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## The Public and Private Faces of Derivative Lawsuits

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# The Public and Private Faces of Derivative Lawsuits

*Robert B. Thompson\**

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I.	DERIVATIVE SUITS' ROLE AS A CONSTRAINT ON MANAGEMENT MISCONDUCT .....	1751
A.	<i>The Traditional Statutory Template of Governance</i> .....	1751
B.	<i>The Role of Derivative Suits in a Changing Menu of Governance</i> .....	1756
II.	EMPIRICAL DATA ON DERIVATIVE SUITS .....	1760
A.	<i>The Data Set: Delaware Litigation at the Turn of the Century</i> .....	1760
B.	<i>Derivative Suits: Small Both in Absolute Number and as a Share of Corporate Litigation</i> ....	1761
C.	<i>Private Company Suits</i> .....	1763
D.	<i>Public Company Derivative Litigation: Do They Have High Litigation Agency Costs?</i> .....	1768
	1. Multiple suits per controversy. ....	1768
	2. Recurring plaintiff firms. ....	1769
	3. Suits are filed quickly. ....	1770
	4. Suits targeted at particular industries. ....	1771
	5. Why Do Public Company Derivative Suits Have Lower Litigation Agency Costs than Other Types of Representative Litigation? .....	1772
E.	<i>The Benefits of Derivative Suits with Public Company Defendants</i> .....	1774
III.	DEMAND IN DERIVATIVE SUITS.....	1780

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IV.	POLICY IMPLICATIONS OF OUR RESULTS .....	1784
A.	<i>Private Company Derivative Suits</i> .....	1784
B.	<i>Public Company Derivative Suits</i> .....	1786
	1. Should Delaware take action to make derivative suits easier to bring?.....	1787
	2. Policy Proposals.....	1789
IV.	CONCLUSIONS .....	1792

Are shareholder derivative suits at death's door? Once described as "the most important procedure the law has yet developed to police the internal affairs of corporations,"<sup>1</sup> derivative suits are today regularly portrayed as nuisance suits whose "principal beneficiaries ... are attorneys."<sup>2</sup> Even if these critics are wrong, there may now be less need for derivative suits, as other forms of representative suits have grown up that do much of their work. Federal securities fraud class actions increasingly address legal claims that raise issues about management care,<sup>3</sup> and fiduciary duty class actions under state law are the principal litigation vehicle to remedy management misconduct in merger and acquisition settings.<sup>4</sup> At the same time, American stock exchanges now require more independent directors for larger public companies, a change that will make it more difficult for derivative suits to survive procedural challenges under existing legal rules.<sup>5</sup>

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1. Eugene Rostow, *To Whom and For What End is Corporate Management Responsible?* in *THE CORPORATION IN MODERN SOCIETY* 48 (E. Mason ed., 1959). See Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 *GEO. L.J.* 1733, 1733 (1994) ("Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers.").

2. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 *J.L. ECON. & ORG.* 55, 65 (1991); Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 *J. LEGAL STUD.* 351, 351 (2001) (asserting that "suits are filed because [shareholders] attorneys stand to reap substantial fees"); STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 402 (2002) ("In almost all cases, the legal fees of plaintiffs exceed the monetary payment to shareholders."); *Id.* at 404 ("A radical solution would be the elimination of derivative suits. . . . Derivative litigation appears to have little, if any, beneficial accountability effects. On the other side of the equation, [it] is a high cost constraint and infringement upon the board's authority.").

3. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 *VAND. L. REV.* 859, 860-61 (2003).

4. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 *VAND. L. REV.* 133, 168 (2004).

5. Increased board independence has two effects that need to be considered here. The first is that the demand futility will be harder to establish in conflict of interest cases if there are more independent directors on the board. See *Aronson v. Lewis*, 473 A.2d 805, 810 (Del. 1984) (demand is not futile unless the plaintiff can allege facts creating a reasonable doubt that either a majority of the board of directors is interested in the challenged transaction, or that the transaction is not the product of a valid exercise of business judgment). This likely will lead to more dismissals of derivative actions for failure to make demand. On the other hand, more

Despite all this adversity, we believe derivative suits continue to play an important role. In fact, we see them having the legal equivalent of a cat's nine lives.<sup>6</sup> They have survived vigorous reform movements in both the 1940s<sup>7</sup> and the early 1980s.<sup>8</sup> Public company suits continue to be filed and to make new law. The impact of decisions in derivative cases like *Caremark*,<sup>9</sup> *Disney*,<sup>10</sup> and *Oracle*<sup>11</sup> goes well beyond the outcome of the cases themselves. These decisions changed the rules for future legal practice by allowing well-motivated legal counselors to get their clients to accept better conduct and procedures. Moreover, derivative suits against private companies perform an important, if less heralded, role in policing conflict of interest transactions and duty of care violations.

To support our claim, we present the data from a study of all corporate litigation in Delaware for a two year period. We find that there are a small number of derivative suits, about thirty per year, brought against public companies incorporated in Delaware. Contrary to earlier studies, we do not find evidence that that these cases are "strike suits" yielding little benefit. Instead, roughly 30 percent of the derivative suits provide relief to the corporation or the shareholders, while the others are usually dismissed quickly with little apparent

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independent boards may help companies avoid self-dealing in the first instance. This latter effect would benefit shareholders by reducing potential duty of loyalty violations.

6. Like the proverbial cat, derivative suits have been pronounced dead on numerous occasions, only to rise from the dead with renewed vigor. See 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, 261 (1981) ("The shareholder derivative suit today faces extinction. . . . Thirty-odd years ago, commentators foresaw the derivative suit's demise when state legislatures began adopting security-for-expenses statutes. . . ."); 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, 959-60 (1982) ("Like the heroine in a Saturday matinee, the derivative suit has repeatedly appeared to be at the cliffs of disaster. The adoption of security for expense statutes, the enactment of broadly permissive indemnification statutes, and even the judicial tightening of pleading requirements against derivative suit defendants have each been proclaimed in turn as the death knell of the derivative suit. . . . [The] latest threat to the derivative suit is the special litigation committee. . . .").

7. See generally, FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS (1944) (reporting that derivative suits in the 1930s and early 1940s were largely frivolous).

8. See generally George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96 (1980).

9. *Caremark Int'l. Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (finding in dicta that boards had a duty to consider whether to create internal monitoring systems).

10. *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 287-89 (Del. Ch. 2003) (denying motion to dismiss complaint alleging that board had breached the duty of good faith in determining executive compensation package).

11. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 942-43 (Del. Ch. 2003) (finding that tenured professors who were members of special litigation committee were not independent where financial ties between university and corporation were substantial).

litigation activity. In cases producing a recovery to shareholders, the amount of recovery typically exceeds the amount of attorneys' fees awarded by a significant margin. The cases do demonstrate some indicia of litigation agency costs (for example, suits being filed quickly, multiple suits per controversy, and repeat plaintiffs' law firms), but each of these costs is much less pronounced for derivative suits than for other forms of representative litigation. Overall, the claim that derivative suits are typically strike suits is much weaker than in earlier periods.

When we examine our data on private company litigation, we find an even smaller number of cases, about a dozen per year, usually involving a dispute among a small group of shareholders. These cases almost always involve claims by a minority shareholder against a controlling shareholder group. They raise none of the problems of representative litigation that can arise in public companies. Evidence of large benefits to shareholders is less visible, but the small number of cases and the focus of the dispute within a very small set of investors also reduce the litigation agency costs.

This Article proceeds as follows. First, we describe the nature of derivative suits and where they fit among the various constraints on management behavior that exist today. We also place their legal regulation in a historical context. Second, we present our empirical study of derivative suits in Delaware, including data that confounds some of the accepted wisdom in the academic literature about their value. Third, we outline a possible role for derivative suits for the future. Few would contest that derivative suits have an important role in the governance of private companies. Even regarding public corporations, we believe that policymakers have swung too far toward discouraging derivative suits. In contrast to earlier times, strong procedural limits in existence today have kept litigation agency costs low in modern derivative suits. The Delaware judiciary, which hears most public company corporate litigation in America, has effectively monitored these cases. There is room to open the door for larger shareholders to utilize these suits to police corporate misconduct. Institutional shareholders, while not willing to take on as large a role in governance as many have suggested in terms of naming directors and the like, may be willing to take a larger role in derivative litigation. Thus, we see potential for derivative litigation to play a more important role in the future. We therefore suggest that suits brought by a 1 percent or larger shareholder should be excused from the demand requirement that is currently applied in derivative suits.

## I. DERIVATIVE SUITS' ROLE AS A CONSTRAINT ON MANAGEMENT MISCONDUCT

The picture of corporate governance presented in American corporations statutes is focused on the board of directors and centered on law as the most visible constraint on the board's broad power. This view of board-centric, law-centric governance is anachronistic. Law is part of a rich array of constraints that also includes markets, private ordering, and norms. Directors share their governance functions with officers, shareholders, and various gatekeepers such as auditors, analysts, and attorneys. In this section, we begin by outlining the traditional view of corporate governance. We then discuss the specific role that shareholder litigation has played in such a system. In each subsection, we explain why the traditional picture no longer accurately describes corporate governance.

### A. *The Traditional Statutory Template of Governance*

State corporation laws create corporations and establish the skeleton of the structure by which they are governed. These statutes start from the foundational premise that *all* corporate power ultimately resides in the board.<sup>12</sup> State corporations statutes identify two additional groups—shareholders and officers—and specify their role in governance, but their role comes nowhere close to that prescribed for directors.<sup>13</sup>

Shareholders by statute are permitted to do two things in very limited doses: voting and suing.<sup>14</sup> They also have a third action that they can take: selling their shares as permitted under the general rules of property law that provide the foundation on which the

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12. For example, Section 8.01 of the Model Business Corporation Act contains such a bold declaration, and Section 141 of the Delaware General Corporation Law expresses a similar rule. See MODEL BUS. CORP. ACT § 8.01(b) ("All corporate powers shall be exercised by or under the authority of . . . its board of directors."); DEL. CODE ANN. tit. 8, § 141 ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . .").

13. In the Model Act, Chapter 7 defines the role for shareholders and Subchapter 8D addresses officers. In Delaware the shareholder role is covered in Section 211 *et seq.*, and the role of officers is defined in § 142.

14. See, e.g., MODEL BUS. CORP. ACT ch. 7B (addressing shareholder voting) and ch. 7D (specifying procedures for derivative proceedings). In Delaware, shareholder litigation rights are mostly a product of case law.

corporations codes rest.<sup>15</sup> Courts cite voting as providing the necessary legitimacy for the directors' broad control over other people's money, but shareholder voting is, in reality, a remarkably limited power.<sup>16</sup> First, shareholder voting is nothing like direct democracy, as shareholders only get to vote on a few "fundamental" corporate changes and then only after the directors have decided they are willing to bring those matters to a vote.<sup>17</sup> Directors control the agenda containing the matters on which shareholders get to vote.<sup>18</sup> Shareholders get to elect directors annually, but management almost always selects the nominees.<sup>19</sup> Even then, most public corporations have staggered boards, like the United States Senate, with one third of the members elected each year, so that if shareholders united to throw the incumbents out, it likely would take two annual meetings to do so.<sup>20</sup>

Officers, the only other governance participant identified in state corporations statutes, are, in fact, barely mentioned in those provisions. Indeed, Delaware's statute is almost completely silent as to officers.<sup>21</sup> It mentions them with directors in terms of authorizing loans and indemnification, but otherwise leaves their identity, qualifications, method of selection, and removal entirely to board resolutions and the company's bylaws.<sup>22</sup> Other stakeholder groups,

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15. State law is mostly silent on shareholder rights in a tender offer. The federal government has filled some of that gap by the Williams Act, which specified some rules for how tender offers are conducted. See *infra* note 29.

16. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (1988) (shareholder voting is "critical to the theory that legitimates the exercise of power . . . by some over vast aggregations of property that they do not own.").

