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The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule

[W]ith the record of corporate executive wrongdoing at dramatic levels, the government is concerned about giving corporate executives more leeway and making litigation against them more difficult. With Wall Street bonuses in the \$40 billion range, Mr. Paulson is worried that Wall Streeters are not treated well enough. With executives' pay in the stratosphere, not even counting what they steal in options, the government is worried that things are too tough for them.

New York Times columnist Ben Stein commenting on efforts by Secretary of the Treasury Henry M. Paulson Jr. to relieve the supposed litigation and regulatory burdens on American business.¹

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¹ Ben Stein, Op-Ed., *The Split-Screen State of the Union*, N.Y. TIMES, Mar. 25, 2007, § 3, at 8.

In *The Path of the Law*, his famous address at the turn of the last century, Holmes eloquently stated that the purpose of a legal system is to hold people accountable for their actions.² One of its chief concerns, then, should be the conduct of corporate officials because they are entrusted with the lion's share of our country's economic resources.³ Yet that is one place where law has not lived up to its high calling.

This lax oversight is most apparent in the business judgment rule, a major principle of corporate law. The business judgment rule has been cleverly called "the rule that isn't a rule"⁴ and "the world's most expensive raincoat."⁵ It is typically invoked as a defense to charges that business officials have failed to use due care in running their companies.

The business judgment rule assumes that courts are ill suited to engage in after-the-fact review of actions by corporate officers and directors.⁶ Its application therefore usually results in the exoneration of those officials from charges that they have failed to act responsibly in their offices. As a classic judicial statement of the rule puts it, corporate executives and directors can only be held liable for "gross negligence" in running their firms.⁷

² If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience.

O.W. Holmes, Justice of the Supreme Judicial Court of Massachusetts, Address at the Dedication of the New Hall of the Boston University School of Law (Jan. 8, 1897), in *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897).

³ Approximately forty-two percent of U.S. adults, eighty-four million individuals, own stock, many indirectly through institutions such as mutual funds and pension plans. Robert C. Clark, *Major Changes Lead Us Back to Basics*, 31 J. CORP. L. 591, 594 n.2 (2006).

⁴ Douglas M. Branson, *The Rule That Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 631 (2002).

⁵ Jonathan Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1131 (2005).

⁶ It has therefore been called an abstention doctrine. See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 83 (2004).

⁷ *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). See *infra* note 189 and accompanying text.

Legislation has weakened that undemanding standard even further.⁸

But “[f]erment is abroad in the law.”⁹ Since the collapse of the dot-com bubble of the late 1990s,¹⁰ one episode of corporate malfeasance after another has come to light.¹¹ The most brazen and pervasive is the ongoing options backdating scandal involving executives of over one hundred known companies, many from the prominent high-tech industry. A large number of executives secretly profited from this blatantly fraudulent practice, and scores of boards appear to have turned a blind eye to it.¹²

This Article will begin by describing how options backdating works, placing it in the context of earlier and still ongoing deceitful corporate operations.¹³ It will then briefly detail various governmental investigations and prosecutions of this corrupt conduct.¹⁴ But public resources can only reach a fraction of such illegal behavior. This Article will therefore use the options backdating scandal to spotlight the derivative suit, an important tool that shareholders can employ on their own to secure redress in these cases as well as in addressing other frauds by corporate insiders.

As it is currently understood, the business judgment rule presents a high hurdle to the maintenance of those vital actions.¹⁵ Fortunately, recent decisions from Delaware involving

⁸ DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). See *infra* notes 192–96 and accompanying text.

⁹ Used with homage to the great jurist Karl Llewellyn. See Karl N. Llewellyn, *Some Realism About Realism—Responding to Dean Pound*, 44 HARV. L. REV. 1222, 1222 (1931).

¹⁰ As one commentator described that high-flying era:

The technology and telecommunications boom made fools of all of us. From the corporate executives who promised results that in hindsight seem absurd to the ordinary day traders . . . , all were overcome with a complex mixture of credulity, jealousy, vanity and greed In between were the enablers—the regulators, bankers, analysts, consultants, accountants, lawyers, credit agencies and journalists who could have done something to stop the madness, but did nothing until way too late.

Jonathan A. Knee, *House of Gas*, N.Y. TIMES, Oct. 26, 2003, § 7, at 14.

¹¹ See *infra* notes 17–33 and accompanying text.

¹² See *infra* notes 48–64 and accompanying text.

¹³ See *infra* notes 17–27 and accompanying text.

¹⁴ See *infra* notes 101–08 and accompanying text.

¹⁵ See *infra* notes 186–88 and accompanying text.

options backdating indicate that courts may no longer automatically accept that defense as a device to thwart meritorious derivative actions.¹⁶ This Article will close by encouraging derivative suits as a way to promote a more robust judicial review of improper corporate conduct.

I

OPTIONS BACKDATING: THE LATEST IN A RUN OF EGREGIOUS CORPORATE MISCONDUCT

A. *A String of Scandals*

1. *Enron and Its Fellow Travelers*

Since the bursting of the high-tech bubble of the late 1990s, our country has been plagued by an excess of improper and fraudulent business activity. Much of the froth in that overpriced market was due to deregulation of two industries, telecommunications and finance. Speculative excesses there followed weak government oversight.¹⁷

Then came Enron and its companion cases in the early years of this decade, where over two dozen large publicly held companies admitted to inflating their revenues through improper accounting practices.¹⁸ Opulent lifestyles¹⁹ and corrupt auditing²⁰ went hand in hand with executive greed. Such revelations precipitated the far-reaching Sarbanes-Oxley

¹⁶ See *infra* notes 225–37 and accompanying text.

¹⁷ See John Cassidy, *Goodbye to All That: Who Killed the Boom? Two Economists Make Their Cases*, NEW YORKER, Sept. 15, 2003, at 92, 94.

¹⁸ Two good books about those scandals are BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003) and REBECCA SMITH & JOHN R. EMSHWILLER, *24 DAYS: HOW TWO WALL STREET JOURNAL REPORTERS UNCOVERED THE LIES THAT DESTROYED FAITH IN CORPORATE AMERICA* (2003).

¹⁹ For the notorious case of Dennis Kozlowski, CEO of Tyco, see Andrew Ross Sorkin, *Tyco's Ex-Chief Going to Court in "Greed Case,"* N.Y. TIMES, Sept. 29, 2003, at A1.

²⁰ Arthur Andersen, a major accounting firm, was convicted of obstructing justice. See Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron,* N.Y. TIMES, June 16, 2002, § 1, at 1.

legislation designed to shore up the integrity of corporate financial statements.²¹

As such wrongdoings came to light, it became apparent that they were condoned by inattentive directors.²² Such lax practices were epitomized by the admission of directors of the New York Stock Exchange that they had only a vague understanding of how the lush compensation package they had handed their chairman, Richard Grasso, might compromise the man charged with policing their industry's trading practices.²³

Accompanying such corporate malfeasance was deceitful conduct by market analysts who distorted their research reports and stock ratings so their firms could curry favor with business clients.²⁴ Trackers of high-flying Internet stocks at leading companies publicly touted their shares at the same time they were calling them "junk" and other epithets in their personal emails.²⁵

Next came disclosures about fraudulent practices by mutual fund managers such as late trading and abusive market timing.

²¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Among other things, the Sarbanes-Oxley legislation created an accounting oversight board for public companies, promulgated stricter standards for auditor independence, enhanced financial disclosure requirements, and stiffened penalties for white collar crime. For a good summary of that legislation and its impact on corporate America, see Joris M. Hogan, *The Enron Legacy: Corporate Governance for a New Era*, 31 SEC. REG. L.J. 142 (2003).

Secretary of the Treasury Henry M. Paulson Jr. led the movement to relax the accounting requirements of Sarbanes-Oxley, which brought the stinging comment that introduces this Article. See *supra* note 1 and accompanying text.

²² See *Corporate Boards: The Way We Govern Now*, ECONOMIST, Jan. 11, 2003, at 59, 59 (asserting that "[t]oo many boards are stuffed with yes men who question little that their chief executives suggest").

²³ See Kurt Eichenwald, *In String of Corporate Troubles, Critics Focus on Boards' Failings*, N.Y. TIMES, Sept. 21, 2003, § 1, at 1; Gretchen Morgenson, *As Scandals Still Flare, Small Victories for Investors*, N.Y. TIMES, Mar. 11, 2007, § 3, at 1.

²⁴ See Press Release, Office of the N.Y. State Attorney Gen. Andrew M. Cuomo, Statement by Attorney General Eliot Spitzer Regarding the "Global Resolution" of Wall Street Investigations (Apr. 28, 2003), http://www.oag.state.ny.us/press/statements/global_resolution.html.

²⁵ Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354 at 12, 34–35, *In re Merrill Lynch and Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003) (Nos. 02 MDL 1484 MP, 02 CV 3210 MP, 02 CV 3321 MP), available at www.oag.state.ny.us/press/2002/apr/MerrillL.pdf (statement of Eric R. Dinallo, Chief of the Investment Protection Bureau of the New York State Department of Law); see also *Merrill Lynch*, 273 F. Supp. 2d at 381 (noting that one such analyst, Henry Blodget, "continued to recommend companies that he internally described as a 'piece of crap,' 'piece of junk,' or 'piece of [expletive]'").

Those executives manipulated their buying and selling practices to benefit themselves at the expense of their investors.²⁶ They also made various sweetheart arrangements with brokers to recommend their offerings.²⁷

2. *Excessive Corporate Compensation and Income Inequality*

Public concern began to focus on soaring executive pay²⁸ and exorbitant bonuses²⁹ that exacerbated an already bad situation of income inequality.³⁰ The average CEO of a sizeable corporation now makes \$10 million per year—almost 400 times the amount paid to an average worker, compared to only twenty times in the 1960s.³¹

²⁶ See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Exchange Act Release No. 33-8343, Investment Company Act Release No. 26,287, 2003 SEC LEXIS 2937, at *5 (Dec. 11, 2007). This illegal mutual fund activity resulted in \$4.3 billion in penalties. Paul H. Dawes & Kory Sorrell, *Tools for the Imperfect Instrument: Practical Advice for Investigating Stock Options Awards*, 1157 PLI/CORP 641, 643 (2006).

²⁷ For example, as part of these investigations the SEC fined Lawrence J. Lasser, the former CEO of Putnam Investments, \$75,000 for using his mutual fund shareholders' money to pay brokerage houses to push Putnam shares. Jennifer Levitz, *Former Putnam CEO Is Fined by the SEC*, WALL ST. J., Jan. 10, 2007, at C13.

²⁸ See, e.g., Gretchen Morgenson, *Peer Pressure: Inflating Executive Pay*, N.Y. TIMES, Nov. 26, 2006, § 3, at 1.

²⁹ See, e.g., Bert Caldwell, *SEC Tugs on Reins of Runaway Bonuses*, SPOKESMAN-REV. (Spokane, Wash.), Dec. 24, 2006, at E1 (discussing how Goldman Sachs's chief executive officer earned a bonus of \$53.4 million in 2006 and the CEO at Morgan Stanley received \$40 million in bonus compensation).

³⁰ Our global economy may be lifting some workers worldwide out of poverty, but here the very rich are seizing almost all of the wealth that it generates. As one astute observer put it: "Meanwhile everyone else—not just blue-collar factory workers but also the wide office-working middle class—shuffles along, grimly waiting for the next round of cost-cuts." *Rich Man, Poor Man*, ECONOMIST, Jan. 20, 2007, at 15, 15.

Globalization may not even be delivering on its promise to raise the standards of living of most people in poor countries. A fine investigative piece by the *Wall Street Journal* stated: "As trade, foreign investment and technology have spread, the gap between economic haves and have-nots has frequently widened, not only in wealthy countries like the U.S. but in poorer ones like Mexico . . ." Bob Davis et al., *Globalization's Gains Come with a Price*, WALL ST. J., May 24, 2007, at A1. For another biting piece on income inequality in America, see Ben Stein, *Of Tax Cuts and Those \$10 Million Bat Mitzvahs*, N.Y. TIMES, Feb. 25, 2007, § 3, at 1.

³¹ Jim Webb, Opinion, *American Workers Have a Chance to Be Heard*, WALL ST. J., Nov. 15, 2006, at A18.

In 2005 the pay of some CEOs topped \$100 million,³² and many times this lavish compensation seemed to have no connection to the performances of those executives. For instance, one study showed that in a number of large companies that did poorly and lost value for their shareholders, CEO pay averaged \$16.7 million and took 6.4% of total earnings.³³

3. Problems with Private Equity, Hedge Funds, and Subprime Lending

The recent rise to economic dominance of two specific types of organizational investors, private equity firms and hedge funds, has also caused various concerns about harm to shareholders and the public interest.³⁴ Private equity is a more genteel name for groups that were called corporate raiders in the 1980s. Their goal is to buy up businesses from stockholders so that they can restructure and resell them in different forms.³⁵

Increasingly, commentators complain that executives of the acquired firms profit at the expense of their shareholders. The Vice Chancellor of Delaware recently gave credence to those concerns by finding that, in two such transactions, the board of

³² Gary Strauss & Barbara Hansen, *Companies Think They're Worth . . . ; Median Pay for CEOs of 100 Largest Companies Rose 25%*, USA TODAY, Apr. 10, 2006, at B1. By contrast, the most highly compensated major league baseball player, Alex Rodriguez, receives \$27.7 million per year. Associated Press, *A-Rod, Giambi and Jeter Top Off Highest Paid List*, ESPN.COM, Apr. 2, 2007, <http://sports.espn.go.com/mlb/news/story?id=2822968>.

³³ Gretchen Morgenson, *The Best and the Worst in Executive Pay*, N.Y. TIMES, Sept. 17, 2006, § 3, at 1.

For an excellent academic study of how executive compensation is virtually unregulated in corporate law, see LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* (2004). The SEC has adopted new rulings requiring public companies to make fuller disclosures of the total compensation packages that officers and directors receive. SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters, SEC Press Release No. 2006-123 (July 26, 2006). Some shareholders are rebelling on this issue, and have submitted proposals for an advisory vote on executive pay at roughly sixty annual meetings. Erin White & Aaron O. Patrick, *Shareholders Push for Vote on Executive Pay*, WALL ST. J., Feb. 26, 2007, at B1.

