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Commentary: Response to Duesenberg's Article "A View From the Inside"

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COMMENTARY

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The application of the “business judgment” rule to decisions by boards of directors or committees not to proceed with derivative litigation against directors or management raises novel and difficult questions. Mr. Duesenberg’s well written article ably presents one side of this controversy; as he states, he is offering “a defense of the rule in its more expansive application.”¹ Mr. Duesenberg is writing from the perspective of a general counsel and secretary of a major publicly held corporation, and that perspective—bias, if you will—shows.

The first part of this Commentary offers a critique of Mr. Duesenberg’s article; the second part consists of my own analysis of the complex issues under discussion.

I.

One basic problem with the Duesenberg article is that he has an extreme view of the world of derivative litigation. Mr. Duesenberg is unusually candid in stating his premises, and at the risk of overstating them somewhat, I list them as follows:

1. Almost all derivative litigation is devoid of substantive merit. “Filing lawsuits with little or no merit has become, it seems, a way of life with many lawyers. . . .”²

2. Most groundless derivative litigation is settled only because of the cost of litigation to the enterprise and to the defendants. “The overdeposed, over-interrogated and over-discovered defendant, pursued by teams of lawyers, becomes victimized by the process, not by the conduct which is alleged wrongfully to have been committed. Pragmatists as they are, managers reluctantly turn their attention to settlement, not to avoid adjudication of their alleged guilt, but to end

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1. Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 Wash. U.L.Q. 311, 332-33 (1982).

2. *Id.* at 333.

the process and return their labors to [the enterprise]. . . .³

3. Derivative litigation is not necessary to assure proper conduct of corporate fiduciaries. That such litigation should be viewed as the “principal means’ for enforcing managerial fiduciary responsibilities reflects either a cynical view of human action or an uninformed perspective of how management works.”⁴

(a) Management is dominantly driven “by the desire to perform effective and superior wealth-producing roles . . . in a culturally acceptable manner.”⁵

(b) Boards and managers do not “consciously skirt close to the margin of illegality or moral turpitude to achieve private aggrandizement or gain competitive advantage.”⁶ To believe that they do is to “indulge in fantasy.”⁷

(c) Corporate management is “circumscribed by a plethora of other constraints [from all sides].”⁸ No significant decision can be made “without in depth examination of wide ranging regulations, contract rights, and business and social pressures, many of which impact or sometimes totally control the decisionmaking outcome.”⁹

4. Unwarranted dismissals of shareholder litigation will not occur because directors not personally involved in claimed misconduct have the independence and objectivity of judgment to review and definitively dispose of shareholder litigation. “[B]oard members are typically strong-willed individuals, not easily maneuvered and quite capable of identifying where they have a bad situation on hand that requires unpleasant resolution.”¹⁰ There is, in short, very little to the argument that even independent directors have a “structural bias” in favor of defendants. “There is a very real limit to the structural bias argument, it seems, and that limit is reached quickly in difficult situations.”¹¹

5. Recognizing that the directors’ power to close off shareholder derivative litigation is subject to abuse, the possible cost is outweighed by

3. *Id.*

4. *Id.* at 332.

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.* at 334.

9. *Id.*

10. *Id.* at 339-40.

11. *Id.* at 340, n. 120.

the value of preserving to responsible management those conditions “that are critical to effective, and hopefully profitable, leadership.”¹² “The goal is a decision in the interest of the entity, and the greater understanding of its needs by those who manage it is a healthy trade-off for the minimal impact that may flow from a ‘structural bias’ labored under by a well-chosen body performing its assignment thoroughly and in good faith.”¹³

6. Finally, the power to dispose of shareholder litigation by director action is not really unlimited, since the courts have the power to give “close scrutiny to afford reasonable assurance of the integrity of the process.”¹⁴ Further, where instances of “egregious wrong” actually show up, “the requisite of disinterest or independence has proven sufficiently elastic to achieve the measure of judicial supervision desired.”¹⁵

If one accepts these premises, there seems little justification for retaining the derivative suit at all. Certainly, any step that reduces the availability of such litigation should be applauded.

What should one say about an argument based on such views of the world? I am willing to accept that there is some truth in most of Mr. Duesenberg’s premises. I do not see, however, how one can accept the premise that derivative litigation is almost always without substantive merit. I have heard the same point of view expressed by several other sophisticated and intelligent lawyers who are house counsel for, or represent, other major American corporations. I have also heard precisely the opposite point of view expressed with equal force by equally sophisticated and intelligent lawyers who form part of the plaintiff’s bar. The limited available empirical evidence, as well as academic commentary, tends to favor the latter point of view. The truth, I suspect, lies somewhere between the extreme views.

