THE ROLE OF THE ATTORNEY IN PROTECTING (AND IMPAIRING) SHAREHOLDER INTERESTS: INCENTIVES AND DISINCENTIVES TO MAXIMIZE CORPORATE WEALTH

JEFFREY MICHAEL SMITH

> "For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics." [1]

INTRODUCTION

In December 1993, an attorney for James Bird informed the board of directors of Lida, Inc. that the corporation was involved in disadvantageous lease agreements with its controlling shareholders.[2] As a noncontrolling stockholder of Lida,[3] Bird was unhappy with the lease agreements, which enriched the controlling shareholders at the expense of the corporation and the other shareholders. Bird presented his information to the board of directors of Lida, and made a demand for investigation.[4] The board subsequently appointed a special committee, which retained independent real estate appraisal firms.[5] Acting on a report from this committee, the board of directors renegotiated the leases in the corporation's favor.[6]

The renegotiation of the leases, instigated as a result of Bird's demand, will save Lida over $680,000.[7] Lida's shareholders as a

1. OLIVER WENDELL HOLMES, *The Path of the Law*, *in* 3 THE COLLECTED WORKS OF JUSTICE HOLMES 391, 399 (1995). Holmes delivered this address at Boston University on January 8, 1897. *See id.* at 391.

2. *See* Bird v. Lida, Inc., 681 A.2d 399, 401 (Del. Ch. 1996).

3. *See id.*

4. *See id.*

5. *See id.*

6. *See id.*

7. *See id.* at 401-02.

group will receive a substantial benefit, but James Bird, being only one of many shareholders, will realize just a small portion of that benefit. His attorney will receive none of the benefit. It was Bird and his attorney, however, who bore the costs of investigating the corporation, discovering the inefficiency, and bringing it to the attention of the board of directors. Bird and his attorney expended resources in a way that created "a substantial quantifiable financial benefit to the corporation."[8] Nevertheless, under current law, the people responsible for this increase of wealth are not entitled to share in it.

There is, however, another side to plaintiffs' attorneys; they do not always create wealth. In fact, attorneys often bring meritless derivative suits against corporations just to extort a settlement.[9] All too often, this technique is successful; empirical studies and practical experience have led to a growing consensus among judges and academics that shareholder litigation is open to abuse by plaintiffs and their attorneys to a greater extent than are other fields of civil litigation.[10] Among shareholder suits, derivative suits are the most likely to be frivolous.[11]

Plaintiffs' attorneys are the controlling force in shareholder litigation,[12] and like most other actors in the economy, including corporate managers and shareholders, they are often motivated by the prospect of personal financial gain or loss. There is nothing necessarily wrong with this motivation; indeed, it's the motivation we have come to expect, and at times even revere, in our capitalist system. However, unlike in private sector markets where the "invisible hand"

8. *Id.* at 403.

9. *See infra* note 141 and accompanying text.

10. *See* Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 368 (1994); Reinier Kraakman et al., *When are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1736 (1994); *see also* Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 949 (1993) (noting that a large percentage of shareholder claims are frivolous and are based on settlement value instead of merit); Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991) (observing that in most derivative suits, plaintiffs' attorneys benefit more than their clients, who usually receive only "minimal compensation").

11. *See* Marcel Kahan & Linda Silberman, Matsushita *and Beyond: The Role of State Courts in Class Actions Invoking Exclusive Federal Claims*, 1996 SUP. CT. REV. 219, 283 n.73 (citing Romano, *supra* note 10, at 55) (concluding that derivative suits are more likely to be frivolous than the other type of shareholder litigation, shareholder class actions).

12. *See infra* notes 118-26 and accompanying text.

turns individual avarice into societal wealth,[13] in the legal system policymakers must take care to craft rules that turn attorneys' self-interest into wealth-maximizing behavior. We must create incentives that reward efficient, wealth-creating activities and deter inefficient, wealth-destroying activities.

Part I.A of this Note discusses the differing incentives between managers and shareholders and explains why managers do not always act in the best interests of the shareholders. Part I.B describes incentives that American law has developed to motivate shareholders and their attorneys to take action against certain types of inefficient management action.[14] Part II discusses the legal debate over the *Bird v. Lida* situation, described above, in which the shareholder and his attorney expend resources, make a demand on the corporation, and create a benefit for the collective shareholders, but do not actually file suit. Finally, Part III suggests two proposals: the first would give plaintiffs' attorneys further incentive to act in wealth-creating ways, while the second would deter plaintiffs' attorneys from engaging in wealth-destroying behavior.

I. SHAREHOLDER OVERSIGHT OF CORPORATIONS

Although there are many corporations that have only a small number of shareholders, the nation's giant corporations, which generally have a large number of shareholders, play a particularly significant role in the economy.[15] It is estimated that the nation's 500 largest corporations control 75% of the United States' industrial assets and are responsible for 75% of the country's new investment.[16] Since such a large percentage of the nation's assets are controlled by corporations, society has a substantial interest in the efficient operation of these corporations; society benefits when corporations use these as-

13. *See* 1 ADAM SMITH, THE WEALTH OF NATIONS 456 (R.H. Campbell et al. eds., Oxford University Press 1976) (1776) (describing how when an individual labors in the economy, though "he intends only his own gain," he is "led by an invisible hand" to promote the economic interests of society).

14. While this Note discusses general corporate law common to most American jurisdictions, it focuses on the corporate law of Delaware, "the dominant corporation law state." Glenn G. Morris, *Shareholder Derivative Suits: Louisiana Law*, 56 LA. L. REV. 583, 585 (1996); *see also* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 125 (7th ed. 1995) (noting that Delaware is "the leading jurisdiction for publicly held corporations").

15. *See* CARY & EISENBERG, *supra* note 14, at 243.

16. *See* MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 117 (1987).

sets in the most efficient manner.[17]

A. Differing incentives between managers and shareholders

The interests of corporate shareholders are aligned with the interests of society; the corporation that acts efficiently will maximize the company's value and thus maximize the value of each shareholder's stock.[18] Shareholders, however, do not run corporations; directors and managers do,[19] and their interests do not always coincide with shareholders' interests.[20] Several factors contribute to this divergence of interest. First, while managers generally own stock in the firm that they manage,[21] they typically own only a small portion of the company, and as such receive only a small percentage of any wealth that their decisions create.[22] Thus, they may not have sufficient incentive to fully use their intellectual capital and labor in the service of the firm. Second, managers are often motivated as much, if not more, by desires for personal power and prestige, as they are by the goal of profit maximization.[23] Third, and perhaps most importantly,

17. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 7 (1991) ("[W]hat is optimal for the [publicly held] firms and investors is optimal for society."). The term "efficiency" refers to the use of resources in a way that maximizes their value. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 11 (4th ed. 1992).

18. *See* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION 30 (1976) ("[A] shareholder's objective is that the corporation maximize its per-share earnings.").

19. *See* Abrams v. Koether, 766 F. Supp. 237, 249 (D.N.J. 1991) ("Under Delaware law, the directors of a corporation, not the shareholders, manage the business and affairs of a corporation."); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("[T]he business and affairs of a Delaware corporation are managed by or under its board of directors."); *see also* CARY & EISENBERG, *supra* note 14, at 242 ("Where shareholdership is highly dispersed [among many shareholders], the corporation will be controlled not by the shareholders, but by management . . . .") (discussing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932)).

20. *See* EASTERBROOK & FISCHEL, *supra* note 17, at 91. Of course, directors and managers are supposed to subjugate their own interest to the interests of the shareholders. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993). However, "[m]any decisions [made by corporate managers] appear to be motivated more by self-interest than by concern for shareholders or even other constituencies. Other decisions appear to be the result of sheer incompetence or inefficiency." Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late*, 43 AM. U. L. REV. 379, 414 (1994).

21. *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 18 (1986).

22. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 10 (1991).

