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A Neglected Policy Option: Indemnification of Directors For Amounts Paid to Settle Derivative Suits—Looking Past “Circularity” to Context and Reform

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Permitting corporations to indemnify directors for amounts directors pay to settle derivative litigation may have merit, despite the consensus against it. It yields more cheaply the same corporate recovery—zero—as a court dismissal. Thus, notwithstanding risks, it is not patently worse than current termination options. Moreover, a board's considering it may pose sharply the question whether no-recovery termination is defensible.

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I. INTRODUCTION

The case against allowing corporations to indemnify directors for amounts directors pay to settle derivative litigation appears overwhelming. The logic against indemnification is circularity of recovery—the corporation returns the recovered amounts to the wrongdoer and, after paying its own expenses and those of the plaintiff, is invariably a net loser. The case and logic against indemnification is persuasive to the vast majority of the states, including Delaware, and to the drafters of both the American Bar Association Model Business Corporation Act ("Model Act")¹ and the American Law Institute Principles of Corporate Governance.² The intuitive reaction of a sophisticated nonlawyer observer is even more decided—allowing a suit in which an acceptable outcome of a successful suit is a net loss for the plaintiff and a wash for the defendant is akin to setting up a system for lawyers to pursue lawsuits without plaintiffs.³

The little scrutinized legal bar on such indemnification rests within a system for litigation to redress directorial misconduct that is heavily


The Committee publishes the Model Act not merely as a persuasive model for comparison but as law which many state legislatures substantially enact into their state corporation codes. Elliott Goldstein, CORPRO: A Committee That Became an Institution, 48 BUS. LAW. 1333, 1334 (1994); see also DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 6:37 (1994) (stating that many states have indemnification statutes drawn from the Model Act and the Revised Model Act).

The changes deserve careful scrutiny because of their probable influence on state code provisions governing indemnification, the importance to public corporations of the provisions protecting directors from large unreimbursed personal liabilities, and the unusual complexity of the subject. See Committee on Corporate Laws, supra, at 749 (referring to provisions for indemnification and advance of expenses as "among the most complex and important in the entire Act").

2. Members of the American Law Institute’s Corporate Governance Project (ALI) created and adopted THE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Proposed Final Draft Mar. 31, 1992)[hereinafter AMERICAN LAW INSTITUTE]. These principles differ from the case of the Model Act, which state legislatures often enact into state corporate law. See Goldstein, supra note 1, at 1334 (describing the Corporate Governance Project).

3. Interview with David Lapin, CPCU; Vice President, Underwriting, Executive Risk Indemnity, Inc., in Detroit, Michigan (Jan. 25, 1995) [hereinafter Interview].
criticized as driven by perverse incentives. For the most part, commentary on the system of corporate litigation takes for granted the fundamental institutional factors that drive lawsuits brought on behalf of investors. Policy evaluations of such litigation are derived from a premise of an atomized moral climate—self-protecting boards, greedy lawyers, passive shareholders, and profit-oriented insurance companies that control funds which make attractive targets for lawsuits. Despite the ferment apparent in recent proposals for new rules and even new legal entities to alter the "market mechanisms" for corporate litigation,


The negative assessment of the usefulness of derivative suits has intensified in recent years in academic writing and in the popular press. See, e.g., Ralph K. Winter, Paying Lawyers, Empowering Prosecutors and Protecting Managers: Raising the Cost of Capital in America, 42 DUKE L.J. 945, 949 (1993) (stating that there is increasing evidence that derivative suits (and class actions) substantially diminish the return to investors in American companies); see also Dan Cordtz & Jennifer Reingold, The Vanishing Director Lawsuits, Angry Shareholders and Public Criticism Make Board Duty Unpopular, FIN. WORLD, Oct. 12, 1993, at 22 (referring to potential directors' well-founded fear of being hauled into court by some disgruntled shareholder).

5. James D. Cox, Searching for the Corporation’s Voice in Derivative Litigation: A Critique of Zapata and the ALI Project, 1982 DUKE L.J. 959, 963 (describing use of "special litigation committees" by boards of directors to, invariably, recommend dismissal of derivative suits).

6. See John C. Coffee, Jr., New Myths and Old Realities: The American Law Institute Faces the Derivative Action; Symposium of Corporate Governance, 48 BUS. LAW. 1407, 1429 n.81 (1993) (noting negative view of idea of "entrepreneurial" lawyers not constrained by clients); id. at 1436 (referring to清醒 evidence of settlements of little benefit to shareholders but very lucrative for plaintiffs' lawyers).


9. Both the 103d Congress and the current 104th Congress saw the introduction of bills intended to trim the extent of corporate litigation in the context of securities class actions. Many of the areas of policy change concern alteration of the incentives that drive this type of corporate litigation. For a summary of the bill introduced in 1994 by
fundamental assumptions about the moral climate that underlies the ground rules for corporate litigation, including the indemnification bar, are mostly intact in the literature. The rationale for the bar, and the possible arguments for removing it, deserve a concentrated examination that they have not received, not only for the possibility of altering policy but also for the insights into the practical differences between the predominant system of resolving derivative suits and its possible extension (through more liberal indemnification).

A. Summary of Argument

This Article presents the case for permitting boards to settle cases by allowing a director to acknowledge liability, pay a sum of money to the corporation, and receive its prompt return from the corporation. To see the question as clearly as possible, the crassest statement of the procedure should be set forth. The corporate board, which universally opposes derivative litigation, would be allowed to end a lawsuit by bribing the lawyers for the shareholders with a fee to allow the board to rescue an errant director from financial liability. While called a "settlement," the transaction is not really a settlement in the true sense, a settlement being a compromise between two opposing parties who sacrifice possible gains to reach a middle position. The proposed procedure is a use of corporate resources to end a lawsuit by bribing the two flesh and blood "parties"—the defendant(s) and the plaintiff's...
lawyer. The fundamental argument for allowing this to occur is procedural and is presented in Section IV.

The argument is defensive in nature. Roughly stated, while corporations are not permitted to bat away derivative suits by an unrestricted power to dismiss them, subject only to review in a second lawsuit under the business judgment rule, they are permitted to establish a mechanism, the special litigation committee ("SLC"), that invariably asks and frequently persuades a court to dismiss a suit as not in the corporation's best interests. Such a mechanism grants substantial leverage to the targets—corporate boards and management—who universally resist, indeed disdain, shareholder initiated efforts to recover damages from directors for injuries to the corporation. The SLC method of terminating suits is an anti-corporate litigation device, either lamented or praised, depending on one's view of the worthwhileness of derivative litigation.

Given the existence of the leverage accorded boards to achieve the dismissal of suits, permitting boards to fund settlements through indemnification—i.e., to "kick" the suit by lubricating the parties with money instead of a judge with reasons—is no worse an alternative. Critically, it achieves precisely the same net payment—zero—from the defendant. The advantage is that it nets the goose egg at a lesser cost and with less delay. That is, it is a faster and cheaper route to frustration.

Viewing the comparison of SLC dismissal and indemnification-funded settlement purely as a comparison of procedures and assuming naively that the board would settle the same suits that the court would have dismissed, the latter is unambiguously the superior procedure. If it produces the same substance, then the faster and cheaper procedure is superior.

Identifying the principle negative requires reducing the naivete of the assumption. The removal of the court from the decision takes away a disinterested body and substitutes one of keen partiality. Despite the use of subgroups buffered from direct enmeshment in the defendants' interests, no mechanism for board created purity bleaches the board to the tint of an outside, independent body. One must concede that if sent to separate rooms to reach a resolution, it is unlikely that the court and the board would make all the same choices.

The significance of this substantive difference can be thought of in at least three ways. First, in an indemnification resolution, the court takes a limited look at the payment arrangements when it approves a
settlement (statutes require settlements be approved). Indemnification is not, however, a point of emphasis; it is more nearly a point of information for the judge of a "be advised" tenor. Second, the board has theoretical liability for wrongful indemnification (indemnity is only authorized when the director has met certain statutory standards and, implicitly, when it serves the corporation's interests). Secondary liability constitutes a safeguard. The safeguard can be strengthened by carving out from the liability-elimination authorizations of corporate codes the decision by a board to grant indemnity. Third, reputational factors would discipline any inclination of boards to grant indemnity lawlessly. Code provisions mandate disclosure of indemnity payments in periodic reports to shareholders. Because almost any shareholder, whether a naif or a callow sophisticate, will experience such a disclosure as a startling revelation, the pressure for boards to act only on the basis of credible (and creditable) reasons will be high, arguably higher than hiring lawyers to build a case for dismissal to present in court.

To the extent these answers to the problem of director partiality are persuasive, they also provide reassurance on the issue of whether the procedure, in comparison with court dismissals, weakens deterrence. In reviewing the salient arguments against the procedure, this Article argues that deterrence is not weakened.

The most jaded observer of derivative litigation might suggest, "Why go through a complex so-called settlement? Just give the board the plain vanilla power to dismiss derivative suits. It's even cheaper and faster, and it creates the same result as a dismissal by a court or an indemnification lubricated 'settlement'. Won't the same arguments about cheaper faster results support that result, too?"

The answer is one of political realism. While the logic is the same, giving boards the power to fund settlements—throw cases out—is done in the framework of established conventions. Indeed, half a dozen states authorize the procedure. The proposal to strip all the forms that afford derivative suits—from docketing to disposition—the label of litigation is too unsettling. By comparison, the suggestion has sometimes been made to dispense with derivative suit plaintiffs, since they are figure-heads only. The answer to both suggestions is, in essence, a breezy brushoff. The form with which we are familiar is litigation: plaintiff(s), lawyer(s), defendant(s), with either adjudication or party resolutions. For the viewer and the participants, the outlines of the forms must be preserved. Any abuse of the form is more readily monitored by shareholders than would be rank use of a general authority to "kick" suits. Reports of litigation not pursued would lack the jolt to shareholders that reports of circular trips of damages would generate.
Thus, the practical proposal for quicker process through director indemnification upon settlement of charges is worthy of a closer look. No other short-circuiting beyond the SLC method is a reasonable alternative.

On the basis of the weak statement of the case for the procedure, it deserves more of a look than it receives. Despite the uncertainty of lessening the friction that impedes the board’s response to derivative litigation from being risklessly enacted in every instance, when juxtaposed to SLC dismissals, a ‘settlement’ method can be seen to make sense in the existing balance of power between management and shareholders.

This Article also raises the question of whether permitting the procedure might generate social good aside from the simple efficiencies that abbreviations of process necessarily produce. The issue is framed in a positive manner, unlike the core argument, which asserts that indemnification-driven termination is not patently worse than the termination process that exists. The reasoning about benefits to be taken from greater board leeway needs to be undertaken more cautiously. The argument that board dispositions may produce benefits beyond more efficient procedure could appear to suggest that the decisions of boards to end cases (or not) are more often “accurate” than are the decisions of courts. Such a suggestion would be an extremely conservative claim since the types of cases SLC’s seek courts to dismiss are “demand excused,” in which board capacity to act appropriately is sharply suspect. Thus, the general presumption of board regularity accorded to the board decision is not present, and to suggest that allowing the board to make the decision might produce superior outcomes would reflect an extraordinarily negative assessment of judicial oversight.10

10. The view that a court created disposition is manifestly superior to any board created outcome is, on the surface, somewhat at odds with the analysis of the logic of indemnification. See infra text accompanying notes 99-111. In that material, indemnification is conceptualized as an escape hatch from the regime of liability administered by courts, in which formal legal liability can be viewed as overinclusive. Under this reasoning, one should view agnostically in a given case the matter of whether the court or the board, if hypothetically differing, would have rendered the more “efficient” distributional solution between the corporation and the director. See infra text accompanying notes 108-111. The impediment to such a blithe acceptance of difference is a combination of “structural bias” and the tethering at all times of board choices to the best interests of the corporation. Indeed, when a board makes a motion asking a court to dismiss a
Thus, any hypothesis that board dispositions may create a good result must be carefully framed to exclude, as an element of the comparison with court dispositions, the question of the rightness of the outcome, i.e., the board’s or court’s yea or nay to the suit. The issues raised in this Article concern the collateral effects of the proposed increase of board authority on the participants and on the quality of the board’s conduct in responding to derivative suits. Principally, the question concerns the possibility that accountability of the board would increase from reconfigured statutes that seek to create a defensible mechanism for a more direct board role in case dispositions. In addition, the possibility seems worth thinking about that the availability of this procedure might reduce the central role assumed by insurance companies in protecting executives from monetary liability, and thus in shaping the litigation environment and imposing costs on corporations.

The suggestion in the second set of materials beyond the core argument is not, then, that the litigation process should be short-circuited on the basis that it produces mistaken outcomes, but that perhaps litigation could be shaped to produce social good not brought to the fore by an outcome, albeit a comparatively trustworthy one, purchased at the price of full-bore adversarial process. The second set of materials also proposes that corporate statutes could be designed to reward corporations for strengthening personal board accountability for litigation decisions rather than handing the same one-size-fits-all provisions for litigation to all corporations. The goal is to encourage defensible models of
corporate resolution of legally meritorious shareholder litigation, which might soften the negative climate of opinion surrounding derivative litigation driven by entrepreneurial lawyers and defensive boards.

B. The Consensus

In many respects the level of development of the rationale for the professional consensus about indemnification and that for the lay response are comparable. Each conforms to ready intuition and largely disengages from the context of derivative litigation. The influence of intuition is apparent. Both the lawyer's and the lay person's rejection of indemnification gain their force from a reaction against the apparent illogic of a system that fosters lawsuits where the winner of a civil monetary judgment by design would in many instances receive no actual recovery. The consensus is disengaged from context in that it fails to consider the incentives of the players in derivative litigation, most especially the board of directors, the nominal plaintiff in a derivative suit. In addition, the consensus fails to consider the impact of alternative statutory "grids" for derivative suit resolutions on these incentives. The noncontextual nature of the reasoning about the question exacerbates the legal tendency to make policy based on minimal empirical reasoning or evidence or, at best, on the basis of common sensical bromides with a modicum of empirical content or even a "mischaracterization of available evidence."

11. See BLOCK ET AL., supra note 4, at 958. Another exception historically found in most statutes precludes indemnification of judgments and amounts paid in settling or otherwise disposing of actions by or in the right of the corporation. The basis for this rule is a belief that it would be circular if funds received by the corporation (the ultimate plaintiff on whose behalf an action by or in the right of the corporation is brought) were simply returned to the defendant director who paid them.

Id.


13. See Seligman, supra note 9, at 1433 (suggesting U.S. Supreme Court mischaracterized available evidence in Central Bank v. First Interstate Bank, 114 S. Ct. 1439 (1994)).
The noncontextual content of the professional consensus and the lay reaction concerning indemnification of settlement amounts has a variety of results. First, a limited conception of the ethos and function of indemnification creates a poor fit with the law’s prevailing treatment of other aspects of derivative suit litigation and more general corporate law principles.

Second, the consensus ignores possible avenues of reform. For example, the prevailing view fails to relate ground rules for disposing of derivative litigation to concrete questions about techniques for improving the functioning of boards of directors as the “conscience” of management. If the statutory pathways to terminate derivative litigation are viewed in the context of evolving models for board operation, the analysis of policy choices should become richer by virtue of taking into account the moral climate of the board room, the aspirational effect on board deliberation of modes of terminating derivative suits, and the situational impact of alternative legal rules on the players in derivative litigation.

14. The consensus is substantial. AMERICAN LAW INSTITUTE, supra note 2, at 905-06 (“Most . . . statutes expressly deny indemnification to directors and officers of judgments or amounts paid in settlement of derivative actions, and permit indemnification in such actions only for reasonable expenses incurred in the proceeding.”). A majority of states (28) expressly bar indemnification for amounts paid in settlement while a small minority (nine) expressly permit it, with an additional six permitting it but only with court approval. Id. at 925; see also BLOCK ET AL., supra note 4, at 958-61 (discussing the apparent trend toward allowing indemnification of settlement amounts with court approval).

The new Model Act indemnification sections contain a provision that can be described in general terms as allowing indemnification of settlement amounts where a director can persuade a court of facts “peculiar to his circumstances” warranting such indemnification. See Committee on Corporate Laws, supra note 1, at 768 (setting forth revised § 8.54(a)(3)). With the adoption of the new Model Act provision for court approval, it may be expected that more states will allow a version of indemnification of settlement amounts upon court approval rather than an absolute bar. See infra text accompanying notes 231-35.

15. See Myles L. Mace, The President and the Board of Directors, HARV. BUS. REV., Mar.-Apr. 1972, at 37, 39-40 (discussing function of board as “corporate conscience” to prevent “unconscionable conduct”).


17. See Coffee, supra note 6, at 1409 (stating that a view of the board’s capacity or objectivity is not the underlying basis of the ALI approach to derivative litigation).

18. Cf. id. at 1415-16 (noting that the demand required/demand excused distinction paradoxically minimizes the board’s role in derivative litigation and places the decision about litigation in the court’s hands).