Even if there is some truth in most of Mr. Duesenberg’s premises, it is inconceivable that they are so largely applicable across the broad range of corporations in modern American society that they should form the basis for prescriptive rules. It is likely that Mr. Duesenberg had in mind only the kind of corporation with which he is most familiar; the large, publicly held corporation, in which shareholder voting power is diffused and highly qualified outside directors constitute a ma-

12. *Id.* at 340.

13. *Id.* at 342.

14. *Id.* at 341.

15. *Id.* at 329.

jority of the board. His argument, however, is not so limited and applies equally to derivative litigation involving small or medium-sized corporations or majority shareholder-dominated corporations as well as Fortune 500 corporations.

I am also troubled by Mr. Duesenberg's assumption that simple standards of "independence" and "disinterest" sufficient to avoid "disabling self-interest"¹⁶ will automatically yield a committee with the independence of mind and spirit that Mr. Duesenberg envisions. Even if many independent directors do have these laudable qualities, some nominally independent directors are too old, too trusting, too cautious, not very intelligent, or so eager to stay on the board that they will accept management's explanation for practically anything.¹⁷ A committee composed of such persons is a stacked committee. And, it is no less stacked if an independent lawyer, retired judge, or similar notable is appointed as special investigator since that person has to deal with a committee and is influenced by the underlying views or beliefs of that committee. In other words, Duesenberg's belief that an "independent" committee is not likely to whitewash a sticky or embarrassing situation or outright illegal conduct seems implausible. It is quite conceivable that an "independent" committee might do precisely that.

My second major criticism of Mr. Duesenberg's analysis is that he significantly misstates the character or nature of much derivative litigation. He assumes that practically all recent derivative litigation deals with illegal payments or stock options machinations, situations in which Mr. Duesenberg persuasively argues that directoral discretion is usually appropriate. Such cases, however, represent only a small proportion of all derivative litigation. Mr. Duesenberg states "[t]he panoply of malfeasance that derivative actions may attempt to redress is not, of course, limited to foreign payments and stock option machinations. *As a hypothetical matter*, the instances of misconduct can be much broader. A survey of cases occurring in the 1970s, the halcyon days of the anticorporate activists, discloses other types of complaints, to be sure, but again in most of these the courts confirmed the power of the board to terminate the action."¹⁸ (emphasis added) To this statement

16. *Id.* at 329.

17. See e.g., Shao, *Amax Fees Paid to Some Outside Directors Stir Questions About Their Independence*, Wall St. J., Apr. 1, 1982, at 10, col. 1.

18. See Duesenberg, *supra* note 1, at 328.

Mr. Duesenberg appends a footnote citing four cases, surprisingly none of which were decided during the 1970s.

One does not really have to guess about the nature of derivative litigation during the 1970s, or rely on cases decided before and after that period. There is a published empirical study covering data on derivative and class litigation filed against 205 corporations during the period 1970-1978.¹⁹ While this study was primarily concerned with dispositions of such litigation, it also gives some information about the nature of the claims being pursued. For example, the 20 suits leading to the largest monetary settlements during the 1970s involved the following complaints:

- disclosure fraud;
- misrepresentation in exchange offer;
- improper sale of subsidiary;
- disclosure violations;
- disclosure fraud;
- disclosure violations;
- unfair tender offer;
- disclosure fraud;
- prospectus disclosure violations;
- improper sale of shares;
- securities violations;
- unfair merger;
- unfair merger;
- illegal contributions and improper compensation;
- disclosure violations and insider trading;
- unfair treatment of subsidiaries;
- illegal tender offer;
- disclosure violations;
- excessive compensation; and
- disclosure violations.²⁰

My point is simply that while some of these suits involved illegal payments and stock options, many of them involved much more traditional kinds of management abuse. Thus, there is really no support for the statement that “instances of egregious wrong are extremely rare in

19. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U.L. REV. 542 (1980).

20. *Id.*, at 548-549. This list consists of a description of the merits of the first 20 settlements described in Table III. Some of them appear to involve class action rather than derivative law suits.

the cases. . .” (footnotes omitted).²¹ Mr. Duesenberg simply was looking in the wrong place.

