CORPORATE MISCONDUCT AND THE PERFECT STORM OF SHAREHOLDER LITIGATION

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When it comes to combating corporate misconduct, is more litigation necessarily better? The conventional wisdom is that we should deploy every weapon in the law's arsenal to combat corporate misconduct. This wisdom, however, reflects legal scholarship that is confined to analyzing securities class actions and derivative suits in isolation, with little inquiry into the interplay between them. By failing to take a broader view of shareholder litigation, legal scholars have missed an opportunity to provide courts with the conceptual tools necessary to meet the complex challenges of complex corporate litigation. In courtrooms and boardrooms across the country, a debate is raging over whether courts should permit shareholders to file parallel securities class actions and derivative suits arising out of the same allegations of corporate wrongdoing—a debate that has gone almost entirely unnoticed in the legal academy. The time has come for legal theory to catch up with legal practice. We must re-conceptualize the tools we use to combat corporate misconduct, recognizing that securities class actions and derivative suits can work together to achieve the diverse goals of shareholder litigation. We should then bring these new conceptual insights to bear on the current legal debate over how courts should handle parallel securities class actions and derivative suits. Now is the perfect time to calm the perfect storm of shareholder litigation.

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INTRODUCTION

In the wake of corporate misconduct, corporations are often caught in a perfect storm of shareholder litigation.[1] In securities class actions, corporations are the defendants, and their goal is to fend off allegations of corporate wrongdoing. In derivative suits, these same corporations (acting through representative shareholders) are the plaintiffs, and their goal is often to prove the very allegations that the corporations are denying in the securities class actions. These lawsuits thus place corporations on both sides of a single legal battle, creating a risk that a corporation will prevail in a derivative suit only to find its victory used against it in a securities class action. Given the recent wave of massive corporate scandals, perhaps the corporation's predicament should not trouble us. Indeed, the flood of litigation may reassure us that similar corporate scandals are less likely to occur in the

1 Like Sebastian Junger, I use the term "perfect storm" in a meteorological sense, in the sense of "a storm that could not possibly have been worse." SEBASTIAN JUNGER, THE PERFECT STORM xiv (1997). The use of this term is not meant to imply that corporations are blameless or that they find themselves in this predicament through mere chance. *Cf.* Nancy B. Rapoport, *Enron,* Titanic*, and* The Perfect Storm, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 927, 929–930 (Nancy B. Rapoport & Bala G. Dharan eds., 2004) (arguing that Enron was brought down by a "synergistic combination of human errors and hubris: a 'Titanic' miscalculation, rather than a 'perfect storm'").

future. Yet a troubling question remains. When it comes to combating corporate misconduct, is more litigation necessarily better?

The conventional wisdom is that we should deploy every weapon in the law's arsenal to combat corporate misconduct.[2] Securities class actions and derivative suits are the primary weapons in this arsenal because they are the means by which shareholders enforce the legal duties of corporations and their managers.[3] Eager to prevent the next Enron, legal scholars have devoted considerable attention to these lawsuits, but their scholarship has been almost entirely confined to analyzing securities class actions and derivative suits in isolation, without examining the interplay between them.[4] In an era when corporations accused of misconduct are besieged by litigation,[5] this

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2 *See infra* Part II.

3 I am speaking here purely about the legal means to enforce fiduciary duties. The market obviously plays a powerful role in policing corporate managers as well. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418–22 (1989). In cases involving mergers or acquisitions, shareholders may also be able to enforce the fiduciary duties of corporate managers through direct suits (usually shareholder class actions) filed under state law. *See, e.g.*, Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 181 (2004) (analyzing the rise of acquisition-oriented shareholder class actions). Outside of the acquisition context and certain other narrow contexts, however, shareholders are generally limited to filing a derivative suit or a federal securities class action to enforce the legal duties of managers.

4 *See, e.g.*, Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1468–76, 1507–22 (2004) (exploring the impact of changes in federal law on securities class actions and the possibility of exporting the securities class action model to other countries); James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 5–19 (1999) (analyzing the deterrent and compensatory goals of derivative suits); Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1758–61 (1994) (analyzing the conflicts of interest inherent in securities class actions); Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1762 (2004) (exploring the role of derivative suits in modern corporate litigation); 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, 2105–09 (1995) (arguing that institutional investors should play a greater role in monitoring the settlements of securities class actions).

5 For example, when the massive fraud at Enron Corporation was revealed, the company was named in nearly one hundred securities class actions and fifty derivative suits. *See* Disclosure Statement for Fifth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code, at app. E, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Jan. 9, 2004), *available at* http://www.elaw4enron.com/EnronPlanframe.htm; Joann S. Lublin & John R. Emshwiller, *Enron Board's Actions Raise Liability Questions*, WALL ST. J., Jan. 17, 2002, at C1.

traditional approach no longer makes sense, if indeed it ever did.[6]

Now more than ever, legal scholars must rethink the way in which they view shareholder litigation. In boardrooms and courtrooms across the country, a debate is raging over whether shareholders should be permitted to file derivative suits based on the same allegations as parallel securities class actions.[7] This debate raises fundamental questions about the ambitions of shareholder litigation and its role in combating corporate misconduct. Scholars have long recognized that shareholder litigation is intended to deter future instances of corporate misconduct and punish the individuals involved in corporate scandals.[8] Yet shareholder litigation—like all private litigation—is also intended to compensate the plaintiffs in these lawsuits, including corporate plaintiffs in derivative suits.[9] These compensatory goals should not fall by the wayside when a securities class action is added to the mix. After all, a corporation has little to gain by winning $5 million in a derivative suit if the suit in turn causes the corporation to lose $50 million in a related securities class action.

The time has come for legal theory to catch up with legal practice. First, we need to reconceptualize the way in which we view shareholder litigation. The current doctrinal framework fails to recognize that securities class actions and derivative suits can work together to achieve the diverse goals of shareholder litigation. As a result, the current framework misses an opportunity to provide courts with the conceptual tools necessary to meet the complex challenges of complex corporate litigation. Second, we must bring these new conceptual insights to bear on the current legal debate over how courts should handle parallel securities class actions and derivative suits. Once we understand that society's desire to deter corporate misconduct need not rest solely on the shoulders of derivative suits, we can (and should) recognize that these suits have greater value in promoting compensatory goals. In practice, this means that courts should

6 A few scholars have discussed briefly the relationship between various types of shareholder litigation. *See, e.g.*, Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 412–15 (2008); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 887–90 (2003). No scholar, however, has ever performed an extensive analysis of this relationship.

7 *See infra* notes 40–42 and accompanying text.

8 *See infra* notes 125–29 and accompanying text.

9 *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 784, 786 (Del. 1981) (holding that "[d]erivative suits enforce corporate rights" and that the law permits shareholders to sue on behalf of corporations where "it is apparent that material corporate rights would not otherwise be protected").

only permit shareholders to pursue derivative suits that are in the best interests of plaintiff corporations, taking into account all of the costs and benefits of the suit, including the impact of the suit on a parallel securities class action—an approach that many courts have steadfastly rejected.

This Article proceeds in three parts. Part I explores the conflict between securities class actions and derivative suits. This Part challenges the conventional wisdom that securities class actions and derivative suits are a zero-sum game, or more specifically, that corporations can use derivative suits to offset their losses in securities class actions. Part II explores the current judicial response to this conflict, arguing that courts have been unable to resolve the conflict because they have failed to understand the proper goals of shareholder litigation. Part III presents a proposed solution to this conflict. This proposal reconceptualizes the relationship between various types of shareholder litigation, recognizing the value, and the limits, of different types of shareholder lawsuits. In the end, more litigation is not necessarily better when it comes to combating corporate misconduct.

I. The Conflict Between Securities Class Actions and Derivative Suits

Legal scholars have ignored the relationship between securities class actions and derivative suits because they have accepted an unspoken but powerful conventional wisdom.[10] According to this conventional wisdom, derivative suits benefit corporations even when they

10 This conventional wisdom is so well accepted in the legal literature that no scholars have questioned it or even addressed it explicitly, and yet it is the common response when the topic of the relationship between securities class actions and derivative suits is raised. We can see more subtle expressions of the conventional wisdom in a number of contexts. For example, courts often permit a single attorney to represent the named shareholders in both a derivative suit and a securities class action. Even though the attorney is representing the corporation in one suit and suing the corporation in the other suit, courts have held that these dual roles are permissible given that the goal of both suits is to "attack . . . alleged misconduct by corporate management." *In re* Dayco Corp. Derivative Sec. Litig., 102 F.R.D. 624, 630 (S.D. Ohio 1984); *see also* Grace v. Rosenstock, No. CV-85-2039, 1986 WL 2709, at *3 (E.D.N.Y. Mar. 6, 1986) ("The prevailing view is that class and derivative actions represented by the same plaintiff and counsel are not inherently precluded by conflicting party alignment." (quoting Herbert B. Newberg, Newberg on Class Actions § 22.23 (2d ed. 1977)). Courts have also permitted plaintiff shareholders to join securities claims and derivative claims in a single lawsuit. *See, e.g.*, Keyser v. Commonwealth Nat'l Fin. Corp., 120 F.R.D. 489, 492 (M.D. Pa. 1988) (joining a securities class action and a derivative suit because both lawsuits were "equally contingent upon the proof of the same nucleus of facts" (quoting *In re* Dayco Corp., 102 F.R.D. at 630)).

follow on the heels of parallel securities class actions because derivative suits allow corporations to recoup the losses that corporations incur in securities class actions.[11] This conventional wisdom, however, misses a key piece of the puzzle. While it recognizes the similarities between securities class actions and derivative suits—similar players, similar factual allegations, and similar legal standards—it ignores the key differences between these lawsuits, including the differences in the amount of recoverable damages and the differences in the interests of the parties filing the lawsuits. When one examines the full picture, similarities and differences, the conflict between securities class actions and derivative suits becomes clear.

A. *Surveying Similarities*

1. Similar Players

To understand the conventional wisdom, as well as its flaws, one must first recognize that the players in securities class actions and derivative suits are often identical, although their roles are not. 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.[12] The defendants in a securities class action are the corporation and the corporation's current or former officers and directors. The corporation is directly liable for its own false or misleading statements and vicariously liable for the false or misleading statements of its officers and directors.[13] Any recovery in the lawsuit goes to the corporation's

11 *See, e.g.*, Geoffrey P. Miller, *Conflicts of Interest in Class Action Litigation: An Inquiry into the Appropriate Standard*, 2003 U. CHI. LEGAL F. 581, 604 ("A . . . zero-sum situation arises when class counsel brings both derivative and direct cases based on the same nucleus of operative fact.").

12 Over 90% of securities class actions allege violations of section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b) (2006), which prohibits corporations or other persons from making false or misleading statements in connection with the purchase or sale of a security. *See* Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 498 (2007).

13 *See, e.g.*, Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 365–66 (5th Cir. 2004) (holding that a corporation is directly liable for all false or misleading statements contained within "the SEC filings, reports and releases issued in its name" as long as the false or misleading statements were made with scienter); *In re* Cylink Sec. Litig., 178 F. Supp. 2d 1077, 1088 (N.D. Cal. 2001) ("A corporate entity can be vicariously liable under section 10(b) for the fraud of its officers. So long as scienter is appropriately alleged for the officers and directors of a company, then it is appropriately alleged for the company itself." (citation omitted)).

shareholders.[14] I will refer to the corporation in its role as a defendant in a securities class action as the "defendant corporation" and to the shareholders in these actions as "securities plaintiffs."

The corporation's role in a derivative suit is reversed. In a derivative suit, the corporation is the functional plaintiff—the real party in interest[15]—and the allegations are that the corporation's current or former officers and directors breached their fiduciary duty to the corporation.[16] Any recovery in a derivative suit is returned to the corporation.[17] As a result, shareholders may receive an indirect benefit from a derivative suit because of their share of ownership in the corporation, but they do not receive any direct financial benefit.

In a derivative suit, despite the fact that the suit is brought in its name, the corporation's role is limited because shareholders file these suits on behalf of corporations. 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 therefore cannot be trusted to make unbiased decisions regarding the merits of these suits.[18] I will refer to the corporation in its role as the plaintiff in a derivative suit as the "plaintiff corporation" and to the shareholders who file derivative suits as the "derivative plaintiffs."

The conflict between securities class actions and derivative suits results in large part from the fact that the same parties are showing up

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14 *See* Volk v. D.A. Davidson & Co., 816 F.2d 1406, 1413 (9th Cir. 1987) (holding that the "general rule" is that shareholders in a securities class action can "recover the difference between the value of the consideration paid and the value of the securities received, plus consequential damages that can be proven with reasonable certainty to have resulted from the fraud").

15 *See* Van Gelder v. Taylor, 621 F. Supp. 613, 620 (N.D. Ill. 1985) ("As a general rule, the plaintiff stockholder in a stockholder's derivative suit is 'at best the nominal plaintiff.' The corporation is the real party in interest, regardless of the fact that the corporate management has failed to pursue the action." (citation omitted) (quoting Liddy v. Urbanek, 707 F.2d 1222, 1224 (11th Cir. 1983))).

16 *See* Janssen v. Best & Flanagan, 662 N.W.2d 876, 882 (Minn. 2003) ("Derivative suits allow shareholders to bring suit against wrongdoers on behalf of the corporation, and force liable parties to compensate the corporation for injuries so caused.").

17 *See* Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 351 (Del. 1988) ("In [a derivative suit] the shareholder sues on behalf of the corporation . . . . [A]ny damages recovered . . . are paid to the corporation." (quoting ROBERT C. CLARK, CORPORATE LAW 639–40 (1986))).

18 *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it.").

in both courtrooms.[19] When a corporation is on the hook for losses resulting from individual defendants' conduct in a securities class action, it will understandably be reluctant to press claims against these same individuals in a derivative suit. This conflict is exacerbated by the fact that the arguments being made in these two lawsuits, from the factual allegations to their legal ramifications, are strikingly similar as well.

2. Similar Factual Allegations

The factual allegations in securities class actions and derivative suits provide a window into a corporation's darkest hours. These lawsuits are replete with allegations of sweeping financial impropriety and corporate duplicity. In securities class actions, shareholders typically allege that the corporation's public statements were false or misleading as a result of the corporation's failure to disclose problems with its business model or financial results.[20] In a derivative suit, shareholders frequently allege that the corporation's officers or directors breached their fiduciary duty to the corporation by making the false or misleading public statements[21] or by causing the problems in the first instance.[22] Thus, shareholders can turn a single set of facts into the basis of both a securities class action and a derivative suit.

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19 It is true that there is often not a perfect overlap between the individual defendants in the two sets of suits. Securities class actions tend to involve claims against corporate officers, while derivative suits tend to involve claims against corporate directors. *Cf.* Thompson & Sale, *supra* note 6, at 895–96 (presenting data illustrating that corporate officers are named in securities class actions more often than corporate directors). For the corporation, however, as long as the factual allegations against the individual defendants revolve around the same core set of events, the fact that the two lawsuits do not involve the exact same group of individual defendants does little to ameliorate the company's predicament.

20 *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS: 2007 MID-YEAR ASSESSMENT 13 (2007), http://securities.cornerstone.com/pdfs/2007%20Mid-Year%20Assessment.pdf (finding that ninety-two percent of securities class actions allege misrepresentations in financial documents).

21 *See* Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) ("[D]irectors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances.").