17. See, e.g., MODEL BUS. CORP. ACT § 11.04. Shareholders vote on a merger only after directors have proposed the transaction for approval; if directors oppose a merger, shareholders do not get to vote. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152-53 (Del. 1990).

18. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 591-95 (1990).

19. The current proposal of the Securities and Exchange Commission to provide shareholders with some direct access to the ballot is the latest effort to address this. See Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274), available at <http://www.sec.gov/rules/proposed/34-48626.htm>.

20. Lucian Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 887 (2002).

21. The Model Business Corporation Act, the basis for corporations law in more than half of the states, goes further than Delaware and includes a section setting standards for the conduct of officers. See MODEL BUS. CORP. ACT § 8.42.

22. DEL. CODE ANN. tit. 8, § 142 (a)-(b). A rare specific officer rule found in this section is to provide that officers may resign at any time. *Id.* § 142 (b). Agency law overlays the statutory framework to flesh out the role of officers in the corporation. Thus, we know that officers are

such as employees, creditors, suppliers, the public, or others whom the corporation's business may impact, have no governance role under the corporations statutes.<sup>23</sup>

Even the governance role for directors is remarkably sketchy. While American stock exchanges now require independent directors,<sup>24</sup> the Delaware statute contains no such requirement.<sup>25</sup> Delaware is distinctive in the extent of its willingness to trust directors to use their broad power as they see fit, subject to occasional judicial constraint via application of fiduciary duties.

For much of its history of involvement in corporate governance, federal law has superficially recognized the power of the states to define the structure of corporate governance. In the wake of the Great Depression and the economic dislocation of that period, the federal government eschewed a federal incorporation statute that would have replaced the state law governance structure. Instead, Congress chose to focus on specific aspects of governance, particularly practices that were aimed to facilitate shareholder use of their voting power as might exist under state law. More specifically, the federal securities laws mandated that extensive information must be provided to shareholders prior to their giving a proxy to vote for directors, mergers, or charter amendments. Federal rules also regulate both the process by which proxies are solicited and the contents of a proxy statement that is sent out to security holders.<sup>26</sup> Beginning in the 1940s, the SEC interpreted Section 14 of the 1934 Exchange Act to authorize shareholder access to a company's proxy statement.<sup>27</sup> The

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clearly subordinate to directors, as they are agents of the corporation charged with those duties as may be defined by the board.

23. Other countries have taken a different approach toward stakeholders' role in the corporation. Employees, for example, are a key part of corporate statutes in countries such as Germany where there is a supervisory board on which labor has half of the seats. MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT* 71-72 (2003).

24. *See, e.g.*, New York Stock Exchange, Listed Company Manual § 303A.01, available at <http://www.nyse.com/listed/1022221393251.html> (last visited Nov. 1, 2004).

25. DEL. CODE ANN. tit. 8, § 142 requires only that directors be natural persons and authorizes the certificate or bylaws to provide other qualifications. Case law uses independence in defining the degree to which directors can act for the corporation and the degree to which the courts will defer to the actions of directors. *See, e.g.*, *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

26. 15 U.S.C. § 78(n); 17 C.F.R. § 240.14a-1 *et seq.*

27. RANDALL S. THOMAS & CATHERINE T. DIXON, *ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL* §16.01[A], at 16-6 (3d ed. 1998) (also discussing the evolution of the shareholder proposal rule).



SEC's recent proposal to expand shareholder access to nominations would further extend the reach of the federal regulations.<sup>28</sup>

When the evolution of markets enhanced the possibility of shareholder selling as a viable takeover strategy, the Williams Act and related SEC rulemaking sought to protect shareholders in their decisions about whether to sell in response to a tender offer.<sup>29</sup> The effect of these new rules was to provide shareholders with more time and information about takeover bids for their company. Yet federal involvement stopped short of overriding defensive tactics such as poison pills authorized by state law that block a shareholder vote.<sup>30</sup>

The recent trend in federal regulation has been to increase its focus on officers and their obligations. During the run-up to the passage of Sarbanes-Oxley in 2002, Federal Reserve Chairman Alan Greenspan observed that the chief executive officer (CEO) is the fulcrum of corporate governance today.<sup>31</sup> Given the importance of officers to good corporate governance, Sarbanes-Oxley regulates officers more than state law has ever done. Sarbanes-Oxley requires the CEO to certify company disclosures,<sup>32</sup> bans loans to insiders,<sup>33</sup> requires disgorgement of officer bonuses after financial restatements,<sup>34</sup> and makes it easier for the SEC to ban individuals from serving as officers or directors of public companies.<sup>35</sup>

In the wake of Enron, new regulation on directors has come mostly from the stock exchanges. The New York Stock Exchange and NASDAQ, prodded by the SEC and after lengthy review by the agency, now require their listed companies to have a majority of independent directors and three board committees composed entirely

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28. See Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274), available at <http://www.sec.gov/rules/proposed/34-48626.htm>.

29. 113 CONG. REC. 854 (1967) (statement of Senator Williams) ("[T]he need for such legislation has been caused by the increased use of cash tender offers rather than the regular proxy fight to gain control of publicly-owned corporations . . . [t]his legislation will close a significant gap in investor protection under the federal securities laws . . .")

30. Instead these are judged under state law fiduciary duty concepts with Delaware courts applying an enhanced scrutiny. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-955 (Del. 1985).

31. Alan Greenspan, *Excerpts from Remarks to the Senate*, N.Y. TIMES, July 17, 2002, at C8 (explaining that "vast and highly leveraged financial markets and institutional shareholders who sell has placed de facto control in the hands of the CEO.")

32. Sarbanes-Oxley § 401, 15 U.S.C. § 7241; this followed SEC action pursuant to its investigatory powers that required top officers of almost one thousand companies to certify their financial results.

33. Sarbanes-Oxley § 402, 15 U.S.C. § 78m(k).

34. Sarbanes-Oxley § 304, 15 U.S.C. § 7243.

35. Sarbanes-Oxley § 1105, 15 U.S.C. § 78u-3.

of independent directors.<sup>36</sup> Directors are required to meet without the chief executive officer, and directors have specific duties regarding audit and compliance.<sup>37</sup>

This director-centric legal system is only a portion of the corporate governance matrix. In addition to law, it is also necessary to model markets, private ordering, and norms as regulators of corporate behavior. The market for executive services dramatically influences governance, and the takeovers market has become a key component of governance in addition to the product market and the capital market.<sup>38</sup> Private ordering is a crucial part of corporate governance, providing a rich array of incentives and monitoring. Contracts such as pay for performance compensation agreements have become a recurring part of governance.<sup>39</sup> Private ordering has also provided a variety of monitoring mechanisms including auditors, analysts, and attorneys.<sup>40</sup> In fact, the board itself is a monitoring mechanism, revealing the hazy line separating legal controls and market or private ordering. Disclosure, a legal requirement of the federal securities laws, facilitates monitoring and incentives generated by private ordering.<sup>41</sup>

In private companies, private ordering is king. There is no separation of ownership and control in most of these firms, as most investors are also employees. Investors often protect themselves through contractual mechanisms, such as buy-sell and shareholder agreements. The federal and state regulatory authorities have been

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36. NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 34-48745 (proposed Nov. 4, 2003), available at <http://www.sec.gov/rules/sro/34-48745.htm>.

37. See, e.g., New York Stock Exchange, Listed Company Manual § 303A.01-13, available at <http://www.nyse.com/listed/1022221393251.html> (last visited Nov. 1, 2004); NASDAQ, Rule 4350(c), available at [http://cchwallstreet.com/nasd/nasd.asp?print=1&printnode=4.22&SelectedNode=4&FileName=%2Fnasd%2Fnasd%5Frules%2FRulesoftheAssociation%5Fmg%2Exml#chp\\_1\\_4\\_18\\_ab](http://cchwallstreet.com/nasd/nasd.asp?print=1&printnode=4.22&SelectedNode=4&FileName=%2Fnasd%2Fnasd%5Frules%2FRulesoftheAssociation%5Fmg%2Exml#chp_1_4_18_ab) (last visited Nov. 1, 2004).

38. See, e.g., John C. Coates IV & Reinier Kraakman, *CEO Incentives and Merger Activity in the 1990s: Stock Options and Real Options* (Working Paper Nov. 3, 2003) (CEO pay structure can affect takeover incidence at individual companies).

39. Kevin J. Murphy, *Executive Compensation*, in HANDBOOK OF LABOR ECONOMICS 2519 (1999).

40. See, e.g., John C. Coffee, Jr., *Understanding Enron: "It's All About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1405 (2002) (detailing professionals' roles as reputational intermediaries who provide verification and certification services).

41. Delaware law does require disclosure in various fiduciary settings, but its courts have acknowledged the expertise of the federal government in this area. See former Chancellor Allen's comments that disclosure is left to federal law where there is more expertise, "An administrative agency—the Securities and Exchange Commission—has a technical staff, is able to hold public hearings, and can, thus, receive wide and expert input, and can specify forms of disclosure, if appropriate." *Lewis v. Vogelstein*, 699 A.2d 327, 332-33 (Del. Ch. 1997).

willing to let privately held firms operate outside of the disclosure regime, and these firms do not have publicly traded securities, so that market discipline is usually lacking.

### *B. The Role of Derivative Suits in a Changing Menu of Governance*

For most of the twentieth century, the dominant paradigm of corporate governance within legal academia was that provided by Berle and Means in their classic 1932 book.<sup>42</sup> They presented large American corporations as management-dominated with shareholders having little power to control management's actions. The market for corporate control was hardly visible in that period. Shareholder voting widely was seen as ineffective even after federal securities law efforts to mandate disclosure that would improve shareholder participation.<sup>43</sup>

Derivative suits were the earliest and principal constraint on director mismanagement.<sup>44</sup> A typical statement is that of the Supreme Court in 1949 in *Cohen v. Beneficial Industrial Loan Corp.* where the Court observed that the derivative suit was "long the chief regulator of corporate management."<sup>45</sup> Growth in derivative suits continued into the second half of the twentieth century.<sup>46</sup>

By the first decade of the twenty-first century it is fair to say that the role of derivative suits has receded from such a lofty position. An account of this decline reflects several dramatic changes from the environment described by Berle and Means. The development of the market for corporate control, particularly in the early 1980s, provided a real alternative to litigation as a method of constraining managers. In addition, private ordering took on a much larger role with the

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42. ADOLF BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

43. Thomas & Dixon, *supra* note 27, at § 1.01[A], at 1-5, 1-6 (quoting Thomas Corcoran's testimony before the House Committee on Interstate and Foreign Commerce).

44. Derivative suits have been "a recognized form of litigation in American courts since 1855." Coffee & Schwartz, *supra* note 6, at 261 (citing the U.S. Supreme Court's decision in *Dodge v. Woolsey*, 59 U.S. (18 How.) 331 (1856) as marking its acceptance of the derivative suit). Professor Deborah DeMott has traced the early history that derivative suits served outside of corporate governance as a vehicle to provide for litigation of constitutional issues. See DEBORAH A. DEMOTT, *SHAREHOLDER LITIGATION* § 1.3 (2002). Derivative suits continue to perform a variety of functions in equity courts such as permitting a beneficiary of a trust to sue for harm done to the trust. But in recent times, the academic focus on derivative suits has narrowed to their role in corporate governance.

45. 337 U.S. 541, 548 (1949) ("It is argued, and not without reason, that without it there would be little practical check on such abuses.").

46. Daniel Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 74 (1967) (describing extensive growth in derivative suits in the 1960s).

advent of incentive-based compensation and CEO employment contracts, among other things.

