching pad for firms that aspire to the more lucrative practice of securities class actions.<sup>81</sup>

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76. These law firms were Barroway Topaz Kessler Meltzer & Check (previously Schiffrin Barroway Topaz & Kessler), Faruqi & Faruqi, and the Law Offices of Thomas G. Amon.

77. As explained below, most suits involved a number of law firms, so more than one of these firms appeared in many of the suits and many suits included a number of consolidated suits.

78. *See, e.g.*, Choi & Thompson, *supra* note 40, at 1514 (finding that there has been "substantial continuity" in the plaintiffs' firms that file securities class actions both before and after the PSLRA).

79. These two firms are Coughlin Stoia Geller Rudman & Robbins and Barroway Topaz Kessler Meltzer & Check. I compared the top firms in my study with RiskMetrics Group's list of top plaintiffs' law firms ranked by the total dollar amount of final securities class action settlements occurring in 2006, 2007, and 2008. *See, e.g.*, RiskMetrics Group, SCAS 50, [http://www.riskmetrics.com/white\\_papers/scas50\\_2008](http://www.riskmetrics.com/white_papers/scas50_2008) (last visited Feb. 15, 2010).

80. As one example, Robbins Umeda & Fink filed thirty-four suits in my study, making it the second most common law firm in my study, but it ranked only forty-fourth in the 2007 RiskMetrics Group list of firms participating in securities class actions. *See* RiskMetrics Group, SCAS 50, [http://www.riskmetrics.com/issgovernance/scas/scas50\\_2007.html](http://www.riskmetrics.com/issgovernance/scas/scas50_2007.html) (last visited Feb. 15, 2010).

81. Another explanation may be that smaller firms cannot afford the costs of litigating securities class actions, given the expensive expert testimony that is increasingly common in such cases.

As the above analysis demonstrates, institutional investors are just as active in derivative suits as in securities class actions, and there is an active plaintiffs' bar in derivative suit litigation just as in securities class actions. The examination now turns to the plaintiff corporations, the entities at the heart of these suits.

*b. Plaintiff Corporations*

Commentators have suggested that the real value of derivative suits is in policing managers of smaller public companies.<sup>82</sup> Such companies do not reap as much benefit from other enforcement mechanisms because they are too small to be named in most securities class actions and too big to take advantage of contractual protections common in smaller, privately held companies.<sup>83</sup> Yet the data in my study suggest that derivative suits are disproportionately filed against large public companies. Out of the 182 cases in my study, 141 (77.5 percent) were filed against public companies. These 141 cases involved a total of 126 different corporations.<sup>84</sup> Another 41 suits were filed against a total of 45 private companies.<sup>85</sup>

As Figure 2 indicates, the vast majority of the 126 public company plaintiffs trade on large public exchanges. Fifty-eight companies (46.0 percent) trade on the New York Stock Exchange (NYSE). Another 60 companies (47.6 percent) trade on the NASDAQ. Only 8 companies (6.3 percent) trade on the American Stock Exchange or another small public exchange.

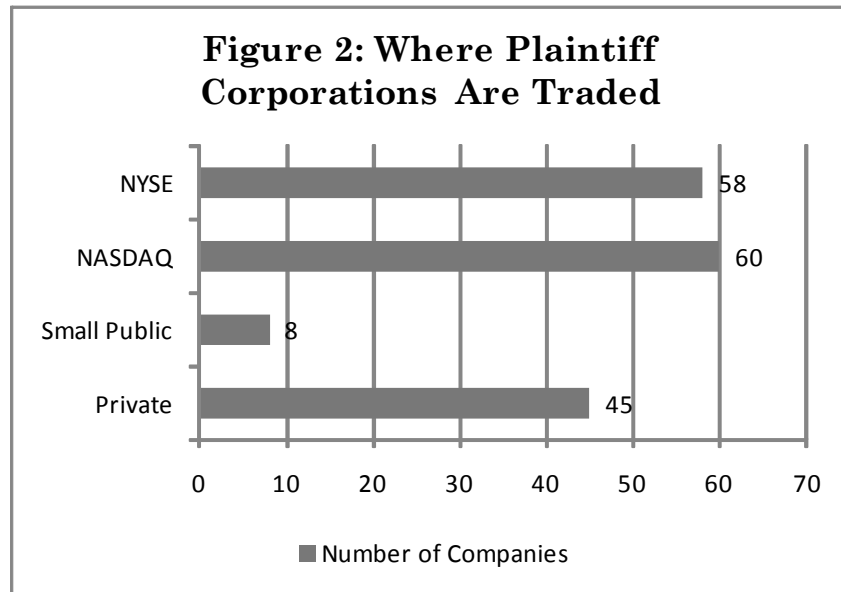
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82. See, e.g., Davis, *supra* note 2, at 450.

83. See *id.*

84. Some companies were named in two or more suits that were not consolidated and thus were tracked separately.

85. A few private company suits were filed on behalf of more than one company.



As this Figure demonstrates, derivative suits are not the province of small disputes within small corporations. Rather, derivative suits are filed on behalf of large public corporations, the same types of companies often named in other types of litigation aimed at deterring corporate misconduct. The next question, therefore, is whether derivative suits are targeting the same defendants as these other suits.

*c. Defendants*

The conventional wisdom is that derivative suits target directors, while securities class actions target officers (as well as the corporation itself).<sup>86</sup> My study indicates that derivative suits, especially public company derivative suits, target directors and officers alike, although more directors than officers find themselves in the litigation crosshairs. The derivative plaintiffs in the public company suits named a median number of twelve defendants per suit.

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86. Thompson & Sale, *supra* note 24, at 895 (“State law fiduciary duty complaints are brought against directors, but federal claims are made against officers.”).



Consistent with the conventional wisdom, these plaintiffs targeted a significant number of directors—a median of nine per suit. This number reflects the fact that most complaints named the entire board of directors.<sup>87</sup>

Yet the complaints frequently named a number of corporate officers as well, including the Chief Executive Officer in 137 cases (97.2 percent), the Chief Financial Officer in 115 cases (81.6 percent), and the Chief Operating Officer in 69 cases (48.9 percent).<sup>88</sup> Even certain lower-ranked officers were named in a substantial minority of cases. In a statistic that will strike fear into the hearts of in-house counsel everywhere, corporate general counsels were named in 31 of the public company cases (22 percent). The Controller or Treasurer was named in 30 of the cases (21.3 percent). Finally, corporate vice presidents or other top officers were named in 78 of the cases (55.3 percent).<sup>89</sup> As these figures demonstrate, directors and officers alike have reason to fear being named in derivative suits.

In sharp contrast, corporate outsiders were rarely named in the suits. Only 16 of the 141 public company complaints (11.3 percent) named a corporate outsider as a defendant, a category broadly defined to include any individual or entity with no apparent relationship to the inside defendants.<sup>90</sup> These corporate outsiders included only three law firms and three investment banks or other financial institutions.<sup>91</sup>

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87. The practice of naming the entire board of directors likely stems from the fact that most derivative plaintiffs choose not to make a presuit demand on the plaintiff corporation's board of directors and instead attempt to claim that demand would have been futile, typically because the board itself was involved in the alleged misconduct. *See infra* Part II.C.1.

88. Many of these figures may have been so high in part because these top officers are often on the plaintiff corporation's board of directors and therefore were swept up when the derivative plaintiff targeted the entire board. On the other hand, there were a significant number of cases in which the derivative plaintiff made specific allegations against the CEO and/or the CFO in their officer capacities.

89. I included in this category vice presidents of any level, directors, officers, or other individuals who appeared to have an equivalent role in the company. I did not include corporate secretaries.

90. More specifically, a corporate outsider was defined to include entities that had no corporate relationship to the plaintiff corporation—thus excluding subsidiaries and parent companies—or individuals who were neither employed by the corporation nor related to any individual employed by the corporation.

91. Although derivative suits typically include breach of fiduciary duty claims, which

If the plaintiffs in the public company cases painted with a fairly broad brush, the plaintiffs in private company cases aimed with a rifle shot. These plaintiffs named a median number of three defendants per suit, a quarter of the number named in public company cases. Moreover, the median number of directors in the private company suits was one, and nineteen of the cases named no directors at all, focusing solely on the officers or other individuals directly responsible for the alleged wrongdoing. The derivative plaintiffs named the plaintiff corporation's Chief Executive Officer in slightly more than 40 percent of the suits. Other top officers, such as the Chief Financial Officer and the Chief Operating Officer, were named in less than 10 percent of the suits.<sup>92</sup> Approximately one-quarter of the private company suits named an outside defendant, including three law firms and two investment banks or financial institutions.

In short, public and private company derivative suits look quite different. Shareholders in public company suits target a significant number of defendants, which often include directors and officers. Private company suits target a more focused group of defendants, often naming only the few directors or officers centrally involved in the alleged misconduct. Having examined the parties on both sides of these suits, the focus now turns to the allegations at the heart of the suits.

### *3. Analyzing the Allegations*

The allegations in federal derivative suits illustrate the important similarities between derivative suits and securities class actions—similarities that the legal literature largely overlooks. As detailed above, in securities class actions, shareholders typically

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cannot be asserted against outside defendants, derivative plaintiffs can file other types of claims against these defendants, such as aiding and abetting a breach of fiduciary duty, breach of contract, negligence, or malpractice claims. *See, e.g.*, Verified Shareholder Derivative Complaint at ¶¶ 401-03, *Esther Sadowsky Testamentary Trust v. Brendsel*, No. 05-CV-2596, 2005 WL 689263 (S.D.N.Y. Mar. 3, 2005) (asserting aiding and abetting claims against four investment banks on behalf of Freddie Mac).

92. Specifically, the derivative plaintiff named the Chief Executive Officer in 17 of the lawsuits (41.5 percent), the Chief Financial Officer in 4 cases (9.8 percent), and the Chief Operating Officer in 3 cases (7.3 percent).

allege that the corporation's public statements were false or misleading because the corporation failed to disclose problems with its business model or financial results.<sup>93</sup> Studies of securities class actions demonstrate that these allegations follow a common pattern, with nearly 90 percent of complaints alleging misrepresentations in financial documents and more than 40 percent of complaints alleging that corporate insiders engaged in insider trading.<sup>94</sup>

The public company derivative suits in my study looked strikingly similar.<sup>95</sup> More than 90 percent of the public company complaints included claims that the corporation or its officers and directors made false or misleading statements to the market—the exact same allegations that form the basis of securities class actions. More than 80 percent of the public company complaints alleged that the plaintiff corporation had misreported its financial results. Approximately 60 percent of the public company suits included allegations of insider trading.<sup>96</sup>

Even more interestingly, more than 30 percent of the derivative complaints filed on behalf of public companies alleged a claim under the federal securities laws, under either section 10(b) or 14(a) of the Securities Exchange Act of 1934.<sup>97</sup> This point is significant. Several scholars have noted similarities between derivative claims and securities fraud claims,<sup>98</sup> but no one has documented the rise of securities fraud claims themselves in derivative suits. Derivative

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93. See *supra* note 25 and accompanying text.

94. See CORNERSTONE 2006 FILINGS, *supra* note 50, at 20. In computing these figures, I used a weighted average of the cases from 2005 and 2006, the same time period from which the cases in my study were drawn.

95. This analysis is based on the last-filed complaint in the case.

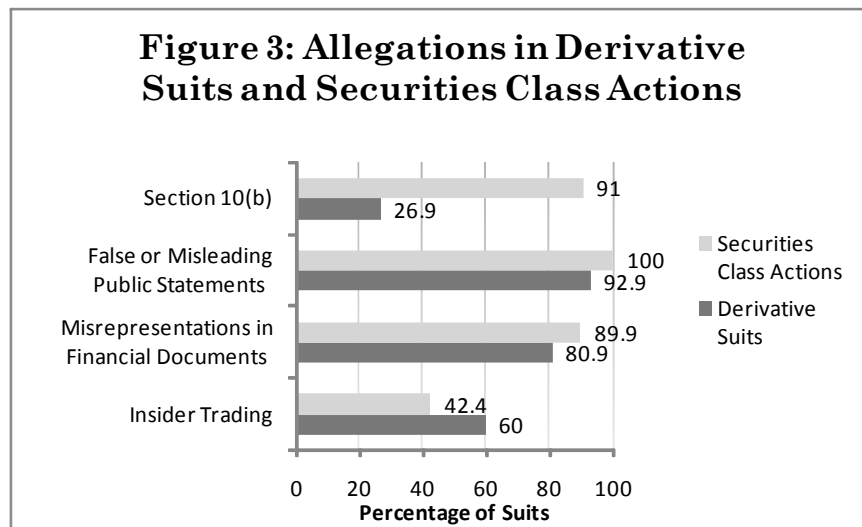
96. This percentage is based on the 101 classic public company suits, or the suits that did not include allegations of backdated stock options. I did not include the stock option suits in this calculation because the derivative plaintiffs in such suits often included allegations of insider trading in their complaints, but did not specify whether these allegations were separate from the backdating claims.

97. 15 U.S.C. § 78a (2006). Specifically, 45 of the 141 public company suits (31.9 percent) included section 10(b) and/or 14(a) claims. Thirty-eight of these suits (26.9 percent) included section 10(b) claims, while 39 suits (27.7 percent) included section 14(a) claims.

98. See, e.g., Davis, *supra* note 2, at 412-14; Jessica M. Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 80-92 (2008).

suits do not just resemble securities fraud claims—they often *are* securities fraud claims.

Figure 3 highlights the similarities between the allegations made in securities class actions and federal derivative suits during the relevant time period.<sup>99</sup>



In addition, the structure of the derivative complaints in my study strongly resembled complaints in securities class actions. The similarity is difficult to measure, but it will be familiar to anyone who has practiced in this area. A securities class action complaint follows a fairly standard pattern. The shareholder plaintiffs include pages of lengthy block quotes from the corporation's public statements that the shareholders claim were false or misleading. These quotes usually describe the company's business in glowing terms, detailing strong revenue growth or strong financial results. These quotes are almost always followed by a section—often titled “The

99. The data for securities class actions in Figure 3 is a weighted average for securities class actions filed in 2005 and 2006. See CORNERSTONE 2006 FILINGS, *supra* note 50, at 3.

Truth is Revealed”<sup>100</sup>—detailing the subsequent disclosure of the company’s poor performance.

Many complaints in my study followed a similar pattern. The complaints were typically quite long and often spanned more than a hundred pages with hundreds of paragraphs of detailed allegations. And, like securities class action complaints, the complaints included long block quotes from the company’s press releases or public filings. Many of the complaints even included the same “truth is revealed” finale.

These parallels between securities class actions and derivative suits reflect a larger trend of shareholders filing derivative suits on the heels of filing a securities class action. In my study, the majority of the public company suits were accompanied by a parallel securities class action. A few of the cases even included securities class claims in the same complaint as the derivative claims. Other practitioners have recognized this trend, opining that “[p]rudent defense attorneys should anticipate that a federal securities class lawsuit will give birth to ... a parallel derivative lawsuit.”<sup>101</sup> Larry Ellison, the Chief Executive Office of Oracle Corporation, even noted this phenomenon in a brief filed with the Supreme Court of California in which he argued that “shareholders have transformed the derivative action into a new way to litigate [securities] fraud claims.”<sup>102</sup>

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100. See, e.g., Consolidated Amended Class Action Complaint for Violations of the Federal Securities Laws at 26, *Minneapolis Firefighters’ Relief Ass’n v. MEMC Elec. Materials, Inc.*, No. 08-01411 (E.D. Mo. Feb. 23, 2009); Class Action Complaint at 18, *New Orleans Employees’ Ret. Sys. v. Novagold Res., Inc.*, No. 08-10181, 2008 WL 5596433 (S.D.N.Y. Nov. 21, 2008).

101. David Priebe, *Piling On: The Reemergence of the Parallel Derivative Lawsuit as the Federal Securities Class Action Window Closes*, in *SECURITIES LITIGATION 1999*, at 333, 335 (PLI Corp. Law and Practice Course Handbook Series No. B-1136, 1999); see also William S. Freeman, *The Securities Class-and-Derivative Litigation Two-Step*, 13 *ASS’N OF BUS. TRIAL LAW. REP.* 1 (2004) (“The securities litigation two-step—a federal class action followed closely by a remarkably similar state derivative complaint—is now commonplace.”).

