A Necessary Gatekeeper: The Fiduciary Duties of the Lead Plaintiff in Shareholder Derivative Litigation

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I. INTRODUCTION

Fraudulent behavior by corporate directors is not a new problem\(^1\) and neither is the

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\(^{1}\) See, e.g., Raines v. Toney, 313 S.W.2d 802, 808 (Ark. 1958) (discussing how a director had breached his fiduciary duties by, among other things, taking corporate opportunities); Stone v. Ritter, 911 A.2d 362, 364–65 (Del. 2006) (rejecting the shareholders’ claim that the directors failed to institute proper oversight systems); Smith v. Van Gorkom, 488 A.2d 858, 874–75 (Del. 1985) (finding that the directors had violated their fiduciary duty of care by failing to make an informed decision on a cash-out merger); In re Caremark Int’l Derivative Litig., 698 A.2d 959, 971–72 (Del. Ch. 1996) (discussing directors’ fiduciary duties).
derivative action—the tool often used to address this problem.\(^2\) In 1957, one commentator noted that “[i]n 1832 it must have appeared, as it does today, that the individual stockholder was in need of a means of invoking judicial power to curb managerial abuse.”\(^3\) This statement is just as true in 2009, as is apparent from the managerial and director abuses that continue to plague corporations.

Although the shareholder derivative action provides a useful tool to address the important problem of director misconduct, the action has faults that can prevent it from accomplishing this goal. Shareholder derivative litigation is representative litigation, meaning that the person who brings the suit represents others’ interests.\(^4\) A major weakness of representative litigation in general is that the agent controlling the litigation often does not have the same interests as the principal.\(^5\) In the case of shareholder derivative actions, a meritless suit brought by a plaintiff without the corporation’s best interest in mind can become a significant drain on the corporation’s and its shareholders’ resources. For better or worse, it is extremely difficult to win a derivative action because of the procedural hurdles in place.\(^6\) Since these barriers make success so unlikely, plaintiffs should be particularly conscientious of the merits of a case.

This Note examines lead plaintiffs’ fiduciary duties in derivative actions, including the duty to refrain from bringing meritless suits. Part II explains the historical development of shareholder derivative actions, representative litigation problems, the differences between shareholder derivative actions and class actions, fiduciary duties—both generally and in the context of class action lead plaintiffs, and the various costs associated with litigation. Part III analyzes why lead plaintiffs owe fiduciary duties in shareholder derivative actions and why bringing meritless suits breaches those duties. Part IV recommends that legislatures and the judiciary take action to delineate and enforce shareholder derivative lead plaintiff fiduciary duties.

II. BACKGROUND

Courts developed the derivative action to fill a void they saw in shareholders’ ability to protect their investments.\(^7\) Many courts and scholars, however, have criticized the derivative form.\(^8\) Importantly, shareholder derivative actions require other shareholders

\(^2\) See generally Bert S. Prutny, Jr., The Shareholders’ Derivative Suit: Notes on Its Derivation, 32 N.Y.U. L. REV. 980 (1957) (explaining the historical underpinnings of shareholder derivative actions, including descriptions of various 19th-century cases dealing with director misconduct).

\(^3\) Id. at 986.

\(^4\) For an explanation of representative litigation, see infra Part II.B.


\(^7\) Eric W. Orts, Shirking and Sharking: A Legal Theory of the Firm, 16 YALE L. & POL’Y REV. 265, 316 (1998) (“Shareholder derivative lawsuits developed historically to allow shareholders to police violations of the fiduciary duties of managers or board members.”); Prutny, supra note 2, at 986 (discussing courts’ development of the derivative action to help individual stockholders “curb managerial abuse”).

to rely heavily on the lead plaintiff in the action to represent both the shareholders’ and the corporation’s interests. This reliance is necessary, given the representative nature of a derivative action, but can lead to problems when shareholders do not feel that the lead plaintiff adequately represented their interests. In order to better understand derivative litigation’s unique procedures, the following section examines its development.

A. The Historical Development of the Shareholder Derivative Action

The derivative action developed in courts of equity. Its origin “lies in judicial recognition of a new wrong or maladjustment for which pre-existing legal procedures proved more or less inadequate.” Developed in both United States and English courts, the first U.S. “classic derivative action[] where [a court permitted] a shareholder . . . to sue to compel the directors to restore corporate assets taken in violation of their fiduciary duty” was Taylor v. Miami Exporting Co., an Ohio case. Several other plaintiffs throughout the country followed suit by filing derivative actions.

Many of the procedural hallmarks of the derivative action that exist today developed in these early cases. Courts required the corporation to be a party to the litigation in order to prevent the possibility of a double recovery in an action later brought by the corporation. Also, any recovery would go to the corporation as opposed to the individual that brought the suit. This made “[t]he corporation’s role in these actions . . . that of a passive recipient of the proceeds as the most logical and convenient mode of aggregate recovery.” Accordingly, “[w]hen a shareholder sued the management he sued on a right belonging to shareholders.” The United States Supreme Court recognized derivative actions in 1855. Despite criticism, shareholders continue to use derivative actions in an attempt to enforce officers’ and directors’ fiduciary duties.

In the 1970s, it became increasingly difficult for a plaintiff to succeed with a
derivative action. While courts previously viewed derivative actions as a useful regulation device, procedural barriers such as special litigation committees make their current efficacy questionable. Additional hurdles arose from legislation, as in Congress’s passage of the Private Securities Litigation Reform Act (PSLRA).

B. Representative Litigation

Both class action and shareholder derivative suits are representative litigation. In representative litigation “the named parties represent others similarly situated.” The lead plaintiff therefore takes on an important role: Representational capacity assumes that the role of acting on behalf of another is a basis for imposing fiduciary obligations on the person who assumes the representational role and, in varying degrees, for binding the represented person to the consequences of the representative’s acts . . . . Such a plaintiff in a class or derivative action has undertaken to act on behalf of the class or the corporation and is treated as a fiduciary, but is not subject to the control of the class or corporation.

Appointing a single lead plaintiff or small group of lead plaintiffs is necessary given the significant number of individuals whose rights representative litigation implicates. Ideally, the lead plaintiff takes charge of the litigation for the class, or in a derivative action, for the corporation.


25. For an example of a special litigation committee’s effect on derivative litigation, see Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

26. See Coffee, Unfaithful Champion, supra note 24, at 5–6 (describing the shift in judicial perception of shareholder derivative actions and the increasing procedural barriers to success). The recent stock option scandals, however, may have “breathed new life into the derivative action.” Michael D. Torpey et al., Defending Securities Claims, in SECURITIES LITIGATION: PLANNING AND STRATEGIES 623 (ALI-ABA Course of Study 2007).


28. Stephen J. Choi & Robert B. Thompson, Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA, 106 COLUM. L. REV. 1489, 1492 (2006); Howard M. Erichson, Beyond the Class Action: Lawyer Loyalty and Client Autonomy in Non-Class Collective Representation, 2003 U. CHI. LEGAL F. 519, 531. Other examples of representative litigation include bankruptcy, where claimants’ interests are represented by a creditor committee, and certain government lawsuits, such as parens patrie suits. Erichson, supra, at 531.

29. Erichson, supra note 28, at 522. Courts have not agreed on a solid definition of “similarly situated,” and some scholars argue that it should mean something different in the context of a derivative action than it does in a class action. See Mary Elizabeth Matthews, Derivative Suits and the Similarly Situated Shareholder Requirement, 8 DEPAUL BUS. L.J. 1, 11–12 (1995) (noting that class actions and derivative actions are “quite different in nature” and therefore should use different definitions of “similarly situated”).