22 *See, e.g.*, Rattner v. Bidzos, No. Civ.A. 19700, 2003 WL 22284323, at *1 (Del. Ch. Sept. 30, 2003) (alleging that the individual defendants in a derivative suit "breached their fiduciary duty of care by inadequately maintaining accounting controls and utilizing improper accounting and audit practices"); Manzo v. Rite Aid Corp., No. Civ.A. 18451-NC, 2002 WL 31926606, at *2 (Del. Ch. Dec. 19, 2002) (relating the plaintiff's allegations that a corporation's directors and officers were liable in a derivative suit under a breach of fiduciary duty theory for allegedly false and misleading

The litigation against Martha Stewart Living Omnimedia, Inc. (MSL) illustrates this point. These claims arose out of the well-known obstruction of justice charges filed against Martha Stewart, the domestic doyenne and former Chief Executive Officer and Chairperson of MSL.[23] Martha Stewart had significant personal holdings in a small biotechnology company called ImClone Systems, Inc.[24] Stewart was also a personal friend of Sam Waksal, ImClone's then-CEO.[25] On December 26, 2001, ImClone learned that the FDA had rejected its drug application for a cancer drug called Erbitux.[26] Over the next several days, Stewart had conversations with her broker regarding her ImClone stock and may also have spoken with Waksal directly.[27] On December 27, 2001, the day before ImClone announced the FDA's rejection of its drug application, Stewart sold all of her personal ImClone stock, then worth approximately $228,000.[28] The timing of Stewart's stock sale raised the suspicion of the Securities and Exchange Commission and the United States Attorney for the Southern District of New York, both of which filed charges in connection with the sale.[29]

In the summer and fall of 2002, MSL sought to protect Stewart by repeatedly denying that she had traded on the basis of inside information.[30] As more information relating to the sale became public, how-

statements "in virtually every single piece of financial information released by Rite Aid for over three years").

23 In March 2004, Stewart was convicted of conspiracy, obstruction of justice, and making false statements relating to her sale of ImClone stock. *See* Associated Press, *Martha Stewart to Fight Civil Case*, WALL ST. J., May 27–28, 2006, at B3. The SEC also filed civil charges of insider trading against Stewart. *See* Press Release, Sec. & Exch. Comm'n, Martha Stewart and Peter Bacanovic Settle SEC's Insider Trading Charges (Aug. 16, 2006), *available at* http://www.sec.gov/news/press/2006/2006-134.htm.

24 *See* Consolidated and Amended Class Action Complaint ¶ 33, Semon v. Martha Stewart Living Omnimedia, Inc., 2003 WL 22769065 (S.D.N.Y. May 23, 2003) (No. 02-CV-6273 (JES)), 2002 WL 32495905 [hereinafter Securities Complaint]. The Consolidated and Amended Class Action Complaint is the last version of the complaint filed in the securities class action. This action consolidated seven securities class actions previously filed in the Southern District of New York. *See* Martha Stewart Living Omnimedia, Inc., Annual Report (Form 10-K), at 12–13 (Mar. 15, 2004).

25 *See* Securities Complaint, *supra* note 24, ¶ 33.

26 *See id.* ¶¶ 44–45.

27 *See id.* ¶¶ 49–53.

28 *See id.* ¶ 53.

29 *See* Press Release, Sec. & Exch. Comm'n, SEC Charges Martha Stewart, Broker Peter Bacanovic with Illegal Insider Trading (June 4, 2003), *available at* http://www.sec.gov/news/press/2003-69.htm.

30 *See, e.g.*, Securities Complaint, *supra* note 24, ¶ 87 ("Martha Stewart did not receive any nonpublic information regarding ImClone prior to her sale of a small number of ImClone shares. Her transaction was entirely lawful." (quoting June 7,

ever, and MSL's shareholders began to fear civil and criminal repercussions against Stewart, the price of MSL's stock began to fall dramatically, from a high of $18.45 on June 3, 2002 to a low of $6.69 on August 9, 2002.[31] By the end of the summer, several MSL shareholders had filed securities class actions alleging that the company made false and misleading statements when it denied that Stewart had received inside information.[32] These class actions were quickly followed by derivative suits based on the same facts.[33] The derivative suits alleged that Stewart, as well as other MSL officers and directors, violated their fiduciary duties to the corporation by failing to ensure that Stewart carried out her personal affairs in a way that did not jeopardize the financial well-being of the corporation.[34]

A comparison of the complaints in the two sets of cases shows how easily the shareholder plaintiffs were able to use the same set of facts to support two different legal theories. Both complaints alleged that MSL depended heavily on Martha Stewart's image, citing the same paragraph of a MSL prospectus in which the company stated that "[o]ur continued success and the value of our brand name . . . depends, to a large degree, on the reputation of Martha Stewart."[35] Both complaints alleged that Stewart instructed her broker to sell her ImClone shares after her broker informed her that

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2002 statement by Susan Magrino, publicist for Martha Stewart Living Omnimedia, Inc.)); *id.* ¶ 90 (quoting a June 12, 2002 MSL Press release in which Stewart stated that she sold her remaining ImClone shares in December 2001 pursuant to a long-standing agreement with her broker and that she "did not have any nonpublic information regarding ImClone when [she] sold" her shares).

31 *See* Yahoo! Finance, Historical Prices for Martha Stewart Living Omnimedia Inc., http://finance.yahoo.com/q/hp?s=MSO&a=05&b=3&c=2002&d=07&e=9&f=2002&g=d (last visited Nov. 11, 2008).

32 *See* Martha Stewart Living Omnimedia, Inc., Annual Report (Form 10-K), at 12–13 (Mar. 15, 2004) (disclosing that the company was named in seven securities class actions filed between August 6, 2002 and September 18, 2002).

33 *See id.* at 13 (disclosing seven shareholder derivative suits, later consolidated into four derivative suits, filed between August 15, 2002 and September 29, 2003).

34 *See, e.g.*, Amended Complaint ¶¶ 59–65, Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961 (Del Ch. 2003) (C.A. No. 19844-NC), 2002 WL 32904940 [hereinafter Derivative Complaint].

35 Securities Complaint, *supra* note 24, ¶ 27. *Compare id.* (noting that at the time MSL went public the company warned that the business would be adversely affected if "Martha Stewart's public image or reputation were to be tarnished" (citing Martha Stewart living Omnimedia Inc., Amendment No. 4 to Form S-1 Registration Statement (Form S-1/A), at 14 (Oct. 18, 1999))), *with* Derivative Complaint, *supra* note 34, ¶ 16 (noting that MSL warned that "'THE LOSS OF THE SERVICES OF MARTHA STEWART . . . WOULD MATERIALLY ADVERSELY AFFECT OUR REVENUES'" (quoting Martha Stewart Living Omnimedia Inc., Amendment No. 4 to Form S-1 Registration Statement (Form S-1/A), at 14 (Oct. 18, 1999))).

members of the Waksal family were selling their shares.[36] Both complaints alleged that MSL and Stewart herself made false and misleading statements regarding the circumstances surrounding the stock sale.[37] Both complaints alleged that Stewart's actions caused MSL's stock price to fall precipitously.[38] Finally, both complaints named as defendants Stewart and Sharon Patrick, MSL's President and Chief Operating Officer.[39]

The Martha Stewart cases are representative of a larger trend in corporate litigation. A growing number of shareholders are filing securities class actions and derivative suits based on nearly identical facts.[40] Indeed, there is a cottage industry of lawyers who piggyback on their arguably more industrious colleagues by monitoring the filing of securities class actions and then filing (a few short weeks later) nearly identical derivative suits. Many practitioners have recognized this trend, opining that "prudent defense attorneys should anticipate that a federal securities class lawsuit will give birth to . . . a parallel

36 *See* Securities Complaint, *supra* note 24, ¶ 53 (alleging Stewart sold remaining 3928 shares of ImClone after her broker told her that the Waksal family had sold its remaining shares); Derivative Complaint, *supra* note 34, ¶ 30 (same).

37 *See, e.g.*, Securities Complaint, *supra* note 24, ¶¶ 87, 90, 93; Derivative Complaint, *supra* note 34, ¶¶ 33–34, 38.

38 *See* Securities Complaint, *supra* note 24, ¶ 108 (stating that MSO shares declined from $19.40 to $6.78 after government investigation of Stewart was made public); Derivative Complaint, *supra* note 34, ¶ 44 (stating that MSO common stock declined sixty-six percent from the time period when public investors had no information regarding government investigation surrounding Stewart's sale of ImClone stock).

39 *See* Securities Complaint, *supra* note 24, ¶¶ 8–9; Derivative Complaint, *supra* note 34, ¶¶ 2–3.

40 *See, e.g.*, Dell, Inc., Current Report (Form 8-K), at 1–2 (Mar. 1, 2007) (disclosing that the company was named in four securities class actions, seven derivative suits, and four ERISA suits "all arising out of the same events and facts" related to the company's disclosures); Blue Rhino Corp., Annual Report (Form 10-K), at 8 (Oct. 21, 2003) (disclosing that the company had been named in several securities class actions and derivative suits "all arising out of substantially the same alleged facts and circumstances" relating to the company's alleged failure to disclose certain facts related to various acquisitions and other transactions); Taser Int'l, Inc., Quarterly Report (Form 10-Q), at 12–13 (May 10, 2007) (disclosing that the company had been named in "numerous securities class action lawsuits" related to "the safety of the Company's products and the Company's ability to meet its sales goals" and that various shareholders had subsequently filed "numerous shareholder derivative actions . . . based on similar facts and events as those alleged in the securities class action complaints"); Tibco Software Inc., Annual Report (Form 10-K), at 17 (Feb. 9, 2007) (announcing that the company had been named in three securities class actions and one derivative suit and that the derivative suit "was based on substantially similar facts and circumstances as the class actions").

derivative lawsuit."[41] 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 actions."[42]

The data supports these observations. It is increasingly common for shareholders to file parallel derivative suits on the heels of the filing of a securities class action. In 2005, thirty-five percent of securities class actions were accompanied by a parallel derivative suit.[43] By 2007, the number had risen to more than fifty-five percent.[44] The cause of this increase is not known. One hypothesis is that the increase may reflect the dramatically escalating settlements in securities class actions,[45] providing financial incentives for attorneys to file related derivative claims in the hopes of getting a cut of the largesse of resulting attorneys' fees.[46] Regardless of the cause, however, there is little doubt that corporations increasingly find themselves on both sides of the aisle in courtroom battles involving similar parties and similar factual allegations. As we will now see, the corporation's struggle to balance these dual roles is exacerbated by the fact that these lawsuits often turn on similar legal standards.

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41 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 & Practice Course Handbook Series No. B-1136, 1999); *see also* Peter M. Stone & Jay C. Gandhi, *The "Clone" Derivative Lawsuit*, ORANGE COUNTY LAWYER, July 2004, at 34 (referring to a "recent spate of 'clone' derivatives—lawsuits which merely replicate the allegations of federal securities class actions and reframe them as ordinary breach of fiduciary duty claims").

42 *See* Petition for Review at 9, Ellison v. Superior Court, S128367 (Cal. 2004), 2004 WL 3080563 (quoting Michael A. Collora & David M. Osborne, *Shareholders are Taking a Fresh Look at Derivative Suits To Pursue Investor Fraud Cases*, NAT'L L.J., Feb. 15, 1999 at B8). *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.* at 9 (quoting Renee Deger, *State of Alert: Silicon Valley Corporate Firms On Guard As the Plaintiffs Bar Takes Securities Cases to State Court*, S.F. RECORDER, Aug. 9, 2001, at 1; Priebe, *supra* note 41, at 335).

43 LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2007 REVIEW AND ANALYSIS 11, *available at* http://www.cornerstone.com/pdf/practice_securities/2007Settlements_Report.pdf.

44 *Id.*

45 *See infra* notes 96–97 and accompanying text.

46 *See infra* notes 122–24.

3. Similar Legal Standards

Over the last twenty-five years, corporate law has undergone a remarkable transformation, a transformation that is responsible in large part for the current conflict between securities class actions and derivative suits. Securities class actions and derivative suits have traditionally operated in separate legal spheres, representing an informal brokering of power between federal and state regulators.[47] Securities class actions are governed by federal law and are premised on disclosure violations,[48] while derivative suits are governed by state law and are premised on fiduciary duty violations.[49] These neat categories, however, mask an increasingly important overlap in the legal standards applicable in the two sets of claims.

To survive a motion to dismiss in a securities class action,[50] plaintiffs must allege facts creating a strong inference that the defendants acted with scienter, defined as a mental state embracing "intent to deceive, manipulate, or defraud."[51] Under this standard, plaintiffs can establish a violation of the federal securities laws by establishing that the defendants *intended* to deceive the market. Every circuit to address the issue has held that securities plaintiffs can also establish scienter through proof of recklessness.[52]

In practice, this standard is extremely similar to the standard used in many derivative suits. Until the mid-1980s, the cornerstone of state corporate law was the business judgment rule.[53] This rule pro-

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47 For a discussion of the role of federal and state law in preventing and deterring corporate misconduct, see Thompson & Thomas, *supra* note 4, at 1753–54.

48 *See id.*

49 Lawton W. Hawkins, *Exchange-Enhanced Special Litigation Committees: Enforcing Fiduciary Duties Amid a Crisis of Trust*, 2003 UTAH L. REV. 587, 588.

50 Surviving a motion to dismiss is a critical hurdle for plaintiffs in securities class actions, as nearly forty percent of securities class actions are dismissed at this stage. *See* TODD FOSTER ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION 4 (2007), http://nera.com/image/BRO_Recent_Trends_SEC1288_FINAL_0307.pdf.

51 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

52 *See In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989); Van Dyke v. Coburn Enters., 873 F.2d 1094, 1100 (8th Cir. 1989); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989); Hackbart v. Holmes, 675 F.2d 1114, 1117–18 (10th Cir. 1982); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961–62 (5th Cir. 1981) (en banc); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023–25 (6th Cir. 1979); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044–45 (7th Cir. 1977).

53 *See, e.g.*, David T. Bazelon, *Clients Against Lawyers*, HARPER'S MAG., Sept. 1967, at 104 ("[The business judgment rule], which began as a minor exception, is now so dominant a winning argument that the only fun left is trying to prove that

tects corporate directors from liability as long as they "'[act] on an informed basis, in good faith, and in the honest belief the action taken was in the best interests of the company.'"[54] Although this rule has traditionally offered substantial protection to corporate managers, the Delaware Supreme Court undercut these protections in *Smith v. Van Gorkom*,[55] a 1995 decision widely maligned by the legal and business communities for its holding that independent directors can violate their fiduciary duty to a corporation if they are not sufficiently informed prior to making a business decision.[56] In the wake of the furor resulting from this decision, the Delaware legislature amended its corporate code to permit corporations to provide their directors with greater protection from liability in suits brought by the corporation or on behalf of the corporation.[57] This statute offers protection to individual defendants in derivative suits well above the safeguards traditionally offered by the business judgment rule.

Across the country, states rushed to follow Delaware's lead. Over the last twenty-five years, all fifty states have enacted statutes inviting corporations to exculpate their directors (and often officers)[58] from liability.[59] Corporations have overwhelmingly accepted this invitation by adopting exculpation clauses that exculpate their directors and officers to the full extent of the law. A recent study found that "virtu-

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[it] . . . does not cover absolutely *all* forms of corporate theft."), *quoted in* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 439 (2005).

54 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

55 488 A.2d 858 (Del. 1985).

56 *See id.* at 893; Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 WAKE FOREST L. REV. 1131, 1141 (2006) ("The business community—and perhaps more pertinently, their insurers—were shocked by the outcome in *Van Gorkom*. . . . *Van Gorkom* appeared not to have applied the BJR so much as to have eviscerated it.").

57 *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); *see also* Bernard S. Sharfman, *Being Informed Does Matter: Fine Tuning Gross Negligence Twenty Plus Years After* Van Gorkom, 62 BUS. LAW. 135, 136–37 (2006) (tracing the history of Delaware's exculpation statute).

58 *See, e.g.*, MD. CODE ANN., CTS. & JUD. PROC. § 5-418 (LexisNexis 2006) (allowing corporations to exculpate their officers or directors); VA. CODE ANN. § 13.1-692.1 (2006) (same).