23. *See* EISENBERG, *supra* note 18, at 31.

managers are "overinvested" in a single corporation (the one they manage) while shareholders are "diversified."[24] Shareholders can, and almost always do, invest in a cross-section of securities, including the stocks of numerous corporations.[25] This allows them to reduce their overall risk (the variance of possible returns on their portfolio) without reducing their expected return.[26] This is desirable to them because people are generally risk averse, preferring a lower variance in returns to a higher variance.[27]

Managers, however, cannot diversify their "portfolios" for three reasons. First, managers typically receive, as part of their compensation, stock and/or stock options that they are not allowed to sell.[28] Second, managers are potentially subject to unlimited personal liability in lawsuits based upon their management, while a shareholder's liability is limited to his investment in the company.[29] Finally, a manager's most important "asset" is his job, and this is with only one company.[30]

This overinvestment causes managers to be primarily concerned with the performance of their firm. Managers, like other people, are risk averse;[31] thus, they are more concerned with minimizing risk, particularly the risk of bankruptcy, than with profit maximization.[32] Shareholders, with their diversified portfolios, do not particularly care about the performance of a single firm; instead, they care about the performance of the overall economy and the stock market.[33] Shareholders will thus prefer a high risk-high return strategy to a low risk-low return one, since they are essentially risk-neutral with regard to each individual firm.[34]

---

24. *See* Coffee, *supra* note 21, at 16-20; EASTERBROOK & FISCHEL, *supra* note 17, at 28-29.

25. *See* EASTERBROOK & FISCHEL, *supra* note 17, at 28-30.

26. *See* FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 101-04 (2d ed. 1989) ("Diversification is almost always beneficial to the risk-averse investor since it reduces risk unless returns on securities move perfectly together (which is an extremely rare occurrence).").

27. *See* EASTERBROOK & FISCHEL, *supra* note 17, at 29-30; MISHKIN, *supra* note 26, at 101.

28. *See* Coffee, *supra* note 21, at 18.

29. *See id.*

30. *See id.*; EASTERBROOK & FISCHEL, *supra* note 17, at 17.

31. *See* EASTERBROOK & FISCHEL, *supra* note 17, at 30.

32. *See* Coffee, *supra* note 21, at 19 ("Because the manager cannot spread his risks, or escape them safely in the event of insolvency, he is economically wedded to his firm.").

33. *See id.* ("Once a shareholder has diversified his portfolio, he is in theory largely immune from firm-specific risk . . . .").

34. *See id.*

B. Combating the Collective Action Problem: Current Law

The collective shareholders have a financial interest in monitoring management and taking action when managers act dishonestly or inefficiently. However, monitoring the corporation and taking action against managers costs money.[35] Although the shareholders as a group will often benefit substantially from such outlays,[36] each individual shareholder will get only a small piece of the benefit. This creates a collective action problem:[37] No shareholder has an incentive to engage in activity that would benefit the collectivity, and bear the full costs of such activity when the benefits will be scattered among all of the shareholders.[38]

One tool crafted to encourage attorneys to alleviate this collective action problem is the derivative suit.[39] Derivative suits are used mainly to sue corporate officers and directors for breaches of the fiduciary duties that managers and directors owe to the corporation.[40] When managers or directors have breached their duty to the corporation and its shareholders, a single shareholder can stand derivatively in the corporation's shoes and sue the delinquent individuals.[41] The claim continues to be owned by the corporation, but the shareholder files and manages the lawsuit.[42] If the suit is successful, the corporation (thus the collective shareholders), receives the monetary recov-

35. *See, e.g.*, Bird v. Lida, Inc., 681 A.2d 399, 403 (Del. Ch. 1996) (discussing the expenditure of resources which led to a benefit for the corporation).

36. *See, e.g.*, *id.* at 401-02 (stating that the corporation saved in excess of $680,000 (in 1996 dollars) as a result of a shareholder's action).

37. *See* Macey & Miller, *supra* note 22, at 10.

38. For further discussion of the collective action problem, see MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (2d ed. 1971).

39. The United States Supreme Court has described the derivative suit as the "chief regulator of corporate management." Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949). Commentators have noted that a derivative suit can increase corporate value in two ways: the prospect of a derivative suit may deter misconduct, and the suit itself may yield positive recovery for the corporation even after subtracting all costs that the corporation incurs as a result of the suit. *See* Kraakman et al., *supra* note 10, at 1736.

40. *See* Morris, *supra* note 14, at 584. A fiduciary duty is a "duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person. It is the highest standard of duty implied by law." BLACK'S LAW DICTIONARY 625 (6th ed. 1990). Types of breaches of fiduciary duty include "grossly negligent mismanagement, waste of corporate assets, excessive compensation, usurpation of corporate opportunity, and . . . general self-dealing." Brandi, *supra* note 10, at 360.

41. *See* Morris, *supra* note 14, at 584.

42. *See id.*

ery.[43] The shareholder who brings suit, however, is entitled to have his attorney's fees paid by the corporation.[44] Thus, both the costs and benefits of the action are shared by the whole group. The derivative suit solves the collective action problem in some circumstances because a single shareholder and his attorney can recover money for the collective shareholders (through the corporation), and have their costs, including the attorney's fees, offset by that same group of collective shareholders (again, through the corporation). The derivative suit makes it profitable for shareholders' attorneys to act against certain types of inefficient activity undertaken by corporate managers.

In *Tandycrafts, Inc. v. Initio Partners*,[45] the Delaware Supreme Court expanded the principle behind the derivative suit by awarding attorney's fees to Initio Partners, a shareholder-plaintiff who had sued on its own behalf rather than in the form of a derivative suit. Initio Partners was the largest single shareholder of Tandycrafts.[46] Tandycrafts' management, apparently fearful of a takeover by Initio Partners, proposed to its shareholders an amendment to the corporate charter that would have imposed an 80% supermajority voting requirement for any takeover not approved by the directors.[47] Initio Partners filed suit against Tandycrafts, alleging that the proxy material issued by Tandycrafts' management was materially misleading.[48] Initio Partners alleged, *inter alia*, that the proxy material was deficient because it failed to mention that Tandycrafts' management owned 7.5% of the stock, and the company's employee benefit plan owned 10.9%.[49] Initio Partners argued that the management's control of 18.4% of the stock made the attainment of an 80% supermajority against the wishes of management virtually impossible.[50]

43. *See id.* at 589-90; Mary Elizabeth Matthews, *Derivative Suits and the Similarly Situated Shareholder Requirement*, 8 DEPAUL BUS. L.J. 1, 1 (1995).

44. *See* Morris, *supra* note 14, at 590. If the plaintiff loses, he does not get reimbursed for his legal fees. This is not generally a problem for the shareholder, however, because these cases are usually brought on a contingency fee basis. *See* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 678 (1986). This means that if the plaintiff loses the suit, his attorney gets nothing, not even reimbursement for the expenses of the litigation. *See id.*

45. 562 A.2d 1162 (Del. 1989).

46. *See id.* at 1163. Initio Partners owned 9.9% of Tandycrafts' common stock. *See id.*

47. *See id.*

48. *See id.*

49. *See id.*

50. *See id.*

While discovery on the suit was proceeding, Tandycrafts issued a supplement to its proxy statement that included a disclosure of the combined holdings of the managers and the employee benefit plan.[51] Despite the clarifications, Initio Partners maintained its position that an injunction should be issued barring a shareholder vote on the amendments.[52] Initio Partner's request was denied, the vote was held, and the proposal was "soundly defeated."[53] Having achieved its objective, Initio Partners filed a motion to dismiss its lawsuit and an application for attorney's fees of $180,000 to be assessed against Tandycrafts.[54]

Tandycrafts argued that a shareholder-plaintiff should not be allowed to recover attorneys' fees from the corporation when it sues for its own benefit and not on behalf of a class or derivatively on behalf of the corporation.[55] The Delaware Supreme Court rejected this argument.[56] Noting that attorney fee-shifting is a flexible concept based on the historic equity power of the Court of Chancery,[57] the court held that, "under certain circumstances, counsel fees may be awarded to an individual shareholder whose litigation effort confers a benefit upon the corporation, or its shareholders, notwithstanding the absence of a class or derivative component," and awarded the fees.[58]

The legal principle set forth by the Delaware Supreme Court in *Tandycrafts* is significant. The Delaware Supreme Court ruled that courts should ascertain whether a benefit was conferred upon the larger shareholder group when determining the propriety of fee-shifting.[59] In holding that "the critical inquiry is not the status of the plaintiff but the nature of the corporate or class benefit which is

51. *See id.* at 1163-64.

