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Jill E. Fisch
University of Pennsylvania Carey Law School

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TEACHING CORPORATE GOVERNANCE THROUGH SHAREHOLDER LITIGATION

Jill E. Fisch[*]

Litigation abuse has received considerable public attention in the last several years. The shareholder suit is at the forefront of this debate. Corporate America, claiming that strike suits are crippling business profitability, has pressed for litigation reform.[1] Regulators at a variety of levels have responded to complaints of excessive litigation.[2] At the same time, defenders of shareholder litigation stress its importance and warn that efforts to curtail litigation will reduce management accountability.[3]

The debate, which is a lively one, offers a variety of teaching issues. Through the material on shareholder litigation, one can explore the basic themes of corporate law and corporate governance, including questions about the appropriate degree of separation of ownership and control in the public corporation, the relative merits of different governance mechanisms that seek to reduce agency costs and increase management accountability, and the appropriate role of litigation in business law. This Essay attempts to illustrate the relevance of shareholder litigation to some of the major themes I cover in the basic Corporations course.

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* Professor, Fordham Law School.

1 *See, e.g.*, Adam F. Ingber, *10b-5 Or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 FORDHAM L. REV. 351, 363 (1993) (describing lobbying group, the Coalition to Eliminate Abusive Securities Suits (CEASS), formed by approximately 300 corporate, accounting, and financial institutions, to press Congress to reform securities litigation); Barbara Franklin, *Business Council Wages War on Derivative Suits*, N.Y.L.J., July 8, 1993, at 5 (recounting lobbying effort by New York Business Council in support of bill to restrict derivative litigation in New York state).

2 *See, e.g.*, Central Bank v. First Interstate, 511 U.S. 164, 188-89 (1994) (observing particular risk of abusive litigation presented by shareholder suits against secondary defendants in connection with decision to reject aiding and abetting liability under section 10(b) of the Securities Exchange Act of 1934); John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, (1996) (explaining concern over abusive litigation that led to adoption of the Private Securities Litigation Reform Act).

3 *See, e.g.*, Kenneth Jost, *New York May Limit Stockholder Suits: Governor, Business Groups Back Bill to Give Directors Veto Over Filings*, 80 A.B.A. J. 24 (Mar. 1994) (quoting shareholder lawyer Ed Labaton).

Resisting the cynical view that the corporation always wins, my emphasis in this material is on the extent to which the rules established through shareholder litigation influence primary conduct. Thus, discussion focuses on the role of litigation in setting norms of corporate behavior and deterring corporate misconduct. The material also enables students to evaluate the role of the market and to consider whether regulation is necessary or appropriate as a response to market problems.

This analysis is most effective in the context of specific examples. Recently I have used two particular topics—executive compensation and corporate philanthropy—as a basis for students to evaluate the effectiveness of shareholder litigation and to compare litigation to other governance mechanisms. This process allows students to assess critically the traditional wisdom on the limited role afforded to shareholder litigation as a means of challenging business decisionmaking.

Toward these ends, I structure my course to include a separate unit on shareholder litigation, which I schedule near the end of the semester. By this time, my students are familiar with the applicable substantive law, including fiduciary duty, the business judgment rule, and the special rules applicable to takeover litigation. We have also extensively considered the problems associated with the separation of ownership and control and alternative governance mechanisms addressed to these problems, including the shareholder voting process, shareholder proposals, control contests, and mandatory disclosure. As a result, in addition to introducing students to the structure and mechanics of shareholder litigation, the unit serves to review and reinforce the previously covered background principles and to locate shareholder litigation within the relevant contract and agency principles of corporate law.[4]

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[4] The shareholder primacy principle can also be examined through the lens of shareholder litigation. Students can weigh the reasoning of cases that reserve to shareholders the right to bring derivative suits to redress a breach of fiduciary duty against the stakeholder theories of the corporation. *See, e.g.*, D. Gordon Smith, *The Shareholder Primacy Norm*, 23 IOWA J. CORP. L. 277 (1998) (describing history and influence of shareholder primacy).

I. THEORIES OF CORPORATE GOVERNANCE AND THE SEPARATION OF OWNERSHIP AND CONTROL

As Berle and Means observed, the separation of ownership and control in the modern public corporation has led to managerial control over corporate decisionmaking.[5] Economics scholars defend specialized management as efficient,[6] yet the agency costs associated with the separation reduce this efficiency and create the risks of shirking and self-dealing.[7] Corporate law responds to these risks with a variety of governance mechanisms—mandatory disclosure, shareholder voting, the market for corporate control, and shareholder litigation.

None of the mechanisms operates perfectly. Disclosure is costly and sacrifices the confidentiality of business operations in favor of greater transparency.[8] Voting suffers from collective action problems such as shareholder apathy, as well as management control of the agenda. The market for corporate control is an overly blunt tool for ongoing management discipline and is subject to extensive market and legal constraints.[9] And shareholder litigation, because of its representative nature as well as collective action problems, offers the possibility of litigation abuse.

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[5] *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 68 (1932) (describing how separation of ownership and control in public corporation has led to effective control by management).

[6] *See, e.g.*, Lynn L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REFORM 19, 22-24 (1988) (describing efficiency model of firm, under which separation of ownership and control is viewed as efficient for society); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (arguing that separation of ownership and control is efficient form of specialization).

[7] *See, e.g.*, Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1367 (1989) (identifying "risk of managerial shirking and diversion" as "the price of operating through manager 'agents' "); Geoffrey S. Rehnert, Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1160 (1985) (describing agency costs resulting from separation of ownership and control).

[8] *See, e.g.*, Roberta Romano, *Empowering Investors: A Market* Approach to Securities Regulation, 107 YALE L.J. 2359, 2373-81 (1998) (identifying and evaluating costs and benefits of mandatory disclosure).

[9] *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 832 (1992) (identifying deficiencies in market for corporate control as mechanism for disciplining management).

In addition to the specific deficiencies of particular corporate governance tools, the general effort to increase management accountability poses a cost to business efficiency.[10] Economics teaches that management must enjoy a degree of discretion to operate effectively. For that discretion to exist, shareholders must be limited in their ability to second-guess management decisions. Extensive shareholder interference with managerial decisions, through voting, litigation, or otherwise, threatens to undermine the efficiency gains generated by the separation of ownership and control. Moreover, excessive accountability can make managers risk-averse and reduce corporate profitability.

As a result of these concerns, corporate law moderates the degree to which shareholders can use governance mechanisms to oversee management decisionmaking. For example, shareholders have the right to vote proactively on very few subjects; the board of directors decides on the slate of director nominees, whether to propose a charter amendment, and whether to approve a merger.[11] State and federal law consider the majority of ordinary business decisions to be outside the scope of shareholder voting authority.[12] Similarly, the effectiveness of the takeover market is largely subject to management control, as the board, through the use of poison pills, staggered boards, and other defensive tactics, can preclude shareholders from selling their stock in a control contest. Finally, shareholder litigation is limited by the business judgment rule, which effectively shields most management decisions from judicial review.[13]

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[10] *See, e.g.*, John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1456 n.51 (1994) (describing how interference with management autonomy by reducing discretion or increasing accountability may sacrifice efficiency provided by centralized management).

[11] *See, e.g.*, Alexander G. Simpson, *Shareholder Voting and the Chicago School: Now is the Winter of our Discontent*, 43 DUKE L.J. 189, 203-04 (1993) (explaining that shareholders are permitted to vote on "major structural issues").