31. See Russell Kamerman, Note, Securities Class Action Abuse: Protecting Small Plaintiffs’ Big Money,
Representative litigation presents some serious problems. Describing representative litigation in the context of class actions, one academic noted:

As individual claims are often small, class members have little incentive to monitor their agent. They also lack the expertise that would enable them to do so. The unmonitored agent can therefore engage in at least two types of problematic behaviors. First, class counsel may do too little, settling the class members’ claims for less than their real value in exchange for quick and substantial fees (a sell-out or sweetheart deal). Second, class counsel may do too much, filing meritless cases in the hopes of extracting nuisance fees (a strike suit).\footnote{This is not to suggest that these incentives cause most, or even many, class counsel to behave inappropriately. Plaintiffs’ attorneys play an important role in protecting shareholders, and honest plaintiffs’ attorneys who vehemently pursue their clients’ rights, instead of their own financial interests, likely far outnumber plaintiffs’ attorneys who file strike suits.}

Plaintiffs’ counsel has significant incentive to engage in these problematic practices when acting as the agent to a class or in a derivative action.\footnote{See generally Kim, supra note 9, at 82–109 (describing differences between class and derivative actions).} This Note addresses both of the above scenarios, but focuses on the second scenario, in which class counsel files meritless cases in hopes of extracting nuisance fees.

\begin{center}C. Comparing Shareholder Derivative Actions and Class Actions\end{center}

The differences between class actions and derivative actions are not always apparent to shareholders.\footnote{See, e.g., Roslyn Falk, May a Shareholder Who Objects to a Proposed Settlement of a Derivative Action Appeal an Adverse Decision? A Report on Public Employees’ Retirement System v. Felzen, 25 DEL. J. CORP. L. 235, 247 (2000) (noting the differences in standing); Lawrence G. Nusbaum & David C. Young, Is Silence Golden? A Director’s Duty to Disclose Preliminary Merger and Acquisition Negotiations, 44 WASH. & LEE L. REV. 807, 809 n.5 (1987) (pointing to differences in standing and who the action benefits).} Although class actions and derivative actions both developed as equitable remedies and are “representative” actions,\footnote{See generally Kim, supra note 9, at 82–109 (describing differences between class and derivative actions).} important distinctions exist between the two.\footnote{Id. at 99; Tooley v. Donaldson, Luften & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004).} These differences include who is injured, who receives the recovery, and who is involved in the decision to bring the action.\footnote{Rubenstein, supra note 5, at 1441–42.}

\begin{center}1. Shareholder Derivative Actions\end{center}

Since the corporation is the injured party in shareholder derivative actions, the resulting recovery goes to the corporation, as opposed to any individual.\footnote{Kim, supra note 9, at 82.} Additionally, “[a] derivative action is actually two causes of action: it is an action to compel the
corporation to sue and it is an action brought by a shareholder on behalf of the corporation to redress harm to the corporation. Derivative actions stand in contrast to class actions, which are direct actions.

a. Direct Versus Derivative

In a direct claim, a plaintiff brings a cause of action for an injury he or she experienced, and any recovery for the action flows to the plaintiff. Shareholders bring a derivative claim when the injury is actually an injury to the corporation. Importantly, although the plaintiff initiates the claim, the corporation continues to own the cause of action “and, therefore, is the real party in interest.” To add to the confusion, some cases contain both derivative and direct claims. In Delaware, determining whether an action is direct or derivative presents a two-fold analysis: first, the court asks who suffered the harm, and second, the court asks who would receive the benefit of the recovery or remedy. The answers to these questions have important procedural and substantive impacts on the progression of the litigation.

Although courts do not uniformly employ these questions to distinguish between direct and derivative suits, different jurisdictions’ analyses have resulted in categorizing certain types of suits as derivative.

Suits based on breaches of the directors’ fiduciary duties of care and loyalty under state law . . . are actionable only as derivative suits. On the other hand, suits for the deprivation of shareholders’ voting rights, preemptive rights, or rights to inspect the corporation’s books and records, suits to compel the declaration of dividends, and suits alleging that the directors/officers fraudulently induced the shareholder to sell stock, are generally treated as direct actions.

Additionally, the way in which the plaintiffs plead the claim may allow them to manipulate the classification of the suit to their advantage.

41. See id. at 359 (noting that courts look to whether the corporation or the shareholder suffered the injury when determining whether an action is direct or derivative); Kim, supra note 9, at 102 (explaining that plaintiffs bring direct actions when they personally suffered the injury).
42. Kim, supra note 9, at 103.
43. Id. at 102.
44. See, e.g., Husvar v. Rapoport, 430 F.3d 777, 779 (6th Cir. 2005) (containing both direct and derivative claims).
45. Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004). The court rejected a “special injury” analysis. Id.; cf. Kim, supra note 9, at 102–03 (discussing the different approaches courts take to distinguish between direct and derivative actions).
46. Tooleys, 845 A.2d at 1036.
47. Brandi, supra note 40, at 359–60.
48. Id. at 360.
49. Id. at 360–61 (citing Reifsnyder v. Pittsburgh Outdoor Advertising, 173 A.2d 319 (Pa. 1961), as an
A court’s determination that a claim is derivative rather than direct imposes additional procedural hurdles on the plaintiffs. These hurdles present some of the prime differences between shareholder derivative actions and shareholder class actions. A primary hurdle, present only in derivative actions, is the demand requirement.

**b. The Demand Requirement**

Once a court determines that an action is in fact derivative in nature, the court and the parties must deal with the demand requirement. Although all jurisdictions address demand, the way in which they do so varies. Demand is a request made to the board of directors of the corporation to investigate and remedy specified claims. In certain jurisdictions, a plaintiff must make a presuit demand, but in Delaware and some other jurisdictions, courts will excuse demand when it would be futile. Particularly, “[i]n order to allege demand futility, a shareholder must allege facts that create a reasonable doubt as to either the independence of the board or the validity of the business judgment exercised in the transaction.” Courts require demand in derivative actions because the shareholder is suing on behalf of the corporation. Since the law invests directors with the power to manage the corporation, demand addresses the “usurpation of the directors’ normal power to manage the corporation” presented by a shareholder derivative action. Allowing plaintiffs to plead demand futility, however, or to bring an action after a board refuses a shareholder’s demand, provides plaintiffs with the opportunity to have someone other than the directors (who may be parties in the case) make the final decision as to whether the suit is appropriate. The demand requirement represents an important distinction between class actions and shareholder derivative suits.

**2. Class Actions**

In class actions, plaintiffs represent both their own interests and the interests of the other class members. Therefore, like shareholder derivative actions, class actions are representative litigation. In a class action suit, the class receives the recovery if the suit
is successful or the parties reach a settlement. Often, the only people who receive significant compensation in a class action suit are the lawyers handling the case. This is regularly the case in shareholder derivative suits as well. The minor effect that the outcome of a case will have on a single class member or shareholder highlights the need for lead plaintiff fiduciary duties, a topic courts and scholars have already examined in the context of class action litigation.

D. Fiduciary Duties Generally

A wide variety of relationships impose fiduciary duties, including lawyer-client relationships; at the same time, “[t]here is no integrated body of principles or precise doctrine that applies uniformly to all forms of fiduciary relationships.” As one commentator notes:

The word “fiduciary,” we find, is not definitive of a single class of relationships to which a fixed set of rules and principles apply. Each equitable remedy is available only in a limited number of fiduciary situations; and the mere statement that John is in a fiduciary relationship towards me means no more than that in some respects his position is trustee-like; it does not warrant the inference that any particular fiduciary principle or remedy can be applied.

Trust, corporate, and partnership law all contain well-developed fiduciary law.

actions. See John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370, 370–71 (2000) [hereinafter Coffee, Accountability] (arguing that class actions are problematic because “the principals cannot effectively monitor their agent”); Kim, supra note 9, at 83 (arguing that class reliance on representatives is particularly heavy in settlement cases, and noting that the Federal Rules of Civil Procedure have methods in place to at least partially address this concern).