59 *See* J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 332 n.93 (2004) (noting that by 2003, all fifty states had statutes enabling corporations to limit or eliminate personal liability for directors).

ally every firm making an SEC filing" between July 2001 and July 2002 had included an exculpation clause in its charter.[60]

The widespread adoption of exculpation clauses brought the applicable standard of liability in derivative suits much closer to the applicable standard of liability in securities class actions. Most exculpation statutes permit corporations to exculpate only those officers or directors who satisfy the standard of conduct specified in the statute. Delaware's exculpation statute, for example, states that a corporation cannot exculpate its directors for, inter alia, "any breach[es] of the director's duty of loyalty" or "for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."[61] Other jurisdictions have adopted similar statutory standards.[62] As a result, to prevail on a fiduciary duty claim, shareholders generally have to prove that the individual defendants breached their duty of loyalty to the corporation, engaged in intentional misconduct or a knowing violation of the law, or failed to act in good faith.

In practice, this standard eliminates a substantial percentage of potential derivative claims.[63] The claims that remain, however, are often quite similar to federal securities claims.[64] This similarity is most conspicuous in cases where shareholders have evidence of intentional (as opposed to reckless) misconduct, as such evidence provides the necessary ammunition to file both a securities class action and a derivative suit, at least if the shareholder can link the alleged misconduct to a false or misleading public statement.

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60 Celia R. Taylor, *The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done About It*, 85 OR. L. REV. 993, 1022–23 & n.131 (2006) (writing that within one year of the date that Delaware enacted its statute permitting exculpation clauses, over ninety percent of a random selection of 180 law firms had adopted such a clause); *see also* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160–61 & n.11 (1990) (same).

61 DEL. CODE ANN. tit. 8, § 102(b)(7).

62 *See* Deborah A. DeMott, *Limiting Directors' Liability*, 66 WASH. U. L.Q. 295, 298–310 (1988) (comparing other states' statutes with Delaware statutory scheme).

63 Davis, *supra* note 6, at 404 ("The exculpatory statutes and enhanced judicial deference to independent directors have combined to marginalize the derivative suit for cases not involving self-dealing or other palpable breaches of the duty of loyalty.").

64 This similarity is most pronounced in claims against large, public corporations alleging duty of care–type claims. As other scholars have noted, and as I discuss later in Part III.C, the overlap between these lawsuits is less pronounced when the derivative claims allege more classic violations of the duty of loyalty. *See* Davis, *supra* note 6, at 439–50 (discussing the fact that a substantial number of derivative suits allege that a controlling shareholder exploited control of the corporation, allegations that can be more difficult to turn into the basis of a securities class action); *infra* notes 240–42 and accompanying text.

Even where the shareholder's evidence does not rise to the level of intentional misconduct, the shareholder may still be able to satisfy the legal requirements for both types of claims. As noted above, Delaware's exculpation statute prohibits corporations from exculpating their directors against conduct that is "not in good faith."[65] In the recent and well-known case involving the Walt Disney Company,[66] the Delaware Supreme Court held that directors do not act in good faith when they are "motivated by subjective bad intent" or evince a "*conscious disregard* for one's responsibilities."[67] This decision is consistent with earlier decisions by the Delaware Court of Chancery holding that a corporation cannot exculpate directors "who *consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[68]

This standard is virtually indistinguishable from the recklessness standard described above under the federal securities laws. As the influential Second Circuit has stated, "allegations of recklessness [are] sufficient where plaintiffs alleged facts demonstrating that defendants failed to review or check information that they had a duty to monitor, or *ignored obvious signs of fraud*."[69] Other courts have explained that "recklessness, understood as a mental state apart from negligence and akin to *conscious disregard*, may constitute scienter."[70] Under this formulation, recklessness closely approaches that which attaches to *conscious deception*[71] and applies when a defendant "turned a *blind eye* to the many red flags"[72] in a corporation's finances or business.

These similar legal standards are on full display in the litigation that has followed the recent collapse of the subprime mortgage lending industry. Over the last several months, the U.S. economy has been battered as the once-profitable practice of giving home mortgages to borrowers with less-than-stellar credit histories has proven dangerously risky.[73] Only a handful of Fortune 500 corporations have been

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65 DEL. CODE ANN. tit. 8, § 102(b)(7).

66 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

67 *Id.* at 62–63 (emphasis added).

68 *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003); *see also In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ. A. 16415, 2004 WL 1305745, at *43 (Del. Ch. June 4, 2004).

69 Novak v. Kasaks, 216 F.3d 300, 308 (2d Cir. 2000) (emphasis added).

70 *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 550 (6th Cir. 1999) (emphasis added).

71 *Id.*

72 *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 679 (S.D. Tex. 2002) (emphasis added).

73 *See* Greg Ip, *Study Finds Wider Impact of Mortgage Losses*, WALL ST. J., Mar. 1, 2008, at A2.

hurt more by the economic downturn than Merrill Lynch, which announced in October 2007 that it would write down nearly $8 billion of mortgage-related securities.[74] Soon after this announcement, many Merrill Lynch shareholders filed securities class actions and derivative suits against Merrill Lynch and several of its officers and directors, alleging that the defendants misled the market by failing to disclose the actual risk exposure of its financial portfolio.[75]

The legal claims in the two sets of complaints are strikingly similar. For example, the shareholders in the securities class action alleged that Merrill Lynch's officers and directors "disseminated or approved . . . false statements [regarding the corporation's risk portfolio], which they knew or deliberately disregarded were misleading."[76] Specifically, the securities plaintiffs claimed that the company's public statements "were materially false due to their failure to inform the market of the ticking time bomb in the Company's [mortgage] portfolio," and that the defendants knew of the risks but "concealed [them] from the investing public."[77] In the derivative suits, the shareholders were likely aware that Merrill Lynch had adopted an exculpation clause that protects the company's directors to the full extent permitted under Delaware law.[78] Thus, they too claimed that the individual defendants had acted intentionally in misleading the market, alleging that "each of the [individual defendants] had actual or constructive knowledge that they had caused the Company to improperly misrepresent the financial results of the Company."[79] The derivative plaintiffs also alleged that the individual defendants had "abandoned and abdicated their responsibilities and fiduciary duties with regard to prudently managing the assets and business of Merrill Lynch."[80]

As the Merrill Lynch example illustrates, shareholders in securities class actions and derivative suits are often aiming at the same legal

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74 *See* Merrill Lynch & Co., Current Report (Form 8-K), at Ex. 99.1 (Oct. 24, 2007).

75 *See* Merrill Lynch & Co., Annual Report (Form 10-K), at 134 (Feb. 25, 2008).

76 Class Action Complaint for Violation of the Federal Securities Laws ¶ 47, Life Enrichment Found. v. Merrill Lynch & Co., No. 1:07-9633 (S.D.N.Y. filed Oct. 10, 2007), *available at* http://securities.stanford.edu/1038/MER_01/20071030_f01c_Life.pdf. Merrill Lynch's shareholders filed numerous securities class actions and derivative suits. This discussion focuses on representative complaints from one securities class action and one derivative suit.

77 *Id.* ¶ 9(b).

78 *See* Restated Certificate of Incorporation of Merrill Lynch & Co., art. XIII, § 1 (May 3, 2001), *available at* http://www.ml.com/media/14259.pdf.

79 Verified Shareholder's Derivative Complaint ¶ 65, Arthur v. O'Neal, No. 1:07-9696 (S.D.N.Y. filed Nov. 1, 2007).

80 *Id.* ¶ 81.

target.[81] Coupled with the fact that these lawsuits often involve nearly identical players and nearly identical factual allegations, it is clear that these lawsuits are far more similar than they may appear at first glance. What do these similarities mean for corporations facing parallel securities class actions and derivative suits?

4. Consequences of the Similarities

At bottom, the similarities mean that corporations cannot treat these lawsuits as unrelated legal battles for at least three reasons. First, plaintiffs may be able to use a corporation's victories in a derivative suit against the corporation in a related securities class action. Imagine, for example, that a derivative plaintiff proved that a corporation's Chief Executive Officer breached his fiduciary duty to the corporation by intentionally misleading the market regarding the corporation's financial results. A securities plaintiff could use that ruling as the foundation for its claims in the securities class action, just as Merrill Lynch or Martha Stewart's shareholders could try to use rulings in the derivative suits described above against these corporations in the parallel securities class actions.

Second, plaintiffs may be able to use a corporation's statements in a derivative suit against the corporation in a related securities class action. As explained in more detail below,[82] state law permits corporations to form a committee of independent directors to review the allegations in a derivative suit, determine whether the suit is in the corporation's best interests, and recommend to the court whether the suit should proceed.[83] The expectation is that these committees will provide a fulsome explanation of the various costs and benefits of the suit, including the legal merits of the claims.[84] If a committee con-

81 These concerns apply even if corporations do not have an applicable exculpation clause. Absent an exculpation clause, courts review fiduciary duty claims alleging a violation of the duty of care under the business judgment rule. *See* Desimone v. Barrows, 924 A.2d 908, 933 (Del. Ch. 2007). The Delaware Supreme Court has likened this standard to one of gross negligence. *See* Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 985 (Del. 2000). Allegations of gross negligence generally do not state a viable claim under the federal securities laws. *See, e.g.*, DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002). However, securities plaintiffs may nonetheless be able to use information gleaned from the derivative case to help build their own cases. They will still need to prove that the officers and/or directors violated the more stringent standard applicable in their cases, but this is obviously far easier than creating a case from scratch.

82 *See infra* notes 139–42 and accompanying text.

83 *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981).

84 No empirical evidence exists regarding the length of these committee reports, but these reports are far from short. The Delaware Chancery Court opined more

cludes that the individual officers and directors breached their fiduciary duty to the corporation and provides factual and legal support for its conclusions, the securities plaintiff may be able to use the committee's report as an admission by the corporation in the securities class action. Not surprisingly, therefore, corporations are very nervous about committee recommendations when they have their financial futures on the line in parallel securities class actions.

Third, these similarities can impact discovery, which has taken on monumental importance in securities class actions. Prior to 1995, discovery abuse was rampant in these cases.[85] According to a congressional report, shareholders would file securities class actions on the barest of suspicion and then use discovery as a "fishing expedition" to find factual support for their claims.[86] Many shareholders also leveraged the high cost of discovery to pressure corporations into settling meritless claims for millions of dollars.[87] In an effort to stem these abuses, Congress enacted the Private Securities Litigation Reform Act

than twenty years ago that "the developing rule of thumb in this jurisdiction would appear to be that a report by a Special Litigation Committee recommending dismissal of a derivative suit must be at least 150 pages in length, exclusive of appendices and attachments." Kaplan v. Wyatt, 484 A.2d 501, 510 (Del. Ch. 1984) *aff'd*, 499 A.2d 1184 (Del. 1985). Over the last twenty years, reports have only grown in length. *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 925 (Del. Ch. 2003) (noting that the committee in that case had produced a report totaling 1,110 pages, excluding exhibits and appendices).

85 *See, e.g.*, Newby v. Enron Corp., 338 F.3d 467, 471 (5th Cir. 2003) (describing plaintiffs prior to 1995 who "would use discovery to substantiate an initially frivolous complaint"); Choi, *supra* note 4, at 1469 (describing problems with discovery in securities class actions prior to enactment of the Reform Act); Cindy Krischer Goodman, *Grin and Bear It? Shareholders Have Other Ideas When Stocks Sink*, CHI. TRIB., Mar. 13, 2000, § 6, at 1 (noting that 1995 enactment of the Private Securities Reform Litigation Act was designed to limit discovery and accordingly reduce the number of frivolous securities class actions).

86 H.R. REP. NO. 104-369, at 37 (1995) ("The House and Senate heard testimony that discovery in securities class actions often resembles a fishing expedition. As one witness noted, 'once the suit is filed, the plaintiff's law firm proceeds to search through all of the company's documents and take endless depositions for the slightest positive comment which they can claim induced the plaintiff to invest and any shred of evidence that the company knew a downturn was coming.'" (quoting testimony of Richard J. Egan, Chairman of EMC Corp.)).

87 *See, e.g.*, *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 263 (2d Cir. 1993) (discussing the need in securities class actions to deter "the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal, even though no recovery would occur if the suit were litigated to completion").

of 1995 (Reform Act),[88] which prohibits plaintiffs in securities class actions from obtaining discovery until after they have survived a motion to dismiss.[89] The Reform Act also established heightened pleading requirements that require courts to dismiss federal securities claims unless the plaintiff alleges "with particularity . . . facts giving rise to a strong inference" that the defendants acted with the requisite state of mind.[90] Thus, securities plaintiffs face the daunting pleading requirements of the Reform Act armed only with information that they have been able to glean from their own investigations.

Or at least that was the goal of the Reform Act. In practice, shareholders often attempt to use derivative suits to satisfy the high pleading standards in securities class actions. Derivative plaintiffs are usually entitled to discovery far earlier than their securities counterparts,[91] and there are typically no restrictions on the ability of derivative plaintiffs to share the fruits of their discovery with securities plaintiffs in corresponding securities class actions.[92] As a result, securities plaintiffs may be able to circumvent the Reform Act's restrictions on discovery by obtaining discovery material from the derivative plaintiffs. The securities plaintiffs can then use this information to bolster their own complaints and increase their likelihood of surviving a motion to dismiss.

The sharing of discovery material between derivative and class plaintiffs is particularly worrisome to corporations because derivative

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

89 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B) (2006).

90 *Id.* § 78u-4(b)(2).

91 *See* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS § 4.15 (1994) (explaining that derivative suits are generally subject to the same discovery rules applicable to all civil actions).

92 Some corporations have been successful in obtaining a court order prohibiting derivative plaintiffs from sharing discovery with securities plaintiffs under a provision of the Reform Act that permits federal courts to stay discovery in a state derivative action if such a stay is "necessary in aid of its jurisdiction" or "to protect or [to] effectuate its judgments." *See In re* DPL, Inc. Sec. Litig., 247 F. Supp. 2d 946, 950 (S.D. Ohio 2003) (quoting 15 U.S.C. § 78u-4(b)(3)(D)); *see also In re* Cardinal Health, Inc. Sec. Litig., 365 F. Supp. 2d 866, 871–72 (S.D. Ohio 2005) (stating that "'upon a proper showing'" a court may stay proceedings "'as necessary in aid of its jurisdiction'" or "'to protect or effectuate its judgments'" (quoting 15 U.S.C. § 78u-4(b)(3)(D))). Some states have also adopted rules making it more difficult for shareholder plaintiffs to obtain discovery. *See, e.g.*, Levine v. Smith, 591 A.2d 194, 208–09 (Del. 1991) (holding that a shareholder alleging that a prelitigation demand on directors has been wrongfully refused is not entitled to discovery prior to responding to a Rule 23.1 motion to dismiss). These measures, however, are not common and do not ameliorate the other problems associated with parallel lawsuits.

plaintiffs are often entitled to discovery material that would otherwise be protected by the attorney-client privilege. Courts around the country have adopted the rule first established by the Fifth Circuit in *Garner v. Wolfinbarger*[93] that derivative plaintiffs are entitled to otherwise privileged communications between the corporation's counsel and its employees upon a showing of good cause.[94] Some courts, however, have refused or expressed reluctance to extend the exception to shareholders in securities class actions, reasoning that shareholders in a securities class action seek to recover only for themselves and other class members and therefore their interests are adverse to the interests of the corporation.[95] Accordingly, not only do derivative plaintiffs get discovery earlier than securities plaintiffs, they also get more discovery.

Do these litigation risks matter? According to the conventional wisdom, they do not. Applying the conventional wisdom, there is no conflict between securities class actions and derivative suits because, even if a derivative suit causes a corporation to incur additional losses in a securities class action, the corporation can simply recoup these losses in the derivative suit. In short, the conventional wisdom rests on the assumption that corporations can actually recoup their losses in derivative suits. If this assumption is wrong, then corporate law has placed corporations in a far more perilous position than legal scholars have recognized.