[12] *See id.* at 203-08 (describing state and federal law restrictions on shareholder control over most other corporate decisions).

[13] *See generally* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE 5-19 (4th ed. 1993) (describing business judgment rule).

II. SHAREHOLDER LITIGATION AND LITIGATION ABUSE

A. THE STRUCTURE OF SHAREHOLDER LITIGATION

Shareholder litigation comes in two forms. The derivative suit enables shareholders to obtain redress for harms inflicted on the corporation, typically by corporate management.[14] Through the derivative mechanism an individual shareholder can initiate suit, but the suit is brought on the corporation's behalf and the corporation, not the shareholder, receives any recovery.[15] The justification for allowing shareholders to initiate derivative suits is the concern that corporations are unlikely to sue officers and directors for harms to the corporation, because management controls litigation decisions.

Direct suits, in contrast, are attempts to redress harms inflicted on the shareholders directly.[16] In corporate law, one of the most important categories is litigation under the federal securities laws, addressing incomplete or inaccurate disclosure in connection with securities transactions.[17] Securities fraud litigation is typically initiated by purchasers or sellers of securities, who rely on misinformation conveyed by corporations or corporate management.[18]

Both types of suits suffer from incentive problems. Although the aggregate damages at stake in shareholder litigation may be considerable, because most shareholders have a limited amount invested in any given corporation, their individual stakes in litigation are quite small. Accordingly, it is neither cost effective for most shareholders to investigate potential causes of action nor for them to initiate litigation. This problem, which is common to much small-stake or small-claimant litigation, is partially addressed by

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[14] *See, e.g.*, Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 470 (Cal. 1969) (explaining nature of derivative suit).

[15] *Id.*

[16] *See id.* (distinguishing direct suits from derivative suits).

[17] *See, e.g.*, James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 6 (1999) (describing significance of shareholder suits in corporate law).

[18] *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (limiting standing to defrauded purchasers and sellers).

allowing representative suits such as class actions.[19] Both securities fraud class actions and shareholder derivative suits allow a single shareholder to initiate a suit based on the aggregate harm. Nonetheless, because the plaintiff's recovery is limited to his or her damages (and because, in the case of a derivative suit, the plaintiff recovers only indirectly), representative litigation does not create a substantial incentive for plaintiffs to litigate. It does, however, create an incentive for plaintiff's counsel to litigate.[20]

The evolution of both class actions and derivative litigation has departed further from the traditional litigation structure by creating an entrepreneurial role for plaintiffs' counsel.[21] Under the current regime, counsel does not look to individual plaintiffs for payment of legal fees. Instead, counsel in a successful shareholder suit receives a court-awarded fee, which is typically paid out of the damages recovered. The size of the counsel fee may be based on the number of hours devoted to the case or the size of the recovery, but the court's evaluation generally considers the extent of the benefit provided by the litigation to the plaintiff class. As a result, plaintiffs' counsel may, and often does, recover substantially more from the suit than any individual shareholder. At the same time, counsel has an incentive to choose suits with large aggregate damage claims.

The growth of the entrepreneurial lawyer creates a risk of litigation abuse. The risk stems from several factors.[22] First, the lawyers who file suit may have a greater stake than any individual

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[19] *See, e.g.*, Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 551 (1997) [hereinafter Fisch, *Class Action Reform*] (explaining how class action model permits cost-effective ligation in small claimant cases).

[20] *See* Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982) (observing that "the real incentive to bring derivative actions is usually not the hope of return to the corporation but the hope of handsome fees to be recovered by plaintiffs' counsel"); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55, 63-65, 84 (1991) (describing empirical study of derivative suit settlements which finds that attorneys, not shareholders, are principal beneficiaries).

[21] *See* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987) (describing entrepreneurial role of plaintiffs' counsel); Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 L. & CONTEMP. PROB. 167, 171-76 (1997) [hereinafter Fisch, *Role of the Plaintiff*] (describing evolution of class action away from traditional litigation model).

[22] *See* Fisch, *Role of the Plaintiff*, *supra* note 21, at 173 (describing incentives created by class action structure).

shareholder, creating an incentive for the lawyers to make litigation decisions in their own, rather than their clients' interests. The problem is aggravated by the relatively small stakes of most shareholders, who are unlikely to monitor counsel's decisionmaking carefully. Additionally, the lawyer-client relationship is subject to its own set of agency costs. The lawyer seeks to maximize recovery subject to constraints of time and effort. The lawyer may also be risk averse, preferring a quick settlement that does not involve the investment of considerable litigation efforts over a lengthy and uncertain trial. Finally, the lawyer will prefer a recovery that maximizes his or her fee award, rather than one that maximizes the benefits to the plaintiffs.

Critics of lawyer-driven litigation argue that lawyer control of litigation decisions leads to several problems.[23] First, they claim that lawyers generate excessive litigation, filing suits for their nuisance value, in an effort to generate quick settlements. Second, they warn that lawyers may make inappropriate settlement decisions without regard to merit in order to secure their fee awards. This may result in meritorious cases being settled too cheaply. Finally, lawyers may seek to file cases that, because they merely transfer money from one set of shareholders to another, produce little net value from the shareholders' perspective.

In corporate litigation, a number of additional factors contribute to the problem. Corporate officers and directors are shielded from most exposure to liability for damages through mechanisms such as indemnification and insurance.[24] These mechanisms insulate individual executives from most financial responsibility for corporate wrongdoing and may cause them to settle rather than incur the aggravation and exposure associated with extensive litigation. Additionally, the limitations on insurance policies and indemnification provisions create a risk that executives who are found liable of serious wrongdoing may lose their coverage. Settlement agreements

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[23] *See* Fisch, *Class Action Reform*, *supra* note 19, at 535 (recounting concerns about litigation abuse that led to adoption of the Private Securities Litigation Reform Act of 1995).

[24] *See* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 861-62 (1984) (describing degree to which officers and directors may be insulated from liability by indemnification and insurance).

can be drafted to insure that management's conduct meets the requirements for coverage.

The extent to which the foregoing risks are realized—that is, the extent of litigation abuse that actually occurs—is unclear. Empirical studies have attempted to quantify litigation abuse by examining settlement statistics. In one of the most widely cited studies, for example, Janet Cooper Alexander evaluated the settlements in six securities class actions and concluded that all the suits settled for roughly the same percentage of the alleged damages, leading her to conclude that the suits were settled without regard to their merits.[25] The problems inherent in measuring damages in shareholder suits create some difficulty in relying on these statistics, however. For example, Professors Elliott Weiss and John Beckerman conducted a study of the industry-wide price declines in the stocks that were the subject of Alexander's study and found that when industry effects were taken into account, Alexander's conclusions were seriously jeopardized.[26]

Moreover, any attempt to evaluate the utility of shareholder litigation cannot focus exclusively on after-the-fact damage awards, but must also consider the effect of litigation on management accountability. Defenders of shareholder litigation argue that the threat of litigation operates as a substantial deterrent to management misconduct.[27] If viable litigation reduces the incidence of wrongdoing, it provides benefits for which empirical studies do not account.

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[25] *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 516-17 (1991) (studying six suits in which settlements ranged from 20% to 27.35% of allowable recovery; two other cases were studied which settled for smaller amounts due to factors unrelated to their merits).