³⁴ According to one source, this constitutes an “unprecedented wave of deal making.” Dennis K. Berman et al., *As Deal Barriers Fall, Takeover Bids Multiply*, WALL ST. J., May 8, 2007, at A1.

³⁵ As to the questionable impact that these have on communities and the economy in general, see Daniel J. Morrissey, *Safeguarding the Public Interest in Leveraged Buyouts*, 69 OR. L. REV. 47, 73–82 (1990).

directors had not made adequate disclosures to shareholders about the incentives paid to management.³⁶

Hedge funds gather capital from well-heeled institutions and individuals for speculative investments. They now account for more than half the trading on the New York and London Stock Exchanges³⁷ and control more than \$2 trillion worth of assets.³⁸ Investing in them is costly since the funds charge their clients hefty percentages of the profits they make. Managers of three funds earned more than \$1 billion in 2006.³⁹

Worries about the deleterious impact that investing organizations can have on the overall economy first surfaced in 1998 with the Long Term Capital Growth fiasco. Federal Reserve Chairman Alan Greenspan and others had to intervene to make sure the collapse of that fund would not imperil our entire financial system.⁴⁰ That unfortunate history may be repeating itself today as concern grows about the exceedingly leveraged and speculative investments hedge funds are making.⁴¹

³⁶ Peter Lattman & Dana Cimilluca, *Court Faults Buyouts*, WALL ST. J., July 12, 2007, at C1.

³⁷ Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1. As one recent commentator on the market put it:

[B]illions of dollars are flowing into hedge funds, unregulated investment funds for the very wealthy that are shaking up the market with aggressive trading strategies. . . .

. . . .
. . . Many use debt as part of their investment strategy, sell stocks short, buy complex derivative securities, or trade using complicated and proprietary mathematical formulas.

KAREN BLUMENTHAL, *GRANDE EXPECTATIONS: A YEAR IN THE LIFE OF STARBUCKS' STOCK* 3, 109 (2007).

³⁸ David Cho, *Hedge Funds Mystify Markets, Regulators*, WASH. POST, July 4, 2007, at A1.

³⁹ John Cassidy, *Hedge Clipping*, NEW YORKER, Jan. 2, 2007, at 28, 28. These earnings are only taxed at the capital gains rate of fifteen percent instead of at the ordinary income rate of thirty-five percent. Many feel this is a misuse of tax categories, and there is a movement to rectify it. See David Cay Johnston, *Tax Loopholes Sweeten a Deal for Blackstone*, N.Y. TIMES, July 13, 2007, at A1; Paul Krugman, Op-Ed., *An Unjustified Privilege*, N.Y. TIMES, July 13, 2007, at A19.

⁴⁰ For a good description of the Long Term Capital Growth collapse, see Michael Lewis, *How the Eggheads Cracked*, N.Y. TIMES MAG., Jan. 24, 1999, at 25.

⁴¹ See Henny Sender, *Hedge Funds' Risky Bets Come to Roost*, WALL ST. J., Mar. 8, 2007, at C1; Randall Smith & Susan Pulliam, *As Funds Leverage Up, Fears of Reckoning Rise*, WALL ST. J., Apr. 30, 2007, at A1.

Hedge funds buy and sell all kinds of financial instruments, including mortgage backed securities⁴² that have suffered devaluations because of increased defaults in the subprime mortgage lending market.⁴³ In June, the investment firm Bear Stearns offered \$3.2 billion in loans to bail out two of its hedge funds that had speculated heavily in such collateralized debt obligations.⁴⁴

As such aggregations of capital have proliferated both in number and resources, investment firms have enjoyed a corresponding access to the privileged information that power brings. As such, it appears that their above average returns may owe more to the misuse of inside information than to investing acumen.⁴⁵

The accounting and analyst scandals of the late 1990s may also be repeating themselves in the crash of companies that specialized in subprime mortgage lending, which, as noted above, is tied to the risks of hedge fund investing. When housing prices were rising, those firms made mortgages to cash-strapped home buyers with money from institutional investors.⁴⁶ But when the housing market recently took a downward turn, the value placed on mortgage backed securities appears not to have

⁴² See Anderson, *supra* note 37.

⁴³ See Scott Patterson, *Subprime Flu Sheds a Light on Derivatives*, WALL ST. J., July 2, 2007, at C1; see also *infra* notes 46–47 and accompanying text.

⁴⁴ Kate Kelly & Serena Ng, *Bear Stearns Bails Out Fund with Big Loan*, WALL ST. J., June 23, 2007, at A1. For a good discussion of how securities that were backed by subprime mortgages were given inflated credit ratings and then sold to hedge funds like Bear Stearns, see Floyd Norris, *Market Shock: AAA Rating May Be Junk*, N.Y. TIMES, July 20, 2007, at C1.

⁴⁵ See Anderson, *supra* note 37. The SEC recently announced a \$16 million settlement against a financial services firm, Zurich Capital Markets Inc., that had aided and abetted four hedge funds in carrying out schemes to defraud mutual funds by illegal market timing. Settled Administrative Proceeding Against Zurich Capital Markets Inc. for Financing of Hedge Funds' Illegal Market Timing, SEC Press Release No. 2007-88 (May 7, 2007). Concerns have also been raised that an SEC investigation of insider trading at a prominent hedge fund may have been compromised by the use of political influence. See Walt Bogdanich & Gretchen Morgenson, *S.E.C. Inquiry on Hedge Fund Draws Scrutiny*, N.Y. TIMES, Oct. 22, 2006, § 1, at 1.

⁴⁶ See, e.g., Vikas Bajaj & Julie Creswell, *Suit Says Neighborhood's Boom Was Built on Mortgage Fraud*, N.Y. TIMES, Oct. 6, 2006, at C1.

been adjusted to reflect the diminished worth of the underlying properties.⁴⁷

B. Options Backdating Front and Center

1. The Rise of Stock Options as Executive Compensation

Against the backdrop of all this troublesome business activity has come disclosure of perhaps the most egregious and pervasive fraudulent conduct by corporate officials in recent memory—options backdating. This particularly pernicious form of corporate kleptomania had its genesis in reformist sentiments two decades ago that sought to align the pay of corporate executives more directly with the interests of their shareholders.⁴⁸

As part of those efforts, companies granted options to their officials giving them the right to purchase the company's stock at some time in the future for its current price, i.e., "at the money."⁴⁹ The officers of those firms, it was assumed, would then have an incentive to increase the worth of their shares so that they could profit by exercising their options to purchase stock that had risen in value. Cash-poor start-up companies also began using options packages liberally to attract and compensate key employees.⁵⁰ Much of this occurred in Silicon Valley high-

⁴⁷ See Gretchen Morgenson, *Crisis Looms in Mortgages*, N.Y. TIMES, Mar. 11, 2007, § 1, at 1.

⁴⁸ See Mark Maremont & Charles Forelle, *Bosses' Pay: How Stock Options Became Part of the Problem*, WALL ST. J., Dec. 27, 2006, at A1; see also Paul Krugman, Op-Ed., *Incentives for the Dead*, N.Y. TIMES, Oct. 20, 2006, at A23. Stock options also gained favor after a 1993 tax law limited the deductibility of executive compensation by corporate taxpayers but exempted options as performance based compensation. See I.R.C. § 162(m) (2006).