102. See Petition for Review at 9, *Ellison v. Superior Court of the State of Cal.*, No. S128367, 2004 WL 3080563 (Cal. Oct. 8, 2004) (internal quotation omitted). Ellison also claimed that “Silicon Valley companies, in particular, have seen a recent flurry of derivative suits that use federal class actions as a springboard to allege fraud and insider trading” and that “[i]t has gotten to the point that a federal securities fraud action now almost inevitably will be accompanied by a parallel derivative lawsuit.” *Id.* (quotations and citation omitted).

Derivative plaintiffs typically use two approaches to turn federal securities claims into the basis of a derivative claim. First, as noted above, many plaintiffs allege a federal securities claim directly, alleging that the corporation was injured by an officer or director's false or misleading statements. Second, many plaintiffs use so-called *Caremark*<sup>103</sup> or other good faith claims to turn federal securities claims into state fiduciary duty claims. In a *Caremark* claim, the shareholder typically alleges that the board breached its fiduciary duty by failing to exercise proper oversight over the plaintiff corporation.<sup>104</sup> For example, the plaintiff in a securities class action may allege that the corporation and its officers and directors violated the federal securities laws by lying to the market. The plaintiff in a parallel derivative suit can then take this same allegation and assert that the officers and directors breached their fiduciary duty to the corporation by causing the corporation to make false statements or by causing the underlying financial problems resulting from the misstatements. More than 90 percent of the public company suits in my study involved *Caremark* claims or related allegations that the defendants failed to exercise proper oversight over the affairs of the corporation.<sup>105</sup>

This phenomenon is more apparent in federal derivative suits than in state derivative suits. In Robert Thompson and Randall Thomas's study of derivative suits filed in the Delaware Court of Chancery, they found that only 7 percent of the public company suits included allegations of false or misleading statements.<sup>106</sup> Moreover, only 26 percent of the suits included allegations of an improper financial record or a *Caremark* claim.<sup>107</sup> The cases in their study were much more likely to include allegations of self-dealing

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103. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (holding that a board of directors has a good faith duty to assure that the company utilizes an information and reporting system to keep directors informed about corporate activities).

104. See *id.* at 971.

105. This categorization was admittedly difficult because many of the complaints were not models of clarity. Few of the complaints alleged a *Caremark* claim specifically. Reading between the lines, however, it appeared that the plaintiffs were relying on the *Caremark*/good faith line of cases, as shown by the lack of specific allegations of the board's wrongdoing, such as conflicts of interest or abuses of control, and the prevalence of allegations regarding the board's failure to supervise the financial affairs of the corporation.

106. See Thompson & Thomas, *supra* note 3, at 1772.

107. See *id.*

by corporate managers, leading them to conclude that “almost 60 percent of the complaints [in their study] raise principally a duty of loyalty claim.”<sup>108</sup> Such loyalty claims were far less frequent in my study,<sup>109</sup> suggesting that shareholders are more likely to file so-called tagalong derivative suits in federal court, reserving state court claims for more traditional duty of loyalty claims.

The practice of filing tagalong derivative suits may well be a reaction to the lead plaintiff provisions in the PSLRA.<sup>110</sup> Prior to the enactment of the PSLRA, it was common for shareholders to file a significant number of nearly identical securities class actions.<sup>111</sup> The PSLRA sought to halt this duplicative litigation by establishing a procedure by which courts appoint one or more shareholders as lead plaintiff(s) in a securities class action, thereby focusing the litigation into a single case.<sup>112</sup> This procedure closes out other shareholders who may have been able to pursue their claims prior to the enactment of the PSLRA. As my study shows, rather than abandoning their litigation efforts, many shareholders—and their attorneys—are now channeling their efforts into derivative suits.

This may be a fairly new phenomenon. Following the enactment of the PSLRA, shareholders tried to get around the Act by filing state law securities class actions.<sup>113</sup> Congress quickly determined that these state suits were “frustrat[ing] the objectives of the [PSLRA]”<sup>114</sup> and enacted the Securities Litigation Uniform Standards Act of 1998, or SLUSA.<sup>115</sup> SLUSA preempts a significant number of securities class actions filed under state law, preventing

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108. *Id.* at 1773.

109. For example, only 10 of the classic public company derivative suits (9.9 percent) involved an alleged conflict of interest other than insider trading, whereas 29 of the private company suits (70.7 percent) involved such allegations.

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

111. See Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2061-64 (1995).

112. See 15 U.S.C. § 78u-4(a)(3) (2006).

113. See Richard A. Rosen, *The Statutory Safe Harbor for Forward-Looking Statements After Two and a Half Years: Has it Changed the Law? Has it Achieved What Congress Intended?*, 76 WASH. U. L.Q. 645, 671-72 (1998).

114. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 2, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.) (congressional findings).

115. *Id.*

shareholders from using these claims as a backdoor around the PSLRA.<sup>116</sup> Congress, however, did not use its preemption power to bar derivative suits,<sup>117</sup> even though these suits also often mirror the allegations in a securities class action. The end result of these statutory enactments is that Congress has drastically limited the ability of shareholders to file securities class actions—whether under federal or state law—but left intact their ability to file derivative suits. It is therefore not surprising that many shareholders are filing derivative suits that look quite similar to federal securities class actions.

My study revealed far fewer similarities between private company derivative suits and federal securities class actions. Instead, the private company suits looked more like typical business disputes. More than half involved allegations by a minority shareholder that a controlling shareholder had engaged in oppression or abuse of control.<sup>118</sup> Many of these cases also reflected struggles for control over the plaintiff corporations,<sup>119</sup> or claims that the individual defendants failed to comply with specific state requirements, such as quorum rules for meetings or the filing of particular corporate documents.<sup>120</sup>

In addition, few of the private company derivative suits included any of the traditional markers of securities fraud claims. Fewer than 5 percent of the suits included section 10(b) claims or allega-

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116. See 15 U.S.C. §§ 77p(b)-(c) (2006).

117. See *id.* § 77p(f)(2)(B).

118. Specifically, 23 of the 41 private company suits (56.0 percent) involved allegations of oppression and/or abuse of control. In contrast, only 9 of the public company suits (6.4 percent) included such allegations. A note about methodology is important here. Nearly all of the complaints—both public and private—included counts alleging oppression and/or abuse of control. These counts, however, rarely reflected the allegations made in the complaint. Specifically, when one examined the allegations, they did not include any of the typical hallmarks of an oppression claim, such as exclusion from management, withholding of dividends, paying excessive salaries to majority shareholders, and similar actions. See, e.g., *Kiriakides v. Atlas Food Sys. & Servs., Inc.*, 541 S.E.2d 257, 267-68 (S.C. 2001) (describing the “classic situation” of minority shareholder oppression, often referred to as “freeze out”). Accordingly, rather than categorizing every complaint with an allegation of oppression as an oppression case, I looked at the specific allegations included in the complaint to determine whether they encompassed key emblems of oppression and abuse of control.

119. Fourteen of these suits (34 percent) involved a struggle for control of the company.

120. Seven of the suits (17.1 percent) involved a claim that a specific action by the company was invalid.



tions of insider trading, and fewer than 15 percent of the suits alleged that the plaintiff company made misrepresentations in its financial documents.

This analysis reveals that derivative suit complaints in federal court fall into two camps. The public company suits bear a striking resemblance to securities class actions, with shareholders alleging that the defendants caused the corporation to violate accounting rules or mislead its investors. The private company suits, on the other hand, follow a different mold, reflecting more traditional business disputes or allegations of oppression. As both types of suits progress beyond the pleading stage, however, derivative plaintiffs face common procedural hurdles that distinguish all derivative suits from their securities law counterparts.

### *C. Procedural Hurdles in Derivative Suits*

In shareholder litigation, the filing of the complaint typically unleashes a wave of procedural battles. In securities class actions, these battles revolve around the adequacy of the plaintiffs' allegations. Federal law demands that shareholders in securities class actions satisfy an increasing array of pleading requirements that prevent approximately 45 percent of plaintiffs from having their day in court.<sup>121</sup> State law has chosen a different approach. Rather than heightening pleading requirements, states have enacted various procedural hurdles that allow the plaintiff corporation's board of directors to regain control over the litigation. My study explored the impact of the two primary procedural hurdles in derivative suits: the demand requirement and the special litigation committee.

#### *1. Demand in the Federal Courts*

The demand requirement is the first and most significant hurdle in a derivative suit. Prior to filing suit, the derivative plaintiff must

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121. Stephanie Plancich & Svetlana Starykh, *2008 Trends in Securities Class Actions*, NERA ECON. CONSULTING, Dec. 2008, at 7, available at [http://www.nera.com/image/PUB\\_Recent\\_Trends\\_Report\\_1208.pdf](http://www.nera.com/image/PUB_Recent_Trends_Report_1208.pdf).

make a demand on the corporation's board of directors, requesting that the board itself file the suit. As the Delaware Supreme Court held, this requirement reflects the "cardinal precept" of corporate law that "directors, rather than shareholders, manage the business and affairs of the corporation."<sup>122</sup> As long as the board of directors is composed of a majority of independent directors, it should decide whether the corporation should initiate litigation.<sup>123</sup>

In federal court, a mix of federal and state law governs the demand requirement. Under Rule 23.1 of the Federal Rules of Civil Procedure, plaintiffs must allege with particularity "any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members."<sup>124</sup> The U.S. Supreme Court held that this rule establishes only the procedural constraints underlying the demand requirement and does not establish substantive demand requirements.<sup>125</sup> Accordingly, state law governs when a derivative plaintiff in federal court is required to serve a demand on a corporate board prior to filing suit.<sup>126</sup>

Nearly all states require derivative plaintiffs to make a presuit demand upon the corporation.<sup>127</sup> Many states, however, waive this

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122. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

123. *In re Consumers Power Co. Derivative Litig.*, 132 F.R.D. 455, 465 (E.D. Mich. 1990) ("Whether to sue or not to sue is ordinarily a matter for the business judgment of directors, just as is the decision that the corporation will make bricks instead of bottles.") (internal quotations omitted).

124. FED. R. CIV. P. 23.1(b)(3)(A).

125. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96-97 (1990) (holding that Rule 23.1 "does not *create* a demand requirement of any particular dimension ... [i]n order to determine whether the demand requirement may be excused by futility in a derivative action founded on § 20(a) of the [Investment Company Act of 1940], we must identify the source and content of the substantive law that defines the demand requirement in such a suit").

126. *See id.* at 108 ("The scope of the demand requirement under state law clearly regulates the allocation of corporate governing powers between the directors and individual shareholders.").

127. *See, e.g.*, N.Y. BUS. CORP. LAW § 626(c) (1983) ("In any [shareholders' derivative] action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board."); TEX. CODE ANN. § 21.553 (Vernon 2008) ("A shareholder may not institute a derivative proceeding until the 91st day after the date a written demand is filed with the corporation."); VA. CODE ANN. § 13.1-672.1(B) (2008) ("No shareholders may commence a derivative proceeding until ... [a] written demand has been made to the corporation to take suitable action."); *see also infra* note 135 and accompanying

requirement if the derivative plaintiff alleges with particularity that the demand would have been futile, typically because a majority of the board could not have considered the demand in an impartial manner.<sup>128</sup> If the derivative plaintiff does not allege futility and instead makes a presuit demand on the board and the board rejects the demand (as it almost always does), the court will review the board's decision under the highly-deferential business judgment rule.<sup>129</sup> Accordingly, in jurisdictions that recognize demand futility, there is a strong incentive for plaintiffs to forgo demand and place all their chips on a futility defense. A number of states, however, have followed the lead of the Revised Model Business Corporation Act in imposing a universal demand requirement.<sup>130</sup> This requirement mandates that plaintiffs make a demand in all cases, eliminating the futility defense and (so the hope goes) the accompanying litigation.

My study examined how these different rules play out in practice. To address the impact of the demand requirement, I first examined the percentage of cases in which the plaintiff made a presuit demand. I excluded nine cases filed on behalf of foreign corporations because the demand rules were unclear in these foreign jurisdictions. Out of the 173 remaining cases, the derivative plaintiff made a presuit demand in 36 of the cases, or 20.8 percent. Put another way, despite the demand requirements adopted in nearly every state, the derivative plaintiff did not make a presuit demand in nearly 80 percent of the cases.

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text.

128. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 808 (Del. 1984), *overruled on other grounds* by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re Guidant S'holders Derivative Litig.*, 841 N.E.2d 571, 576 (Ind. 2008).

129. *Levine v. Smith*, 591 A.2d 194, 212 (Del. 1991), *overruled on other grounds* by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

130. See MODEL BUS. CORP. ACT § 7.42 (2003). This study counted the following states as universal demand jurisdictions: Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Iowa, Maine, Massachusetts, Michigan, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, Pennsylvania, Rhode Island, Texas, Utah, Virginia, Wisconsin, and Wyoming. In Texas, the relevant statute recognizes a futility exception only in derivative suits filed on behalf of closely held corporations. See TEX. BUS. CORP. ACT ANN. art. 5.14(L) (Vernon 2003). All of the Texas companies in my study are public, and I accordingly coded them all as universal demand cases.

The vast majority of the cases were governed by law that recognized a futility exception to the demand requirement. This is not surprising given that 98 of the plaintiff corporations in my study (53.2 percent) were incorporated in Delaware, and Delaware has long recognized a futility exception.<sup>131</sup> Of the 24 cases subject to a universal demand requirement, the derivative plaintiff complied with this requirement in only 13 of the cases, or 54 percent of the universal demand cases, a figure that indicates that universal demand requirements do not necessarily lead to universal demands.

On the other hand, universal demand requirements do increase the likelihood of a presuit demand. Of the 149 cases not subject to a universal demand requirement, the derivative plaintiff made a demand in only 23 of the cases, or 15.4 percent. This data suggests that universal demand requirements greatly increase the number of cases in which the board has an opportunity to take control of the suit on the front end. Even in universal demand jurisdictions, however, this opportunity is never guaranteed.

Nor do universal demand requirements eliminate litigation fights over demand. In the eleven universal demand cases in which the derivative plaintiff did not make a presuit demand, the defendants filed a motion to dismiss on this basis in five of the cases, or just under half. It is impossible to draw definitive conclusions from this small sample, but it is interesting to note that overall, demand was an issue of contention in more than 20 percent of the universal demand cases—the same cases in which demand was not supposed to be a subject of dispute. The court ruled on four of these motions and dismissed three cases on this basis.<sup>132</sup>

Universal demand requirements may not eliminate litigation over demand, but they certainly do reduce it. In the cases not subject to a universal demand requirement, the defendants moved to dismiss in more than half of those in which the derivative plaintiff did not make a presuit demand. Although several suits

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131. *Aronson*, 473 A.2d at 808.

132. In the fourth case, the court acknowledged that the applicable state law did not recognize a futility defense, but held that demand was excused under a different exception to the demand requirement. See *Nedler v. Vaisberg*, 427 F. Supp. 2d 563, 571, 573 (E.D. Pa. 2006).

settled or were voluntarily dismissed while the motion was pending, the court dismissed nearly 80 percent of the cases (22 out of 28) in which it ruled on this issue. Couched more broadly, however, these figures also show that only 25 out of the 182 cases in this study (13.7 percent) were dismissed because the plaintiff failed to make a presuit demand. Another five cases were dismissed because the plaintiff made a presuit demand, but the board rejected the plaintiff's demand and this decision was protected by the business judgment rule or the plaintiff did not give the board sufficient time to consider the demand.

These findings highlight the curious role of demand requirements in federal derivative suits. Parties spend significant time and money fighting over the issue, but in the end, relatively few cases turn on it. Interestingly, a similar point can be made about the other key procedural hurdle in derivative suits—special litigation committees.

## *2. Special Litigation Committees*

Derivative plaintiffs who prevail on the issue of demand face yet another procedural hurdle. All fifty states allow the plaintiff corporation to appoint a committee of independent directors, called a special litigation committee or SLC, to review the allegations in a derivative complaint and determine whether the suit is in the best interests of the corporation.<sup>133</sup> If the SLC determines that the suit is not in the plaintiff corporation's best interests, it will recommend that the court stay or dismiss the suit.<sup>134</sup> If the SLC determines that the suit is in the plaintiff corporation's best interests, it will typically recommend that the SLC take control of the suit and pursue redress against the individual defendants.<sup>135</sup>

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133. See 2 MODEL BUS. CORP. ACT § 8:25, at 8-146 (Supp. 2002); DAN K. WEBB ET AL., CORPORATE INTERNAL INVESTIGATIONS § 3.03[d], at 3-54 (2009).