[26] *See* Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2083-84 (1995) (finding that, after adjusting for industry-wide effects on stock price, settlements in Alexander's study ranged from 23.11% to 79.77% of recoverable damages).

[27] *See, e.g.*, Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 643 (1996) (recommending that securities litigation be refocused to make deterrence the primary objective).

B. REGULATORY RESPONSES TO THE RISK OF LITIGATION ABUSE

Business law has responded to the potential for abusive shareholder litigation in two ways. First, the law limits the claims that may be raised in shareholder litigation. The business judgment rule is the most prominent of these limitations. By reducing the role of the courts in evaluating the merits of business decisions, the business judgment rule effectively insulates most management decisionmaking from judicial review.[28] Moreover, because the business judgment rule imposes a threshold pleading burden on a plaintiff-shareholder, it allows courts to dismiss much litigation at an early stage. By reducing the cost to fight meritless litigation, the rule reduces the potential for nuisance suits.

Federal securities law contains similar substantive limitations. The Private Securities Litigation Reform Act of 1995[29] creates a safe harbor for forward-looking statements, effectively allowing corporations that comply with the statutory requirements to insulate themselves from liability.[30] By adopting a proportionate liability scheme, the Reform Act also reduces the liability exposure of secondary defendants. The United States Supreme Court's decision in *Central Bank v. First Interstate*,[31] which rejected aiding and abetting liability, further limits the ability of plaintiffs to sue secondary wrongdoers. Together the statute and the *Central Bank* decision substantially curtail the ability of shareholders to sue deep pocket defendants who have limited involvement in the challenged transactions.[32] The net result is to reduce the extent to which

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[28] *See, e.g.*, Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1316 (1991) (describing difficulty for shareholder in attacking management decisions because "[t]he business judgment rule virtually insulates all day-to-day decisions of management from attack").

[29] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. §§ 77a et seq. (1995)).

[30] *See, e.g.*, Harris v. IVAX Corp., 182 F.3d 799, 803 (11th Cir. 1999) (describing scope of safe harbor and concluding that it insulates defendants from liability for certain false and misleading statements and omissions).

[31] 511 U.S. 164 (1994).

[32] *See, e.g.*, Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1303-05 (1999) (evaluating combined impact of Reform Act and *Central Bank* decision on liability exposure of secondary defendants).

frivolous litigation can increase the costs associated with employing the services of lawyers, accountants and investment bankers.

The alternative to substantive limitations on liability exposure is procedural gatekeeping. State statutory and common-law rules impose a variety of procedural requirements on a shareholder who seeks to bring a derivative suit.[33] Plaintiffs must make a pre-suit demand that the corporation file suit or demonstrate that such a demand would be futile.[34] Plaintiffs must meet the standing requirement of the contemporaneous ownership rule.[35] In many states, plaintiffs must post a bond as security for the corporation's expenses in the event that a court finds the suit was meritless.[36] Even when the plaintiff has complied with these requirements, the corporation may wrest control of the suit and have it dismissed over plaintiff's objection.[37]

I devote particular attention in class to demand and dismissal of derivative litigation. The key issue in derivative litigation is whether the suit would benefit the corporation. The question posed by the demand and dismissal rules is who should make that determination. At one extreme, some courts have described litigation as a business decision no different from any other and accordingly held that the business judgment rule applies without qualification to a board's decision to refuse a demand or terminate litigation.[38] Other cases have recognized the structural problems associated with allowing directors to decide whether to sue their fellow directors and given the courts a more active role in exercising

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[33] *See, e.g.*, Theresa A. Gabaldon, *Free Riders and the Greedy Gadfly: Examining Aspects of Shareholder Litigation as an Exercise in Integrating Ethical Regulation and Laws of General Applicability*, 73 MINN. L. REV. 425, 435-37 (1988) (explaining common-law and statutory procedural restrictions on derivative litigation).

[34] *See* Aronson v. Lewis, 473 A.2d 805, 808 (Del. 1984) (describing demand requirement).

[35] *See, e.g.*, N.Y. BUS. CORP. LAW §626 (b) (McKinney 1999) (requiring that plaintiff be a shareholder "at the time of bringing the action" and "at the time of the transaction of which he complains").

[36] *See, e.g.*, N.Y. BUS. CORP. LAW § 627 (McKinney 1999) (imposing requirement that plaintiff post security for expenses).

[37] *See, e.g.*, Zapata v. Maldonado, 430 A.2d 779 (Del. 1981) (describing circumstances under which properly filed derivative suit may be dismissed by corporation).

[38] *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994, 1002 (N.Y. 1979) (applying deferential business judgment rule scrutiny to decision of special litigation committee to terminate shareholder derivative suit).

their independent judgment as to whether dismissal is proper.[39] Notably, however, courts give little deference to the shareholders' judgment, despite the theoretical objective of providing some shareholder control over litigation decisions. No state, for example, puts the issue of whether litigation should be pursued to a shareholder vote. Nor do courts solicit the opinions of substantial shareholders as to whether the litigation should proceed.

In light of these concerns, we discuss the universal demand requirement of the American Law Institute Principles of Corporate Governance.[40] A universal demand requirement increases the degree of management control at the expense of shareholder authority. Because the New York legislature discussed adopting the universal demand requirement several years ago,[41] we have the opportunity to consider the legislative role in revising corporate governance rules. My involvement in responding to the legislature's request for assistance in evaluating the proposal allows me to give the students detailed information on the process, including explaining the identity and objectives of the bill's proponents, the concerns expressed by members of the legislature, and the role of lawyers, through the Association of the Bar of the City of New York, in addressing the proposal.[42] Ultimately, the New York legislature failed to adopt the proposal. Perhaps this failure was due in part to a carefully drafted evaluation by the Bar Association warning that

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[39] *See, e.g.*, *Zapata*, 430 A.2d at 787 (rejecting application of pure business judgment analysis to dismissal decision). Further complications are created by the process of delegating the decision to an independent committee. We discuss the increasing reliance by courts on procedural safeguards, such as disinterested directors, independent counsel and extensive investigations and reports, the costs associated with this review, and the appropriate scope of judicial scrutiny.

[40] *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 7.03 (1992) (proposing universal demand requirement except in cases in which corporation would suffer irreparable injury); *see also* Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1353-56 (1993) (describing universal demand requirement).

[41] *See, e.g., Legislative Agenda: Bills Aim to Attract More Business to New York*, N.Y. L.J., Feb. 16, 1995, at 5 (describing New York bill); Jost, *supra* note 3 (discussing same).

[42] I chaired a committee of the Association of the Bar of the City of New York, which submitted comments to the legislature that included recommended changes in the proposed bill. *See Legislative Agenda*, *supra* note 41 (discussing support and opposition for proposal, including positions of Business Council and plaintiffs' bar).

legislative reform might disrupt the existing balance between addressing wrongdoing and protecting corporate decisionmaking.[43]

The Private Securities Litigation Reform Act follows the state law approach of adopting procedural safeguards in an effort to curb litigation abuse.[44] The heightened pleading standard of the Reform Act provides a threshold burden, like the business judgment rule, that allows early dismissal of purported nuisance litigation.[45] By giving defendants the opportunity to have cases dismissed without incurring the time and cost of discovery, the Reform Act reduces the incentive for them to settle non-meritorious cases. The lead plaintiff provision is designed to create a procedural structure for reducing the agency problems associated with lawyer-driven litigation by vesting a lead plaintiff with greater control over litigation decisionmaking.[46] Finally, the Reform Act adopted a variety of restrictions intended to prevent the use of professional plaintiffs, including provisions that limit the number of lawsuits in which a person can serve as class representative,[47] ban referral fees to brokers,[48] and prohibit class representatives from receiving special compensation.[49]

Again, because of my involvement in reviewing these reforms and the predecessor proposals in the Republican Contract with America, I am able to situate the existing statute within the framework of the alternative approaches that were considered and rejected.[50] We

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[43] *See id.* (describing recommendations of City Bar committee).