B. Deciphering Differences

1. Differences in Damages

The conventional wisdom starts to break down when damages are added to the mix because corporations often cannot use derivative suits to recoup their losses in securities class actions. To understand this point, imagine a case in which a corporation's Chief Financial Officer (CFO) intentionally causes the corporation to misstate its financial results, leading to a $100 million settlement in a securities

93 430 F.2d 1093 (5th Cir. 1970).

94 *See id.* at 1103–04; *see also* Sandberg v. Va. Bankshares, Inc., 979 F.2d 332, 352 (4th Cir. 1992) ("The Garner good faith exception has become accepted doctrine."), *vacated*, 1993 WL 524680 (4th Cir. 1993); Grimes v. DSC Commc'ns Corp., 724 A.2d 561, 568 (Del. Ch. 1998) ("In determining whether a stockholder has shown sufficient 'good cause' to preclude application of the attorney-client privilege, Delaware courts follow the approach outlined in *Garner.*").

95 *See Sandberg*, 979 F.2d at 353–54; Ward v. Succession of Freeman, 854 F.2d 780, 786 (5th Cir. 1988); Weil v. Inv./Indicators, Research & Mgmt., Inc., 647 F.2d 18, 23 (9th Cir. 1981).

class action. The corporation can try to recover this amount, as well as the corporation's litigation costs and any other expenses associated with the misstatement, in a derivative suit. If the corporation is able to recover $100 million or more from the CFO, there would be no conflict between the two suits because the corporation would be able to recoup in one lawsuit what it lost in the other. This logic applies even if the existence of the derivative suit increases the amount of money paid in the securities class action.

The reality, however, is often far from this neat picture. Corporations face serious hurdles in recovering their full damages in derivative suits, hurdles that result in large part from the fact that the defendants in derivative suits are almost always individuals.[96] Individual defendants may have the personal resources to satisfy relatively small judgments, but few corporate executives can afford to pay the mega-settlements that are increasingly common in securities class actions. According to a recent study by Cornerstone Research, the median settlement in securities class actions in 2007 was $9 million, while the average settlement was $62.7 million.[97] Even wealthy individual defendants are hard-pressed to satisfy these types of large damage awards, especially considering that these defendants often face multiple other lawsuits[98] and thus multiple other claims on their assets.[99]

In contrast to the large settlements in securities class actions, the settlements in derivative suits are far smaller. There is little empirical data on settlement amounts in derivative suits,[100] but the anecdotal

96 *See* Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993) ("Derivative suits have been used most frequently as a means of redressing harm to a corporation allegedly resulting from misconduct *by its directors*." (emphasis added)).

97 SIMMONS & RYAN, *supra* note 43, at 2; *see also* 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, 1624 (2006) (finding that the median settlements in securities class actions since the 1995 passage of the Private Securities Litigation Reform Act was approximately $5.7 million).

98 *See infra* notes 232–35 and accompanying text.

99 Colloquy, *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 151 (2000) ("[T]here's only so much blood you can get out of individual directors.").

100 A 1991 study by Roberta Romano found that only one-half of the settlements of the derivative suits examined ended with the corporation receiving a monetary payout, and that the average monetary payout in these suits was approximately $6 million. *See* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 61 (1991). As more than fifteen years have passed since Romano's study, the statistics may look very different today. Similarly, Professors Thompson and Thomas' study of all of the derivative suits filed in the Delaware Court of Chancery in 1999 and 2000 found that of the sixteen cases that ended with some type of affirma-

evidence suggests that many of these settlements are largely nominal, consisting of agreements by the corporation to implement small-scale corporate governance reforms.[101] Even in the more high-profile derivative suits that attract parallel securities class actions, the typical settlement does not come anywhere near $9 million, much less $62.7 million.[102] As a result, corporations face a significant discrepancy in the amount of money that they must pay out in a securities class action as a result of the individual defendants' conduct and the amount of money that they can recover from these same individuals in a parallel derivative suit.

This discrepancy would not be a problem if corporations could use insurance to bridge the gap. They often cannot. Most corporations have directors & officers (D&O) insurance, which protects corporations against losses caused by their directors and officers.[103] In theory, if our hypothetical CFO does not have $100 million to satisfy a judgment in the derivative suit, the corporation may be able to recover this amount from its D&O policy, preventing the corporation from suffering a net loss as a result of the two suits. This theory, however, breaks down for at least two reasons.

First, all D&O policies have maximum policy limits,[104] which corporations can exhaust early and easily in the litigation battles that follow on the heels of corporate scandal.[105] The policy limit for the average D&O policy in 2006 was $9.86 million,[106] close to the median

tive relief for the corporation (all through settlements), only six of these settlements involved monetary relief, while the remaining ten settlements involved some other type of non-monetary relief. *See* Thompson & Thomas, *supra* note 4, at 1776.

101 SIMMONS & RYAN, *supra* note 43, at 11 ("Derivative cases are often resolved with changes to the issuer's corporate governance practices and little or no cash payment . . . .").

102 *See* Thompson & Thomas, *supra* note 4, at 1776–77. Indeed, in situations where the corporation simultaneously settles a securities class action and derivative suit, the settlement of the derivative suit is often simply folded into the larger settlement of the securities class action with the corporation receiving little or no separate monetary benefit from settling the derivative suit. *See, e.g.*, *In re* Ikon Office Solutions, Inc. Sec. Litig., 194 F.R.D. 166, 191 (E.D. Pa. 2000).

103 *See* Baker & Griffith, *supra* note 12, at 494 (explaining that public corporations have a significant need for D&O insurance as a result of shareholder litigation).

104 *See* Matthew Brodsky, *The Soft Side of Executive Scandals: D&O Coverage Seems More Important These Days, and Luckily, It's Cheap*, RISK & INS., Apr. 1, 2006, at 10, 10.

105 A 1991 study revealed that D&O insurance pays only fifty to eighty percent of the settlement monies in securities class actions. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 550 (1991).

106 *See* TOWERS PERRIN, DIRECTORS AND OFFICERS LIABILITY: 2007 SURVEY OF INSURANCE PURCHASING AND CLAIM TRENDS 14 (2008). Not surprisingly, the largest compa-

settlement amount in securities class actions.[107] Corporations often use a substantial portion of their insurance proceeds to pay litigation costs, leaving even less money to fund settlements in securities class actions.[108] As a result, it is not uncommon for corporations to have to reach into their own pockets to pay sizable settlement amounts in securities class actions.[109]

Second, the timing of the two lawsuits makes it difficult for corporations to predict with any confidence the extent to which their losses in the securities class action will be covered by insurance. This point is tricky, but important. Imagine that our hypothetical corporation knows that it has $20 million in insurance coverage and that it will eventually settle the securities class action for $10 million. Under these facts, the corporation will not be overly concerned about the securities class action because the corporation knows that it will not have to pay any money out of its own pocket.[110] Now imagine that the corporation knows that the facts uncovered in the derivative suit will push the settlement in the securities class action up to $15 million. The corporation will still not be overly concerned because it still knows that all of its losses will be covered by insurance.[111]

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nies report the largest policy limits. Companies with over $10 billion in assets report average policy limits of approximately $146 million. *See id.*

107 *See supra* note 97 and accompanying text.

108 *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1815 (2007).

109 *See, e.g.*, Baker & Griffith, *supra* note 12, at 488 n.3 ("There may be a recent trend in the U.S. toward increasing (but still small) numbers of settlements above the D&O policy limits."); *see also* Press Release, CryoLife, Inc., CryoLife Announces Agreements in Principle to Settle Shareholder Class Action and Shareholder Derivative Action Lawsuits (July 28, 2005), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=80253&p=irol-newsArticle&ID=736340&highlight= (announcing that the company had agreed to settle a securities class action for $23.25 million, approximately $11.5 million of which would be paid from insurance proceeds); Press Release, DHB Indus., Inc., DHB Industry Enters into Memorandum of Understanding to Settle Class Action and Derivative Lawsuits (July 13, 2006), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=75442&p=irol-newsArticle&ID=1074443&highlight= (announcing that the company had agreed to settle a securities class action and derivative suit for $34.9 million in cash, of which $12.9 million would be paid by the company's D&O carrier).

110 As Professors Baker and Griffith have noted in a forthcoming article, when boards learn that the entire settlement in a securities class action will be funded by insurance, "[t]he next question is 'What time is lunch?'" Tom Baker & Sean J. Griffith, *How the Merits Matter: D&O Insurance and Securities Settlements*, 157 U. PA. L. REV. (forthcoming 2008) (manuscript at 38–39), *available at* http://ssrn.com/abstract=1101068.

111 This example is obviously oversimplified. The corporation will only be content to allow the derivative suit to move forward if the corporation is also compensated for

In the real world, of course, corporations have no such looking glass. Corporations do not know the eventual impact of a derivative suit on a securities class action at the time that they are evaluating the merits of the derivative suit. In most instances, shareholders pursue securities class actions and derivative suits simultaneously, and courts typically require corporations to evaluate derivative suits soon after they are filed.[112] The corporation does not know at that time whether facts uncovered in the derivative suit will push the settlement in the securities class action to $15 million, $150 million, or even $1.5 billion.[113] In light of this uncertainty, many corporations rationally decide to hedge their bets and seek dismissal of derivative suits.

It is important to note that corporations do not forgo any of their insurance proceeds by hedging their bets in this way. Generally speaking, a corporation is entitled to insurance reimbursement of settlements amounts paid in a securities class action even if the corporation does not pursue a derivative suit against the alleged wrongdoers.[114] Thus, a derivative suit may well increase the amount of money that the corporation ends up paying in the securities class action, while bringing in little additional money.

From the corporation's perspective, therefore, the filing of a parallel derivative suit may have substantial cost but little reward. This fact raises one last question in the effort to understand the conflict between securities class actions and derivative suits: given the impact of derivative suits on parallel securities class actions, why do shareholders file them?

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all of the costs related to the increased settlement in the securities class action, including legal fees, lost time of executives, additional negative publicity, and future increases in its insurance premiums.

112 *See, e.g.*, Abbey v. Computer & Commc'ns Tech. Corp., 457 A.2d 368, 375 (Del. Ch. 2003) (holding that a derivative suit should only be stayed for a "reasonable time" to permit an SLC to complete its investigation).

113 The corporation can try to predict its exposure, of course, based on the drop in the company's stock price during the relevant time period and other factors, but its predictions will likely be far from perfect, especially prior to discovery.

114 *See* Lisa L. Casey, *Reforming Securities Class Action from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 BYU L. REV. 1239, n.91 ("[M]ost negotiated resolutions of securities class actions follow a similar pattern. The settling defendants, while denying all wrongdoing, agree to pay to the class some amount of money and/or securities, often funded with the proceeds of directors' and officers' liability insurance, into a fund from which class members may make claims and class counsel will receive compensation and reimbursement of costs.").

2. Differences in Interest

The reason is simple. Shareholders' interests, and the interests of their attorneys, are not always aligned with the interests of plaintiff corporations.[115] Although derivative plaintiffs have a fiduciary duty to act in a corporation's best interests,[116] they generally lack the incentives to carry out this duty properly. A shareholder can bring a derivative suit if he owns only a single share of stock,[117] and many derivative plaintiffs own little more than this single share,[118] as reflected in the fact that large investors, including institutional investors, rarely serve as derivative plaintiffs.[119] A derivative plaintiff who owns only a few shares of stock is unlikely to see any real benefit from a derivative suit because any recovery in a derivative suit is returned to the corporation and even a substantial recovery for the corporation will provide only a small pro rata indirect benefit to the shareholder. As a result, shareholders who agree to serve as representative plaintiffs do not have the financial incentives to ensure that a derivative suit is in the best interests of the plaintiff corporation.[120]

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115 *See* James D. Cox, *Heroes in the Law:* Alford v. Shaw, 66 N.C. L. REV. 565, 570 (1988) ("The central problem with derivative suit litigation is the weak incentives of each of the suit's participants to serve the corporation's interests.").

116 *See, e.g.*, Breault v. Folino, No. SACV010826GLTANX, 2002 WL 31974381, at *1 (C.D. Cal. Mar. 15, 2002); Goodwin v. Castleton, 144 P.2d 725, 732 (Wash. 1944).

117 *See* FED. R. CIV. P. 23.1 (requiring only that the derivative plaintiff allege that he or she "was a shareholder or member at the time of the transaction complained of").

118 *See* Lewis v. Curtis, 671 F.2d 779, 788 (3d Cir. 1982) (holding that the fact that the shareholder plaintiff owned only 100 out of 8 million outstanding shares was "irrelevant"); Ohio-Sealy Mattress Mfg. Co. v. Kaplan, 90 F.R.D. 21, 25 (N.D. Ill. 1980) (holding that plaintiffs adequately represented the corporation even though they together owned only 0.7% of the corporation's outstanding shares).

119 *See* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1355–56 (2005) ("While often appearing as lead plaintiffs in securities class actions, [institutional investors] have rarely done so in derivative suits.").

120 In response to this point, one might ask why shareholders bother to serve as derivative plaintiffs when the financial rewards are so minimal. There is no empirical research on this question, but anecdotal evidence suggests that many derivative plaintiffs lend their name to the suit because they are angry that alleged corporate misconduct caused them financial harm and want to punish the wrongdoer. *See, e.g.*, David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1823–26 (2001). Alternatively, plaintiffs may view themselves as "corporate gadflies" who view their stock ownership as a means of enforcing corporate norms in society generally. Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1906 (reviewing GRAEF CRYSTAL, IN SEARCH OF EXCESS (1991)). In such instances, the derivative plaintiff's interests are not aligned with the corporation's interests because the plaintiff is more interested in deterring corporate misconduct

Nor do their attorneys. As the Second Circuit has stated, "The real incentive to bring derivative actions is usually not the hope of return to the corporation but the hope of handsome fees to be recovered by plaintiffs' counsel."[121] As this quote illustrates, attorneys have their own financial incentives to file derivative suits, and these incentives are not always consistent with the best interests of the plaintiff corporation. Plaintiffs' attorneys typically receive a percentage—often between twenty and thirty percent—of a plaintiff corporation's recovery regardless of the costs of the suit.[122] For plaintiffs' attorneys, therefore, it does not matter whether derivative suits cause corporations to incur substantial losses in securities class actions because such losses are not factored into their fees. If a plaintiff corporation recovers $5 million in a derivative suit, the plaintiff's attorney will likely be entitled to more than $1 million in fees, even if the suit costs the corporation $10 million in related litigation. As a result, the only question for a plaintiff's attorney is whether the expected value of the suit, discounted by the probability of success, is greater than the attorney's other litigation opportunities.[123] Given this calculus, it is not surprising that derivative plaintiffs file derivative suits that are not in the best interest of plaintiff corporations.

In sum, the conventional wisdom is wrong. The perfect storm of shareholder litigation is real, and it has real consequences for the corporations struggling to juggle their conflicting roles in these lawsuits. Corporations named in parallel securities class actions and derivative suits have legitimate reason to fear that their offensive position in the derivative suit may threaten their defensive position in the securities class action. The question for courts and legal scholars is how to resolve these conflicting roles in a way that is consistent with the underlying goals of shareholder litigation.

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generally than in ensuring that the corporation is compensated for its own managers' alleged misdeeds. *See, e.g.*, John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 218 (1983) (noting the "conventional theory" that the "role of private litigation is not simply to secure compensation for victims, but is at least equally to generate deterrence").

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

122 *See* 4 ALBA CONTE & HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 14.6 (4th ed. 2002) (stating that the usual attorneys' fee award is twenty to thirty-three percent of a common fund).

123 *See* Franklin A. Gevurtz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits*, 46 U. PITT. L. REV. 265, 290–91 (1985) (explaining the calculus for plaintiffs' attorneys).