19. See Alexander, supra note 8, at 529-48, 558-66 (surveying the incentives of participants in class action litigation).
Third, a noncontextual approach to board ability to indemnify fails to cast light on the practical rationale of the entire Model Act, which includes a provision for disclosure of indemnification payments. This provision has the potential to buttress a vision of the corporate board’s role in managing and settling derivative litigation as one combining efficiency, accountability, and moral aspiration. A view of indemnification as a board option that might foster the good of greater information for shareholders about derivative litigation should alter the calculus of cost and benefit that non-situational reasoning about “circular” movement of money assumes. A purposive conception of shareholder litigation as seeking net positive results measured by the recovery by the corporation from individual lawsuits, compared with the outlay, focuses evaluation on a narrow cost-benefit analysis. This is perhaps less useful than a conception that asks what system-wide, prospective and case-specific, benefits can arise from mechanisms for resolution of shareholder suits that lift the moral climate of the boardroom by forcing a process of dialogue and disclosure.

Fourth, failing to analyze board indemnification of directors for settlement amounts contextually—by comparing it with court dismissal of derivative suits—directs attention away from the possibility that such indemnification may be superior as a board accountability device to either a court dismissal granted, at the instance of a board initiated corporate motion, or to settlements funded by insurance payments, made by insurance companies facing their highest risk of exposure for bad faith claim denial.

Fifth, the analytic neglect of the function of indemnification in the overall context of derivative litigation is unfortunate in light of the

20. MODEL BUSINESS CORP. ACT ANN. § 16.21 (1984) ("Other Reports to Shareholders").


22. See infra text accompanying note 159.

23. Interview, supra note 3; see Eugene R. Anderson et al., Liability Insurance: A Primer for Corporate Counsel, 49 BUS. LAW. 259, 270-72 (1993) (describing the “duty to indemnify” and the “duty to defend” under the Commercial General Liability Policy); see also Alexander, supra note 8, at 561 (describing insurance company exposure for bad faith refusal to settle).
momentum gained by efforts to sharply limit litigation by corporate shareholders. Close attention to indemnification might direct attention to nuanced reform possibilities that would discipline the process of derivative litigation by conferring authority to indemnify while fine-tuning the limitation of liability rules\textsuperscript{24} to provide a real discipline on boards when they make the decision to indemnify another director.\textsuperscript{25} Paradoxically, increasing corporate boards' authority to indemnify, if done with careful attention to the context of corporate litigation and the "non-givenness" of the general moral climate surrounding such litigation, might be a means of placing greater legal and moral pressure on boards to achieve defensible resolutions of derivative suits.

Finally, the noncontextual character of the consensus is consistent with the general analytic neglect of the settlement process in corporate litigation. While the character of corporate settlements—in particular, the extent of their relation to the merits of cases—is controversial,\textsuperscript{26} there is general consensus that settlements are the predominant mode of disposition of derivative suits.\textsuperscript{27} Yet the level of attention given to the

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\item \textsuperscript{24} DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (permitting charter amendments to eliminate liability of directors for fiduciary duty of care breaches); MODEL BUSINESS CORP. ACT ANN. § 2.02(b)(4) (Supp. 1994).
\item \textsuperscript{25} Cf. Bernard S. Black, \textit{Is Corporate Law Trivial?: A Political and Economic Analysis}, 84 NW. U. L. REV. 542, 573 (1990) (softening argument that mandatory rules have limited effect to suggest that mandatory rules may influence managers in such a way that agency costs are reduced). This Article suggests that greater freedom might have a salutary effect on the corporate culture. \textit{Cf. id.} at 573 (considering effect on corporate culture of legal rules compared with professional norms).
\item \textsuperscript{27} See Coffee, supra note 6, at 1436 (citing Roberta Romano, \textit{The Shareholder Suit: Litigation Without Foundation?}, 7 J.L. ECON. & ORG 56 (1991)).
\end{itemize}

As mentioned above, the term "settlement" is largely a misnomer, since a derivative suit settlement is not a compromise between two parties with opposed interests but a collusive agreement to end a lawsuit by financing the lawyers' fees and the damages. Yet a derivative suit settlement shares in common with real settlements the feature that the parties decide to reach a non-adversarial ending to a legal dispute. The process is disciplined by the rules set forth in the statutes giving the court some role in approving settlements and not by the opposing interests framed by a legal dispute between true adversaries. Thus, although it is not a mere quibble to say that derivative suit settlements share few characteristics with the settlements about which literature has developed, it is nonetheless the case that a non-adversarial resolution of legal matters will produce effects different from full-bore litigation. The literature on settlement is relevant to the question of what benefits (or negatives) might arise from a process that relocates the disposition of cases from adjudication to negotiation among the participants.
dynamics and effects of derivative suit settlement by statutes and scholars is scant. Policy discussions are necessarily impoverished.\(^28\)

The real-world effect of the prohibition is to limit board authority on a subject of critical importance to any business—the bringing and management of litigation. A code provision prohibiting corporations from indemnifying directors creates a gap in the corporate board’s capacity to manage derivative litigation in the interests of the corporation.\(^29\) Board influence over the termination of derivative litigation is otherwise affirmed by, and indeed central to, the typical corporate code’s efforts at balancing the levers of shareholder initiative with board authority over corporate affairs. The gap opened in the ability of the board to manage the litigation is not trivial. To the contrary, it is significant in light of the need for efficient means of ending lawsuits that have some legal merit but will on balance bring more harm than benefit to the corporation.

C. A Note on the Significance of the Topic

The importance of finding socially useful pathways to terminate derivative litigation depends on the degree of exposure of directors to lawsuits for damages based on their conduct as directors. With substantial permission given to corporations to eliminate liability for directors in corporate chartering documents, the need for buttressing the capacity of corporations to manage derivative litigation might be questioned.\(^30\) It is useful to consider the type of lawsuits to which

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28. *Id.* at 1440 (commenting that settlement is the critical stage at which reforms seem necessary and remarking on the legal profession’s conservatism about reforms that may affect its own interest).

29. The gap can be seen most sharply where indemnification is mandatory when a director is successful on the merits or otherwise in defense of a suit. *See, e.g.*, MODEL BUSINESS CORP. ACT ANN. § 8.52 (Supp. 1994). When combined with provisions making indemnification and advancement of legal expenses mandatory, the gap in board indemnification authority and the structuring of incentives in a manner compatible with continued litigation without reference to a board best-interests determination may be particularly hazardous to corporate best interests.

directors remain exposed—i.e., suits with some merit even after liability of directors has been substantially reduced under the statute—and to seek indications of the volume of suits that appear to have some merit in the existing regimes of liability.

A hypothetical may be useful. Assume a director named Harry in a medium-sized corporation, Y Corporation. Harry is neither the paradigmatic predator nor the ideal disinterested director. He has personal interests of various kinds that differ from the interests of the shareholders. Harry has been an officer for several years, with a comfortable compensation package that he could not readily replicate in another job with another company. Harry also has financial interests in entities, the affairs of which could become intertwined with those of Y Corporation in various ways. Harry does not intend to bring active harm to Y Corporation or to abandon its interests, but neither does he intend to abandon his own interests. Harry has a healthy regard for his personal well-being.

Harry is potentially capable of conduct that could give rise to a meritorious claim of a violation of his duty of loyalty. Y Corporation is publicly traded and thus a possible target for a takeover bid. Harry is unlikely to see the business need for a change of control of Y Corporation, whereby the entire management structure of the company will be upended. Key operations of the company would be at risk of relocation, creating damaging effects on local businesses in which Harry is an investor. If a takeover bid should occur and fail as a result of takeover defenses voted for by Harry, Harry may become a target of a shareholder’s derivative suit with some degree of merit. Whether the continuation of the suit is in the best interests of Y Corporation is a matter that can be determined through litigation of a dismissal procedure, or addressed in settlement discussions shaped by the ability of Y Corporation to extend an offer of indemnity to Harry for any monetary settlement.

authorizations for corporation to relax duty of care standard with "rebuttable" presumption in favor of the duty of loyalty and stating that no state permits limiting or eliminating liability for loyalty violations, despite variations in formulation of exception of duty of loyalty for authorization to eliminate liability).

31. See Ralph E. Jones, III & John P. Coonan, The Return on D & O: Director and Officers Insurance, 89 BEST'S REV., PROP. & CASUALTY INS. EDITION, Feb. 1989, at 28 (asserting that entrenchment is a common allegation for which D & O insurance is necessary).

32. It is beyond the scope of this Article to consider the effect of the formula to award attorneys’ fees on the need for a monetary judgment to justify such fees; even without the preference of attorneys for awards of money damages to justify awards, the logic of money damages would persist. The potential for damages is necessary for deterrence; the assessment of money damages, even where the director is indemnified
Harry may also be an active investor. This activity leaves Harry open to possible second-guessing. Consider the following facts drawn loosely from a reported case.\textsuperscript{33}

Corporation Y decides to acquire another corporation through the purchase of preferred stock, which has voting rights attached to it. The corporation acquires the preferred stock. When common stock becomes available, the majority of the directors, including Harry, personally acquire all the common stock that becomes available.

A stockholder brings a derivative suit, alleging misappropriation of a corporate opportunity and self-dealing. Y Corporation appoints an SLC, consisting of a distinguished former governor and university president, who was also a board member at the time of the disputed transactions. After investigation, the SLC concludes that Harry and the other defendant directors acted in good faith and the suit should be dismissed. The court concludes that the corporation has not carried its burden\textsuperscript{34} of proving that the SLC was independent. Furthermore, the court finds that the transaction is not protected by a finding that the directors acted in good faith, because it is now subject to a standard of entire fairness due to the SLC's lack of independence.

This is an example of a case with legal merit that, in a court's view, must proceed. It confirms the fact that liability continues to exist, despite statutory permission for corporate charters to eliminate considerable liability. This case also illustrates the risks, and the possible ameliorating factors and benefits, attached to allowing boards to indemnify directors for settlement of derivative suits.

Despite the considerable distinction of the board and the SLC, a court would not conclude the suit is lacking in legal merit, that the SLC is independent, and that the suit is not in the best interests of the corporation. Yet the court is at pains to avoid suggesting that the SLC has any other than good motives.

It is useful to consider the alternative routes the case might have taken if the option of settling, with a grant of indemnification to the directors, had been available. An obvious possibility is that the SLC would have

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\textsuperscript{33} Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985), appeal denied, 504 A.2d 571 (Del. 1986).
\textsuperscript{34} See Zapata v. Maldonado, 430 A.2d 779 (Del. 1981).
\end{flushleft}
settled the case and reimbursed the directors on the basis of the same thinking that led it to recommend to the court that the case be dismissed. Without being guilty of a corrupt motive, the SLC may have fallen into flawed judgment, allowing its partiality to obscure the necessity of looking with a skeptical eye on its own independence in addition to assessing the corporation's best interests and the underlying legal merits. \(^{35}\)

However, it is also possible that the risk of secondary liability for wrongful indemnification, or reputational harm, would have altered the SLC's deliberation, raising to the fore the issue of independence and corporate best interests. If an SLC determined that ending the case without corporate recovery through the mechanism of indemnification of settling directors was not justified, the SLC might well pause at recommending dismissal to the court. Without an initial examination by an SLC in possession of a conscience pricked by the moral weight of acting as the decision-maker, rather than only as the legal proponent of a motion to the court, the possibly mild embarrassment of having the court disagree on dismissal may not weigh heavily on the SLC's mind. After the exercise of moral responsibility associated with a full review of corporate options for ending the litigation, a director of the good motives attributed to the above SLC might well doubt the ethics of attempting to persuade the court to take an action which the SLC had deemed personally unacceptable. \(^{36}\) In the event that the board indemnified Harry and settled the case, when the court would have denied dismissal, at least Harry must bear the onus of a home grown conclusion that he has committed an actionable wrong. Indeed, the end result of a refusal by the court or the board to end the case—without Harry in the clear financially—may be a settlement funded by insurance. Such a settlement is likely to be one drained of the internal moral assessment

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35. It is worth considering whether boards might be encouraged to link the calculus for determining the best interests of the corporation to their assessment of the legal merits, which might argue for a generous assessment of the merits of the charges on the grounds that corporate interests would be served by articulating strong standards for directors' performance.

36. Of course, much of the reasoning will take place on the part of lawyers, who present heavily digested recommendations to the board. In the review of options, the lawyers too would have the experience of reviewing the possibility of having the board take the direct route and appreciating the significance of any rejection of that option for the propriety of the next option. Cf. Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 Tex. L. Rev. 477, 523, 529-37 (1995) (arguing the legal constraints on corporations encourage managers to abdicate moral responsibility, but applying the insight to proposals to broaden the corporate purpose to include ethical considerations as well as profit and to take into account the interests of non-shareholder constituencies).
that board-granted indemnification would encourage in the process of conceding the legal wrong and terminating the litigation. Thus, while no claim is made that a board termination by indemnification is superior to the results of court mandated litigation, it is nonetheless not a total wipeout for corporate accountability if a system of indemnification creates the occasional result that the board terminates litigation that a court would have permitted to continue.

If the facts of this case had been such that the court would have granted dismissal, then the question is presented whether director indemnification might be a more beneficial route to the same result. The job of the SLC would be to focus not merely on legal doctrine but on the best interests of the corporation. Arguably, and with greater development of the practice of fashioning statements of a defensible basis for settlement via indemnification, the best interests statement may include a useful assessment of the flaws in conduct that should be acknowledged in tandem with receipt by a director of indemnification. That is, a more fine-grained analysis of the demerits of the conduct in question could be encouraged as part of a resolution of charges designed to serve the best interests of the corporation.

Rather than focusing exclusively on legal doctrines that might or might not be a predicate for legal liability, the negotiations could address in a prudential fashion the parties' assessment of the wisdom of the transactions, given the legal standards, reputational considerations and the business atmosphere surrounding the transaction. A far more useful narrative of the transaction, and the lessons to take from it, might well be garnered from an indemnified settlement than from a record of court proceedings in which dismissal is granted. The court's primary attention is to best interests, assuming the underlying legal merits. In contrast, the corporation has an opportunity to create a document that thoroughly dissects the business and ethical content of the conduct in question. Indeed, a well disciplined process for creating an indemnified settlement would encourage the corporate representatives to articulate the strengths of the case against Harry and his colleagues to justify entering into a settlement, rather than exclusively making the case against liability. If associated with a requirement of disclosure and a set of standards for the process that encouraged the type of reflection sought

37. See Lewis, 502 A.2d at 967-69.
in managerial audits, the result could be a brand of self-criticism more productive of accountability and of guideposts for directors’ conduct than court-mandated dismissal of the lawsuit.

Despite the reduction of the total monetary exposure to which Harry is potentially subject, it is clear that the opportunity and motives remain for Harry to breach his director’s duty by misappropriating from his corporation. Thus, a constructive procedure for deterring Harry’s bad conduct and resolving charges that arise against Harry remains a topic of importance in corporate law. For those cases in which the court would grant dismissal, the procedure of indemnification-driven dismissal provides the board with an opportunity to enhance the social good attached to the termination of the lawsuit. For those cases in which the court would deny dismissal, the procedure carries with it certain risks that are arguably ameliorated by the addition of an option that focuses the board’s attention on whether the board could justify terminating the suit without consulting the court. While the board may choose improperly to indemnify and settle, it also may gain in moral insight from the review of its options and thereby choose neither to settle nor seek dismissal. In any event, the legal system tolerates some degree of risk of “wrong” decisions (as discussed below).

Legal liability of directors remains. Within that zone of liability, opportunities exist to increase the social usefulness of the process for imposing, or foregoing the imposition of, such liability.

D. The Need for Contextual Analysis and Policy Proposals

Given the nonempirical quality of the legal writing about indemnification and the significance of the gap in board authority, a framework for empirical reasoning needs to be articulated. Among the analytic tasks is to form hypotheses about the relationship between the options available to boards to end derivative litigation and such unruly “real-world” phenomena as the amount purchased, terms, and cost of directors’ and officers’ insurance. The gap in board authority over

38. While it is beyond the scope of this Article to empirically explore the nuances of the effect on the acquisition decision and the subset of questions about the interaction among the insured, the board, and the insurance company in an instance of covered litigation, it appears reasonable to hypothesize that the modes of disposition available have an effect on the patterns of purchase of insurance and the leverage between the parties when coverage comes into play.

While seven states now allow indemnification of settlement amounts, the lore surrounding the business practice of executive risk protection draws heavily upon the visibility of Delaware law, which omits to authorize indemnification of settlement amounts and substantially affects the standard national practice of building protection for directors in the event of lawsuits against them. DEL. CODE ANN. tit. 8, § 145(a) (1974).
litigation may have some degree of effect on the patterns of risk coverage thought necessary, perhaps largely from habits brought about by the "grid" of protection available to directors. At a minimum, it may be hypothesized that the inability of boards to indemnify settlement amounts is an important factor in the practice of corporations to bear the cost of (lightly regulated) insurance coverage and participate in settlement negotiations driven substantially by a "repeat player." This repeat player, the underwriter of executive risk insurance, brings sophistication, experience, and situational leverage that gives it the preeminent role in managing most specific occurrences of derivative litigation. While the repeat player may arguably bring benefits to the process of litigation, such as acting as the de facto manager of corporate litigation and funding recoveries for the corporation as the actual derivative plaintiff, it also: (a) allocates influence over decision-making about corporate affairs to a corporate outsider; (b) (by creating an incentive to rely on insurance) imposes an overall system

Thus, even though some states might theoretically be "laboratories of experimentation," it may be that there is no critical mass of corporate players who have considered the possibility of altering standard practice based on the potential impact of a differing state law.