[44] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. §§ 77a et seq. (1995)).

[45] *See, e.g.*, Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003, 1023-27 (1998) (describing statutory language, legislative history and cases interpreting Reform Act's pleading standard).

[46] *See* Fisch, *Class Action Reform*, *supra* note 19, at 537-50 (discussing lead plaintiff provision).

[47] *See* 15 U.S.C. § 77z-1(a)(3)(B)(vi) (1997); 15 U.S.C. § 78u-4(a)(3)(B)(vi) (limiting individuals to serving as lead plaintiffs in no more than five securities class actions during three-year period).

[48] 15 U.S.C. § 780(c)(8).

[49] 15 U.S.C. § 77z-1(a)(4); 15 U.S.C. § 78u-4(a)(4).

[50] For example, I participated in a panel discussion at the City Bar Association that considered H.R. 10, the "Contract with America." H.R. 10: Common Sense Legal Reform or Unequal Access to Justice (Roundtable Discussion at the Association of the Bar of the City of New York, Feb. 7, 1995). I also drafted comments on various legislative proposals on behalf of the City Bar Association.

discuss procedural proposals such as loser pays[51] and guardians ad litem,[52] as well as substantive proposals such as imposing an actual knowledge standard and eliminating fraud on the market.[53] In addition to evaluating the merits of these alternatives, my students are able to understand the evolution of a statute and appreciate the role of compromise and moderation.

The procedural and substantive limitations on shareholder litigation can best be understood as creating a balance or trade-off between two competing objectives. On the one hand, these limitations reduce both the potential for litigation abuse and the extent to which excessive litigation will unduly interfere with management decisionmaking. At the same time, the cost of these effects is diminished management accountability. By reducing the ability of plaintiff shareholders to litigate, these restrictions cause corporations and their shareholders to sacrifice some degree of compensation for damages caused by management malfeasance. In addition, by reducing the expected likelihood that management will be held accountable for wrongdoing, the restrictions reduce the deterrent effect of corporate law's liability rules.

III. THE ROLE OF LITIGATION IN ADDRESSING CURRENT GOVERNANCE ISSUES

The foregoing theoretical and legal analysis is more interesting and comprehensible when it is situated within the factual context of particular corporate decisions. In my course, I focus on two areas in which managerial decisionmaking may be suspect and explore the effectiveness of shareholder litigation in addressing the potential for management self-dealing. These examples also illustrate the relative advantages and disadvantages of shareholder litigation in relation to other governance mechanisms.

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[51] *See, e.g.*, D. Brian Hufford, *Deterring Fraud vs. Avoiding the "Strike Suit": Reaching An Appropriate Balance*, 61 BROOK. L. REV. 593, 597-98 (1995) (describing loser-pay provisions that were initially part of bills that became Reform Act).

[52] An earlier version of the Senate bill that became the Reform Act proposed guardians ad litem and plaintiffs' steering committees. S. 240, 104th Cong. §§ 101(c), 103 (1995). These provisions did not survive in the enacted legislation.

[53] *See* Common Sense Legal Reforms Act of 1995, H.R. 10, 104th Cong. § 204 (1995) (requiring proof of actual reliance in 10b-5 actions).

A. EXECUTIVE COMPENSATION

Commentators have criticized the growth of executive compensation in the 1980s and 1990s.[54] Executive compensation is frequently described as excessive in comparison to average worker salaries,[55] the salaries paid to foreign executives,[56] and the value added by top executives.[57] Executive compensation has been at the forefront of corporate governance concerns for the last several years. The same media that bemoans shareholder litigation as abusive and excessive decries the large salaries paid to American executives as excessive and wasteful.[58] Executive compensation also presents the prototypical opportunity for management self-dealing. Although state corporation law typically vests the board of directors with the authority to set the salaries of top corporate executives, there are a variety of reasons to question the ability of a board to exercise independent judgment over compensation decisions. Indeed many experts have concluded that executive compensation is not dictated

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[54] *See, e.g.*, James E. Heard, *Shareholders Focus Concerns on Executive Compensation at 1992 Annual Meetings*, 6 INSIGHTS 20 (1992) (describing average CEO compensation as increasing by more than 200% during the 1980s).

[55] *See* John A. Byrne et al., *That Eye-Popping Executive Pay*, BUS. WK., Apr. 25, 1994, at 55 (describing "gulf between the executive suite and the shop floor" as "as wide as a canyon"); Tim Smart, *Pay Gap Widens Between Worker, Boss*, WASH. POST, Aug. 30, 1999, at A6 (reporting that "the sixth annual survey of executive compensation by the Institute for Policy Studies and United for a Fair Economy, finds the ratio of top executive to factory worker pay has exploded this decade to 419 to 1 last year from 42 to 1 in 1980").

[56] *See* Don L. Boroughs et al., *Winter of Discontent*, U.S. NEWS & WORLD REP., Jan. 22, 1996, at 47, 54 (comparing ratio between compensation of CEO and that of average worker in United States to that in Germany); Uma V. Sridharan, *CEO Influence and Executive Compensation*, 31 FIN. REV. 51 (1996) (describing high level of U.S. CEO compensation relative to that in Japan).

[57] *See* Robert J. McCartney, *Executive Pay Rises, as Profits Fall*, WASH. POST, Apr. 25, 1992, at C1 (stating that average CEO compensation at U.S. corporations rose during 1991 even though profits fell sharply); Irwin M. Stelzer, *Are CEOs Overpaid?*, THE PUBLIC INTEREST, Winter 1997, at 26, 32 (reviewing several empirical studies which conclude that link between CEO pay and corporate performance is "somewhere between weak and non-existent").

[58] *See, e.g.*, John A. Byrne, *The Flap Over Executive Pay*, BUS. WK., May 6, 1991, at 90 (describing attention and controversy over executive pay levels).

by market forces and that corporate CEOs exert undue influence over their compensation packages.[59]

Shareholder litigation is rarely successful in challenging compensation decisions. Courts traditionally treat executive compensation as a routine business decision that is virtually immune from judicial review under the business judgment rule.[60] Indeed, executive compensation seems to be a prototypical subject for application of the business judgment rule. As the court in the classic *Heller v. Boylan*[61] decision explained, courts are ill-equipped to review compensation decisions.[62] Moreover, although the doctrine of waste remains available as a basis for challenging particularly egregious cases of overcompensation, as evidenced in *Rogers v. Hill*,[63] the case is perhaps most noteworthy for its aberrational nature.[64]

The recent case of *In re Walt Disney Co. Derivative Litigation*[65] provides a typical illustration of the utility of shareholder litigation as a tool for challenging compensation decisions. Shareholders brought suit based on the Disney board's decision to award a severance package of $140 million to Michael Ovitz after concluding that his employment as president of Disney for fourteen months was not working out.[66] The court in *Disney* was unswayed by allegations that the severance package was "larger than almost anyone anywhere will receive in the lifetime of any of the parties, and perhaps larger than any ever paid."[67] Despite its size, the court

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[59] One of the best-known compensation consultants, now a critic of excessive pay, wrote a book several years ago describing a process by which a CEO could get his or her board of directors to approve virtually any compensation package unconstrained by legal or market forces. GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991).