II. Policy and Practice

As we have seen, legal theory does not match legal reality when it comes to shareholder litigation. The conventional theory of shareholder litigation—which is based on viewing securities class actions and derivative suits as discrete and unrelated events—is fundamentally flawed. The focus now turns to crafting a new theory of shareholder litigation. This task has evaded courts thus far, largely because courts have been ambivalent about the underlying goals of shareholder litigation. Shareholder litigation has long had lofty ambitions. It is intended to compensate parties injured by corporate misconduct—including shareholders and plaintiff corporations—but it is also supposed to benefit society as a whole by punishing those who engage in market-related misconduct and by deterring others from engaging in similar misconduct. The following discussion first examines these diverse goals, and then explores how these goals have impacted judicial efforts to reconcile the conflict between securities class actions and derivative suits.

A. *The Public and Private Goals of Derivative Suits*

All litigation serves public and private interests.[124] When an employee sues her employer for sexual harassment, she is seeking redress for her own injuries, but she is also sending a message to all employers that sexual harassment will not be tolerated in the workplace. When a company sues one of its suppliers for breach of contract, the company is seeking compensation for its own damages, but it is also reinforcing the legal norm that companies should keep their promises (or pay the resulting damages).

In most civil lawsuits, however, the private interests trump the public interests, at least when it comes to certain fundamental decisions about the lawsuit such as whether to sue and whether to maintain the suit once filed. In a sexual harassment case, for example, the plaintiff is entitled to decide whether she wants to press forward with her claims, even if society's interests point toward a different decision. Similarly, a company with a meritorious breach of contract claim is permitted to settle the suit to maintain its business relationship with the supplier, even if the settlement does not reinforce important legal

124 *Cf.* William B. Rubenstein, *On What a "Private Attorney General" Is—And Why It Matters*, 57 VAND. L. REV. 2129, 2131 (2004) ("[T]here are so many players [in litigation] who mix public and private functions in so many different ways . . . [that] '[a]nyone . . . can call himself a "private attorney general."'" (quoting Jeremy A. Rabkin, *The Secret Life of the Private Attorney General*, 61 LAW & CONTEMP. PROBS. 179, 194 (1998))).

norms to the same extent as a full trial and judgment on the merits. These decisions rest with the plaintiffs, not with the public at large.

In theory, derivative suits should be no different. And yet they are, at least in the eyes of many scholars. Legal academics have devoted a substantial amount of ink to debating whether the public or private interests of derivative suits should reign supreme in these suits.[125] This debate has occurred because derivative suits are different from other types of private litigation. Unlike in other private litigation, the true parties in interest in derivative suits—plaintiff corporations—do not control these suits, and thus there is potentially more room for public concerns to shape derivative suits than in other types of private litigation.[126] Third parties overseeing the litigation, including derivative plaintiffs, their attorneys, and courts, may decide that the interests of the plaintiff corporation are not as important as the public interests—punishing the alleged wrongdoer, deterring similar misconduct in the future,[127] or even creating new legal precedent that will further advance the development of the law.[128] In this way, derivative plaintiffs play a role in derivative suits that looks more like the role played by private attorney generals than the role played by typical plaintiffs.

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125 *See, e.g.*, John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 307–08 (1981) ("The differences between deterrent and compensatory rationales come into clearest focus when one poses the hardest practical questions about derivative litigation: Should a court dismiss an otherwise meritorious derivative action if it appears that costs of litigation will exceed the likely recovery?"); Cox, *supra* note 4, at 13 ("[T]he public role of shareholder suits is muted, and indeed obfuscated, both by the characterization of their mission as the compensation of those harmed by the defendant's misconduct and by the nurturing of settlements through the courts' extraordinary deference to the bargain struck by the suit's attorneys. In the end, shareholder suits have but a private existence so that in the public's eye they are just another commercial dispute."); Thompson & Thomas, *supra* note 4, at 1774 ("There are two main benefits that result from derivative suits: (1) the deterrence of corporate wrongdoing provided by their very existence, and (2) the possibility that the suits yield a positive net recovery for shareholders.").

126 Coffee, *supra* note 120, at 218 ("The conventional theory of the private attorney general stresses that the role of private litigation is not simply to secure compensation for victims, but is at least equally to generate deterrence, principally by multiplying the total resources committed to the detection and prosecution of the prohibited behavior.").

127 *See id.*

128 *See* Colloquy, *supra* note 99, at 155 (stating that Delaware corporate law can only develop through litigation); Davis, *supra* note 6, at 435 (discussing "the production of precedent" as another "public good that sometimes is cited on behalf of derivative litigation").

These unique characteristics have led to two models of derivative suits. The first model—the private model—is based on the belief that derivative suits are designed primarily to compensate plaintiff corporations for losses that they have sustained. This model is focused on the interests of the plaintiff corporation. The second model—the public model—is based on the belief that these suits are designed to serve broader social goals such as deterring future legal violations by managers in corporate America.[129] This model preferences the interests of society over the interests of the plaintiff corporation.

Courts have traditionally resisted exhortations to preference the public model of derivative suits over the private model,[130] as reflected in two important procedural rules governing derivative suits.[131] First, under the contemporaneous ownership rule, derivative plaintiffs can maintain derivative suits only if they owned stock in the plaintiff corporations at the time of the transactions at issue.[132] The shareholders must also hold their stock for the duration of the lawsuit.[133] This rule is based on the private model of derivative suits.[134] If the sole goal of such suits were to deter and punish corporate misconduct, there would be no need to limit the universe of potential plaintiffs. Enterprising plaintiffs' lawyers could sue on behalf of anyone to rectify alleged harms committed against plaintiff corporations. Limiting the

129 I am distinguishing here general deterrence, or deterrence in society generally, from specific deterrence, or deterrence directed at the plaintiff corporation. *See* Hawkins, *supra* note 49, at 593–95. The desire for general deterrence comes within the scope of the public model, while the desire for specific deterrence would come within the private model.

130 *See, e.g.*, Coffee & Schwartz, *supra* note 125, at 302 (noting that the public model "has never been the dominant rationale" for derivative suits, and "indeed some decisions appear frankly skeptical of it").

131 These rules have been met with much scholarly resistance, which courts and legislators have traditionally ignored. *See, e.g.*, Cox, *supra* note 4, at 8 ("[I]n the corporate setting, shareholder suits are consistently dismissed when they fail to serve a compensatory end, even though the goal of deterrence would be advanced by the suit's successful prosecution. Simply stated, compensation is the prevailing objective of shareholder suits and deterrence, its valuable byproduct.").

132 *See* FED. R. CIV. P. 23.1(a); DEL. CODE ANN. tit. 8, § 327 (2001); *see also* Strategic Asset Mgmt. v. Nicholson, No. 20360-NC, 2004 Del. Ch. LEXIS 178, at *4 (Del. Ch. Nov. 30, 2004) ("The 'continuous ownership' requirement is a fundamental and ongoing burden that a plaintiff in a Delaware derivative action must satisfy.").

133 *See* 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 13.11, at 13-33 (3d ed. 1997 & Supp. 2008).

134 The American Law Institute has proposed that states relax the contemporaneous ownership rule to allow directors of corporations to file derivative suits, but the motivation for the proposal appears to be to to increase the number of plaintiffs likely to act in the corporation's interest, not to change the purpose of these suits. *See* 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 7.02(c) & cmts. (1994).

class of potential plaintiffs to a plaintiff corporation's stockholders, however, may mean that some meritorious claims are never brought simply because the corporation's shareholders are not aware of the alleged wrongdoing or do not want to invest the (admittedly minimal) time and resources necessary to bring a lawsuit.[135]

Second, courts have adopted the net-loss rule, which prohibits shareholders from pursuing a derivative suit unless the plaintiff corporation suffered a net loss as a result of the alleged wrongdoing.[136] As a result of the net-loss rule, corporate managers can escape liability to the corporation even if they engaged in flagrant violations of the law—such as falsifying financial results, bribing foreign officials, or price fixing—as long as their actions did not harm the corporation.[137]

These rules do not mean that the social impact of derivative suits is irrelevant. They do, however, suggest that it is not enough to argue that the defendants engaged in misconduct, even egregious misconduct, that violated the law. Rather, derivative plaintiffs must prove that there is a compensatory aspect to their suits. The plaintiff corporation remains the real party in interest, and any suit brought on its behalf must reflect this fact.

As these rules illustrate, the private model of derivative suits has traditionally prevailed over the public model, despite the unique char-

135 *See* Lawrence A. Larose, *Suing in the Right of the Corporation: A Commentary and Proposal for Legislative Reform*, 19 U. MICH. J.L. REFORM 499, 514 (1986) (arguing that allowing a wider range of plaintiffs would allow more effective sanctions against corporate wrongdoers).

136 This requirement stems from a series of New York state cases, particularly in the antitrust context. The defendants in these cases argued that the cases should be dismissed because the derivative plaintiffs failed to allege that the plaintiff corporations suffered a net loss as a result of the defendants' conduct. The defendants suggested that the derivative plaintiffs had failed to include such allegations because the defendants' conduct had actually benefited the plaintiff corporations. *See, e.g.*, Borden v. Cohen, 231 N.Y.S.2d 902, 903 (N.Y. Sup. Ct. 1962); Spinella v. Heights Ice Corp., 62 N.Y.S.2d 263, 263 (N.Y. Sup. Ct. 1946); Diamond v. Davis, 31 N.Y.S.2d 582 (N.Y. Sup. Ct. 1941). The courts held that the derivative plaintiffs' allegations were insufficient because there is no "actionable claim unless the acts otherwise worked harm to the corporation." *Borden*, 231 N.Y.S.2d at 903; *see also Spinella*, 62 N.Y.S.2d at 263 (holding that the derivative complaint was "insufficient in law" because there was no demonstration of damage to the corporation); *Diamond*, 31 N.Y.S. 2d at 584 (dismissing the suit because, inter alia, the acts complained of were "not such that the injury to the corporation would ordinarily be inferred" from them).

137 *See* Cox, *supra* note 4, at 8–9 ("[D]irectors who knowingly violate the law are not without a defense. Absent proof that the corporation suffered a net loss through their illegal act, the suit must be dismissed. Therefore, if the plaintiff fails to establish that the harm suffered by the corporation as a consequence of the misconduct exceeded the benefits it received by their misconduct, the defendant escapes any sanction by a derivative suit.").

acteristics of derivative suits. This is not surprising when one considers the interplay between public and private interests in most derivative suits. With the contemporaneous ownership requirement, for example, some cases may fall through the cracks, but there is likely to be at least one shareholder willing to serve as a derivative shareholder in the most egregious cases. In such cases, attorneys are more likely to spend the resources to locate a derivative plaintiff, and shareholders are more likely to hear about the alleged wrongdoing and be willing to serve as a named plaintiff. As a result, while there may not be a willing plaintiff in every case, there likely will be a willing plaintiff in the cases involving the most glaring examples of corporate misconduct.

As we shall see in the next section, judges are less confident that the public interest will be vindicated when it comes to the conflict between securities class actions and derivative suits. Accordingly, the legal landscape looks quite different when a corporation asks a court to dismiss a derivative suit that conflicts with the corporation's position in a securities class action. This difference reflects a fundamental fact about shareholder litigation: the more egregious the allegations, the more lawsuits shareholders are likely to file.[138] As a result, a corporation is most likely to be named in parallel shareholder litigation in precisely the cases that society most wants to deter. This point is especially worrisome for courts that take a narrow view of shareholder litigation, focusing only on a single derivative suit before them, rather than the ability of securities class actions and derivative suits to work together to achieve important deterrent and compensatory goals. We return to these two vantage points in Part III, but, as we will now see, for judges focusing on the single derivative suit before them, the choice is stark. Should they dismiss derivative suits raising allegations of serious corporate misconduct if these suits are likely to threaten the defensive positions of corporations in related securities class actions? Or should they further minimize the role of corporations in derivative suits by permitting shareholder plaintiffs to pursue suits that are not in the best interests of the corporations on whose behalf these suits are brought?

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138 *See, e.g.*, SIMMONS & RYAN, *supra* note 43, at 11–13 (finding that securities class actions with high estimated damages are more likely to be accompanied by derivative suits or SEC enforcement actions than securities class actions with lower estimated damages); James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 763–77 (2003).

B. *Putting Policy into Practice*

1. Procedural Backdrop

Courts face these questions at a key moment in derivative suits: the moment when the plaintiff corporation finally makes its voice heard. Following the filing of a derivative suit, or upon the receipt of a demand from a shareholder that the corporation itself file a derivative suit, the plaintiff corporation often forms a committee of independent directors—directors without a personal interest in the outcome of the suit—to evaluate the allegations in the suit and decide whether the suit is in the corporation's best interest.[139] This committee is called a special litigation committee, or SLC. If the SLC determines that the suit is not in the plaintiff corporation's best interests, it will decline to pursue the suit, and if the suit has already been filed, the SLC will recommend that the court stay or dismiss the suit.[140] 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.[141]

The SLC process underscores the plaintiff corporation's role and importance in the litigation. It is designed to ensure that the suit remains focused on the best interests of the plaintiff corporation.[142] As the conflict between securities class actions and derivative suits demonstrates, a derivative suit may be an easy win for the derivative shareholder and still not be in the plaintiff corporation's best interests. SLCs must therefore perform both a legal role and a managerial role in deciding whether to recommend that a derivative suit go forward. This process essentially mimics the process that general counsels use when reviewing other types of cases in which the corporation is a potential party.

Once an SLC makes its recommendation, the focus shifts to the reviewing court, which must decide whether to accept the recommendation. The level of deference to the SLC's recommendation depends on state law.[143] Some jurisdictions require the reviewing

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139 *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981).

140 *See id.* at 788; *see also* Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Unlimited Liability Companies*, 58 BAYLOR L. REV. 63, 81–86 (2006) (detailing SLC procedures).

141 *See Zapata Corp.*, 430 A.2d at 788.

142 *See id.* ("The basis of the [plaintiff corporation's] motion is the best interests of the corporation, as determined by the committee.").

143 *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 550 (1949) (holding that states have "plenary power" over derivative suits). This section discusses the relevant standards for so-called demand excused cases, or cases where the court has deter-

court to dismiss a derivative suit pursuant to an SLC recommendation if the court concludes that the SLC was independent and conducted an adequate investigation.[144] Other jurisdictions, including influential Delaware, provide for greater judicial scrutiny. In *Zapata Corp. v. Maldonado*,[145] the Delaware Supreme Court established a two-step process of review to evaluate SLC recommendations. The court must first determine whether the SLC was independent, acted in good faith, and had a reasonable basis for its decision.[146]

If these threshold standards are met, the court can then exercise its own "independent business judgment" to determine whether the suit should nonetheless proceed.[147] The court held that the second step of *Zapata* "is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration *in the corporation's interest.*"[148] The court also held, however, that courts should use this step to give "special consideration to matters of law and public policy in addition to the corporation's best inter-

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mined that the shareholder was not required to make a demand on the corporation prior to filing suit. I focus on this standard because it is my experience that shareholders rarely make a demand and therefore the more deferential standard applicable in cases where shareholders do make a demand rarely comes into play. Instead, at least in my own experience, shareholders almost always allege that demand is futile, knowing that their suit will be dismissed if they are wrong, but that they will get the benefit of the *Zapata* standard if they can persuade the court on this crucial point.

144 *See, e.g.*, CONN. GEN. STAT. § 33-724(a) (2005 & Supp. 2008) ("A derivative proceeding shall be dismissed by the court on motion by the corporation if [the SLC] has determined in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation."); MASS. ANN. LAWS ch. 156D, § 7.44 (LexisNexis 2005) ("A derivative proceeding commenced after rejection of a demand shall be dismissed by the court on motion by the corporation if the court finds that either: (1) [the SLC] has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation; or (2) shareholders specified in subsection (b)(3) have determined that the maintenance of the derivative proceeding is not in the best interests of the corporation.").

145 430 A.2d 779 (Del. 1981).

146 *See id.* at 788–89.

147 *Id.* at 789.

