Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven

Charles J. Goetz
A VERDICT ON CORPORATE LIABILITY RULES
AND THE DERIVATIVE SUIT:
NOT PROVEN

Charles J. Goetz †

Most of what Fischel and Bradley (F&B) argue in their paper is useful, interesting, and frequently persuasive.1 In such a provocative paper on a controversial subject, one expects—and finds—some observations that are ultimately unconvincing. In order to get on with the commentator's assigned task of dredging up possible weak points, I shall dispense praise only briefly. It would nonetheless be unfortunate and unintended if this overall focus on reservations about certain of F&B's arguments were taken as evidence of substantial disagreement with the major thrust of their discussion. At best, they have enlightened me, and at worst, they have perplexed me.

A major contribution of F&B's work is that the authors raise the right issues. One aspect of this flows out of the recognition that alleged violations of management duties may be analyzed from the perspective of contract rather than that of tort. Contract law is generally permissive. It provides "off the rack" rules that parties can tailor to their own needs by adding express terms that supplement or "trump" features of whatever relationship the law has preformulated for them.2 One can imagine a variety of ways in which differ-

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ent groups of stockholders might wish to structure the agent-
principal relationship with managers. Some of the major rules
courts apply to corporate managers, however, seem to be relatively
fixed features of the legal landscape. Since stockholders are the
presumed beneficiaries of the rules in question, F&B rightly raise the
fundamental question: are these the rules that stockholders really
want and value, or are they arbitrary and wasteful judicial artifacts?
The answer to this important question is perhaps more difficult to
derive than F&B acknowledge, however.

A second general contribution of F&B’s work is their insistence
that commentators evaluate alternative responses to agent-principal
problems in terms of a criterion fabled, at least in the Goetz house-
hold, as the “As compared to what?” standard. In the real world,
solutions to complex problems are all likely to suffer from major
flaws. It is a snare for the unwary to argue that a solution that per-
mits certain “abuses” is ipso facto a bad choice. In truth, the least
bad choice is necessarily a comparatively good policy choice.

Most of my reservations about F&B’s analysis stem from the au-
thors’ lapses in tracing out all the alternative pathways of their own
methodological road map. Unlike this author, F&B have a sophisti-
cated and fully matured view of the corporate law terrain. While in
most respects this is surely an advantage to them, it raises the dan-
ger that they see the expected bushes, shrubs, and trees where more
naive eyes see only shadowy mists and lumpy boulders. In a few
important instances their rationales for policy implications seem lit-
tle or no more plausible than counter-rationales with dramatically
different policy implications.

I

The Empirical Test

An initial puzzle arises because of the significance that F&B at-
tribute to their empirical study of the effect of derivative case dis-

contract terms to their needs than does Uniform Commercial Code); Jackson, “Anticipa-
tory Repudiation” and the Temporal Element of Contract Law: An Economic Inquiry into Contract
Damages in Cases of Prospective Nonperformance, 31 Stan. L. Rev. 69, 98 n.91 (1978) (con-
tract law provides rules suitable in most cases but allows individuals to agree to deviate).
Some insufficiently acknowledged drawbacks to this permissiveness are analyzed in
Goetz & Scott, The Limits of Expanded Choice: An Analysis of the Interactions Between Express
and Implied Contract Terms, 73 Calif. L. Rev. 261 (1985) [hereinafter cited as Goetz &
Scott, Expanded Choice].

F&B admit, for example, that special litigation committees are an imperfect
method of decisionmaking. They conclude, nonetheless, that the costs of unmeritorious
derivative suits outweigh the disadvantages of giving a management-appointed commit-
tee the power to terminate litigation. See F&B, supra note 1, at 274.
missals on stock prices. First, it is not clear what one's a priori expectation should be about the direction of the effect purportedly measured. There is no reason to reject in principle the possibility that some derivative suits are wealth-maximizing and others are not. A court's dismissal of a suit might generate either an abnormal positive or negative return depending on the particular factual context of the case. By averaging the individual cases in their sample, F&B conceivably allow dissimilar announcement effects to net out against each other. Although their data presumably permit statistical testing for unusual price movement of any kind, i.e., without regard to algebraic sign, F&B do not report any findings on this arguably more relevant point.