Proposals that would make stock options deductible from corporate profits were defeated in 1994. Thus, as one commentator put it, "[W]hat wasn't there to like about a stock option? . . . You could grant them in unlimited amounts with no expense, and claim a tax deduction." Maremont & Forelle, *supra* (quoting compensation expert Paula Todd).

In 2004 and 2006, all that finally changed when accounting and tax principles were modified to respectively require that options be shown as expenses on a company's income statements and to reflect their imputed costs as well. Pearl Meyer et al., *Option Pricing Abuse*, 1562 PLI/CORP 285, 287 (2006).

⁴⁹ Maremont & Forelle, *supra* note 48.

⁵⁰ *Id.*

tech companies, where many investigations for wrongdoing are now focused.⁵¹

Sometimes stock purchase rights provided legitimate incentives to executives, but many times they were just piled on top of already lush compensation packages.⁵² And in the bull market of the late 1990s, the rising tide richly rewarded all executives who held options regardless of their efforts.⁵³ Those excesses were exacerbated when such grants were reloaded (given again to replace old ones that were exercised) or repriced (reissued at lower exercise charges when the market fell after their original award).⁵⁴

On top of this, those generous options packages committed companies to selling large numbers of their shares at prices below what they could get for them later in the open market, thus diluting the value of their existing shares. And as the practice grew, this devaluation became even more pronounced until shares sold to optionees accounted for a sizeable percentage of the equity of large companies.⁵⁵ As far back as 1998 one renowned shareholder, the savvy and successful Warren Buffet, questioned executive options as “wildly capricious in their distribution of rewards, inefficient as motivators, and inordinately expensive for shareholders.”⁵⁶

2. *The Practice of Backdating*

When the stock market plummeted in the early part of this decade, many of those options grants were put “underwater,” i.e., the stock’s market price fell below the exercise price of the

⁵¹ See Richard Marmaro & Ryan Weinstein, Opinion, *Should Steve Jobs Go to Jail?*, WALL ST. J., Jan. 10, 2007, at A17.

⁵² Maremont & Forelle, *supra* note 48.

⁵³ See Charles Forelle & James Bandler, *The Perfect Payday*, WALL ST. J., Mar. 18–19, 2006, at A1. As one commentator put it, “The public was told that gigantic executive paychecks were rewards for exceptional performance, but in practice executives were lavishly paid simply for showing up at the office.” Krugman, *supra* note 48.

⁵⁴ Maremont & Forelle, *supra* note 48.

⁵⁵ From the early 1990s to 2003, major corporations increased the average number of shares set aside for equity grants for employee incentives from eight percent to over seventeen percent of shares outstanding. Meyer et al., *supra* note 48, at 287.

⁵⁶ Dawes & Sorrell, *supra* note 26, at 643–44.

options.⁵⁷ A host of companies then repriced those rights downward.⁵⁸ It was then just a short step for greedy executives to cross the line into patently illegal conduct by simply backdating their options.⁵⁹ They did so by selecting a time before the options were issued when the underlying shares were trading for a much lower price, and clandestinely changed the grant days to make it appear that the purchase rights were awarded at the earlier time.⁶⁰ With a lower strike price, the executives could thus fraudulently increase their gains when they exercised those options.⁶¹ It was like betting on a winning horse after the race had been run.⁶²

⁵⁷ Maremont & Forelle, *supra* note 48.

⁵⁸ *Id.* As the author astutely points out, however, this practice of repricing had been going on for some time at many companies. *See id.* About eleven percent of companies repriced options at least once between 1992 and 1997. *Id.* Many did so a number of times as their stocks kept plunging.

⁵⁹ An example of how this occurred at a prominent company that was notorious in this backdating scandal is the case of Mercury Interactive, a high-tech software firm. When the options issued to one of its star salesmen went underwater, the board of directors got the members of the company's compensation committee to backdate those awards. Eric Dash, *Who Signed Off on Those Options?*, N.Y. TIMES, Aug. 27, 2006, § 3, at 1.

Investing honestly in stocks, of course, is a notoriously risky business. Much advice is available on that difficult process. One well-written recent book about the market's mysteries is Karen Blumenthal's *Grande Expectations*, *supra* note 37, which tracks the movements of Starbucks's stock during one calendar year.

⁶⁰ *See* Adam Lashinsky, *Options Gone Wild!*, FORTUNE, July 10, 2006, at 86, 86; Maremont & Forelle, *supra* note 48. The Sarbanes-Oxley legislation appears to have put an end to this practice by requiring notice of the granting of options two days after it occurs. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Previous rules were much laxer.

⁶¹ As Professor Eric Lie put it in his 2005 study revealing these patterns of illegal conduct, "Unless executives have a superior ability to forecast the future short-term marketwide movements that drive the predicted stock returns, the results indicate that at least some of the official grant dates must have been set retroactively." Eric Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 803 (2005).

⁶² In refusing to dismiss a shareholder suit against UnitedHealth Group, Inc. for options backdating, U.S. District Judge James Rosenbaum wrote:

Plaintiffs' theory lies at the core of the plot in one of Hollywood's most entertaining and honored films. In *The Sting*, the bad guy is ultimately brought down by utterly charming con men, played by Paul Newman and Robert Redford. They gain their revenge through a scheme involving "past-posting," or betting on horse races after the results are known.

David Phelps, *A Little Hollywood Logic Keeps UnitedHealth Lawsuit in Court*, STAR TRIBUNE (Minneapolis, Minn.), June 5, 2007, at 2D. For a further discussion of options backing at UnitedHealth Group, see *infra* notes 84-91 and accompanying text.

Others seemed to have found even more ingenious ways to game the system by forward-dating the grant dates to take advantage of market swings or keeping them open so they could pick the lowest point in a stock's history to buy it.⁶³ And it appears that some of those executives were also engaging in tax fraud by reporting their purchases at a time when the stock price was lower than when they actually bought it. In that way, they could hide some of their gains.⁶⁴

3. *Outing the Fraud*

For some time, analysts and shareholder activists were aware of suspiciously fortuitous timing in the awarding of options.⁶⁵ But they shrugged it off as another form of insider trading, ascribing it to questionable practices known as "spring-loading" and "bullet-dodging."⁶⁶ In the former, options are awarded before the release of good news that sends the stock price higher. In the latter, companies issue options right after the release of bad news, making their exercise price correspondingly lower. Either way, the executives conveniently benefit from favorable changes in the stock's price.⁶⁷

In 2005, however, an unprepossessing professor of finance at the University of Iowa, Erik Lie, published a study of almost six thousand options granted to corporate executives from 1992 to 2002.⁶⁸ Many times he found big jumps in stock prices right after options were said to have been granted even though there was no obviously favorable news that would account for such rises.⁶⁹

⁶³ Adam Lashinsky, *Why Options Backdating Is a Big Deal*, FORTUNE, July 26, 2006, <http://money.cnn.com/2006/07/26/magazines/fortune/lashinsky.fortune/index.htm>.

⁶⁴ See Eric Dash, *Dodging Taxes Is a New Wrinkle in the Stock Options Game*, N.Y. TIMES, Oct. 30, 2006, at C1.