This recent empirical study also sheds light on Mr. Duesenberg’s assumption that most derivative litigation is without merit, though the data are not conclusive. A total of 531 suits were brought during the 1970s against the 190 Fortune 500 corporations involved in the study. Of these, 100 were pending at the close of the period and 71 had been disposed of in an unknown manner during the period. Thus, the study considered the disposition of 360 suits. Of these, 246 were settled, 16 led to judgments for plaintiffs or defendant compliance with the demands of the plaintiff, and 72 were complete victories for the defendants [59 by dismissal and 13 by judgment]. In another 14 cases suits were dismissed because class action status was denied. Since complete victories or complete defeats account for a small proportion of all the cases, the evaluation of the derivative suit largely revolves around an appraisal of the 246 cases that were settled. Fifty-five settlements, involving 228 of the 246 suits, were described in sufficient detail to be analyzed. Of these, 23 involved settlements ranging from \$34,000,000 to \$1,000,000, another 15 involved settlements from \$930,000 to \$44,000, and one involved a payment of only \$4500. Obviously, absolute amounts paid in settlement are an unreliable guide to substantive merit in the absence of information about the reasonable amount initially in dispute. The large amounts paid in many of these settlements, however, tend not to support Mr. Duesenberg’s belief that derivative suits are usually groundless and settlements involve defendants buying their peace from rapacious plaintiffs’ attorneys.

Another facet of this study is that ten settlements involving fourteen suits included nonmonetary agreements by the corporation to make changes in their internal corporate governance. This category included several illegal payment cases. If these cases had been subjected to the unlimited business judgment rule dismissal urged by Mr. Duesenberg, it is unlikely that this type of relief would have occurred.

The academic literature cited by Mr. Duesenberg, as well as the draft of the American Law Institute study on corporate governance which he criticizes, treat the continued vitality of the derivative suit as an important control over corporate conduct. Mr. Duesenberg attacks this position frontally, stating that “[n]o empirical evidence suggests that

21. See Duesenberg, *supra* note 1, at 329.

lawsuits or their threat have any major impact in keeping others in line,"²² and the belief that derivative litigation is the principal means of enforcing managerial responsibility "reflects either a cynical view of human action or an uninformed perspective of how management works."²³ The comments being criticized, of course, are not original with the authors but are based on judicial statements from a number of different opinions.

Given the unattractive choice of being cynical or uninformed, I opt for a "cynical view of human action."²⁴ In my view much human action is constrained to some extent by the recognition that if certain conduct is engaged in, then unpleasant consequences may follow. Derivative litigation is simply one of those unpleasant consequences. To choose examples at random, I am sure that many lawyers (and law professors, too, for that matter) would not report all their income for tax purposes except for the civil and criminal consequences of getting caught; similarly, sexual relationships between university professors and their students probably occur with less frequency than they otherwise would because of the unpleasant consequences that follow from being caught. Now, there are doubtless many lawyers who report all their income for tax purposes as a matter of principle and would do so even though all sanctions for nonreporting were eliminated. Similarly, some professors would doubtless avoid relationships with students even if there were no sanctions. But we are not talking only about high-minded people; we are talking about many persons, a continuum of personalities with varying degrees of moral standards, from high to medium to virtually nonexistent. It seems unnecessary to require "empirical evidence" to show such fundamental aspects of human behavior. Thus, I am willing to concede that many members of management are guided by the principles described by Mr. Duesenberg, and they would continue to be so guided even without the sanctions of the derivative

22. *Id.* at 332.

23. *Id.*

24. *Id.* Most of the law review analysis cited by Mr. Duesenberg was written by law professors, and it may be that Mr. Duesenberg believes that the other alternative—"an uninformed perspective of how management works"—applies to the (theoretician) law professor who may lack experience in the "real world." However, the law professors who have written on derivative litigation generally have experience in corporate practice, often for five or more years before going into teaching; many also maintain active practice or "of counsel" relationships on the side that constantly expose them to the nonacademic world. It would be convenient to dismiss all academic comment with which one disagrees as "uninformed" but that is not factually accurate.

suits. To my mind, however, that is not enough to justify a significant dilution or elimination of all sanctions applicable to everyone.

II.