40. Anderson et al., supra note 23, at 259 ("Unfortunately, corporate policyholders cannot look to state insurance regulators for protection.") (citing Jon Harkavy, Protecting Buyers' Needs: State Regulators Must Give Policy Form Changes Greater Scrutiny, BUS. INS., July 20, 1992, at 19 ("[T]he commercial insurance consumer is little more than an afterthought to a state regulator.")

41. See Leo Herzel, Law Should Allow Indemnity for Derivative Suits, LEGAL TIMES, Mar. 31, 1986, at 11 (asserting that, with statutory permission to indemnify directors for settlement payments, companies would only need to provide directors with insurance in case of insolvency).

42. Given the prevalence of settlements, it has been said that the "strategic position of repeat players" in securities litigation is the primary factor in settlements, rather than legal standards. Marc Galanter & Mia Cahill, Symposium on Civil Justice Reform: "Most Cases Settle": Judicial Promotion and Regulation of Settlements, 46 STAN. L. REV. 1339, 1385 n.208 (1994) (citing Janet C. Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 STAN. L. REV. 497, 566 (1991)).

43. Anderson et al., supra note 23, at 288 (describing typical liability insurance policies for corporations as contracts of adhesion sold to policyholders on a "take-it-or-leave-it" basis).

44. See Herzel, supra note 41, at 11 (arguing that directors prefer indemnification to insurance coverage but must have insurance because the risk of a derivative suit recovery by the corporation against the director is unindemnifiable).
cost—corporate insurance premiums—that creates a break-even effect, given investor diversification, \(^45\) less justified by loss spreading \(^46\) than in casualty coverage; and (c) invites litigation that targets the insurance fund because of the practicality of bringing a cash payment to a corporation’s treasury without the counter-intuitive “wash” that indemnification represents on a case-by-case basis.

The plausibility of such linkage is supported by the behavior of one chief executive officer who has strikingly embraced an empirical hypothesis about the effect of insurance on corporate litigation by adopting a “go naked” policy of refusing to purchase insurance that pays directors and officers in the event of suit. \(^47\) Further indication that outside repeat players are not ideal solutions in the mind of the corporate world are recent movements to allow a greater freedom for corporations to self-insure \(^48\) directors and officers—a movement with the probable effect of aligning more closely the interests of the corporation, the defendant, and the insuring group. \(^49\)

Thus, assessing the gap and deciding whether the legal system’s usual reaction to a gap—“fill it”—is in order requires a look at the entire context of derivative litigation in which indemnification occurs. A critical component is a device that has enabled boards to recapture the initiative in derivative litigation, after being for a time stymied by the legal system’s view that a board whose members had been sued could not play a significant role in resolving the suit. The law accords a large measure of deference to this device, known as the special litigation committee, or “SLC,” described below. \(^50\) The SLC has functioned in many instances to restore a measure of control over corporate derivative litigation to the boards of corporations. It is all the more striking, then, in evaluating the context surrounding the function indemnification might play, that the technical success of the SLC at enabling the corporation

45. Cf. Winter, supra note 4 at 948 (diversified investors’ losses in one company matched by gains in companies that receive damages payments).
46. Id. at 951 (settlements funded by insurance, if viewed in the aggregate, do not yield investors any return over premiums paid).
47. Sweeney, supra note 39, at 30.
48. See BLOCK ET AL., supra note 4, at 1091-92 (noting “substantial number of jurisdictions” authorizing alternatives to D & O insurance such as self-insurance).
49. While such a move may primarily reflect a concern for “hostile indemnification” situations after a change of control, it nonetheless is a solution to the problems presented above—the pre-eminence in the particular lawsuit of a repeat player that is alien to the interests of the corporation and the intuitive rejection of circular movement of money from the defendant to the corporate treasury and back again. But see id. at 1092 (noting rejection by Delaware of self-insurance on the grounds that it is “fundamentally circular”).
50. See infra text accompanying notes 160-62.
to end litigation does not bring about complacency by commentators satisfied with the SLC as a significant factor in disciplining derivative litigation. Indeed, the SLC device enjoys individual case applications during a time of substantial growth of anti-corporate-litigation sentiment and policy.  

Evaluating, endorsing, or criticizing the SLC is not a goal of this Article. Despite reservations expressed frontally by skeptical scholars and indirectly by judges calibrating the details of the accepted legal approach, the ability of corporations to end derivative litigation with the assistance of the SLC has reached that state of affairs in which a legal practice or rule has moved outside the arena of practical dispute. Nothing that is written about SLCs has a prospect of ousting them from the arsenal of corporate defenses against derivative litigation, absent a movement to fundamentally reorder the mechanisms by which corporations are held accountable to shareholders or, more implausibly in the current political climate, to create corporate accountability to non-shareholder constituencies.

E. Contemporary Policy Currents

The current policy context, to the contrary, is one fraught with reactivity to perceived negative features of shareholder litigation—the circulation of proposals and rhetoric aimed at disabling the mechanisms of shareholder litigation more radically, rather than by strengthening the authority of boards of directors to manage it in the interests of the corporation. Among the stronger proposals that have been in circulation is one to shift fees in private securities actions. A requirement of higher

51. See supra note 9; infra text accompanying notes 55-63; see also Dooley & Veasey, supra note 7, at 514 (stating that the premise of the ALI reporters in 1988 seems to be that there was too little derivative litigation).

52. See Coffee, supra note 6, at 1424 (describing liberal scholars' citation of evidence that SLCs almost invariably recommend dismissal of derivative suits). But see Quillen, supra note 30, at 124 (claiming that SLCs have fallen into disuse since Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985), appeal denied, 504 A.2d 571 (Del. 1986), given the risk that SLC findings will become a blueprint to prosecution of the suit); infra text accompanying note 212.


54. See Winter, supra note 4, at 952 (proposing appointment of a special master with authority to terminate derivative suits).
proof and pleading requirements for securities actions was enacted by Congress over President Clinton's objection.\textsuperscript{55} The latter policy initiatives, while not frontally aimed at derivative litigation,\textsuperscript{56} reflect an approach to the reform of corporate litigation that avoids tinkering with the ground rules of corporate governance. Also, the approach nominally leaves intact the general duties of boards to act lawfully, but prunes away doctrines of law and long-standing practices that enable plaintiffs to hire lawyers and offer proofs.\textsuperscript{57}

A negative view of corporate settlements of litigation is at the forefront of the current policy thinking. In other contexts, settlement is the mythical cure all for excesses of litigation, but not in corporate matters. The few reported empirical findings, given their rarity in legal writing, have assumed totemic significance: the finding by Janet Cooper Alexander that corporate litigation is settled without reference to the merits\textsuperscript{58} is taken as a last word sort of finding. Alexander demonstrates on a "need we say more basis" that corporate litigation and settlement is a corrupt and damaging process, inflicting untold waste on corporate America\textsuperscript{59} and emanating from opportunistic individual investors unconcerned with collective interests who are represented by attorneys

\begin{itemize}
\item \textsuperscript{55} See supra note 9.
\item \textsuperscript{56} Derivative Litigation is not, in the usual instance, federal securities litigation. Securities litigation is typically litigated as a class action. See, e.g., Grundfest, supra note 26, at 747 (referring, in context of securities litigation policy proposals, to the issue of "private class action securities litigation."); see also Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (holding that breach of state law fiduciary duty, in absence of deception, misrepresentation, or nondisclosure, does not violate Rule 10b-5).
\item \textsuperscript{57} Even before the introduction of the Common Sense Legal Reform Act of 1995, the director of the Enforcement Division of the Securities and Exchange Commission, William McLucas warned, "[L]itigation reform should seek to eliminate frivolous claims and abusive litigation without diluting the effectiveness of private remedies against fraud." Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong., 1st Sess. 114 (1993) [hereinafter McLucas Statement] (statement of William R. McLucas, Director, Division of Enforcement, SEC).
\item \textsuperscript{58} Alexander, supra note 8, at 567. Citations to the Alexander piece proliferate with vigor in textbooks, scholarship, and judicial opinions. See, e.g., Winter, supra note 4, at 949-51; Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1309 (3d Cir. 1993).
\end{itemize}

The near universal approbation of the finding—and its implications—has been moderated by the recent exchange between Professors Grundfest and Seligman. See Seligman, supra note 26; Grundfest, supra note 26.

\begin{itemize}
\item \textsuperscript{59} Sweeney, supra note 39, at 6 (quoting Intel general counsel on the cost of disposing of a frivolous suit "that $500,000 could have supported another, say, 10 production workers. We could have had engineers designing products."); cf. McLucas Statement, supra note 57, at 118 ("[M]ost judges believe that groundless litigation presents only a small problem on their dockets.").
\end{itemize}
prepared to file computer-stored pleadings virtually without effort. The prevailing portrait does not lack for human interest, carrying with it the image of well-intended executives subjected to a harrowing onslaught of litigation as repayment for their service to the investing public. Thus, far from being a target of critical scrutiny, the SLC is simply one device in the growing arsenal of weapons being developed by the legal system to allow corporate boards to reduce the threat of derivative litigation. The moral onus of the perceived shortcomings of derivative litigation comes to bear mainly on the reputation of the proponents of the litigation rather than either the targets or the context created by overall assumptions and policy. Yet the moral climate of derivative litigation is a social product of a collaboration in ways of doing business of all who participate—Code writers, the corporate bar, plaintiff's lawyers, directors, management, plaintiffs, investors, and legal commentators. If suits are brought and settled on grounds other than merit, it may suggest, not the need for noncontextual, technical tinkering mainly aimed at lawyers' incentives, but a direct concern with the socially created moral climate in which settlements are felt to arise from an impaired process of bargaining among improperly motivated players.

What might be useful in the current policy context is to demonstrate, as has not been done previously, the logical nexus between the (relatively) uncontroversial judicial and statutory practice of allowing SLCs to terminate shareholder suits by moving to dismiss them, and the generally rejected but, as this Article argues, parallel alternative of allowing SLCs to terminate such suits by indemnifying settling directors. The logical connection, not recognized, between the two types of SLC

60. See Cordtz & Reingold, supra note 4, at 24 ("All the elements are in place: assertive investors, a small army of sophisticated class action attorneys and a slew of idle computers.").

61. See id. at 23-25. A Louis Harris poll indicates that half of all outside directors have already been sued at least once in connection with their board service. Worries of directors increased in 1991 when a jury imposed $100 million fraud penalty on two Apple directors in a weak case. Id.

62. Interestingly, solicitude for corporate executives is high at a time when public officials face an increasing level of scrutiny demanded by the voting public.

63. Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1310 (3d Cir. 1993) (permitting appeal of settlement of derivative action settlement because of risk that "[p]laintiffs' attorneys and the defendants may settle in a manner adverse to the interests of the plaintiffs by exchanging a low settlement for high fees").
action is that the latter is simply another route to terminate cases, the same activity in which the SLC engages when it provides the grounds for a successful motion by the corporation to dismiss a derivative suit.\textsuperscript{64} The usual arguments against the extension of the SLC's authority to terminate cases by settlement backed by indemnification of directors do not hold up well to critical scrutiny.\textsuperscript{65}

Their vulnerability to attack by logic may or may not call for a rehabilitation of their object or its configuration as a critical element in the policy response to the perceived shortcomings of derivative litigation. Nonetheless, the relative unpersuasiveness of the received wisdom, combined with the flaws in the general conception of the policy context of thinking about derivative litigation, suggests the merits of greater attention to the possible strengths of the processes that might encourage the oft-maligned outcome of derivative suit settlements. Although comparing the SLC role in the accepted mode of termination with its possible role in the alternative of indemnification of directors yields some arguable comparative weaknesses, especially the absence of immediate judicial review of an adversarially litigated matter,\textsuperscript{66} it also yields arguable comparative strengths—the moral accountability and (at least nominal) legal liability\textsuperscript{67} of the board for an action that was not blessed by immediate judicial review.\textsuperscript{68}

This Article, then, contains something for the proponent, and something for the critic, of the SLC role in terminating derivative litigation. Either is invited to reflect upon the insights located in this unexplored area of the close relationship of the SLC to a neglected pathway to termination of derivative litigation. The proponent may decide that indemnification of settlements—"filling the gap"—is advisable, or that, for new and different reasons, the alternative should continue to be rejected. The critic may regard the tightness of the connection—and the relentless quality of the arguments presented below for recognizing extending the logic of that connection as grounds not merely for adopting the view that the extension is not necessary but for pressing for a reconsideration of the accepted learning.

\textsuperscript{64} Oblique recognition occurs in occasional judicial references to the similarity. \textit{See, e.g.}, Zapata v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (stating that there is "some analogy to a settlement in that there is a request to terminate litigation without a judicial termination of the merits").

\textsuperscript{65} \textit{See infra} notes 206-08 and accompanying text. \textit{But see infra} note 212 (concerning deficiencies of SLC discovery and advocacy).

\textsuperscript{66} \textit{See infra} notes 209-12 and accompanying text (secondary liability).

\textsuperscript{67} \textit{See infra} notes 206-08 and accompanying text.
The reformer, neither of the state of mind of the determined skeptic nor the Babbitesque proponent, may see the restatement of the question as one that invites a more nuanced consideration of the possibilities for fine-tuning the mechanism of derivative litigation rather than making wholesale decisions about its vitality. The opportunity arises to consider reasonable arguments for and against enhancing SLC roles in terminating litigation and to review the learning and the existing mechanisms for managing shareholder litigation. Such a review would be in search of policy responses to shareholder litigation sensitive to the pro’s and con’s of allowing the corporation to end such litigation by either of the methods—litigated dismissal or negotiated termination—rather than shaped more bluntly by choices of starkly differing perspectives on the social usefulness of shareholder litigation.

II. A NOTE ON ANALYSIS

The analytic background to assessment of the gap in board authority arises from conceptual points about the function of doctrines of liability, compared with rules of financial exoneration of settling directors, general litigation-efficiency thinking about dispute processing, other corporate law doctrines that deflect punishment from directors for conduct deserving of some degree of moral disapprobation or deterrence, and of the evolution of corporate governance under the influence of reform proposals intended to soften the effect of board self-perpetuation.

A. Doctrines of Liability and Indemnity

1. Need for and Primary Source of Doctrines Protecting Directors from Draconian Liability

Shielding directors from liability has an animating purpose of “fairness” to directors as a practical necessity for efficient delegation of tasks to them as agents. By hypothesis, corporations benefit from legal

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69. See Winter, supra note 4, at 949 (suggesting that existing procedures for derivative and class actions diminish return on capital).

70. Cf. Grundfest, supra note 26, at 742 (arguing for more “textured” conclusion in debate on whether merits matter in which policy strategies are sought to filter out weaker claims earlier in process while allowing more meritorious claims to proceed).
doctrines that protect their agents from bearing the risk associated with the corporations' profit generating activities. Agency doctrine, as utilized in the public corporation, attempts to assign risk of business loss to more efficient risk bearers and away from less efficient risk bearers. In the corporate context, this is conceived as shifting risk away from directors and managers for corporate losses on sub-maximal transactions toward the more efficient risk bearers—the corporate owners, i.e., the shareholders. Corporate costs commonly cited as being associated with incorrectly assigning losses to managers (not including the costs of the litigation itself) are discouragement of risk-taking by corporate managers and harm to recruitment of competent corporate directors. If directors faced a high probability of being required to fund corporate business losses, competent individuals would not serve. If they served, they would only pursue low risk projects.

Patently, indemnification (at least so far as indemnification for amounts paid to satisfy claims) does not serve as the primary safeguard against legal liability so draconian that rational persons would refuse to serve as directors. The principal safeguard is the rationality and reasonableness of the doctrines that impose liability on directors for business failure—the known tendency of the doctrines to serve primarily as aspirational statements for good conduct and to set the outside limits of nonfeasance, or malfeasance. The major work of safeguarding directors' interests so as to encourage service and risk-taking is done by the liability doctrines themselves—not by the rules of indemnification.