52. *See id.* at 1164.

53. *Id.*

54. *See id.*

55. *See id.* Tandycrafts also argued that there was no causal connection between Initio Partners' suit and the supplementary material issued by Tandycrafts. *See id.* In fact, there were two causal issues: whether Initio's suit caused Tandycrafts to issue the supplement, and whether the issuance of the supplement caused the proposed amendments to fail. For a discussion of causation and where the burden of proof should be placed for an assessment of attorney's fees, see *infra* Part III.A.1.

56. *See Tandycrafts*, 562 A.2d at 1165.

57. *See id.* at 1166.

58. *Id.* at 1163. The court set out three requirements that must have been met for a petitioning plaintiff to be awarded attorney's fees: "(a) the claim was meritorious when filed; (b) the action was benefiting the corporation; . . . and (c) the benefit was causally related to the lawsuit." *Id.* at 1167.

59. *See Tandycrafts*, 562 A.2d at 1163.

causally related to the filing of suit,"[60] the court rejected formalism in favor of spreading the costs of the lawsuit among the shareholders whom the court found had benefited from the suit. While reaction to this holding has been mixed,[61] the rule set forth in *Tandycrafts* is sound. By allowing the shareholder-plaintiff to spread the costs to those who received the benefit, the court created another tool to deal with the collective action problem, and it gave shareholders and their attorneys greater incentive to monitor corporate management and prevent inefficient behavior.

II. THE NO SUIT-NO FEE RECOVERY DEBATE

As described in Part I.B, Delaware law allows a shareholder to recover his legal expenses when he and his attorney confer a benefit on the corporation through a lawsuit. In *Bird v. Lida, Inc*,[62] however, Bird and his attorney conferred a benefit on the corporation without filing a lawsuit.[63] After acquiring information on the corporation's leases, Bird and his attorney made a demand on the corporation.[64] Such a demand is required under Delaware law before a derivative suit can be filed.[65] Once Lida received Bird's demand and the accompanying information, it remedied the problem, creating value for the corporation.[66] Bird and his attorney, however, had personally incurred the costs that led to that gain. Bird filed suit to recover his

60. *Id.* at 1166.

61. *Compare* Scott R. Haiber, Note, *Derogating the Derivative:* Tandycrafts, Inc. v. Initio Partners *and the Role of Attorneys' Fees in Shareholder Litigation*, 3 DEPAUL BUS. L.J. 213, 214 (1990) (contending that "the holding [of *Tandycrafts*] inadvertently undermines the careful procedural balance constructed around the derivative suit"), *with* Recent Case, *Attorneys' Fees—Substantial Benefit Doctrine—Delaware Supreme Court Grants Fees to Plaintiff Suing as an Individual Shareholder*—Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162 (Del. 1989), 103 HARV. L. REV. 1187, 1187-88, 1192 (1990) (arguing that the court's "decision to force unrepresented shareholders to pay legal fees, although at first surprising, makes sense. The shareholders who benefited from the plaintiff's efforts should bear a portion of the plaintiff's expenses in bringing the suit.").

62. 681 A.2d 399 (Del. Ch. 1996). For a discussion of the facts of this case, see *supra* notes 2-8 and accompanying text.

63. *See* 681 A.2d at 402-05.

64. *See id.* at 401.

65. *See* DEL. CH. CT. R. 23.1. The demand requirement is strictly enforced by Delaware courts. *See* Haber v. Bell, 465 A.2d 353, 357 (Del. Ch. 1983). Most other states have similar requirements, *see* Brandi, *supra* note 10, at 373, as do the federal courts, s*ee* FED. R. CIV. P. 23.1.

66. *See Lida*, 681 A.2d at 401-02.

costs,[67] presenting the issue of whether a shareholder can recover legal expenses incurred when a benefit is conferred on the corporation but no lawsuit is filed.[68]

A. Prior Case Law

The issue presented in *Lida* had been addressed in *Foley v. Santa Fe Pacific Corp*.[69] In *Foley*, an Illinois court applied Delaware law in deciding whether attorneys' fees could be awarded in the absence of a suit.[70] While it noted that Delaware cases had allowed for recovery of attorneys' fees where the underlying lawsuit was settled or rendered moot,[71] the court held that, under Delaware law, no recovery can be granted in a case where no suit has been filed.[72] The *Foley* court based its decision on Delaware case law; it offered no policy rationale for denying recovery in situations in which no suit was filed.

The Southern District of New York addressed the same issue in *Kaufman Malchman & Kirby, P.C. v. Hasbro, Inc.*[73] In that case, Darren Suprina, a shareholder of Hasbro, a Rhode Island Corporation, had demanded, through his attorneys, Kaufman Malchman & Kirby, P.C. (KMK), that Hasbro stop paying royalties on expired patents.[74] After initial hesitation, Hasbro's board of directors decided to substantially comply with Suprina's request.[75] KMK then commenced suit seeking fees for its representation of Suprina.[76]

The court ruled that where no lawsuit had been filed, a plaintiff is categorically denied from recovering his expenses under either Rhode Island or New York law.[77] As a matter of law, the court's

67. *See id.* at 402.

68. While Bird did eventually file a lawsuit seeking recovery of his costs, the corporate benefit had already been conferred as a result of his initial demand on the corporation.

69. 641 N.E.2d 992 (Ill. App. Ct. 1994).

70. *See id.* at 996.

71. *See id.* (citing Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162 (Del. 1989); Sugarland Indus., Inc. v. Thomas, 420 A.2d 142 (Del. 1980)).

72. *See id.*

73. 897 F. Supp. 719 (S.D.N.Y. 1995).

74. *See id.* at 720.

75. *See id.*

76. *See id.*

77. *See id.* at 721-24. The court declined to determine whether New York or Rhode Island law governed, finding that the result under either would be the same. *See id.* at 722. The plaintiff had argued, unsuccessfully, that federal law should apply because patents are created and governed by federal law. *See id.* at 720-21. This is an interesting argument, as the plaintiff had initially filed the suit in a state court, and it was the defendant who removed the suit to federal

ruling was probably correct. Federal courts sitting in diversity cases must apply the substantive statutory and case law of the forum state.[78] If the law of the forum state is unclear, a federal court must predict how the highest court of that state would resolve the issue.[79] It is very unlikely that either the Rhode Island Supreme Court or the New York Court of Appeals would have awarded the fees sought by KMK.[80] Rhode Island statutory law is silent on the issue and the Rhode Island Supreme Court has consistently found that costs will not be awarded unless authorized by a statute or contract.[81] New York permits recovery where "the action on behalf of the corporation was successful, in whole or in part, or if anything was received by the . . . claimant . . . as the result of a judgment, compromise or settlement of an action or claim."[82] The issue for the courts is whether making a demand without filing a lawsuit constitutes an "action" under that statute.[83] In 1962, a New York court held that it does not: "It would be unwise to authorize compensation to counsel for a stockholder whenever management took action beneficial to the corporation as a result of a request or demand by a stockholder."[84]

Unlike the court in *Foley*, the *Hasbro* court offered policy arguments to support the position that fee recovery should not be allowed when no suit has been filed.[85] The court argued that if there were no filing requirement, "shareholders could bring frivolous lawsuits merely to accrue attorneys' fees or to force the company to enter into clandestine settlements,"[86] and concluded that "allowing shareholders to recover attorneys' fees for making a demand would defeat the

court. *See id.* at 720 n.1. State courts do not have jurisdiction over cases arising under the federal patent laws. *See id.* at 721.