134. See WEBB ET AL., *supra* note 133, § 3.03[d], at 3-54.

135. See *id.*

Despite scholarly interest in SLC decision making,<sup>136</sup> the conventional wisdom is that SLC decisions are rare and that, in those few instances in which an SLC does reach a decision, the decision is predictably in favor of the plaintiff corporation.<sup>137</sup> Indeed, Robert Thompson and Randall Thomas's study of derivative suits filed in Delaware state court found only a few cases in which the plaintiff corporation utilized an SLC and only one case in which an SLC made a recommendation that led to dismissal of the suit.<sup>138</sup> Other research has challenged this finding, with one recent study concluding that SLCs may be more likely to recommend that the plaintiff corporation pursue or settle derivative claims than prior research has recognized.<sup>139</sup>

My study found that a relatively high number of plaintiff corporations formed an SLC, but that few of these SLCs issued a report and even fewer cases were dismissed on the basis of such a report. In my study, the plaintiff corporation formed an SLC in 41 of the 182 total cases in the study (22.5 percent).<sup>140</sup> Nearly all of these suits involved public companies, suggesting that SLCs are not significant players in private company suits. The SLCs, however, issued a report or similar document in only 17 of these cases (41.4 percent). These 17 cases produced a total of 13 reports because a few cases involved the same corporation and a single report.<sup>141</sup> In

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136. See, e.g., Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309 (2009); Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305 (2005); Lawton W. Hawkins, *Exchange-Enhanced Special Litigation Committees: Enforcing Fiduciary Duties Amid a Crisis of Trust*, 2003 UTAH L. REV. 587.

137. See, e.g., 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.10 cmt. d (1994) ("Commentators have emphasized that a consistent pattern has surrounded the use of the special litigation committee: once such a committee is formed to review the merits of the litigation, the outcome of the process is generally a foregone conclusion—namely, dismissal of the action is recommended against all defendants.").

138. See Thompson & Thomas, *supra* note 3, at 1781.

139. See Myers, *supra* note 136, at 1311.

140. This is a conservative estimate because it only includes cases in which an SLC is mentioned in the case filings. There may be many more cases in which the plaintiff corporation formed an SLC, but did not inform the court that it had done so.

141. There were two instances in which a single report was filed in three separate, nonconsolidated cases filed on behalf of the same corporation. As an aside, the SLCs in my study were relatively small, ranging in size from one to nine committee members. The median number of committee members was two.

the remaining 24 cases, the case either settled or was dismissed before the SLC issued its report.

By and large, the SLCs in my study recommended dismissal of the claims. In the 17 cases in which an SLC issued a report and recommendation, the SLC recommended pursuing claims against one defendant in only one of the cases. In three cases, the SLC recommended settling with one or more individual defendants.<sup>142</sup> In all of the cases, the SLC recommended dismissing the claims against at least one (and usually more than one) defendant. The SLCs gave fairly predictable grounds for their recommendations, ranging from the legal merits of the claims to the distraction of key personnel, the impact of the derivative suit on parallel litigation, and the costs of pursuing the claims.<sup>143</sup> Interestingly, several SLCs did conclude that individual defendants engaged in wrongdoing, especially in the stock option cases, but concluded that pursuing the suit was nonetheless not in the best interests of the plaintiff corporation because of the cost or negative publicity of litigation.<sup>144</sup>

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142. See, e.g., Notice of Motion and Motion by the Special Litigation Committee of KLA-Tencor's Board of Directors, (A) to Terminate and Dismiss the Amended Consolidated Complaint, and (B) to Approve Settlements With Certain Individuals at 1, *In re* KLA-Tencor Corp. S'holder Derivative Litig., No. 5:06-cv-03445, 2008 WL 1907583 (N.D. Cal. Mar. 25, 2008); UnitedHealth Group Inc. Report of the Special Litigation Committee at 60, 63, *In re* UnitedHealth Group Inc. S'holder Derivative Litig., No. 0:06-cv-01216-JMR-FLN, 2007 WL 4298730 (D. Minn. Dec. 6, 2007); Report of the Special Litigation Committee of the Board of Directors of Rambus, Inc. at 1-2, *In re* Rambus, Inc. Derivative Litig., No. 5:06-cv-03513-JF (N.D. Cal. Oct. 5, 2007) [hereinafter Rambus Special Committee Report].

143. See, e.g., Rambus Special Committee Report, *supra* note 142, at 18 ("[T]he Company ... is subject to a pending shareholder class action ... asserting federal securities fraud claims. The Company's interest in the securities fraud action[ ] will not be well served by providing the Company's litigation opponents with a substantial amount of work product generated by the SLC's counsel. Accordingly, this report states the SLC's conclusions.... It does not, however, set forth the specific factual findings that led the SLC to these conclusions."); Report of the Special Litigation Committee of Nominal Defendant Take-Two Interactive Software, Inc. at 88, *St. Clair Shores Gen. Employees Ret. Sys. v. Eibeler*, No. 06-cv-0688 (MBM) (HBP) (S.D.N.Y. Mar. 23, 2007) (recommending dismissal of all claims based on the legal merits of the claims and "the expense and attendant disruption to the Company's management that continued pursuit of such claims would necessarily entail").

144. See, e.g., UnitedHealth Group Inc. Report of The Special Litigation Committee, *supra* note 142, at 59-60 ("Although the SLC concluded that some of the claims against Dr. McGuire may have merit, it also considered the costs and risks attendant to protracted ongoing litigation against him ... [including] the disruption of, and distraction from, the ongoing business of the Company as a result of litigation against its former Chief Executive Officers; the significant costs that the Company would bear in connection with such litigation; and Dr.

Although the plaintiff corporation filed a motion to dismiss on the basis of the SLC's recommendation in all seventeen cases, the court ruled on the motion in only six of these cases. In the remaining cases, the parties settled prior to a ruling on the SLC's recommendation or the court dismissed the case on other grounds. In the six cases in which the court ruled on the recommendation, the court granted the motion and dismissed the case in five cases. In the sixth case, the court denied the motion, holding that one of the two SLC members was not independent.

In short, the two procedural hurdles discussed here—the demand requirement and special litigation committees—were major sources of battle for many parties in my study. Less than 20 percent of the cases, however, were dismissed as a result of these two hurdles.<sup>145</sup> The larger question remains: what was the resolution of the remaining derivative suits in the study?

#### *D. Four Paths to Resolution*

Scholars and commentators have long criticized derivative suits as nuisance or strike suits.<sup>146</sup> The data is now available to test this criticism. Put simply, the key question is whether derivative suits benefit plaintiff corporations. If the evidence indicates that derivative suits do benefit plaintiff corporations, these suits can take their rightful place as a valuable tool in corporate governance. On the other hand, if the criticism is justified, then the time has

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McGuire's potential rights to advancement of fees and indemnification by the Company.”).

145. Of course, SLCs can benefit plaintiff corporations even if the case is not dismissed on the basis of the SLC report. SLCs typically conduct an investigation of the allegations in the complaint, and this investigation can be beneficial even if the case settles or is dismissed before the SLC files its report. Additionally, the SLC process itself may facilitate settlement simply because it presents the risk (in the eyes of derivative plaintiffs) that the SLC will issue a report concluding that the suit is not in the best interests of the corporation.

146. See, e.g., Thompson & Thomas, *supra* note 3, at 1758 (explaining that the different incentives of plaintiff corporation and the attorneys “have created the possibility of strike suits or, as they are sometimes called, nuisance suits”); Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 357 (1994) (“Traditionally, the debate over frivolous shareholder suits has focused to a large extent on the shareholder derivative suit rather than on direct shareholder actions.”); Sarah Wells, *Maintaining Standing in a Shareholder Derivative Action*, 38 U.C. DAVIS L. REV. 343, 349 (2004) (arguing that courts presiding over derivative suits “are concerned with thwarting potential strike suits to blackmail the corporation”).



come to re-evaluate the role of derivative suits in corporate law. Nearly all of the suits in my study (170 out of 182, or 93.4 percent) have been resolved.<sup>147</sup> These suits ended in one of four ways: (1) judgment, (2) involuntary dismissal, (3) voluntary dismissal, or (4) settlement. This Section explores the resolution of these cases with an eye toward assessing the continued role of derivative suits in corporate law.

### *1. Judgment*

Only two suits in the study ended with a judgment favorable to the plaintiff corporation, and both suits were filed on behalf of private corporations. In the first suit, the derivative plaintiffs sued on behalf of Plaintiffs' Shareholders Corporation, a corporation that was formed pursuant to an earlier securities class action settlement involving Southern Farm Bureau Life Insurance Co. (Southern Life).<sup>148</sup> The sole defendant in the derivative suit was Southern Life, which was alleged to have made false and misleading statements to the plaintiff corporation in connection with the purchase of an investment vehicle.<sup>149</sup> Following an eight-day trial, the jury concluded that Southern Life had violated the federal securities laws and awarded \$31.7 million to the plaintiff corporation, a verdict that the district court upheld.<sup>150</sup> This was the only trial in my study, reflecting the larger phenomenon of the "vanishing trial" in the U.S. judicial system.<sup>151</sup>

The second case involved a derivative suit filed on behalf of a small private corporation named Pipeanum Technologies, Inc.<sup>152</sup> The sole defendant in the suit was Pipeanum's president and sole

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147. Many of these cases appear to have been abandoned or have been stayed for years pending resolution of a parallel securities class action or other lawsuit. Others are in discovery or other pre-trial proceeding.

148. See Class Action Complaint at 2-3, *Badger v. S. Farm Bureau Life Ins. Co.*, No. 6:06-cv-637 (M.D. Fla. May 11, 2006).

149. See *id.* at 2.

150. See Plaintiffs' Motion to Alter or Amend the Final Judgment for the Imposition of Prejudgment Interest and Incorporated Memorandum of Law at 2, *Badger*, No. 6:06-cv-637.

151. See generally Marc Galanter, *The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts*, 1 J. EMPIRICAL LEGAL STUD. 459 (2004).

152. Third Amended Complaint, *Brown v. Pownall*, No. 05-0496 (D. Nev. Oct. 31, 2006).

director, who allegedly converted corporate funds for his own personal use and then fled to Canada.<sup>153</sup> After the defendant failed to respond to the complaint, the court entered a default judgment in favor of the individual shareholders personally, not in favor of the plaintiff corporation.<sup>154</sup>

Thus, two suits in my sample ended with the vindication of the plaintiffs' claims, although the plaintiff corporation only received compensation in one. None of the 141 public company suits in my study went to trial or ended with a judgment in favor of the plaintiff corporation. Accordingly, any value in these suits must come from other types of resolution.

## *2. Involuntary Dismissals*

An additional 43 percent of the resolved suits (73 out of 170) in my study were involuntarily dismissed by the court.<sup>155</sup> These involuntary dismissals almost always turned on procedural grounds, rather than the merits of the derivative plaintiff's claims. As stated above, 25 of the derivative suits (14.7 percent of the resolved suits) were dismissed because the plaintiff failed to make a presuit demand on the board of the plaintiff corporation. An additional five suits were dismissed because the board rejected the derivative plaintiff's demand or the derivative plaintiff did not wait the appropriate time after making a demand before filing suit. Five suits were dismissed on the basis of an SLC report.

An additional 36 suits were dismissed for other procedural reasons<sup>156</sup>:

- 12 suits were dismissed for lack of jurisdiction;<sup>157</sup>

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153. *Id.* at 4, 8-13.

154. Such direct recovery by shareholders is not unprecedented. *See* Thompson & Thomas, *supra* note 3, at 1777 (noting that "[d]erivative litigation has long provided for direct recovery within a derivative suit").

155. This Section refers to the ultimate termination of the suit. I have not included procedural rulings when the case continued after the derivative plaintiff filed an amended complaint.

156. A small number of suits were dismissed on multiple grounds.

157. In several cases, the derivative plaintiff attempted to get into federal court by alleging a claim under § 304 of the Sarbanes-Oxley Act of 2002. In many of these cases, the court held that there was no private right of action under § 304 and then declined to exercise

- 9 cases were dismissed when the derivative plaintiff did not have or lost standing, generally because of a merger or sale of the plaintiff corporation;
- 8 cases were stayed or dismissed when the plaintiff corporation filed for bankruptcy;
- 6 cases were dismissed for lack of prosecution;
- 1 case was dismissed because the court determined that the derivative plaintiff was not an adequate representative of the plaintiff corporation.<sup>158</sup>

A far smaller percentage of the cases (4.8 percent, or 8 cases) was dismissed because the court found fatal deficiencies in the substantive legal merits of the claims.

These dismissal rates are similar to the dismissal rates in securities class actions,<sup>159</sup> but are much higher than the comparable figures in civil litigation more generally. According to data from the Federal Judicial Center, less than 20 percent of federal civil cases nationwide end with an involuntary dismissal.<sup>160</sup> The data from the Federal Judicial Center are older than the data in my study,<sup>161</sup> but they reflect more than thirty years of federal litigation between 1970 and 2001. Over this thirty year period, the rate of involuntary dismissals ranged between the most recent low of approximately 17 percent to a high in the early 1980s of approximately 24 percent.<sup>162</sup> Notably, during this entire period, the involuntary dismissal rate never rose above 25 percent.<sup>163</sup>

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supplemental jurisdiction over the remaining claims. The plaintiffs may have re-filed these suits in state court. Records of state court suits are not available on PACER and were outside the scope of my study.

158. Rule 23.1(a) provides that “[t]he derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.” FED. R. CIV. P. 23.1(a).

159. *See supra* note 102.

160. Gillian K. Hadfield, *Where Have All the Trials Gone? Settlements, Nontrial Adjudications, and Statistical Artifacts in the Changing Disposition of Federal Civil Cases*, 1 J. EMPIRICAL LEGAL STUD. 705, 720 fig.5 (2004).

161. Hadfield’s analysis of the Federal Judicial Center’s data examined involuntary dismissal rates between 1970 and 2001. *See id.* Due to missing data, she was unable to examine data between 1971 and 1979. *See id.* at 710.

162. *See id.* at 720 fig.5.

163. *See id.*

Do these figures indicate that derivative suits are less meritorious than the average civil case in federal court? Perhaps not, given that nearly all of the derivative suit dismissals were on procedural grounds. The judges in these cases did not conclude that the allegations lacked merit. They simply concluded that the derivative plaintiffs could not overcome the steep procedural hurdles in derivative suits. On the other hand, it is difficult to see how these suits benefitted the plaintiff corporations. In many of these suits, the corporations likely paid significant legal fees and devoted managerial resources to litigate a case that ultimately provided no tangible benefit to the corporation.<sup>164</sup>

A note of caution is appropriate here. The involuntary dismissal data, along with the voluntary dismissal data below, present a compelling case that derivative suits are broken. This does not mean that the underlying claims lacked merit or that corporate managers do not engage in misconduct. Certainly there are cases in which officers and directors violate their fiduciary duties. The goal of this Article is to examine whether derivative suits are operating as an effective mechanism to enforce these duties. An involuntary dismissal rate that is more than twice as high as the rate in civil litigation generally suggests that they are not.

### *3. Voluntary Dismissals*

The next category—voluntary dismissals—inspires even less confidence in derivative suits. Rule 41 of the Federal Rules of Civil Procedure permits a plaintiff to dismiss a suit without court approval by filing a notice or stipulation of dismissal.<sup>165</sup> In essence, a voluntary dismissal is a dismissal as a result of the plaintiff simply walking away from the case. One-quarter of the suits in my study were voluntarily dismissed by the derivative plaintiff.<sup>166</sup> More

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164. It is possible that the mere filing of the derivative suits provides some benefit, even if the suits end with no tangible relief. I discuss this possibility below in Part III.C.

165. See FED. R. CIV. P. 41(a)(1).

166. Specifically, 42 out of the 170 resolved suits (24.7 percent) were voluntarily dismissed. In a number of additional cases, the plaintiff filed a notice of dismissal after the plaintiff corporation filed for bankruptcy, the court dismissed the claims, or the claim was revealed to be legally deficient in some fatal way (such as a lack of standing after the plaintiff corporation merged). In these instances, I classified the case as an involuntary dismissal

of the private company suits (29.7 percent) were voluntarily dismissed than the public company suits (23.3 percent).<sup>167</sup>

Once again, these percentages are far higher than in civil litigation more generally. According to data from the Federal Judicial Center, slightly more than 10 percent of all federal civil cases are voluntarily dismissed every year, a figure that has held fairly steady since the early 1990s.<sup>168</sup> Accordingly, while relatively few civil plaintiffs abandon their lawsuits, one-quarter of derivative plaintiffs do so.