72. Id. at 285 (asserting that public corporations transfer most risk to security holders because of their comparative advantage in bearing risk).
73. Id. at 265.
74. BLOCK ET AL., supra note 4, at 943.
75. Dooley, supra note 30, at 502 (suggesting that lack of cases holding directors liable for negligence means articulation of duty of care is intended as mostly hortatory).
76. Id. at 503.
77. Id. at 506.
78. Nonetheless, much rhetoric about indemnification and about insurance comes to rest upon the claim that indemnification and insurance are necessities to ensure the willingness of directors to serve. BLOCK ET AL., supra note 4, at 943. The result is to place undue emphasis on indemnification as a component of director welfare rather than a tool for corporate decision-making about litigation.
2. Role of Indemnification in Director Protection

The exception to the marginality of indemnification as director protection is indemnification for the costs of defending suits. The common law contains the concept in its purest form: agents are entitled to be paid the expenses of their defense against a baseless suit brought because of acts they performed for their principal.⁷⁹ While the liability doctrine ultimately is a sufficient protection against the substantive claim, the American rule on fees exposes agents to an intolerable risk of incurring transaction costs to receive the vindication to which they are entitled.⁸⁰ Common law courts and authoritative legal summaries conclude that agents are entitled to indemnification for expenses (and for judgments) in the absence of an agreement to the contrary where their conduct is blameless.⁸¹ The degree of protection for the legal defense of conduct that is not clearly blameless is a matter that can be adjusted by negotiation between the principal and the agent as part of the understanding concerning compensation. An agreement to compensate is not lightly implied in the absence of express agreement, so the contours of indemnity is a natural subject for express agreement. However, between an agent and a principal which is a natural person, indemnity for breach of duty to the principal—protection for blameworthy conduct—is equivalent to waiver or elimination of liability since the principal would exercise considerable caution in suing over a matter for which an indemnity has been extended. There is no equivalent of the corporate problem of lawsuits launched by a representative of the principal against the agent despite an agreement of indemnity (or of elimination of liability). Similarly, advance promises by a natural person to indemnify an agent against third party judgments for negligence run entirely to the benefit of the agent, since an individual can decide at any time to exonerate an agent (with the agent's leave). There is no need for enforceable agreements that permit the use of the principal's assets for agent exoneration, since the principal has unrestricted freedom to settle and indemnify in accordance with a cost-benefit judgment relating to the merits of a lawsuit. Thus, indemnity between private individuals is very

⁷⁹. Admiral Orient Line v. United States, 86 F.2d 201 (2d Cir. 1936).
⁸⁰. See Sweeney, supra note 39, at 6.
much a matter of inducements to serve and of compensation. The entire subject is one guided by the agent’s interests and the pricing between the principal and agent of the probability of faithless or negligent conduct by the agent. Pricing of the riskiness of the transaction can be calibrated to fit the exact agency, thus enabling private principals and agents to strike bargains they see as fair.\textsuperscript{82}

3. Limitations on Negotiated Express Agreements for Indemnity

Complications arise where the principal is a legal entity owned by dispersed shareholders. The corporation’s promise of indemnity is not equivalent to a promise by shareholders not to sue.\textsuperscript{83} While the compensation problem for the agent is the same as with a private principal, the agent (the director) and the shareholder are not able to participate in the making of an express agreement concerning the contours of indemnification outside of the automatic common law protection for conduct in which an agent is sued for doing exactly the bidding of his principal. Thus, promises of indemnity are not equivalent to a waiver of liability tailored to the characteristic risks of the particular agency, but instead are standard forms made available to the corporate community and adopted by the corporation as a representative of the interests of both the agent (director) and the business entity with the pro-forma approval of the principals (shareholders). At a minimum, the compunction not to sue does not exist. The availability of indemnification through the corporation as principal does not answer the question of the propriety of a suit by the dispersed owners.

The predictability of suits where the agent has sought to preclude them does not undercut the general point that substantial agent protection from bearing the cost of business losses derives from reasonable doctrines of liability. Despite the fundamental fact that the American legal system ranks as rational, costly litigation between the principal and the agent is

\textsuperscript{82} A similar point has been made in the partnership context. See Larry E. Ribstein, \textit{The Revised Uniform Partnership Act: Not Ready for Prime Time}, 49 BUS. LAW. 45, 54 (1993).

Partners often do not contract to be strict fiduciaries in the typical agency or trust sense of one who controls the property of another. In other words, partners are not necessarily comparable to directors or executives of publicly held corporations. Instead, partners may be self-seeking co-venturers who are constrained from the worst kinds of misconduct by their contingent compensation, personal liability for debts, and their co-partners’ close monitoring and power to withdraw at any time.

\textit{Id.}

\textsuperscript{83} Cf. Dooley, \textit{supra} note 30, at 492 n.109 (contrasting closely held corporations, in which all adaptive decisions are made by the residual claimants, with publicly held corporations).
a business problem for corporations. The substantive doctrines of liability cannot be so sensitively calibrated that they prospectively locate for each instance of disputed director behavior the efficient break-point between avoiding a monetary penalty for well-intentioned but legally vulnerable conduct and extracting a penalty for conduct so blameworthy that its cost should fall on the agent rather than the dispersed shareholders. The resulting problem is not primarily one of undue director exposure to litigation and possible inefficient cost shifting of losses to directors and thus disincentives to service, but of litigation conducted with insufficient attention to the interests of a corporation. Thus, indemnification should be considered with primary attention to the business needs of corporations in the management of litigation and the possibilities for influencing the moral climate in which these business needs are attended to.

4. The Separate Domains of the Law's Search for Efficient Solutions

While much writing laments the plight of directors, concern for fairness for directors in the moral sense of just deserts is not the underlying rationale for schemes of liability and indemnity. The search is, or should be, for doctrines that allocate losses efficiently between directors and shareholders. Unsatisfactory results would take the form of uncompensated losses falling on agents or, contrariwise, the costs of faithless conduct being assigned to the shareholders. Policy choices to avert such results involve the search for a workable standard of liability for corporate agents and efficient processes and substantive rules for indemnification.

84. E.g., Cordtz & Reingold, supra note 4, at 22-25 (asserting that hostile climate makes service of corporate boards unpopular).

85. Alex Elson & Michael L. Shakman, The ALI Principles of Corporate Governance: A Tainted Process and a Flawed Product, 49 Bus. Law. 1761 (1994) (arguing that the ALI Principles were unduly influenced by lawyers representing the interests of corporate management).

86. See Manning, supra note 12, at 1498 (duty of care); Dooley, supra note 30, at 486 n.27 (discussing duty of care and limitation of liability respectively).

87. Whatever the specific contours of statutory permissions to indemnify for types of obligations incurred, statutes consistently impose a standard of conduct that a director must be found to have met in order to be eligible for indemnification of any expense at all. See, e.g., MODEL BUSINESS CORP. ACT ANN. § 8.51. The Act sets the following minimum standards:

(1) (i) he conducted himself in good faith; and
The attempt of the legal system to reach efficient solutions has resulted in a slicing up of doctrine and process into separate domains. These are: (1) the articulated rules of director conduct; 88 (2) the standard of monetary liability to which the law in fact subjects directors for breaches of the rules of conduct; 89 (3) the exoneration by the corporation (acting through the board) of the director for monetary liability imposed under the liability standard; 90 (4) the exoneration by a court of the director for monetary liability imposed under the liability standard; 91 (5) the standards for the insuring of directors by an outside insurance company; 92 and (6) the rules for exoneration of the director by corporate self-insurance. 93 The standard of liability once was co-extensive with the articulation of the standards imposed by law on corporate directors. 94 With the enactment of section 141(f) of the Delaware Code 95 and section 2.02(b)(4) of the Model Act, 96 the articulation of the standards became separate from the regime of liability. 97 The recent work in the Model Act has moved the law of

(ii) he reasonably believed;

(A) in the case of conduct in his official capacity, that the conduct was in the best interests of the corporation; and

(B) in all other cases, that his conduct was at least not opposed to the best interests of the corporation; or

(2) he engaged in conduct for which broader indemnification has been made permissible or obligatory under a provision of the articles of incorporation (as authorized by § 2.02(b)(5)).

88. See Dooley, supra note 30.

89. See Committee on Corporate Laws, supra note 1, at 741 (Model Act provision permitting articles of incorporations provisions eliminating or limiting director liability).

90. See id. at 749 (indemnification discussion).

91. See id. at 768-71 (setting forth and discussing provision for court-ordered indemnification).

92. See BLOCK ET AL., supra note 4, at 994-96 (discussing limits of insurance coverage of directors, officers and employees).

93. See id. at 1089-97 (discussing “captive” insurance subsidiary arrangements).

94. See Manning, supra note 12, at 1478, 1498 (arguing, prior to enactment of statutes permitting liability limitation, that duty of care articulation was unrealistic and should be reworked).


96. See MODEL BUSINESS CORP. ACT ANN. § 2.02 (b)(4) (3d ed. 1994).

97. While § 141(f) and § 2.02(b)(4) only permit the insertion into articles of limitation of liability provisions, as a practical matter, all public corporations will limit liability. See JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 211 (1995) (over 90 percent of a random sample of 180 Delaware firms adopted a limited liability approach within one year of the enactment of Delaware’s limitation of liability provision). Compare Quillen, supra note 30, at 119 (suggesting that requirement of shareholder vote to enact § 102(b)(7) provision militates against dilution of standard and arguing that § 102(b)(7) emphasizes enforcement of duty of care at injunction stage).
liability forcefully toward substantial curtailment of liability for the conduct of directors other than for acts of defalcation. 98

5. The Inevitable Persistence of “Extra” Liability

Despite the breakthroughs of the proponents of a smaller sphere of liability for corporate agents, some unpredictable amount of liability will persist. Judges must interpret phrases that preserve liability for such conduct as “receipt of financial benefit to which [a director] is not entitled” and “an intentional infliction of harm on the corporation. . .”. 99 Moreover, despite the political clout today of the forces that oppose the use of legal proceedings as a club to deter director misconduct, 100 the boundaries of legal liability will predictably shift with the ebb and flow of political forces and judicial opinion. 102 However much corporate codes may trim director liability under the influence of the corporate bar, the complications associated with solving the borderline cases where liability rules do not deflect actions that have legal merit, but may not justify cost shifting, will remain—to be addressed by doctrines of indemnity. Indeed, indemnity is the play in the joints of legal liability—the permission for reasoned judgment by individuals to overcome the woodenness of legal doctrine. The effort to protect the corporation from bearing the cost of faithless conduct by agents while also protecting agents through either mandating

98. See Dooley, supra note 30.
99. See MODEL BUSINESS CORP. ACT ANN. § 2.02(b)(4)(A), (B) (3d ed. 1994).
100. See Elson & Shakman, supra note 85, at 1764 (influence of management view in ALI Principles published in 1994).
101. See Coffee, supra note 6, at 1428 (describing real benefit of derivative litigation as deterrence, not financial recovery).
102. Judge Ralph Winter, whose concern about the effect of corporate litigation on capital formation, see Winter, supra note 4, at 948-49, has become a prominent citation in the anti-corporate litigation commentary (despite the balance suggested by the portion of the article’s title referring to “protecting managers”), even to the extent of being cited by the Supreme Court in the course of trimming the amount of liability under the Securities Act of 1934, Rule 10b-5, see SELIGMAN, supra note 97, at 1433, nonetheless held in a leading case on SLCs that the SLC was not entitled to the benefit of the business judgment rule in a motion to dismiss, because leaving the decision on enforcement of fiduciary duties to the defendants’ appointees would eliminate fiduciary duties of directors and officers. See Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).
103. See, e.g., Jones & Coonan, supra note 31, at 30 (referring, following first wave of limitation of liability statutes, to “formidable list of leftover liability exposures”).
or permitting indemnification thus can be seen to result in a disjunction of legal standards, one protective of the corporation and one protective of the agent. The standard for legal liability of directors isinclusive of director misconduct that is also included within the category of conduct eligible for indemnification. That is, the standard for indemnifying directors is more liberal to directors than is the standard for assessing legal liability. The creation of the more liberal standard means that the legal system has in some sense, more or less direct, acknowledged that the standard for director's liability for breaches of duty is overinclusive. The category of director liability picks up breaches of duty that do not demand a redistribution of entitlements from the director to the corporation, or, that, in any event, are consistent with distributing transaction costs from the corporation to the director. The standard to indemnify the director is more liberal, because it is conceived of as making available the ideal distributional solution following the nominal (or actual) imposition of a corrective statement to a breaching director.

104. The standard is more liberal both with respect to indemnification of legal costs (where indemnification of liability amounts is precluded) and with respect to indemnification of settlement amounts. In both cases, the general point holds that legal doctrine acknowledges a disjunction between the goods of assessing liability as a symbolic corrective for agency failings and distributing costs between the agent and the principal.

It is noteworthy that the Model Act expressly allows indemnification for legal expenses for the exact conduct for which liability has been eliminated, see MODEL BUSINESS CORP. ACT ANN. § 8.51(a)(2) (citing § 2.02(b)(5)), and expressly, in the alternative, allows indemnification based upon a finding that the director was acting in the reasonable belief, in the case of conduct in his official capacity, that his conduct was in the best interests of the corporation and, in all other cases, that his conduct was at least not opposed to the best interests of the corporation. See id. § 8.51(a)(1)(ii)(A), (B). Thus, the Model Act cleanly segregates a category of indemnification that addresses conduct not eligible for elimination of liability.

105. In the context of master-servant law, the argument has been made that servants should not bear the loss by way of indemnity to the master for their negligence when they have accidents in the course of working for the master, since such accidents can be considered "mere inadvertence" and are foreseeable results of a servant's working for the master. See Fireman's Fund Am. Ins. Co. v. Turner, 488 P.2d 429, 432-35 (Or. 1971) (rejecting argument on ground that tort law requires that all persons be held responsible for the consequences of their wrongful acts). The Turner case is cited in J. DENNIS HYNES, AGENCY AND PARTNERSHIP: CASES, MATERIALS, PROBLEMS 229-30 (1994).

106. "Legal remedies are sought to overcome a present distribution that is out of line with the parties' claimed entitlements." Galanter & Cahill, supra note 42, at 1364. Note that, as discussed supra note 104, even where the indemnification only covers legal costs, the existence of one standard imposing liability and the other redistributing legal costs from the recovering corporation to the breaching agent reveals a disjunction in the assessment of the agent's culpability.

107. See supra note 104.
6. The Reason for "Extra" Liability

What good is produced by imposing legal liability that is promptly canceled by the regime of indemnity? The obvious candidates are: deterrence of misconduct by imposing overinclusive categories of liability;\(^\text{108}\) the educative function of applying corporate legal doctrines to novel directorial conflicts of interest; and the function of enlarging the "shadow of the law"\(^\text{109}\) effect on bargaining by agents concerning structural solutions to alleged conflicts of interest. The potential effect of the regime is to impose stigma, for which no indemnity is possible.

The substantive doctrines of corporate cost allocation between agents and corporations, then, strive for a statement of the ideal distributional solution between directors and shareholders in terms of symbols and resources. If these could be imposed with complete accuracy by cost free decision-making, the system would attain the ideal results—deterrence, education, and innovation combined with the correct distribution of business losses. Given the impossibility of achieving perfect accuracy in decision-making, the system, in substance, tolerates the risk that imposition of liability or provision of indemnity will be over-applied or under-applied. The system distributes the risk of misapplication between two regimes of authoritative decision-making, one associated with liability imposition and one associated with indemnity decisions. In addition, the system tolerates the risk that striving for "deterrence"—stated positively, encouraging responsibility\(^\text{110}\)—will impose costs in individual instances that exceed the recovery to the corporation.\(^\text{111}\)

\(^\text{108.}\) See Coffee, supra note 6, at 1428-29 (discussing the deterrence effect of cases that do not yield a positive net recovery).


\(^\text{110.}\) See Dooley, supra note 30, at 463 (describing governance aspects of ALI Principles designed to promote "Responsibility," in contrast with "Authority").

\(^\text{111.}\) Coffee, supra note 6, at 1428-29 (suggested that benefit of derivative action more likely lies in deterrence than in financial recovery generated); see also id. at 1436-37 (comparing inability to measure deterrence in derivative suits to criminal law enforcement).
B. Indemnification of Settlement Amounts as a Mode of Case Disposition

The risk of inaccurate decisions about liability is primarily located in the adjudicative function, while the risk of inaccurate decisions about indemnity (or self-insurance payments) is primarily located in the function of private decision-making in the shadow of the law. Any assessment of these relative risks should be made in light of a conceptual shift from a focus on the risks of inaccurate indemnification decisions (or, indeed, the incongruous results of accurate decisions) and toward a vision of indemnification of directors for settlement amounts as an alternative mode of disposing of derivative litigation on par with a motion to dismiss. While indemnification of directors for settlement amounts has the effect of shielding directors at the margin from an inappropriate shifting of costs from the principal (the group of shareholders) to the agent (the defendant directors), it also can be thought of as a choice in the array of litigation-ending methods available in a legal system. Indemnification of directors for settlement amounts can be seen as a dispute resolution doctrine as well as an allocation of substantive entitlements and examined as a technique, with incidental allocative effects, of dispute resolution. As discussed below, settlements arise from factors created by legal doctrines and occurring in processes presided over by courts from close range or at a distance. They are not a "stray byproduct of the judicial process" but a set of results brought about by policies chosen and administered by the legal system.

C. Indemnification of Directors for Settlement Amounts As a Pro-Settlement Policy

The third conceptual point concerns the fact that permitting boards to indemnify directors for payment of settlement amounts should generate more settlements, or, in any event, alter the timing of settlements. It is, as suggested above and described below, a pro-settlement policy. The policy is not merely an allocational decision relating to substantive entitlements, but an alteration of the probable modes of generating dispositions of derivative suits. Such alteration will affect: (1) the transaction costs; (2) the nearness to which the distribution of substan-

112. See Galanter & Cahill, supra note 42, at 1349.
113. See infra notes 187-96 and accompanying text.
114. See supra text accompanying note 64.
115. See Galanter & Cahill, supra note 42, at 1390-91, quoted infra note 175.
116. Id.
tive entitlements approaches the "correct" distribution of substantive entitlements; and (3) the social goods lost or gained by substituting settlement for litigation.

I. Assessment

Assessment of the statutory choice of allowing corporations to indemnify settlements requires some consideration of the need for, and the functioning of, settlement as a mode of ending derivative litigation. The first, the need for settlement, is implied by the common conclusion by legal writers that corporate litigation imposes more costs on corporations than it provides recovery or prevention of losses, at least for individual corporations made the subject of litigation. It has been argued at a system level that various factors combine to make derivative litigation (and class actions by shareholders) a net drain on corporate assets, thereby "substantially diminish[ing] the return to American investors in American companies." Specific costs associated with derivative litigation are the cost, substantially borne by corporations, of defending directors and officers from allocation to them of losses correctly borne by the corporate owners and the costs of liability insurance and various types of opportunity costs to the corporation of involvement in litigation. The starkest statement that derivative suits are

117. See id. at 1360-64 (discussing use of "legal remedies to overcome a present distribution that is out of line with parties' claimed entitlements").