⁶⁵ See Steve Stecklow, *Options Study Becomes Required Reading*, WALL ST. J., May 30, 2006, at B1; see also INSTITUTIONAL SHAREHOLDER SERVS., AN INVESTOR GUIDE TO THE STOCK OPTION TIMING SCANDAL 2 (2006), available at <http://www.issproxy.com/pdf/OptionTiming.pdf> (discussing several academic studies published before 2005 that described that phenomenon).

⁶⁶ See Frank Bruni, *A Buzz Saw of Buzzwords*, N.Y. TIMES, Dec. 24, 2006, § 4, at 1.

⁶⁷ See Floyd Norris, *They Deceived Shareholders. Who Cares?*, N.Y. TIMES, Oct. 6, 2006, at C1.

⁶⁸ Lie, *supra* note 61, at 802.

⁶⁹ Stecklow, *supra* note 65.

The *Wall Street Journal* followed with a study of its own on options awarded to select executives, finding that many times the underlying stock rose precipitously right after the purported grant dates of those rights—again without any concomitant news that would ostensibly trigger that jump.⁷⁰ The obvious conclusion was that the dates when those options were purportedly granted had not resulted from a random walk. Rather, they had been cherry-picked to engineer the largest possible gain when exercised. Professor Lie estimated that this occurred in 29.2% of listed companies.⁷¹

The latest revelations on this matter are even more startling. The post–September 11, 2001, period was apparently prime time for such fraudulent activity. With the market having its worst week in over sixty years, dozens of companies reported option grants to their executives or other employees. But now a number of them have disclosed that those awards were made weeks later and backdated to that time.⁷²

4. *Can It Be Legal?*

Theoretically, these transactions, though unseemly, could be legal.⁷³ Backdating options to a time when a stock's price was lower than its current value puts them immediately “in the

⁷⁰ Charles Forelle & James Bandler, *Five More Companies Show Questionable Options Pattern*, WALL ST. J., May 22, 2006, at A1. In that story, the *Journal* included a chart showing options grants to five CEOs, with three particularly favorable grant dates for each. *Id.* Right after each grant there was a big jump in the stock price. The *Journal* calculated the odds that such a pattern would occur by chance if the grant dates had been given at random without any attempt to pick times where the stock was trading at a low point. For Frank Lin, the CEO of Trident Microsystems, and Sam Brooks, the CEO of Rental Care Group, the odds were one to 100 million that they would be so fortunate. *Id.* Likewise, the chances that Ken Levy, Founder and CEO of KLA-Tencor, E.Y. Snowden of Boston Communications Group, and John Diebel, founder of Meade Instruments, would be so lucky were respectively one in 20 million, one in 5 million, and one in 800,000. *Id.*

⁷¹ Holman W. Jenkins, Jr., Opinion, *How Backdating Is Like a 1980s “Rockumentary,”* WALL ST. J., Aug. 16, 2006, at A11.

⁷² Mark Maremont et al., *Companies Say Backdating Used in Days After 9/11*, WALL ST. J., Mar. 7, 2007, at A1.

⁷³ See Patrick Richard et al., *Backdating Is Not Always Fraudulent: How to Distinguish Between Lawful and Fraudulent Ratification*, ANDREWS CORP. OFFICERS & DIRS. LIAB. LITIG. REP., Sept. 7, 2006, available on Westlaw at, 22 No. 5 ANCODLLR 2.

money,” i.e., their holders recognize gain right away.⁷⁴ If those options were validly approved by the board as a form of executive compensation, properly expensed on the company’s financial statements, and accurately disclosed in the firm’s required public filings,⁷⁵ there would appear to be no violation of corporate or securities law.

Commentators, however, have effectively debunked the probability of such proper treatment. As one succinctly put it:

[T]he whole point of backdating is to pretend that you’re not granting in-the-money options when in fact you are. And to say it’s up to the bean-counters to catch this situation is silly, because the whole reason you’re using phony dates is so that the bean-counters won’t know what you really did.⁷⁶

Announcing the indictment of former executives of Comverse Technology, Inc., Deputy Attorney General Paul McNulty made this blunt judgment: “When options are backdated to a time when the share price was lower, and without honest disclosure, those options are simply theft from shareholders.”⁷⁷ As of March 2007, more than 140 companies were under investigation for this practice, and more than seventy corporate officials had been fired or resigned because of it.⁷⁸

5. *Board Complicity*

All this would not have happened if directors who are supposed to oversee executive behavior had been doing their jobs. But as Ted White, a consultant to the Council of

⁷⁴ Jenkins, *supra* note 71. Jenkins speculates that much of the backdating was motivated by employee preferences for “in the money” options. *Id.* Such actions might be legal if approved by the board, publicly disclosed, and properly recorded in the company’s financial statements. Yet, as Jenkins admits, companies appear to have routinely “duck[ed] the prescribed accounting.” *Id.*

⁷⁵ Under rules and forms promulgated by the SEC, 17 C.F.R. § 240.14a-101 (2006), companies are required to disclose material features of their executive compensation plans, including option grants. Items 10(a)(1) and 10(b)(2) of Schedule 14A govern matters that must be disclosed in proxy statements. In July 2006, the SEC went one step further, requiring companies to specifically disclose instances of options backdating in their proxy statements. *See supra* note 33.

⁷⁶ Roger Parloff, *On the Theory That Backdating’s Not Illegal if You Account for It Correctly*, FORTUNE, Apr. 26, 2007, <http://legalpad.blogs.fortune.cnn.com/2007/04/26/on-the-theory-that-backdatings-not-illegal-if-you-account-for-it-correctly/>.

⁷⁷ Charles Forelle & James Bandler, *Stock-Options Criminal Charge: Slush Fund and Fake Employees*, WALL ST. J., Aug. 10, 2006, at A1.

⁷⁸ Maremont et al., *supra* note 72.

Institutional Investors, put it, “A ‘deeply troubling’ aspect of the stock options controversy . . . is ‘the possibility that some boards were complicit in this.’”⁷⁹

Typically, separate committees deal with a firm’s audit and the compensation of its officers. The former is in charge of the annual certification of the company’s financial statements by an outside accounting firm, and the latter recommends and reviews the pay packages of its top officials.⁸⁰ Both should be comprised of members who are independent of management, and together they should make it impossible for company officials to engage in such patently dishonest behavior as options backdating.⁸¹ And those committees should be made up of different directors so they can check each other and make sure that their oversight functions are performed effectively.⁸²

If those directors are to do their jobs, they must, of course, have the necessary information on executive compensation and scrutinize it carefully. As the former chief accountant of the Securities and Exchange Commission (“SEC”) said about directors who are derelict in those monitoring responsibilities, “If you knew those grants were being awarded on a backdated basis and you didn’t say anything about it when you are sitting

⁷⁹ *Scandal over Stock Options Widens*, MSNBC, June 9, 2006, <http://www.msnbc.msn.com/id/13231111/>.

⁸⁰ Section 301 of the Sarbanes-Oxley legislation required the SEC to make rules governing the independence of audit committees for companies whose securities are listed on a stock exchange or the NASDAQ. The SEC promulgated such rules in Standards Relating to Listing Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, Investment Company Act Release No. 26,001, 68 Fed. Reg. 18,788 (Apr. 25, 2003). The SEC promulgated similar rules pertaining to the independence of compensation committees in NASD and NYSE Rulemaking: Related to Corporate Governance, Exchange Act Release No. 34-48745, 68 Fed. Reg. 64,154 (Nov. 4, 2003).