60. Id. The fact that any one person’s recovery will likely be small supports the use of the class action form in order to encourage suits to deter future wrongdoing by the defendant that plaintiffs would not otherwise bring. Id.

61. See Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 FLA. L. REV. 71, 72 (2007) (“Class action litigation often seems to be a mechanism for greedy class counsel and shrewd defendants to negotiate settlements that undermine the interests of the class.”).

62. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 597 (1991) (“Some evidence seems to show that derivative actions tend to be resolved for structural or cosmetic changes with no tangible economic benefit to the corporation, plus large attorney’s fees.”).


64. See Strickland v. Washington, 466 U.S. 668, 692 (1984) (calling the duty of loyalty “the most basic of counsel’s duties”).


66. Id.


68. See Meinhard v. Salmon, 249 N.Y. 458, 464 (1928) (discussing the fiduciary duties of partners); O’Kelley & Thompson, supra note 52, at 235–38 (discussing corporate directors‘ fiduciary duties); Sealy,
These duties are not identical, but all hold fiduciaries to higher standards than nonfiduciaries. As Justice Cardozo described in *Meinhard v. Salmon*:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

This explanation of the fiduciary duty owed by one partner to another highlights the increased responsibility of a fiduciary.

### E. Lead Plaintiff Fiduciary Duties in the Context of Class Action Litigation

Class action lead plaintiffs owe fiduciary duties to class members. Although the PSLRA places statutory requirements on class action lead plaintiffs, it does not create new fiduciary obligations. Courts, however, have applied fiduciary duties developed in other contexts to their analyses of class action lead plaintiff duties.

Lead plaintiffs’ obligations include selecting lead counsel and determining whether lead counsel and nonlead counsel fee requests are appropriate. As fiduciaries to fellow class members, lead plaintiffs owe duties of care and loyalty. The lead plaintiff must fairly represent the interests of the entire class. If she violates that duty, she may be subject to liability.

### F. The Private Securities Litigation Reform Act of 1995

The PSLRA places statutory requirements on class action lead plaintiffs. Congress did not, however, intend the lead plaintiff provisions of the PSLRA to “confer any new fiduciary duty on institutional investors—and the courts should not impose such a duty.” Additionally, the PSLRA seeks to “restrict professional plaintiffs” by preventing

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supra note 67, at 69 (noting the close connection between fiduciary duties and trust law).


70. Id. (internal citation omitted).


73. See, e.g., Cendant Corp., 404 F.3d at 200 (citing Air Line Pilots Ass’n, Int’l v. O’Neill, 499 U.S. 65 (1991), a case involving the fiduciary duties of a union, for the proposition that a fiduciary owes duties of loyalty and care to the principals).


75. Cendant Corp., 404 F.3d at 199–200.

76. Id. at 200.

77. Id. at 203.

78. Black et al., supra note 63, at 1113.

79. Cendant Corp., 404 F.3d at 200.

people or organizations from serving as lead plaintiffs more than five times in three years. 81

The PSLRA attempts to encourage institutional investors to serve as lead plaintiffs. 82 In order to achieve this goal, the Act creates a presumption that the appropriate lead plaintiff is the one with the “largest financial stake in the relief sought.” 83 Research indicates that although settlements tend to be larger in cases in which institutional investors serve as lead plaintiffs, 84 institutional investors have not petitioned to serve to the extent envisioned by Congress. 85

G. Litigation Costs

Litigation in general is expensive, but the cost of shareholder derivative suits can be exorbitant. 86 In 1985, the average cost of defending claims against directors was $592,000 87 and is likely substantially larger today. Monetary costs include attorneys’ fees, 88 court fees, discovery costs, and transcripts. 89 After factoring in additional expenditures unique to derivative actions, such as a special litigation committee, a case becomes expensive long before trial begins.

Opportunity cost also plays a significant role in shareholder derivative litigation. 90 Resources that the corporation expends because of litigation are necessarily resources that the litigation takes away from other—likely more profitable—uses. 91 The defendants

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81. Id. at 35.
82. Id. at 34.
83. Id.
85. See Martinez, supra note 84, at 683 (noting that institutional lead plaintiffs are rare because they do not petition to serve in the role). But see Savett, supra note 84, at 81 (noting the significant increase in institutional investor participation since 2000 and even since 2005).
87. Roberta Romano, What Went Wrong with Directors’ and Officers’ Liability Insurance?, 14 DEL. J. CORP. L. 1, 8 (1989) (noting that “legal fees have outpaced inflation”).
90. See Shaun Mulreed, Comment, Private Securities Litigation Reform Failure: How Scienter Has Prevented the Private Securities Litigation Reform Act of 1995 from Achieving Its Goals, 42 San Diego L. REV. 779, 790 (2005) (noting that opportunity costs are a significant factor in derivative actions); Coffee, Unfaithful Champion, supra note 24, at 15 (noting that defendants have larger opportunity costs than plaintiffs); Coffee, Understanding, supra note 8, at 702 (highlighting the opportunity costs of corporate directors’ time).
91. See BLACK’S LAW DICTIONARY 372 (8th ed. 2004) (defining opportunity cost as “[t]he cost of acquiring an asset measured by the value of an alternative investment that is forgone”).
in the action are often directors, and while “losing a hundred hours of janitorial time would not be financially damaging to most corporations, losing the same amount of [a] Chief Executive Officer’s time could be a damaging blow.”

III. ANALYSIS

Lead plaintiffs in derivative suits are fiduciaries of the corporation and its shareholders. Class action lead plaintiffs have fiduciary duties, and these obligations are even more important in the context of shareholders derivative actions. Derivative actions and class actions share the same agency concerns. Additionally, the award flows to the corporation rather than the plaintiff in a shareholder derivative suit since the plaintiff brings the corporation’s claim. Although the plaintiff may benefit indirectly through an increase in stock price, she does not directly benefit the way a successful class action plaintiff would. This makes the derivative action lead plaintiff more closely analogous to fiduciaries who deal with others’ assets, such as a trustee, or, ironically, a corporation’s directors.

Courts hold trustees to a high fiduciary standard. Trustees that do not meet those standards face significant repercussions. Shareholder litigation demonstrates that fiduciary breaches by a director can have serious consequences. Trustees and directors are just two examples of actors held to high fiduciary standards. Since courts take fiduciary duties seriously in other contexts, they should do so in the context of shareholder derivative action lead plaintiffs as well.

Additionally, fiduciary decisionmaking is easier in derivative actions than in some

92. Mulreed, supra note 90, at 790 n.52.
93. See supra Part II.B (discussing the problems of representative litigation).
95. See Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004) (noting that to determine whether a claim is direct or derivative, one relevant question is who would receive the recovery).
97. This is ironic because the focus of much shareholder derivative litigation is director fiduciary breaches.
98. See, e.g., Humane Soc’y of Austin & Travis County v. Austin Nat’l Bank, 531 S.W.2d 574 (Tex. 1976) (noting “the high fiduciary standards applicable to all trustees”).
100. Although perhaps not serious enough. As this Note highlights, there is a large gap between bringing a suit for a potential director fiduciary breach and actually succeeding in proving that breach. Also, since Delaware exculpates duty of care breaches, see DEL. CODE ANN. tit. 8, § 102(b)(7) (2008), in order to recover money damages in Delaware the plaintiff must show a breach of the duty of loyalty (which encompasses good faith, among other things). Although directors are unlikely to face private civil consequences for their duty breaches, they may face criminal consequences. Christine Hurt, The Undercivilization of Corporate Law, 33 J. CORP. L. 361, 417 (2008) (“Theoretically, in the current environment, a civil lawsuit claiming breach of fiduciary duties may fail under the same set of facts that are the basis of a successful criminal prosecution.”).
101. See supra Part II.E (discussing the fiduciary duties of class action lead plaintiffs).
other contexts. For example, lead plaintiffs in shareholder derivative actions serve a simpler role than those in class actions. Class action suits have two main purposes: to compensate wronged investors and to deter future wrongdoing. These purposes are similar in shareholder derivative suits, but, unlike in the class action context, the purposes are not in tension in the shareholder derivative context. In shareholder derivative actions, the goals of the litigation are both to deter future director misconduct and compensate the corporation. Since the overall goal is to achieve the best outcome for the corporation, these two goals often coincide.