118. Id.

119. See, e.g., Mark D. West, The Pricing of Shareholder Derivative Actions in Japan and the United States, 88 NW. U. L. REV. 1436, 1473 & n.169 (1994) (noting that "most derivative actions end not in litigation but in settlement," and arguing that "[s]ettlements, like derivative actions pursued to judgment, often result in a bounty to the attorney, yet little gain to the shareholder"); see also Winter, supra note 4, at 952 (asserting that in most derivative and class action suits the corporation receives no benefit but pays everyone's legal fees).

120. Winter, supra note 4, at 949. The evidence cited by Winter does not really support the proposition except in the most indirect way. Id. at 949 n.9 (citing article that concludes that "many [class and derivative] suits result in settlements that benefit[,] the attorneys more than the shareholders").

121. It should be noted that some costs of defense are borne by the corporation even if the director may be said "correctly" to bear a loss.

122. See Ronald A. Dabrowski, Note, Proportionate Liability in 10b-5 Reckless Fraud Cases, 44 DUKE L.J. 575, 576 (1994) (costs of defending § 10b-5 private causes of action are broad, ranging from direct costs of legal expenses and damages to indirect costs of higher insurance premiums and reputational harm); see also BLOCK ET AL., supra note 4, at 942.
not net gainers for corporations comes in the suggestion of viewing in
the aggregate the payment of settlement amounts and litigation costs
through funding by insurance paid for by the corporation; premiums paid
by all corporations should be equivalent to amounts recovered.123

2. The Anti-Settlement Tone of Writing about Corporate
Litigation—The Need for a Fresh Look

The writing about the problem of "inevitable inefficiency" in the
process of derivative litigation does not necessarily assume that
settlement is the solution to the problem. Rather, the availability of
settlement is portrayed as an influence exacerbating the proliferation and
reinforcing the inefficiency of lawsuits that raise the cost of capital.124
Among the claims made are: (1) amounts paid in settlement are largely
unrelated to the merits of the action,125 thereby blunting the sharpness
of suits as a means of enforcing fiduciary obligations; (2) the motivation
for bringing suits is attorneys' fees,126 which are better assured by
settlement than by litigation; (3) management does not oppose
settlements that fail to match the merits because "[m]anagement rarely
cares to assume the burdens and distractions of a trial,"127 and (4) a
large percentage of derivative and class actions are said to be frivo­
lous,128 with the availability of attorneys' fees at settlement, even
without a monetary recovery—the presumed motivator.129 Unlike the
case of the typical "bilateral" lawsuit, in which settlement often tends to
be touted as a panacea130 for the hazards of litigation, litigation harms
are identified as peculiarly intractable in lawsuits brought by sharehold­
ers in the name of the corporation. The specter of meritless lawsuits
ended by collusive settlements looms large as a conceptual block to
envisioning solutions devised out of the grab bag of techniques for
abbreviating litigation to serve everyone's interests.131 The primary

123. See Winter, supra note 4, at 951 n.25.
124. See id. at 950-51.
125. See id. at 950 (citing Janet C. Alexander, Do the Merits Matter? A Study of
Settlements in Securities Class Actions, 43 STAN. L. REV. 497 (1991)).
126. See id. at 949.
127. See id. at 950 (no supporting evidence).
128. Id. at 949 (citing FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING
STOCKHOLDERS DERIVATIVE SUITS (1944)).
129. See id. (relying on Roberta Romano, The Shareholder Suit: Litigation Without
Foundation?, 7 J.L. ECON. & ORGANIZATION 55 (1991)).
130. See Galanter & Cahill, supra note 42, at 1341 ("The popular wisdom about
civil justice perceives courts as resolving cases by adjudication, accepts that American,
society brings an excessive amount of litigation to the courts, and concludes that
settlement is a good thing.").
131. See supra text accompanying notes 58-61.
solutions fashioned explicitly to address concern about derivative litigation involve adjudication devices—adversarial confrontations, authoritatively decided in court, between shareholder-propelled proponents of a continued suit and manager-supported opponents of continuing the litigation and other adjudication refinements, such as the requirement of pleading derivative suits with particularity. Reform proposals articulate a need for an ideal solution: "Some mechanism ... must be adopted that weeds out meritless claims at the threshold, prevents claims that cannot benefit investors from going forward, does not overcompensate weak claims, and does not undercompensate strong claims." Because of the hypothesized impediments to party driven solutions based on the assumption that party motivations are insufficiently adverse for greed to check greed, Judge Winter has proposed the creation of an outside force, i.e., a special master, capable of making a sensitively calibrated determination of the moment when a derivative suit can be concluded to be a net loser for investors. The goal is to bear the cost associated with such an ad hoc institutional framework in return for the gain of deterring or quickly dismissing weak claims and avoiding the settlement of strong claims at inadequate amounts.

Such analysis presumes that settlement of derivative suits is part of a pathology, and, not, as usually presumed in the evolution of thinking about litigation, an element of an array of solutions to societal addiction to litigation. Yet that assumption, particularly coming from relatively conservative quarters, is a startling vote of no confidence in the capacity of existing methods of reducing agency costs in the corporate

132. See supra text accompanying notes 50-51 (SLC); infra text accompanying notes 158-68 (general description of procedures for dismissal of derivative litigation).
133. See Winter, supra note 4, at 952.
134. Id. at 977-78.
136. See Winter, supra note 4, at 953 (If the moment arrives when “the officer determines that the likely recoverable damages discounted by the probability of a finding of liability are not substantially greater than the likely costs to the corporation, then the action should be dismissed.”).
137. Id.
138. See Galanter & Cahill, supra note 42, at 1341.
context to place pressure on the processes surrounding settlement to produce the benefits sought in the bringing and resolution of derivative suits. The prevalence of such a vote of no confidence in quarters that might be expected to see the good in pro-settlement refinements to the litigation process is apparent in the large reduction in director liability adopted by the Model Act and the general acceleration of anti-litigation proposals. A fresh look at the question from the pro-settlement view prevalent in other areas can direct attention conceptually and practically to the role indemnification of settlements might play in refining and strengthening derivative litigation as a mechanism of self-governance.

D. Board Authority to Approve Morally Doubtful Conduct—Comparison of Rules for Approving Self-Interested Transactions

A final conceptual point relates to the type of conduct that is viewed by the predominant legal doctrine as potentially blameworthy but not so much so that the conduct cannot be sanctioned by the board of directors. The salient instance in corporate doctrine of conduct occupying such an intermediate status of moral weight is a director’s engaging in a self-interested transaction that would be considered subject to penalties but is not because of the approval of other members of the board of directors. Conduct that was once flatly prohibited has, in the evolution of doctrines to address the practical reality of corporate business dealings, been granted a degree of statutory protection, administered by boards of directors. While the distance traveled for the status of the conduct—from flat prohibition to a degree of statutory approval—is the greatest for close corporations, the statutory assistance nonetheless applies to conduct by directors in public corporations of the kind that might well become subject to derivative suits in the absence of approval by a group of directors found eligible under the statutes for “blessing” an arguably interested transaction by a

139. See Fischel & Bradley, supra note 71, at 274-76 (reviewing alternative methods of assuring contractual performance by corporate managers).
140. See supra note 1.
141. See supra note 9.
143. Importantly, the rationale is not the well-being of directors but the business needs of corporations. The residual effect is advantage to directors, but the driving force is the needs of business.
144. Public corporations do not generally engage in direct transactions, in which a director sells property to the corporation. N.Y.S.E. Listed Co. Manual (CCH) ¶ 307.00.
Indeed, the type of transaction in public corporations that can be insulated by the format of approval is of the type that is potentially subject to derivative suits—proposed organic changes in which directors have motives of entrenchment or self-advancement. The policy choice in law-making may well be between allowing directors to prospectively bless a doubtful transaction without direct challenge versus requiring after-the-fact justification.

In short, the convergence of types of conduct that can be blessed with types of conduct for which directors might be indemnified demonstrates that the quality of conduct or the trustworthiness of directorial judgments about such quality of their fellow directors’ conduct is not the deciding consideration in the gap that exists in the capacity of boards of directors to end derivative suits by inducing directors to settle them. The blessing of interested director statutes demonstrates that a broad range of conduct exists that, while attracting some degree of disapprobation, can expose directors to potential litigation losses that, consensus concludes, can and should be ameliorated by the action of fellow directors. The recognition that the directors are exercising a similar judgment and creating a similar outcome, at least in terms of symbolic policing of business morals, when they approve interested director transactions as when they provide indemnification, points to an analysis of the pressure placed on the integrity of board decision-making by the structuring of the judgmental issue presented to the board. Such structuring is created by the form in which the issue is presented—approving self-interested transactions, indemnifying directors for settlement amounts or indemnifying directors for amounts paid in judgment, and, of course, recommending dismissal of a derivative suit.

In order to understand the existing consensus and its extent of divergence from the SLC model, we must first examine the fundamentals of derivative litigation.

145. Cf. Kahn v. Lynch Communication Sys., Inc., 683 A.2d 1110 (Del. 1994) (ground rules for court determinations of entire fairness where a controlling or dominating shareholder in a public corporation appoints an independent committee to negotiate the terms of a forced merger of a subsidiary into a parent); Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc., 430 N.W.2d 447 (Iowa 1988) (application of interested director approval statute to self-dealing transactions by controlling shareholder/director in close corporation with passive investors).

146. See supra note 14.
III. BACK TO THE BASICS—AN INTRODUCTION TO DERIVATIVE LITIGATION

The boards of directors of public corporations are agents charged with a duty to exercise business judgment and to act with due care and with disinterest on behalf of shareholders. Shareholders have limited ability to protect their interests directly or to influence board decision-making. The shareholder derivative suit allows shareholders to seek damages payable to the corporate treasury for a director's breach of a fiduciary duty. In a shareholder derivative suit, a shareholder sues the breaching board member in the right of the corporation. The purpose is to allow shareholders to force action when the board is reluctant to proceed against one or more other board members.

A. Governing Principles

The basic corporate law principle that boards retain control of the business affairs of a corporation remains operative even when derivative litigation is pending. The rationales are substantial and well rehearsed in corporate law. Critically, no sole shareholder or group of shareholders has a duty or ability comparable to the board's to safeguard the corporation's interests. An unconstrained license to sue directors would inflict devastating harm on the routine pursuit of the corporation's affairs. The state corporation code statutes governing derivative suits respond to such considerations by providing procedures to enable

147. See Block et al., supra note 4, at 20-44 (discussion of the duties of directors).
148. See American Law Institute, supra note 2, at 588 (commenting that no single technique of corporate accountability is likely to be optimal under all circumstances and suggesting that shareholders are best served by an overlapping system of protections); see also Robert C. Clark, Corporate Law 396 (1986) (discussing inadequacy of proxy contest as solution to collective action problem).
150. Id.
151. Id. at 928.
152. "The dismissal section] confirms the basic principle that a derivative suit is an action on behalf of the corporation and therefore should be controlled by those directors who can exercise an independent business judgment with respect to its continuance." Model Business Corp. Act Ann., ch. 7, subch. D, introductory comment (discussing "Derivative Proceedings").
153. See Fischel & Bradley, supra note 71, at 271-72.
boards of directors to bring an end to at least some shareholder derivative suits. 155

1. Corporate Best Interests

The derivative suit statutes attempt to devise procedures that will allow a role for shareholder efforts to bring directors to task yet still accord respect to board judgments of corporate best interests. 156 The first role that the statutes set forth for the board concerns the right of the shareholder to maintain the suit. 157 Statutes set up a procedure for boards to ask the court to dismiss the suit as not in the best interests of the corporation. 158 The Model Act, for instance, provides that the court shall dismiss a derivative action if a statute-specified determining group "has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation." 159

2. Procedure: The SLC

Again using the Model Act for illustration, the determining votes may arise from either a majority vote of independent directors present at a meeting of the board if the independent directors constitute a quorum, or, without reference to the quorum, a majority vote of a committee consisting of two or more independent directors appointed by majority vote of independent directors present at a meeting of the board of directors. 160 In the alternative, upon motion by the corporation, a court may appoint a panel of independent persons to make a determination. 161 Typically, corporations avail themselves of the opportunity to make a credible statement to the court about the worthiness of the litigation by appointing a committee of independent directors. This

155. See, e.g., BLOCK ET AL., supra note 4, at 721-33 (function of demand requirement to retain director control over derivative suits); id. at 830-34 (describing state statutes patterned after Model Act provisions for dismissal of derivative proceedings upon motion of independent directors).
156. Id. at 711-20.
157. See id. at 830-34.
158. Id.
159. MODEL BUSINESS CORP. ACT ANN. § 7.44 (3d ed. 1994).
160. Id. § 7.44(b)(1)-(2).
161. Id. § 7.44(f).
committee, which is called an “SLC” or special litigation committee, discussed above, then investigates the charges.\footnote{162} This statutorily blessed group gains stature from the experience and independence of its membership.\footnote{163} It proceeds to determine whether maintenance of the suit is in the best interests of the corporation.\footnote{164} If the SLC’s conclusion is negative, the corporation then moves to dismiss the suit. As noted above, dismissal must occur if the corporation has met the statutory standards of a good faith determination following reasonable inquiry upon which the conclusion is based.\footnote{165}

The Model Act places the burden of proof for this issue on the corporation if a majority of the board of directors does not consist of independent directors at the time the determination is made. The burden is placed on the plaintiff if the majority of the board of directors does consist of independent directors at the time of the determination.\footnote{166} Despite differences in the particular approaches taken in various codes, the typical refrain—the one expressed in the Model Act—is to allow the board to retain its primary role as the conservator of the corporation’s best interests even though one or more members of the board may be implicated in wrongdoing.\footnote{167}

3. Consensual Resolutions

Although the screening device may end litigation, in effect aborting it at the outset, it does so through a full blown legal contest.\footnote{168} In contrast, many of the actual pathways for ending a derivative suit short of judgment require negotiation and consensus of the parties. Yet, compared with the screening mechanism, scenarios for consensual endings receive little statutory attention.\footnote{169} The disparity is unsurpris-

\footnote{162} See DEMOTT, supra note 1, § 5:14, at 56-58 (describing creation by corporations of special litigation committees).
\footnote{163} See, e.g., In re Oracle, 852 F. Supp. 1437 (N.D. Cal. 1994) (applying a “totality of the circumstances” test to assess independence of Special Litigation Committee (citing Johnson v. Hui, 811 F. Supp. 479, 486 (N.D. Cal. 1991))).
\footnote{164} MODEL BUSINESS CORP. ACT ANN. § 7.44(a) (3d ed. 1994).
\footnote{165} Id.
\footnote{166} Id. § 7.44(e).
\footnote{167} Id. § 7.44 & cmt.
\footnote{168} It is beyond the scope of this Article to document the procedural and chronological sequence of discovery and litigation about whether to litigate the alleged cause of action that takes place in a typical dismissal procedure. See generally Joel Seligman, The Disinterested Person, An Alternative Approach to Shareholder Derivative Litigation, 55 LAW & CONTEMP. PROBS. 357, 360-62 (1992) for a discussion of the discovery process in the litigation of motions to dismiss derivative litigation.
\footnote{169} The basic rules respecting settlement of derivative suits are described tersely in the Model Act as follows: “A derivative proceeding may not be discontinued or
ing, because a negotiation is not a legal contest and does not require formal elaboration. Nonetheless, consensual endings are frequently of more practical import than an initial argument over the future of the litigation. The screening process, heavily elaborated as a moment of formal legal decision-making, is in fact a moment that may never arrive for many suits. As a principle example, in suits that the board of directors chooses to settle without at any time seeking to reject the shareholder’s effort to proceed on behalf of the corporation, the ending may foreclose the need for the screening mechanism.

Thus, suits come and go in a multitude of fashions. Their means of exit share one feature in common—the legal system has found a way to bless a termination of the suit. The board may seek to constrain a shareholder’s effort to prosecute to judgment a suit in the interest of the corporation by a variety of means: (1) rejection of demand coupled with a motion of the corporation to dismiss based on a special litigation committee’s recommendation (the screening process); or (2) settlement encouraged by either (a) payment of the defendant directors’ costs of suit, including fees or settlement amounts or both, or (b) a structural remedy that imposes no damages on the defendant directors. These suit-ending efforts may occur—indeed will occur—in

settled without the court’s approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation’s shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected.” Model Business Corp. Act Ann. § 7.45 (3d ed. 1994).

170. Demott, supra note 1, § 1:01, at 2 (“Most derivative suits are ultimately dismissed or settled rather than tried.”).

171. See, e.g., In re Oracle, 852 F. Supp. 1437, 1444 (N.D. Cal. 1994) (describing SLC’s conclusion that settlement was superior to moving to terminate the derivative action entirely in light of settlement’s capping fees and costs at amount less than potential fees and costs of litigating motion to dismiss).

172. The Model Act requires a shareholder who intends to pursue derivative litigation to place a demand to sue upon the corporation, to wit:

“No shareholder may commence a derivative proceeding until:

(1) a written demand has been made upon the corporation to take suitable action; and

(2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90 day period.”