A second problem with F&B's study is that the price-impact test they use implicitly presupposes that the dismissals are new information to the market. If, instead, investors' expectation of a dismissal has already substantially "leaked" into the stock's evaluation, there would be no reason to anticipate any market reaction at all. Thus, what F&B might be measuring is the effect of announcements devoid of significant information rather than the real impact of the suits themselves.

Finally, it is less than obvious what magnitude of price effect ought to be observable, even if we assume that (1) derivative suits do enter the market's calculus in some systematic way and (2) the dismissal announcements are genuinely new information. At most, a dismissal alters the investors' preexisting expected value of a future income stream. What kinds of success probabilities are relevant for suits that survive such dismissals? What potential magnitudes of recovery are involved? Perhaps most important, however, is the issue of the normative implications that may be derived from evidence of negligible price effect. Does the absence of impact mean that derivative suits are "neutral," a nonproblem? Because F&B would answer the latter question in the negative, this author is uncertain why they seem so cheerful about their reported empirical results.

II
INTERPRETING THE FACTS: AN ALTERNATIVE CHARACTERIZATION

If we were certain that the market value of a stock typically falls when a derivative suit is filed and rises when the suit is dismissed, what could or should we conclude from this information? Presumably F&B would interpret these facts as strong evidence of what they
illuminatingly discuss as minority-rule suits: actions that are not cost-effective and are therefore inconsistent with the wealth maximization goal of the average stockholder.\(^5\) Under this interpretation, if stockholders were free to structure corporate liability rules contractually, they would enhance their wealth by limiting such suits. One such limiting device is the litigation council, a filter on unprofitable suits, and therefore arguably a desirable institution. F&B's inference is plausible, but one can posit and defend another scenario with precisely opposite policy implications.

The alternative scenario can be illustrated by a two-step game-theory model, wherein the manager first chooses whether to be honest and then stockholders choose how to react. Suppose that a potentially deviant\(^6\) corporate manager views his payoff matrices as having a form similar to Exhibit I.\(^7\) The matrix indicates that the manager's returns depend on a combination of his own conduct and whether the stockholders sue him if he cheats. The exact numbers are not important, but their relative magnitudes are: a key element of the game's structure is that the manager maximizes his payoff by cheating when he does not expect retaliatory suit.

Exhibit I
Payoff Matrix for the Manager

<table>
<thead>
<tr>
<th>Manager's Conduct</th>
<th>Stockholder's Reaction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Suit</td>
</tr>
<tr>
<td>Conform</td>
<td>90</td>
</tr>
<tr>
<td>Cheat</td>
<td>100</td>
</tr>
</tbody>
</table>

Exhibit II shows the analogous payoff matrix for the stockholders. Again, only the relative magnitudes of the numbers are important. The shareholders maximize their payoff when the manager is honest and there is no occasion for legal action. If the manager

\(^5\) *Id.* at 271-74 (contrasting ability of any shareholder to bring a derivative suit with general majority-rule system of corporate governance).

\(^6\) F&B's paper provides a good discussion of the difficulties in defining the obligations of the manager. It follows that the term "deviant" conceals a multitude of problems. *Id.* at 264-65.

\(^7\) The intent of this matrix is to depict a manager who is susceptible to the lure of dishonest behavior but recognizes the prospect of legal liability. Of course, other considerations such as a sense of honor, guilt, or concern for reputation may influence the perceived payoffs to a degree that any legal sanctions become irrelevant. Although legal sanctions may have little relevance to the conduct of most managers, it makes sense to focus here on at least that subset for whom legal incentives matter. Obviously, the game in the text oversimplifies the real world in other respects, but it captures the essential flavor of a real behavioral dilemma.
cheats, however, a stockholder suit is not cost-effective. If the stockholders choose to litigate, the stock market will reduce the value of the firm's stock because the suit exacerbates the loss from the manager's conduct.