Commentator Keith Johnson uses the example of a case in which class action plaintiffs could either accept a ten million dollar settlement paid by the corporation’s insurer, or a five million dollar recovery from the actual defendants. In the class action context this situation requires the class representative to choose between greater deterrence (by forcing the defendants themselves to pay the five million dollar recovery) and the largest possible recovery for the class (the ten million dollars paid by the corporation’s insurer). In a derivative suit, however, the result is simple: achieve maximum deterrence and the best overall recovery for the corporation by forcing the actual wrongdoers to pay five million dollars. This decision is in the corporation’s best interest because it deters the wrongdoers. Further, although five million dollars is substantially less than ten million dollars, the decision provides the best recovery since a pay out by the corporation’s insurer will likely increase the cost of the corporation’s insurance premiums. This difference makes the decision in a derivative case easier than a decision in a class action. Therefore, courts and legislatures should place similar (or stricter) fiduciary duties on lead plaintiffs in derivative actions.

Although the above example illustrates that the corporation will benefit most (both through deterrence and in a financial sense) when a director pays for a settlement, this scenario often does not occur in shareholder derivative action settlements. In fact, in a recent article discussing class and derivative action settlements, the authors noted that in class actions, directors often pay significant amounts to cover settlements above their insurance coverage. In derivative actions, however, the authors described large settlements funded mainly by the companies themselves and their insurance providers. This trend highlights the disjunction between what is in the best interests of the

103. See id. (noting the tension that can exist between actually deterring the wrongdoer and receiving the largest recovery).
104. Id. at 155 n.3.
105. Id.; see also Black et al., supra note 63, at 1113 (noting that extracting out-of-pocket payments from directors in order to “send a message” in a class action “will generally require the lead plaintiff to sacrifice the interest of the class in maximizing its recovery”).
106. See Dale A. Oesterle, Limits on a Corporation’s Protection of Its Directors and Officers from Personal Liability, 1983 WIS. L. REV. 513, 571 (noting the negative impact that insurance payouts for shareholder derivative actions can have on premiums).
108. Id.
109. Id.
corporation and what some lead plaintiffs actually allow to occur. Lead plaintiffs who bring claims with very little chance of success also exemplify this disjunction.

A. Current Gatekeeping Functions Do Not Prevent Plaintiffs from Filing Detrimental Shareholder Derivative Actions

Plaintiffs must overcome significant hurdles to successfully litigate a shareholder derivative action. These hurdles are not, however, sufficient to prevent derivative actions with little to no chance of success from wasting corporate resources. First, derivative actions require several layers of gatekeepers and checks to ensure that inappropriate actions do not occur. Our underlying belief that checks on decisionmakers are appropriate is apparent in many legal contexts—from our Constitution to our corporate and securities laws.\(^\text{110}\) Second, the gatekeeping functions already in place occur too late to save initial expenses.\(^\text{111}\) Third, the only gatekeeper other than the lead plaintiff that has the ability to stop the suit at the inception is the lawyer, who has financial conflicts.\(^\text{112}\)

1. Special Litigation Committees, Demand Requirements, and High Pleading Standards are Inadequate Gatekeepers Because of Timing

Current shareholder derivative litigation gatekeepers often do not enter the picture early enough to prevent the costs associated with the beginning stages of litigation. For example, in the case of a jurisdiction like Delaware that allows plaintiffs to plead demand futility, once a plaintiff files a claim, the court will hear motions and arguments centered on the plaintiff’s claim of futility.\(^\text{113}\) The special litigation committee does not perform its gatekeeping function until after the court has determined that demand is futile,\(^\text{114}\) which, again, is after the corporation has already expended significant resources. Additionally, although derivative actions have high pleading standards, the plaintiff’s complaint forces the defendant to litigate a motion to dismiss in order to determine if the plaintiff has met those standards.\(^\text{115}\)

2. The Lead Plaintiff is in a Better Position than the Plaintiff’s Attorney to Police the Course of the Litigation

Although held to high fiduciary standards, lawyers, like most people, do not always live up to the standards set for them—especially when it is financially advantageous to ignore or evade those standards. In most cases, clients play the role of their lawyer’s monitors, making sure that the lawyer handles their cause of action appropriately, or that

\(^{110}\) See Thompson & Thomas, supra note 6, at 1751 (noting that auditors, analysts, and attorneys serve a gatekeeping function for corporations).

\(^{111}\) See infra Part III.A.1.

\(^{112}\) See infra Part III.A.2.

\(^{113}\) See supra Part II.C.1.b.

\(^{114}\) A special litigation committee is a subset of the board of directors, created specifically to address derivative litigation. Aronson et al., supra note 39, at 172–76. In demand futility cases, a board may form a special litigation committee to determine whether the litigation should continue after the court has excused demand. Id. at 175.

\(^{115}\) See, e.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 976 (Del. Ch. 2003) (noting that derivative actions are subject to “more stringent pleading requirements”).
the lawyer is fighting for the deal the clients want. In the case of a shareholder derivative suit, lead plaintiffs may not have a large enough interest in the suit to make them effective monitors. This is why, in addition to placing fiduciary requirements on the lawyer in the case, courts and state legislatures must impose fiduciary responsibilities on the lead plaintiff.

a. Problems with Relying on Plaintiffs’ Attorneys to Police Derivative Litigation

The fiduciary duties of plaintiffs’ attorneys in shareholder derivative and class action suits are the topic of much scholarly literature and the focus of many court opinions. Unfortunately, however, fees produce an inherent conflict that may prevent some plaintiffs’ attorneys from appropriately championing their clients’ causes. Whether a shareholder derivative suit presents a valid claim or not, the plaintiffs’ lawyer may stand to receive a large fee from a settlement, even a settlement that brings little or no benefit to the corporation. This may lead attorneys to “recruit clients and run to the courthouse” over claims that, if they were to reach trial, would almost certainly fail. These types of actions actually harm the lead plaintiff, as a shareholder, because

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116. See, e.g., Ericson, supra note 28, at 524 (noting that plaintiffs have more control in nonrepresentative litigation); see also Model Rules of Prof’l Conduct R. 1.2(a) (2007) (stating that the client sets the objectives of the representation, and that the lawyer “shall consult the client as to the means by which [the objectives] are to be pursued”).

117. See, e.g., Susan R. Martyn, Accidental Clients, 33 Hofstra L. Rev. 913, 946–47 (2005) (noting that class action plaintiffs’ lawyers have fiduciary duties to the entire class); John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working, 42 Md. L. Rev. 215, 220 (1983) (“In theory, the private attorney general is induced by the profit motive to seek out cases that otherwise might go undetected.”); Julie Rubin, Auctioning Class Actions: Turning the Tables on Plaintiffs’ Lawyers’ Abuse or Stripping the Plaintiff Wizards of their Curtain, 52 Bus. Law. 1441, 1441 (1997) (“The potential for large fees alone is enough for many lawyers to recruit clients and run to the courthouse without thoroughly investigating their claims.”).

118. See, e.g., Goldberger v. Integrated Res., Inc., 209 F.3d 43, 52–53 (2d Cir. 2000) (discussing the negative incentives that attorneys’ fees can provide).

119. For example, “[a]ssuming that a megacase settles for $100 million, plaintiffs’ counsel could expect to receive $25 million for their litigation services.” Lisa L. Casey, Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging, 2003 BYU L. Rev. 1239, 1241–42.