78. *See* Erie R.R. v. Tompkins, 304 U.S. 64, 80 (1938).

79. *See id.*; *see also* Travelers Ins. Co. v. 633 Third Assocs., 14 F.3d 114, 119 (2d Cir. 1994) (stating that the court would rule based upon a prediction of how the New York Court of Appeals would resolve the issues).

80. *See Hasbro*, 897 F. Supp. at 722-24.

81. *See id.* (citing Eleazer v. Ted Reed Thermal, Inc., 576 A.2d 1217, 1221 (R.I. 1990); Newport Yacht Management, Inc. v. Clark, 567 A.2d 364, 366-67 (R.I. 1989)). Rhode Island does not even allow fee recovery for plaintiffs in derivative suits. *See id.* at 722.

82. N.Y. BUS. CORP. LAW § 626(e) (McKinney 1986).

83. *See Hasbro*, 897 F. Supp. at 723.

84. Ripley v. International Rys., 227 N.Y.S.2d 64, 68 (N.Y. App. Div. 1962), *aff'd*, 187 N.E.2d 131 (N.Y. 1962).

85. *See Hasbro*, 897 F. Supp. at 723-24.

86. *Id.* at 724 (citing Gordon v. Elliman, 119 N.E.2d 331, 346 (N.Y. 1954); Shapiro v. Magaziner, 210 A.2d 890, 894 (Pa. 1965)).

purpose of the [demand] requirement."[87]

The court's concerns, however, are misplaced. If recovery were based on the plaintiffs' ability to prove that the corporation benefited from the action, frivolous lawsuits or demands would not increase, because frivolous demands, by definition, do not confer a benefit on the corporation. Furthermore, allowing a shareholder to recover his expenses when he has conferred a benefit on the corporation would strengthen, not defeat the demand requirement. Under the system defended by the court, a shareholder or shareholder's attorney has an incentive to share as little information as possible when he makes his demand because he can only recover his legal fees if the corporation does not meet his demand and he is able to file a lawsuit. If recovery was based upon whether a benefit was conferred rather than upon the technical status of the shareholder's claim, the shareholder would have greater incentive to fully inform the corporation at the demand stage and less incentive to go to court.

B. Bird v. Lida, Inc.

A somewhat different result was reached when a Delaware judge interpreted Delaware law in *Bird v. Lida, Inc.*[88] In *Lida*, Chancellor Allen found that a shareholder who confers a benefit on a corporation without filing suit can *sometimes* be awarded attorneys' fees. Allen acknowledged the Delaware Supreme Court's statement that fee-shifting should occur only if "the claim was meritorious when filed,"[89] but argued that to rely on the phrase "when filed" would be to engage in "stunted literalism."[90] Allen chose instead to emphasize the word "meritorious," stating that "[t]he 'when filed' restriction is intended, I suppose, to preclude fee awards in cases that do not have 'merit' . . . when filed, even if discovery later shows the existence of a litigable and settleable case. Thus the 'when filed' term means to discourage derivative suits brought as a 'fishing expedition.'"[91] Allen concluded that this purpose was irrelevant to the issue in *Lida*.[92]

After determining that *Tandycrafts* did not preclude an award to

87. *Id.*

88. 681 A.2d 399 (Del. Ch. 1996). For a discussion of the facts of *Lida*, see *supra* notes 2-8 and accompanying text.

89. Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162, 1167 (Del. 1989).

90. *Lida*, 681 A.2d at 404-05.

91. *Id.* at 405.

92. *See id.*

James Bird of his legal expenses, Chancellor Allen turned to *Kaufman v. Shoenberg*,[93] a 1952 Court of Chancery case. In *Kaufman*, then-Chancellor Seitz[94] held that "a stockholder is entitled to his reasonable investigation fees if his demand produces some real benefit to the Corporation without the necessity for litigation."[95] Although *Kaufman* was not direct precedent because in that case a suit had been filed,[96] Chancellor Allen found this factual distinction to be irrelevant. He held that *Kaufman* required him to recognize a shareholder's right to recover investigation fees including attorney's fees, in connection with the making of a demand pursuant to Delaware Chancery Court Rule 23.1[97] under certain circumstances.[98] Allen buttressed his legal conclusion with policy arguments[99] concluding, among other things, that Bird's demand, which led to a nearly $700,000 gain for the collective shareholders, appeared to be "the sort of activity that rational shareholders would encourage and would agree to reimburse [if] they had the relevant information *ex ante*."[100]

Chancellor Allen's "economic analysis" led him to recognize "a powerful argument in favor of" reimbursement of expenses by a shareholder whose "meritorious" demand has led to a quantifiable benefit for the corporation.[101] Nevertheless, James Bird did not prevail. Theory and practice convinced Allen to reject one arbitrary technical rule: that the presence or absence of a filed suit would de-

93. 92 A.2d 295 (Del. Ch. 1952).

94. Collins Seitz later served as Chief Judge of the United States Court of Appeals for the Third Circuit.

95. *Kaufman*, 92 A.2d at 295.

96. *See id*. As in *Tandycrafts*, the suit in *Kaufman* was dismissed before the litigation could be completed. *See id.* For further discussion of the facts of *Kaufman*, see *Kaufman v. Shoenberg*, 91 A.2d 786, 788-90, 793-94 (Del. Ch. 1952) (holding that in a shareholder action to enjoin a corporation from implementing a stock option plan for key employees, the agreement of employees, to whom options were given, that they would remain in employment for two years constituted legal consideration for the grant of the options).

97. For a discussion of the importance of Rule 23.1, see *supra* note 65 and accompanying text.

98. *See Bird v. Lida, Inc.*, 681 A.2d 399, 405 (Del. Ch. 1996). Those circumstances are:

> at least (1) the presentation of a meritorious corporate claim by a shareholder, (2) the expenditure of funds or credit by the shareholder in investigating such claim, (3) action by the board that confers a quantifiable financial benefit on the corporation, (4) which action is causally related to the making of the shareholder demand.

Id.

99. *See Lida*, 681 A.2d at 402-05 (arguing that awarding fees in this context would reward behavior that is beneficial to shareholders without encouraging "frivolous" demands).

100. *Id.* at 403.

101. *Id.*

termine whether a shareholder could recover his costs.[102] However, refusing to allow economic analysis to take him too far from traditional legal analysis,[103] Allen instituted another arbitrary technical rule: that a shareholder can only recover costs if he makes a "meritorious" corporate claim in the Rule 23.1 demand.[104] To be indemnified for his costs under Chancellor Allen's rule, James Bird's demand would have to "involve not simply a claim of business suboptimization, but a 'meritorious' claim of legal (including equitable) wrong."[105] Under Delaware law, a claim is only meritorious if the plaintiff can prove facts that give him a reasonable chance of prevailing at trial.[106] If the court is convinced that the shareholder presenting the demand would not have been able to compel the corporation to capitulate to the demand in a lawsuit, the shareholder cannot recover expenses, regardless of the economic benefit his actions may have conferred upon the corporation.

Chancellor Allen found that if James Bird's demand had been disregarded by Lida and Bird had filed a lawsuit, his suit would not have been meritorious because the "unreasonable" leases of which Bird complained were entered into before Bird or any other public shareholder acquired stock.[107] No public shareholder had actually been wronged by the leases,[108] because the market price of the stock when the public shareholders bought it reflected the unfair leases.[109] Thus, the $680,000 gained by the corporation as a result of Bird's demand were windfall profits to the shareholders. It is ironic that if

102. *See id.* at 404-05.

103. *See id.* Allen reasoned:

> The law comprises more than the determination of contested facts and the unmediated application of principles of economic efficiency . . . . While notions of economic efficiency will appropriately play a role in the myriad instances in which common-law courts shape the law interstially [sic], case by case, courts do tend to look . . . to concerns more directly affecting legal values. Thus, courts are primarily concerned with legal values such as procedural fairness; fidelity to authoritative pronouncements of substantive law; the application of a professionally defined canon of construction techniques to produce legal meanings; and the acceptance of an established hierarchy of authority. . . . [I]t is not satisfactory for a court to begin and end its analysis of a legal problem with . . . economic analysis . . . .