[60] 29 N.Y.S.2d 653 (N.Y. Sup. Ct. 1941).

[61] *Id.*

[62] *Id.* at 679-80.

[63] 289 U.S. 582 (1933).

[64] *See, e.g.*, Steiner v. Meyerson, No. CIV.A.13139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995) (observing that non-fraudulent (and non-negligent) claims against disinterested parties that meet legal standard of waste may be "rarest of all" and "possibly non-existent"); *id.* at *8 (holding that grant of immediately exercisable stock options does not constitute corporate waste "[s]o long as there is some rational basis for directors to conclude that the amount and form of compensation is appropriate").

[65] 731 A.2d 342 (Del. 1998).

[66] *Id.* at 350, 352.

[67] *Id.* at 350.

explained that conventional corporate governance laws applied, and concluded that the suit was barred by the demand requirement and the business judgment rule.[68]

The case demonstrates that the procedural barriers to derivative litigation effectively preclude challenges to executive compensation. The *Disney* court was unpersuaded by plaintiffs' allegations that the decisionmaking process leading to the package was defective. Plaintiffs demonstrated that Ovitz was a close personal friend of Disney CEO Michael Eisner[69] and presented a variety of conflicts and personal ties between members of the Disney board and Eisner, suggesting that the board of directors could not fairly evaluate the compensation.[70] Nonetheless, the court concluded that the Disney board was sufficiently capable of exercising independent business judgment.[71] This decision foreclosed further judicial inquiry. Accordingly, the court dismissed the complaint for failure to comply with the demand requirement.

Rogers v. Hill[72] and *Disney* pose threshold questions about how to evaluate executive compensation. Are the media claims of overpayment justified? Can we compare the salaries of top executives with those of football players and movie stars?[73] These

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[68] *Id.* at 350-51, 361, 365.

[69] *Id.* at 355.

[70] *Id.* at 356-61.

[71] *Id.* at 361. The court found the board sufficiently independent notwithstanding widespread public criticism of the Disney board's lack of independence. *See, e.g.*, John A. Byrne, *The Best and Worst Boards*, BUS. WK., Dec. 8, 1997, at 90 (naming Disney's directors worst board in America in its second annual analysis of corporate governance); Bruce Orwall & Joann S. Lublin, *The Plutocracy: If a Company Prospers, Should its Directors Behave by the Book?*, WALL ST. J., Feb. 24, 1997, at A1 (detailing personal ties between several board members and Eisner); Paul Tharp, *Eisner's Problems Put Him Deeper into Mouse Hole*, N.Y. POST, May 20, 1999, at 36 (stating that "[j]ust three of Disney's 16 directors are fully independent, and the rest are either friends or financial associates").

[72] 289 U.S. 582 (1933).

[73] At a recent conference, Professor Melvin Eisenberg drew a comparison between compensation of top executives and that of professional athletes, suggesting that the athletes were compensated more appropriately based on past performance. Panel Discussion, Compensation: Balancing Accountability and Incentives, The Federalist Society, Fourth Annual Conference on Corporate Governance Issues (Sept. 16, 1999) [hereinafter Federalist Society Conference]. *But see* Sam Walker & Jonathan B. Weinbach, *All-Stars of '99*, WALL ST. J., Sept. 3, 1999, at W1 (describing lack of correlation between pay and performance among top football players); *Top Executive Pay Peeves The Public*, BUS. WK., June 25, 1984, at 15 (describing poll finding that "[o]n the scale of public tolerance for the amount of money they make, executives rank a little above star professional athletes").

questions lead to a discussion of pay-for-performance. Recent trends toward incentive-based compensation have generated a variety of innovative compensation tools and have increased the percentage of executive compensation that is, at least nominally, performance-based.[74] At the same time, these trends have apparently accelerated the inflation of compensation packages.[75] An alternative approach to executive compensation focuses on the decisionmaking process.[76] Are decisions improved by the use of compensation consultants and independent compensation committees?[77] Graef Crystal's role in designing Ovitz's compensation is illustrative of the role of consultants.[78]

The *Disney* court's decision may be justified on the basis that shareholder litigation is a poor tool for challenging executive compensation. That conclusion must be based, however, on an assessment of the available alternatives for monitoring compensation decisions. Several such alternatives exist. One alternative is a regulatory solution—legal limits on the amount or type of executive compensation that corporations can pay. The adoption of Internal Revenue Code section 162(m) represents a limited regulatory approach. Section 162(m) limits the deductibility of non-performance-based compensation payments exceeding $1 million per

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[74] *See* Kevin J. Murphy, Executive Compensation 9-25 (working paper dated Apr. 1998) (copy on file with author) (describing components of CEO compensation).

[75] *See id.* at 21 (describing "explosion in stock option grants" which "now constitute the single largest component of CEO pay").

[76] Recently a respected practitioner suggested to me that the problem of excessive executive compensation could be addressed through careful guidelines on the composition and responsibilities of compensation committees akin to the proposals for audit committees contained in the NASD Blue Ribbon Committee's Report and Recommendations on Improving the Effectiveness of Corporate Audit Committees (1999).

[77] *See, e.g.*, Chris O'Malley, *Executive Pay Committees: It's a Question of Objectivity*, INDIANAPOLIS STAR, May 23, 1999, at A01 (identifying variety of conflicts that could compromise independence of compensation committee decisions).

[78] Crystal, who advised the Disney board on Ovitz's employment agreement, was later quoted as saying that "nobody quantified [the total cost of the severance package] and I wish we had." *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 361 (Del. 1998). In his book Crystal describes the compensation consultant's role primarily as furnishing ammunition for the CEO to justify his or her desired increase in compensation to the board of directors. CRYSTAL, *supra* note 59, at 42-50.

year.[79] The provision provides a good example of the shortcomings of regulatory approaches to corporate governance. In addition to being subject to criticism for arbitrarily specifying a fixed dollar amount limit without reference to corporate size, section 162(m) has had the perverse effect of causing many companies to increase executive salaries to the $1 million cap[80] or, alternatively, causing companies to pay their executive with stock option grants worth many times the limit because option grants are deemed performance-based compensation and, hence, are exempted from the cap.[81]

An alternative governance approach is disclosure. Sensitive to concerns about excessive executive compensation, the Securities and Exchange Commission (SEC) amended its rules to mandate disclosure of executive compensation in corporate proxy statements.[82] As several commentators have observed, however, this disclosure may have the perverse effect of increasing compensation levels as corporate executives become increasingly aware of payments made to their peers.[83] Disclosure may actually provide executives ammunition with which to negotiate pay increases from their corporations.

Executive compensation has also been the target of increased shareholder activism. Institutional investors have mounted challenges to executive compensation through the shareholder

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[79] *See* James R. Repetti, *Accounting and Taxation: The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 708-09 (1997) (describing operation of Regulation 162(m)).