This phenomenon is disturbing for two reasons. First and foremost, it is difficult to see how a derivative suit that is voluntarily dismissed benefits the plaintiff corporation. This is especially true when the voluntary dismissal comes after protracted litigation—as many of the dismissals in my study did—forcing the plaintiff corporation to spend considerable time and money participating in the litigation only to see the suit come to a sudden end.<sup>169</sup> Moreover, voluntary dismissals likely erode the deterrent power of derivative suits, contributing to the already widespread belief among corporate officers and directors that these suits are nothing more than strike suits.

Second, many of the voluntary dismissals violated Rule 23.1 of the Federal Rules of Civil Procedure. Rule 23.1(c) provides that “[a] derivative action may be settled, *voluntarily dismissed*, or compromised *only with the court’s approval*. Notice of a proposed settlement, voluntary dismissal, or compromise must be given to shareholders or members in the manner that the court orders.”<sup>170</sup>

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rather than a voluntary dismissal. In addition, I did not code a case as a voluntary dismissal where claims against only a few defendants were voluntarily dismissed, if the rest of the suit continued.

167. It is difficult to determine whether these plaintiffs refiled their suits in another court or whether other plaintiffs pursued similar claims elsewhere. As discussed above, PACER is not searchable, and therefore it is difficult to track related litigation through the federal judicial system.

168. Hadfield, *supra* note 160, at 721 fig.6.

169. See *infra* Part II.D.4.b for a discussion of the plaintiff corporation’s costs in a derivative suit.

170. FED. R. CIV. P. 23.1(c) (emphasis added). Rule 23.1 was amended in 2007 as part of the stylistic amendments to the federal rules. FED. R. CIV. P. 23.1 advisory committee’s notes (2008). The prior version of the rule stated that a derivative suit “shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or

The rule contemplates that the judge will order briefing regarding the merits of the dismissal followed by a hearing at which shareholders opposed to the dismissal can challenge it.<sup>171</sup> This rule is designed to prevent collusive settlements cloaked as dismissals when, for example, the individual defendants pay the attorneys for the derivative plaintiff to dismiss the suit without any benefit going to the plaintiff corporation.<sup>172</sup>

Only two cases in my study (4.8 percent of the voluntary dismissals) complied with the mandate of this rule.<sup>173</sup> In many of the remaining cases, the parties simply submitted a short notice of voluntary dismissal and the court dismissed the case without further inquiry or analysis.<sup>174</sup> In seven of these cases, the court agreed with the parties—typically without any written analysis—that notice and hearing were not necessary.

Did these voluntary dismissals mask settlements that should have been subject to judicial scrutiny? In approximately 40 percent of the voluntary dismissals (18 out of 42) the parties represented to the court that they would bear their own attorneys' fees and costs, suggesting (although certainly not conclusively) that the parties did not secretly settle the suit.<sup>175</sup> Many of the remaining suits, however,

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compromise shall be given to shareholders or members in such manners as the court directs." FED. R. CIV. P. 23.1 (2005). This amendment did not make any substantive changes to the rule.

171. 7C CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE & PROCEDURE § 1839, at 197-99 (3d ed. 2007).

172. *See id.* at 195-96.

173. Interestingly, Robert Garber filed both cases. Garber is the shareholder discussed earlier who filed more than twenty-five derivative suits and who the court determined to be "appallingly ignorant of the many derivative actions that have been filed in his name." *See supra* notes 72-73 and accompanying text. In both cases, Mr. Garber decided, after months or even years of litigation, that he no longer wanted to pursue the litigation. *See* Memorandum of Law in Support of Unopposed Motion for Voluntary Dismissal of Action at 1, *In re Avon Prods., Inc. Sec. Litig.*, No. 05-6803 (S.D.N.Y. Feb. 11, 2009); Order Regarding Dismissal of Action at 1, *Garber v. Paulson*, No. 05-9327 (S.D.N.Y. Nov. 17, 2008). In one case, this decision followed the court's expression of skepticism regarding Mr. Garber's litigation history and an order that he be deposed to determine "his qualifications to maintain th[e] action ..., the history of his involvement in this litigation, and the history of his relationship with the Robbins Umeda & Fink law firm." Order, *supra*, at 1-2.

174. In a few additional cases, the parties asked the court to waive the notice and hearing requirements because they were not warranted in the particular case (for example, because all of the shareholders were before the court).

175. Such a representation does not guarantee that the parties did not settle the suits

trigger more suspicion. In these cases, the parties filed a joint notice of dismissal simply informing the court that the case had ended, often after protracted and heated litigation.<sup>176</sup> The derivative plaintiffs in these cases may have decided not to pursue suits that they realized they could not win. Yet it is unlikely that all of these plaintiffs would simply walk away from ongoing litigation that they had previously fiercely contested, suggesting that at least some of these dismissals were actually settlements. Regardless of whether they settled or just dismissed the cases, however, the parties did not comply with the mandate of Rule 23.1.

This analysis returns full circle to the question with which we began: do federal derivative suits have merit? As we have seen, nearly 70 percent of the resolved cases in my study ended with an involuntary or voluntary dismissal—resolutions that do not provide any significant tangible benefit to the plaintiff corporations. Aside from the two private company cases that ended with a favorable judgment for the plaintiff corporation, any value from derivative suits will have to come from the last category of case resolution, the settlements.

#### *4. Settlements*

Approximately 30 percent of the resolved cases in my study—53 out of 170 cases—ended with a settlement.<sup>177</sup> This percentage is far less than the percentage of settled suits in civil litigation more generally. A recent study by Theodore Eisenberg and Charlotte Lanvers found that approximately 67 percent of federal civil suits

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because the defendants could have paid the settlement and the derivative plaintiff could have then used this money to pay its fees and other costs.

176. The voluntary dismissals in my study came anywhere between two to forty-nine months after the filing of the complaint. The median length of the suits that were voluntarily dismissed was eleven months.

177. I have included two settlements in the category that have obtained preliminary, but not final, approval from the court as well as two settlements that (at the time this Article went to press) had been submitted to the court but had not received preliminary or final approval. The notice and hearing process can take several months, and it is rare for judges to reject a settlement proposed by the parties. Accordingly, I have included these settlements to get a more complete view of settlements in derivative suits. It is obviously possible, although unlikely, that these settlements will change.

settle.<sup>178</sup> Eisenberg and Lanvers limited their study to two federal district courts,<sup>179</sup> but this disparity again raises difficult questions about the benefits of derivative suits. As Eisenberg and Lanvers note, settlement is the “most common successful outcome for plaintiffs,”<sup>180</sup> and the low settlement rate in derivative suits, coupled with the lack of trials or other favorable judgments, means that relatively few derivative suits lead to a successful outcome for the plaintiff corporation.<sup>181</sup>

The 53 settlements in my study include 11 private company settlements and 42 public company settlements. These two categories of settlements differ to such an extent that it makes sense to address each category separately to draw broader conclusions about the role of derivative suits in the public and private spheres.

#### *a. Private Company Settlements*

The private company settlements raise the same Rule 23.1 concerns described above, albeit with a small sample size. Eight of the eleven cases settled without the parties providing the courts with any information about the settlements. Rule 23.1 requires court approval of settlements in derivative suits and contemplates that the court will conduct a careful review of the settlements prior to approving them.<sup>182</sup> The significant number of cases that did not follow this procedure, this time in the settlement context, further illustrates that parties in the federal courts are often ignoring the constraints of the federal rules—and that judges are letting them.

On the other hand, the fear of collusion may not have been significant in these cases. Private companies tend to have a smaller number of shareholders who are more likely to be involved in the corporation’s day-to-day management. Given this watchful eye, it is less likely that a few shareholders could reach a collusive

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178. Eisenberg & Lanvers, *supra* note 12, at 115.

179. *Id.* at 111.

180. *Id.* at 112.

181. Of course, as discussed above, the actual settlement rate may be higher than 30 percent if some of the voluntary dismissals discussed above are actually settlements.

182. See FED. R. CIV. P. 23.1; see also *supra* notes 170-75.



settlement with the individual defendants at the expense of the plaintiff corporations. Nonetheless, Rule 23.1 does not create any exceptions for settlements in private companies, nor is there any guarantee that these settlements benefitted the plaintiff companies.<sup>183</sup>

The parties provided the court with information about the settlements in only three of the private company cases. None of these settlements involved the payment of money to the plaintiff corporation. In the first suit, the parties agreed to appoint a receiver to manage the plaintiff corporation.<sup>184</sup> In the second suit, the settlement agreement required the plaintiff corporation to buy the shares of the derivative plaintiffs.<sup>185</sup> This settlement obviously benefitted the derivative plaintiffs, who were able to escape the difficulties of a minority position in a closely held corporation.<sup>186</sup> The settlement also may have benefitted the plaintiff corporation by allowing it to rid itself of divisive shareholders and move forward with a more united shareholder vision for the corporation. In the final suit, one plaintiff in a larger ERISA case brought derivative claims, and the suit ended with a portion of the settlement funds going to settle a Department of Labor suit, with the remaining money distributed to ESOP participants and beneficiaries.<sup>187</sup>

We can put the settlement figures together with the figures from the previous sections to obtain a broader picture of derivative suits brought on behalf of private companies. Of the 41 suits filed on behalf of private companies, 2 suits (4.9 percent) ended with a judgment in favor of the plaintiff corporation or its shareholders. Thirteen suits (31.7 percent) ended with an involuntary dismissal,

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183. See FED. R. CIV. P. 23.1.

184. See Joint Motion for Stipulated Judgment in Favor of Plaintiff on Count One and Dismissal of All Other Claims, *Fleet Dev. Ventures, LLC v. Brisker*, Case No. 3:06-cv-0570 (D. Conn. Nov. 3, 2008).

185. See Amended Order, *Nedler v. Vaisberg*, No. 05-cv-2976 (E.D. Pa. Dec. 12, 2008); Stipulated Consent Order, *Nedler v. Vaisberg*, No. 05-cv-2976 (E.D. Pa. Feb. 13, 2008).

186. See, e.g., Benjamin Means, *A Voice-Based Framework for Evaluating Claims of Minority Shareholder Oppression in the Close Corporation*, 97 GEO. L.J. 1207, 1217 (2009) (explaining that the plight of minority shareholders in close corporations turns on the "critical fact" that these shareholders have no exit strategy).

187. See Memorandum in Support of Motion for Preliminary Approval of Settlement and For a Fairness Hearing, *Johnson v. Couturier*, No. 2:05 cv-02046 RRB GGH LE.D.Cal. (E.D. Cal. Jan. 5, 2010).

while another 11 suits (26.8 percent) ended with the derivative plaintiff voluntarily dismissing the suit. As discussed above, given the litigants' failure to comply with Rule 23.1, it is impossible to know whether the voluntary dismissals were actually settlements or if the derivative plaintiffs simply dropped the suits. Another 11 suits (26.8 percent) settled, but 8 of these settlements did not comply with Rule 23.1 and accordingly no information is available about these suits either. Four suits (9.8 percent) are still pending. Table 1 provides the outcome of the private company suits in my study.

<b>Table 1: Outcome of Private Company Derivative Suits</b>	
<b>Outcome</b>	<b>Number of Suits (Percent)</b>
Favorable Judgments	2 (4.9%)
Involuntary Dismissals	13 (31.7%)
Settlements	11 (26.8%)
Voluntary Dismissals	11 (26.8%)
Still Pending	4 (9.8%)
<b>Total</b>	<b>41 suits</b>

In short, given the lack of compliance with Rule 23.1, not much information is available about private company suits. My study does not reveal many documented benefits for the plaintiff companies in these suits, but these benefits may simply be hidden in private settlements. Greater compliance with Rule 23.1 would provide more information about these suits, in addition to promoting the goal, inherent in the rule itself, of protecting the interests of plaintiff corporations and their shareholders.

*b. Public Company Settlements*

Far more information is available about the public company suits in my study. Overall, 42 of the 141 public company suits (29.8 percent) settled. Sixty of the public company suits (42.6 percent) were involuntarily dismissed. Another 31 suits (22 percent) were voluntarily dismissed. Only 8 suits (5.7 percent) are still pending. As Table 2 demonstrates, the classic suits in my study fared worse than the stock option suits.

<b>Table 2: Outcome of Public Company Derivative Suits</b>			
<b>Outcome</b>	<b>Classic Suits</b>	<b>Stock Option Suits</b>	<b>All Public Company Suits</b>
Involuntary Dismissals	48 (48%)	12 (30%)	60 (43%)
Voluntary Dismissals	23 (23%)	8 (20%)	31 (22%)
Settlements	25 (25%)	17 (43%)	42 (30%)
Still Pending	5 (5%)	3 (7.5%)	8 (5.7%)
<b>Total</b>	<b>101</b>	<b>40</b>	<b>141</b>

Nearly all of the public company settlements fell into three categories: (1) money, (2) corporate governance reforms, or (3) a combination of the two.<sup>188</sup> Only 4 settlements (9.5 percent of the settlements) involved the payment of money to the plaintiff corporation, without any accompanying corporate governance reforms. The settlements in 18 suits (42.9 percent) included the

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188. Three of the 42 public company settlements did not fall into these categories, either because the parties did not provide the court with any information regarding the settlements or because the derivative claims were simply folded into the settlement of parallel claims, resulting in no independent relief for the plaintiff corporation.

payment of money or other financial consideration, as well as corporate governance reforms. In another 17 suits (40.5 percent), the only consideration for the settlement was corporate governance reforms.

The most promising settlements, in terms of value for the plaintiff corporations, are the 22 settlements with a financial component. Yet even these settlements often did not involve the payment of cash to the plaintiff corporation. In fact, the plaintiff corporation only received a cash payment in 13 of these settlements.<sup>189</sup> The defendants in many of these cases made substantial payments, often totaling several million dollars.<sup>190</sup> In the derivative suit arising out of the stock options backdating scandal at Affiliated Computer Services, for example, the company received \$30 million in cash from the individual defendants' insurance company.<sup>191</sup> In the derivative suit filed on behalf of Apple Inc., the defendants' insurance company agreed to pay a lump sum of \$14 million to settle the derivative suit, \$5.15 million of which went to Apple itself.<sup>192</sup> The remaining \$8.85 million went to the plaintiffs' attorneys.<sup>193</sup> Importantly, however, 12 of the 13 cases in which the plaintiff corporation received a cash payment were stock option cases, or cases in which the derivative plaintiff alleged that the defendants had backdated stock options. Only 1 of the 101 suits that I have termed classic derivative suits involved a cash payment to the plaintiff corporation.<sup>194</sup>

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189. Stated differently, the plaintiff corporation received cash in 9.2 percent of the public company suits. In a few additional cases, the defendants agreed to relinquish a severance package or other nominal benefits.

190. These cash payments often consisted of repayment of improperly priced stock options.

191. See Unopposed Joint Motion for Preliminary Approval of Settlement at 1-2, 6, *In re Affiliated Computer Servs. Derivative Litig.*, No. 06-1110 (N.D. Tex. May 6, 2009).

192. *Apple Officers Settle Shareholders Suits for \$14 Million*, REUTERS, Sept. 10, 2008, available at [www.reuters.com/articlePrint?articleId=USN1049004420080910](http://www.reuters.com/articlePrint?articleId=USN1049004420080910).

193. *Id.*

194. This case is *In re Escala Group, Inc. Derivative Litigation*, No. 1:06-cv-03902 (S.D.N.Y. Sept. 10, 2008). Pursuant to the settlement agreement, the plaintiff corporation received \$3.5 million from the insurer of the defendant directors and officers and an additional \$2 million from a defendant accounting firm. See Stipulation of Settlement at 11-12, *In re Escala Group, Inc. Derivative Litig.*, No. 1:06-cv-03902, AKH (S.D.N.Y. Sept. 10, 2008). Even in this case, however, it does not appear that the plaintiff corporation was able to keep the money. The settlement of the derivative suit was part of a global settlement that included settlement of a securities class action in which the corporation agreed to pay \$10

Additionally, 13 of the financial settlements included the repricing or forfeiture of stock options by the individual defendants, either in addition to or instead of direct cash payments.<sup>195</sup> Although the individual defendants did not have to write a check in these cases, these cases often had significant estimated value to the plaintiff corporations. In the derivative suit filed on behalf of UnitedHealth Group, Inc., for example, the parties estimated that the value of the repriced and cancelled stock options was approximately \$900 million, making it the largest settlement ever in a derivative suit.<sup>196</sup> In the other cases, the estimated value of the repriced or cancelled options was much smaller, but several exceeded \$10 million. Not surprisingly, all of these settlements occurred in cases involving the alleged backdating of stock options.