173. Id. § 7.44.

174. For example, procedures may be put in place to avoid repetition of the behavior challenged by the litigation. The suit may terminate on this basis with no
different derivative suits in sequences and with practical meanings that are part of the unique shape of the given suit. The statutes, by concentrating attention on the role of the board at the entry screen, address only a portion of the available termination scenarios for a given derivative suit. It is the underreasoning, a form of neglect not unique to corporate statutes, by the statutory drafters respecting the remainder of litigation-ending events that has given rise to the problem addressed by this Article.

B. A Gap in the Board's Role

As seen above, the Model Act's conceptualization of the screening of derivative litigation does not displace the deference granted to director action, and, absent disabling conflict, accords a presumption of regularity to board judgment. In the statutory planning for derivative litigation, where the question of the amount of liability is set aside and the ground rules for engagement between management and shareholder representatives are devised, a balance is sought that protects the board's role compared with outside decision-makers. Courts have a vital role, yet a limited one. The Model Act provides courts with techniques that avert their displacing the directors of corporations at the urging of derivative plaintiffs.

payment by the defendants, although the corporation will pay a counsel's fee to plaintiff's lawyer for the benefit to the corporation that resulted from the lawsuit. See, e.g., Granada Invs. v. DWG Corp., 823 F. Supp. 448, 451 (N.D. Ohio 1993) (settlement dismissing claims against defendant Victor Posner in exchange for Posner's relinquishment of both board positions and exercise of voting control over common stock of company).

175. See Galanter & Cahill, supra note 42, at 1390-91.

Once courts were envisioned as dedicated exclusively to adjudication, so that settlement was seen as the product of a consensual private departure from the public forum. The results were an accidental byproduct for which the court was not accountable. But now it is common knowledge that most remedy seeking in the vicinity of courts is going to eventuate in settlement. We share an inescapable awareness that courts do more than adjudicate. They preside over a cluster of dispute processes. They project models, sanctions, bargaining chips, categories, and doctrine that support processes of negotiation, mediation, and arbitration, some within the precincts of the courts and some at a distance. Once we see settlements not as a stray byproduct of the judicial process, but as part of the essential core, the responsibilities of courts can no longer be defined as co-extensive with adjudication. Once we apprehend the multiplex connection between court and settlement, ensuring the quality of these processes and the settlements they produce is a central task of the administration of justice.

Id. (footnote omitted).

176. See MODEL BUSINESS CORP. ACT ANN. § 7.44 (e) (3d ed. 1994).
177. Id.
Why does the Model Act derivative suit procedure appear to repose such confidence in boards? The answer lies in part in the unsuitability, well described in volumes of legal and business writing, of any other candidate. Given the depth of the consensus that the board must govern, for no one else can, the Model Act, like the corporate codes it influences, is based on a vision of the corporation as a profit maximizing entity using agents to advance the wealth of a collective body of shareholders. The underlying psychology, determined in degrees by necessity rather than science, depicts agents, pulled by the ties of collegiality and friendship, but capable of functioning honestly to advance the best interests of the corporation—i.e. capable of making honest determinations that the best interests of the corporation will be served by rejections of shareholder efforts to sue directors on the corporation’s behalf. The picture of board authority over litigation developed by the Model Act drafters is a particularly bright one. The Model Act displays a limited degree of concern for structural bias, but generally grants directors who are not lawsuit targets their undiminished status as fiduciaries when making derivative suit determinations, whatever the course of events that brought them to the board.

178. See, e.g., BLOCK, ET AL., supra note 4, at 5-11 (discussing the historical view that neither courts nor shareholders are competent to manage corporations).


180. See Dooley & Veasey, supra note 7, at 534 (skeptical summary of concept of structural bias). For a vigorously argued view that numerous factors militate against independent directors’ acting independently to disapprove overreaching interested transactions by fellow directors or to evaluate the merits of derivative suits evenhandedly, see Victor Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 HARV. L. REV. 597, 607-20 (1982).

181. See Brudney, supra note 180, at 607-20 (arguing that outside directors have incentives to act independently of management).

182. Although the normal rule is that the plaintiff has the burden of challenging the bona fides of a committee that determined that continuation of a suit is not in the corporation’s best interests, the burden shifts to the corporation when the majority of the entire board is deemed not to be independent of the litigation. With a seeming reluctance, the committee adopted this burden-shifting rule “to respond to concerns of structural bias.” MODEL BUSINESS CORP. ACT ANN., commentary to § 7.44 (3d ed. 1994).

183. But see DEMOTT, supra note 1, § 5:16, at 65 (“[C]ourts have not arrived at a consensus position on the appropriateness of the litigation committee device as a means to determine the corporation’s position in derivative litigation, nor do courts agree
If boards are the forum for shaping shareholder efforts to litigate on the corporation’s behalf into a case disposition that protects the best interests of the corporation, gaps in the ability of the board to act as a source of authority for any type of ending scenario represent a puzzling impairment of boards’ ability to act constructively on behalf of shareholders, at least where director misconduct is implicated. A gap—whereby boards are not merely hampered but precluded from effecting a particular type of resolution—would suggest that the Model Act drafters, despite their seemingly happy view of the credibility of board determinations in dismissal proceedings, have not discarded all worries about board credibility and good faith in derivative suit litigation. If such a gap also disabled boards from taking the practical steps necessary to achieve a settlement, it is of both practical and theoretical interest.

As already discussed above, the existence of such a gap is clear. In the flow of real world litigation, it is a significant subtraction from the authority and the ability of a board to end derivative litigation on a schedule that it considers to serve the best interests of the corporation. While statutory provisions for ending derivative litigation recognize that some suits will end in settlement, the heavy consensus condemns indemnification of directors for amounts paid in settlement of derivative litigation. Yet settlement negotiations—the weighing and measuring, chopping and cutting, buying and selling—take place between parties who have something to offer and something to gain. If the amount paid in settlement cannot be indemnified—thus making impossible the board’s assuring such indemnification—the defendant directors may lack the incentive to accept a settlement on terms desired by the board. The board, however, may view a settlement as the quickest, least costly method of terminating the suit, a method plainly superior to a longer, more expensive procedure involving the screening of the case by an SLC and the litigation by all parties of a corporate motion to dismiss. Such a possibility is by no means fanciful, as is seen in a recent federal district court decision in which the court agreed with

on the appropriate degree or content of judicial review in this context.”); id. § 5.18, at 71 (questioning credibility of special litigation committees, especially use of “expansion” or replacement directors to constitute . . . committee”). Compare Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982) (stating that the “conflict of interest which renders the business judgment rule inapplicable in the case of directors who are defendants is hardly eliminated by the creation of a special litigation committee”).


185. See AMERICAN LAW INSTITUTE, supra note 2.
IV. EVALUATION AND ANALYSIS: THE PROCEDURAL ARGUMENT

As previously noted, the drafters of corporate legislation hesitated to accord to boards a role in a principal practical mode of terminating derivative litigation largely because of relatively abstracted arguments and intuitions. The forces that ordinarily serve as advocates for the interests of management uncharacteristically abandon the pro-management perspective on indemnification of directors for settlement payments, saving their firepower for an assault on the legitimacy of shareholder initiated litigation and the existence of liability for directors. Let us look critically at the anti-indemnification arguments as they have generally been presented.

A. The Arguments Against Indemnification of Settlement Amounts

1. Circularity

The principal theme struck against allowing indemnification of settlement amounts, that is, the principal argument favoring a gap in the board’s practical ability to end derivative litigation, is circularity of recovery.Circularity of recovery refers to the immediate return by the corporation to a director of amounts paid by that director in settlement of a suit charging a breach of directorial duty. The idea imbedded

187. Committee on Corporate Laws, supra note 1, at 761; AMERICAN LAW INSTITUTE, supra note 2, at 918 (discussing circularity in connection with prohibition of indemnification of amounts paid to satisfy an adverse judgment); BLOCK, ET AL., supra note 4, at 958 (“The basis for this rule [against indemnification of settlement amounts] is a belief that it would be circular if funds received by the corporation (the ultimate
in the phrase is that derivative litigation which ends in the return of the
recovered amounts to the defendant is not only futile but indeed harmful
to the corporation. As the ABA Commentary states:

Permitting indemnification of settlements and judgments in derivative
proceedings would give rise to a circularity in which the corporation receiving
payment of damages by the director in the settlement or judgment (less
attorneys' fees) would then immediately return the same amount to the director
(including attorneys' fees) as indemnification. Thus, the corporation would be
in a poorer economic position than if there had been no proceeding. 188

A strong intuition wars with allowing such a result.

a. The Inaptness of a “Corporate Waste” Argument

The ABA Commentary, however, pairs the recommendation and
argument against indemnification of amounts paid in settlement with the
recommendation against indemnification of amounts paid to satisfy an
adverse judgment. 189 This pairing erases a critical distinction between
the two types of indemnification. Only by restoring the distinction may
the analysis prove instructive. Where circularity concerns repayment by
the corporation to the director of judgment amounts, the argument seems
plainly to be a good fit for the corporate law goal of advancing the best
interests of the corporation. When a director has been found liable for
misconduct in a court adjudication, no construction is viable that the
corporation's interest would be served by sending the recovery in a
circle back to the civilly liable director. Indeed, where the circumstance
involves an adverse judgment, classic corporate doctrine bristles with
rules 190 that would prohibit a board-authorized approval of a return
payment, for which a benefit to the corporation appears wholly lacking.
Seen in this light, the meaning of the circularity reference, which carries
such persuasive power as a one word summary of the case against
indemnification of amounts paid in judgment, is that boards should not

plaintiff on whose behalf an action by or in the right of a corporation is brought) were
simply returned to the defendant director who paid them.” (citing DEBORAH A. DEMOTT,
SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 6:08, at 6-54 (1994) and
1 ERNEST L. FOLK, ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW

188. Committee on Corporate Laws, supra note 1, at 761.
189. Id.
doctrine of corporate waste applied to payment to directors found to have lacked a
corporate purpose), discussed in Charles Hansen, The Duty of Care, the Business
Judgment Rule, and The American Law Institute Corporate Governance Project, 48 BUS.
LAW. 1355, 1365 (1993).
waste corporate assets by paying sums of money without any matching benefit to the corporation. 191

In contrast, indemnification of directors for sums paid in settlement could indeed involve a consideration of the corporation’s best interests in that the possibility of indemnification may play a central role in a consideration by the board of a method of disposing of litigation that appears to be bringing more harm to the corporation than possible benefit. 192 A determination that the corporation’s best interests would be served by a settlement that is encouraged by—and perhaps dependent upon—indemnification of the settlement is a prudential judgment that is located in the very heart of the board’s responsibility to exercise business judgment. The term circularity of recovery lacks an animating meaning when transposed from the context of an adverse judgment to the context of a settlement. The force of the argument, powerful in the instance of the adverse judgment, is fully spent on its proper object, and wholly unpersuasive when aimed recklessly at a genuine business judgment rendered by the board.

Moreover, the argument of circularity does not show a consistency with the overall model for board management of derivative litigation. The prototype for board management of derivative litigation is to provide a mechanism that enables the board to deem a suit “not in the best interests” of the corporation and for courts to provide some measure of respect for that determination. 193 While specific implementations of the prototype vary in the degree of deference accorded the board mechanism, the Model Act and the specific statutes have in common the expectation that the board may create an outcome in which the corporation receives a recovery of zero. The phrase circularity of recovery, while piquant, nonetheless describes a result that is the equivalent of the outcome of board-driven dismissals of derivative litigation—zero recovery for the corporation. In fact, since costs are inevitably incurred in the dismissal proceeding, the corporation will as much be a net loser in this scenario as in a negotiated termination involving indemnification of amounts paid in settlement. Thus,

192. See Joy v. North, 692 F.2d 880, 890 (2d Cir. 1982) (holding that a derivative suit may be dismissed if a court finds that dismissal is in the corporation’s best interest).
193. See supra text accompanying notes 156-67.
circularity does not describe a result that differs from other available outcomes in the prototype and cannot be viewed as an objection on the basis of outcome.

b. Inconsistency with Treatment of Expenses

The argument of circularity is also inconsistent with the typical generosity of the models in allowing boards to reimburse a director’s expenses, even where the director settles the suit with an admission of culpability. Although the funds used to repay the legal fees are not sent in a tight circle, in that the payment funds legal fees rather than liability, the principle remains the same. The payment to the corporation is reduced by a simultaneous payment to the director. That payment for fees may well exceed the recovery to the corporation. Indeed, the longer the litigation persists, the more that such legal fees will mount, imposing on the corporation a risk of a suit ending in a low recovery where the corporation is contractually obligated to provide indemnification.

Mounting legal fees add to the circumference of a circle of futile activity and wasteful expenditures in many instances. Yet the prototype of

   Unless ordered by a court under section 8.54(a)(3), a corporation may not indemnify a director:
   (1) in connection with a proceeding by or in the right of the corporation, except for reasonable expenses incurred in connection with the proceeding if it is determined that the director has met the relevant standard of conduct under section (a).

Committee on Corporate Laws, supra note 1, at 756 (setting forth the text of the proposed statute).

195. It should be noted that contracts that entitle directors to reimbursement are enforceable. See, e.g., MODEL BUSINESS CORP. ACT ANN. § 8.58 (3d ed. 1994), which permits a corporation to obligate itself in advance to provide indemnification that is authorized by the statute. See also Committee on Corporate Laws, supra note 1, at 779-80 (setting forth text of proposed statute and commenting: “Many corporations have adopted such provisions, often with shareholder approval.”). It is also of interest that, once such obligatory indemnification has been provided by contract with the director, courts have counted the prospective obligation to reimburse attorneys’ fees as one of the costs that counts against the advisability of continued litigation. See In re Oracle, 852 F. Supp. 1437, 1443 (N.D. Cal. 1994) (noting that because “the indemnity agreements require Oracle to advance to the individual defendants their costs of suits which the defendants are not required to reimburse unless they are found not to be entitled to indemnification . . . Oracle faces the prospect of financing both sides of the derivative litigation”). Cf. Joy, 692 F.2d at 892 (counting as costs of continuing the litigation indemnification that is mandatory under corporate by-laws, private contract or state law but refusing to count for best interest determination indemnification the corporation may pay as a matter of discretion).
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derivative litigation views the circle in which legal fees travel as tolerable despite the futility.196

2. Concerns about Meritless Suits

Although the circularity argument does not of itself justify the gap in a board's ability to influence the outcome of derivative litigation that the bar on indemnification produces, there are other justifications, both practical and theoretical, that merit close attention. The portion of the Model Act commentary quoted earlier continues:

In view of these considerations [liability limiting code provisions], it is unlikely that directors will be unnecessarily exposed to meritless actions. In addition, if directors were to be indemnified for amounts paid in settlement, the dismissal procedures . . . might not be fully employed since it could be less expensive for the corporation to indemnify the directors immediately for the amount of the claimed damages rather than bear the expense of the inquiry required by [the dismissal procedures]. The result could increase the filing of meritless derivative proceedings in order to generate small but immediately paid attorneys' fees.197

The arguments advanced are twofold. One relates to the absence of meritless suits, and the other to their presence.

a. Specious Litigation As the Wrong Issue

The first argument is that indemnification of settlement amounts is unnecessary since specious suits are unlikely to occur. The second is that authorization for indemnification of settlement amounts will, in self-defeating fashion, create incentives for such suits.

The initial argument is undeniably correct to the extent that it characterizes specious litigation as a fairly minor problem. The barriers

196. In this regard the Model Act is typical. See Committee on Corporate Laws, supra note 1, at 756, 761-62 (setting forth text of § 8.51(d)(1) authorizing board to indemnify for legal expenses even in the case of settlement and commenting: "Despite the prohibitions on indemnification of a settlement or a judgment in a derivative proceeding, subsection (d)(1) permits indemnification of the related reasonable expenses incurred in that proceeding so long as the director meets the relevant standards of conduct set forth in section 8.51(a)."; see also AMERICAN LAW INSTITUTE, supra note 2, § 7.20 (b)(1)(d) (excluding board payment of settlement amounts but not excluding board payment of expenses where director settles case); DEL. CODE ANN. tit. 8, § 145(b) (1991) (allowing indemnification of attorneys' fees in settlements).
197. Committee on Corporate Laws, supra note 1, at 761.
standing in the way of strike suits adequately protect corporations from rampant harassing litigation. Yet the argument misdescribes the type of suit to which corporations need to take strong, flexible responses. The Model Act fails to address the practical threat to directors that lies in the possibility that complex corporate transactions may, although conducted in good faith, give rise to colorable claims of breach of duty, particularly where self interest is involved.198 It is these claims that can produce the type of protracted, expensive litigation that the board would probably wish to terminate at a cost lower than that which continued litigation would produce. The ability to indemnify amounts paid in settlement would provide an avenue to end the matter via settlement, an avenue that may otherwise prove unacceptable to the defendant directors.