Exhibit II
Payoff Matrix for Stockholder

<table>
<thead>
<tr>
<th>Stockholder's Reaction</th>
<th>Manager's Conduct</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Conform</td>
<td>Cheat</td>
</tr>
<tr>
<td>No Suit</td>
<td>100</td>
<td>70</td>
</tr>
<tr>
<td>Suit</td>
<td>na</td>
<td>60</td>
</tr>
</tbody>
</table>

If stockholders rationally assess the returns from a suit, managers should have no fear of retaliatory litigation. The predicted result of the game is that managers cheat and stockholders fail to sue. Ironically, stockholders would be better off if they irrevocably committed themselves to "irrationally" suing whenever a manager cheats. Managers would then choose to conform to their obligations, litigation would be unnecessary, and stockholders would maximize their payoffs. Stockholders can threaten management by announcing an intention to litigate, but the threat is not very credible; once the cheating manager calls the stockholders' bluff, wealth-maximizing stockholders will "forget" the threat and refrain from suing. In this scenario the presence of a small stockholder group that may sue on "principle," or because of some other motive that deviates from Exhibit II, takes on special significance as an element of the bluffing game. Exposing management to a significant prospect of suit by uncontrollable gadflies may therefore have a certain bizarre but powerful deterrent logic that benefits majority stockholders.

This last scenario provides a theory that is entirely consistent

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8 This assumes that the game is not frequently iterated. If stockholders were exposed to cheating frequently, it would be rational to engage in loss-exacerbating suits, thus earning a reputation for unreasonable litigiousness and making up any transient losses through future deterrence of managerial cheating.

9 The logic of this scenario is quite similar to the strategies of retaliatory precommitment dealt with in some of the "nonlegal enforcement" contract literature alluded to by F&B. See F&B, supra note 1, at 263 n.7. This reasoning also is similar to the underlying point of an article co-authored by Fischel which discusses precommitment strategies of nonresistance to takeover bids. See Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARY. L. REV. 1161 (1981). Viewed once a takeover offer has materialized, nonresistance is an apparently irrational policy that lowers the buy-out price. But viewed much earlier in time, the nonresistance commitment arguably produces benefits that outweigh the loss because it reduces agency costs by stimulating greater scrutiny of the company by hostile bidders.
with the hypothesized empirical data. If a manager cheats, the institution of a derivative suit will be opposed by majority stockholders because litigation will depress the stock value. The devaluation of the firm’s stock, however, only reflects the excess burden of a failed precommitment deterrent. If we focus only on such diminutions in value, we will fail to account for the possibility of overbalancing benefits of the successful deterrent precommitments which eliminate cheating and lawsuits. Thus, rational wealth-maximizing stockholders will ex ante choose to allow derivative suits, even if they occasionally have good reason to regret the commitment ex post when the deterrent fails to work.

III

OTHER AMBIGUITIES: “CONTRACTING AROUND” THROUGH INSURANCE

The preceding section attempted to show that plausible alternative theories can generate conflicting normative implications from the same set of facts. A similar plight befalls F&B’s conclusions regarding the significance of management’s ability to insure against liability. At first blush, a strong case can be made for F&B’s interpretation of insurance as an attempt to “contract around” state-imposed liability rules. The authors impliedly assert that if stockholders thought that management liability was in their best interest they would not pay to nullify that liability by insuring their managers against it. F&B’s unstated conclusion can thus only be that it would be simpler and more efficient just to abolish the liability rules.