148 *Id.* (emphasis added); *see also* Biondi v. Scrushy, 820 A.2d 1148, 1164 n.40 (Del. Ch. 2003) (holding that the second step of *Zapata* is intended "to provide a safeguard against the danger that the difficult-to-detect influence of fellow-feeling among directors (*i.e.*, so-called 'structural bias') does not cause cessation of meritorious litigation valuable to the company)," *aff'd sub nom. In re* HealthSouth Corp. S'holders Litig., No. 19896, 2004 WL 835879 (Del. Apr. 14, 2004).

ests."[149] This language reflects the unique quasi-public attributes of derivative suits described above. In short, the second step of *Zapata* is the legal hook that allows courts to resurrect the public model of derivative suits. As we shall see, courts have used this hook, albeit largely implicitly, in a number of cases where SLCs have requested that courts stay or dismiss a derivative suit that was not in the best interests of the plaintiff corporation.

2. Stays of Derivative Suits

SLCs have two choices when they are asked to opine on a derivative suit that threatens the plaintiff corporation's defense of a parallel securities class action. They can ask the court to stay the derivative suit until the securities class action has been resolved, or they can ask the court to dismiss the derivative suit altogether.[150] In many cases, a stay will achieve the best of both worlds. It will prevent a derivative suit from negatively impacting a securities class action, while still allowing the plaintiff corporation to pursue the derivative claims if it chooses following resolution of the securities class action.

Many courts, however, have rejected requests by SLCs to stay derivative suits under these circumstances, proceeding on the assumption that justice delayed for the derivative plaintiff is justice denied.[151] The famous *Tyco*[152] case demonstrates this point. At the time of the court's 2003 decision, Tyco International, Ltd. (Tyco) was in the middle of one of the most well-known corporate scandals in recent history. The company's executives had been accused of looting the company of hundreds of millions of dollars, including (infamously) more than $1 million for a party for the CEO's ex-wife and $6000 for a shower curtain.[153] Following the announcement of significant accounting irregularities, Tyco's stock price fell precipitously, from a

149 *Zapata Corp.*, 430 A.2d at 789.

150 *See, e.g.*, Abbey v. Computer & Commc'ns Tech. Corp., 457 A.2d 368, 369 (Del. Ch. 2003).

151 It is common for courts to stay derivative suits during an SLC investigation. Such a stay, however, ends when the SLC issues its recommendation, which is often long before the end of a related securities class action. *See, e.g.*, *id.* at 375 (holding that a derivative suit should only be stayed for a "reasonable time" to permit an SLC to complete its investigation).

152 *In re* Tyco Int'l, Ltd. Multidistrict Litig., No. 02-1335-B, 2003 WL 23830479 (D.N.H. Jan. 29, 2003).

153 *See* Andrew Ross Sorkin, *Tyco's Ex-Chief Going to Court in 'Greed Case,'* N.Y. TIMES, Sept. 29, 2003, at A1. Tyco's CEO L. Dennis Kozlowski was later sentenced to 8 1/3 to 25 years in prison for his role in the scandal. *See* Andrew Ross Sorkin, *Ex-Tyco Officers Get 8 to 25 Years*, N.Y. TIMES, Sept. 20, 2005, at A1.

high of $45.4375 per share on September 1, 2000 to a low of $7.41 per share on September 27, 2001.[154] Tyco was hit with a wave of shareholder suits, including forty securities class actions, eight ERISA suits, and numerous derivative suits.[155] These suits were all based largely on the same underlying allegations of accounting fraud and corporate waste.

In 2002, Tyco asked the U.S. District Court for the District of New Hampshire, which was overseeing the consolidated lawsuits, to stay discovery in the derivative and ERISA suits until the court ruled on the company's motion to dismiss the securities class action.[156] The company argued that a stay was necessary because discovery in the derivative suits would allow the securities plaintiffs to circumvent the Reform Act's mandatory stay of discovery in the securities class action.[157] Tyco also asked the court to bar the securities plaintiffs from obtaining access to documents produced in the ERISA and derivative suits.[158]

The court denied both requests. The court recognized that allowing the derivative suit to move forward might hurt Tyco's defense of the securities class actions but expressly declined to elevate the private compensatory goals of the derivative suit over the public goals.[159] The court acknowledged, for example, that the plaintiffs in the securities class action might be able to use discovery material from the derivative and ERISA suits to bolster their claims, stating "if plaintiffs in the ERISA and Derivative Actions uncover new evidence of wrongdoing by the defendants, they are likely to amend their complaints and thereby provide the plaintiffs in the Securities Actions with information that may be useful in drafting their own amended complaint."[160] The court held, however, that "any interest that the defendants have in delaying discovery does not override the legitimate interest that the plaintiffs in the ERISA and Derivative Actions have in obtaining an expeditious resolution of their claims."[161]

The court also permitted the securities plaintiffs to obtain immediate access to the discovery material in the case, despite the stay of

154 *See* Consolidated Securities Class Action Complaint ¶ 243, *In re* Tyco Int'l, Ltd. Multidistrict Litig., No. 02-1335-B, 2008 WL 489257 (D.N.H. Feb. 20, 2008), 2004 WL 3770745.

155 *See* Tyco Int'l, Ltd., Annual Report (Form 10-K), at 22–30 (Dec. 11, 2006).

156 *In re Tyco*, 2003 WL 23830479, at *3.

157 *See id.*

158 *See id.* at *4.

159 *See id.* at *3.

160 *Id.*

161 *Id.*

discovery under the Reform Act. The court noted that the securities claims were not frivolous and "keeping all parties on an equal footing with respect to discovery serves important case management interests in this complex litigation."[162] Thus, the court in *Tyco* acted consistently with the public model of derivative suits, basing its decision more on the legal merits of the suit and concerns about judicial efficiency than on whether the suit would benefit Tyco.[163]

Other courts have been more receptive to requests to stay derivative suits under these circumstances, largely because they have focused on the central importance of corporate self-interest in assessing the merits of the suit. In *Breault v. Folino*,[164] for example, the derivative plaintiff alleged that several of the corporation's officers and directors had engaged in a host of corporate misdeeds, including insider trading and lying to the public.[165] These claims were nearly identical to claims in a parallel securities class action.[166] The plaintiff corporation asked the court to stay the derivative suit during the pendency of the securities class action, arguing that simultaneous prosecution of the two suits could harm the corporation's defense of the securities class action.[167]

Unlike *Tyco*, the court in *Breault* agreed to stay the derivative suit. The court noted that a derivative suit "may proceed only when it is in the company's best interest."[168] The court held that prosecution of the derivative suit could interfere with the corporation's defense of the securities class action because the individual defendants in the derivative suit would likely be witnesses in the securities class action and the shareholder plaintiff could only prevail by undermining their credibility.[169] The court also noted that prosecution of both actions would divert the corporation's financial and management resources

162 *Id.* at *4; *see also In re* FirstEnergy S'holder Derivative Litig., 219 F.R.D. 584, 587 (N.D. Ohio 2004) (holding that the court was "utterly unconvinced that it should enter a protective order [in a derivative suit] based on [the] speculative harm" that the plaintiff in a parallel securities action could use information it obtained against the corporation in that action).

163 Tyco eventually settled the consolidated securities class action for $2.975 billion, one of the largest settlements in history in a securities class action. *See* Press Release, Tyco Int'l, Ltd., Tyco Enters into Agreement to Resolve Legacy Securities Class Action Litigation (May 15, 2007), *available at* http://investors.tyco.com/phoenix.zhtml?c=112348&p=irolnewsArticle&ID=1000469&highlight=.

164 No. SACV010826GLTANX, 2002 WL 31974381 (C.D. Cal. Mar. 15, 2002).

165 *See id.* at *1.

166 *See id.*

167 *See id.*

168 *Id.*

169 *See id.* at *2.

away from the securities class action.[170] Accordingly, the court concluded that it was not in the corporation's best interest to prosecute the derivative suit at the same time that the corporation was defending against the securities class action.[171]

Taken together, *Tyco* and *Breault* illustrate the uncertain legal landscape that SLCs face in their efforts to protect the corporate interest. The challenges for SLCs do not end here because, even where available, a stay is far from a perfect solution. First, it is often impossible to stay a derivative suit until all threats to the corporation have passed. In many cases, the corporation may not be named in a securities class action at the time that the corporation is trying to decide whether to proceed with a derivative suit, but the corporation may fear that a shareholder will file a securities class action at a later date. The corporation may be especially concerned that a securities class action will follow a victory in the derivative suit. It is unlikely that the court will stay the derivative suit for several years until the statute of limitations on a securities class action has expired.

Second, even if a corporation resolves a securities class action, it may fear subsequent government investigations. The federal securities laws empower the SEC to file civil enforcement acts against those who mislead market investors.[172] The SEC has five years to file a suit for the enforcement of any civil fine, penalty, or forfeiture,[173] but there is no similar restriction on remedial actions brought by the SEC, such as actions for injunctions or disgorgement of ill-gotten gains.[174] As a result, even the passage of time cannot protect a corporation from all of the risks of parallel litigation.

Finally, the passage of time can negatively impact the corporation's likelihood of success in a derivative suit. If the corporation waits until a parallel securities class action has ended to file a derivative suit, it may find that the statute of limitations on the derivative suit has

170 *See id.*

171 *See id.*; *see also In re* E.F. Hutton Banking Practices Litig., 634 F. Supp. 265, 270 (S.D.N.Y. 1986) (stating that "a disinterested board" faced with parallel derivative suits and securities class actions "might well . . . conclude it to be unwise to subject [the corporation] to further litigation [in the derivative suit] clearly calculated to undercut [the individual defendants'] veracity and general effectiveness as witnesses"); Brudno v. Wise, No. Civ. A. 19953, 2003 WL 1874750, at *1 (Del. Ch. Apr. 1, 2003) (staying a derivative suit that was in reality a placeholder indemnity action "for any injury suffered by [the corporation] as a result of the Federal Securities Action").

172 *See* 15 U.S.C. § 78u(3)(A) (2006).

173 28 U.S.C. § 2462 (2006).

174 *See, e.g.*, SEC v. Rind, 991 F.2d 1486, 1492 (9th Cir. 1993); SEC v. Williams, 884 F. Supp. 28, 30–31 (D. Mass. 1995).

expired[175] or that the relevant evidence has withered over time (as memories have a tendency to do) or disappeared entirely. These concerns often lead SLCs to recommend that courts dismiss derivative suits entirely.

3. Dismissals of Derivative Suits

SLCs face even more skepticism from the courts when they recommend dismissal of derivative suits. Many courts are reluctant to dismiss these suits because they think that dismissals will allow alleged wrongdoers off the hook. As with the stay decisions, however, courts have not spoken with one voice. A few courts have sided with the corporation, granting SLC requests to dismiss derivative suits that conflict with parallel securities class actions. The two cases discussed below illustrate both sides of the debate.

The first case is the Second Circuit's decision in *Joy v. North*.[176] The plaintiff in *Joy* alleged that the defendant officers and directors breached their fiduciary duty to Citytrust Bancorp, Inc. (Citytrust) by issuing multimillion dollar loans to a financially precarious real estate developer who ultimately defaulted on the loans.[177] Citytrust appointed an SLC to review the allegations and the SLC concluded that the suit against certain of the defendants should be terminated because there was no reasonable possibility of success against these defendants.[178] The district court granted the corporation's motion to dismiss and the Second Circuit reversed and remanded the case back to the district court.[179]

In justifying its decision, the Second Circuit placed strict limitations on the type of costs that a district court (or an SLC) can consider in reviewing an SLC recommendation.[180] The court held that a district court can consider the direct costs and benefits of the derivative suit, including attorneys' fees, other litigation costs, and expenses related to mandatory indemnification.[181] In most cases, according to the Second Circuit, these are the only relevant factors. Where, however, "the court finds a likely net return to the corporation which is

175 *See, e.g.*, Kahn v. Seaboard Corp., 625 A.2d 269, 270–71 (Del. Ch. 1993) (noting that the statute of limitations in derivative actions is three years unless a continuing wrong extends the applicable limitations period).

176 692 F.2d 880 (2d Cir. 1982).

177 *See id.* at 884.

178 *See id.* The SLC also recommended that the company attempt to settle the claims against other defendants. *Id.*

179 *See id.*

180 *See id.* at 892.

181 *See id.*

not substantial in relation to shareholder equity, it may take into account two other items as costs."[182] First, "it may consider the impact of distraction of key personnel by continued litigation."[183] Second, "it may take into account potential lost profits which may result from the publicity of a trial."[184]

The court did not directly address whether a district court can consider the effect of a derivative suit on other litigation pending against the corporation, such as a securities class action. The court's analysis, however, appears to rule out such consideration. The court acknowledged that the corporation might incur "other less direct costs" and that "such factors, with the two exceptions noted, should not be taken into account."[185] It justified its holding by noting that "[q]uite apart from the elusiveness of attempting to predict such effects, they are quite likely to be directly related to the degree of wrongdoing, a spectacular fraud being generally more newsworthy and damaging to morale than a mistake in judgment as to the strength of consumer demand."[186]

This same analysis would apply to consideration of the impact of a derivative suit on other litigation. As discussed briefly above, the risk that a corporation will face substantial liability in a securities class action if an SLC recommends going forward with a derivative suit is related in large part to the degree of wrongdoing by corporate officials. The conflict between a derivative suit and a securities class action is most often apparent in the most egregious cases of corporate wrongdoing,[187] and thus it is in these cases that SLCs will be most concerned about liability in resulting securities class actions. Accordingly, one could fairly read *Joy* as prohibiting a corporation or a court from considering the impact of a derivative suit on a parallel securities class action. Other courts have agreed with the holding in *Joy*.[188]

Like the *Tyco* decision, these cases are based largely on the public model of derivative suits. These courts want SLCs to concern themselves largely with the legal merits of derivative suits, not with the busi-

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182 *Id.*

183 *Id.*

184 *Id.*

185 *Id.*

186 *Id.*

187 *See supra* note 138 and accompanying text.

188 *See, e.g.*, *In re* Par Pharm., Inc. Derivative Litig., 750 F. Supp. 641, 647 (S.D.N.Y. 1990) (holding expressly that an SLC cannot consider the impact of a derivative suit on other pending litigation because "[t]he issue . . . is whether [the derivative] claims are viable in this derivative action not whether they conflict with the position taken in another litigation").

ness impact of the suits. If a case involved a clear violation of the law (and defendants with large pockets), *Joy* and other similar cases would likely allow the suit to continue, even if the suit had substantial indirect costs and thus was not in the corporation's best interests.

The Eastern District of Michigan's decision in *In re Consumer Powers Co. Derivative Litigation*[189] represents the opposite end of the spectrum. The SLC in *Consumer Powers* rejected a shareholder's demand that the corporation commence litigation against certain of the corporation's directors and officers.[190] In conducting its investigation, the SLC interviewed the company's counsel regarding the impact of the suit on several pending proceedings, including a securities class action, an SEC investigation, and a rate case before the Michigan Public Service Commission.[191] The company's counsel told the SLC that "if Consumers filed a complaint against its directors for wrongdoing, this complaint would be deemed to be an admission in the [securities] case of the very claims Consumers had denied in that case."[192] The potential recoverable damages in the derivative suit were approximately $50 million, while the corporation stood to lose billions of dollars in the other related proceedings.[193] Based on this analysis, the SLC concluded that it was not in the corporation's best interests to pursue a claim against the corporation's officers and directors. The shareholder then filed a derivative suit, arguing that the SLC's decision not to bring the suit was based on the SLC's improper consideration of the impact of the derivative suit on the other suits.[194]

The court dismissed the shareholder's challenge, holding that the SLC's decision was reasonable in light of the risk that the derivative suit posed to the other proceedings. The court stated, "[f]or some, such as plaintiffs' counsel, forgoing $50,000,000 to pursue a 'doomed litigation' posture is folly."[195] "For others," the court explained:

> [P]ursuing $50,000,000 in the derivative claim at the risk of enhancing the likelihood of loss in Consumers' other litigation and corporate endeavors would be equivalent to the directors of the White Star Lines on April 14, 1912, ordering a midnight auction of the Titanic deck chairs instead of trying to save the ship.[196]

189 132 F.R.D. 455 (E.D. Mich. 1990).
190 *See id.* at 458.
191 *See id.* at 478–79.
192 *Id.* at 478.
193 *See id.* at 486.
194 *See id.*
195 *Id.*
196 *Id.*

The court concluded that:

> [I]t is not for this Court to decide who is right, nor to second-guess the special Advisory Committee, but only to consider whether the plaintiffs have evidence that would support a determination that the decision-making procedures were so uninformed and curtailed as to lie beyond the parameters of behavior that would be acceptable to reasonable business people.[197]

The court accordingly dismissed the suit. And just as some courts have followed the *Joy* decision at one extreme of this issue, other courts have adopted the opposite result in *Consumer Powers*.[198]

These decisions reflect the private model of derivative suits. The court based its decision on the best interests of the plaintiff corporation, not on a desire to punish the alleged wrongdoers or deter similar misconduct in the future. Given this focus, the court left the fate of the litigation in the hands of the SLC because the determination of a corporation's best interests is a business issue best left to corporate directors.