The benefits of the derivative suits are more attenuated in examining the six financial settlements that included neither an outright payment of cash to the plaintiff corporation nor the repricing or cancellation of stock options. The financial component in these cases fell into one or both of the following categories. In one case, the plaintiff corporation received a cash payment from its insurance company, but had to turn around and pay this entire amount to the attorneys for the derivative plaintiffs.<sup>197</sup> Although the corporation nominally received a financial benefit, the attorneys were the only ones who ended up with money in their pockets.

In other cases, the settlement agreement purported to place limitations on the amount of money that the plaintiff corporations would have to pay in parallel litigation in which they were the defendants or included payment of insurance funds to settle

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million in cash and stock to the class, far more than it received from the defendants in the derivative suit. *See* Escala Group, Inc., Current Report (Form 8-K), at 1 (May 30, 2008).

195. Nine cases included both the payment of cash to the plaintiff corporation and the forfeiture and/or repricing of stock options.

196. *See* Margaret Cronin Fisk & Avram Goldstein, *UnitedHealth's Former Chief To Repay \$600 Million*, BLOOMBERG.COM, Dec. 6, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a.lhETzJe3CQ>.

197. *See* Stipulation and Agreement of Settlement at 28-33, *In re* DHB Indus., Inc. Derivative Litig., No. 05-4396(JS) (ETB) (E.D.N.Y. Dec. 15, 2006). The settlement in this case was part of a global settlement that included settlement of a securities class action. The class cash part of the settlement was \$34.9 million, the derivative cash portion of the settlement was \$300,000, all of which was paid to the derivative plaintiffs' attorney. The settlement also included various corporate governance reforms.

parallel litigation. These cases generally involved the global settlement of multiple claims arising out of the same underlying events, and the purported value of the derivative claims was to limit or eliminate the corporation's contribution to the settlement of a securities class action.

Again, the value of these settlements is open to debate. Although it is certainly in the corporation's interest to minimize its contribution to these settlements, it is not clear that the corporation's contribution would have been different but for the existence of the derivative suit. Insurance funding of settlements in securities class actions is the norm,<sup>198</sup> and therefore corporations typically do not have to pay anything toward these settlements, even without the filing of parallel derivative suits. The insurance companies likely would have had to pay the same exact amount regardless of whether they agreed to do so as part of a parallel settlement in a derivative suit. It is possible that these derivative suits allowed the corporations to tap into additional insurance funds,<sup>199</sup> but the parties did not make this claim in their briefs filed with the court

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198. See, e.g., Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 760-61 (2009) ("Virtually all U.S. public corporations buy D&O insurance, and the vast majority of securities claims settle within or just above the limits of the defendant corporation's D&O coverage.").

199. D&O Insurers Fund \$118 Million Partial Settlement of Broadcom Options Backdating Derivative Suit, *The D&O Diary*, <http://www.dandodiary.com/2009/09/articles/options-backdating/do-insurers-fund-118-million-partial-settlement-of-broadcom-options-backdating-derivative-suit/> (Sept. 1, 2009) (explaining how the filing of a derivative suit on behalf of Broadcom allowed the company to access additional insurance funds).

in support of the settlements.<sup>200</sup> In sum, the financial benefits of these settlements was likely minimal at best.<sup>201</sup>

Putting these data together, a total of 18 out of 42 settlements (42.9 percent) in the public company cases included a meaningful financial component—typically a direct cash payment to the corporation and/or the repricing or cancellation of stock options. There were additional cases in which the attorneys received money or the filing of the derivative suit ostensibly lowered the corporation's contribution in other litigation, but only 18 cases involved a meaningful and tangible financial gain for the plaintiff corporation.<sup>202</sup> Sixteen of these 18 cases were stock option cases. Accordingly, 40 percent of the stock option cases ended with the

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200. For example, in a derivative suit filed on behalf of Bally Technologies, Inc., the settlement provided that the only monetary component of the settlement was an agreement that "the Company would only make a limited contribution of Company assets towards the settlement of the Securities Class Actions, [while as] a further and far more substantial part of this Settlement, the Individual Defendants and Bally have agreed to cause \$14.25 million of available Director and Officer Insurance policies to be utilized for the settlement of the Securities Class Actions." Stipulation of Settlement at ¶ 2.1, *Longbine v. Miodunski*, No. 06-cv-00373-LDG-RJJ (D. Nev. May 15, 2007) [hereinafter *Longbine Stipulation of Settlement*]. In the brief in support of the settlement, as well as in the accompanying affidavit, the derivative plaintiff only mentions this component of the settlement briefly, focusing far more on the corporate governance aspects of the settlement. See Plaintiff's Memorandum of Points and Authorities in Support of Motion for Approval of Settlement and Award of Attorneys' Fees and Expenses, *Longbine v. Miodunski*, No. 06-cv-00373 (D. Nev. Aug. 1, 2007); see also Stipulation of Settlement at 6, *In re R&G Fin. Corp. Derivative Litig.*, No. 05-cv-5547 (S.D.N.Y. June 12, 2008) (providing that, as the monetary component of the settlement of the derivative suit filed on behalf of R&G Financial Corp., the company's D&O insurance carrier would pay the company \$2.7 million to settle the derivative suit with the parties "acknowledg[ing] that [the company] intend[ed] to contribute that ... amount ... toward the settlement fund to be established in the Class Action").

201. The same cannot necessarily be said for a global settlement in one of the stock option suits in which the *individual defendants* agreed to contribute to the settlement of the securities class action, as occurred in two of the cases in my sample. See Amended Stipulation and Agreement of Settlement at 11, *Gunther v. Tomasetta*, No. 2:06-cv-02529-R(CTx) (C.D. Cal. Nov. 26, 2007); Stipulation and Agreement of Partial Settlement at 23, *In re Doral Fin. Corp. Sec. Litig.* No. 1:05-md-01706-JSR (S.D.N.Y. May 1, 2007). A derivative suit may have an impact in causing individuals, as opposed to insurance companies, to agree to pay their fair share toward parallel litigation. Accordingly, this case was coded as providing a meaningful financial benefit.

202. It is obviously difficult to draw a line between meaningful and nonmeaningful components in settlements. At the end of the day, however, it is difficult to see how plaintiff corporations benefit from payments that they never see and agreements by insurance companies to pay what they likely had to pay anyway.

plaintiff corporation obtaining a meaningful financial benefit.<sup>203</sup> In contrast, only 2 of the 101 (2 percent) classic derivative suits, or suits that do not involve allegations of backdated stock options, involved a meaningful financial benefit.<sup>204</sup>

One key metric for measuring the merit of derivative suits is the value returned to the plaintiff corporations. Using this metric, several of the stock option suits in my study benefitted the plaintiff corporations, either because the plaintiff corporation received a cash payment or because the plaintiff corporation was able to cancel or reprice improperly granted stock options. Far fewer of the classic derivative suits returned value, at least if value is measured as money in the bank for the plaintiff corporation.

Indeed, in reading the settlement agreements in these classic derivative suits, it is clear that money was not the point of the settlements. Corporate governance reform was the point. The figure below compares the number of settlements in my study that include meaningful financial components with the number of settlements that include corporate governance components.

**Figure 4**

Settlements with Meaningful Financial Components	Settlements with Corporate Governance Components
<ul style="list-style-type: none"> <li>• 2 of the classic settlements</li> <li>• 16 of the stock option settlements</li> <li>• <b>A total of 18 settlements, or 13.5 percent of the resolved public company cases</b></li> </ul>	<ul style="list-style-type: none"> <li>• 21 of the classic settlements</li> <li>• 14 of the stock option settlements</li> <li>• <b>A total of 35 settlements, or 26.3 percent of the resolved public company cases</b></li> </ul>

203. I am not weighing this financial gain against the costs of the suits. It is possible that the corporations spent more than their multimillion dollar recovery to litigate the suit, especially considering that the corporations are often required to indemnify the defendants for all of their legal expenses.

204. The two classic derivative suits that arguably ended with a meaningful financial benefit were *In re Escala Group, Inc. Derivative Litigation* and *In re Doral Financial Corp. Securities Litigation*. See *supra* notes 194 and 201 and accompanying text. In neither case, however, was the company's financial gain in the derivative suit larger than its payment in the parallel securities class action.



As this figure illustrates, corporate governance settlements are far more common in federal derivative suits than financial settlements, especially when it comes to the classic derivative suits. This fact leads to a crucial point about the value of derivative suits. Aside from the relatively few settlements in which the plaintiff corporation received a financial payment, the value of federal derivative suits turns largely on the merits of corporate governance settlements. The next Part analyzes the merits of these settlements directly. Before turning to this analysis, however, it is important to understand the specifics of these settlements, as well as their costs.

In general, these corporate governance settlements included a relatively uniform list of reforms. No settlement agreement included all of the reforms listed below, but the similarity of the reforms included in the agreements was nonetheless striking (for reasons discussed below in Part III). These reforms included:

- A rule requiring a majority or more of the directors to meet existing or enhanced independence requirements (17 settlements);
- A requirement that the board or certain committees of the board meet regularly in executive sessions (15 settlements);
- An agreement to appoint, or enhance the duties of, a lead independent director (14 settlements);
- The addition of one or more independent directors to the board (14 settlements);
- A policy allowing the board and/or its committees to hire advisors (13 settlements);
- A limitation on the number of boards on which the directors can serve (12 settlements);<sup>205</sup>
- A requirement that directors attend a certain percentage of board, committee, or shareholder meetings (14 settlements);
- A requirement or recommendation that the board adopt a “clawback” provision, or a provision requiring executive officers to repay bonuses or other monies in the event of a restatement of the company’s financial statements (11 settlements); and

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205. These settlement agreements specified that the directors could serve on between one and six additional boards, with a median number of three.

- A provision allowing major shareholders to nominate candidates for the corporation's board of directors (9 settlements).

In most of the suits, the plaintiff corporation agreed to maintain these reforms for a set number of years, typically between two and five years.

Before turning to a closer examination of the benefits of these settlements, it is important to understand their costs. Derivative suits are not cheap for plaintiff corporations. First, the corporation has to hire lawyers to represent the corporation's interests in the litigation. Second, the corporation often has to pay the legal bills of its officers and directors pursuant to indemnification agreements.<sup>206</sup> Third, as explained above, corporations often form a special litigation committee to investigate the allegations in the suit.<sup>207</sup> The cost of forming such a committee can dwarf the other expenses in the litigation because SLCs typically hire a law firm with no connection to the case to ensure the firm's independence, and the law firm then commences a full-blown investigation, complete with extensive document review and interviews of dozens of people close to the alleged events.<sup>208</sup> Fourth, the corporation incurs additional indirect costs when its key personnel have to divert attention from other corporate duties to assist with the litigation. These costs can be considerable, especially given that my study found that, on average, more than six law firms were involved in each lawsuit.<sup>209</sup>

These expenses alone are considerable, but in nearly all of the settlements in my study, the corporation also agreed to pay the expenses of the derivative plaintiffs' attorneys. It is generally accepted that courts can order plaintiff corporations to pay the attorneys' fees of derivative plaintiffs as long as the suit confers a

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206. Indemnification is typically mandatory if the defendants are successful in the lawsuit. *See, e.g.*, DEL. CODE ANN., tit. 8, § 145(c) (2009). States also allow corporations to enter into indemnification agreements with their officers and directors, permitting indemnification in cases of settlements or even judgments against these individuals as long as the defendants have not acted contrary to a statutory standard of conduct. *See, e.g., id.* § 145(b). It is common for corporations to indemnify their officers and directors to the full extent permitted by law (and for officers and directors to insist on such protection prior to agreeing to serve).

207. *See supra* text accompanying note 133.

208. *See* WEBB ET AL., *supra* note 133, § 3.03[d] at 3-54, 55.

209. Twenty-nine of the public company suits involved ten or more law firms, and six involved twenty or more.

substantial benefit on the corporation, even if the benefit is nonpecuniary.<sup>210</sup> Accordingly, courts are permitted to award attorneys' fees in cases in which the sole consideration for the settlement is corporate governance reforms.<sup>211</sup> In most of the public company settlements in my study, the parties agreed on these fees in the settlement agreement. The attorneys' fees were significant, ranging from a low of \$60,000 to a high of \$29.7 million.<sup>212</sup> The median fee amount was slightly less than \$1 million.

These fees depended in large part on the consideration in the settlement. In the cases in which the corporation received a meaningful financial benefit, the median attorneys' fees were \$6.65 million. In the cases in which the only consideration for the settlement was the reform of corporate governance policies, the median fees were a fraction of this amount at \$460,000.<sup>213</sup>

In the end, therefore, we return to the same question with which we began. Do derivative suits benefit the corporations on whose behalf the suits are brought? The vast majority of the suits do not. Nearly 70 percent of the resolved suits in the study were dismissed, leaving the corporation without any remedy for the alleged misconduct. Nearly all of the remaining 30 percent settled. A relatively small number of settlements include meaningful financial components that appear to benefit the plaintiff corporation, although the cost-benefit analysis is less clear when costly attorneys' and other

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210. See *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 395 (1970) (holding that "a corporation may receive a 'substantial benefit' from a derivative suit, justifying an award of counsel fees, regardless of whether the benefit is pecuniary in nature"); *Kaplan v. Rand*, 192 F.3d 60, 70-72 (2d Cir. 1999) (holding that courts can award attorneys' fees based on corporate governance settlements as long as the reforms in these settlements provide "substantial benefit" to the plaintiff corporation and are not simply "illusory" or "superficial"); *In re Nvidia Corp. Derivative Litig.*, No. C-06-06110-SBA (JCS), 2008 WL 5382544, at \*3 (N.D. Cal. Dec. 22, 2008) (approving an award for attorneys' fees in connection with a settlement comprised largely of corporate governance reforms because "strong corporate governance is fundamental to the economic well-being and success of a corporation").

211. See, e.g., *In re Rambus Inc. Derivative Litig.*, No. 06-3513 JF (HRL), 2009 WL 166689, at \*3 (N.D. Cal. Jan. 20, 2009) (stating that "courts consistently have approved attorneys' fees and expenses in shareholder actions where the plaintiffs' efforts resulted in significant corporate governance reforms but no monetary relief").

212. These figures include both fees and costs for the derivative plaintiffs' attorneys, as many settlement agreements do not break out these amounts.

213. The fees exceeded \$1 million in several suits, including one suit where the fees were nearly \$7.5 million.

fees are added to the mix. Far more settlements, however, did not involve meaningful financial components and were instead based on promises by the plaintiff corporation to reform aspects of its corporate governance practices coupled with significant attorneys' fees. Accordingly, before we can decide whether derivative suits enhance corporate value, we must turn to the final piece of the puzzle—whether corporate governance settlements enhance corporate value.

### III. ASSESSING CORPORATE GOVERNANCE IN THE COURTROOM

We have now seen that the value of derivative suits depends in large part on the value of corporate governance settlements. Despite the importance of these settlements, legal scholars have not studied them at all. This Part establishes a conceptual framework to evaluate these settlements, a framework that examines corporate governance settlements from three angles. First, it addresses whether these settlements provide redress for plaintiff corporations, exploring the link between the specific reforms in the settlements and the misconduct alleged in the litigation.<sup>214</sup> Second, it analyzes whether these settlements are effective in reforming corporate governance more broadly, an analysis that draws on empirical studies from business and finance literature.<sup>215</sup> Third, it examines whether these settlements deter future misconduct by corporate managers, building on scholarship that argues that deterrence, rather than compensation, should be the goal of representative litigation.<sup>216</sup> This analysis is intended to lay the foundation in an area of the law ripe for further scholarly inquiry.

#### *A. The Promise of Redress*

There is no perfect way to determine whether corporate governance settlements benefit the plaintiff corporations in derivative suits, because, unlike traditional settlements, no money changes

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214. See *infra* Part III.A.

215. See *infra* Part III.B.

216. See *infra* Part III.C.

hands in these settlements. Corporate governance experts occasionally try to place a monetary value on governance reforms,<sup>217</sup> but such calculations are necessarily difficult and imprecise. After all, the value of these reforms lies in the hope that they will prevent future instances of corporate misconduct, and there is no looking glass to determine whether such reforms will be effective.