⁸¹ A board that is hostile to management can have its problems too. As one commentator puts it, “Boards also need to be a place where a chief executive officer can discuss weaknesses and ask for help.” George Anders, *A Healthy Boardroom Is United and Focused on Lending a Hand*, WALL ST. J., Oct. 23, 2006, at B1 (quoting Jeffrey Sonnenfeld, head of the Chief Executive Leadership Institute at Yale University). The Anders article goes on to discuss the hostility between former Hewlett-Packard board chair Patricia Dunn and certain directors, which led to her ouster after it was revealed that she had hired investigators to spy on some board members. *See id.*

⁸² *See* Dash, *supra* note 59.

on the audit committee, it would be most appropriate for the S.E.C. to take you out and hang you high from the oak tree.”⁸³

Boards of two prominent companies serve as egregious examples of such lax oversight. At UnitedHealth Group, Inc., the country’s second-largest health care insurer, CEO Dr. William McGuire resigned after it was disclosed that he had received twelve grants of options in the company’s stock between 1994 and 2002, each dated right before a run-up in the share price.⁸⁴ By the end of 2005 he had amassed gains of approximately \$1.8 billion.⁸⁵

As it happened, Dr. McGuire got some of those lucrative options from a compensation committee headed by a New York investment manager who was listed as an independent director in the company’s proxy statement.⁸⁶ However, that official also managed money for Dr. McGuire’s children, and Dr. McGuire had put up \$500,000 to help him reacquire ownership of his firm from a larger concern.⁸⁷ Former New Jersey Governor Thomas H. Kean was another member of UnitedHealth’s compensation committee.⁸⁸ His son, a candidate for the U.S. Senate in 2006, received \$25,000 in campaign contributions from officials of the company.⁸⁹

In March 2007, UnitedHealth announced a restatement of its earnings from 1994 to 2002, admitting that it had “used incorrect measurement dates and made other errors” in options grants involving about 390 million shares given to various employees.⁹⁰

⁸³ *Id.* (quoting Lynn E. Turner).

⁸⁴ James Bandler & Charles Forelle, *In Internal Probes of Stock Options, Conflicts Abound*, WALL ST. J., Aug. 11, 2006, at A1.

⁸⁵ *Id.* For subsequent litigation involving options backdating at UnitedHealth, see *supra* note 62 and accompanying text.

Dr. McGuire also makes a cameo appearance in the recent movie *Sicko* by Michael Moore, which describes the inadequacies of the American health care system and the refusal of organizations like UnitedHealth to honor claims for certain medical treatment. *SICKO* (Lionsgate 2007).

⁸⁶ Bandler & Forelle, *supra* note 84.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ Laura B. Benko, *Options Cut United Profits*, MODERN HEALTHCARE, Mar. 12, 2007, at 22, 22.

The effect on the firm's bottom line was to reduce its pretax profit by \$1.56 billion.⁹¹

At the end of 2006, Apple Computer revealed that it had improperly made almost 6500 grants of options on forty-two dates during a five year period, acknowledging that options backdating was a pervasive practice at that prominent company.⁹² It also revealed that Steve Jobs, the company's famed CEO, was "aware or recommended" favorable dates on some of the grants.⁹³

Yet an investigating committee of the company's board, including former Vice President Al Gore, concluded that it had "complete confidence in Steve Jobs and the senior management team."⁹⁴ A number of options and corporate governance experts, however, said that they could not reconcile Apple's statements defending Jobs with its disclosures about his complicity in the fraud.⁹⁵ Jobs remains under investigation by federal officials.⁹⁶

In April 2007, the SEC filed charges against two former Apple officials, General Counsel Nancy R. Heinen and CFO Fred D. Anderson, for improper options backdating.⁹⁷ Among other things, the SEC alleged that Heinen signed fictitious minutes backdating 7.5 million options given to Jobs for a board meeting that never took place.⁹⁸ According to the SEC, both Heinen and Anderson themselves received millions of dollars in unreported compensation as a result of the backdating.⁹⁹ Anderson settled his action with the SEC by agreeing to pay approximately \$3.5 million in disgorgement and penalties.¹⁰⁰

⁹¹ *Id.*

⁹² Nick Wingfield et al., *Jobs Helped Pick "Favorable" Dates for Option Grants*, WALL ST. J., Dec. 30-31, 2006, at A1.

⁹³ Marmaro & Weinstein, *supra* note 51.

⁹⁴ *Id.*

⁹⁵ Wingfield et al., *supra* note 92.

⁹⁶ Marmaro & Weinstein, *supra* note 51.

⁹⁷ SEC v. Heinen, No. 07-2214-HRL (N.D. Cal. Apr. 24, 2007), 2007 SEC LEXIS 783, at *1.

⁹⁸ *Id.*

⁹⁹ *Id.* at *1-2.

¹⁰⁰ *Id.*

C. Some Remedies for Backdating

1. Government Actions

An SEC official told a congressional panel in September 2006 that the SEC was investigating over 100 companies for possible fraudulent reporting of stock option grants.¹⁰¹ By March of 2007, however, several members of Congress criticized the SEC for its slow pace in those actions.¹⁰² The hang-up appeared to be an internal debate at the SEC on the appropriate fines to be assessed. That dispute centered on whether a company should be penalized when its officers do wrong.¹⁰³ The SEC was also said to be stymied by difficulty in fixing the exact damage each backdating incident had caused.¹⁰⁴

The Department of Justice, in contrast, announced its first criminal indictment for options backdating on July 20, 2006.¹⁰⁵ Its targets were officers of Brocade Communications Systems, a Silicon Valley maker of switching devices for data storage systems.¹⁰⁶ At the same time, the U.S. Attorney for the Northern District of California also announced the formation of a task force to investigate options backdating.¹⁰⁷ A number of companies have since reported receiving grand jury subpoenas

¹⁰¹ DIV. OF ENFORCEMENT, U.S. SEC. & EXCH. COMM'N, TESTIMONY CONCERNING EXECUTIVE COMPENSATION AND OPTIONS BACKDATING PRACTICES (2006), available at www.sec.gov/news/testimony/2006/ts090606lt.htm. A month earlier, SEC Commissioner Roel C. Campos said in a speech about options backdating, "If the facts permit . . . it wouldn't surprise me to see charges brought against outside directors." Dash, *supra* note 59.

¹⁰² Kara Scannell, *Options Fines: A Hard Call*, WALL ST. J., Mar. 8, 2007, at C1.

¹⁰³ That issue has been dividing the SEC for some time. See Kara Scannell, *Cox's Penalty Framework Is Slowing SEC Cases*, WALL ST. J., May 22, 2007, at C1.

¹⁰⁴ See Scannell, *supra* note 102.

¹⁰⁵ Charles Forelle & James Bandler, *Brocade Ex-CEO, 2 Others Charged in Options Probe*, WALL ST. J., July 21, 2006, at A1.