Id. at 403.

104. *See id.* at 405-06.

105. *Id.* at 406.

106. *See* Chrysler Corp. v. Dann, 223 A.2d 384, 387 (Del. 1966).

107. *See Lida*, 681 A.2d at 406.

108. *See id.*

109. *See id.* at 406 n.4 ("[T]he market priced what the buyer was buying, warts and all. It would be neither fair nor efficient to permit later complaints about a disclosed wart.").

the shareholders had been entitled to the $680,000,[110] they would have had to pay Bird's expenses. However, because they were not legally entitled to the $680,000, they received it for free. Under the rule of *Bird v. Lida, Inc.*, shareholders must pay for what they are entitled to, but they do not have to pay for undeserved gains.

As Chancellor Allen seems to realize, economic analysis does not justify this distinction.[111] However, Allen balanced economic efficiency against "certain legal institutional concerns."[112] He argued that awarding fees for a "meritorious" demand was only a "small step" from fee-shifting in litigation, and one that was required by *Kaufman*, while awarding fees for a nonmeritorious demand that confers the same benefit upon the corporation was a "larger step."[113] While Allen conceded that this "larger step" "would certainly be rational," he concluded that it was not sufficiently "supported by existing legal authorities to warrant judicial adoption at this time."[114]

It is not clear how Chancellor Allen can read *Kaufman* as compelling precedent for his "small step," but not for the "larger step." Chancellor Seitz did not address the issue of "merit" in his eight sentence opinion in *Kaufman*. To Seitz, the issue was "whether, as a matter of law, a stockholder is entitled to his reasonable investigation fees if his demand produces some real benefit to the Corporation without the necessity for litigation."[115] Seitz held that a stockholder is entitled to such fees if he can prove that his demand produced a benefit for the corporation.[116] Seitz extended recovery in this way because, "substantially the same benefit accrues to the Corporation whether it be as the result of the demand or of successful litiga-

110. That is, had they been wrongfully deprived of the money by the directors and then gotten it as the result of a "meritorious" demand.

111. *See Lida*, 681 A.2d at 407. Specifically, Chancellor Allen stated:

> [I]f we appreciate the collective action problem of shareholders and the neat solution to the collective action problem that paying a bounty to successful shareholders['] lawyers represents, why should the law care whether Mr. Bird conferred a benefit through a meritorious legal claim or through stimulating the board simply to act in a way he correctly thought was advantageous? In either event the collective action problem of shareholders was overcome and a substantial financial benefit was realized by the corporate collectivity.

Id.

112. *Id.*

113. *Id.*

114. *Id.*

115. Kaufman v. Shoenberg, 92 A.2d 295, 295 (Del. Ch. 1952).

116. *See id.*

tion."[117] Since Bird and his attorney produced a "real benefit" of over $680,000 for the corporation, the logic, as well as the language, of *Kaufman* would seem to counsel in favor of recovery for James Bird.

III. PROPOSALS

In our adversarial system, attorneys are expected to be loyal advocates, zealously carrying out their clients' wishes.[118] Plaintiffs' attorneys in shareholder suits, however, do not fulfill this role.[119] In shareholder litigation, the attorney usually represents all the shareholders of a given corporation (class action) or the corporation itself (derivative suit).[120] In such cases, the attorney is almost always the driving force behind the litigation.[121] The attorney is an entrepreneur, seeking opportunities to increase his personal wealth.[122] He will generally find a promising suit first and then look for a "client" to allow him to bring the suit.[123] Once the suit has commenced, the attorney remains the decisionmaker, with the client serving as a mere figurehead.[124] The decisions made by the entrepreneur-attorney, both be-

117. *Id.*

118. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(a) (1992) ("A lawyer shall abide by a client's decisions concerning the objectives of representation . . . and shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter."); Coffee, *supra* note 44, at 677.

119. *See* Macey & Miller, *supra* note 22, at 3.

120. *See id*. at 9-11. There are some cases where an attorney represents a single plaintiff in a shareholder suit. *See, e.g.*, Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162, 1163 (Del. 1989) (recognizing as the plaintiff a corporation that was the largest single stockholder in the defendant corporation).

121. *See* Macey & Miller, *supra* note 22, at 7-8 (noting that plaintiffs' attorneys in shareholder suits "are not subject to monitoring by their putative clients, [and thus] they operate largely according to their own self-interest"); Coffee, *supra* note 44, at 677-79 (discussing evidence that class actions and derivative suits are generally attorney-motivated).

122. *See* Macey & Miller, *supra* note 22, at 3.

123. *See* Coffee, *supra* note 44, at 679 (describing the plaintiffs' attorney as a "bounty hunter" who is "motivated to prosecute legal violations still unknown to prospective clients"). Both class action and derivative suits require nominal plaintiffs, *see* Macey & Miller, *supra* note 22, at 5; however, "identifying and securing a nominal plaintiff is often only a necessary procedural step that seldom poses a substantial barrier," Coffee, *supra* note 44, at 682.

124. *See* Macey & Miller, *supra* note 22, at 5; *see also* Piambino v. Bailey, 757 F.2d 1112, 1144 (11th Cir. 1985) (reprimanding the plaintiffs' attorneys for not serving the interests of all their clients); Foster v. Boise-Cascade, Inc., 420 F. Supp. 674, 681, 695 (S.D. Tex. 1976) (recognizing the plaintiffs' attorneys' incentive to settle a case when settlement is not necessarily in the best interests of the clients and rejecting the attorneys' fee of $12,000, arrived at in a settlement with the defendant-corporation, as unreasonable), *aff'd*, 577 F.2d 335 (5th Cir. 1978).

fore and after the suit has been filed, reflect the attorney's own interests and not those of the client.[125] Because the plaintiffs' attorney controls the litigation, it is necessary to align the incentives of plaintiffs' attorneys with those of general wealth maximization.[126]

A. Recovery for a Benefit Conferred

1. *A New Question for Courts.* The question that should be asked in fee recovery cases is: "Was a benefit conferred upon the corporation as a result of costs borne by the shareholder and his attorney?" If the answer is "yes," then the corporation should be required to compensate the shareholder for his costs, including legal fees.[127] Courts should be directed to focus on economic solutions such

125. *See* Macey & Miller, *supra* note 22, at 4 (stating that "the plaintiff's attorney—not the client—controls the litigation").

126. *See id.* at 3-4.

127. Fee recovery should be granted only if the benefit to the corporation exceeds the fees generated by the shareholder. If the fees are greater than the benefits, the action was not efficient, and should not be rewarded or encouraged. While this point may seem obvious, at least one court, acting in a class action setting, has allowed plaintiffs' attorneys to collect fees far in excess of the benefit that they created. In *Kamilewicz v. Bank of Boston Corp.*, Judge Frank Easterbrook discussed a class action suit in which an Alabama state court had allowed a settlement that granted the plaintiff's attorneys more money than was recovered from the defendants:

> A class action contending that the Bank of Boston and its affiliates (collectively, the Bank) did not promptly post interest to real estate escrow accounts was filed in Alabama by a Chicago law firm. Settlement ensued, and the class members learned only what the notice told them. Few opted out or objected, because the maximum award to any class member was less than $9. Any recovery, however small, seemed preferable to initiating a separate suit or even bearing the costs of protesting the settlement's terms. After the state judge approved the pact, the Bank carried out its part: it disbursed more than $8 million to the class attorneys in legal fees and credited most accounts with paltry sums. Problem: the [legal] fees, equal to 5.32 percent of the balance in each account, were debited to the accounts. For many accounts the debit exceeded the credit. Dexter J. Kamilewicz, for example, received a credit of $2.19 and a debit of $91.33, for a loss of $89.14.