120. See Weinberger v. Great N. Nekoosa Corp., 925 F.2d 518, 524 (1st Cir. 1991) (noting the conflict that can exist between a class and its lawyer: “The problem has two aspects: extortion (that is, the prosecution of strike suits) and collusion (that is, the tension which necessarily arises between class members and class counsel when settlements and attorneys’ fees are negotiated simultaneously.”); see also infra Part III.C (discussing the considerations that enter into a decision to settle).

121. Rubin, supra note 117, at 1441; see also Coffee, Accountability, supra note 58, at 371–72 (noting that “where the plaintiffs’ attorney was once seen as a public-regarding private attorney general, increasingly the more standard depiction is as a profit-seeking entrepreneur, capable of opportunistic actions and often willing to subordinate the interests of class members to the attorney’s own economic self-interest”); In re Cox Commc’ns, Inc. S’holders Litig., 879 A.2d 604, 608 (Del. Ch. 2005) (discussing the “race to the courthouse” that certain corporate transactions can elicit).

122. See Coffee, Unfaithful Champion, supra note 24, at 9 (noting that the majority of shareholder derivative actions are resolved through settlement, and that the rare cases in which judges reach the merits are overwhelmingly decided in the defendant’s favor). Although Rule 11 of the Federal Rules of Civil Procedure and its state counterparts impose sanctions on lawyers who bring frivolous claims, courts rarely do so. See generally Charles Yablons, Hindsight, Regret, and Safe Harbors in Rule 11 Litigation, 37 Loy. L.A. L. Rev. 599 (2004) (noting the decrease in Rule 11 motions since the Rule’s revision in 1995). Additionally, for this Note’s
of the money the corporation pours into negotiations and settlement. Since the attorney may gain from an action that the corporation and lead plaintiff will lose from, it makes sense to focus on the lead plaintiff’s fiduciary duties rather than on the attorney’s.

The case of William Lerach provides a primary example of a situation where lead plaintiffs can play an important role in supervising their attorneys. Lerach was “widely recognized as one of the leading securities lawyers in the United States. He has headed the prosecution of hundreds of securities class and stockholder derivative actions resulting in recoveries amounting to billions of dollars for defrauded shareholders.”

On February 11, 2008, however, a U.S. district court sentenced Lerach to two years in prison for conspiring to obstruct justice. These charges stem from kickback payments made by his former firm to induce individuals to act as lead plaintiffs in securities litigation suits.

According to Lerach, these payments were “industry practice” and the kickbacks did not harm plaintiffs. Lerach may be right, and some good surely came from his actions. The corporations he sued, however, would argue otherwise. In fact, many companies would settle suits they felt were baseless when faced with Lerach’s aggressive tactics, “rather than incur years of legal fees” defending against such suits. In addition to his prison time, Lerach paid eight million dollars in fines, which seems small in comparison to the $200 million he earned in practice.

Lerach’s case presents a prime example of an instance in which the attorney in a derivative suit or class action has a significant financial incentive to sue. Since this


123. In a suit against a director or directors for breach of fiduciary duty, the corporation often must pay directors’ defense and settlement expenses. See DEL. CODE ANN. tit. 8, § 145 (2008) (authorizing, and demanding, indemnification in certain situations). Of course sometimes the settlement requires the director to pay the settlement costs and attorneys’ fees. See, e.g., Steven D. Frankel, Comment, The Oracle Cases Settlement: Too Charitable to Ellison and the Plaintiffs’ Attorneys?, 4 DEPAUL BUS. & COM. L.J. 625, 625 (2006) (discussing the Oracle settlement, which required Larry Ellison to donate $100 million to charity and to pay millions in plaintiffs’ attorneys’ fees).


126. Id.

127. Id.

128. Peter Burrows, Payback Time for Bill Lerach? The King of Shareholder Litigation Against Silicon Valley Firms May Be Caught up in a Federal Probe of Allegedly Improper Payments to Plaintiffs, BUS. WK. ONLINE, June 30, 2005, http://www.businessweek.com/technology/content/jun2005/te20050630_1337_te024.htm (describing the many enemies that Lerach made in his securities litigation career).

129. Id.

130. Lattman, supra note 125. For a fascinating examination of the government’s case against Lerach, see generally Casey, supra note 71.
financial incentive could negatively impact a corporation, and therefore its shareholders, the lead plaintiff has a responsibility to ensure that the case is brought based on its merits and chances of success, not on the hope the suit will settle with little benefit to the corporation and significant benefits to the attorneys. In this way, the lead plaintiff can perform a gatekeeping function that an attorney may fail to perform because of financial disincentives.

**B. Institutional Investors Provide a Source of Lead Plaintiffs with Knowledge of the System and the Likelihood of a Claim’s Success**

The average person owning a few stocks in a corporation may not have the interest or knowledge to direct the course of shareholder litigation. They, therefore, may be more likely to rely blindly on the attorneys in the case for information and advice. In this context, placing the burden of fiduciary duties (and, more importantly, providing consequences for failing to fulfill those duties) on lead plaintiffs is not only a waste of time, but also unfair. Institutional investors, however, have developed a strong presence in securities litigation, and these investors have the interest and knowledge to bear the fiduciary burdens that lead plaintiffs should. In fact, institutional investors have already been responsible for some successful shareholder actions, and the PSLRA encourages the use of institutional lead plaintiffs in class actions.

In passing the PSLRA, Congress noted institutional investors’ superior position to lead these lawsuits:

One of the express goals of the [PSLRA] was to strip plaintiffs’ attorneys of their perceived control over the prosecution of securities class actions and to encourage institutional investors to take the helm. Perceiving a crisis in the number of “lawyer-driven” strike suits, Congress believed that institutional investors with large financial stakes in the subject corporations, and therefore the largest losses as a result of securities fraud, would be effective guardians of the litigation process. Congress hoped that the lead plaintiff provisions of PSLRA, combined with more stringent pleading standards and a stay of discovery pending motions to dismiss, would be the key to reducing frivolous

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132. See Johnson, *supra* note 102, at 155 (“If an institutional investor, which represents the long-term interests of many small investors, decides that a certain form of relief is appropriate, it is more likely superior for the majority of investors than the relief which would be sought by a ‘professional plaintiff’s’ lawyer.” (quoting Gluck v. CellStar Corp., 976 F. Supp. 542, 548 (N.D. Tex. 1997))).

133. See, e.g., Eisenhofer, *supra* note 131, at 151 (noting that in 2005 and 2006 “institutional investors recorded seven of the ten largest securities class action settlements in history”); Stephen Taub, Freddie Mac Settles Suit for $410 Million, CFO.COM, Apr. 21, 2006, http://www.cfo.com/article.cfm/6846382 (discussing a case initiated by the Ohio Public Employee Retirement System and Ohio’s State Teachers Retirement System that led to a $410 million settlement as well as governance reforms).

securities fraud litigation. In the case of derivative actions, since institutional investors often have a large financial interest, that interest drives them to encourage governance reforms and attempt to get as much of the settlement as possible from the defendants, as opposed to “wringing” cash from the corporation itself. Additionally, many of these institutional investors already owe statutorily imposed fiduciary obligations to their investors, and are therefore accustomed to the fiduciary role.

C. Why Settle a Worthless Suit?

The lead plaintiff’s fiduciary duties are particularly important in shareholder derivative litigation because of the many considerations beyond the merits of a case that enter into a decision to settle. A derivative action that is unlikely to succeed on its merits may still have a significant settlement value to a plaintiffs’ lawyer. Litigation is expensive, and settling a case, even a case that would not succeed on its merits, can be less expensive than the costs of getting the case dismissed, and certainly less expensive than going to trial.