[80] *See* John A. Byrne, *That's Some Pay Cap, Bill*, BUS. WK., Apr. 25, 1994, at 57 (explaining that cap has effectively established standard for executive pay).

[81] Repetti, *supra* note 79, at 709.

[82] *See* Executive Compensation Disclosure, Securities Act Release No. 33-6962, 52 SEC Doc. 1961 (Oct. 16, 1992) (imposing extensive disclosure requirements for executive compensation); Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1161 (1993) [hereinafter Fisch, *Proxy Regulation*] (describing rationale behind SEC's decision to require disclosure of executive compensation).

[83] *See* Donald C. Langevoort, Commentary, *Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U.L. REV. 93, 97 (1998) (observing that disclosure of compensation may have caused corporations to raise pay faster "as peer payments become more visible"); *see also* Federalist Society Conference, *supra* note 73 (noting that disclosure of executive compensation may be counterproductive in that transparency may be counterproductive—if CEOs know what their peers are being paid, each has negotiating ammunition to pressure his or her corporation to pay comparably).

proposal process,[84] by voting against compensation plans,[85] and by withholding votes from the board of directors to protest excessive compensation packages.[86] The SEC has facilitated the use of shareholder voting to address executive compensation by reversing its position under Rule 14a-8 and requiring corporations to include shareholder proposals dealing with executive compensation on the corporate proxy.[87]

Disney provides students with a good case study for examining the operation of these governance alternatives. Students can review the SEC-mandated disclosure in Disney's proxy statement and learn how much CEO Michael Eisner gets paid, as well as evaluate the effectiveness of Disney's performance-based compensation structure.[88] Students can also evaluate the quality of this disclosure by reviewing articles in the popular press.[89] Recent articles also detail the response by institutional investors both to Eisner's compensation package and to Disney's governance structure. We discuss a number of the initiatives that investors have directed at Disney, such as a recent proposal that Disney's future stock option

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[84] *See, e.g.*, *Corporate Governance: Firms Flex Their Muscles*, PENSIONS & INVESTMENTS, Oct. 19, 1998, at 109 (stating that institutional investors filed 71 shareholder proposals addressing executive compensation during 1998 proxy season); Citigroup, 1999 SEC No-Action Letter, LEXIS 138, at *10 (Feb. 4, 1999) (describing proposal which sought, inter alia, to establish "a cap on total CEO compensation as a multiple of pay of the lowest paid worker at Citigroup").

[85] *See, e.g.*, Richard C. Ferlauto, *Labor's Growing Shareholder Activism Agenda*, PENSIONS & INVESTMENTS, Mar. 23, 1998, at 12 (citing 1996 Corporate Governance Review data showing increase in shareholder voting cast against executive compensation plans).

[86] *See, e.g.*, James E. Heard & Patrick S. McGurn, *Corporate Governance Audit for 1998*, INSIGHTS, Dec. 1997, at 3 (describing "just vote no" efforts by activist investors in 1997 proxy season).

[87] Previously the SEC has determined that shareholder proposals addressing executive compensation could be excluded under Rule 14a-8(c)(5) as matters relating to the ordinary business operations of the issuer. *See* Fisch, *Proxy Regulation*, *supra* note 82, at 1160-61 (describing SEC's original position and its reversal of that position in 1991).

[88] Disney's 1999 Proxy Statement, dated February 23, 1999, is available on LEXIS-NEXIS in the EDGARPlus file. Michael Eisner's employment agreement is described on page thirteen and his compensation is quantified in a table on page fourteen.

[89] *See, e.g.*, Derrick Z. Jackson, *Falling into the Gap*, BOSTON GLOBE, Sept. 3, 1999, at A19 (describing Eisner as highest paid U.S. executive in 1998 with compensation totaling $575.6 million).

grants be performance-based[90] and TIAA-CREF's proposals calling for a more independent board of directors.[91] We also observe that CalPERS cast "no" votes for Disney's board nominees in an effort to protest the board's lack of independence.[92]

Finally, I ask the student to consider possible corporate responses and the degree to which these initiatives may change governance policies. We observe that Disney recently bowed to institutional pressure and agreed to add two additional independent directors to its board.[93] At the same time, we note the continued corporate efforts to preclude institutional activism. For example, Disney resisted the CWA shareholder proposal on performance-based stock options, arguing that it is excludable because it deals with the ordinary business operations of the company.[94] Disney also responded to the anticipated controversy at its annual meeting by changing the location of that meeting from Anaheim to Kansas City.[95]

B. CORPORATE PHILANTHROPY

A second topic that tests the operation of the tools of corporate governance is corporate philanthropy. Early in the course, in connection with fiduciary duties, I teach a unit covering corporate objectives. In this unit, we discuss the stakeholder model of the corporation and contrast it with the principle of shareholder primacy. I then ask the students whether corporate philanthropy can be justified.

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[90] *See* Phyllis Feinberg, *Disney Stars in First Proxy War: Union Wants 1999 Proposal on Performance-Based Options*, PENSIONS & INVESTMENTS, Nov. 2, 1998, at 3 (detailing shareholder proposal submitted by Communication Workers of America requesting that all future stock option grants be performance-based).

[91] *See* Dave McNary, *Stockholder Ends Bid to Open Disney Board*, DAILY NEWS OF L.A., Dec. 5, 1998, at B2 (discussing TIAA-CREF's decision to withdraw its 1999 proposal after Disney agreed to add two independent directors following 35% shareholder vote in support of CREF's 1998 proposal).

[92] Heard & McGurn, *supra* note 86, at 3.

[93] *See* McNary, *supra* note 91 (illustrating how Disney caved to TIAA-CREF pressure).

[94] *See* Feinberg, *supra* note 90 (describing Disney's efforts to persuade SEC that CWA proposal can be excluded from proxy statement).

[95] *See* Claudia Eller, *Disney Could Encounter Stormy Scene at Midwest Meeting Site*, L.A. TIMES, Feb. 24, 1998, at D1 (questioning whether change of annual meeting site was motivated by effort to avoid controversy).

Under either model, the rationale for corporate philanthropy is unclear. Although corporations defend much of their charitable giving in business terms, and this defense is reasonable, donations that enhance long-term corporate value do not require different legal treatment from other corporate expenditures. Nonetheless, both corporate law and tax law afford special treatment to corporate expenditures that are characterized as philanthropic. Specifically, under the laws of most states, management need not defend charitable giving as serving the interests of the corporation, no matter how those interests are defined.[96] Indeed, some statutes, such as the New York Business Corporation Law, explicitly authorize management to make charitable donations "irrespective of corporate benefit."[97] This language suggests that it is legal and, at least in some cases, appropriate for corporations to make donations that cannot be justified in business terms.[98] The application of this principle presents a challenge for corporate governance.

The broad language of statutory authorizations of corporate philanthropy make such philanthropy nearly impossible to challenge through shareholder litigation. If corporate philanthropy need not serve a business purpose, what standard should the courts apply in reviewing a donation? One obvious possibility is the business judgment rule, yet there are problems in applying the business judgment rule to a non-business decision.[99] The potential for management self-dealing in connection with corporate philanthropy also raises a question about the suitability of applying the business judgment rule's deferential standard of review.[100] An alternative

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[96] *See* Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 602-03 (1997) (describing current state corporate law regulation of corporate philanthropy).