In the end, this split in the case law leaves SLCs in a difficult position. On the one hand, an SLC will not want to recommend pursuing a derivative suit if the suit may hurt a corporation's position in other pending litigation. On the other hand, an SLC does not want to issue a recommendation that rests on legally impermissible grounds. SLCs are well aware that their recommendations may face intense scrutiny, both from within the corporation and from shareholders, regulators, and the public,[199] and they do not want to risk issuing a recommendation that will not withstand judicial scrutiny. Resolution of this issue will significantly benefit the SLC process by letting SLCs know the permissible scope of their review. It will also benefit the other stakeholders in derivative suits—shareholders, corporations, and society generally—by carving out a unique role for derivative suits within the larger framework of shareholder litigation.

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197 *Id.*

198 For example, in *Weiland v. Illinois Power Co.*, No. 89-1088, 1990 WL 267364 (C.D. Ill. Sept. 17, 1990), a corporation moved to dismiss a derivative suit on the basis of an SLC report. The plaintiff argued that the SLC could not have been independent or acted in good faith because the SLC would have exposed the corporation to liability in an investigation by the Illinois Commerce Commission if it had recommended going forward with the derivative suit. *Id.* at *10. Applying *Zapata*, the court rejected this argument. The court stated that "the future impact a derivative action will have on a corporation is a relevant consideration in addition to the consideration of the likelihood of the success of the claims." *Id.* at *15.

199 *See* Davis, *supra* note 119, at 1326 ("From the outset, the SLC conducts its process with the awareness that its recommendation, if favorable to the director-defendants, will almost certainly be challenged and scrutinized.").

III. Toward a Broader View of Shareholder Litigation

We have now seen that shareholder litigation rests on an often-flawed theoretical foundation. These flaws result from the fact that courts and scholars alike have failed to consider the way in which various types of shareholder litigation can work together to achieve the goals of shareholder litigation. In this Part, I argue that we need to reconceptualize shareholder litigation, bringing theory and practice together to solve the conflict between securities class actions and derivative suits. I then discuss the impact of this proposed solution on the compensatory and deterrent goals of shareholder litigation.

A. Proposed Solution

How should courts resolve the conflict between derivative suits and securities class actions? Should they follow the private model of derivative suits and grant SLC requests to stay or dismiss derivative suits that conflict with parallel securities class actions? Or should they hold true to the public model of derivative suits and permit shareholders to proceed with these suits even if they are not in the best interests of the corporations in whose names these suits are brought?

The answer lies in remembering why derivative suits exist in the first place. As discussed above in Part I, derivative suits were created because of a conflict of interest between corporations and their officers and directors.[200] Although state law normally empowers officers and directors to control corporate legal strategy,[201] this approach does not work where the officers or directors themselves stand accused of misconduct. Derivative suits are designed to avoid this conflict of interest by permitting shareholders to sue on the corporation's behalf.[202] Thus, derivative suits are a solution to a limited problem, not an effort to reshape the remedies against alleged wrongdoers. Put another way, despite their unique form, derivative suits are still private lawsuits brought on behalf of private litigants. As in any civil lawsuit, the court should not force these suits to continue if they

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200 *See supra* notes 18–19 and accompanying text.

201 Kaplan v. Peat, Marwick, Mitchell & Co., 529 A.2d 254, 259 (Del. Ch. 1987) (stating that it is a "basic principle of corporate governance that decisions on behalf of a corporation (including a decision whether to commence litigation) are normally made by the corporation's board of directors"), *aff'd in part, rev'd in part by* 540 A.2d 726 (Del. 1988).

202 *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management. The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it.").

are not in the best interests of the parties on whose behalf the suits are brought.[203]

This analysis leads to a simple solution to the conflict between derivative suits and securities class actions. In deciding whether a derivative suit should proceed, an SLC acting in good faith should be permitted to consider *all* of the costs and benefits of the suit for the plaintiff corporation, including the impact of the derivative suit on a parallel securities class action. If the SLC believes that such costs exceed the suit's benefits, it should ask the court to stay or dismiss the suit. The reviewing court should then examine whether the SLC was independent and conducted an adequate investigation. Depending on the requirements of state law, the court may also consider the reasonableness of the SLC's analysis.[204] The court may not, however, reject the SLC's request on the ground that the SLC was not entitled to consider the indirect costs of the derivative suit, including the potential impact of the suit on a related securities class action.

This analysis mirrors the analysis that a corporation's general counsel would perform prior to deciding whether the corporation should initiate a lawsuit. A general counsel would not file suit without considering all of the costs and benefits of the suit. Likewise, an SLC should be able to consider all of the costs and benefits before deciding whether to recommend that a derivative suit proceed. It should not matter whether the suit's costs come in the form of legal bills from Skadden Arps or additional legal risk in a securities class action.[205]

The same analysis should apply when SLCs are faced with other types of parallel litigation filed against the corporation, such as ERISA lawsuits or government enforcement actions. A recent study found that over twenty percent of all securities class actions filed since 1995 have been accompanied by a corresponding SEC action.[206] There are not figures showing the percentage of derivative suits that are accompanied by SEC actions, but that figure is likely to be significant. An

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203 *See, e.g.*, Davis, *supra* note 6, at 434 (asking whether the shareholders of the corporation named in a derivative suit should be asked to subsidize society's deterrent efforts).

204 This step would apply in jurisdictions that follow the Delaware Supreme Court's decision in *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788–89 (Del. 1981). *See supra* notes 147–48 and accompanying text (discussing *Zapata*'s "second step").

205 This calculation should include the corporation's desire for specific deterrence, or deterrence of the plaintiff corporation's own officers and directors. Corporations that take a hard stand against wrongdoing by their executives are less likely to be victims of similar wrongdoing in the future. Corporations that have had to pay significant damages as a result of their executives' conduct may want to take such a hard stand to avoid a repeat of such situations in the future.

206 SIMMONS & RYAN, *supra* note 43, at 12.

SLC should be able to take into account the impact of a derivative suit on a parallel ERISA suit or SEC enforcement action just as it should be able to take into account the impact of the derivative suit on a parallel securities class action.

This proposal will fit into the existing legal framework with only a few necessary tweaks. For the most part, courts can simply fold this proposal into their review of SLC recommendations. The most significant change concerns the concluding statements of the Delaware Supreme Court in *Zapata*, a decision that has shaped judicial review of derivative suits across the country.[207] In *Zapata* the court established a two-step process of review.[208] The court must first determine whether the SLC was independent, acted in good faith, and had a reasonable basis for its decision.[209] If these threshold standards are met, the court should then exercise its own "independent business judgment" to determine whether the suit should be dismissed.[210] At the end of its opinion, the court held that a reviewing court could use this second step to "give special consideration to matters of law and public policy in addition to the corporation's best interests."[211] Although courts have not cited expressly to this step of *Zapata*, the sentiment behind it has informed cases addressing the conflict between securities class actions and derivative suits, as we saw above.

My proposal requires abandoning this part of *Zapata*, as well as the underlying sentiment that it represents. The Delaware Supreme Court should make clear that the second step of the *Zapata* test is designed to ensure that the SLC is actually acting in the corporation's best interests, not to bring additional considerations into the mix.[212]

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207 As just one example, a Westlaw search reveals that the decision has been cited over fifteen hundred times over the last seventeen years.

208 *See supra* notes 145–48 and accompanying text.

209 *See Zapata Corp.*, 430 A.2d at 788–89.

210 *Id.* at 789. At least one judge has been skeptical of this standard, stating that the second step of *Zapata* requires him to determine in his "oxymoronic judicial 'business judgment,' [whether the suit] is in the best interests of the [corporation]." *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 928 (Del. Ch. 2003); *see also* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 39 (1991) ("[T]he idea that a trial court can exercise 'business judgment' is anomalous. Trial judges are not businesspeople; they do not possess the practical experience and exposure to the special needs of the corporation that characterizes the business judgment of corporate managers.").

211 *Zapata Corp.*, 430 A.2d at 789.

212 I am not the first commentator to find fault with this step of the *Zapata* test. *See* James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 988–89 ("Although the court in *Zapata* apparently approved [of courts taking into account the public interest in

This interpretation of the test will not undercut *Zapata*; to the contrary, it will give real teeth to judicial review of SLC recommendations. Many commentators have argued that SLCs suffer from a structural bias that predisposes them to recommend against pursuing a derivative suit.[213] By using the second step of *Zapata* as a judicial check on whether SLCs are acting in the best interests of plaintiff corporations, courts can ensure that SLCs base their decisions on the best interests of corporations, rather than a "there but for the grace of God go I"[214] empathy for defendants.

This judicial check may come into play in assessing an SLC's recommendation to dismiss a derivative suit as opposed to staying the suit. On this issue, I would advocate deference, tempered by meaningful judicial review, to SLCs. As explained in Part II, there are often legitimate reasons why a corporation would prefer outright dismissal over a stay.[215] The corporation may want to minimize the public relations fallout from the alleged wrongdoing, or it may fear subsequent lawsuits, including SEC enforcement actions, that might follow a securities class action. Weighing the respective costs and benefits of a stay versus a dismissal requires a complicated assessment of business and legal objectives. An SLC is particularly well-suited to conduct this assessment in the first instance given its insider knowledge of the corporation. Yet this is also an area in which SLCs may reveal their biases against derivative suits, recommending dismissal without giving serious consideration to less drastic alternatives. Accordingly, a court applying the second step of *Zapata* should give special attention to this issue, looking skeptically upon an SLC's recommendation to dismiss a derivative suit when a stay would suffice.[216] The level of skepticism will vary depending on the intricacies of state law, but regardless of

deciding whether to dismiss a derivative suit, this position] conflicts with accepted views of the purpose of derivative suits and would pose insurmountable problems." (footnote omitted)).

213 *See, e.g.*, 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 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.").

214 *Zapata Corp.*, 430 A.2d at 787.

215 *See supra* notes 171–74 and accompanying text.

216 In jurisdictions with less extensive judicial review of SLC recommendations, an SLC may be entitled to greater deference in deciding between a stay and outright dismissal. *See, e.g.*, VA. CODE ANN. § 13.1-672.4 (2006) (requiring a court to dismiss a derivative proceeding if an SLC, after a good faith review and evaluation, has determined that a derivative proceeding is not in the best interests of the corporation).

these differences, courts should remain a check on SLC decisionmaking.

The same judicial oversight should come into play when an SLC recommends staying or dismissing a derivative suit out of fear that decisions in the derivative suit could harm the corporation in other lawsuits that have yet to be filed. Although derivative suits often follow on the heels of securities class actions, this order is not set in stone. An SLC may rationally fear that, even if shareholders have not yet filed a securities class action, one may follow a successful derivative suit. In this situation, the reviewing court should again look to the SLC to answer some probing questions: How likely is it that shareholders or the government will file related litigation in the future? Would the plaintiffs in these other lawsuits be able to use decisions or facts uncovered in the derivative suit to help build their case against the corporation? What are the likely damages in such lawsuits? An SLC may not be able to provide a definitive answer to these questions, but it should have thought about these questions and factored the likely range of possible outcomes into its recommendation.

Before we turn to the benefits of and possible objections to this approach, a few final words about the proposal itself are in order. First, this proposal does not mean that the broader deterrent goals of derivative suits are irrelevant. Like all private suits, derivative suits send a message to other potential wrongdoers that they may be held accountable for their actions. To the extent that courts can stress the deterrent goals of these suits in a way that is consistent with the plaintiff corporation's interests, they should do so, a point discussed further below. Where the plaintiff corporation's interests are inconsistent with such goals, however, courts should choose an approach that best protects the interests of corporations.

Second, this proposal views corporations *qua* corporations. Shareholders may well have legitimate grievances against the officers or directors named as defendants in these suits, or even against the corporations themselves. These grievances, however, should be aired in securities class actions or other lawsuits in which the shareholders themselves are the parties in interest. Shareholders should not be permitted to exercise their representative power in derivative suits to vindicate their own individual interests, especially where these interests are contrary to the interests of the corporations on whose behalf these suits are brought.

Finally, this proposal reflects a belief that courts should not use derivative suits to solve perceived problems with securities class actions. The federal securities laws impose steep procedural hurdles on securities plaintiffs.[217] A prime example is the Reform Act's prohibition on discovery prior to a decision on a motion to dismiss. As described above in Part I, plaintiffs' attorneys often use derivative suits to circumvent the Reform Act's stay of discovery by obtaining discovery material in derivative suits that they can then use to bolster their complaints in parallel securities class actions.[218] This loophole will disappear if corporations are permitted to stay or dismiss derivative suits that threaten their defense of securities class actions. As a result, there is a risk that courts will dismiss a greater number of meritorious securities class actions simply because the securities plaintiffs could not obtain the necessary discovery to support their claims. This risk is real, but it should not be addressed by using derivative suits as an unofficial back door around the restrictions in the Reform Act.

In the end, the approach outlined in this Article reflects a broader view of shareholder litigation. Under this view, securities class actions and derivative suits should work together to achieve the diverse goals of shareholder litigation. To understand this point, we now turn to the benefits of and possible objections to this approach, a discussion that will bring us full circle back to the public and private models of derivative suits introduced in Part II.

B. Benefits of the Proposal

An obvious benefit of this approach is its impact on the private model of derivative suits. This approach furthers the private model—and the compensatory goals that this model represents—by ensuring that corporations have a legal mechanism to stay or dismiss derivative suits that are not in their best interests. As a result, under this approach, derivative suits will be far more likely to benefit the corporations on whose behalf they are brought.

The approach outlined in this Article also promotes compensatory goals more subtly by enhancing the SLC process. This process is the best way to ensure that derivative suits represent the interests of plaintiff corporations. Every state has agreed with this assessment, with all fifty states adopting some version of the SLC process.[219] Given

217 *See supra* notes 85–90 and accompanying text.

218 *See supra* notes 92–96 and accompanying text.

219 The Annotated Model Act statutory comparison provides, "[A]ll 52 jurisdictions provide for committees to be appointed by the board of directors. The District of Columbia and South Dakota statutes only refer specifically to an executive committee. The other jurisdictions follow the Model Act in expressly allowing for the creation of other committees." 2 MODEL BUS. CORP. ACT ANN. § 8:25, at 8-146 (Supp. 2002).

this common ground, it makes no sense to place constraints on SLCs that erode the value that SLCs bring to derivative suits.

My proposal lifts these restraints, enhancing the SLC process in three important and related ways. First, it permits SLCs to take into account the very factors they are best equipped to consider. These factors include considerations related to the corporation's business, such as the distraction of key personnel, the risk of negative publicity, and the impact of the derivative suit on other parallel litigation. If an SLC is prohibited from considering these factors and is only permitted to consider the legal merits of the suit, there is no real reason for SLC involvement.[220] SLC members are appointed for their business skill, not their legal acumen, and if the permissible considerations are primarily legal, their input will not add significant value to the suit. Given that states have universally endorsed the SLC process, the law should allow the SLC process to work in the intended manner.