In re Caremark Derivative Litigation provides an example of a settlement that

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135. Id.; see also James D. Cox & Randall S. Thomas, Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions, 106 COLUM. L. REV. 1587, 1588–89 (2006) (noting that “Congress clearly envisioned that various financial institutions . . . were the most likely types of investors who could combine a large financial stake in the suit’s outcome with the sophistication to guide the suit to an appropriate result”). In order to encourage institutional lead plaintiffs, the statute creates a rebuttable presumption that the shareholder with the largest financial interest in the action, who also meets the requirements of Rule 23, is the appropriate lead plaintiff. Eisenhofer, supra note 131, at 152 (citing 15 U.S.C. § 78u-4(a)(3)(B) (2000)).

136. Eisenhofer, supra note 131, at 162.


Plaintiffs . . . are likely to be able to impose far greater litigation costs on defendants than defendants can impose on plaintiffs or plaintiffs’ counsel . . . [R]ational defendants, knowing that they are going to win but that it will cost a fair amount of time and money, should be willing to settle if the settlement offer is low enough to be a fraction of expected litigation costs.

Yablon, supra, at 585.

139. See Burrows, supra note 128 (noting that corporations would often settle when faced with suits by aggressive plaintiffs’ litigators “rather than incur years of legal fees”).

140. See supra Part II.G.

141. See Winter, supra note 138, at 949 (noting that “even frivolous cases must be defended” and that “these costs may be substantial”).

cost the corporation money without producing any significant benefits. Caremark involved a derivative action brought against Caremark’s directors after the government forced the corporation to pay millions of dollars in civil and criminal fines for violating, among other things, anti-kickback statutes. Chancellor Allen approved the proposed settlement, explaining:

I conclude that this settlement is fair and reasonable. In light of the fact that the Caremark Board already has a functioning committee charged with overseeing corporate compliance, the changes in corporate practice that are presented as consideration for the settlement do not impress one as very significant. Nonetheless, that consideration appears fully adequate to support dismissal of the derivative claims of director fault asserted, because those claims find no substantial evidentiary support in the record and quite likely were susceptible to a motion to dismiss in all events.

Additionally, Chancellor Allen approved attorneys’ fees and expenses of $869,000. So, Caremark agreed to settle a case and pay significant legal fees even though the plaintiffs’ claims had “no substantial evidentiary support” and were “susceptible to a motion to dismiss.” The defendants likely agreed to settle because they determined it would cost less to settle than it would to win the motion to dismiss. Yet, the corporation itself—the purported beneficiary—funds the settlement and pays the attorneys’ fees (both the plaintiffs’ and defendants’). In the end, the corporation, the actual owner of the cause of action, is the real losing party.

Another situation that highlights why a corporation would agree to settle a case that may not succeed at trial is the Disney litigation. This case provides an example of a situation in which the defendants did not settle, and the plaintiffs had enough evidence to survive the motion to dismiss, but the plaintiffs still lost in the end. In this case the plaintiffs’ attorneys did not get paid, but the defendants’ did—and since the court determined no fiduciary breaches occurred, the corporation had to pay those attorneys’ fees.

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143. Id. at 960–61. Anti-kickback statutes address payments to doctors by health care providers for referrals of Medicare or Medicaid patients. Id. at 961–62.
144. Id. at 970–71.
145. Id. at 972. This was less than the $1,025,000 the lawyers requested. Caremark, 698 A.2d at 972.
146. Id. at 971.
147. See id. at 972 (noting the cost of attorneys’ fees and that the benefits of the settlement were “very modest”).
148. See In re Walt Disney Co. Derivative Litig. (Disney IV), 906 A.2d 27 (Del. 2006); In re Walt Disney Co. Derivative Litig. (Disney III), 907 A.2d 693 (Del. Ch. 2005); Brehm v. Eisner (Disney II), 746 A.2d 244 (Del. 2000); In re Walt Disney Co. Derivative Litig. (Disney I), 731 A.2d 342 (Del. Ch. 1998).
149. The case managed two trips to the Delaware Supreme Court, and, as is apparent from footnote 148, supra, spanned close to a decade.
150. Conversely, this case provides a good example of the risks that plaintiffs’ attorneys take in bringing these suits, both highlighting their motivation to settle, and possibly providing an argument for why they deserve high fees when settlements occur.
151. Disney IV, 906 A.2d at 35–36.
152. See Del. Code Ann. tit. 8, § 145 (2008) (authorizing, and demanding, indemnification in certain situations). Given that the court determined the directors did not breach their fiduciary duties and did not commit waste, the Walt Disney Co. presumably covered the directors’ legal expenses. See Disney IV, 906 A.2d
D. Bringing a Worthless Suit Breaches a Lead Plaintiff's Fiduciary Duties to the Corporation and Other Shareholders by Wasting Corporate Assets

As noted above, even a suit with little chance of success can cost a corporation a lot of money. Therefore, bringing a suit with such a slim chance of success violates a lead plaintiff's fiduciary duty to the corporation and its shareholders. Bringing a worthless action, whether because of ignorance or some other motive, violates the high requirements of fiduciaries. By agreeing to serve as the figurehead for the litigation, the lead plaintiff takes on the duty to be informed about the litigation, the prospects of success, and who is likely to pay the bill.

A lead plaintiff's failure to properly direct the derivative litigation can have serious consequences for the corporation. For example, Chancellor Chandler explained how inappropriate or poorly pleaded demand futility could injure the corporation:

If there is no reasonable doubt that the board could respond to demand in the proper fashion, failure to make demand and filing the derivative action results in a waste of the resources of the litigants, including the corporation in question . . . . If the facts to support reasonable doubt could have been ascertained through more careful pre-litigation investigation, the failure to discover and plead those facts still results in a waste of resources of the litigants and . . . in addition, ties the hands of this Court to protect the interests of shareholders where the board is unable or unwilling to do so. This results in the dismissal of what otherwise may have been meritorious claims [and] fails to provide relief to the company’s shareholders . . . .

This statement demonstrates that lead plaintiffs have the obligation to retain competent attorneys, as well as supervise the course in which those attorneys take the litigation.

IV. RECOMMENDATION

A. State Legislatures Should Enact a Statutory Framework Addressing Lead Plaintiff Fiduciary Duties

Lead plaintiffs are a significant piece of the enforcement puzzle. Plaintiffs’ counsel, and courts themselves, act as fiduciaries in derivative litigation. Lead plaintiffs, at 75 (affirming the Chancery Court’s finding in favor of the defendants at trial).

153. For example, a shareholder wishing to take over control of the corporation may bring an action claiming that the directors breached their fiduciary duties in order to enhance his or her takeover plans.

154. The lead plaintiff may have a similar role to that of a special litigation committee appointed by a corporation to determine if litigation is an appropriate solution to the claim. The special litigation committee's analysis “requires a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal.” Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981) (quoting Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980)).


156. Courts have come to take a more active role in approving or denying settlements. For example, in In re Fairchild Corp. Shareholder Derivative Litigation, C.A. No. 871-N (Del. Ch. May 18, 2005), Chancellor Strine refused to approve a settlement the parties presented to the court, citing the court’s “‘fiduciary responsibilities’ to the unrepresented Fairchild stockholders.” Gregory V. Varallo & Geoffrey G. Grivner, Recent Developments in Delaware Corporate Law, in 39TH ANNUAL INSTITUTE ON SECURITIES REGULATION 701, 745 (PLI Corporate Law & Practice, Course Handbook Series No. 11,518, 2007).
however, can serve an additional gatekeeping function: preventing meritless claims from costing corporations money.