Since the time of Berle and Means, the board has gradually become more of a monitoring body made up mostly of outside directors.<sup>47</sup> At the same time, in most large American companies, ownership has shifted away from dispersed individual shareholders toward large institutional investors.<sup>48</sup> Law, private ordering, and norms all have strengthened the roles of various gatekeepers who affect corporate governance, particularly auditors, but also attorneys and analysts. All of these changes have necessarily decreased the roles of law and litigation. In this sense, law is humble; it does not take on a role for itself that can be more effectively done by markets or private ordering.<sup>49</sup>

Even in the part of the spectrum in which law and litigation retain relative advantage as regulators of corporate governance, derivative suits have had to share this function with younger cousins. Changes to the Federal Rules of Civil Procedure in the 1960s permitted the growth of widespread class actions based on securities fraud.<sup>50</sup> These lawsuits, ostensibly based on incomplete or inadequate disclosure, increasingly address management decisions in running the corporation. Moreover, in recent years, the number of class actions brought in state court alleging violations of director fiduciary duties under state law has become very large.<sup>51</sup> These class action suits arise mostly in an acquisition context and now greatly exceed the number of derivative claims brought against public companies in Delaware.<sup>52</sup> Finally, a relatively small but important number of cases are filed seeking judicial determinations concerning other corporate problems,

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47. See e.g., AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01(a) (1994) (recommending that large public corporations should have a majority of outside directors).

48. THOMAS & DIXON, *supra* note 27, at §1.01[C], at 1-13, 1-14 (by 1990 institutional investors owned more than 50 percent of all outstanding equity securities of American corporations).

49. See Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 839 (1981) ("Where incentive mechanisms created by one part of the corporate structure — the various markets in which the corporation and its managers function — constrain managerial discretion to perform inefficiently, one would not expect a different part of that structure to provide redundant controls. As we have seen, the legal elements of corporate structure are consistent with this conclusion.").

50. But this was not the original purpose of the class action provisions. See 3B JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 23.02-6 (2d ed. 1995) (noting that Rule 23 was enacted for the "specific purpose" of ensuring class actions would be available to enforce civil rights statutes).

51. Thompson & Thomas, *supra* note 4, at 167 tbl. 2.

52. *Id.*

such as appraisal actions, direct suits, books and records access, corporate dissolutions, and annual meetings.<sup>53</sup>

At the same time that these alternatives to derivative suits have been growing, both in the form of other kinds of litigation and with the development of market and private ordering described above, derivative suits have been increasingly limited by a variety of procedural and substantive restrictions imposed to prevent perceived abuses generated by such suits.<sup>54</sup> A derivative suit is brought in the name of the collective entity, the corporation, by an individual shareholder asserting the right to speak for the corporation.<sup>55</sup> Any recovery usually goes to the corporation. This means that the return to an individual shareholder via a pro rata increase in the value of the shares owned by the shareholder (recognized only if the shareholder sells the shares) is dwarfed by the immediate expense of bringing the suit.<sup>56</sup> Law firms are the economic actors most likely to be willing to bear the expense of such suits, but the result is the creation of litigation agency costs, to the extent that these individual plaintiffs and their attorneys have different interests than the shareholders.<sup>57</sup> These differing incentives of the nominal plaintiff and the attorneys have created the possibility of strike suits or, as they are sometimes called, nuisance suits.

A 1940 study by Franklin Wood gave great attention to this story of abuse and led to new restrictions on derivative suits, such as the requirement for a bond to be posted by the plaintiff.<sup>58</sup> More recently, the procedural focus has centered on the requirement that the shareholder make a demand on directors prior to bringing the suit, which effectively gives directors the opportunity to dismiss the suit as

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53. See *id.* at 169-171 (documenting the number and type of actions filed in the Delaware Chancery Court from 1999 through 2000).

54. One threshold question that plaintiffs must often litigate is whether their claim is a derivative or direct claim. As the Delaware Supreme Court has recently noted, the law in this area has "not [been] helpful to a proper analytical distinction between direct and derivative actions." *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004). As a result, that court overruled its earlier decisions and restated the distinction as follows: "The analysis must be based solely on the following questions: Who suffered the alleged harm—the corporation or the suing shareholder individually—and who would receive the benefit of the recovery or other remedy?" *Id.*

55. JAMES D. COX & THOMAS LEE HAZEN, *COX AND HAZEN ON CORPORATIONS* §15.02 (2d ed. 2003).

56. In a limited set of circumstances, the individual shareholder can seek an individual recovery. *Id.* § 15.04 (giving as an example a situation in which, if wrongdoers are still in control of corporation and there is no fear that creditors will be harmed, then individual recovery may be awarded).

57. We explore this in more detail in Thompson & Thomas, *supra* note 4, at 14-18.

58. See WOOD, *supra* note 7. We discuss the Wood report at length in our earlier paper, Thompson & Thomas, *supra* note 4, at 14-15.

not in the best interests of the corporation.<sup>59</sup> As a practical matter, plaintiffs never make such a demand on the board, but rather plead that a demand would be futile. To establish demand futility in Delaware, for instance, plaintiffs must plead facts that create a reasonable doubt that a majority of the board is capable of independently determining whether to pursue the litigation.<sup>60</sup> The main difficulty is that the plaintiffs cannot use discovery to learn information that they need to formulate such allegations.<sup>61</sup> Empirical research has shown that defendants frequently succeed in challenging the plaintiffs' claim that the demand would be futile.<sup>62</sup>

Even if a suit survives the demand hurdle, the board of directors can still form a special independent litigation committee that can dismiss the case.<sup>63</sup> The academic presentation of derivative suits, for the most part, reflects the hostility of the Wood report, both (1) in its conclusion that derivative suits are an ineffective instrument of

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59. See, e.g., MODEL BUS. CORP ACT ch. 7D (requiring written demand with notice be made upon directors before a shareholder brings a derivative suit).

60. Aronson v. Lewis 473 A.2d 805, 810 (Del. 1984) (finding demand only excused if reasonable doubt is created as to directors' disinterestedness or their independence or that the challenged transaction was otherwise the product of a valid exercise of the board's business judgment). On the crucial question of director independence, the Delaware Supreme Court's recent decision in *Beam v. Martha Stewart*, 845 A.2d 1040, 1050 (2004) has clarified the standard under Delaware law. There the court held that mere friendships or outside business relationships between the director and alleged wrongdoer are not sufficient by themselves to disqualify the director from being independent in determining demand futility. *Id.*

61. The Delaware courts claimed to have opened the door to derivative actions by repeatedly admonishing plaintiffs to use the Delaware books and records statute to gain access to internal corporate documents before filing a derivative complaint. See, e.g., *Rales v. Blasband*, 634 A.2d 927, 934 n.10 (Del. 1993). While occasionally a well-funded plaintiff does file such a case, and thereby improves its pleading substantially (see, e.g., *In re Walt Disney Shareholders Litigation*, 825 A.2d 275, 279 (2003)), the fact remains that after ten years of judicial prodding, the idea has not sparked much interest. In short, based on its use to present, it seems unlikely that using the books and records statute is going to have much effect on the way the Delaware courts do business. See Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 360 (1996) ("[M]any plaintiffs will be reluctant to rely on such an uncertain, lengthy, and costly procedure to learn if they should bring an action for corporate wrongdoing.").

62. Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U.L.Q. 569, 576-80 (2001) (For cases challenging executive compensation in Delaware after *Aronson v. Lewis*, motions to dismiss for failure to make demand are made in 75 percent of the sample cases and the defendants succeed in about 61 percent of these motions. By contrast, in all other jurisdictions over the same time period, such motions are only made about 25 percent of the cases and are successful only about 57 percent of the time).

63. However, the members of the special committee must be truly independent in order for the court to give any deference to its recommendation that a derivative action be dismissed. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 942-43 (Del. Ch. 2003).

corporate governance,<sup>64</sup> and (2) in its assertion that derivative litigation generates high agency costs.<sup>65</sup>

The academy has virtually ignored derivative suits against private companies. Yet in many states, such 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.

## II. EMPIRICAL DATA ON DERIVATIVE SUITS

### A. *The Data Set: Delaware Litigation at the Turn of the Century*

Our data set of all corporate law complaints filed in Delaware for a two-year period permits a systematic examination of derivative litigation in the country's most important corporate law jurisdiction.<sup>66</sup> More than half of the country's largest companies are incorporated in Delaware, and an even larger ratio of companies that have recently gone public chose Delaware. But even those numbers understate the importance of Delaware corporate law. The minority of companies that incorporate outside of Delaware usually choose the state in which they are headquartered. Looking only at companies that choose to incorporate outside of the state where they have their headquarters, Delaware has a greater than 85 percent share of the incorporation market.<sup>67</sup> Under the internal affairs doctrine, recognized generally by American courts, corporate governance questions are decided under the laws of the state of incorporation.<sup>68</sup> Thus, while derivative suits against public corporations do occur outside the state, the Delaware courts capture the bulk of derivative litigation against public companies.

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64. Romano, *supra* note 2, at 84.

65. BAINBRIDGE, *supra* note 2, at 402 ("In almost all cases the legal fees generated exceed the monetary payment to the shareholders.")

66. See Thompson & Thomas, *supra* note 4, at 31-47 for an overview of the data. In this paper, we focus more narrowly on the derivative lawsuits in our sample.

67. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J. L. & ECON. 383, 395 (2003).

68. COX & HAZEN, *supra* note 55, at § 9.02.

Under Delaware law, all corporate law cases are filed in the Delaware Court of Chancery.<sup>69</sup> The great majority of cases filed in this court relate to corporate law. Its five judges develop an expertise in corporate law unrivaled by any other court in the country. We looked at all complaints filed in the Chancery Court in 1999 and 2000.

Table 1: All Delaware Court of Chancery Cases 1999 & 2000

Total Complaints filed	1716
Corporate	1280 (75%)
Fiduciary Duty	1003
Statutory	277
Non Corporate	436 (25%)

Three-quarters of these cases related to corporate law, while one-quarter related to trusts and other issues that come before an equity court. Of the corporate law cases, most (78 percent) alleged breaches of fiduciary duty by corporate directors or officers (usually brought as derivative suits or class actions), while the remaining 22 percent raised various statutory issues.<sup>70</sup> These statutory rights cases are most often brought by an individual shareholder as a direct suit seeking to obtain, for example, a shareholder's meeting, or to ascertain who is a director, or to ask for indemnification or appraisal.<sup>71</sup>

### *B. Derivative Suits: Small Both in Absolute Number and as a Share of Corporate Litigation*

The fiduciary duty cases can be divided into three subgroups depending on whether they are derivative suits, class actions or individual (direct) claims.<sup>72</sup>

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69. The Chancery Court is a court of equity in which all Delaware corporate cases originate. It was formed in 1792, and is the oldest of the Delaware courts. THE DELAWARE STATE BAR ASSOCIATION, THE DELAWARE BAR IN THE TWENTIETH CENTURY 395 (1994). As a court of equity, its judges decide cases without a jury. *See generally* COURT OF CHANCERY, STATE OF DELAWARE (1992) (for essays about the distinctive characteristics of that court).

70. Thus, in 1999 and 2000 there were 1,003 complaints raising fiduciary duty questions and 277 complaints raising a statutory claim.

71. See Thompson & Thomas, *supra* note 4, at 36-38 for further discussion of the statutory cases.

72. The three types of suits total 1,048, which is 45 more than the total number of complaints because a few suits have both class and derivative counts (22) or derivative and direct counts in their complaints (15) or class and direct counts (2) or class, derivative and direct counts



TABLE 2: TYPES OF FIDUCIARY DUTY ACTIONS

Type of Case	Total All Complaints	Total Lead Cases
Fiduciary Duty Cases	1048	348
Class Actions	824	223
Derivative	137	84
Direct	87	74

Somewhat surprisingly given the emphasis that derivative suits receive in corporate law casebooks and in law review discussion, they make up only 13 percent of the fiduciary duty complaints in our study. During the 1999 and 2000 time period, only 137 complaints made derivative claims versus 824 class action and 87 individual direct complaints.<sup>73</sup> The class actions almost always arise in an acquisition context, with the shareholders claiming that the managers mishandled the sale of the company. They seek relief that would provide additional consideration to each shareholder in a way that makes the suit a class of individual claims. By contrast, derivative claims produce recoveries to the corporation. The relative popularity of class actions could stem from the fact that these plaintiffs avoid some of the difficulties arising from the demand requirements and other procedural provisions that apply to derivative suits.<sup>74</sup>

Having reduced the set of 1716 Chancery cases down to 137 derivative suits, one additional division is useful in this initial data presentation. Derivative suits are filed against both publicly held corporations and close corporations. Eighty percent of the derivative complaints (108) are brought against public companies with the remaining 20 percent (26) against closely held companies

TABLE 3: DERIVATIVE SUITS: PUBLIC AND PRIVATE COMPANIES

Type	Total Complaints	Lead Cases
Derivative	137	83
Public Entity	108	57
Private Entity	26	25
Not Available	3	2

in the same complaint (3). Lead cases refer to the number of cases remaining after all cases arising out of the same controversy have been consolidated.