100 F.3d 1348, 1349 (7th Cir. 1996) (citation omitted) (denying a petition for a rehearing en banc of *Kamilewicz v. Bank of Boston Corp.*, 92 F.3d 506 (7th Cir. 1996)) (Easterbrook, J., dissenting). The United States Court of Appeals for the Seventh Circuit refused to set aside this result because it found that it did not have jurisdiction. *See Kamilewicz*, 92 F.3d at 509. This was because federal courts, other than the Supreme Court, do not have jurisdiction to review decisions of state courts. *See* District of Columbia Court of Appeals v. Feldman, 460 U.S. 462, 476 (1983); Rooker v. Fidelity Trust Co., 263 U.S. 413, 415 (1923); Hoover v. Wagner, 47 F.3d 845, 849 (7th Cir. 1995).

While the outcome of *Kamilewicz* is unjust, such an outcome in the derivative suit or shareholder demand context would be even more egregious because, unlike in the class action context, there would be no right to "opt out." For further discussion of questionable settlements of shareholder suits, see Brandi, *supra* note 10, at 392 (stating that "courts quite often as giving shareholders and attorneys the incentive to solve the collective action problem, rather than technicalities such as whether a suit was classified as a derivative or individual suit,[128] whether a suit was filed or merely threatened,[129] or whether the benefit resulted from "righting a wrong" or simply increasing efficiency.[130] If a shareholder can prove that his action, which entailed costs such as attorneys' fees, created a benefit for the corporation, then he should be indemnified by the corporation.

This would place a two-part burden of proof on the shareholder and his attorney. First, they would have to prove the existence of a benefit to the corporation. Second, they would have to prove that their actions *caused* that benefit. Placing this burden of proof on the shareholder is a departure from the present law governing fee-shifting after a derivative suit is filed. Under current law, "[o]nce it is determined that action benefiting the corporation chronologically followed the filing of a meritorious suit, *the burden is upon the corporation* to demonstrate 'that the lawsuit did not in any way cause [its] action.'"[131] However, placing the burden on the corporation to prove that the corporate benefit did not result from the demand might encourage plaintiffs' attorneys to demand that a corporation undertake an action the corporation had already planned to take in the hope that the corporation would not be able to prove its prior intention. Furthermore, in light of the fact that the Delaware Supreme Court has held that noneconomic benefits, such as changes in corporate policy or increased corporate disclosure, can justify an award of attorneys' fees,[132] it would be virtually impossible, in many cases, for a corporation to prove that a specific noneconomic change did not confer a benefit on the corporation. This would result in shareholders being rewarded for actions that created change but did not actually benefit the corporation,[133] and were thus not efficient actions. Placing

approve settlements that involve only cosmetic procedural relief for the shareholders but at the same time grant high attorney fees" (footnote omitted)); Romano, *supra* note 10, at 84; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 26-33.

128. *See supra* notes 45-61 and accompanying text.

129. *See supra* Part II.

130. See *supra* notes 101-17 and accompanying text.

131. Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162, 1165 (Del. 1989) (quoting Allied Artists Picture Corp. v. Baron, 413 A.2d 876, 880 (Del. 1980)) (emphasis added).

132. *See id.* at 1164-65; *see also* Chrysler Corp. v. Dann, 223 A.2d 384, 386 (Del. 1966).

133. One quarter of shareholder settlements result in structural relief. *See* Romano, *supra* note 10, at 84. In most of these cases, the changes are merely cosmetic. *See id.* It seems likely

the burden of proof on the shareholder is consistent with the general common law tradition that the plaintiff bears the burden of proof in civil suits. Furthermore, it is consistent with Chancellor Seitz's holding that a shareholder is entitled to recover costs only "if *he* is able to substantiate his contention factually."[134]

2. *The Business Judgment Rule.* The business judgment rule might be perceived as an obstacle to the expansion of recovery for shareholders who confer a benefit upon the corporation, but it is not. The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[135] Under the business judgment rule, courts will defer to business decisions made by disinterested directors unless the plaintiff can prove an abuse of discretion by the directors.[136] In Delaware, courts require a showing of "gross negligence" before they will conclude that the directors abused their discretion.[137]

recover, regardless of how much benefit would have accrued to the corporation if the board had accepted the demand. Directors would be under a fiduciary duty to accept the demand if they believed that it was in the best interests of the corporation,[138] but they would be free to use their business judgment and reject any demand that they found was not in the corporation's best interest. The shareholder could then proceed with a derivative or individual suit and recover his fees if the suit was successful. This is unchanged from current law.[139]

B. Striking Back at Strike Suits

1. *The English Solution: Making the Loser Pay*. The proposal put forth in Part III.A.1 would give an incentive to plaintiffs' attorneys to act in an efficient, wealth-maximizing way. However, there is an equally important need for a disincentive to deter these attorneys from acting in wealth-destroying ways. Attorneys act destructively when they bring "strike suits"[140]—shareholder suits which would not win in court on their merits, and which have no potential to benefit the corporation—for the purpose of inducing the corporation to settle in order to avoid the costs and disruptions of litigation. Unfortunately, the strike suit is a common occurrence.[141] Although strike suits are meritless,[142] corporations and their officers

138. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (noting that "[i]n exercising [their] powers, directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders"); *see also* Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995) ("[A]ny exercise of . . . managerial power is tempered by the fiduciary duties which directors owe to the corporation and its shareholders.").

139. *See supra* Part I.B.

140. "The term 'strike suit,' coined in the 1930s, refers to a derivative action whose nuisance value gives it a settlement value independent of its merits." Brandi, *supra* note 10, at 357 n.1 (citing Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308 (1934)).

141. *See id.* at 369 (noting that "powerful incentives seem to exist to bring nonmeritorious actions for their nuisance and settlement value") (citing PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 589 (Proposed Final Draft 1992)); *see generally* Coffee, *supra* note 44, at 677-84 (exploring the monetary incentives which may encourage plaintiffs' attorneys to overpursue derivative actions); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 534-45 (1991).

142. It should be noted that "meritless" as it is used in this Note is different from "frivolous." "A claim or defense is frivolous if a proponent can present no rational argument based upon the evidence or law in support of that claim or defense." BLACK'S LAW DICTIONARY 668 (6th ed. 1990) (citing Liebowitz v. Aimexco Inc., 701 P.2d 140, 142 (Colo. Ct.

have powerful incentives to settle them. The corporation must bear the litigation expenses to fight the suit, and, perhaps more significantly, the existence of a pending lawsuit may have a substantial deleterious effect on the defendant's normal business activity.[143] These incentives to settle make meritless strike suits profitable for attorneys.

The proper disincentive for these meritless suits is to require a plaintiff who loses on the merits to reimburse the defendant for a portion of its litigation expenses.[144] This rule is fair because a shareholder who files a meritless lawsuit unilaterally thrusts costs upon the corporation and its shareholders. This rule is efficient because it would encourage corporations to fight meritless lawsuits rather than settle them, providing a powerful deterrent to these destructive suits. Finally, this rule is necessary because other attempts to deter frivolous shareholder litigation, such as the contemporaneous ownership rule[145] and security-for-expense statutes,[146] are inadequate; those fee-shifting provisions are not related to the merits of the case and thus

App. 1985)). In this Note, a suit is "without merit" or "meritless" if, after the completion of legal proceedings, including any appeals, the plaintiff has lost. It is entirely possible that a plaintiff could have rational arguments for his position (thus making his claim nonfrivolous) but still lose (thus making his claim meritless), as the defendant may have stronger rational arguments for its position.

143. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975). Part of the disruption of normal business activity stems from "[t]he prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents." *Id.* at 741. The *Blue Chip* opinion "discusses particularly the merits and dangers of class [action shareholder suits]. However, [the Court's] considerations are equally valid for derivative suits." Brandi, *supra* note 10, at 370 n.77; *see also* EASTERBROOK & FISCHEL, *supra* note 17, at 106 (stating that the real costs of a derivative suit include "the opportunity costs of the managers' time devoted to defense"); Alexander, *supra* note 141, at 571 (stating that pending litigation may distract the efforts of employees who participate in the litigation, harm the company's reputation, limit the company's ability to obtain additional financing, and curtail business options, such as mergers or acquisitions).