Second, the approach in this Article will enhance the SLC process by ensuring that SLC members are truly independent. State law deems directors independent if they base their decisions on "'the corporate merits of the subject before the board rather than extraneous considerations or influences.'"[221] This independence requirement would be turned on its head if SLC members were prohibited from considering the impact of a derivative suit on a parallel securities class action, a consideration that goes directly to the "corporate merits" of the derivative suit.[222] Given the increasing importance of independence in corporate law today,[223] it would make no sense to adopt a legal framework for shareholder litigation that rejects this key notion.

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220 *Cf.* Coffee & Schwartz, *supra* note 125, at 324 (arguing that SLCs should be required to "advance a substantial business judgment independent of the merits of the litigation" to justify dismissal of a derivative suits because "courts and not litigants should decide the merits of the litigation").

221 *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003) (quoting Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984)); *see also* Strougo v. Padegs, 27 F. Supp. 2d 442, 449–50 (S.D.N.Y. 1998) (refusing to accept plaintiff's argument that an SLC member was not independent because, inter alia, he allegedly considered the interests of the public at large, in addition to the corporation's interests, in deciding whether to recommend that a derivative suit be allowed to proceed).

222 *See, e.g.*, *supra* notes 96–113 and accompanying text (discussing the inability of derivative actions to recoup the losses from security actions).

223 *See, e.g.*, Seth W. Ashby, *Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence*, 2005 U. ILL. L. REV. 521, 540–45; William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 967 (2003) (explaining the increased push for director independence in the wake of Enron); Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOR-

Third, the approach in this Article enhances compensatory goals by adding legitimacy to the SLC process. SLCs are already under fire by critics who claim that they lack the capacity to perform an independent review of derivative suits.[224] It will only add fuel to the fire to prohibit SLCs from issuing reports that take into account the impact of derivative suits on other pending litigation. Such a limitation would be a difficult calculus for SLCs to adopt. Indeed, it is likely that many SLCs will refuse to serve in this role. Instead, in cases where a narrow calculus (such as the one advocated by the court in *Joy*) tilts in favor of the suit, but a more exhaustive review of the suit's costs and benefits reveals that the suit is not in the plaintiff corporation's best interests, an SLC will likely choose from one of two alternatives. First, an SLC may simply refuse to make a recommendation. This option is unsatisfying, as it prevents corporations from having their voices heard in suits brought on their behalf. It also creates a risk that parties in other related litigation will deem the SLC's silence as a "practical 'admission'" of the allegations in the derivative suit and will attempt to use the SLC's silence against the corporation in those other cases.[225] The Supreme Court of Delaware has recognized this risk, holding that an SLC that attempts to remain neutral regarding the merits of a derivative suit may be deemed to have given "tacit approval for the continuation of the litigation."[226]

Alternatively, and perhaps more likely, an SLC may only pretend to follow *Joy*. They may continue to consider the full spectrum of costs and benefits, but rest their recommendations only on those costs and benefits that courts have deemed acceptable. This may not even be a deliberate strategy. Weighing the costs and benefits of a derivative suit is not an exact science. An SLC armed with the knowledge that a derivative suit could threaten the corporation's defense of a related securities class action may weigh the other costs and benefits of the suit more harshly. This option is even more destructive to the SLC process than the option of silence. Considering that SLCs are already

EST L. REV. 855, 856 (2003); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1241 (2002).

224 *See, e.g.*, AM. LAW INST., *supra* note 213, § 7.10 cmt. d ("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.").

225 *In re* Consumers Power Co. Derivative Litig., 132 F.R.D. 455, 487–88 (E.D. Mich. 1990).

226 Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 731 (Del. 1988).

subject to criticism from those who doubt their ability to make independent assessments of derivative suits, the SLC process will lose even more legitimacy if courts and commentators believe that SLCs are masking the true motivations behind their recommendations.

In short, we should encourage courts to take a broader view of shareholder litigation in part because this perspective will go a long way toward enhancing the compensatory nature of these suits. Once we recognize that derivative suits are private suits brought on behalf of private litigants, we should take the next step of reshaping these suits to enhance their compensatory value. Moreover, as we will now see, taking this step does not mean that the other important goals of shareholder litigation are forgotten.

C. Potential Objections

Critics may argue that the approach outlined in this Article protects compensatory goals, only to ignore the important deterrent goals that shareholder litigation is also supposed to serve. As explained in Part II, many courts and scholars have viewed the choice between the public and private models of derivative suits as a zero-sum game. They can either choose the private model and stay or dismiss derivative suits that conflict with parallel securities class actions, or they can choose the public model and permit these suits to continue. In the end, however, this either-or analysis misses the mark. There are persuasive reasons to adopt the proposal set forth in this Article even if one supports the public model of derivative suits and the deterrent goals that it represents.

It is undoubtedly true that fewer derivative suits will survive SLC review if SLCs are permitted to take into account the full costs and benefits of these suits.[227] The derivative suits that remain, however, are more likely to have a real impact in deterring corporate wrongdoing and thus are more likely to enhance the public model of derivative suits. Corporate litigation today resembles an Oklahoma land rush.[228] A corporation's announcement of bad news all too often leads to a flurry of nearly identical litigation, including securities class actions, derivative suits, ERISA suits, and government investigations. In this

227 I note here again, however, that an SLC (or a reviewing court) may determine that staying a parallel derivative suit is a more appropriate prophylactic than dismissing the case entirely.

228 This apt analogy was developed by Professor John Coffee. *See* Coffee, *supra* note 120, at 228 (describing litigation as often "resembling the Oklahoma land rush, in which the filing of the public agency's action serves as the starting gun for a race between private attorneys, all seeking to claim the prize of lucrative class action settlements, which public law enforcement has gratuitously presented them").

environment, it is unlikely that derivative suits add much additional deterrence.[229]

This point underscores a flaw in the public model of derivative suits. This model is based on the idea that society needs derivative suits to deter corporate misconduct because individual wrongdoers will otherwise escape liability for their actions.[230] It is not surprising that advocates of the public model would therefore frown upon a rule that permitted SLCs to recommend dismissal of derivative suits based on the impact of those suits on parallel securities class actions. It seems contrary to good governance principles to allow individual wrongdoers off the hook simply because their actions have created such problems for the corporation in other litigation that the corporation cannot risk going after them.

This belief is understandable, but based on an overly narrow view of shareholder litigation. The conflict addressed in this Article only arises where a corporation faces multiple lawsuits arising out of the same conduct. In all likelihood, the alleged wrongdoers will also be named as defendants in these other lawsuits. It is extremely rare for a corporation to be the only defendant named in a securities class action; in almost all cases, the corporation is sued along with a number of its officers and directors.[231] In addition, the SEC has stated that, where shareholders were the primary victims of the alleged wrongdoing, it will focus its enforcement efforts on the individual wrongdoers, rather than on corporations.[232] The SEC has also frequently required individuals to waive their right to indemnification from their employers as a precondition to settling an SEC enforce-

229 Interestingly enough, for all of the scholarly focus on shareholder litigation, no one really argues that derivative suits are an effective weapon in the fight against corporate misconduct. *See, e.g.*, AM. LAW INST., *supra* note 213, at 5 (stating that the ALI "recognizes that the derivative action is neither the initial nor the primary protection for shareholders against managerial misconduct").

230 *See* Coffee & Schwartz, *supra* note 125, at 307–08 (stating that under the private model of derivative suits, courts will be "placed in the morally compromising position of having . . . to acknowledge that, despite the best efforts of the state, crime did indeed pay").

231 Robert Thompson and Hillary Sale reviewed all of the complaints in securities fraud class action suits filed in 1999 in the Courts of Appeals for the Second, Third, and Ninth Circuits. *See* Thompson & Sale, *supra* note 6, at 895. They found that all the complaints named the corporation as a defendant. *Id.* In only four of the eighty-six complaints, however, was the corporation the only defendant. *Id.* The remaining eighty-two complaints named individual defendants as well. *See id.*

232 Press Release, Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

ment action, a requirement that forces these individuals to pay financial penalties out of their own pockets.[233] Accordingly, individual wrongdoers may escape liability to the corporation as a result of their actions, but it is unlikely that they will escape liability altogether.[234]

On the other hand, derivative suits can have a real deterrent effect in situations in which they are the only suits that are filed. The recent scandal concerning the backdating of stock options demonstrates this point. In late 2005, news spread that many companies had backdated, or altered the dates on, grants of stock options to their executives. Although backdating is not illegal per se,[235] it appears that many of the companies that engaged in this practice did not adequately disclose the practice to their stockholders and did not follow the applicable tax rules.[236] As a result, many companies had to restate their earnings.[237] Although this scandal captured the attention of the business press, it did not lead to a wave of securities class actions. As of September 2008, shareholders had filed only 39 securities class actions relating to the alleged backdating of stock options compared to 168 derivative suits.[238] This example demonstrates that there are cases where the private model and the public model of derivative suits can coexist, allowing shareholders to pursue derivative suits without jeopardizing a corporation's position in other litigation.[239]

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233 *See, e.g.*, 17 C.F.R. § 229.510 (2008) (stating that, in the SEC's view, corporate promises to indemnify officers and directors for violations of the Securities Act of 1933 are "against public policy" and "therefore unenforceable").

234 As Professors Coffee and Schwartz have noted, "[T]he key question must be whether derivative litigation is likely substantially to further and enforce the policies of [federal law] in a manner superior to other means of enforcement." Coffee & Schwartz, *supra* note 125, at 298. Given the well-known weaknesses of the derivative suit, there is no reason to believe that the derivative suit will provide greater deterrence than these other suits. *See, e.g.*, Davis, *supra* note 6, at 428 ("[I]n circumstances where securities class actions had also been filed . . . it is questionable what [derivative suits] add by way of either compensation or deterrence.").

235 *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1601–02 (2007) ("[N]either backdating nor forward-dating by itself is illegal, as long as it is duly authorized by the board, fully disclosed, and reported in keeping with tax rules.").

236 *See* Frank Ahrens, *Scandal Grows Over Backdating of Options*, WASH. POST, Oct. 12, 2006, at D01.

237 *See id.*

238 The D&O Diary, http://www.dandodiary.com/ (July 20, 2006) (post entitled "Counting the Options Backdatings Lawsuits"), http://www.dandodiary.com/2006/07/articles/options-backdating/counting-the-options-backdating-lawsuits.

239 For a detailed examination of the different types of derivative suits, including certain types of suits that shareholders cannot easily morph into securities class actions, see Davis, *supra* note 6, at 414–49.

Additionally, derivative suits are frequently the only suits that are filed in cases alleging more classic violations of the duty of loyalty by a single officer or director.[240] Take, for example, a case alleging that a CEO embezzled money from his company or took kickbacks from customers. It is unlikely that such allegations would spawn securities class actions, as the CEO's behavior likely did not impact the accuracy of the company's disclosures, at least in any material way, but the allegations could easily lead to one or more derivative suits.[241]

Finally, derivative suits may be the only type of suit filed in cases involving small and/or private companies.[242] Securities class actions against such companies are "exceedingly rare," as they generally involve small damage claims and thus are not a worthy investment for those plaintiffs' attorneys accustomed to the large fees in securities class actions.[243] As these examples illustrate, there are important areas where derivative suits do not simply mirror the allegations in parallel securities class actions.[244]

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240 Professors Thompson and Thomas's study of all of the derivative suits filed in the Delaware Court of Chancery in 1999 and 2000 found that shareholders alleged self-dealing by corporate managers in eighty-four percent of the suits involving privately held corporations and forty-nine percent of the suits involving public corporations. *See* Thompson & Thomas, *supra* note 4, at 1766, 1772.

241 *See, e.g.*, Davis v. Anten, No. B118437, 2006 WL 848282 (Cal. Ct. App. Apr. 3, 2006) (ruling on a derivative suit filed against former officer alleging that he had embezzled funds from the corporation).

242 Professors Thompson and Thomas's study also showed that of the twenty-five derivative suits filed against private companies in the Delaware Court of Chancery in 1999 and 2000, only a single company was named in more than one suit. *See* Thompson & Thomas, *supra* note 4, at 1765. They note, "By contrast, in derivative and class actions against public companies, the same transaction generated up to forty-one separate suits." *Id.* They conclude that:

> [Derivative] suits retain an important role in policing management in closely held corporations. Unlike public corporations, there is neither an established market for a private company's stock nor similar constraints on manager's misuse of the centralized power that is given to directors under Section 141 of the Delaware Code and Section 8.01 of the Model Business Corporation Act. Derivative suits can play an important role for protecting minority shareholder rights in the private company setting.

Id. at 1760. As Dean Davis points out, however, shareholders may be able to file other types of suits in this context, including petitions for dissolution and direct suits for minority oppression. *See* Davis, *supra* note 6, at 423–27.

243 *See* Choi, *supra* note 4, at 1466, 1499–502 ("For smaller firms, private class action litigation is exceedingly rare.").

244 *See, e.g.*, Thompson & Thomas, *supra* note 4, at 1760 (arguing that although "the academy has virtually ignored derivative suits against private companies, . . . in many states, such suits retain an important role in policing management" in these companies).

Derivative suits will have a greater deterrent impact if they are concentrated in areas like these where they do not duplicate allegations in other lawsuits. As Professor James Cox has argued, the deterrent value of derivative suits is linked to the public image of these suits.[245] Derivative suits are currently seen as largely frivolous suits, filed by plaintiffs' attorneys seeking to participate in the scramble of litigation against high-profile corporations and ending with little or no compensation paid to the corporation.[246] Given this perception, it is not surprising that the defendants in derivative suits are often viewed as unfortunate victims of a flawed litigation system, rather than as actual wrongdoers, a perception that limits the deterrent impact of this litigation.[247] If directors believed that these suits had real teeth, the suits would have a greater chance of deterring corporate misconduct.

The proposal in this Article will not lead to the demise of derivative suits. There are plenty of areas where derivative suits can serve the public interest without harming the corporations on whose behalf these suits are filed. The key is to focus the law's efforts on these suits, rather than assuming that every type of corporate lawsuit is appropriate to remedy every allegation of corporate wrongdoing.

Conclusion

In the face of recent corporate scandals, courts have been understandably reluctant to forgo any opportunity to deter corporate misconduct. It is precisely in this era of corporate scandals, however, that the limitations of shareholder litigation have become most apparent. Contrary to the conventional wisdom, securities class actions and derivative suits are not a zero-sum game for corporations. Nor is there evidence that parallel securities class actions and derivative suits deter corporate misconduct more effectively than more targeted litigation. Casting aside these erroneous assumptions, we must embrace a new conceptual framework that promotes all of the diverse goals of shareholder litigation. Only then can we bring these new conceptual insights to bear on the current legal debate over how courts should handle parallel securities class actions and derivative suits. In short,

245 Cox, *supra* note 4, at 5–9 (arguing, inter alia, that "the message of the individual derivative suit or securities class action is affected by the company it keeps with other shareholder suits").

246 *See id.* at 14–15.

247 *See id.* at 8; *see also* Hawkins, *supra* note 49, at 602 (noting that "no shame is attached to being the victim of an unfair proceeding").

more litigation is not necessarily better when it comes to combating corporate misconduct.

As empirical evidence continues to mount regarding securities class actions and derivative suits, this broader view of shareholder litigation raises additional questions. How can courts reshape the rules governing securities class actions and derivative suits to ensure that these suits are focused in the areas in which they have the greatest potential to benefit all of the constituencies of shareholder litigation? How can courts further refine the rules regarding other types of corporate litigation to ensure that these lawsuits work together to achieve the diverse goals of our legal system? These questions remain for another day, but their very existence reflects a fundamental point: legal theory must catch up to legal practice in analyzing the tools used to combat corporate misconduct. Now is the perfect time to calm the perfect storm of shareholder litigation.