[97] N.Y. BUS. CORP. LAW §202(12) (McKinney 1999).

[98] *See* Jill E. Fisch, *Corporate Philanthropy is as American as Apple Pie*, 84 CORNELL L. REV. 1282, 1326 (1999) [hereinafter Fisch, *Corporate Philanthropy*] (distinguishing category of corporate philanthropy that cannot be justified in terms of benefit to corporation).

[99] *See* Faith Stevelman Kahn, *Legislatures, Courts and the SEC: Reflections on Silence and Power in Corporate and Securities Law*, 41 N.Y.L. SCH. L. REV. 1107, 1123 (1997) (arguing that "[t]he [existing] standards of fiduciary care and loyalty and the business judgment rule cannot appropriately be applied, at least as they have traditionally been defined in the corporate case law, to the review of management's decisions regarding charitable contributions").

[100] Jill E. Fisch, *Questioning Philanthropy from a Corporate Governance Perspective*, 41 N.Y.L. SCH. L. REV. 1091, 1096 (1997) [hereinafter Fisch, *Questioning Philanthropy*].

approach would permit courts to review donations in terms of their size by applying some variation of a reasonableness standard.[101] As the preceding material on executive compensation demonstrated, however, the absence of judicially manageable standards for determining when an expenditure is reasonable, particularly when viewed against the scale of a large public corporation's earnings or other expenditures, makes such an evaluation impractical.[102] Even a very large contribution represents an almost immaterial fraction of the earnings of an IBM or Exxon.

Again, the problem is best illustrated by example. The decision in *Kahn v. Sullivan*[103] demonstrates the impotence of shareholder litigation as a tool for maintaining accountability in corporate charitable giving. After Armand Hammer, then CEO of Occidental Petroleum, became dissatisfied with the responsiveness of the Los Angeles Museum of Art to his overtures,[104] he proposed that Occidental build a museum to house his art collection. The proposal for the Armand Hammer Museum and Cultural Center of Art, which would cost $86 million,[105] was approved by Occidental's board of directors.[106] The project was subsequently challenged through shareholder litigation. The Occidental board appointed a special litigation committee, and the litigation was rapidly resolved[107] through a cheap settlement, allowing the project to proceed with

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[101] *See* Kahn, *supra* note 96, at 606-08 (describing Delaware courts' use of reasonableness approach).

[102] *See id.* at 606-07 (criticizing Delaware courts' reliance on charitable contribution provisions of Internal Revenue Code as measure of reasonableness for corporate contributions).

[103] 594 A.2d 48 (Del. 1991).

[104] Apparently the museum refused Hammer's request that galleries be named after him. *See* Melvin A. Eisenberg, *Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, The Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure*, 28 STET. L. REV. 1, 23 (1998) (describing history of Hammer museum project).

[105] *Id.*

[106] *See Kahn*, 594 A.2d at 52-55 (describing board's consideration of museum proposal).

[107] The settlement negotiation process was, itself, somewhat questionable. *See* Kahn v. Occidental Petroleum Corp., Civ. A. No. 10808, 1989 Del. Ch. LEXIS 92, at *1, *13 (Del. Ch. July 19, 1989) (denying "extraordinary motion to preliminarily enjoin a settlement in the process of being negotiated," but observing that negotiation process raised "troublesome issues" that could be heard at settlement hearing).

some minor modifications in terms.[108] Although other shareholders, including CalPERS, objected to the settlement terms,[109] the Delaware Court of Chancery ultimately approved the settlement, and the Delaware Supreme Court affirmed.[110]

In reviewing the settlement, the Delaware courts were faced with the task of determining whether the settlement terms were fair and reasonable. In doing so, courts weigh the likelihood that the suit will be successful against the benefits provided to the corporation and its shareholders by the settlement.[111] In *Kahn*, the benefits conferred by the settlement were, by all accounts, minimal; the Court of Chancery described the settlement as "meager."[112] Nonetheless, the courts concluded that the suit had little likelihood of success on the merits because it was "highly probable" that the business judgment rule would protect the directors' decision.[113]

The courts reached this conclusion despite the absence of any proffered business purpose for the donation and despite no evidence that the donation was reasonable in size.[114] The absence of a legal requirement that corporate philanthropy be justified by a business purpose makes it virtually impossible for a court to review philan-

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[108] The terms of the settlement, which are described in the opinion of the Delaware Court of Chancery, included changing the name of the museum to the "Occidental Petroleum Cultural Center Building," and limiting Occidental's expenditures for the museum to $50 million plus an additional $10 million for cost overruns. *See* Sullivan v. Hammer, No. Civ. A. 10823, 1990 Del. Ch. LEXIS 119, at *10-11 (Del. Ch. Aug. 7, 1990) (describing terms of settlement). The additional $10 million expenditure was approved by Occidental's special committee even before the appeal of the Court of Chancery decision approving the settlement reached the Delaware Supreme Court. *See Kahn*, 594 A.2d at 58 (describing special committee meeting to approve expenditure).

[109] *Kahn*, 594 A.2d at 50-51.

[110] *Id.* at 63.

[111] *See, e.g.*, Lewis v. Hirsch, No. Civ. A. 12,531, 1994 Del. Ch. LEXIS 68, at *6-7 (Del. Ch. June 1, 1994) (describing legal standard for judicial review of proposed settlement).

[112] *Sullivan*, 1990 Del. Ch. LEXIS 119, at *3.

[113] *Kahn*, 594 A.2d at 51. As the Court of Chancery explained, "[t]he potential for ultimate success on the merits here is, realistically, very poor. The business judgment rule, as consistently reiterated by the Delaware Supreme Court, stands as an almost impenetrable barrier to the plaintiffs." *Sullivan*, 1990 Del. Ch. LEXIS 119, at *15.

[114] The Court of Chancery, relying on *Theodora Holding Corp. v. Henderson*, 257 A.2d 398 (Del. Ch. 1969), held that the test for whether a charitable contribution was proper was its reasonableness. *Sullivan*, 1990 Del. Ch. LEXIS 119, at *19. The court then stated conclusorily, "[f]rom the present record it is also clear that the present gift (as now limited) is within the range of reasonableness." *Id.*; *see also Kahn*, 594 A.2d at 61 (detailing objectors' arguments that size of Occidental's contribution was unreasonable).

thropic decisions under existing legal standards. As a result, the *Kahn* court had little choice but to approve the settlement regardless of its terms.

The opinions in *Kahn* actively discourage shareholders from using litigation to challenge corporate philanthropy. Although *Kahn* presents one of the more egregious cases of self-dealing masquerading as philanthropy, the courts refused to look behind the Occidental board's superficial justification of the expenditures in affording the transactions the presumptive protection of the business judgment rule. Thus, to the extent that corporate donations pose the risk of management self-dealing,[115] shareholders must consider governance alternatives.

Existing alternatives offer little potential for maintaining management accountability with respect to corporate philanthropy. Current law does not require corporations to disclose their charitable donations. Shareholder voting is not a viable alternative because state law does not require shareholder approval of charitable expenditures, and it is unclear whether shareholder efforts to vote on charitable giving would be permissible.[116] Moreover, although shareholders have attempted to place the propriety of corporate giving policies before the shareholders through use of precatory shareholder proposals, the SEC generally has permitted corporations to exclude such proposals on the ground that they relate to the company's ordinary business operations.[117]

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[115] *See generally* Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem*, 41 N.Y. L. SCH. L. REV. 1147 (1997) (describing risk of self-dealing presented by corporate philanthropy).