144. It is unlikely that the court could order relief that would entirely offset the costs of the litigation. As difficult as it is to assess the value of legal services rendered, it is plausible that a court could do so. However, it would be virtually impossible to put a dollar value on wasted time of corporate employees, disruption in business, or business documents released in the discovery process.

145. "The contemporaneous ownership rule, as it exists in the majority of jurisdictions, requires either that the derivative suit plaintiff was a shareholder at the time of the transaction which is the subject of the complaint or that the plaintiff thereafter obtained the shares by operation of law." Brandi, *supra* note 10, at 372 (citing ROBERT CHARLES CLARK, CORPORATE LAW 650 (1986)).

146. "Security-for-expenses statutes, which exist in about one-third of the states, give corporate defendants the right to demand that the shareholder-plaintiff post security for the payment of defendants' reasonable litigation expenses before filing suit." *Id.* (footnotes omitted).

affect meritorious as well as nonmeritorious suits.[147]

2. *The "American Rule."* A potential hurdle for the proposal put forth in Part III.B.1 of this Note is the "American rule" on fee-shifting. While the majority of the world's industrialized democracies require lawsuit losers to pay some or all of the winners' attorneys' fees, the rule in the United States continues to be that each party is responsible for its own fees.[148] The American rule has been riddled with legislatively created exceptions at both the state and federal level.[149] Nevertheless, the United States Supreme Court indicated in *Alyeska Pipeline Service Co. v. The Wilderness Society*[150] that the American rule continues to be the general rule in the United States.[151] However, this affirmation of the American rule may not be as rigid as it first appears; in *Alyeska*, the Court simply stated that lower courts should follow the rule in the absence of statutory direction. The court made it clear that it was not taking any position on whether the American rule was good policy.[152] *Alyeska* is an exercise in judicial restraint[153] rather than an endorsement of the merits of the American

147. *See id.*

148. *See* Thomas D. Rowe, Jr., *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651, 651.

149. *See id.* Examples at the federal level include the following: Amendments to Freedom of Information Act, 5 U.S.C. § 552(a) (1994); Packers and Stockyards Act, 7 U.S.C. § 210(f) (1994); Perishable Agricultural Commodities Act, 7 U.S.C. § 499g(b) (1994); Bankruptcy Act, 11 U.S.C. §§ 330(a)(1), 503(b)(4) (1994); Clayton Act, 15 U.S.C. § 15 (1994); Unfair Competition Act, 15 U.S.C. § 72 (1994); Securities Act of 1933, 15 U.S.C. § 77k(e) (1994); Trust Indenture Act of 1939, 15 U.S.C. § 77www(a) (1994); Securities Exchange Act of 1934, 15 U.S.C. §§ 78i(e), 78r(a) (1994); Consumer Credit Protection Act, 15 U.S.C. § 1640(a)(3) (1994); 17 U.S.C. § 116 (copyrights); Organized Crime Control Act of 1970, 18 U.S.C. § 1964(c) (1994); Norris-LaGuardia Act, 29 U.S.C. § 107(e) (1994); Fair Labor Standards Act of 1938, 29 U.S.C. § 216(b) (1994); Longshoremen's and Harbor Workers' Compensation Act, 33 U.S.C. § 928 (1994); Federal Water Pollution Control Act of 1972, 33 U.S.C. § 1365(d) (1994); Marine Protection, Research, and Sanctuaries Act of 1972, 33 U.S.C. § 1415(g)(4) (1994); 35 U.S.C. § 285 (relating to patent infringement); 42 U.S.C. § 7604(d) (1994) (relating to clean air standards); Civil Rights Act of 1964, 42 U.S.C. § 2000a-3(b) (1994), and § 706(k), 78 Stat. 261 (codified at 42 U.S.C. §§ 2000a-3(b), 2000e-5(k) (1994)); Noise Control Act of 1972, 42 U.S.C. § 4911(d) (1994); Communications Act of 1934, 47 U.S.C. § 206 (1994); FED. R. CIV. P. 37(a), (c).

150. 421 U.S. 240 (1975).

151. *See id.* at 271.

152. *See id.* at 270 ("We do not purport to assess the merits or demerits of the 'American Rule' with respect to the allowance of attorneys' fees.").

153. *See id.* at 271 ("[I]t is not for us to invade the legislature's province by redistributing litigation costs . . . ."); *see also* THE FEDERALIST NO. 48, at 310 (James Madison) (Clinton Rossiter ed., 1961) (discussing the "superiority" of the legislature over the judiciary); THE FEDERALIST NO. 78, at 465-66 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (discussing the founders' view of the judiciary as "beyond comparison the weakest of the three depart-

rule, and the decision leaves to Congress at the federal level, and by analogy, to state legislatures at the state level,[154] the prerogative to reverse the American rule completely, or to enact further exceptions where there is reason to do so.

There have been many appeals to reverse the American rule in its entirety.[155] However, the proposal put forth in this Note would

ments of power . . . ."); David Luban, *Justice Holmes and the Metaphysics of Judicial Restraint*, 44 DUKE L.J. 449, 450 (1994) ("It is a platitude of our political culture that judicial self-restraint should likewise be numbered among the judicial virtues, alongside incorruptibility, disinterest, fairness, and wisdom.").

154. *Alyeska* constrains only federal courts. *See* 421 U.S. at 269. However, many state high courts have issued similar opinions stating that the American rule is the rule for courts to follow absent statutory instruction. *See, e.g.*, Eleazer v. Ted Reed Thermal, Inc., 576 A.2d 1217, 1221 (R.I. 1990) ("[T]he right to collect attorney's fees did not exist at common law and . . . consequently such fees may be taxed only when there is . . . specific statutory authority . . . ."); Jackson v. Town of Searsport, 456 A.2d 852, 855 (Me. 1983) ("In our state, as elsewhere in this country, the 'American Rule' for attorney's fees is followed: each party pays the costs of his own lawyers."); Hamer v. Kirk, 356 N.E.2d 524, 528 (Ill. 1976) (citing with approval the holding of *Alyeska*). The rule in Delaware is actually slightly more lenient than the federal rule. The American rule applies generally in Delaware, but fee-shifting is allowed if there is an applicable statute *or* a court-created "equity doctrine." Goodrich v. E.F. Hutton Group, Inc., 681 A.2d 1039, 1043-44 (Del. 1996); *see also* Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162, 1166 (Del. 1989) (discussing the "common benefit exception" which allows courts to use their equity powers to shift attorneys' fees).