In order to accomplish this goal, state legislatures should develop a statutory framework addressing the duties of shareholder derivative action lead plaintiffs. The PSLRA provides a beginning framework for attempting to encourage active lead plaintiffs. Its incentives and limitations, however, prevent the PSLRA from achieving its underlying goal of enlisting the most “effective guardians of the litigation process.”\(^\text{157}\) Problems with the PSLRA include its failure to impose affirmative fiduciary duties and corresponding penalties on lead plaintiffs, its lack of incentives, its limit on “professional plaintiffs,” and its failure to address what should happen when no plaintiff should bring a suit because of its low chance of success. This Part attempts to address the problems of the PSRLA, and to provide suggestions that would tailor PSLRA-type legislation to fit the needs of state derivative actions.

1. Require a Plaintiff Filing a Derivative Action to Provide Notice to Shareholders Who May Then Move to Serve as Lead Plaintiff

Certain provisions of the PSLRA are useful and state legislatures should incorporate these provisions into a statutory framework addressing shareholder derivative lead plaintiff fiduciary duties. One such provision is the notice requirement. This requires that within 20 days of filing a complaint, the class action plaintiff must “provide notice to members of the purported class in a widely circulated business publication.”\(^\text{158}\) At this point, interested shareholders have 60 days to petition to serve as lead plaintiff.\(^\text{159}\) At the end of the period the court selects the lead plaintiff based on who has the largest stake in the relief sought.\(^\text{160}\) That individual should be the petitioning plaintiff with the largest current shareholdings, who is therefore likely to have the corporation’s best interest in mind. When selecting the lead plaintiff the court should take into account possible conflicts of interest. The suggested sanctions,\(^\text{161}\) however, may independently deter would-be plaintiffs with conflicts from petitioning.

2. Allow the Court-Appointed Lead Plaintiff to Dismiss the Case

Some scholars have argued that institutional lead plaintiffs obtain larger settlements because they cherry-pick the best actions.\(^\text{162}\) This is a positive sign. The suits that plaintiffs should bring are those with the best chance of benefiting the corporation. In order to address the litigation expense problems highlighted in this Note, the court-appointed lead plaintiff should be able to dismiss the action with the permission of the court if the plaintiff feels the action has little to no chance of success. As a check on possible collusion between lead plaintiffs and defendants, if the court feels the claims have merit it should be able to deny the lead plaintiff’s request and appoint a new lead plaintiff. Allowing the lead plaintiff to dismiss the case is an important feature of this

\(^{157}\) Eisenhofer, supra note 131, at 152.


\(^{159}\) Id.

\(^{160}\) Id. at 33–34.

\(^{161}\) See infra Part IV.A.5 (discussing recommended sanctions).

\(^{162}\) Choi & Thompson, supra note 28, at 1506.
proposed system because it will help to ensure that plaintiffs do not bring suits that will not benefit the corporation.

3. Introduce Incentives for Institutional Investors to Serve as Lead Plaintiffs

Much of this Note’s argument relies on the presence of sophisticated investors to play the role of lead plaintiff. In order to encourage continued institutional investor participation in light of affirmative fiduciary duties, the statutory scheme should include the possibility of direct recovery for lead plaintiffs. The PSLRA takes an inappropriate approach to compensating plaintiffs. Congress determined that “[l]ead plaintiffs are not entitled to a bounty for their services” and that “[i]ndividuals motivated by the payment of a bounty or bonus should not be permitted to serve as lead plaintiffs.” This approach is suitable when individuals receive illegal kickbacks to serve as lead plaintiffs in litigation that they will not direct and know nothing about, but this approach is not suitable for institutional investors for whom time is money. Imposing fiduciary duties and implementing consequences for violating those duties would likely deter petitions from the very “professional plaintiffs” that concerned Congress.

The statutory scheme must address two main issues through its incentive system. First, it must encourage institutional investors, who are likely the most competent lead plaintiffs, to bring suits. Second, it should attempt to ensure that claims that do not benefit the corporation do not proceed and cost the company money. To accomplish this, the statutory scheme should include compensation for time spent on the litigation, as well as bonuses based on the outcome.

a. The Statutory Scheme Should Fully Compensate Lead Plaintiffs for Their Time and Efforts

Institutional investing is big business, and the industry’s time is valuable. Therefore, the statutory scheme should allow courts to award significant compensation for the lead plaintiff’s time and expenses. Of course, the court should have the discretion to determine if compensation requests are reasonable, but the court should keep in mind the value of the lead plaintiff’s time.

Additionally, if (1) the lead plaintiff examines the case and decides to bring a motion to dismiss; (2) the court determines the plaintiff made this decision in good faith; and (3) the plaintiff did not originally file the suit, then the court should award a small fee for the institution’s time. Conditioning the award on the court’s determination of the plaintiff’s good faith and requiring that the plaintiff not have originally filed the suit provide two safeguards to ensure that plaintiffs do not bring suits and then dismiss them.

163. See Joshua D. Fulop, Agency Costs and the Strike Suit: Reducing Frivolous Litigation Through Empowerment of Shareholders, 7 J. BUS. & SEC. L. 213, 213 (2007) (arguing that Congress’s intent to encourage institutional investor participation through the PSLRA is hindered by the fact that the Act does not offer incentives for institutional investors to serve as lead plaintiffs); Martinez, supra note 84, at 684–92 (recommending that courts fully compensate institutional lead plaintiffs in class action suits and provide incentives to serve as lead plaintiff).


165. See supra notes 124–130 and accompanying text (discussing William Lerach’s practice of paying illegal kickbacks).
in order simply to obtain a fee award. The corporation should pay this fee to the institutional investor. Although this suggestion initially seems counterintuitive, given the desire to keep costs to the corporation to a minimum, paying a small fee to the institutional investor for its time is less expensive (and a better use of resources) than litigating or settling a case that is without merit.

b. The Statutory Scheme Should Award Bonuses Based on Who Pays the Settlement and for Significant Governance Reforms

In addition to providing compensation for time, the statutory scheme should provide for bonuses based on who pays the settlement and for significant governance reforms. Awarding lead plaintiffs compensation for their time and costs would hypothetically lead them to break even, plus accrue any possible benefit from the stock increase. Institutional investors may feel that the litigation is not worth the effort to break even, and therefore may not petition to serve as lead plaintiff. By providing bonuses in addition to basic compensation, this statutory scheme would address possible free-rider problems and encourage qualified lead plaintiffs to petition the court to serve in this role.

i. The Statutory Scheme Should Allow Courts to Award a Bonus When the Actual Defendants Contribute to the Settlement

The value of a settlement to a corporation depends largely on who pays the settlement. If the corporation itself pays the settlement, it loses, because it will pay the lead plaintiff’s fees and attorneys’ fees. Mandatory and permissive indemnification requirements could present difficulties, but to the extent the settlement can avoid these issues, lead plaintiffs should seek to recover directly from defendants. This both provides the best cost recovery for the corporation, and deters future director malfeasance.166

ii. The Statutory Scheme Should Allow Courts to Award a Bonus for Significant Governance Reforms

In order to adequately deter future wrongdoing, a corporation needs to have systems in place that detect and highlight wrongdoing.167 Settlements that improve monitoring systems may be just as valuable to a corporation as actual money paid by defendants. To encourage governance reforms, the statutory scheme should authorize courts to award bonuses to lead plaintiffs who negotiate significant168 governance reforms as part of a settlement package.

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166. See supra notes 102–106 and accompanying text (describing how maximum deterrence and the best compensation for the corporation often align).
167. See generally In re Caremark Int’l Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (discussing the importance of appropriate monitoring systems).
168. Although the statutory scheme should leave what amounts to a “significant” reform to the discretion of the courts, courts should be cognizant of the term, and not award bonuses for minor changes or changes that the corporation already planned to implement. Cf. id. at 972 (noting that the governance reforms agreed to in the settlement provided “very modest” benefits).
iii. Incentives Independent of the Proposed Statutory Scheme

Additional avenues for encouragement lie in the interplay between shareholder derivative actions, institutional investors, and ERISA. Academics and courts have suggested that when certain institutions hold a corporation’s stock in trust for others, ERISA may require those investors to bring a suit when it is in the best interest of the corporation.169 ERISA and other legislative requirements placed on certain institutional investors may provide them with the encouragement they need to continue filling the lead plaintiff role, even in light of newly delineated fiduciary responsibilities to the corporation in question.