Of course, if the suit is harmful to the corporation’s interests, the corporation could seek termination via the screening process set forth in the statutes. Yet, as previously suggested and as the Model Act commentary notes, authorization to indemnify directors for amounts paid in settlement may lead a board to forego the screening route where the realities of the case point to a cheaper, more expeditious method of termination based on settlement via indemnification. On its face, the result is not a bad one. Legislative strictures that demand that more cumbersome and costly methods be utilized cannot be said to be obviously in the corporation’s best interests. Thus, the gap referred to earlier produces its effect. Nonetheless, there are additional considerations that cannot be ignored, which suggest that closing the gap will produce unwanted side effects.

b. Board Resistance to “Strike Suits”

In the course of its second argument noted above, the Model Act commentary suggests that the ease of termination that settlement plus indemnification produces carries with it the encouragement of strike suits in which plaintiffs’ lawyers expect to be, and are in effect, bribed to accept the settlement. Yet it is not apparent why such suits should appear to be a pressing problem.199 Here the concern primarily emanates from a protective stance toward target corporations, which would pay unnecessary settlements and legal fees and suffer the distraction of numerous nuisance suits. The argument is not supported by reference to any empirical evidence or case lore, and should be

198. See supra text accompanying notes 31-35.
199. See supra note 35 (arguing that corporations may benefit if boards assess merits more generously in a settlement posture than in a court adjudication approach); see also infra note 200.
assessed in light of other disciplinary mechanisms for discouraging meritless litigation. In light of sanctions for frivolous litigation imposed by the courts and the attorney's ethical duties in signing pleadings, the argument does not appear strong on its own merits.

What of this argument's fit into the overall conception of derivative litigation? It appears to be a poor fit. The board is conceived of as a body that is vigilant to protect the corporation's business interests and is thus empowered in the prototype model for dismissing derivative litigation to make inquiries and determinations that result in the dismissal of suits. The model reposes trust in the board's ability to form judgments about the appropriate level of inquiry necessitated by the gravity and credibility of the charges. Statutes presuppose sufficient inquiries where the charges are grave, in a circumstance where considerable temptation for rote recitations praying for a "best interests" dismissal of charges against colleagues looms large in the eyes of critics of the model dismissal procedures. While the board is trusted to dig a deep trench of investigation when charges against present or former colleagues are grave and credible, it is not trusted to safeguard the interests of the corporation in responding to meritless suits. While it may be true that well funded targets have the occasional impulse to ward off pests with small payments, genuine harm would only arise if weak willed corporate boards were so disposed to dispense sums of money as to create a culture of corporate blackmail reminiscent of nineteenth century matrimonial suits handled by the firm of Howe & Hummel. Such deterioration of the corporate ethical climate will not occur if for no other reason than the fact that directors will not ask

200. FED. R. CIV. P. 11. A more vigilant stance against potential meritless litigation may have been thought necessary at one time because of courts' traditional reluctance to require the payment of attorneys' fees for frivolous lawsuits. See CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 16.6 (1986).

201. See supra text accompanying notes 156-67.

202. But see DeMOTT, supra note 1.

203. Brudney, supra note 180; see also Seligman, supra note 168 (discussing discovery).

204. But see Brudney, supra note 180, at 607-20 (skepticism concerning independent directors' independence); Seligman, supra note 168, at 361 (deficiencies of SLC fact-finding).

205. Cf. RICHARD H. ROVERE, HOWE & HUMMEL: THEIR TRUE AND SCANDALOUS HISTORY 112 (1947) (general charges of seduction under the promise of marriage redeemable by alleged seducers at sums varying between five and ten thousand dollars).
their colleagues to sully their reputations by pleading guilty to totally unfounded allegations of scurrilous behavior.

3. Structural Bias

Although never stated in the Model Act commentary, the fundamental objection to indemnification for amounts paid in settlement, indeed the only objection that has serious force, is that its very utility in permitting expeditious termination of suits makes it easier for structural bias\(^\text{206}\) to rear its head once more. The concern is that a board, sympathetic to the plight of fellow directors who find themselves the target of litigation, will seek to take them out of the line of fire regardless of the merits of the case. To the extent that this does occur, individual corporations will lose the benefit of litigation in which they would be net gainers, and the deterrent effect of derivative suits is diluted. The same concern, of course, is present in the screening process, where the Model Act drafters grant considerable deference to a directorial determination that continued litigation is not in the best interests of the corporation. Nonetheless, in that situation, immediate judicial review occurs, a factor that is not involved in a board determination to pay indemnification. It would therefore seem that the structural bias risk is greater in the indemnification situation.

In fact it is doubtful that this is the case. Two responses are apparent, the first of only modest rebuttal value and the second of much stronger force. The first concerns the opportunity that settlement approval proceedings afford the court to learn of the intended indemnification. If indemnification of settlement is to occur, it will normally be part of an arrangement in which the board consents to the payment in order for the settlement to be accomplished. At the time the parties present the settlement to the court for approval, candor will require that they also apprise the court of the indemnification arrangement. A degree of judicial examination of that aspect of the case is likely to occur.\(^\text{207}\) The judicial review will not, however, be of the most far-reaching variety. Concededly, the judicial approval of a settlement takes place in the context of a proceeding in which all parties are in agreement; no one is challenging any aspect of the proposed case resolution. The consequence may be a less searching judicial review at the point of settlement than after the heated debate surrounding a corporate motion to dismiss following a statutory screening procedure.

206. See supra note 10.
Nonetheless, although judicial review of the indemnification process may not of itself calm all fears about structural bias, a second response to fears about structural bias provides a significant degree of comfort. The decision to indemnify must be made in compliance with statutory standards. The board must decide that the settling directors either engaged in conduct for which the statute allows corporate charters to eliminate liability or that they acted in good faith and in a reasonable belief that the action was in, or not opposed to, the corporation’s best interests.\(^{208}\) Thus, the board must not only determine that its grant of indemnification is itself in the corporation’s best interests, but also that the relevant standard for indemnification has been met. A failure to comply with the duties leaves the board vulnerable to possible personal liability\(^{209}\) (unless the Model Act’s new provision, adopted in 1994, is in effect—allowing elimination of personal liability for conduct if it falls short of receipt of a financial benefit to which a director is not entitled, an intentional infliction of harm on the corporation or its shareholders, or an intentional violation of criminal law.)\(^{210}\) This vulnerability, a

\(^{208}\) Committee on Corporate Laws, *supra* note 1, at 756 (setting forth proposed § 8.51(a) requiring a corporation to indemnify a director if “(i) he conducted himself in good faith; and (ii) (A) in the case of conduct in his official capacity, that his conduct was in the best interests of the corporation; and (B) in all other cases, that his conduct was at least not opposed to the best interests of the corporation”); *see also* DEL. CODE ANN. tit. 8, § 145(b) (1994) (featuring a similar standard).

\(^{209}\) *See supra* note 87.

\(^{210}\) MODEL BUSINESS CORP. ACT ANN. § 2.02(b).

The articles of incorporation may set forth:

(4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take action, as a director, except liability for:

(A) the amount of a financial benefit received by a director to which he is not entitled;

(B) an intentional infliction of harm on the corporation or the shareholders;

(C) a violation of section 8.33; or

(D) an intentional violation of criminal law.

*Id.*

By comparison, Delaware law allows liability to be eliminated for breaches of fiduciary duty other than, among others, breaches of the duty of loyalty to the corporation or its shareholders, acts or omissions not in good faith or that involve intentional misconduct or knowing violation of law, or a transaction from which the director derived an improper personal benefit.
vulnerability that Code writers have the option of reinforcing,211 contrasts sharply with both the minimal risk that directors face when seeking to have a suit dismissed via the screening process and the veil of good faith that is tossed across the fact-finding on which is predicated an SLC finding that a proceeding is not in the best interests of the corporation.212 In a dismissal proceeding, the directors are attempting to convince a court to respect their conclusion that the suit should end. Assuming that they have not flagrantly misled the judge, the danger of some sanction is remote.213 The decision to indemnify, however, is one that the board makes and must accept responsibility for. Thus, the desire to assist fellow directors and remain loyal to the group may be tempered by a reasonable concern to preserve personal reputation and avoid exposure to renewed legal proceedings.

One might argue that the legal hazard of improper indemnification is virtually obliterated by the statutory permissions to eliminate, by provisions inserted in the articles of incorporation, personal liability for negligent conduct by directors, particularly given the Model Act broadening of the permitted exculpatory language as compared with the language in Delaware.214 Given the broad exculpation permitted by

211. See infra text accompanying notes 237-38.
212. See Seligman, supra note 168, at 361 for a litany of the manifold deficiencies of the fact-finding process in which counsel for a special litigation committee engages (describing lesser incentive of SLC counsel to probe witness' veracity compared with adversarial counsel, lesser penalties for witness memory lapse or fabrication than in courtroom, psychological predisposition of SLC counsel to accept corporate witness claims, and limitations of evidentiary basis for SLC counsel to question witnesses).

It should be noted that the issue presented to the court is not whether continuing the suit is in the best interests of the corporation, but whether the court finds that the SLC has made a determination in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation. MODEL BUSINESS CORP. ACT ANN. § 7.44(a) (3d ed. 1994). Thus, the investigation need only withstand scrutiny as to good faith and reasonableness, not accuracy, thoroughness, or even defensibility of the conclusion. Arguably, the standard for dismissal and the structure of the decision-making process is less demanding than in the case of approval of interested director transactions. In the latter, the safe harbor protection of such transactions from later attack can vanish if disclosure is inadequate. Moreover, some cases suggest that courts should apply a “heightened scrutiny” to transactions in which a portion of the board blesses the interested-director transaction of other members of the board. See MODEL BUSINESS CORP. ACT ANN, § 8.31 cmt. (1970) (“sole purpose of section 8.31 is to sharply limit the common law principle of automatic voidability” conflict of interest transactions); see also Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (conflict of interest section does not remove conflict of interest from judicial scrutiny); Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc., 430 N.W.2d 447, 452 (Iowa 1988) (holding that the common law relating to interested director transactions is not negated by statutory procedures to allow interested director transactions without clear breach of duty).

213. See Seligman, supra note 168, at 361 (concerning fact-finding).
the Model Act, secondary liability to which directors might be subject is relatively unrealistic.

This need not be considered an insuperable problem. The solution is relatively straightforward. Any code provision permitting indemnification of directors for payment of settlement amounts should be accompanied by a code provision excepting decisions to award such indemnity from the coverage of the liability limiting provision. The provision as it now exists is arguably insufficiently nuanced. It extends the right of prospective exculpation of directors to all corporations for all types of corporation transactions, whether routine or extraordinary in nature and limited only by actual receipt of an improper personal benefit or by the commission of an intentional and focused act of harm aimed (seemingly maliciously) at the corporation. The provision is noncontextual, conferring limitation of liability on the vast array of corporate entities wholly without reference to qualifying characteristics. As will be discussed below, thinking about the context of indemnification draws attention to the possibilities of more nuanced policy choices for corporate accountability. The statutory means are readily at hand to strengthen the moral currency in which indemnification decisions are made and to maintain the advantage in director accountability of indemnification scenarios for lawsuit termination over dismissal scenarios.

4. Consideration of Deterrence Value

For such reasons, concern that the deterrence value of derivative litigation would be diluted by authorizing indemnification of settlements seems misplaced as well. Among the goals of an indemnification statute propounded by the drafters of the Model Act is to “prohibit indemnification where it might protect or encourage wrongful or improper conduct.” While loss of deterrence is not cited in the case in chief against indemnification of settlement amounts, concern not to “encourage socially undesirable conduct” is one of the policy underpinnings of a statute on the subject of indemnification and advance of expenses set forth in the Model Act exposition.

215. Committee on Corporate Laws, supra note 1, at 750.
216. Id. at 761.
217. Id. at 750.
What is the likelihood that a board member, intent on committing an intentional breach of duty, would be prospectively influenced by the availability of board approved payment of settlement amounts to proceed with such a breach? The practical concern would be that a director, unable to purchase insurance protection for intentional breaches of duty, would view the availability of board approved indemnification as a security for malfeasance. The director would presumably view the board as a reliable ally that would act without reference to the usual statutory standard for granting indemnification—a finding that the director had a good faith belief her action was in, or not opposed to, the best interests of the corporation. To conclude that deterrence value is lost by allowing boards to indemnify directors for settlement requires a belief that a prospectively breaching director would place faith in the probability of a board decision to indemnify in defiance of the statute, with the attendant liabilities on, and reputational harm to, board members acting in breach of their own duties. Given the mechanisms for assuring a disinterested board for indemnification determinations, the specter of lawless boards acting in such an unchecked fashion is unrealistic.

Will boards of directors never abuse the power to indemnify directors for amounts paid in settlement? Certainly some will. The risk of abuse is highest when the settlement follows the court's rejection of a

218. See BLOCK, ET AL., supra note 4, at 993 (overwhelming majority of indemnification statutes authorize corporations to purchase and maintain liability insurance for directors and officers); id. at 1075-83 (describing “D & O” insurance crisis of the mid-1980s).

219. See supra note 87.

220. See supra text accompanying notes 157-67.

221. See Dooley, supra note 30, at 507 (arguing that directors are unlikely to forgive morally culpable cheating in comparison with treatment of mistakes in judgment).

Indeed, the preference of boards to dismiss derivative litigation is said to be encouraged by a boardroom culture that views derivative suits as unscrupulous. James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 LAW & CONTEMP. PROBS. 83, 89 (1985). Since a settlement is an acknowledgment that the suit has merit, it may be a more difficult decision for a board subject to bias against such suits than the decision to seek dismissal, despite the protective aspect of also proving indemnification of the liability to a fellow director.

In addition, after a board acknowledges liability, deciding to indemnify on the grounds that the director has met the applicable standards is arguably a weightier moral judgment than asking a court to dismiss a suit on the grounds that continuing the suit is not in the best interests of the corporation (which may be made without regard to the moral culpability of the defendant director). If a board engages in a sequence of reasoning by which it a) concludes that the suit has sufficient merit for a settlement and b) concludes that indemnification of the director for the settlement payment is not defensible, the usual readiness of boards to seek dismissal may well diminish, despite the logically distinct nature of the questions posed by settlement versus dismissal.
corporation's motion to dismiss on best interests grounds, or when indemnification occurs in the post-settlement period independently of the settlement. In the first case, the corporation may be seeking to overcome a judicial determination that the suit should proceed; in the second situation, the board is permitting circularity to occur, in circumstances reminiscent of indemnification of adverse judgments, that is, without any corresponding corporate benefit. Yet the flagrant nature of such abuse militates against ready resort to it by faithless boards. Courts, in command of procedural history, may hesitate to approve settlements that seek to vitiate a judicial finding that a suit should proceed. Likewise, directors may be hard pressed to justify payments of settlement amounts to defendants who settled with no assurance that indemnification would occur.

In sum, the risk of abuse is real, but far from uncontainable or inevitable. Each corporate dispute has its own personality, with possibilities for constructive settlements or misuse of statutory process. For the reasons discussed above, the probability of abuse should not be estimated to be so high that the benefits of board authority to indemnify amounts paid in settlement are overlooked. On the other side of a balance scale from the risk of abuse sit the benefits of closing the gap that now prohibits boards from seeking the cheapest, most expeditious manner of ending litigation that they conclude is not in the company's best interests.

V. A NOTE ON THE CRITERIA FOR ASSESSING SETTLEMENT IN THE CONTEXT OF DERIVATIVE SUITS

It has been suggested above that the ready equation of the prevalence of settlement in corporate litigation with negative conclusions about the usefulness of such litigation may be a too ready assumption that corporate settlements do not produce socially useful results. While it is beyond the scope of this Article to assess empirically the social utility of settlements of corporate lawsuits, in particular derivative suits, it is nonetheless useful to briefly consider the criteria that might form the basis of an empirical evaluation. Galanter and Cahill have proposed several categories of hypotheses of reasons why settlements in the general context of litigation are useful. They label these as arguments
concerning party-preference, cost-reduction, superior-outcome, and superior general effects. 222

Because, as discussed above in the summary of the argument, 223 settlement in derivative litigation is not, in standard terms, settlement, but rather a purchased ending of a lawsuit, the settlement literature may be seen as lacking direct relevance to settlement via indemnification. Certainly, it is apparent that the first criterion is non-operative, since the plaintiff is in large part an abstraction and the satisfaction of the "players" is of no theoretical or practical importance. The cost reduction criterion is applicable to, and is the principal component of, the "procedural" argument presented above.

As mentioned above, a derivative suit settlement shares in common with real settlement the feature that the parties decide to reach a non-adversarial ending to a legal dispute. Despite the bloodless character of any issues of party satisfaction, the decision to divert the litigation from an adversarial pathway to final conclusion is a social collaboration, involving parties who engage in different actions to end the suit cooperatively rather than to contest it. 224 The nature of the collaboration is not preordained. The criteria that the settlement literature proposes for assessing settlement compared with litigation are also suggestive of opportunities in the shaping of statutory options for the termination of litigation by which it may be possible to affect the moral content of the process.

The superior-outcome and superior-general-effects categories contain the criteria with potential application to, and conceptual development for, derivative suit settlements. The specific criteria listed by Galanter and

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222. See Galanter & Cahill, supra note 42, at 1350-56.
223. See supra part I.A.
224. In addition, the dispute is "real" in that it represents contested perspectives generally associated with "insiders" and investors. However, it should be conceded that, by hypothesis, the right solution can only be the decision that the court would have made; the underlying assumption is that the parties do not have the capacity to find a better resolution than the court.