Again, a plausible alternative theory suffices to muddy the waters. The key to this alternative explanation is the use of external parties for monitoring purposes. The use of external auditors is a device that stockholders use to overcome a lack of both monitoring incentives (the free rider problem) and monitoring expertise. Insurance companies can be used as an effective monitoring device. Private individuals, whose insurance policies cover mainly property of modest value, underestimate the amount of monitoring done by the carriers of liability on large-exposure risks. For instance, commercial buildings and warehouses are frequently the subject of insurance company inspections for fire and other safety hazards. What better way exists to get an external expert to monitor one’s

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10 F&B, supra note 1, at 285 (“Indemnification and insurance allow firms to contract around liability rules in certain circumstances.”).
11 But see Judge Richard Posner’s surprising opinion in Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), cert. denied, 459 U.S. 880 (1982) (holding primary duty to monitor inventory fraud was that of stockholders, not auditors).
management than by giving it a large stake in the potential losses? Thus, insurance is more than mere risk pooling or diversification; it reduces risk by shifting the prospective loss to a party with a better prospect of effectively monitoring the conduct that generates the risk. Insurance acquisition could perhaps best be viewed as the purchase of monitoring services rather than risk indemnification. The existence of liability rules creates the insurable risk and the external monitoring opportunity. Hence, stockholders who opt for liability insurance are not necessarily expressing a preference for repealing the liability itself.

On a different but related tack, insurance cannot completely cure excessively risk-averse behavior by managers. Indemnification of the manager will never cover all costs, including the reputational ones, of being sued. Therefore, the manager will still have powerful incentives to avoid the risk of being sued—although he may care less about the size of the damages being claimed.

IV

The Care-Loyalty Distinction: Is It Meaningful?

Contract methodology suggests that F&B are too quick to condemn the distinction between the duty of care and the duty of loyalty as one that is artificial. Although all broad formulations have an element of fuzziness to them, F&B do not convincingly prove that factfinders are unable to distinguish conduct that breaches one of these standards rather than the other.

If one concedes that the distinction between the duties is meaningful, the only further test ought to be a practical one. A classification is "artificial" only if no theoretical or empirical reason exists for supposing that the parties affected by the rules might find it useful to treat the two areas of conduct differently. Contrary to the position of F&B, the legal system should be applauded for carving out common understandings about principles of distinction that could help parties articulate their relationships. From this perspective one can defend the distinction between care and loyalty on a number of grounds, including the differing ability of judges to iden-

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12 In risk pooling, the expected value of the risk is unchanged, and the advantage comes from reduction in its variance. Risk reduction actually reduces the probability of the loss. See the discussion of different sources of least-cost risk bearing in C. Goetz, Law and Economics (1984).

13 F&B, supra note 1, at 291. In an earlier draft of their paper F&B described the distinction as "artificial." They remain critical of the distinction, however, and I persist in my contention that the distinction has value.

14 See, for instance, the discussion of "invocations" in Goetz & Scott, Expanded Choice, supra note 2, at 281-83.
tify a failure of loyalty as opposed to one of care.\footnote{15}

F&B's apparent hostility to the care-loyalty distinction may partially stem from an inartful expression of their views. Their actual discomfort is probably not with the distinction itself but rather the particular kind of legal treatment that the courts and the ALI drafters have grounded upon it. The rationales offered by the drafters are, in truth, not entirely persuasive. Since the differential treatment is mandatory rather than permissive, it certainly cannot claim to have been validated by any revealed-usefulness test.

Conclusion

This author cannot claim to know much about corporate law, and indeed, my knowledge has probably advanced by an embarrassingly large fraction as a consequence of reflecting on F&B's paper. The conflicting hypotheses in this reply are offered essentially in the nature of a devil's advocate for the "not proven, tell me more" camp. Indeed, some of what have been described above as conflicting theories are not necessarily mutually exclusive; the real world may be captured only by complex webs drawn from these separate conceptual threads. The problem is one of finding an oversupply of intellectually interesting theories among which it is difficult to choose.

\footnote{15 The law seems to find this distinction useful in other areas as well. In tort, for instance, a potential rescuer is not generally held to a duty of loyalty to intervene. See W. Prosser & W. Keeton, The Law of Torts § 56, at 375 (5th ed. 1984). If he does intervene, however, courts may imply a duty of care. One reason for this may be quite simply that courts are more comfortable at recognizing incompetent rescuers than they are at balancing the reasons for nonintervention. Although one may wonder at why the courts apparently take the opposite approach in treating this distinction within corporate law, the underlying principle of behavioral classification certainly seems "meaningful".}