If we cannot measure the value of these settlements directly, we may be able to do so indirectly. One way to measure the benefits of corporate governance settlements is to examine the link between the alleged misconduct and the specific reforms included in the settlement agreement. Lawsuits typically arise from specific problems, and the remedies typically relate to these problems. If the alleged misconduct in a derivative suit resulted from poor internal controls, for example, and the settlement strengthens these internal controls, then at least on its face, the settlement has the potential to benefit the plaintiff corporation.

In reviewing the settlement agreements, however, it was striking how few of the reforms responded directly to the allegations in the complaint. The analysis here is necessarily qualitative because the link between harms and benefits is difficult to measure with any precision. Few derivative plaintiffs used these settlements to remedy the particular misconduct that gave rise to the litigation. Instead, a considerable number of the reforms exhibited a tenuous link to the allegations, perhaps improving more general corporate governance at the corporation, but not addressing the specific problem that gave rise to the suit.

The clearest links to the alleged misconduct were in the settlements in the stock option suits. In nearly all of these settlements, the plaintiff corporation agreed to adopt detailed and often extensive reforms to improve the procedures relating to the granting of stock options. In the derivative suit filed on behalf of Infosonics

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217. See, e.g., *In re Apple Computer, Inc. Derivative Litig.*, No. C 06-4128 JF (HRL), 2008 WL 4820784, at \*2 (N.D. Cal. Nov. 5, 2008) (stating that plaintiffs' expert estimated that value of various corporate governance "reforms could increase Apple's market value by an amount well in excess of several hundred million dollars"); *Unite Nat'l Ret. Fund v. Watts*, No. Civ.A. 04CV3603DMC, 2005 WL 2877899, at \*2 (D.N.J. Oct. 28, 2005) (noting that plaintiffs' expert Robert Monks estimated that various governance reforms were worth not less than \$2.3 billion).

Corp., for example, the company agreed that its outside counsel would be involved in all grants of stock options, that the company would ask its outside auditor to identify the stock option granting process as a high risk audit item, and that any future stock option plans would clearly state the exercise price, grant date, and fair market value.<sup>218</sup> Several other agreements in stock option suits include similar provisions.<sup>219</sup>

Additionally, several settlement agreements included specific provisions to address accounting irregularities alleged in the litigation. In the derivative suit filed on behalf of Bally Technologies, Inc., for instance, the shareholders alleged that the company was using improper revenue recognition policies to boost its earnings.<sup>220</sup> As part of the settlement, the company agreed to improve these policies, specifying, for example, that the Chief Executive Officer and the Chief Financial Officer would be responsible for maintaining the policy, that the board would review the policy, and that any disputes about the policy would be decided by the Audit Committee.<sup>221</sup> Other settlements also included specific reforms to remedy the specific problems identified in the complaint, including the termination of particular individuals alleged to have participated in the misconduct,<sup>222</sup> hiring of additional staff in departments with poor performance,<sup>223</sup> or strengthening of insider trading policies.<sup>224</sup>

Even in these cases, however, the benefits to the plaintiff corporations were not always clear. The cases involving the alleged backdating of stock options are a good example. As noted above,

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218. See Stipulation and Agreement of Settlement at 9, *In re Infosonics Corp. Derivative Litig.*, No. 06-cv-1336 (S.D. Cal. Oct. 17, 2008).

219. See, e.g., Stipulation of Settlement at 11-12, *In re Marvell Techs. Ltd. Derivative Litig.*, No. C-06-03894-RMW(RS) (N.D. Cal. Mar. 20, 2009) [hereinafter *Marvell Stipulation of Settlement*]; Stipulation of Settlement at 12-14, *In re Sanmina-SCI Derivative Litig.*, No. C-06-03783-JF (N.D. Cal. Feb. 26, 2009).

220. Verified Shareholder Derivative Complaint at 41, *Longbine v. Miodunski*, No. 2:06-cv-373 (D. Nev. Mar. 27, 2006).

221. *Longbine Stipulation of Settlement*, *supra* note 200, Ex. B. ¶ 2.

222. See, e.g., *Marvell Stipulation of Settlement*, *supra* note 219, at 10-11.

223. See, e.g., Stipulation of Settlement at Ex. B, *In re General Motors Corp. Derivative Litig.*, No. 06-1749 (E.D. Mich. Sept. 18, 2008).

224. See, e.g., Stipulation of Settlement at 11-12, *Green Meadows v. Impac Mortgage Holdings*, No. SAVC 06-0091 CJC(RBNx) (C.D. Cal. May 18, 2007).

nearly all of the settlements in these cases involved an agreement by the plaintiff corporation to modify its procedures for awarding or repricing stock options—a specific solution to a specific problem.<sup>225</sup> Yet it seems unlikely that these corporations would have repeated their past mistakes even in the absence of such an agreement. The scandal concerning backdated stock options spent months on the front pages of the *Wall Street Journal* and other national newspapers,<sup>226</sup> and several top executives have faced criminal charges.<sup>227</sup> Many of these same companies were investigated by the Securities and Exchange Commission and subjected to lengthy internal investigations.<sup>228</sup> Just as importantly, the Sarbanes-Oxley Act of 2002 changed the relevant accounting rules, making the backdating of stock options much less likely.<sup>229</sup> The spotlight on this practice makes it exceedingly unlikely that any of these companies will turn around and backdate stock options again, especially in the two to five year time period covered by these settlements.

A similar point can be made about the cases in which the derivative claims arose out of a specific accounting error. In these cases, the plaintiff corporation often had to restate its earnings and may have been subject to an internal investigation and/or a Securities and Exchange Commission investigation.<sup>230</sup> Under these

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225. See *supra* notes 218-19 and accompanying text.

226. See *supra* note 36.

227. See *First Backdating Conviction Brings Prison Term and \$15 Million Fine*, N.Y. TIMES, Jan. 17, 2008, at C2 (reporting that former Chief Executive Officer of Brocade Communications Systems was sentenced to twenty-one months in prison, although this conviction has since been overturned); *Former Take-Two Official Is Sentenced in Backdating Case*, N.Y. TIMES, Aug. 9, 2007, at C3 (reporting that former Take-Two general counsel was sentenced to three years probation).

228. At least 31 of the 40 companies named in the stock option suits (77.5 percent) were also investigated by the Securities and Exchange Commission, and nearly all conducted internal investigations.

229. Securities Exchange Act of 1934 § 16(a)(2)(C), 15 U.S.C. § 78p(a)(2)(c) (2006) (requiring corporations to report all high-level executive stock option grants and exercises within two business days).

230. See, e.g., Second Amended Shareholder Complaint, *In re Apple Inc. Derivative Litig.*, No. 06-cv-4128-JF, 2007 WL 4936967 (N.D. Cal. Dec. 19, 2007) (alleging that Apple had backdated its stock options, resulting in a restatement of approximately \$105 million, as well as investigations by the Securities and Exchange Commission); Verified Shareholder Derivative Complaint for Breach of Fiduciary Duty, Abuse of Control, Gross Management, Waste of Corporate Assets, and Unjust Enrichment, *In re HCA, Inc. Derivative Litig.*, No. 3:05-cv-0968 (M.D. Tenn. Nov. 20, 2005) (alleging that HCA, Inc. made various accounting

circumstances, it is likely that the corporation will be especially cognizant of the relevant rule in the future and will take care not to violate it again, even without the mandated reforms of a legal settlement. Accordingly, even in cases in which there is a clear link between the alleged harm and the reforms in the settlement, the value to the corporation is not always clear.

Many more provisions in the settlement agreements, however, were not tailored to the specific problems alleged in the complaint. Indeed, there was often a striking disconnect between the alleged problems and the reforms in the settlement agreements. In several suits that did *not* involve allegations of stock option backdating, for example, the settlement agreements included promises by the plaintiff corporation not to reprice or backdate stock options. For instance, the derivative plaintiff in one suit alleged that the defendants breached their fiduciary duties to the plaintiff corporation by approving various related-party transactions that were not in the corporation's best interests.<sup>231</sup> In the settlement, however, the plaintiff corporation agreed to a number of reforms that had little to do with such related-party transactions, including a promise that the corporation would not reprice previously issued stock options without the approval of the independent directors.<sup>232</sup> This provision likely reflected the fact that stock option backdating was on the front pages of the newspapers at that time, even if there were no allegations that a particular corporation had backdated options. Put simply, the agreement was not a specific solution to a specific problem; it was a specific solution to someone else's problem.

Moreover, as detailed above in Part II, there was remarkable uniformity in the types of reforms included in the settlement agreements. For example, twelve of the settlement agreements included provisions limiting the number of corporate boards on which the directors of the plaintiff corporations can serve. None of the complaints in these cases alleged that the underlying wrongdoing stemmed from the directors in question serving on too many

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errors that later led to an insider trading investigation of various HCA executives by the Securities and Exchange Commission and the U.S. Department of Justice).

231. See Stipulation and Agreement of Compromise, Settlement, and Release at 2, *Beitchman v. Aduddell*, No. 5:05-cv-01465 (W.D. Okla. Dec. 7, 2007).

232. See *id.* at 6.



boards, and yet, in twelve separate cases, the parties agreed that this particular reform would benefit the plaintiff corporation. Similarly, thirteen of the settlements required the plaintiff corporations to allow their boards or board committees to hire advisors. Again, there were no allegations in these cases that the underlying harm was caused by the board being unable to hire advisors, and yet, the parties in more than a dozen cases decided that this reform was appropriate.

At first glance, such uniformity is puzzling. Across the country, in different suits involving different types of allegations, parties are sitting down at the negotiating table and agreeing to a fairly common set of reforms, many of which are unrelated to the alleged wrongdoing in their particular cases. What accounts for this phenomenon?

One possible answer is that these reforms are part of a larger movement by activist investors to reform corporate governance. Investors are demanding these reforms at the negotiating table because these are the reforms that they want corporations to adopt more generally. Although shareholders as a group are notoriously passive,<sup>233</sup> a distinct group of shareholders are much more active and attempt to use their power to improve the way that corporations are governed. These shareholders, many of whom are public pension or retirement funds, have articulated a fairly consistent set of corporate governance goals—"best practices"—that include increasing the independence of corporate boards and improving the monitoring function of these boards.

Over the last several years, it has become apparent that there are few avenues for these activist investors to promote their reforms. Shareholders can join together and use their collective power to replace the board of a troubled company, but few institutional investors want to take on the challenges of running a public company.<sup>234</sup> Shareholders have also tried to reform corporate

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233. See, e.g., Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 362 (2004); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 523 (1990).

234. See Thompson & Thomas, *supra* note 3, at 1789 (noting that institutional investors "show little inclination to become directors or to offer names of those who are willing to

governance through shareholder proposals, or proposals for reform that shareholders can place directly on the company's proxy statement.<sup>235</sup> Shareholder proposals have limited effectiveness in transforming corporate governance, however, because many have low success rates and the votes ordinarily are not binding on a corporation's board of directors.<sup>236</sup>

In the face of these difficulties, it is not surprising that activist investors have turned to litigation to reform corporate governance. Indeed, a 2001 article in *Forbes* magazine exhorted "Shareholders Of The World: Sue!"<sup>237</sup> A top plaintiffs' law firm touts that "a ... revolution" has begun in litigation across the country and that the resulting settlements "have begun the essential reform of making directors truly accountable to shareholders."<sup>238</sup> In a study of institutional investors by James Cox and Randall Thomas, several institutional investors stated that an important benefit of getting involved in shareholder litigation was the potential to reform corporate governance.<sup>239</sup> According to their study, "[t]hese institutions wanted to 'change the system' and therefore were willing to expend the extra time and effort to become involved."<sup>240</sup> Corporate governance reform has moved into the courtroom, and corporate governance settlements are the current battleground for these reform efforts.

This shift is evident in a comparison of the reforms that activist shareholders promote with the reforms in the settlements in my study. The most obvious example are shareholder efforts to enhance director independence. Many institutional shareholders support efforts to increase the number of independent directors on corporate boards, believing that a board that includes a significant percentage

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serve").

235. See 17 C.F.R. § 240.14a-8 (2009).

236. See *id.* § 240.14a-8(i)(1); RISKMETRICS GROUP, 2008 POSTSEASON REPORT SUMMARY 3 fig.1 (2008) (on file with author), available at [http://www.riskmetrics.com/docs/2008\\_postseason\\_review\\_summary](http://www.riskmetrics.com/docs/2008_postseason_review_summary) (click "Download"; then create free account and log in).

237. Geoffrey Colvin, *Shareholders Of The World: Sue!*, FORTUNE MAG., Mar. 19, 2001, at 50.

238. Richard Bennett, *A Quiet Revolution*, [http://www.csgrr.com/csgrr-cgi-bin/mil?templ=news/articles/quiet\\_revolution.html](http://www.csgrr.com/csgrr-cgi-bin/mil?templ=news/articles/quiet_revolution.html) (last visited Feb. 15, 2010).

239. Cox & Thomas, *Does the Plaintiff Matter?*, *supra* note 14, at 1600-01.

240. See *id.* at 1601.

of independent directors will be less beholden to management and thus better able to serve as a check on management.<sup>241</sup> RiskMetrics Group, an influential company that advises institutional investors on proxy voting,<sup>242</sup> devotes several pages of its policy guide to the question of independence, laying out detailed requirements that directors must meet to qualify as independent and recommending that shareholders support proposals to split the CEO and Chairman positions.<sup>243</sup> Similarly, the Council of Institutional Investors recommends that at least two-thirds of the directors on a board should be independent and that the board should be chaired by an independent director.<sup>244</sup> Independence is also a core component of the policy guidelines of the most prominent institutional investors, from CalPERS<sup>245</sup> to TIAA-CREF.<sup>246</sup>

Consistent with this focus, nearly all of the corporate governance settlements in my study included provisions strengthening or upholding the independence of the plaintiff corporation's board of directors. For example, twenty of the settlement agreements

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241. See Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 447 (2008).

242. Wachtell Lipton has said that "[b]ecause many institutional investors strictly adhere to [RiskMetrics'] recommendations, public companies are obliged to take note of the updated recommendations." David A. Katz & Laura A. McIntosh, *Corporate Governance Update: RiskMetrics Update Continues To Hamper Director Discretion*, Jan. 22, 2009, <http://blogs.law.harvard.edu/corpgov/files/2009/02/riskmetrics-update-continues-to-hamper-director-discretion.pdf>.

243. RiskMetrics Group, U.S. Corporate Governance Policy: 2009 Updates 11 (2008), available at <http://www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdateUnitedStates.pdf>.

244. THE COUNCIL OF INSTITUTIONAL INVESTORS CORPORATE GOVERNANCE POLICIES §§ 2.3, 2.5d at 3-4 (2008), available at <http://www.cii.org/UserFiles/file/council%20policies/CIH%20Corp%20Gov%20Policies%204-11-08.pdf> [hereinafter COUNCIL POLICIES]. The Council of Institutional Investors is an association of public, union, and corporate pension funds that advises these funds on corporate governance issues.

245. CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE 10-11, 48-49 (2009), available at <http://www.calpers-governance.org/docs-sof/marketinitiatives/2009-04-01-corp-governance-pub20-final-glossy.pdf>.

246. TIAA-CREF, POLICY STATEMENT ON CORPORATE GOVERNANCE 7-8 (2009), available at [http://www.tiaa-cref.org/pubs/pdf/governance\\_policy.pdf](http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf) [hereinafter TIAA-CREF PRINCIPLES]; see also CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM, CORPORATE GOVERNANCE PROGRAM POLICIES 12 (2006) (on file with author); FIDELITY INVESTMENTS, FIDELITY FUNDS' PROXY VOTING GUIDELINES: MARCH 2009, <http://personal.fidelity.com/myfidelity/InsideFidelity/InvestExpertise/governance.shtml.tvsr> (click on "Full Text of Proxy Voting Guidelines").

included an agreement by the company to appoint or continue to have a lead independent director or split the CEO and Chairman positions. Seventeen of the settlement agreements included provisions strengthening or maintaining the company's definition of independence. Fourteen of the agreements included provisions requiring or encouraging the company to appoint one or more new independent directors.

Other reforms included in corporate governance settlements also mirror the reform agenda of activist investors. For example, many institutional investors have adopted policies mandating director attendance at a minimum percentage of board or shareholder meetings.<sup>247</sup> Fourteen settlements in my study included similar attendance policies. Many institutional investors want corporations to adopt limitations on the number of boards on which their directors can serve.<sup>248</sup> Twelve settlements in my study included such limitations. Many institutional investors want outside directors to meet in executive session outside the presence of management.<sup>249</sup> Fifteen settlements in my study mandated or encouraged the outside directors of the plaintiff corporations to meet in executive session.