This may appear to be in contrast to other settlements, where the parties have the ability to compromise their selfish interests from the most expansive claim of entitlement to an agreeable middle position. But the theory of settlement does not posit a universe of legal disputes in which there are no right answers and the parties may supply any of several equally valid answers, but a world in which the cost and uncertainty of vindicating legal entitlements makes parties willing to accept less than their entitlements. Because a party whose selfish interests are at stake chooses a compromise of entitlement, the concern for legitimacy is not as sharply posed, but it is still present. See Galanter & Cahill, supra note 42, at 1362 (discussing "full entitlement" standard). But see id. at 1347 (suggesting that actors may define disputes differently as a result of engaging in settlement rather than adjudication). The theoretical difference between derivative suit "settlements" and other settlements is not on the order of a chasm.
Cahill under superior-outcome are golden mean, superior knowledge, normative richness, inventiveness, more compliance, and personal transformation. Under superior-general-effects are found deterrence, moral education, mobilization and demobilization, and precedent and patterning. While some of these seem more applicable to disputes between individuals, several of them are evocative of the types of benefits that could flow from an explicitly designed process for enabling boards of directors to embrace settlements as constructive outcomes of derivative litigation.

There is, however, no existing set of controlled experiments that might provide a basis for tentative conclusions. Although certain states now allow indemnification of settling directors, it does not appear likely that these states provide a fertile territory for empirical comparisons with practices in states that maintain the bar. The tendency to rely on directors' and officers' insurance, for instance, does not seem likely to be less pronounced in the former states. It seems fair to conclude, on the available evidence, that the market for executive risk insurance is a national one, in which the standards of coverage and practice are set nationally and companies do not negotiate changed terms to reflect individual circumstances, including the law of the state of incorporation.

It also seems likely that the corporate mind-set created by the national market and the prevalence of reliance on insurance for protection of executives blunts the impact of variation in incentives to purchase directors' insurance that might be created by the differences in corporate statutes. For example, corporate lawyers in Michigan—which permits indemnification of settling directors—represent both Michigan and Delaware corporations. Despite high levels of sophistication, they do not differentiate the insurance needs of Michigan and Delaware corporate executives, nor do outside attorneys report direct experience with the insurance practices of their clients. The predominant views of derivative litigation appear to influence executives and their advisers. General truths about the risk level for corporate executives and the need for insurance are in circulation without reference to state law variations.

225. See id. at 1371-87.
226. See Anderson et al., supra note 23, at 262 n.18, 286-89.
An alteration of statutes (more generally than in a handful of states) that directed attention to settlement as a viable and approved alternative might influence the climate of sophisticated opinion about derivative litigation and thus reshape practices. The necessity for insurance might be rethought; pricing could be affected. While the assumption that the board would only settle those cases that the court would dismiss leaves a chunk of liability for which prospective indemnification does not protect a director, the moral climate should be nonetheless altered and some of the negative response to director exposure to lawsuits softened. It would be clear that the unindemnifiable legal exposure would be for acts that resemble, in moral quality, theft from the corporation, for which the court would determine that litigation of the matter is in the best interests of the corporation, despite the many costs and negative factors.

The potential for practice to evolve, as it has been suggested it might in the area of corporate purchase of insurance, has relevance to the issues of moral education as well as precedent and patterning. Two concerns about the effect of settlement on these criteria of the social utility of dispute resolution might arise from the phenomenon in litigation of confidentiality agreements. First, moral education would be compromised by settlements that relieve a director of financial exposure and obscure the facts of the case. Second, precedent and patterning would be reduced by private settlements that are not published. In addition, settlements, even if published, might not produce law in the sense that judicial decision-making does.

It should be borne in mind, however, that the relevant comparison remains that between cases the court would have dismissed and cases that the board settles. In such cases, when the court dismisses the case on the basis of corporate best interests, it will have affirmed that the charges have legal substance. But the focus of the court is not on resolving the charges. The court, therefore, does not typically produce fine-grained analysis of the alleged breach. A settlement of the same charges has the potential to equal or exceed in educative function the court opinion dismissing the case. The nub of the matter is a requirement of disclosure that precludes standard confidentiality agreements, in which the settling parties recite that the act of settling does not constitute an admission.

Further development of a requirement of disclosure, such as has been included in section 16.21 of the Model Business Corporations Act, could

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228. Cf. Black, supra note 25, at 584 (suggesting that judges have limited power to create nontrivial corporate law).
enhance the "general effect"\textsuperscript{229} by avoiding what Galanter and Cahill refer to as "the appropriation for private benefit of the public goods produced by the dispute processes"\textsuperscript{230} as a result of confidentiality agreements. When considering the comparison of indemnification-driven settlement and court dismissal, the comparison should be made in light of the opportunity to shape the process by which settlements are fashioned.

VI. CONCLUSION

A. An Alternative Approach: Court Approval?

This Article suggests that the decision to indemnify payments made in settlement could be treated as simply one more aspect of corporate life where boards exercise their discretion. If the risk of abuse is considered to be greater than this proposal for a strong board role in indemnification of settlement amounts acknowledges, the option of court approval of such indemnification may appear an attractive middle position.

As previously noted, the Model Act contains a provision for court approval.\textsuperscript{231} It is framed, however, without fashioning a statutory format for the board to exercise any function. Indeed, the discussion above has accorded little emphasis to the Model Act provision for court approval, instead it has suggested that the provision is best denominated as an escape valve and has treated the Model Act as one that removes the board from the process of awarding indemnification for settlement payments. By its terms, the Model Act court approval provision excludes the board from any statutorily assigned role. The only party that can petition for such payment is the director, who must establish that the award would be "fair and reasonable."\textsuperscript{232} The commentary to the relevant sections speaks of the process somewhat cryptically:

\textsuperscript{229}. See supra text accompanying note 225.
\textsuperscript{230}. See Galanter & Cahill, supra note 42, at 1386.
\textsuperscript{231}. See supra note 14.
\textsuperscript{232}. MODEL BUSINESS CORP. ACT ANN. §8.54(a) (3d ed. 1994). Indeed, the Model Act drafters themselves state: "[F]or the unusual situation, an 'escape hatch' is provided in section 8.54(a)(3), permitting a court to order indemnification for settlements of derivative proceedings." Committee on Corporate Laws, supra note 1, at 743-44.
A director seeking court-ordered indemnification or expense advance under section 8.54(a)(3) must show that there are facts peculiar to his situation that make it fair and reasonable to both the corporation and to the director to override an intra-corporate declination or any otherwise applicable statutory prohibition against indemnification, e.g., sections 8.51(a) or (d) . . .

It should be emphasized again, however, that the director seeking indemnification must make a showing of fairness and reasonableness and that exercise of the power granted by section 8.54(a)(3) is committed to the court's discretion. 233

Both the form of the statute, confining the moving party to the director herself, and the commentary appear to envision a situation in which, after settlement occurs, a director may attempt to convince a court either of her rectitude or some extraordinary circumstance that would allow the court to soften the generally applicable rule. The provision does not fill the gap, discussed above, in the ability of the board to fashion a settlement of which indemnification is an essential part. Put another way, the Model Act places the focus on whether atypical circumstances justify a director's petition for discretionary court-ordered indemnification rather than whether the best interests of the corporation demand that the board provide indemnification.

To be sure, a corporation could utilize the Model Act to permit boards to indemnify as part of a settlement package. The director, who must make the motion for indemnification, could function as a transmitter of the work product of the corporation's lawyers arguing their case for the wisdom of indemnification. A court, overlooking the structure of the Model Act provision as an after-the-fact appeal for court mercy, might then order indemnification as part of the settlement process without applying rigorously the statutory guidance to search for "peculiar circumstances" that appeal to the court's conscience. At best, this is a backhanded approach, the application of which is uncertain and thus of limited utility as a board asset in settlement negotiations.

More importantly, the wresting away of the provision from its intended use as a backstop to assure fairness to individuals234 to an unintended use as part of a board managed settlement creates the undesirable effect of insulating the board from responsibility for, or liability resulting from, improper indemnification. If a corporation succeeds in achieving its purpose to indemnify by means of a director's motion appealing to the court's mercy, the board of the corporation escapes all accountability for a board action. The corporation has made no court motion, as it does in the case of a motion to dismiss, and thus

233. Committee on Corporate Laws, supra note 1, at 770 (emphasis added).
234. See id.
need not take the reputational risk associated with corporate endorsement of the indemnification. In addition, it has not taken any corporate action for which the responsible board members could be held personally liable.

The Model Act provision is, therefore, not a good source for a middle position of allowing court approval. If court approval is to be the mechanism for increasing the board’s capacity to settle derivative litigation but subjecting board recommendations to a heightened judicial review, court-accorded indemnification should be at the corporation’s behest and based upon an explicit consideration of two criteria: 1) the director has met the statutory standards for indemnification; and 2) granting of indemnification will serve the corporation’s best interests.

Whether such a mechanism for court approval constitutes a superior approach depends upon the estimate of the gain received as a result of additional court process compared with the increase in expense associated with additional judicial review. Because the hearing that would occur under a statute allowing the corporation to seek court approval of payment of settlement amounts would occur without the presence of an advocate against the proposition that indemnification would serve the corporation’s interests, the additional scrutiny is not of the character that can be expected in a litigated dismissal proceeding. Thus, the amount of additional confidence in the result that is purchased with an increase in legal expenses and time and with a reduction in the assurance the corporation can provide directors during negotiations is unclear. Moreover, court approval, even where the corporation makes the motion, at least partially cheapens the moral currency with which the board pays the settlement amount to a present or former colleague.

Thus, the middle ground of court approval does not appear to be a good compromise point, for it lacks the quality of a sound compromise. A sound compromise should be that, except for the areas of intended concession, the position being compromised—here, a policy against overly convenient avenues for boards to indemnify settlement amounts—is not otherwise worsened. For better or worse, the question presents a choice between competing visions of corporate law and

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235. The level of attention accorded to the fees awarded to plaintiffs' attorneys in derivative litigation might be a useful comparison. For an example of such court review of fees, see In re Oracle, 852 F. Supp. 1437, 1444-59 (N.D. Cal. 1994).
reality. Drafters of codes should, rather than temporize, make the choice.

B. Procedural Argument: Conclusion

The bar on indemnification of settlement amounts is by no means cost free for corporations that engage routinely in complex transactions that invite second-guessing of their agents by shareholders. Were the case against allowing such payments a strong one that stood up well to critical scrutiny, the cost might well be seen as necessary. But the case in favor of allowing boards, in the exercise of their fiduciary duty and with due regard for the consequences of its breach, to conclude that the corporation will benefit from expeditious consensual conclusion of a particular suit has sufficient substance to suggest that the benefits and burdens of the bar need a new weighing. An effort to compromise is not advisable, however. The choice should be taken between the traditional bar on indemnification of settlement amounts and the proposal for a fuller board role set forth herein. Drafters should avoid fudging the choice by adding court review, the benefits of which are doubtful and the effect of which may be, ironically, to lighten the board's sense of accountability for an indemnification payment.

C. Configuring Policy—New Alternatives?

The choice of allowing indemnification of directors for settlement payments need not be conceptualized starkly as a yes or no option within an unchanged existing system of derivative litigation. Derivative litigation is not a naturally occurring phenomenon of invariant moral content.236 The participants take their guidance from the statutory narrative that validates the roles they play.

The existing statutory grid for disposing of derivative litigation is substantially determined by a set of debates over subtle variations in emphasis on the business judgment rule and structural bias that give greater or lesser encouragement to the use of derivative litigation to

236. Compare Black, supra note 25, at 576. We usually evaluate changes in corporate law taking as given the attitudes of the people affected by the change. That assumption works well for local change, but may fail for global change. If we don't allow for cultural change, a global change may seem worse than the current set of rules when it is really an improvement. Yet allowing for cultural change in designing optimal rules is nearly impossible. How can we do more than speculate about how culture might change?
monitor director conduct.\textsuperscript{237} These debates have been fully vetted and are not a likely source for new policy initiatives in legislation setting the balance of power between the participants in derivative litigation.

1. \textit{Time to Shop for a New Model of Raincoat?}

A potentially more fertile source of ideas for policy configuration is a careful look at how the statutes might effect a socially useful process in which corporate boards make self-assessments leading to defensible outcomes of derivative litigation. This context—seeking to insert moral accountability and visible resolutions of claims of director misconduct into derivative litigation—could become the basis for a more textured set of statutes, designed to create incentives for corporations to create credible processes for resolving charges of directorial misconduct. The current statutory practice of extending standard treatment to corporations, including uniform availability of liability limiting charter provisions, could be rethought to make available alternative regimes of accountability conditioned upon differing corporate approaches to shielding directors from financial risk.

Current statutes produce a system of substantial buffering of directors from liability, despite the continued existence of doctrines to police their adherence to fiduciary duty. In particular, the statutes contain an authorization for a “raincoat” protection for all directors, granted unconditionally without regard to the alignment of powers and interests between directors, management, and shareholders in any given corporation and without regard to the risks associated in any given corporation with director malfeasance.

The first obvious alteration of that unconditional grant of exoneration in a manner sensitive to context should be for it to be withdrawn from the decision of a board to indemnify a director for settling a derivative lawsuit. States that allow such indemnification should amend their statutes and states that adopt such a grant of indemnification power should only do so in connection with amending their raincoat provision. The argument against the proposal would be that directors would not use the indemnification procedure if they took on such exposure in doing so; if true, nothing would be lost from the present system. But those boards that had the confidence in their integrity, legal knowledge, and practical

\textsuperscript{237} See Coffee, \textit{supra} note 4, at 7-8.
judgment would have the opportunity to act in the interests of the corporation and with appropriate, wholesome disclosure. Given the variety of corporations and corporate legal and investor environments, this freeing up of the corporate statute from the strictures of cold-eyed realism—wholesale exoneration because lawsuits are generally suspect and a bar on indemnification of settlements because boards are generally suspect—would be a constructive beginning in the direction of more nuanced statutes.

2. Liability by Menu?

Other more thorough-going changes can be imagined. Instead of a unitary system applicable to all corporations, there could be a menu approach, which corporate charters can elect. The theoretical pricing by shareholders can be hypothesized to move corporations toward regimes more highly valued by shareholders. While proposals of menu approaches in other corporate law contexts have languished, the degree of discontent with corporate litigation may make experimentation more attractive than in areas where problems are perceived as heavily theoretical.

How might these choices of regime be designed? One possibility would consist of the following combination of features of the regime of liability for an electing corporation:

1) No bar on indemnification of settlements;
2) No raincoat provisions at all;
3) Creation of a guardian ad litem, to whom plaintiff lawyers report; and
4) Limitation of insurance coverage of directors to amounts for draconian liability.

The guardian ad litem mechanism is similar to a proposal in the Common Sense Legal Reform Act of 1994 for securities class actions. One should recall once more that a hypothesis that no corporation would elect this or that no board member would serve is not fatal, since it is only presented as an available choice in a statutory menu of regimes of liability. The existence of one corporation that, on its own motion, disclaims the use of directors’ and officers’ insurance has been previously noted. Statutory rewards might well nudge other corporations in similar directions.

239. See supra note 4.
240. See supra text accompanying note 47.
3. Getting More Radical: Changing Lawyers' Incentives

A more radical proposal would be to afford electing corporations a statutory limitation of lawsuits against them to ones in which the shareholders' attorney is drawn from a cadre of lawyers certified as corporate monitors, with an ethical code that specifies that the interests of the corporation must be regarded as their "client's" interests. Fees would be paid from a fund created by contributions in lieu of insurance premiums. While the savings from foregoing insurance coverage would be reduced, there would be a considerable gain in the credibility of the process brought about by severing the attorneys' incentives from the search for an award of attorneys' fees the size of which is tied to the benefit brought to the corporation by the litigation.

The alternative described may be too greatly at odds with fundamental features of our system of litigation; a politically viable and prudent method for constructing the list of attorneys would be a knotty problem. One possibility is for an electing corporation to publish annually the list of attorneys it has certified for the role; shareholder advocates could employ adverse publicity to penalize corporations that did not choose attorneys deemed credible and competent. Another possibility is to create a body to certify such lawyers. While either of these methods is a radical departure from the entrepreneurial model of lawyering that now controls the dynamics of corporate litigation, the problems of an entrepreneurial driven system have been diagnosed and regretted endlessly. Experimentation that departs from that system, rather than merely tinkering with the balance of adversarial power in an entrepreneurial system, would be useful. An additional benefit might be the education of a body of lawyers practicing at the state level who were drawn to corporate law for reasons of public service rather than an

241. Nonetheless, it would still enjoy the benefits of the private development of legal resources and their provision through market-based private entrepreneurs, particularly if the control on the identity of the lawyers was corporate disclosure. By way of contrast, other solutions to the ills of the entrepreneurial system impose greater probable costs. For instance, Judge Winter has suggested a special master with the authority to stop a lawsuit when it passes the point of bringing benefit to investors. This is a mechanism bearing some resemblance to a court, with the same type of associated costs but constituting an additional layer above and beyond the court itself. In contrast, a special corps of corporate monitor attorneys would have the potential to decrease costs by substituting a less costly style of lawyering for a more profit-oriented one.
original enthusiasm for the elegance of corporate law or for a business lawyer’s legal practice serving managerial interests. A more general literacy about corporate law might be encouraged, and perhaps perspectives from outside the corps of corporate management lawyers would be articulated with greater sophistication than general critics of corporate practice now muster.