4. Clearly Impose Fiduciary Duties on Shareholder Derivative Action Lead Plaintiffs

The statutory scheme should clearly delineate the lead plaintiff’s fiduciary duties to the corporation. In order for lead plaintiffs to fulfill their fiduciary duties, they must know of and understand those duties. While Congress did not intend for the PSLRA to impose fiduciary duties on lead plaintiffs,170 state legislatures should make clear that the lead plaintiff in a derivative action is a fiduciary, and therefore has duties to the corporation.

a. Borrow from Current Statutory Fiduciary Duty Frameworks

Current statutory frameworks exist that address fiduciary duties. These statutes could provide a resource for delineating the fiduciary duties of a shareholder derivative action lead plaintiff. One example of a statutory source of fiduciary law is ERISA.171 ERISA imposes five fiduciary duties on the pension plans it covers.172 First, it requires the fiduciary to act solely in the interest of plan participants and beneficiaries.173 Second, it requires the fiduciary to “act with the care, skill, prudence, and diligence of a prudent person acting in like capacity.”174 Third, the plan must diversify its investments.175 Fourth, the pension plan “must act in accordance with the provisions of the plan documents.”176 Finally, the fiduciary cannot participate in transactions that ERISA expressly prohibits.177 These requirements implicate the basic fiduciary duties of loyalty and care.178

The proposed statutory scheme would need to tailor the specific fiduciary requirements to the role of the lead plaintiff. ERISA demonstrates, however, that statutes can incorporate the fiduciary duties of care and loyalty into clearly defined statutory responsibilities. By using the underlying concepts of care and loyalty, legislatures could

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171. Martin & Metcalf, supra note 137, at 1404.
172. Id. (citing 29 U.S.C. § 1104 (1994)).
173. Id.
174. Id.
175. Id.
177. Id. at 1405.
178. Id. at 1405–06.
develop fiduciary frameworks that inform lead plaintiffs of their responsibilities, while providing courts with a standard against which to judge violations.

b. Borrow from Case Law Defining Fiduciary Duties

Fiduciary duties have developed largely through the efforts of courts. Delaware courts have been particularly helpful in giving substance to the fiduciary duties of care and loyalty.\textsuperscript{179} These decisions provide a solid structure upon which legislatures can define the specific duties of the derivative action lead plaintiff.

c. Leave Room for Court Discretion

Although the proposed statutory framework should clearly define the lead plaintiff’s duties, it should also leave room for judicial discretion. As mentioned above, courts have long dealt with the implications and requirements of fiduciary duties.\textsuperscript{180} Additionally, people are creative—it is difficult to plan for the bad-faith courses of action people and institutions may take. By allowing courts to address bad-faith actions on the part of lead plaintiffs, the system will better address the realities of shareholder litigation.\textsuperscript{181}

5. Sanction Lead Plaintiffs Who Violate Their Fiduciary Duties

Lead plaintiffs must face consequences for violating their fiduciary duties. Punishment must be adequate to discourage meritless claims and disloyal or careless behavior, yet it should not be so severe that it deters shareholders from bringing worthwhile suits.\textsuperscript{182} Appropriate sanctions will ensure both that lead plaintiffs take control of the action and champion the corporation’s cause, and that lead plaintiffs will not affirmatively violate their duties. In instituting a statutory scheme, legislatures should consider implementing a combination of three sanctions: (1) disgorge fees awarded to the lead plaintiff; (2) require plaintiffs to pay the corporation’s legal fees; and (3) disallow future service as a lead plaintiff.

Under the proposed statutory scheme, lead plaintiffs would receive significant compensation and be eligible for outcome bonuses.\textsuperscript{183} Therefore, if lead plaintiffs violate their fiduciary duties, the statutory scheme should require them to return any compensation or bonuses to the corporation. For example, courts have disgorge legal fees from attorneys who have breached their fiduciary duties to their clients.\textsuperscript{184}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{179} See, e.g., In re Walt Disney Co. Derivative Litig. (\textit{Disney IV}), 906 A.2d 27 (Del. 2006) (discussing the fiduciary duties of care and loyalty).
\item \textsuperscript{180} See supra Part IV.A.4.b.
\item \textsuperscript{181} For an example of a court removing a lead plaintiff because of suspicions that the plaintiff had sold its stock short to help drive down the price of the corporation’s stock, see Burrows, \textit{supra} note 128.
\item \textsuperscript{182} But see Weiss & Beckerman, \textit{supra} note 169, at 2125–26 (arguing that courts should implement a procedural environment where institutional investors could face liability for not serving as lead plaintiffs). Considering the business judgment rule’s important role in shareholder derivative litigation, it is difficult to ignore the justification for the rule when imposing consequences on lead plaintiffs. Too much second guessing can discourage the best people from taking a position in which the appropriate action is not always clear. For a discussion of the business judgment rule, see Hal R. Arkes & Cindy A. Schipani, \textit{Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias}, 73 OR. L. REV. 587, 613–16 (1994).
\item \textsuperscript{183} See supra Part IV.A.3.
\item \textsuperscript{184} Hendry v. Pelland, 73 F.3d 397, 402 (D.C. Cir. 1996); see also FED. R. CIV. P. 11(c) (authorizing the
\end{enumerate}
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Considering the value of institutional investors’ time, this remedy could place significant financial burdens on lead plaintiffs who choose to violate their duties to the corporation.

As this Note highlights, one of the major problems with meritless derivative suits is that litigation is expensive. If lead plaintiffs choose to violate their fiduciary duties, and in doing so either bring a suit that should not have been brought, or cause extra litigation expenses to the corporation, the statutory framework should allow courts to award the corporation the cost of its fees in relation to the breach. This encourages lead plaintiffs to litigate carefully and in good faith, and compensates the corporation (and its shareholders) if they do not.185

The point of this proposed statutory scheme is to encourage competent, trustworthy plaintiffs to control the course of the corporation’s litigation. If lead plaintiffs violate their fiduciary requirements, they are not meeting the standards of the lead plaintiffs that should be in control of shareholder derivative litigation. Therefore, the proposed statute should bar lead plaintiffs who violate their fiduciary duties in the course of a derivative action from further service for at least three years.186

V. CONCLUSION

Derivative actions can positively influence corporate America. These actions allow shareholders to bring a corporation’s cause of action to fruition, even if the directors refuse to address the situation either because of self-interest or in order to protect fellow board members. Unfortunately, many courts, commentators, and much of the public do not view the shareholder derivative action in the positive light that they once did. In order to prevent a backlash against derivative actions that could effectively destroy them, the courts and state legislatures need to address the problems with shareholder derivative actions, as well as with other forms of representative litigation. The issue is perhaps best articulated by Vice Chancellor Strine:

particularly in the representative litigation context, where there are deep concerns about the agency costs imposed by plaintiffs’ attorneys, our judiciary must be vigilant to make sure that the incentives we create promote integrity and that we do not, by judicial doctrine, generate the need for defendants to settle simply because they have no viable alternative, even when they have done nothing wrong. This vigilance is appropriate not because the representative litigation process is not important to our corporate law’s ability to protect stockholders against fiduciary wrongdoing, but precisely because it is so important. That process should not be one that we permit to be seen as
lacking in integrity and therefore vulnerable to elimination. \(^{187}\)

By requiring lead plaintiffs to take responsibility for the course of the litigation, courts and legislatures can reduce frivolous claims, leaving more judicial energy for meritorious claims that can deter future corporate wrongdoing.

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