In short, many of the reforms included in corporate governance settlements are not specific solutions to specific allegations of misconduct. Instead, they are part of a larger movement to reform corporate governance. This point, however, does not answer the broader question of whether corporate governance settlements are beneficial. Even if many provisions in these settlements do not

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247. COUNCIL POLICIES, *supra* note 244, § 2.6c; TEACHER RETIREMENT SYSTEM OF TEXAS, PROXY VOTING POLICY 3 (2008), *available at* [http://www.trs.state.tx.us/investments/documents/proxy\\_voting\\_policy.pdf](http://www.trs.state.tx.us/investments/documents/proxy_voting_policy.pdf).

248. COUNCIL POLICIES, *supra* note 244, § 2.8; T. ROWE PRICE GROUP, INC., CORPORATE GOVERNANCE GUIDELINES 2 (2009), *available at* [http://files.shareholder.com/downloads/TROW/690856276x0x229862/7afb792d-a55c-490f-bb8d-c72dab07b9cf/Corporate\\_Governance\\_Guidelines.pdf](http://files.shareholder.com/downloads/TROW/690856276x0x229862/7afb792d-a55c-490f-bb8d-c72dab07b9cf/Corporate_Governance_Guidelines.pdf); JPMorgan Chase & Co., Corporate Governance Functions of the Board, <http://www.jpmorganchase.com/corporate/About-JPMC/corporate-governance-principles.htm> (last visited Feb. 23, 2010).

249. COUNCIL POLICIES, *supra* note 244, § 2.9c; TIAA-CREF PRINCIPLES, *supra* note 246, at 11; LEGG MASON INC., CORPORATE GOVERNANCE PRINCIPLES 4, 6 (2007), [http://www.leggmason.com/about/documents/corp\\_governance\\_principles.pdf](http://www.leggmason.com/about/documents/corp_governance_principles.pdf); VANGUARD, OUR VIEWS ON CORPORATE GOVERNANCE, <https://personal.vanguard.com/us/content/Home/WhyVanguard/AboutVanguardCorpGovernPrinciplesContent.jsp> (last visited Feb. 15, 2010).

address the specific problems alleged in the litigation, they may nonetheless benefit the corporations by improving overall corporate governance at these corporations. Accordingly, to assess the merits of corporate governance settlements, we must analyze these settlements more directly.

*B. The Limits of Reform*

An analysis of the merits of corporate governance settlements turns on whether the specific provisions in these settlements benefit the plaintiff corporations. For example, settlements that force corporations to overhaul flawed governance systems may well benefit these corporations by reducing the likelihood of future misconduct. The next question, therefore, is whether the reforms in the settlement agreements are likely to improve the governance practices more generally at the plaintiff corporations. This analysis begins by evaluating the relevant reforms in light of empirical studies in the business and finance literature that have examined several key reforms included in corporate governance settlements.

As discussed above, nearly all of the corporate governance settlements in my study included provisions requiring corporations to enhance the independence of their boards. Corporations agreed in these settlements to add additional independent directors, strengthen the company's definition of independence, split the CEO and Chairman positions, and/or appoint a lead independent director. Put simply, one of the chief goals of many settlements in my study was to make the boards of the plaintiff corporations more independent.

Turning to the empirical evidence, however, one wonders whether all this effort was for naught. Business and finance scholars have examined the relationship between independence and firm performance from nearly every angle, and they have been unable to come up with any empirical evidence linking board independence with increased firm value. One prominent study, for example, concluded that companies with a higher percentage of independent directors "do not achieve improved profitability, and there are hints in our

data that they perform worse than other firms.”<sup>250</sup> Another study concluded that “the addition of independent directors to a corporate board is subject to both diminishing marginal increases and absolute declines in relative performance.”<sup>251</sup> A recent article surveying the relevant literature concluded that “the decisive balance of studies has found no relation between director independence and performance.”<sup>252</sup> In short, these settlements are chasing a goal that has already been debunked.

A similar conclusion can be drawn about the twelve settlements in my study that placed limitations on the number of outside boards on which the board members of the plaintiff corporations could serve. These provisions reflect the belief that board members can better monitor the corporations for which they serve if their attention is not divided between a large number of other directorships. Yet, the empirical evidence, though sparse, suggests that such limitations do not enhance firm performance.<sup>253</sup> A study by Professors Ferris and Jagannathan conducted of more than 6000 firms concluded that “directors of firms with higher growth opportunities tend to hold a greater number of directorships in spite of the potential costs to the firm” and that the number of directorships is *positively* correlated with nearly every measure of firm value, including market-to-book ratios, total assets, corporate

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250. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002).

251. Barry B. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 573 (1984); cf. Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 891 (2002); Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101, 111 (1991).

252. Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1814 (2008); see also James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1239 (1993) (“Overall, studies have found no correlation between board composition and firm performance.”).

253. See Stephen P. Ferris & Murali Jagannathan, *The Incidence and Determinants of Multiple Corporate Directorships*, 8 APPLIED ECON. LETTERS 31, 32-35 (2001). Moreover, the study found that multiple directorships were fairly rare, with only 12.9 percent of the directors in the sample holding more than one board seat and only 4 percent of the directors holding more than two board seats, suggesting that “arguments for restrictions on board memberships may be a solution for a problem that does not exist.” *Id.* at 32, 34.

operating performance, and return to equity.<sup>254</sup> Once again, the empirical evidence reveals no benefits for a provision commonly found in corporate governance settlements.

It is important to note that these studies focus on the relationship between corporate governance and firm performance. The studies do not measure whether the reforms reduce future occurrences of fraud, a separate metric of value to many shareholders. It is possible, for example, that boards with a greater percentage of independent directors do a better job of rooting out corporate misconduct and, therefore, benefit corporations even if measures of profit and other financial indicia remain unchanged. This theory has not been tested, but it is also important to note that nearly all of the public companies in my study are already subject to stringent listing standards enacted by the national stock exchanges that require board independence. Both the New York Stock Exchange and the NASDAQ require boards of member companies to include at least a majority of independent directors.<sup>255</sup> The settlements in my study are, therefore, premised on the theory that boards with a slightly greater percentage of independent directors will be better able to ferret out misconduct, a theory that is possible but empirically untested.

Many of the other provisions in corporate governance settlements have not been subject to empirical review. I could not locate any studies examining, for example, whether board attendance policies or requirements that boards meet in executive session enhance corporate value. The lack of empirical evidence may again argue in favor of caution at the negotiating table, but it also presents the difficult question of how to assess the value of these provisions. Even without this empirical backdrop, however, we may still be able to assess the benefits of these provisions by examining whether the provisions are likely to benefit the particular companies at issue.

For example, fourteen of the settlements in my study included provisions requiring or encouraging directors to attend board and/or

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254. *See id.* at 33.

255. NYSE, Inc., Listed Company Manual § 303.A01 (2004); NASDAQ, Inc., Manual, Rule 4350(c)(1) (2007).

shareholder meetings. In a vacuum, these attendance policies make sense. Many derivative suits are premised on a board's failure to prevent or remedy misconduct. If board members are at least present during critical meetings, perhaps they will be more likely to catch future misconduct. The problem with this theory, at least as applied to the cases in my study, is that most of the corporations that agreed to such provisions did not have attendance problems—the directors of these particular companies were already attending meetings, at least according to the companies' proxy materials. It is hard to imagine how these plaintiff corporations benefitted from settlements requiring them to do what they were already doing.

For example, in one derivative suit in my study, the plaintiff corporation agreed as part of the settlement to amend its bylaws to require directors to attend 75 percent of board meetings.<sup>256</sup> Yet the corporation's proxy materials for the relevant years indicate that the corporation's directors already attended more than 75 percent of board meetings in the several years prior to the settlement.<sup>257</sup> In numerous other cases in which the settlement agreements included similar provisions, the corporations' proxy materials made clear that these corporations also did not have attendance problems or were simply silent on the board's attendance record. Overall, none of the fourteen corporations that agreed to attendance policies had a documented attendance problem.

Similarly, fifteen settlements in my study included provisions requiring or encouraging the outside directors of the plaintiff corporation to meet in executive session outside the presence of management. I have not found any empirical data examining whether executive sessions boost corporate value, but again, the

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256. Stipulation and Agreement of Compromise, Settlement, and Release, *supra* note 231 at 5.

257. Aduddell Indus., Inc., Definitive Proxy Statement (Form 14A), at 5 (Apr. 30, 2007) ("All of the directors attended at least 75% of the formal meetings of the Board and the committees on which they serve."); Zenex Int'l, Inc., Definitive Proxy Statement (Form 14A), at 5 (Apr. 25, 2006) ("All of the directors attended at least 75% of the formal meetings."); Zenex Int'l, Inc., Definitive Proxy Statement (Form 14A), at 4 (May 3, 2005) ("All three directors attended at least 75% of the formal meetings."); Zenex Int'l, Inc., Definitive Proxy Statement (Form 14A), at 3 (Apr. 29, 2004) ("All three directors attend[ed] at least 75% of the formal meetings.").



theory seems sound. Independent directors have a better chance of serving as a check on management if they can have frank discussions about management without management listening. The problem is that many of the corporations in my study that agreed to such provisions already had policies requiring their independent directors to meet in executive session.<sup>258</sup> As just one example, take the settlement agreement in the derivative suit filed on behalf of SFBC International, Inc. This agreement includes a requirement that the independent directors regularly meet outside the presence of management,<sup>259</sup> a requirement that the derivative plaintiff highlighted as one of the “most significant provisions” in the settlement agreement.<sup>260</sup> Yet a review of the company’s proxy materials indicates that the board had adopted this policy years earlier, before the derivative suit was even filed.<sup>261</sup>

Indeed, many of the settlements included governance reforms that the corporation adopted well before the date of the settlement agreement. A prime example is the settlement agreement in the derivative suit filed on behalf of Rambus, Inc., which was filed with the court on October 29, 2008. In the settlement agreement, Rambus highlighted changes that the company had made to the policies by which it granted stock options.<sup>262</sup> The company agreed,

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258. This is not surprising given that, again, the listing standards of the major stock exchanges require independent directors to meet in executive session. *See* NYSE, Inc., Listed Company Manual § 303A.03 (2004) (“To empower nonmanagement directors to serve as a more effective check on management, the nonmanagement directors of each listed company must meet at regularly scheduled executive sessions without management.”); NASDAQ, Inc., Manual, Rule IM-5605-1 (2009) (“Independent Directors must have regularly scheduled meetings at which only Independent Directors are present (‘executive sessions’).”).

259. Stipulation and Agreement of Settlement at Ex. A, § 5(iv), *In re SFBC Int’l, Inc. Sec. & Derivative Litig.*, 495 F. Supp. 2d 477 (D.N.J. Aug. 6, 2008) (No. 2:06-cv-00165).

260. Memorandum of Law in Support of Final Approval and for an Award of Attorneys’ Fees and Expenses at 5 & n.7, *In re SFBC Int’l*, 495 F. Supp. 2d 477 (No. 2:06-cv-00165).

261. The company’s proxy statement in 2004 states that “our independent directors have begun meeting in executive sessions both alone and with our independent auditors and have adopted a policy to do so at each Board and Committee meeting.” SFBC Int’l, Inc., Definitive Proxy Statement (Form 14A), at 4 (May 12, 2004). The proxy materials for the next several years continue to note that the independent directors regularly met in executive session. *See, e.g.*, SFBC Int’l, Inc., Definitive Proxy Statement (Form 14A), at 4 (May 23, 2005); SFBC Int’l, Inc., Definitive Proxy Statement (Form 14A), at 5 (July 24, 2006); Pharmanet Dev. Group, Inc., Definitive Proxy Statement (Form 14A), at 9 (Apr. 30, 2007); Pharmanet Dev. Group, Inc., Definitive Proxy Statement (Form 14A), at 7 (Apr. 29, 2008).

262. *See* Stipulation of Settlement ¶ 2 at 9-13, *In re Rambus Inc. Derivative Litig.*, No. C

for instance, to adopt stock ownership guidelines for its directors and executive officers that required them to accumulate and maintain a certain value of the company's common stock.<sup>263</sup> It also agreed that new hire grants for all employees would be made on the first trading day of the month following their date of hire.<sup>264</sup> Yet Rambus's public filings indicate that it enacted these reforms in 2006,<sup>265</sup> after the filing of the derivative suit but approximately two years before the settlement. Several other settlement agreements in my study also included reforms that the company had implemented prior to entering into the settlement.<sup>266</sup>

Many other settlements included additional provisions of questionable value. In several suits, for example, the plaintiff corporation agreed as part of the settlement that it would not violate the law, a requirement that presumably applied prior to the filing of the suit.<sup>267</sup> The settlement agreement in the derivative suit filed on behalf of McAfee, Inc., for instance, requires the corporation to ensure that "[t]he members of the Audit Committee [are] financially literate as may be required by the rules of the NYSE" and states that "[t]he company shall comply with applicable federal proxy rules and the laws of the State of Delaware regarding shareholder proposals."<sup>268</sup> Similarly, the settlement agreement in

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06-3513 JF (HRL), 2009 WL 166689 (N.D. Cal. Oct. 29, 2008).

263. See *id.* ¶ 2.4 at 11.

264. See *id.* ¶ 2.5 at 12 (B).

265. See Rambus, Inc., Annual Report (Form 10-K), at 72-73 (Sept. 14, 2007) (stating that the company adopted the stock ownership guidelines in October 2006 and the new hire grant procedures in November 2006).

266. See, e.g., *In re Marvell Tech. Ltd. Derivative Litig.*, No. C-06-03894-RMW(RS), 2009 WL 1257012 (N.D. Cal. Mar. 20, 2009) (stating that Marvell had already dissolved its Stock Option Committee, amended the charter of its Audit Committee, and adopted new policies regarding the granting of equity based awards); Stipulation of Settlement ¶ 2.7 at 13, *In re Gen. Motors Corp. Derivative Litig.*, No. 06-1749 (E.D. Mich. Sept. 18, 2008) (stating that consideration for the settlement includes certain "changes in internal controls ..., some of which were implemented since the commencement of the Actions, were adopted in part as a response to issues of the type raised in the Actions"); Stipulation of Settlement ¶ 2.5 at 11, Stipulation of Settlement, Ex. D, *In re Semtech Corp. Derivative Litig.*, No. 2:06-cv-03510 (C.D. Cal. Sept. 4, 2008) (stating that consideration for the settlement includes reforms made in 2006 and 2007).

267. These provisions may provide some small benefit by allowing the derivative plaintiffs to return to the same court and reopen the same lawsuit if the plaintiff corporation violates the specified laws. Yet this benefit seems miniscule compared to the costs of a derivative suit.

268. Stipulation of Settlement at 20, 24, *In re McAfee, Inc. Derivative Litig.*, No. 5:06-cv-

a derivative suit involving Vitesse Semiconductor Corp. states that “the Company shall comply with legal requirements for proper disclosure and proper accounting [of stock options].”<sup>269</sup> It is hard to imagine that the corporation benefitted from spending millions in legal fees only to end up with an agreement prohibiting it and its executives from violating the law.

My point here is not that the settlements in these cases were without merit. My analysis takes issue with select provisions in the settlement agreements, while recognizing that other provisions reflect a closer link to the specific harm alleged in the complaint. Ironically, despite the inefficacy of many of the reforms in my study, empirical research shows that certain corporate reforms *do* have merit and thus that corporate governance settlements may be a promising concept. These reforms are just not the ones typically included in corporate governance settlements.

For example, Professor Lucien Bebchuk and others determined that six specific policies are negatively correlated with firm valuation and, therefore, eliminating these provisions may enhance corporate value.<sup>270</sup> These policies include staggered boards, limitations on shareholders’ ability to amend bylaws, supermajority requirements for charter amendments, supermajority provisions to approve a merger, golden parachutes, and poison pills.<sup>271</sup> Yet, few corporate governance settlements in my study included these reforms, which suggests that corporate governance settlements are not living up to their potential. Only two settlements included provisions to repeal or amend a poison pill, only five of the settlements include provisions for the annual election of directors, and few agreements included the other items on Professor Bebchuk’s list. Instead, the settlements typically included a long list of other reforms that have no proven impact on corporate performance. As Professor Bebchuk and his coauthors noted, this “kitchen

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3484-JF (N.D. Cal. Oct. 1, 2008).