73. A few cases included both class and derivative counts in the same complaint or both direct and derivative or all three. In such settings, they were counted as falling in each of the categories meaning that the total number of observations increased from 1,003 to 1,048.

74. See *supra* notes 58-60.

This contrasts with class actions, 98 percent of which are brought against public companies (808 of 824 class actions we are against publicly traded companies), and with direct suits, a majority of which are brought against private firms (of eighty-seven direct suits, thirty-six were against public companies and fifty-one against private companies).<sup>75</sup>

### C. Private Company Suits

Delaware does not have the same dominant position as to close corporations that it does as to public corporations. Its share of total non-public incorporations is less than three and a half percent.<sup>76</sup> In terms of litigation rights provided for resolving disputes within closely held corporations, Delaware is on the trailing edge among all American jurisdictions, refusing to provide dispute resolution devices that other states have provided for close corporations. For example, all but a dozen states have an “oppression” statute that authorizes courts to grant relief if the majority has used the centralized power provided by the corporations statute to frustrate the parties’ reasonable expectations.<sup>77</sup> A majority of states, including several of the dozen that do not have an oppression statute, permit a broadened use of direct suits in a close corporation such that a derivative suit is not necessary.<sup>78</sup> If the dispute is really between only two sets of shareholders, a derivative label is often an additional weapon of majority control. Delaware, by contrast, has limited litigation rights, reminding shareholders that their protection is not in the courts

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75. See Thompson & Thomas, *supra* note 4, at 167 tbl. 2. It would be possible to have several hundred shareholders sufficient to generate the possibility of class status, but not to be publicly traded.

76. In order to arrive at this estimate, we began with the IACA (International Association of Corporate Administrators) 2002 Annual Report of Jurisdictions which reports incorporation data for forty-six states. We used the data in Bebchuk and Cohen, *supra* note 67, at 395 tbl. 2 to determine the number of publicly traded firms in forty-one of those states, including most of the largest states. We then subtracted the number of public companies incorporated in each state from the total number of firms incorporated in each state to arrive at an estimate of the number of privately held firms incorporated in the states with the most incorporations. This gave us a rough estimate of Delaware’s share of the privately held incorporation market. Obviously the number in the text overstates Delaware’s share of all private incorporations because it omits about 20 percent of the (mostly smaller) states.

77. See F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL AND THOMPSON’S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 7.13 (2d ed. 2004) (identifying the thirty-eight states that have oppression statutes).

78. *Id.* at § 7.08.

applying principles of corporations law, but rather in self-help through well-crafted contractual agreements.<sup>79</sup>

Given these significant differences between Delaware law and that of other states, what does our data tell us about the role played by derivative suits in privately held Delaware corporations? Of the twenty-five derivative suits filed against private companies in the Delaware Chancery Court in 1999 and 2000 (one transaction having generated two suits), eighteen were against corporations, five named limited partnerships (both large and small) as defendants, one was against a mutual company, and the last one was against a limited liability company. Almost all companies had only a few investors. The number of investors owning each of the companies is summarized in Table 4 below.

Table 4: Number of Shareholders/ Other Investors in Closely Held Complaints

Number of shareholders or other investors in the company	# in study (n=25)
2	7
3	6
4-8 (unrelated)	6
4-8 (family)	2
300 or more	4

Table 4 reveals how derivative suits are almost exclusively filed in disputes among small groups of investors. In twenty-two out of twenty-five cases,<sup>80</sup> or 88 percent, derivative suits were used to resolve disputes among eight or fewer investors. For these closely held cases, about 40 percent of the companies were both based in Delaware and incorporated under its laws. This percentage is much higher than the percentage of public companies incorporated in Delaware and headquartered there, as almost all of the Delaware public companies are headquartered elsewhere. Thus, Delaware non-public derivative cases are often local disputes with local parties, but unlike the corporate caseload in other states, these local disputes make up only a small minority of the corporate cases before the state judiciary.

79. *Nixon v. Blackwell*, 626 A.2d 1366, 1380-81 (Del. 1993).

80. The one case in which two complaints were filed involved a company with 300 or more investors.

Is private company derivative litigation focused on any particular industry? The lines of business of the companies that are the subject of derivative suits are somewhat concentrated. Of the twenty-five closely held enterprise derivative cases, seven are in real estate, six in Internet/computer/telecom businesses, and five grow out of disputes in enterprises in the finance field (including mortgage financing, insurance and consulting). The remaining six are spread through individual lines of business, including pharmaceuticals, furniture, and consumer goods.

Ownership in private companies is much more concentrated than in public companies. Close company investors also tend to be more actively involved in the business, making them superior monitors of corporate mismanagement. Therefore, we expect to find that these investors will be closely involved in any litigation arising from allegations of corporate wrongdoing. These suits should not exhibit the same indicia of litigation agency costs found in public company derivative suits.

Our data support this hypothesis. Unlike the derivative suits brought against public companies, the close corporation derivative suits lack the indicia of litigation agency costs that appear in derivative suits against public companies and other forms of representative suits, such as class actions under state or federal law. For example, in only one situation did the same controversy generate more than one suit. By contrast, in derivative and class actions against public companies, the same transaction generated up to forty-one separate suits. Moreover, unlike public company suits, in more than half of the private company derivative cases, the complaint joined an individual claim to the derivative claim.<sup>81</sup> This illustrates that the plaintiff in these cases also has individual rights at stake in the suit.

Similarly, we do not find repeat plaintiffs filing these private company cases, and only rarely do repeat law firms show up in these suits. In previous work, we identified sixteen law firms that were involved in about three quarters of all fiduciary duty class actions brought under Delaware state law.<sup>82</sup> Not surprisingly, the only nonpublic companies in which these law firms appear are the mutual and limited partnership cases that are in the category with more than 300 owners. In short, the professional plaintiff and traditional plaintiffs' bar are not players in close corporation litigation.

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81. In fourteen of the twenty-five derivative cases, there were also claims framed as individual or direct claims.

82. Thompson & Thomas, *supra* note 4, at 186-187.

What issues do these cases raise? Almost all of these cases (twenty-one of twenty-five, or 84 percent) utilize duty of loyalty claims, usually when there is a controlling shareholder.

Table 5: Allegations of Wrongdoing in Derivative suits Against Non-Publicly Traded Companies

Type of Transaction	# of suits (n=25)
Self-Dealing Benefit to Managers	21 (84%)
Improper Financial Record; Duty to Supervise	1 (4%)
Acquisition	2 (8%)
Other	1 (4%)

Occasionally, a dispute ranged beyond a duty of loyalty claim, as with a dispute over a buy/sell agreement between the two owners, or involved limited partners complaining about the managers selling a major asset too quickly. Yet even the latter claim contained an allegation that the quick sale was on terms that benefited parties affiliated with the manager. Furthermore, unlike the public company class action cases brought in Delaware during this same period, where 94 percent attacked director actions in an acquisition, only a small minority (two of twenty-five, or 8 percent) of the derivative cases involving nonpublic companies occurred in an acquisition setting.

How successful are the plaintiffs in these cases? Table 6 shows that about half of the derivative cases were dismissed with no relief, although we find affirmative relief in about one-third of the cases. Of those nine cases in which affirmative relief was granted, two targeted large limited partnerships and one had a large mutual company defendant.<sup>83</sup> These types of entities are quite similar to publicly traded companies, the defendants in the public company cases. In the remaining five, two provided for money payments to minority owners, two changed the allocation of ownership, and in one the complaining shareholders sold their shares to the corporation.

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83. The three cases are *Truv-Serv Corp.*, C.A. No. 18236, a mutual company, and *Winthrop Miami Associates Limited Partnership*, C.A. No. 17274 and *Resources Accrued Mortgage Investments*, C.A. No. 18059, both limited partnerships.

TABLE 6: DISPOSITION OF DERIVATIVE SUITS FOR CLOSELY HELD COMPANIES

Disposition	# of cases (n=25)
Pending	3
Inactive	1
Dismissed without prejudice	3
Dismissed with prejudice	9
Affirmative Relief Granted	9

When we look at how much actual litigation takes place in these cases, we find that in 60 percent of the private company derivative suits (fifteen out of twenty-five), substantive motions are filed.<sup>84</sup> By comparison, if we look at class action lawsuits filed against private companies (most often limited partnerships), we see dispositive motions filed in about 80 percent (eight of ten) of the cases. Thus both of these forms of representative litigation against nonpublic companies seem to be actively litigated.

Finally, we note that the procedural restrictions on derivative suits appear to play little role in private company litigation. For instance, demand is not often an issue in this group of cases. We believe the reason is that the claim is usually a duty of loyalty claim when the defendant is a majority shareholder who will not satisfy the independence requirement necessary for a demand to be required under case law. We found only two cases in which a court addressed a demand issue, and in both cases it found that demand was excused.<sup>85</sup>

To summarize our findings, private company derivative litigation in Delaware plays little role in the governance of these firms. Close corporation investors have a very limited set of litigation options in Delaware compared to that available elsewhere. Few suits are filed, and relief appears to be obtained in less than half of the cases. While this may reflect a superior private ordering system that makes litigation unnecessary to the resolution of internal corporate disputes, it could also demonstrate such incredible weakness of minority shareholder rights in Delaware that such suits simply are not filed.

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84. We define substantive motions to include motions to dismiss for failure to state a claim, motions for summary judgment, and motions to dismiss for failure to make demand.

85. See *Beneville v. York*, 769 A.2d 80, 82 (Del. Ch. 2000) (excusing demand where one member of a two-member board could not impartially consider demand request) and *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1230-31 (Del. Ch. 2001) (requiring arbitration; alternative holding that demand excused).

*D. Public Company Derivative Litigation: Do They Have High Litigation Agency Costs?*

In evaluating the impact of derivative lawsuits against public companies, we need to look at both the costs associated with them and the benefits realized from them. In this section, we focus on the litigation agency costs that are claimed to be generated by these suits, and in the next section we turn to their benefits to shareholders.

Derivative suits against public companies differ from their counterparts in a nonpublic setting in that they are representative suits brought by one shareholder for the benefit of a large body of shareholders. In that sense, public company derivative suits could share the same indicia of litigation agency costs (that is, that the agent bringing the suit for the group may not have the same interests as the entire group) as other representative suits, such as securities fraud class actions or state law fiduciary duty class actions that arise in an acquisition context. In earlier work,<sup>86</sup> we identified the common indicia of representative litigation associated with nuisance suits, including the speed with which suits are filed (if there are multiple suits filed for the same transaction) and whether there are repeat law firms involved in the suits.

Our data reveal that derivative suits share some of these characteristics but that these costs are not as pronounced as they are for class actions. To illustrate this point, we present comparable data for derivative suits against nonpublic companies, derivative suits against public companies, and state law class actions against public companies.

1. Multiple suits per controversy

For state class actions against public companies, we found there were almost four suits filed per transaction.<sup>87</sup> With derivative suits against public companies, this drops sharply. As shown in Table 7 below, almost two-thirds of transactions that produced a state class action filing generated more than one lawsuit per case, with the number ranging up to forty-one separate suits. For derivative suits against public firms, about half generated only one derivative suit per transaction and seldom were there more than two such suits. For the two years of our study, the 108 public company derivative complaints

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86. Thompson & Thomas, *supra* note 4, at 152-57.