[116] *Cf.* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 414, 467-68 (1998) (arguing that shareholder-proposed bylaws attempting to limit directors' power to adopt "poison pills" impermissibly interfere with directors' authority under Delaware statute to manage corporation).

[117] *See, e.g.*, Pacific Telesis Group, 1992 SEC No-Act. LEXIS 218 (Feb. 20, 1992) (finding proposal that registrant make contributions to Planned Parenthood excludable under Rule 14a-8(c)(7) as "the determination to commence contributions to a particular charity"); SCE Corp., 1992 SEC No-Act. LEXIS 214 (Feb. 20, 1992) (holding proposal that registrant consider donating prescribed amount of money to qualified charities which work to improve fisheries and wildlife habitat excludable under Rule 14a-8(c)(7) as "the determination to commence contributions to a particular charity"); Kmart Corp., 1998 SEC No-Act. LEXIS 350 (Mar. 4, 1998) (finding proposal that registrant refrain from donating to organizations that perform abortion excludable under Rule 14a8(c)(7) as dealing with "contributions to specific types of organizations").

To date, corporate philanthropy has not spurred the public and regulatory attention that has been focused on executive compensation.[118] Nonetheless, commentators have warned that philanthropy poses analogous risks of management self-dealing.[119] Several preliminary proposals seek to increase accountability through analogous governance mechanisms, such as Congressman Paul Gillmor's bill requiring public companies to disclose their charitable donations to investors.[120]

As with executive compensation, these proposals demonstrate the weaknesses of existing governance tools. For example, mandated disclosure of philanthropy raises application issues similar to those that plague disclosure of compensation: the definitional scope of philanthropy, the problem of quantifying contributions of property and employee time, and the extent to which cause-related marketing programs should be classified as philanthropy. More broadly, any increase in required corporate disclosures triggers concerns that corporations will sacrifice business confidences and that disclosure will unduly increase interference with day-to-day business operations.

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[118] The relative absence of efforts to regulate corporate philanthropy is independently worthy of comment. Charitable giving may provide a mechanism by which corporations can purchase political favor while avoiding the legal restrictions on corporate political activity. Fisch, *Questioning Philanthropy*, *supra* note 100, at 1101-02. Accordingly, a public choice analysis may explain legislative reluctance to subject philanthropic decisions to increased public scrutiny.

[119] *See* Barnard, *supra* note 115, at 1148 (warning that much corporate giving is driven by personal desires of executives rather than strategic considerations); Kahn, *supra* note 96, at 624-25 (proposing mandatory disclosure of corporate contributions in order to deter management self-dealing). The potential for management self-dealing strengthens the analytical connection between executive compensation and corporate philanthropy as governance issues.

[120] Representative Gillmor has introduced two bills proposing alternative ways of regulating corporate philanthropy. The first follows the disclosure policy employed by the SEC with respect to executive compensation. It would require public companies to report the amounts and recipients of charitable contributions in connection with their periodic disclosure to investors. H.R. 944, 105th Cong. (1997). The second bill, modeled on Berkshire Hathaway's Berkshire Plan, would require public companies to permit shareholders to determine the recipients of corporate charitable giving. *See* Fisch, *Corporate Philanthropy*, *supra* note 98, at 1323 (describing two bills); *see also* Barnard, *supra* note 115, at 1170 (proposing modification of tax code to limit deductibility of corporate charitable contributions that fail to meet specified criteria).

IV. SOME PEDAGOGICAL CONSIDERATIONS

The foregoing material allows the students to evaluate the effectiveness of shareholder litigation at addressing two problematic areas in corporate governance. After an analysis of the substantive issues and the potential for management self-dealing, the students are able to recognize the substantial limitations on shareholder litigation as a governance tool. Indeed, courts have essentially insulated these particular subjects from judicial review by relegating challenges to the little-used doctrine of waste and ignoring the potential for management self-dealing that, in the context of the duty of loyalty, typically justifies enhanced judicial scrutiny.

Our discussion then considers whether these limitations on shareholder litigation are appropriate. We consider the concern of lawyer-driven litigation that animates calls for litigation reform and debate whether shareholder litigation on these topics presents the risk of abusive litigation. We also consider the viability of governance alternatives. While executive compensation has been the target of considerable experimentation in regulatory reform, corporate philanthropy has received comparably little attention. Yet, the materials demonstrate that both topics present consistent examples of management excesses that corporate law appears unable to remedy. Indeed, these topics demonstrate the failure of corporate law to address essential problems stemming from the separation of ownership and control.

We conclude by considering reform efforts that run counter to the current popular wisdom. Should the procedural or substantive rules governing shareholder litigation be modified to provide more meaningful review, either in general or in particular subject areas? Students have at their disposal an illustration of this approach in the one area in which Delaware courts have applied a more rigorous standard of review: management's use of anti-takeover defenses.[121]

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[121] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (adopting intermediate standard of scrutiny for management's use of anti-takeover defenses to resist hostile tender offer); Ronald Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 248 (1989) (describing *Unocal* test).

Chuck Yablon has made a similar proposal with respect to compensation decisions and suggested that courts use a proportionality test to evaluate executive compensation rather than a deferential waste or business judgment standard.[122] Under Yablon's test, courts would ask whether executive compensation is reasonable in light of the expected benefits to the corporation.[123] Yablon argues that a proportionality test would be workable and, if limited to an area like executive compensation, would not present significant risks of litigation abuse.[124] Using the tools provided by our analysis of shareholder litigation, students can analyze this claim and discuss the workability of Yablon's proposal.

Finally, students can consider the potential deterrent effect of this regulatory change on corporate behavior. Too frequently our teaching emphasizes the lawyer's role in litigation, yet the business lawyer commonly acts as an adviser when the client seeks to minimize the risk of litigation. In these cases, legal rules serve as the backdrop for corporate transactional decisionmaking. Yablon claims that the potential for greater judicial involvement would deter management overreaching by invigorating board deliberations over compensation decisions.[125] He offers an example of how his proposal might affect the dialogue between a CEO and his counsel.[126] It can be particularly useful for students to play the role of corporate counsel and consider the way legal standards can affect their advice to a corporate board or their ability to deal with a recalcitrant CEO.

V. CONCLUSION

In teaching students about the role of shareholder litigation, I hope to leave them with a richer appreciation for the nuances in the currently ongoing debates about litigation reform. I want my students to understand the concerns about litigation abuse as well

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[122] Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1897-98 (1992) (book review).

[123] *Id.* at 1897.

[124] *Id.* at 1901.

[125] *Id.* at 1897-98.

[126] *Id.*

as the economic structure of shareholder litigation that creates the potential for this abuse. At the same time, I do not want students to fall prey to the Nirvana fallacy. The role of shareholder litigation must be understood within the context of corporate law's effort to address the agency costs associated with the separation of ownership and control. Limitations on the effectiveness of governance mechanisms have the potential to sacrifice management accountability. Accordingly, reform efforts must consider the availability of alternative methods of controlling management self-dealing. By seeking to cultivate a thoughtful approach to the role of litigation in corporate governance, I try to keep my students questioning the purposes served by the legal rules they study.