269. Amended Stipulation and Agreement of Settlement, *supra* note 201, at Ex. C, ¶ 2(f).

270. Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783, 784-87 (2009). Professor Bebchuk and his coauthors were careful to note that the negative correlation does not establish causality and that additional work in this area is needed.

271. *See id.* at 784-85.

sink” approach can encourage reforms that ultimately accomplish little.<sup>272</sup>

Why do derivative plaintiffs, and their attorneys, agree to settlements that include provisions of such limited value? This section began by presenting evidence that corporate governance settlements are the latest frontier for shareholder activism,<sup>273</sup> and it is certainly true that the reforms in many of these settlements are the same “best practices” reforms that activist shareholders promote outside of the courtroom.<sup>274</sup> Yet it is just as true that at least some of these reforms have little value, either empirically or for the specific companies at issue.<sup>275</sup>

This observation raises a more cynical possibility about corporate governance settlements. Although several of these settlements may be legitimate efforts to reform corporate governance, others may simply be means for plaintiffs’ attorneys to recover their fees.<sup>276</sup> Even if individual defendants will not pay millions of dollars to settle the suits, the plaintiff corporations may be willing to agree to nominal reforms and relatively small attorneys’ fees to make the suits go away. The prevalence of corporate governance settlements in my study supports the view of scholars and commentators that many derivative suits are strike suits in which the real winners are not corporations or their shareholders, but attorneys.<sup>277</sup>

Indeed, these settlements may reflect the type of “cosmetic compliance” that scholars such as Kimberly Krawiec have docu-

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272. See *id.* at 787.

273. See *supra* notes 239-49 and accompanying text.

274. See, e.g., Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1795 (2007) (noting the overlap between the best practices espoused by the Court in *Caremark* and those contained in the ensuing shareholder proposals that activist shareholders presented).

275. See Bebchuk et al., *supra* note 251.

276. Early studies of derivative suits raised a similar possibility. Roberta Romano’s study of shareholder litigation in the 1970s and 80s found that parties often settled derivative suits in exchange for “cosmetic” corporate governance reforms. Romano, *supra* note 41, at 63. She stated that “a likely explanation” for these settlements “is the need to paper a record to justify an award of attorneys’ fees to courts.” *Id.*

277. See, e.g., Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 3-4 (1999) (arguing that the value “obtained by ‘successful’ plaintiffs [in derivative suits] has often been insubstantial, especially when viewed in light of the fees sought by plaintiff’s counsel”).

mented in other settings.<sup>278</sup> Even if corporate governance settlements have the potential to be a meaningful avenue for corporate reform, they are perhaps even more likely to be an opportunity for managers to adopt merely cosmetic reforms. Such reforms pass the minimal judicial scrutiny that is the norm in derivative litigation without having any tangible impact on corporate controls. In short, corporate managers “may press an interpretation of law that signals compliance with the relevant legal regime, but fails to fulfill the normative goals of regulation.”<sup>279</sup>

The legal system does not include safeguards to ensure that corporate governance settlements are comprised of more than window dressing. As scholars have long noted, derivative plaintiffs usually own too little stock in the plaintiff corporation to ensure that settlements are in the best interests of these corporations.<sup>280</sup> Even institutional investors who typically own more stock in the plaintiff corporation often face practical constraints on their ability to demand more meaningful reform.<sup>281</sup> Nor do their attorneys have the incentive to ensure meaningful reform. As discussed above, plaintiffs’ attorneys are entitled to compensation in derivative suits as long as the settlement provided “substantial benefit” to the plaintiff corporation, a point to which the parties typically stipulate in the settlement agreement and that is rarely challenged by the court.<sup>282</sup>

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278. Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 533 (2003) (“Senior management of business organizations, for example, may seek to disrupt current practice as little as possible, while still assuring courts and regulatory agencies that they have met the goals of any new policy.”).

279. *Id.*

280. See, e.g., Erickson, *supra* note 98, at 100.

281. For example, Roberta Romano argued that public pension funds—the type of institutional investors most common in federal derivative suits—face conflicts of interest that often prevent them from demanding more meaningful reforms. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 798 (1993) (concluding that “[i]ncreasing public funds’ activism is ... a problematic substitute for a well-functioning market for corporate control as a means of mitigating the agency problem at the heart of corporate law”); see also Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 337-41 (2008) (discussing survey evidence regarding the incentives of public pension funds to participate in litigation activism).

282. See *supra* note 210 and accompanying text.

The other players in a derivative suit offer little additional protection. Corporate managers have little incentive to use derivative suits to overhaul corporate governance in a meaningful way. These managers are often named in the suits<sup>283</sup> and may, therefore, come to the negotiating table in a defensive posture. Moreover, many managers likely resist new reforms being forced upon them—after all, if they thought significant reform was a good idea, they would have adopted the reforms independent of the litigation. Even courts, who are charged under Rule 23.1 with protecting the interests of plaintiff corporations,<sup>284</sup> rarely engage in a searching review of these settlements. Instead, my study found that courts typically rubberstamp settlements in derivative suits with little inquiry into the merits of specific governance reforms.<sup>285</sup> Given the parade of weaknesses inherent in the system, it is not surprising that many corporate governance settlements include only cosmetic changes.

Before writing off corporate governance settlements entirely, however, perhaps we can analyze these settlements from another angle. Thus far, the inquiry has focused on whether corporate governance settlements benefit plaintiff corporations or their shareholders. It is possible, however, that even if many of these settlements have little compensatory value for corporations, the value of these settlements instead lies in deterring future misconduct—a final possibility to which we now turn.

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283. *See supra* Part II.B.2.c.

284. FED. R. CIV. P. 23.1.

285. The judges in my study rarely probed the terms of the settlements. Yet there have been cases in which courts played a more active role in reviewing the settlements, which can have a positive impact on the final settlement terms. A prime example is the derivative suit filed on behalf of Zoran Corporation. The parties originally agreed to a settlement that included only the repricing of options and corporate governance reforms. The court rejected the settlement, calling it “illusory” because the company adopted many of the terms of the settlement independent of the derivative suit. Order Denying Preliminary Approval of Proposed Settlement of Derivative Action at 16-17, *In re Zoran Corp. Derivative Litig.*, No. C 06-5503 WHA (N.D. Cal. Apr. 7, 2008). Forced back to the negotiating table, the parties negotiated a new settlement in which the plaintiff corporation received a multimillion cash payment. *See* Lead Plaintiff’s Motion for Preliminary Approval of Proposed Settlement at ¶ 2.4, *In re Zoran Corp. Derivative Litig.*, No. 06-05503-WHA (N.D. Cal. May 29, 2008).

*C. The Possibility of Deterrence*

A growing group of scholars has argued that the aim of representative litigation, including derivative suits or class actions, should be deterrence rather than compensation.<sup>286</sup> Myriam Gilles and Gary Friedman, for example, argued that representative litigation is ill-suited to providing meaningful compensation, whereas it can have a powerful impact in deterring future misconduct.<sup>287</sup> In the class action arena, class members often have little interest in recouping small-scale damage awards and, therefore, they argued that class action law should devote less attention to protecting class members' rights in trifling sums that they often do not want.<sup>288</sup> Instead, the focus should be on evaluating whether class actions adequately deter misconduct.<sup>289</sup> Class actions perform well under this analysis, according to Gilles and Friedman, because "[e]xecutives tempted to lie about earnings are more concerned about Bill Lerach and Melvyn Weiss [two formerly high-profile plaintiffs' attorneys currently in prison for giving kickbacks to clients] than they are about the Securities and Exchange Commission."<sup>290</sup> Perhaps the same logic applies to derivative suits.

Derivative suits may have their most promise when viewed through the lens of deterrence. This promise is not always evident, however, especially in light of the outcomes of the suits in my study. As explained above, approximately 70 percent of the suits were dismissed.<sup>291</sup> It is hard to see at first glance how such dismissals meaningfully deter corporate officers and directors. Indeed, as other scholars have recognized, the deterrent value of litigation depends in large part on two factors: the sanctions imposed in the litigation

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286. Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 106 (2006); A.C. Pritchard, *Markets as Monitors: A Proposal To Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 929-30 (1999).

287. Gilles & Friedman, *supra* note 286, at 105-06.

288. *See id.*

289. *See id.* at 106.

290. *See id.*; *see also* Joe Nocera, *Serving Time, but Lacking Remorse*, N.Y. TIMES, June 7, 2008, at C1.

291. *See supra* Part II.D.2-3.

and the social shame from being named in the litigation.<sup>292</sup> In the derivative suits that end in dismissal, the individual defendants face no sanctions whatsoever. Moreover, the high dismissal rate contributes to the prevailing belief that shareholder litigation is frivolous,<sup>293</sup> which diminishes the social shame associated with being named as a defendant in such litigation.

The remaining 30 percent of suits that settled had more mixed deterrent effects. Many of the stock option suits in my study did successfully target the individual defendants, forcing them to pay money out of their own pockets and/or reprice or forfeit their stock options.<sup>294</sup> These settlements likely had some deterrent value, demonstrating that backdating stock options does not pay.

The classic derivative suits in my study, that is, those that did not involve backdated stock options, had less deterrent value. This value certainly did not come from the outcomes of the suits. After all, only two of the classic derivative public company cases ended with any of the defendants paying any money out of their own pockets. In the remaining cases, the individual defendants were largely absent. As detailed above, the plaintiff corporation typically agreed to reform specific parts of its corporate governance, from adding additional directors to hiring experts to advise the board.<sup>295</sup> The lives of the individual defendants, however, were unchanged. If corporate managers are contemplating engaging in malfeasance, it is hard to see how the threat of corporate governance settlements will deter them.

Moreover, the deterrent value of these suits must be viewed in light of the other litigation commenced as a result of the alleged wrongdoing. The vast majority of the derivative suits in my study filed on behalf of public companies were accompanied by a parallel securities class action.<sup>296</sup> These class actions were typically filed against the plaintiff corporation and many of the same individual

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292. James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 5 (1999).

293. See *supra* note 146 and accompanying text.

294. See *supra* notes 195-201 and accompanying text.

295. See *supra* Part III.A.

296. Far fewer of the private company suits were accompanied by a parallel securities class action.



defendants named in the derivative suits. Many companies and individual defendants were also targeted in enforcement actions filed by the Securities and Exchange Commission. Accordingly, any deterrent value is likely reduced by the fact that the company and many of its managers are already named in parallel litigation, litigation that typically results in stiffer penalties and thus greater deterrent value.

Yet it is critical to recognize that derivative suits may have deterrent value even if they rarely end with meaningful sanctions against the alleged wrongdoers. Importantly, derivative suits likely deter corporate managers who do not want to suffer the reputational harm of being publicly identified with corporate wrongdoing.<sup>297</sup> These suits may also deter directors who are risk averse in the face of the possibility of liability.<sup>298</sup> Moreover, most corporate managers do not know just how unsuccessful most derivative suits are.<sup>299</sup> These managers may decide not to engage in misconduct simply because they overestimate the likelihood that they will face sanctions.

Furthermore, fiduciary duties are alive and well in the boardroom even if they are largely absent from the courtroom. Derivative suits are the procedural mechanism to enforce fiduciary duties,<sup>300</sup> and these duties retain a strong presence in corporate law despite the now-documented shortcomings associated with derivative suits. Corporate lawyers still spend significant time explaining fiduciary duties to corporate managers, and managers still listen.<sup>301</sup>

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297. See Cox, *supra* note 292, at 5 (arguing that an additional deterrent of shareholder litigation is “the social opprobrium that attaches to the suits’ defendants”).

298. See, e.g., Brandi, *supra* note 146, at 386-87 (noting that directors’ risk aversion, which stems from their focus only on the litigation at hand and their potential personal liability, often leads to settlements with plaintiffs).

299. See *id.* at 386 (pointing out that most directors and officers “tend not to be experienced in dealing with ... shareholder litigation”).

300. Shareholders can also bring fiduciary duty claims directly if they, rather than the corporation, suffered the injury. Such direct claims are common, at least in the Delaware Court of Chancery, but outside the scope of this study. See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 167-68 (2004) (analyzing the rise of acquisition-oriented shareholder class actions).

301. See generally Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 4 BUS. LAW. 1105 (2009).

Seminal Delaware decisions such as *Disney*,<sup>302</sup> *Caremark*,<sup>303</sup> and *Van Gorkom*<sup>304</sup> have shaped the way that boards approach key corporate decisions, encouraging boards to surround themselves with knowledgeable advisors, ensure independent review of related party transactions, and monitor corporate compliance practices.<sup>305</sup> Indeed, these high-profile cases have likely had a much greater impact on the best practices of corporate boards than the majority of securities class actions. Fiduciary duties still provide an important framework for board decision making even if the enforcement mechanisms for these duties are broken.

In the end, however, without an effective enforcement mechanism, doctrine can only do so much. Even if fiduciary duties shape discussions in corporate boardrooms, these duties standing alone cannot compel managers to comply with their duties or penalize disloyal managers. The chief function of derivative suits should be to enforce the fiduciary duties of corporate officers and directors. As derivative suits become simply another tool of activist shareholders and eager attorneys, this function is increasingly left by the wayside.

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302. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 35-36 (Del. 2006).

303. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 961 (Del. Ch. 1996) (holding that neither the failure of the board to predict the consequences of its strategies, nor the scale of the company's liability, "[gave] rise to an inference of breach of any duty imposed by corporation law upon the directors of Caremark").

304. *Smith v. Van Gorkom*, 488 A.2d 858, 864 (Del. 1985) (holding that the board's approval of a cash-out merger was not an informed business decision, and that the board furthermore "did not deal with complete candor with the stockholders by failing to disclose all material facts ... before securing the stockholders' approval of the merger").

305. See, e.g., Lawrence A. Hamermesh, *Twenty Years After Smith v. Van Gorkom: An Essay on the Limit of Civil Liability of Corporate Directors and the Role of Shareholder Inspection Rights*, 45 WASHBURN L.J. 283, 284 (2006) ("[T]he *Disney* case itself has illustrated [that], the civil liability system, by providing a forum for intense public inspection of the content of director action, has had a salutary effect on the development of corporate governance standards by eliciting useful director attention."); see also Hill & McDonnell, *supra* note 274 (noting "the rush to abide by '*Caremark* duties' after the case was decided" leading to "[c]orporations employ[ing] well-paid advisers to tell them how to avoid conduct that might trigger liability").

## CONCLUSION

Shareholder derivative suits stand at a crossroads. Mounting empirical evidence reveals that the vast majority of shareholder derivative suits do not benefit the corporations on whose behalf the suits are brought. As my study reveals, shareholder derivative suits have become the latest battleground for shareholder activism, with shareholders agreeing to settle shareholder derivative suits in exchange for corporate governance reforms that are often untested and/or patently unhelpful for both the corporations and their shareholders. The chief beneficiaries of this strategy are law firms, which receive hundreds of thousands or even millions of dollars in attorneys' fees.

As the focus turns to reforming shareholder derivative suits, several possibilities emerge. At the very least, district courts should exercise far more oversight over settlements in these suits. Courts should not simply accept the parties' representations regarding the merits of the settlements, especially when settlements are comprised solely of corporate governance reforms. Instead, courts should probe the settlement terms in shareholder derivative suits much more carefully and examine whether the specific reforms set out in the settlement agreements are likely to benefit the specific corporations named in the suits.

The time is coming, however, when we will have to address the broader question of whether to draw the curtain on shareholder derivative suits altogether. My study finds that shareholder derivative suits are broken, a conclusion that leads to two possible—but very different—avenues for reform. If shareholder derivative suits are duplicative of other litigation, then corporate law may not need them. If, on the other hand, shareholder derivative suits have the potential to serve as an independent and meaningful check on corporate misconduct, then policymakers and scholars should focus on reforming these suits. For example, the law could restrict the filing of derivative suits to those shareholders who own sufficient stock in the plaintiff corporation to represent the corporation's interests in an effective way. Alternatively, policymakers may consider eliminating procedural hurdles such

as the demand requirement for shareholders with a sizeable ownership interest in the plaintiff corporation. The choice between reforming shareholder derivative suits and abandoning them depends on their role within the larger landscape of corporate law, an area that awaits further empirical inquiry.

These issues remain for another day, but one thing is clear—although shareholder activism has moved to the courtroom, there is little evidence that this move has advanced the cause of corporate accountability. In the end, the courtroom is not the best place to reform corporate governance.