87. *Id.* at 161-62.

reflected fifty-seven disputes, an average of just under two suits for every transaction. Federal securities fraud class actions have exhibited a level of suits per transaction similar to the public company derivative actions.<sup>88</sup>

TABLE 7: SUITS PER TRANSACTION OR CONTROVERSY

Type of Lawsuit	# suits/transaction
Derivative (nonpublic)	1.04 (26/25)
Derivative (public)	1.90 (108/57)
Fiduciary Duty Class Action (public)	3.79 (808/213)

## 2. Recurring plaintiff firms

Derivative suits, like state class action suits based on fiduciary duty, are representative suits in which the lawyer often has the largest economic incentive to pursue the litigation. In our earlier study of Delaware class action litigation, we found that sixteen law firms were involved in 75 percent of the state law class actions brought in the two years covered by our study.<sup>89</sup> An even higher degree of concentration in law firms is exhibited in the securities fraud class action area, where the firm of Milberg Weiss Bershad Hynes & Lerach is said to appear in more than 50 percent of these cases.<sup>90</sup>

While there are several possible implications of this degree of concentration, most commentators view it as an indicia of high litigation agency costs. As Table 8 shows, when we look at public company derivative suits, the number brought by the same sixteen firms drops to just about 45 percent.<sup>91</sup> This appears to indicate a lower level of litigation agency costs for these suits. Finally, in the private company derivative suits, we see a small percentage (12 percent) of these representative lawsuits are filed by one of these firms.

88. *Id.*

89. *Id.* at 185-87.

90. *Id.* at 162. In 2004, this firm split into two firms.

91. These sixteen firms do bring a larger share of the derivative suits brought against the larger companies listed on the NYSE and NASDAQ (twenty-one of forty-two or 50 percent) versus only three of thirteen brought against other public firms.



TABLE 8: PRESENCE OF REPEAT PLAINTIFF FIRM

Type of Lawsuit	# suits in which a Top 16 firm is present
Derivative (nonpublic)	12% (3 of 25)
Derivative (public)	44% (25 of 57)
Fiduciary Duty Class Action (public)	75%

### 3. Suits are filed quickly

We next examine if there is a difference in how quickly the lawsuits are filed as a third potential indicator of high litigation agency costs. As Table 9 illustrates, two-thirds (508 of 760) of the class actions were filed within three days of the event described as triggering the claim.<sup>92</sup> Securities fraud class actions are claimed to have similarly fast filing times prior to the enactment of the Private Securities Litigation Reform Act of 1995 (PSLRA).<sup>93</sup> For derivative suits against public companies, the number of suits filed this quickly is only 11 percent (nine of seventy-eight) of the total claims for which the time of the triggering event could be determined.<sup>94</sup>

Table 9: Filing Times for Complaints

Type of Suits	0-3 Days	4-6 Days	6-10 Days	10-30 Days	31+ Days	N/A
Number of Class Action Suits Filed	508	92	46	57	57	63
Number of Derivative Suits Filed	9	6	6	20	37	59

92. In sixty-three cases the time between the transaction and the filing could not be determined.

93. Thompson & Thomas, *supra* note 4, at 162-63. Post-PSLRA the filing times for federal securities fraud cases have increased dramatically. *Id.*

94. There were fifty-nine complaints in which the time between the wrong and the filing could not be determined, about 43 percent of all derivative complaints and a much higher percentage than for class actions.

## 4. Suits targeted at particular industries

In recent debates over the alleged abuses of representative litigation, particularly prior to the enactment of the PSLRA, opponents of representative litigation claimed that suits were targeted toward particular industries, such as those in the high tech corridor of Silicon Valley.<sup>95</sup> To test whether public company derivative suits might suffer from similar biases, we identified the headquarters of the companies that were subject to the suit and their principal industry. We found that the percentage of derivative suits that involved companies headquartered in California (10 percent) was less than that state's share of the country's population and less than the share of state class action suits brought against companies headquartered in California (16 percent). Internet and computer companies made up about 19 percent of the companies subject to derivative suits; about the same percentage as those companies made up for the sample of state class action suits, but each of those numbers is lower than the share of those industries in federal securities class action suits.<sup>96</sup>

Public company derivative claims relate to corporations that are generally larger than the public companies against which state law class actions are brought. Table 10A shows that the largest percentage of public company derivative suits are brought against New York Stock Exchange companies, with an additional 30 percent against target companies listed with NASDAQ.

TABLE 10A- TYPE OF ENTITY SUED

Type of entity	Derivative suits(n=57)	Class action suits(n=213)
NYSE	25 (44%)	98 (46%)
Nasdaq	16 (28%)	81 (38%)
Small public	16 (28%)	34 (16%)

Table 10B shows that among public companies, the subject companies in derivative suits are larger than the companies who are the targets of state class action suits based on fiduciary duty. These distributions are statistically significantly different at the less than the 1 percent level.<sup>97</sup>

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95. Thompson & Thomas, *supra* note 4, at 163.

96. *Id.* at 173.

97. The two distributions are not normally distributed, so we use the Wilcoxon two-sample rank test to make the comparison. For a discussion of the Wilcoxon two-sample rank test, see DAVID R. ANDERSON ET AL., STATISTICS FOR BUSINESS AND ECONOMICS 813 (7th. ed. 1999).

TABLE 10B- MARKET CAP OF COMPANIES SUED

Market Cap of Company Sued	Derivative suits	Class Actions suits
25 <sup>th</sup> Percentile	\$219 Million	\$118 Million
Median	\$1.138 Billion	\$389 Million
75 <sup>th</sup> percentile	\$6.15 Billion	\$1.39 Billion

These differences are driven by derivative suits that allege improper financial records, failure to supervise, or misleading statements, all of which are usually filed against very large companies.

#### 5. Why Do Public Company Derivative Suits Have Lower Litigation Agency Costs than Other Types of Representative Litigation?

Thus we see that public company derivative suits have consistently lower levels of the indicia of litigation agency costs than do class action suits filed in the same court or federal securities class actions. The other striking finding is that there are relatively few of these cases being filed in comparison to the number of state court class actions or federal securities fraud class actions. What could explain these two important findings?

An examination of the types of problems derivative suits address reveals a partial explanation. Table 11 illustrates the nature of the claims made in our public company suits.

Table 11: Allegations of Wrongdoing in Derivative Suits Against Non-Publicly Traded Companies

Type of Transaction	# of suits (n=57)
Self-Dealing Benefit to Managers	28 (49%)
Improper Financial Record; Duty to Supervise	15 (26%)
Acquisition	6 (11%)
Misleading Statements	4 (7%)
Charter Amendment	1 (2%)
Other	3 (5%)

Almost half (twenty-eight of fifty-seven lead cases that are derivative suits) make claims of self-dealing against managers, officers, or both. In addition, six cases (11 percent) occur in a merger or transactional setting, virtually always claiming a breach of the duty of loyalty by the managers/controllers for negotiating the terms to favor their own interests over those of another group of

shareholders. Thus, almost 60 percent of the complaints raise principally a duty of loyalty claim.

The remaining 40 percent of the complaints are quite different. More than one quarter (fifteen out of fifty-seven) raise allegations that generally would come under the directors' duty of care, as opposed to loyalty, such as allegations of improper financial records or failure to supervise. Four cases (7 percent) raise claims asserting misleading statements. These are all claims that probably could have been made in federal securities fraud class actions if the plaintiffs had chosen to pursue that avenue.

The data in Table 11 may illustrate that plaintiffs' law firms have a choice of forum for many derivative cases, allowing them to choose to file a state court class action, a federal securities class action, or a derivative suit based on the same underlying facts. We hypothesize that the reason that there are relatively few derivative suits against public companies is that the procedural barriers to filing derivative suits, in particular the demand requirement and the possibility of the appointment of a special litigation committee, may discourage the plaintiffs' bar from filing derivative actions in circumstances where they could bring the same claims in an alternative manner or venue. Moreover, in the duty of care area, Delaware's statutory provision that permits companies to include a provision in their certificates of incorporation that exculpates their officers and directors from monetary liability for breach of the duty of care has undoubtedly led plaintiffs to file these cases in federal court as securities fraud class actions.<sup>98</sup>

Our hypothesis may account for why there are hundreds of class action complaints challenging director conduct in acquisitions but only six derivative suits containing similar claims, with all of those six being companion cases to class actions.<sup>99</sup> Moreover, with regard to claims that could be filed in federal court, such as suits alleging either improper financial records or failure to monitor officer conduct, we find only a handful of public company derivative suits, while there are hundreds of federal securities law cases filed every year.<sup>100</sup>

If we are correct, then plaintiffs' lawyers will only choose to file a derivative case when they either are certain they can satisfy the

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

99. While the PSLRA preempted state court jurisdiction over most class actions alleging claims that could be construed as raising issues under the federal securities laws, it continues to permit shareholders to file class actions challenging director conduct in change of control transactions in the state courts. 15 U.S.C. § 77p(d)(1) (1999).

100. Thompson & Thomas, *supra* note 4, at 168-169.

demand requirement or have no other possible venue or type of claim to file. If this were so, we would expect to find that most public company cases are brought where demand is excused and that there would be relatively low levels of litigation over the demand requirement.<sup>101</sup> This would explain the small number of these public company suits in comparison to the state court class actions or federal securities fraud cases.

The higher barriers to bringing a successful derivative suit could also explain the lower level of the indicia of litigation agency costs we find associated with these suits. For example, a strong plaintiffs' law firm, which is experienced in shareholder litigation, would be likely to know that these suits face higher hurdles. If all of these firms know this is true, then as a group they (1) will be less likely to file derivative cases against any transaction (fewer suits per transaction and fewer appearances by the top plaintiffs' firms); (2) will know that they need to make sure they can satisfy the demand requirement before filing a complaint (longer filing time); and (3) will generally use this form of litigation only as a last resort or in a particularly appropriate situation (such as a more dispersed group of defendants).

### *E. The Benefits of Derivative Suits with Public Company Defendants*

Having discussed the cost part of the picture in terms of evaluating derivative suits, we now turn to the benefits of derivative suits. The results produced by derivative suits filed against public companies have been an important part of the debate over the effectiveness of these representative suits. The most biting claim against them has been that they almost never produce real recovery for shareholders and that the lawyers representing investors make out much better than the investors themselves.<sup>102</sup> Our data suggests that current public company derivative suits do not fit that traditional story.

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.<sup>103</sup> Empirical studies often overlook the

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101. See Part III. *infra* for further analysis of this point.

102. Romano, *supra* note 2, at 84.

103. Kraakman et al., *supra* note 1, at 1736.

benefits of deterrence<sup>104</sup> because researchers cannot precisely quantify its effects. While we do not know what percentages of frauds or self-dealing transactions are deterred because of the possibility of being exposed or challenged in shareholder litigation, the probability of detection of corporate wrongdoing is greater when private plaintiffs are able to pursue such actions.<sup>105</sup> Therefore, we need to count this as a benefit in comparing the costs and benefits of derivative suits.

Turning to the data on the value of settlements in our sample, Table 12 presents the outcomes of these suits.<sup>106</sup> More than half of the suits ended with no relief: of fifty-seven lead cases brought against public corporations, thirty-four were dismissed with no relief. In twenty-one of these cases, the dismissal was without prejudice. In another six cases, the dismissal was with prejudice. In the remaining seven suits, the dismissal followed a defendant's victory on a motion relating to demand or summary judgment.

Affirmative relief was granted in sixteen (or 28 percent) of the lead cases. In six of these sixteen, the plaintiffs received monetary relief. In ten others there was no monetary relief paid to investors, but there was other relief, such as rescission of a purchase agreement or payment of attorneys' fees. Seven cases remain open. In one of these seven, the plaintiff won in preliminary legal skirmishes in which the court ruled that demand was excused.<sup>107</sup>

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104. See James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 4-5 (1999) (arguing that the deterrent value of shareholder litigation is tied to the public's perception of the value of such litigation).

105. Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 323 (1986) ("Liability rules, enforced by shareholder litigation, are theoretically sound and profoundly affect the conduct of corporate managers"); see James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 763-64 (2003) (concluding that while the SEC pursues many fraud cases, private plaintiffs act to supplement its enforcement efforts). *But see* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 262-63 (1986) (arguing that the premise that managers' legal liability in shareholder litigation will reduce agency costs of equity is "far from obvious" because corporate managers act in shareholders' best interests already and because liability rules "play little or no role in creating incentives for beneficial conduct.").

106. We note that these data present gross recoveries for shareholders. We do not have data on the costs that the corporation has to bear in these suits, which we would need in order to calculate net recoveries.

107. *In re The Student Loan Corp. Derivative Lit.*, C.A. No.17799, 2002 WL 75479, at \*3 (Del. Ch. Jan. 8, 2002).

TABLE 12: DISPOSITION OF DERIVATIVE SUITS AGAINST PUBLIC COMPANIES

Case Disposition	# (n=57)
<b>Dismissed With No Relief</b>	<b>34 (60%)</b>
Dismissed Without Prejudice	21
Dismissed With Prejudice	6
Dismissed After Defendants Prevail on Motion	7
<b>Cases Providing Relief</b>	<b>16 (28%)</b>
Monetary Relief to Plaintiff	6
Non-Substantive Relief Including Attorneys Fees	10
<b>Cases Open</b>	<b>7 (12%)</b>

The six cases that produced cash payments show the strong interconnection of derivative suits and other litigation. In one suit (*Olsten*), the settlement went directly into a securities settlement for a related suit alleging the stock had been artificially inflated by the corporation's systematic failure to take steps regarding Medicare billing.<sup>108</sup> In another (*Anchor Glass*), the settlement went toward the settlement of bankruptcy reorganization.<sup>109</sup> In four, management conduct related to an acquisition and the settlement led to additional payments to the corporation or to the shareholders.<sup>110</sup> Of the sixteen lawsuits that produced affirmative relief described in Tables 13 and 14, six complaints (or 37.5 percent) included both derivative and class counts in their complaint. In contrast, for derivative cases that did not result in any kind of affirmative relief, only five of forty-two complaints (or 11.9 percent) included both class action and derivative counts in the complaint. Table 13 presents the data for monetary relief in publicly held entities.

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108. *Olsten Corp.*, C.A. No. 17135.

109. *Anchor Glass Container Corp.*, C.A. No. 18417.

110. *Digex Corp.*, C.A. No. 18336; *M&F Worldwide*, C.A. No. 18502; *Plains All-American Ltd. P'ship*, C.A. No. 17627; *Bank of America Corp.*, C.A. No. 16964.

TABLE 13A: MONETARY RELIEF IN DERIVATIVE CASES AGAINST PUBLIC CORPORATIONS

Name	Claim	Settlement	Attys Fees
Digex C.A. #18336	Majority shareholder merged with acquirer instead of selling subsidiary	\$165 M (both class and derivative actions)	\$12 M
M&F C.A. #18502	Corporation paying too much for another corp. owned by 32% shareholder	\$140 M (estimated) (Treated as class for settlement)	\$12.154 M
Olsten C.A. #17135	Systematic failure in monitoring Medicare billing	\$11 M (paid directly into securities settlement)	\$900 K
Plains All-American C.A. #17627	Management self-dealing around time of acquisition	\$10.6 M	\$1.05 M
Anchor Glass C.A. #18417	Challenging series of transactions between corporation and controlled group	\$9.33 M (paid to bankruptcy proceeding)	\$2.5 M
BankAmerica C.A. #16964	Goodbye fee paid to directors in acquisition	\$2.5 M	\$250 K

The three larger settlements producing relief for non-publicly traded entities discussed earlier are reproduced in Table 13B to give a more complete picture of the derivative transactions from which monetary relief results. The complaints in two of these three (*Resources* and *Winthrop*) included both derivative and class action counts, but all three provided for immediate payouts to the group of owners. Derivative litigation has long provided for direct recovery within a derivative suit.<sup>111</sup> These cases show that in a large number of derivative cases courts find a direct recovery is appropriate, either by finding the derivative claim is a class action for settlement purposes or by approving a settlement which includes immediate payment to the owners.

111. See, e.g., *Perlman v. Feldmann*, 219 F.2d 173, 178 (2d Cir. 1955) (providing for individual recovery where corporate recovery would have primarily benefited those who were said to have breached their fiduciary duty).



TABLE 13B: MONETARY RELIEF IN DERIVATIVE CASES AGAINST  
LARGER BUT NOT PUBLICLY TRADED CORPORATIONS

Name	Claim	Settlement	Attorneys' Fees
Winthrop (limited partnership)	Misrepresentation in getting limited partners to vote for sale of assets on terms benefiting GP	\$9,750,000	\$1.8 M
Resources Associated Mortgage (limited partnership)	General partner's sale of assets as waste and self-dealing	\$9,000,000	\$1.8 M
Tru-Serv (mutual co.)	Change in withdrawal rights	\$5,000,000	\$725 K

The cases in Table 13A include the most visible of the derivative suits. In the *Digex* litigation, Intermedia, the majority shareholder of Digex, agreed to merge with WorldCom instead of selling Digex, which plaintiffs alleged diverted the gain attributable to Digex. The settlement reports \$165 million paid to the Digex minority shareholders with attorneys' fees of \$12 million. *M&F Worldwide* involved group of companies affiliated with high-profile financier Ronald Perelman. The corporation (32 percent owned by a Perelman affiliate) was alleged to have paid too much in buying another corporation in which the insiders had a much larger ownership. The lawsuit was settled by unwinding the challenged transaction estimated by some plaintiffs to provide a benefit of \$140 million to the corporation with \$12.154 million in attorneys' fees awarded.

In the suits producing non-monetary relief, shown in Table 14, two of the cases included rescission of a purchase agreement, and one provided for rescission of substantial executive compensation. In three other claims arising out of an acquisition, the settlements contain no specific relief other than attorneys' fees. In those cases, a takeover resulted very quickly.<sup>112</sup> In the last four cases, non-monetary relief seemed less substantial. One produced corporate governance changes and \$100,000 in attorneys' fees; another corrected a scrivener's error in a merger agreement with \$75,000 in attorneys' fees; a third involved repricing stock options and attorneys' fees of \$17,000; and the

112. These takeovers resulted in the company's shareholders being bought out at substantial premiums. General Housewares, C.A. No. 17192; JSB, C.A. No. 17741; Kenetech C.A. 17702.

last permitted inspection but awarded no attorneys' fees and awarded costs to the defendant. The important things to note are that in the nonmonetary settlements, there were very real gains for shareholders in some cases and that an award of attorneys' fees is appropriate when the shareholders benefit from the litigation.<sup>113</sup>

TABLE 14: NONMONETARY RELIEF IN INDIVIDUAL DERIVATIVE CASES AGAINST PUBLIC CORPORATIONS

Name	Allegation	Relief	Atty Fees	Outcome
Ascent Entern. C.A. # 17201	CEO had deal with proposed purchaser	Rescind purchase agreement	\$4M	Sale to another bidder
Waste Management C.A. # 17318	Inappropriate executive compensation	\$23 million in cancelled executive compensation	\$1.6M	
THI C.A. 17032	Company acquisition of company co-owned by founder	Withdrew purchase agreement	\$275K	Company continues to lease until July 2002
Gen. Housewares #17192	Board rejected hostile bid and took defensive tactics		\$75K	Acquisition successful
JSB C.A. 17741	Board put company up for sale and took nominally 2d highest bid		\$300K	Acquisition successful
Kenetech C.A. 17702	CEO's purchase of 27% block said to be corporate opportunity		\$146K	Acquisition successful
RSA C.A. #18107	Agreement predating IPO with VP who also was President of a possible competitor	Corporate governance change	\$100K	
Union Financial C.A. # 17392	Challenging stock issuance and other actions	Correcting scrivener's error in agreement	\$75K	
Acap C.A. # 17140	Challenging transaction with brother of executive	Additional disclosure	\$17K	
Siebel #18150	Repricing of nonstatutory options to CEO	Inspection	\$0	

113. Cf. Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 6 (1999) (Courts should not approve attorneys' fees in derivative litigation "unless the settlement (1) generates a common fund out of which such fees may be paid, (2) produces an intangible benefit reasonably susceptible of valuation, or (3) reflects a strong nexus between the relief sought in the complaint and the relief obtained.").

Finally, we have data about the frequency with which substantive motions are filed in these cases. For the fifty-seven public company cases in our sample, we find that substantive motions were filed prior to settlement in thirty-eight of them, or about two-thirds of the time. In contrast, if we look at public company class action litigation, we find that only 41 percent (88 out of 213) of lead cases had substantive motions filed. Thus, it appears that the public company derivative cases are more heavily litigated than their class action counterparts.

To sum up the results of our empirical analysis of the benefits of public company derivative actions, a substantial minority of these suits resulted in large monetary damage awards to investors. A second group of cases led to non-monetary relief for shareholders, yielding less quantifiable but still significant gains. The remaining suits, a majority of the sample, were dismissed with no relief, most frequently without prejudice.

### III. DEMAND IN DERIVATIVE SUITS

Both the Delaware Chancery Court rules of procedure and the corporations statutes of many states require that a plaintiff shareholder make a demand on directors prior to bringing a derivative suit, unless such demand would be futile.<sup>114</sup> This requirement is at the center of most current academic discussions about derivative suits. Beginning about twenty-five years ago, defendants in derivative suits began to appoint special litigation committees to respond to derivative suits. In a series of highly visible cases, Delaware approved actions by such a committee to terminate derivative suits with a degree of judicial review that comes close to the deference of the business judgment rule. The Delaware Supreme Court's decision in *Zapata Corp v. Maldonado* continued a more intrusive level of judicial review when demand has been excused as futile,<sup>115</sup> but the court's subsequent case *Aronson v. Lewis* reduced dramatically the number of cases that would be considered under *Zapata*.<sup>116</sup> The increased litigation that comes with the demand requirement is one of the principal reasons that litigants, where possible, seek to bring class actions, for which the demand requirement does not apply. The eight-to-one relationship

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114. See, e.g., MODEL BUS. CORP. ACT § 7.40 *et seq.*

115. 430 A.2d 779, 788-89 (Del. 1981).

116. *Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984). Because of *Aronson*, the number of cases that fall into *Zapata* is small. A rare example of a Delaware case applying *Zapata* is *Kaplan v. Wyatt*, 484 A.2d. 501, 505 (Del. Ch. 1984).

between the number of class actions as compared to derivative suits reported in Table 2 likely reflects this legal requirement.

Other states have taken a different view of demand.<sup>117</sup> Indeed, this may be the area in which there is the most difference between Delaware and other states as to the law governing public corporations. Furthermore, some states have limited the ability of special committees to dismiss derivative suits.<sup>118</sup> At the same time, many states, including those following a revision to the Model Business Corporation Act, have inserted a provision requiring a demand on directors in every case.<sup>119</sup> This precludes lengthy litigation over whether making a demand is futile, but it moves the judicial focus to the appropriate level of judicial review of a committee decision to recommend termination of the suit. The Model Act contains an elaborate test with a shifting burden of proof depending on the degree of independence of the board appointing the special committee.<sup>120</sup> There have been few published opinions interpreting such language, showing how dominant Delaware law remains. In the face of such lack of interpretation, it would not be at all surprising if states asked to interpret such a provision looked to Delaware precedent, resulting in convergence between Delaware and the other states to a much greater degree than the difference in statutory language might suggest.