I turn now to the fundamental substantive issue addressed by Mr. Duesenberg. The basic issue is whether corporate management (broadly defined) should be given complete and essentially unreviewable discretion to decide which claims of breach of fiduciary duty may be investigated by the adversary judicial system and which may not. Even if one assumes that these “go/no go” decisions are always made in basic good faith by persons with no *direct* financial involvement in the outcome, I doubt that corporate management should have that broad a power. Self-investigation too easily becomes an apology or a justification for what has occurred rather than an investigation. This is not solely a matter of “structural bias,” as Mr. Duesenberg uses the term, or an adverse reflection on the independence or honesty of directors. It is a commentary on the fundamental human characteristic of loyalty which gets in the way of effective self-investigation.²⁵

On the other hand, I find equally unsatisfactory the position taken by the Court of Chancery in the *Maldonado*²⁶ litigation that “courts and

25. I am reminded of the “self-investigation” by the Commissioner of the Food and Drug Administration in the 1970s of charges that high level FDA staff personnel were biased in favor of the drug industry and had engaged in abusive personnel practices. This self-investigation was conducted by persons without any involvement in the specific events in question and reviewed by a Commissioner who had taken office long after the events investigated had occurred. The principal investigator was a highly competent attorney, now with a prestigious Washington D.C. law firm. However, all the persons who conducted and reviewed the “self-investigation” had considerable loyalty to the Food and Drug Administration and shared a concern that widely publicized charges might injure the effectiveness of FDA regulation. The “self-investigation” did not resolve the charges satisfactorily in the eyes of many observers, and a subsequent reinvestigation was made by a truly independent panel (of which I was a member) appointed by the Secretary of Health, Education & Welfare. This reinvestigation revealed that while many of the individual allegations turned out to be dubious or unfounded (e.g., involving only clashes of strong personalities with different but reasonable regulatory philosophies or almost paranoid claims of mistreatment by the complainants), the commissioner’s “self-investigation” was itself defensive and self-serving. It did not uncover, for example, one relatively clear case of perjury in a sworn affidavit, and a number of equally clear and apparently intentional violations of personnel regulations. Despite this rather negative evaluation of the “self-investigation,” I am convinced that it was honestly conducted, and that its failure lay in the natural tendency of institutional self-investigations to minimize or overlook marginal or wrongful conduct.

26. *Maldonado v. Flynn*, 413 A.2d 1251, 1283 (Del. Ch. 1980), *rev’d*, *Zapata Corp. v. Maldonado*, 430 A.2d 779 (1981).

not litigants should decide the merits of litigation.”²⁷ This position results in a corporation that has lost all control over how its litigation resources are to be employed. It must fight even patently absurd or clearly discretionary decisions through discovery, at least until a judge can be persuaded that the suit is so without merit that it should be dismissed. I therefore accept Mr. Duesenberg’s argument to the extent that in some areas, such as suits seeking to surcharge directors for illegal corporate payments from which they did not personally profit, courts should give considerable weight to a committee decision that litigation should not be pursued.

The problem, as I see it, is to articulate a middle ground, which encourages courts to accept reasonable business decisions not to pursue litigation without binding them to accept all such decisions in all cases merely on the basis that minimum procedural requirements were followed. It is also important that this review of the “go/no go” decision itself not become bogged down in a procedural morass or be preceded by excessive and expensive pretrial procedures.

In recent months, there have been several attempts to develop such a middle ground. The innovative opinion by the Delaware Supreme Court in *Maldonado*²⁸ was the first attempt. This opinion points out the dangers involved when “directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members”²⁹ and attempts to steer “a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to unbridled plaintiff stockholder control.”³⁰ The solution adopted was a two step analysis: first, the establishment of the independence and good faith of the committee (as Mr. Duesenberg proposes), and second, *the Court should apply its own “independent business judgment” to the question whether the motion to dismiss should be granted.* This second requirement was designed to pick up situations where formal requisites of independence were met but where the grievance would appear to deserve further consideration in the corporation’s interest.

The draft of the American Law Institute study on Corporate Gov-

27. *Maldonado v. Flynn*, 413 A.2d at 1263.

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

29. *Id.* at 787.

30. *Id.* at 788.

ernance, obviously strongly influenced by the *Maldonado* opinion, suggests that the Court should exercise its own "independent judgment" to evaluate whether the business justification for dismissal put forth by an independent committee is outweighed by other factors relating to the best interests of the corporation as a whole. I am not sure whether the word "business" in the *Maldonado* formulation adds to or subtracts from the tentative ALI standard; it probably adds little.