155. *See* Rowe, *supra* note 148, at 651 ("In recent decades, the American rule of no attorney fee shifting has come under increasing questioning and criticism."). For recent examples of criticism of the American rule, see PRESIDENT'S COUNCIL ON COMPETITIVENESS, AGENDA FOR CIVIL JUSTICE REFORM IN AMERICA 24 (1991) ("The 'loser pays' rule (sometimes called the English Rule) is grounded in fairness—in the equitable principle that a party who suffers should be made whole. Where the rule operates, it also prompts more realistic case evaluations."); Lucian Arye Bebchuk & Howard F. Chang, *An Analysis of Fee Shifting Based on the Margin of Victory: On Frivolous Suits, Meritorious Suits, and the Role of Rule 11*, 25 J. LEGAL STUD. 371, 371 (1996) (noting that the American rule "does not induce optimal litigation decisions"); Gregory A. Hicks, *Statutory Damage Caps Are an Incomplete Reform: A Proposal for Attorney Fee Shifting in Tort Actions*, 49 LA. L. REV. 763, 793 (1989) (arguing that a "prevailing plaintiff fee shifting system" would, more than the American rule, "encourage the bringing of strong claims"); Gregory E. Maggs & Michael D. Weiss, *Progress on Attorney's Fees: Expanding the "Loser Pays" Rule in Texas*, 30 HOUS. L. REV. 1915, 1915-37 (1994) (arguing that a loser pays rule is preferable to the American rule: "A loser pays rule . . . would benefit the legal system as a whole in two ways. First, it would reduce the tendency of attorney's fees to thwart the substantive goals of [the law]. Second, it would encourage meritorious lawsuits while discouraging frivolous ones."); Keith N. Hylton, *Fee Shifting and Incentives to Comply with the Law*, 46 VAND. L. REV. 1069, 1120-21 (1993) (contending that the American rule was the "unintended byproduct of mercantilist interests" and that a rule that shifts fees in favor of prevailing plaintiffs promotes both compliance with legal rules and the settlement of disputes); Lorraine Wright Feuerstein, Comment, *Two-Way Fee Shifting on Summary Judgment or Dismissal: An Equitable Deterrent to Unmeritorious Lawsuits*, 23 PEPP. L. REV. 125, 128 (1995) ("The American rule provides no deterrent to groundless litigation. In fact it invites spurious claims.") (citing further scholarly criticism of the American rule); Bradley L. Smith, Note, *Three Attorney Fee-Shifting Rules and Contingency Fees: Their Impact on Settlement In-*

simply add to the many legislative exceptions to the rule. Such an exception is warranted by the fact that securities suits in general, and derivative suits in particular, are the subjects of particular abuse by plaintiffs' attorneys.[156] There are two additional reasons why the case for a "loser pays" rule[157] is stronger in the derivative suit context than in other civil suits. First, unlike in most civil suits, under existing law, the shareholder-plaintiff in a derivative suit can force the corporation to pay his legal fees if he wins or favorably settles his suit.[158] Requiring plaintiffs in suits which destroy rather than create corporate value (i.e., suits in which the corporation expends economic resources defending the suit, but where the plaintiff's claim turns out to be without merit) to pay the corporation's legal fees would level the playing field between plaintiffs and defendants.

Second, the argument most often advanced against a "loser pays" rule is particularly weak in the derivative suit context. This argument goes as follows: A "good faith" plaintiff would run the risk of being financially punished for advancing what he believed to be a legitimate claim that turns out to be meritless. This risk, it is argued, would scare potential plaintiffs and chill meritorious lawsuits.[159] However, since shareholder suits are generally brought by "entrepreneur" attorneys, with clients acting as mere figureheads, attorneys generally advance the litigation expenses, receiving reimbursement, including a fee, only if they are successful.[160] The risk of having to remunerate a victorious defendant would be an additional cost that the entrepreneurial plaintiffs' attorney could and would bear in order to get potentially profitable cases. The attorney would still bring cases that have strong probabilities of success, because even if there were an occasional loss, the attorney could cover the costs with his gains from his victorious efforts. However, the plaintiffs' attorney would be much less likely to bring meritless claims in the hope of set-

centives, 90 MICH. L. REV. 2154, 2186 (1992) (concluding that the American rule, when compared with other possible fee-shifting rules, is "least conducive to settlement").

156. *See supra* notes 9-11, 140-43 and accompanying text.

157. The "loser pays" rule is sometimes referred to as the "English rule" because it has been the rule in England for centuries. *See Alyeska*, 421 U.S. at 247. The rule was imposed there by statute. *See id.*

158. *See supra* note 44 and accompanying text.

159. For statements of this argument, see Lee Goldman, *The World's Best Article on Competitor Suits for False Advertising*, 45 FLA. L. REV. 487, 515 (1993); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 26 (1990); Smith, *supra* note 155, at 2155.

160. *See* Coffee, *supra* note 44, at 678.

tlement, as these would be likely to result in large losses for the attorney.

CONCLUSION

Plaintiffs' attorneys in shareholder litigation serve an important role in deterring and punishing certain types of inefficient action by corporate managers and directors. The derivative suit facilitates this role, allowing successful attorneys to recover fees from the corporation, and thus providing the necessary incentive for attorneys to police corporate inefficiency. However, current law in this area is both under- and over-inclusive. In certain situations, attorneys and shareholders are not compensated or rewarded for wealth-creating activity,[161] and thus that beneficial activity is not encouraged; in other situations attorneys are rewarded for wealth-destroying actions,[162] encouraging this detrimental activity. This Note provides two proposals that would alleviate these problems. The collective action problem, which hinders shareholder oversight of management, can be overcome by allowing shareholders who confer a benefit on the corporation to recover their attorneys' fees from the corporation. This would encourage future James Birds and their attorneys to add value to the economy. Similarly, the "strike suit" problem, through which unscrupulous shareholders and attorneys cause harm to the corporation, could be greatly reduced by requiring the shareholder-plaintiff to pay the corporation for the unnecessary legal costs he caused it to incur.

One hundred years after Oliver Wendell Holmes predicted that the "man of the future" would be "the master of economics,"[163] economic analysis plays an increasingly large role in the formulation of American law and public policy.[164] As Chancellor Allen demon-

161. *See, e.g.*, Kaufman Malchman & Kirby, P.C. v. Hasbro, Inc., 897 F. Supp. 719, 722-24 (S.D.N.Y. 1995) (holding that a law firm that represented a shareholder who had successfully demanded that a toy manufacturer stop paying license fees on expired patents without instituting litigation was not entitled to recover attorney fees under Rhode Island or New York law); *Lida*, 681 A.2d at 407 (holding that a shareholder could not recover attorney's fees, even though his demand resulted in a benefit to the corporation); Foley v. Santa Fe Pac. Corp., 641 N.E.2d 992, 996 (Ill. App. Ct. 1994).

162. *See supra* notes 9-11, 140-43 and accompanying text.

163. HOLMES, *supra* note 1, *reprinted in* 3 THE COLLECTED WORKS OF JUSTICE HOLMES, *supra* note 1, at 399.

164. *See* POSNER, *supra* note 17, at 19 (noting the recent application of economics to all aspects of the legal system). Former Supreme Court nominee Robert Bork observed:

> One of the most startling, and I think beneficial, developments in the law has been the relatively recent spread of economic learning among judges (even more perhaps

strated in *Lida*, however, economic analysis is not always determinative.[165] This Note does not disagree with Allen's assertion that the law is and should be concerned with values other than economic efficiency.[166] The values which concerned Chancellor Allen, "procedural fairness; fidelity to authoritative pronouncements of substantive law; [canons of construction]; and the acceptance of an established hierarchy of authority,"[167] are certainly important. Other noneconomic values such as substantive fairness, democracy and the rule of law, equality, and individual rights are even more important, and will often (properly) lead courts away from the most efficient outcome. Additionally, it may be, as Chancellor Allen noted in *Lida* and the United States Supreme Court noted in *Alyeska*, that the changes advocated by this Note would be better made by legislatures than courts.[168] Legislators should not be deterred from making new rules that will increase economic efficiency simply because the old rules are long-standing.

> among their clerks), among professors in law schools, among practitioners . . . and in many other segments of the policymaking and lawmaking world. . . . It's the spread of basic economic concepts and the awareness of economic ideas to noneconomists that is so unexpected and so promising. One does not have to be a real economist to benefit, because microeconomics is a field in which the simple ideas are the most powerful ideas.

Robert H. Bork, *The Role of the Courts in Applying Economics*, 54 ANTITRUST L.J. 21, 21-22 (1985).

165. *See* Bird v. Lida, Inc., 681 A.2d 399, 403 (Del. Ch. 1996).

166. *See generally* Bork, *supra* note 164, at 22 (arguing that people should not suffer under "the delusion that all of the law's problems can usefully be analyzed through economics"). *But cf.* POSNER, *supra* note 17, at 3 (arguing that "economics is a powerful tool for analyzing a vast range of legal questions").

167. *Lida*, 681 A.2d at 403.

168. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc., 421 U.S. 240, 271 (1975); *Lida*, 681 A.2d at 403.