¹⁰⁶ *Id.*

¹⁰⁷ John C. Grugan & Alison Tanchyk Dante, *DOJ and SEC Options Backdating Investigations Net First Indictments*, WHITE COLLAR LITIG. & SEC. ALERT (Ballard Spahr Andrews & Ingersoll, LLP, Phila., Pa.), July 26, 2006, at 1, available at http://www.ballardspahr.com/files/tbl_s11Newsletters/PDFFile142/750/7-26-06.White%20Collar%20Litigation%20alert.pdf.

In 2007, Gregory Reyes, Brocade's former CEO, was convicted for falsifying the company's financial statements in connection with a scheme to backdate options in Brocade's stock. *Former CEO to Serve 21 Months for Backdating*, MSNBC, Jan. 16, 2008, <http://www.msnbc.msn.com/id/22685773/>. On January 16, 2008, he was sentenced to twenty-one months in prison. *Id.*

related to options backdating, not only from that office but also from U.S. Attorneys in the Southern and Eastern Districts of New York.¹⁰⁸

2. *Direct Shareholder Suits*

With the ubiquitous nature of this deceitful activity, it may be hard for government authorities to prosecute more than a fraction of the actual wrongdoing.¹⁰⁹ One alternative remedy might be a direct securities fraud class action claim by shareholders.¹¹⁰ However, such suits do not seem to offer effective relief in options backdating situations.

In a direct shareholder action for securities fraud under federal law, an investor must show, among other things,¹¹¹ that the defendants' wrongdoing caused her economic loss.¹¹² The loss is usually alleged to have occurred because the fraud caused the stock's price to be inflated and to fall when the true facts

¹⁰⁸ Keller-Rohrbach Law Offices, Practice Areas: Stock Option Backdating, <http://www.krclassaction.com/Default.aspx?tabid=1464> (last visited Mar. 16, 2008).

¹⁰⁹ While the Author was a junior attorney in the SEC's Division of Enforcement in the late 1970s, he was told that the SEC could only investigate approximately two percent of ongoing wrongdoing in the business world.

As two commentators recently put it in the context of shareholder suits for corporate wrongdoing, "[D]oes anyone seriously doubt that there is immense deterrent power in the contemporary class action? Executives tempted to lie about earnings are more concerned about Bill Lerach and Melvyn Weiss [renowned shareholder lawyers] than they are about the Securities and Exchange Commission . . ." Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 106 (2006).

Bill Lerach was sentenced to two years in prison after pleading guilty to making misrepresentations to the court that no special compensation was paid to lead plaintiffs in his class action suits on behalf of shareholders. *Lerach Pleads Guilty in Milberg Bribe Case*, WALL ST. J., Oct. 30, 2007, at B11. For an interesting interview with Mr. Lerach about his practice, see Jeffrey Toobin, *The Man Chasing Enron*, NEW YORKER, Sept. 9, 2002, at 86, 86-94.

¹¹⁰ The most effective way to bring such a claim is the private right of action allowed under Rule 10b-5 of the Securities Exchange Act of 1934. For a thorough discussion of the elements of such an action and their pitfalls, see generally DONNA M. NAGY ET AL., *SECURITIES LITIGATION AND ENFORCEMENT* 19-259 (2003).

¹¹¹ The elements of such an action are: "(1) a material misrepresentation (or omission) . . . ; (2) scienter, . . . (3) a connection with the purchase or sale of a security . . . ; (4) reliance . . . ; (5) economic loss . . . ; and (6) loss causation, i.e. a causal connection between the material misrepresentation and the loss." *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005) (citations and emphasis omitted).

¹¹² *Id.* at 342.

were disclosed.¹¹³ There has, however, been no uniform response in stock prices when backdating is announced. Some companies' shares have declined while others have not.¹¹⁴

Even if a company's stock has substantially declined after backdating is made public, there is no automatic presumption that such a drop was due to the fraud.¹¹⁵ As one leading defender of such suits has commented, "Economists and econometricians should be able to analyze this data and show that the observed stock price declines were due to factors other than the disclosure of the accounting adjustments."¹¹⁶

II

DERIVATIVE SUITS

A. The Best Remedy for Financial Fraud

1. The Nature of the Action

Because of the shortcomings of governmental and direct shareholder actions, a derivative suit is a more promising way to redress the grievances of stockholders hurt by options backdating.¹¹⁷ In a derivative suit, a shareholder brings suit on behalf of the corporation against the officers and directors whose actions have harmed the company.¹¹⁸ The plaintiff

¹¹³ This is the so-called fraud on the market theory. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 241–42 (1988).

¹¹⁴ Marc H. Folladori, *Stock Option Backdating: Regulators and Plaintiffs Take the Controversy to the Next Level (Client Memo)*, 1578 PLI/CORP 659, 664 (2007).

¹¹⁵ The misrepresentation must be the proximate cause of the stock's fall, and many other factors may exist that might cause it to decline subsequent to the announcement. See *Dura Pharm., Inc.*, 544 U.S. at 342.

¹¹⁶ Folladori, *supra* note 114, at 664.

¹¹⁷ Beth Bar, "Biggest Thing Going": *Plaintiffs' Attorneys Jockey for Backdating Cases*, N.Y. L.J., July 20, 2006, at 5. It has not always been easy to distinguish a derivative suit from a direct one. Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave*, 1557 PLI/CORP 125, 131–37 (2006). Earlier courts said that "distinct injury" to a shareholder was necessary for the latter. See, e.g., *Strougo v. Bassini*, 282 F.3d 162, 172 (2d Cir. 2002). However, in 2004 the Delaware Supreme Court stated its disapproval of that distinction and said that the matter should turn on: (1) who suffered the alleged harm (the corporation or the suing shareholders directly), and (2) who would receive the recovery. *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004).

¹¹⁸ For discussions of the justifications for derivative suits, see generally Aronson v. Lewis 473 A.2d 805 (Del. 1984); Daniel J. Morrissey, *New Rulings Threaten the Derivative Suit—Will the "Needed Policeman" Keep Walking the Beat?*, 36 S.C. L.

shareholder thus serves as a “self-appointed champion of the corporate right.”¹¹⁹ The action consists of two separate claims. First, the shareholder must sue the corporation as a nominal defendant for refusing to pursue its rights.¹²⁰ Second, she asserts the corporation’s claim on its behalf against the wrongdoers.¹²¹

Even the threat of such a suit can keep management honest and properly attentive to shareholder concerns. Some years ago, one commentator called derivative actions a “needed policeman,”¹²² citing the reasoning of an earlier court that such actions have done much to “educate corporate directors in the principles of fiduciary responsibility and undivided loyalty.”¹²³ Judge Wyzanski perhaps put the justification for derivative suits best: “[I]t is recognized that while minority [shareholders] are often actuated by selfish interests, they . . . become the most effective instruments for ferreting out wrongdoing, for pursuing it publicly and for giving point to the only sanctions actual and potential wrongdoers fear.”¹²⁴

Since the corporation, although the nominal defendant, is the party seeking relief, the action must allege the harm done to it. In the case of options backdating, the harm includes breach of fiduciary duty, fraud, and unjust enrichment by the corporate officials, who are the true defendants.¹²⁵ As Chancellor Chandler ruled in a recent opinion from Delaware, options backdating provides a windfall for officers and directors by reducing the strike price in clear violation of shareholder-approved plans.¹²⁶ It is hard to conceive of a more flagrant

REV. 631 (1985); Bradley T. Ferrell, Note, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation*, 60 OHIO ST. L.J. 241 (1999).