The "independent business judgment" standard of *Maldonado* is strongly criticized by Mr. Duesenberg. He first suggests that no one knows what "independent business judgment" means in this context; that the choice of words should be viewed "as unfortunate and confusing" and he hopes that the second branch of the test is only a restatement of the principle that the "irrationality of any decision that is reached" may bring into question the validity of the procedures employed.³¹ That is obviously a crabbed reading of the Court's opinion. In context, it is perfectly clear that the Delaware Supreme Court was ordering courts to assess the wisdom of the committee's decision in the light of the best interests of the corporation.

In a recent article³² two practitioners also reject the "independent judgment" test of *Maldonado* but propose an intermediate position that also seems plausible. They criticize the "independent business judgment" test as being "so open-ended," so complicated, and so "subject to judicial whimsy"³³ that it will inevitably fail to be a simple, inexpensive and straightforward way to eliminate derivative litigation that is detrimental or undesirable. They then suggest the following as a substitute:

In certain extraordinary cases the court should go beyond good faith, independence and due care and examine the merits of the committee's decision to ascertain whether there may have been an "abuse of discretion." It may also be appropriate in these cases to shift the burden of proof to the directors on the issues of due care, independence and good faith. Such cases should include (1) self-dealing transactions involving controlling shareholders, (2) sales of all, or substantially all of the corporation's assets, (3) efforts taken to resist tender offers, and (4) other transactions so critical to the operations and profitability of the company that failure to pursue the claim might seriously impair the future of the com-

31. See Duesenberg, *supra* note 1, at 343. (footnote omitted).

32. Block & Prussin, *The Business Judgment Rule and Shareholder Derivation Actions: Viva Zapata?*, 37 BUS. LAW 27 (1981).

33. *Id.* at 62.

pany . . . [S]uch an overview of the merits, to determine whether the board's action was within the bounds of a reasonable exercise of discretion, is not a new concept under the business judgment rule, but has often been used where the transaction at issue was of special importance.³⁴

To my mind, this approach addresses the problem I have with both polar views. I view an "overview of the merits to determine whether the board's action was within the bounds of a reasonable exercise of discretion" to differ in degree and not in kind from the *Maldonado* test of "independent business judgment". Even in Mr. Duesenberg's "more expansive" reading, there may be some give. He notes that an irrational result may at least be questioned by a court by a review of procedures. In a way, it is regrettable that the first decisions in this line of cases took such dogmatic and polar extreme positions.³⁵ The resulting rhetoric may have masked a core of common agreement that some kind of judicial control has to be imposed on the otherwise unlimited power of independent committees to dismiss derivative litigation. The issue is when, how much, and with what degree of freedom.

34. *Id.* at 72. The authors also discuss how to obtain independent and disinterested persons to review transactions and what the record should consist of for the court to review. These are substantial questions that also must be addressed if the process of handling derivative suits is to be an efficient one. This brief commentary does not permit an examination of these proposals.

35. Mr. Duesenberg argues that an "independent business judgment" by a court on the discontinuance of litigation is fundamentally inconsistent with one of the basic principles underlying the business judgment rule: judges are not experts or businessmen and therefore should not review or second guess directors' business decisions. The cases are studded with examples of judicial declarations of inadequacy to establish dividend policy, to decide what cash reserves an automobile company needs, and so forth. Is the question of dismissing a derivative suit against fiduciaries of the same class? I submit that it is not. Lawyers may not be very good businessmen, and judges may be lawyers who are even worse businessmen than the average. But one thing every lawyer can do is to evaluate the probabilities of success of a lawsuit, and whether a settlement seems reasonable, given the uncertainties of litigation. We are not talking about the cash needs of an unfamiliar business; we are talking about whether a law suit charging misconduct has so little potential advantage to a corporation or chance of success that management's recommendation that it should be dismissed should be accepted. A judge should be able to decide this about as readily as a businessman. This issue is really no different from judicial decisions, for example, weighing the reasonableness of proposed settlement of derivative litigation, of litigation involving the rights of a minor or an incompetent, and so forth. I should add that a dictum in the recent case of *Joy v. North*, 519 F. Supp. 1312, 1328, n. 9, (D. Conn. 1981), states that the court "disagrees with the approach recently adopted by the Delaware Supreme Court" in *Maldonado* since "[t]here is simply no basis to assume that a court is more qualified than the directors or the shareholders to assess the merits and values of a derivative suit to the corporation." I fail to see why this should be so, given the nature of the inquiry into a proposed settlement.