We have few cases in our derivative suit sample in which a special litigation committee is utilized. We found only one case in our data set in which a recommendation by a special committee led to dismissal of a claim.<sup>121</sup> In another case, the appointment of a special litigation committee after the suit was filed led to a settlement in which payment was made to three shareholders collectively owning 40 percent of the company.<sup>122</sup>

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117. See generally Deborah A. DeMott, *Demand in Derivative Actions: Problems of Interpretation and Function*, 19 U.C. DAVIS L. REV. 461, 462 (1986). One commentator on this paper claimed that the Delaware courts are much tougher on demand than the courts in other states, even when those courts purport to be applying Delaware law. This commentator stated that this led plaintiff's lawyers to file derivative actions against Delaware corporations in the state where they are headquartered rather than in the Delaware Chancery Court.

118. See, e.g., *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983) (excusing demand due to potential for structural bias on litigation committee resulting from their appointment by directors).

119. MODEL BUS. CORP. ACT Annotated § 7.42 (adopted by Arizona, Connecticut, Georgia, Hawaii, Idaho, Iowa, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, Texas, Virginia, Wisconsin, and Wyoming).

120. MODEL BUS. CORP. ACT § 7.44.

121. Letter opinion of Chancellor William B. Chandler, *Kindt v. Lund*, C.A. No.17751 (Del. Ch. May 30, 2003).

122. *DE Commercial Inc.*, C.A. No. 18180.

Our data provides a detailed look at demand cases filed during a two-year period. We did not find a single example in which the complaint said that a demand had been made on the directors. Given the demand requirement outlined above, an allegation to support the futility of demand is an essential part of all derivative cases, both in public and private corporations. We found that the demand allegations in the complaints were not always fully developed. Most, but not all, of the complaints state the number of directors, a crucial fact because Delaware law requires that demand will not be excused unless there is a showing that a majority of the directors were unable to make a disinterested or informed decision on behalf of the corporation. In terms of pleading futility, complaints typically alleged that some or all of the directors were conflicted. A second category alleged that directors were not disinterested because of employment in the corporation. A third group of complaints added directors alleged to be disabled from making a decision because of other relationships that compromised independence. A fourth argument for futility is based on a single self-interested shareholder's dominance of the board. A fifth category alleged no demand because of the board's failure to meet its duty of care. Finally, a sixth category, found in acquisition cases, alleged futility because of an entrenchment motive of the board. We found all of these reasons alleged as set forth in Table 15. We also found numerous examples where the face of the complaint failed to allege facts that a majority of directors were disqualified from passing judgment on a demand or did not address demand in any detail. Derivative counts that were joined with class action counts in the same complaint explain some of this last group.

TABLE 15- DEMAND FUTILITY ALLEGATIONS IN COMPLAINTS

Futility Grounds in Complaint	# of cases(n=57)
Majority conflicted	12
Majority disabled by combining conflicted and employed	10
Majority disabled by also adding other indirect reason challenging independence	4
Domination	8
Duty of care	5
Waste	5
Complaint alleges futility reason only for a minority	6
Complaint lacks futility specifics	7

Given the perceived centrality of demand in derivative litigation and the lack of precision in many of the complaints on this issue, it was somewhat surprising that in only eight cases, a Chancery Court judge made a ruling on demand (six against public corporations—11 percent of all lead cases brought against public corporations—and two against nonpublic corporations). Of that subset of eight, defendants were successful in five of the public company cases, meaning the claims were dismissed for failure to make demand.<sup>123</sup> In the other three cases, a Chancery Court judge found that demand was excused, including two private company cases.<sup>124</sup> Cases dismissed for failure to make demand comprised only about one-quarter of the cases that were dismissed without relief. The cases that were dismissed for not showing futility were spread across five of the factual allegation categories described in Table 15.<sup>125</sup> It is noteworthy that three of the five dismissals for failure to show futility were in cases alleging financial irregularities or failure to supervise, and the other two were in acquisition transactions. That is, none of the dismissals for failure to show futility arose in a conflict of interest case. The one public company case in which demand futility was accepted was a case alleging self-dealing. Thus demand seems to be doing most of its work in derivative cases outside of the duty of loyalty cases. Overall, however, demand does not appear to be carrying as much of the weight of derivative litigation as one might think given the attention devoted to that topic in the academic literature and case commentary.

Why might this be the case? Recall our earlier discussion of how plaintiffs' law firms have a choice of forum for many derivative cases, which often gives them the option of filing a state court class action, or a federal securities class action on the same underlying fact pattern.<sup>126</sup> In that discussion, we hypothesized that the plaintiffs' bar would select derivative actions from their set of options only in circumstances in which they could either satisfy the demand requirement or have no other possible venue or type of claim to file. If

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123. Paxson Communications, C.A. No. 17568; Priceline, C.A. No. 18473; Delta Pine, C.A. No. 17707; RiteAid, C.A. No. 17740; McKesson, C.A. No. 17132.

124. See *In re The Student Loan Corp. Derivative Litig.*, No. C.A.17799, 2002 WL 75479, at \*3 (Del. Ch. 2002) (demand excused where board of public corporation not impartial); *Beneville v. York*, 769 A.2d 80, 82 (Del. Ch. 2000) (demand excused); *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1230-31 (Del. Ch. 2001) (alternative holding that demand excused).

125. There was one each in the "Majority Self-interested Category," the "Majority-independence Category," "Domination," "Minority-only allegations," and "Incomplete Allegations."

126. See *supra* Part II.D.5.

we are correct, this would explain why we find relatively low levels of litigation over the demand requirement for public companies.

For private companies, demand will typically be excused. Remember that in small closely held firms, the investors are typically also directors and officers of the company. There are not usually any independent directors, and firms are therefore less able to claim successfully that demand is required.

#### IV. POLICY IMPLICATIONS OF OUR RESULTS

Our empirical data about derivative suits helps us to understand the role that they currently play in corporate governance. The picture that emerges is that derivative suits against public companies play a very different role than they do against private companies. What are the policy implications of these findings? We discuss each setting separately.

##### A. *Private Company Derivative Suits*

As we noted earlier, Delaware's governance system for private firms is different from those in other states. Delaware has no involuntary dissolution statute and does not recognize oppression remedies that are widely available to minority shareholders of close corporations in other states. As a result, shareholders of Delaware privately held firms have three types of remedies: direct suits, derivative suits, and private contractual remedies.

Well-advised shareholders will undoubtedly avail themselves of the privately negotiated protections that they and their advisers prudently put into place at the formation of their firm, or at least prior to the development of any serious problems between the investors. However, as all teachers and scholars of corporate law know, not all investors are far-sighted enough to foresee their future problems. Furthermore, even the best-advised investors may fail to predict a particular problem and thus need to devise an *ex post* solution. The absence of a liquid market for the firm's stock will complicate matters, as it removes one readily available solution. This suggests that litigation will play an important role in many privately held firms in resolving disputes amongst their shareholders.

We find little evidence that derivative litigation does much of the heavy lifting in Delaware. Few derivative suits are filed against private firms, and only a small fraction of these suits result in any relief for the plaintiffs. On a positive note, we find almost no

indication of high litigation agency costs in these suits, and no effective procedural barriers to their litigation.

One possible explanation for our findings could be that direct actions are the preferred vehicle for minority shareholders in private company litigation, perhaps because any recovery will go to the shareholder rather than the firm.<sup>127</sup> There were about twice as many direct actions filed against private companies as there were derivative actions. When those cases that include both direct and derivative counts are eliminated, the margin of direct suits over derivative suits increases to a three-to-one margin. Affirmative recovery occurs in all three categories. The small number of cases in each category makes it difficult to draw additional conclusions regarding outcomes in the three categories.<sup>128</sup> A second possibility is that Delaware's insistence that investors rely on private ordering remedies has led to the greater use of such provisions among its closely held firms. This might be especially likely if the private firm is not headquartered in Delaware but specifically elected to be incorporated there to select its unique close corporation regulatory structure. Thus, if an out-of-state firm chooses to incorporate in Delaware, it could well be that sophisticated counsel intended to provide contractual protections for its investors in lieu of those judicially and legislatively provided elsewhere.<sup>129</sup>

In terms of policy conclusions, we note that the low level of litigation agency costs associated with these suits argues in favor of relaxing any procedural barriers that stand in their way. However, as discussed earlier, the existing hurdles do not stop any private company derivative cases in our sample. In short, there does not appear to be much demand by plaintiffs to bring these cases, either because direct actions provide a better vehicle for obtaining relief, or private ordering is effective, or there are relatively few Delaware private corporations.

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127. As we noted earlier, however, the plaintiff can seek an individual recovery in a derivative suit if putting the money back in the firm would not provide an adequate remedy. *Supra* note 56.

128. There were forty-eight direct suits against nonpublic companies and twenty-five derivative suits, with fourteen in each category that also include a count raising the other kind of claim.

129. A more sinister possibility is that Delaware was selected by a control shareholder primarily because it does not provide minority shareholders with much protection. It would be interesting to compare the number of privately held companies by state and the private company litigation rates across states to see if there are significant differences. We lack the data at this point to test this hypothesis.



### B. Public Company Derivative Suits

Theory tells us that in U.S. public corporations with dispersed ownership structures, where there are markets, independent directors and other checks on corporate misconduct, representative shareholder derivative suits have a monitoring role to play in corporate governance. While others have claimed that derivative suits are the evil stepsister among the potential monitors and are thereby better off banished from the kingdom, our data show that in some circumstances derivative suits can be a valuable part of public company shareholder monitoring.

To briefly recap those findings, the bulk of all public company derivative suits challenge conflict of interest transactions, and in those derivative cases that produce affirmative relief, the majority relate to acquisition transactions, in which the plaintiffs allege that a control shareholder group has a conflict of interest. Acquisitions involve directors in a final period problem, in which the law could have a greater role, even if there are independent directors. These cases almost uniformly allege breaches of the duty of loyalty by directors.

Delaware has ceded the area of directors' duty of care to the federal realm. Our cases illustrate this point vividly: of the cases that have produced affirmative relief, the only one that does not focus on the conflict of the entity's core managers is one in which the settlement was paid directly into a securities class action. After the Delaware Supreme Court's decision in *Smith v. Van Gorkom*, imposing liability on directors for breach of their duty of care,<sup>130</sup> the Delaware legislature (followed by legislatures in the other states) quickly passed a statute permitting a corporation to include a provision in its articles of incorporation exculpating its officers and directors from monetary liability related to the duty of care.<sup>131</sup> It is very rare for a public company not to have taken advantage of this exculpation.<sup>132</sup> As a result, the Delaware judiciary, the ten judges that make almost all of American corporations law and who are the only judges in the country who have enough repeat business to become experts in the area, is left unable to hear many of the cases that relate to corporate governance.

Events outside of Delaware have cast doubt on the continued viability of the public company derivative suit. The adoption of the

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130. 488 A.2d 858, 893 (Del. 1985).

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

132. Lawrence Hamermesh, *Fiduciary Duty, Limited Liability and the Law of Delaware: Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 479 (2000).

new listing standards by the New York Stock Exchange and NASDAQ will increase the number of independent directors on the largest public companies' boards of directors. All public corporations now must have a majority of independent directors, and three core board committee—the audit, compensation, and nominating/governance committees—must be composed entirely of independent directors. As a result, it will be more difficult for a plaintiff to show that demand should be excused by claiming that a majority of the board is disabled from acting for the corporation. This will make it harder to sustain derivative suits.

1. Should Delaware take action to make derivative suits easier to bring?

In light of our results, and the changes in listing standards, should Delaware consider opening up the doors to more derivative law suits? To answer this question, we need to focus on duty of loyalty cases separately from duty of care cases. In duty of loyalty cases, we find that derivative suits are already bringing some significant benefits to investors with relatively low litigation agency costs. With the adoption of the new listing standards, boards will have more independent directors to monitor conflict of interest transactions. The hard question is whether independent directors are better monitors of conflict of interest transactions than the Delaware courts.

Certainly to the extent that outside directors are truly disinterested and acting in good faith, their superior knowledge of the circumstances surrounding each transaction at the time of its approval should make them the best judges of whether it is in the firm's best interests. However, it is a stylized fact of the corporate world that true independence is often lacking, and that good faith is easily feigned. The prospect of judicial review helps stiffen the backbone of the independent director.<sup>133</sup> For that reason, we believe that the Delaware courts should try to keep the courthouse doors open to public company derivative lawsuits challenging duty of loyalty transactions, so long as this does not result in significant increases in litigation agency costs.

For duty of care cases, federal regulation has moved increasingly to specifying what officers must do in managing the corporation and providing a forum for litigation when governance has

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133. See generally James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1273 (1993) (finding that outside directors serve the purpose of discouraging managerial overreaching due to increasingly stringent disclosure principles placed upon them).

broken down.<sup>134</sup> This litigation in turn is heard by federal district courts across the country. Federal district judges seldom return to a given topic about which he or she may have gained some expertise, and the federal appellate bench is so numerous and diverse that it, too, lacks continuity. The Supreme Court is noted for its absence from making any significant law in the area, having decided only four minor securities law cases in the last eight terms, and having not heard a corporate law case in recent memory.<sup>135</sup>

Thus, the hard question in duty of care cases is whether Delaware should be concerned about such a shift in the range of corporate governance issues resolved in Delaware and those that go to federal court. Delaware has at least three significant advantages over the federal courts as a forum for resolving these cases: (1) Delaware has more experienced trial court judges; (2) these judges work to create a unified body of case law; and (3) the Delaware courts resolve civil cases much more quickly than their federal counterparts. Yet we must acknowledge that public company derivative litigation of duty of care cases is not producing significant monetary benefits for shareholders at present.<sup>136</sup> Undoubtedly, plaintiffs' counsel are aware of the impact of 102(b)(7) on their chances of gaining a monetary recovery in these cases<sup>137</sup> and are filing these suits in federal court as securities class actions alleging disclosure violations. If the Delaware courts are to attract these cases, they need to address earlier precedents as to the extent that the 102(b)(7) statutory exculpation provisions can be applied in disclosure cases. Delaware might be reluctant to take this action if it believed that it might render other states more attractive as incorporation forums.

In short, the desirability of making duty of care cases easier to bring is more tenuous than for duty of loyalty cases. If litigation agency costs can be kept low, and if the corporate governance benefits from duty of care suits are sufficiently large, it would benefit Delaware to encourage these suits to move to Delaware so that its judiciary could resolve these corporate governance issues.

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134. Thompson & Sale, *supra* note 3, at 897, 910.

135. E. Thomas Sullivan & Robert B. Thompson, *The Supreme Court and Private Law: The Disappearing Place of Securities and Antitrust*, 53 EMORY L.J. 1571 (2004).

136. However, derivative suits alleging violations of the duty of care also can lead to corporate governance changes that have beneficial effects for shareholders.

137. For example, in the second round of the Disney litigation over executive compensation, the plaintiffs chose to cast their complaint as one for breach of the duty of good faith, rather than the duty of care, almost certainly because Disney's charter contained a 102(b)(7) provision in it. See *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003).

## 2. Policy Proposals

How should we change the law to encourage public company derivative suits?<sup>138</sup> As we discussed earlier, the relatively high procedural barriers to successfully litigating derivative suits have resulted in their exhibiting much lower levels of the indicia of litigation agency costs than either state court class actions or federal securities fraud class actions. Removing all of these barriers in all derivative actions might result in a sharp shift away from its competitors—the state and federal class action—into the now procedurally-easier derivative suit. In other words, we must be sensitive to the degree of substitutability of these different forms of representative litigation and not cause a sudden shift in favor of derivative suits, or we could create high litigation agency costs for derivative actions.

However, if we limit the reduction of these barriers to suits that are filed by larger institutional shareholders, we predict this will not have such an effect. Our reasons for this statement are as follows. First, it bears remembering that the census of shareholders and the effectiveness of markets have changed dramatically from the time when derivative suits were seen as the principal regulator of corporate governance to when the current procedural limitations were put in place. Institutional shareholders now own the majority of shares in most large American public corporations. Many of the recent corporate governance proposals have been aimed at enhancing the role of the institutional shareholders—to permit them to use their voting or selling power so as to check abuses by the board. The recent proposals by the SEC on shareholder access to the nomination process would add a complex set of regulations that, if they are to work at all, require the active participation of institutional investors.<sup>139</sup> All of these forces push institutional investors to become active in corporate governance.

Yet institutional investors have shown themselves unwilling to become too closely intertwined with their portfolio companies.<sup>140</sup> They show little inclination to become directors or to offer names of those who are willing to serve. They have pushed for greater powers to

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138. It is possible that the dearth of derivative suits has little to do with legal obstacles, but rather stems from a lack of financial incentives. If derivative suits primarily benefit corporations by policing petty theft or minor frauds, then perhaps plaintiffs simply do not see any point in filing them, preferring instead to let corporate boards deal with such matters.

139. See *supra* note 19.

140. See generally, Michael Klausner, *Institutional Shareholders, Private Equity, and Anti-takeover Protection at the IPO Stage*, 152 U. Pa. L. Rev. 755 (2003) (institutions have different objectives with their voting and investment decisions).

accept a tender offer, so that they support poison pill redemption and board declassification proposals, but they have not sought to bring about additional corporate governance changes through their voting or selling power.

The PSLRA tried to get institutional shareholders to use their shareholder's right to sue to become lead plaintiffs in securities fraud class actions. The hope was that they would increase the size of recoveries while simultaneously reducing the litigation agency costs associated with those suits. Bringing a suit does not require institutions to take on the role of director or insider that causes problems for the institutions. As a result, institutional shareholders have become more involved in federal securities law claims, and some law firms have developed a repeat relationship with institutional shareholders. However, the federal experience with the PSLRA's lead plaintiff provision indicates that institutional plaintiffs have not become overactive litigants,<sup>141</sup> making it unlikely that opening up derivative litigation to these plaintiffs would result in an avalanche of new suits.<sup>142</sup>

In light of these facts, we propose that Delaware and other states modify the demand requirement for derivative litigation so that demand is excused for a 1 percent shareholder.<sup>143</sup> At the large companies that are the focus of most public company derivative litigation, most such shareholders are likely to be institutions. One percent owners hold substantial financial interests in these companies and are unlikely to act against their own self-interest by inflicting injuries on the firms they own.<sup>144</sup> This is the intuition behind the recent SEC proposal for shareholder access to proxy, a federal intrusion into the heart of state corporate law.<sup>145</sup> Moreover, if

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141. James D. Cox & Randall S. Thomas, *Reassessing the Lead Plaintiff Provision: Is the Experiment Paying Off* (Working Paper, Mar. 20, 2003) (on file with authors).

142. The harder question, is if we remove the procedural barriers, will institutional investors pursue corporate wrongdoing using derivative suits? If derivative cases involve petty theft, or minor frauds, then it is quite possible that the economic incentives to go after them will be insufficient. Indeed, even in the securities fraud arena, where some of the frauds have been spectacular, institutional investors have been slow to file suits.

143. The most expeditious method for enacting such a change would be a legislative amendment to Section 327 of the Delaware General Corporation Law.

144. Another alternative would be to permit long-term holders to file suit without satisfying the demand requirement. The idea here would be that such shareholders have a stronger interest in the firm and are more likely to have been monitoring it over a longer period of time. A third option would be to trade-off the two requirements. For example, the initial threshold for the exemption might be designed for a 1 percent shareholder. However, as the period of time a shareholder held the stock increased, the amount of stock they would be required to hold would decline. We thank Professor Steve Choi for suggesting this point.

145. See Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be

Delaware adopted a 1 percent shareholder exemption from the demand requirement, this would still leave it with much greater procedural protections against abusive suits than exist in most state and federal securities class actions, in which only a relatively small number of lead plaintiffs hold that much stock.<sup>146</sup>

The more difficult question is whether Delaware should go further and remove some of the other obstacles to public company derivative litigation. For example, the possibility that a corporation will appoint a special litigation committee to investigate the claims made in cases brought by 1 percent shareholders could have a chilling effect on the likelihood that institutions would file such cases. In duty of loyalty cases, this takes us back to the hard question of whether independent directors are better monitors of conflict of interest transactions than courts. While this is a difficult call to make, we think courts can review duty of loyalty situations effectively because the presence or absence of a conflict is readily verifiable and because methods of obtaining disinterested director or shareholder approval are easily accessed. Furthermore, when an entire fairness analysis is required, a court is a more disinterested decision-maker than even an independent director. On the other side of the equation, special litigation committees have often been used to stop judicial inquiry into the facts surrounding conflict of interest transactions.<sup>147</sup> While arguably worthwhile as a method of stopping frivolous litigation in a world of high litigation agency costs, the justification for using them disappears when institutional investors are the plaintiffs representing the company.

In duty of care cases, it is less clear that courts have an advantage over the independent directors of a special litigation committee. On the one hand, courts can verify the types of procedures used and whether they were sufficient to provide the board with all material information reasonably available to them concerning the transaction at issue. On the other hand, directors have a better

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codified at 17 C.F.R. pts. 240, 249, 274), available at <http://www.sec.gov/rules/proposed/34-48626.htm>.

146. Cox & Thomas, *supra* note 141 (finding that in a sample of federal securities fraud class actions, the median individual lead plaintiff held only 0.09% of the company's stock).

147. The limited data that has been collected on this question supports the view that the appointment of a special litigation committee almost always leads to dismissal of the case. Cox, *supra* note 6, at 963 (as of 1982 reporting that "there have been more than a score of special litigation committees to date, in all but one the committee concluded that the suit in question was not in the corporation's best interests."). Professor Cox also reports that as of 1988, there were forty-four reported SLC cases with only one case where the special committee recommended pursuing some of the claims brought to their attention. Correspondence between authors and Professor James D. Cox (May 5, 2004) (on file with authors).

understanding of the board's knowledge as of the time of the transaction, and their analysis will be reviewed by the court.

One interesting aspect of the duty of care cases is that special litigation committees do not appear to be used in federal securities litigation over disclosures concerning duty of care violations. This suggests that at least the federal courts have decided that these groups do not provide an adequate substitute for judicial review of duty of care violations.

We think that this issue merits further consideration after adoption of the 1 percent shareholder exemption for the demand requirement. If companies respond with widespread use of special litigation committees, then we would argue in favor of eliminating any judicial deference to special litigation committee reports for cases brought by these plaintiffs, at least in the duty of loyalty setting.

#### IV. CONCLUSIONS

This paper analyzes all derivative suits filed in the Delaware Chancery Court during 1999 and 2000. We find that relatively few derivative actions are brought, about forty per year, with two-thirds of them naming public company defendants and the remaining one-third against private companies.

For public company derivative litigation, we hypothesize that these suits have been strangled by procedural hurdles, such as the demand requirement and other constraints that make ultimate recovery unlikely, including special litigation committees and Delaware's statutory limitation on monetary recovery for duty of care claims. For those suits that are filed, however, we find that the associated litigation agency costs are low in comparison to other forms of representative litigation and that there are significant benefits. For that reason, we argue that Delaware and other states should consider creating exceptions to the existing procedural and substantive barriers to these suits for institutional investors holding more than 1 percent of the company's stock. These exemptions should not increase litigation agency costs and may significantly benefit other shareholders.

For closely held firms, the small number of derivative lawsuits presents something of a puzzle. Given the absence of other types of remedies for minority investors in Delaware's legal scheme, derivative lawsuits should comprise an important piece of Delaware's system of regulating close corporate management. However, both the small number of these cases, and the relatively small number of cases resulting in a recovery for the plaintiff, support the claim that private

company derivative litigation is not carrying much weight. We can only speculate whether that is because Delaware's emphasis on private ordering remedies is more efficient in resolving disputes than the court system, or because there is another type of legal remedy, such as the direct suit, being used by minority investors in Delaware companies.



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