¹¹⁹ FRANKLIN A. GEVURTZ, CORPORATION LAW 387 (2000).

¹²⁰ *Ross v. Bernhard*, 396 U.S. 531, 538 (1970).

¹²¹ *Id.* In *Ross*, the Supreme Court extended the right of trial by jury to shareholders in a derivative suit when the underlying claim, had it been asserted by the corporation, would have been tried by a jury. *Id.* at 542. See generally Bert S. Prunty, Jr., *The Shareholders’ Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980 (1957) (discussing the origins of the derivative suit in nineteenth-century English and American law).

¹²² Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 78 (1967).

¹²³ *Brendle v. Smith*, 46 F. Supp. 522, 525 (S.D.N.Y. 1942).

¹²⁴ *Pomerantz v. Clark*, 101 F. Supp. 341, 346 (D. Mass. 1951).

¹²⁵ See Folladori, *supra* note 114, at 663.

¹²⁶ *Ryan v. Gifford*, 918 A.2d 341, 354–55 (Del. Ch. 2007).

breach of the duties of good faith, fair dealing, and loyalty by corporate officials.¹²⁷

2. *A Good Tool for Backdating Cases*

In such cases, damages should consist of any illegal compensation received in violation of the authorized plans. But other harms to corporations, such as declines in the price of a company's stock proximately caused by fraudulent practices, should be remedied too.¹²⁸ It is not unusual for share prices in situations of outrageous management fraud to be downgraded by the so-called "liars' discount." The market loses confidence in the integrity of management and punishes the company's stock.¹²⁹

Often, relief in these actions may also come in the form of therapeutic changes to a company's governance structure. Courts in such cases have found that litigation produces a substantial benefit for corporations by obtaining changes that will prevent future misconduct.¹³⁰ Attorneys' fees are set either

¹²⁷ One defense attorney argues that a company might not be harmed by options backdating. If the options were not backdated, Marc H. Folladori says, the firm might have had to pay cash to compensate the employees at the appropriate level. Folladori, *supra* note 114, at 663. Or, perhaps the market was somehow able to intuit the true cost of the options by reading certain information in the company's financial statements. *Id.* Both of those defenses, however, fly in the face of basic rules of corporate law requiring honest and accurate disclosure of all corporate expenses. Such action is thus tantamount to an employee who believes he is underpaid reaching into the firm's cash register and sticking money in his pocket.

Along the same lines, Folladori argues that backdating could have occurred because of "administrative problems" (late approval by directors or shareholders). *Id.* Administrative problems, of course, look suspiciously like attempts to get one's friends to help cover up earlier improprieties.

¹²⁸ As of May 2006, companies that acknowledged backdating have lost nearly \$35 billion in stock value. Dawes & Sorrell, *supra* note 26, at 645. Prominent examples include Mercury Interactive Corp., whose stock dropped twenty-five percent on the news of backdating, and Comverse Technology, whose stock fell twenty-two percent. *Id.*

¹²⁹ See MCKINSEY & COMPANY, GLOBAL INVESTOR OPINION SURVEY: KEY FINDINGS 2 (2002), available at <http://www.mckinsey.com/clientservice/organizationleadership/service/corpgovernance/pdf/globalinvestoropinionsurvey2002.pdf>. A study by the international consulting firm McKinsey & Company surveyed a number of institutional investors and found that over seventy-five percent of them would be willing to pay a premium for the shares of companies that were well governed. *Id.* at 5.

¹³⁰ See, e.g., *Fletcher v. A.J. Indus., Inc.*, 72 Cal. Rptr. 146, 153 (Cal. Dist. Ct. App. 1968); *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996).

by a percentage of the recovery or at an hourly rate that takes into account not only the time counsel worked but also the risk and degree of difficulty that the case entailed.¹³¹

3. *A Controversial Remedy*

Despite its obvious advantage to redress corporate wrongdoing in situations like options backdating, the derivative suit is a complicated mechanism replete with difficult requirements for its effective maintenance. Almost all of those complexities are owed to a fundamental question: who is the appropriate advocate to prosecute the corporation's grievances against its internal malefactors?

In theory, of course, management of a corporation is vested in its board of directors,¹³² and that responsibility also includes the decision whether to pursue legal action against those who have harmed it. But the driving presumption of a derivative suit is that those in control of the corporation have either committed the wrongful act themselves or have effectively condoned it. Such officials are unlikely to sue themselves.

Yet considerable skepticism exists about the bona fide motivations of shareholder-plaintiffs or more particularly about the motivations of their counsel. Corporate defendants are quick to claim that these are "strike suits," frivolous litigation brought without merit by lawyers hungry for big, quick settlements.¹³³

¹³¹ See GEVURTZ, *supra* note 119, at 424–25. As a fine recent piece of scholarship has argued, these lawyers earn their compensation by serving as effective deterrents for corporate wrongdoing. Gilles & Friedman, *supra* note 109, at 111. For that proposition, the authors cite the eminent father of the law and economics school, Judge Richard Posner, who wrote regarding class action suits, "[T]he most important point, on an economic analysis, is that the violator be confronted with the costs of his violation—this achieves the allocative purpose of the suit—not that he pay them to his victims." RICHARD A. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 349–50 (1972).

¹³² See MODEL BUS. CORP. ACT § 8.01(b) (1994).

¹³³ See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 55–56 (1991).

B. A Major Procedural Hurdle: The Demand Requirement

1. How Demand Is Justified

The law has evolved a testing device to separate *ex ante* the wheat (meritorious claims) from the chaff (frivolous strike suits). Before bringing the action, the shareholder must first initiate it by making a demand on the board.¹³⁴ According to the Federal Rules of Civil Procedure, the shareholder must specifically allege the efforts she has made to get redress from the board.¹³⁵ If she has failed to get such a result, she must state why that is so or alternatively give her reasons for not making the effort.¹³⁶

That “demand requirement” has a number of justifications. It is said to recognize the directors’ rightful prerogative to run the affairs of the company by letting them judge whether such a suit is in the firm’s best interest.¹³⁷ It presumptively also allows them to employ the company’s ample resources to pursue the wrongdoers and make a decision about whether the matter can be settled without litigation, thus promoting judicial economy.¹³⁸ It may also spur the board to take corrective action.¹³⁹

Such is the theory, but in practice boards typically reject demands out of hand, claiming that these suits are not in the corporation’s best interest.¹⁴⁰ At least in Delaware, the preeminent jurisdiction for corporate litigation, two unhelpful results are apt to occur if the plaintiff makes a demand and it is refused, as is likely. Both flow from the belief that by making a demand the shareholder has implicitly conceded that the board is independent from the wrongdoing and thus capable of objectively evaluating the matter.

First, any challenge to the board’s refusal to bring the suit will meet a formidable barrier in the business judgment rule. Under

¹³⁴ *Tasner v. Billera*, 379 F. Supp. 815, 825 (N.D. Ill. 1974). The formalities of demand are relatively simple. Mailing a copy of the complaint to the board and demanding that it commence the action will likely satisfy the requirement. *Id.* The directors’ failure to respond in a reasonable time will constitute a refusal to sue. *Id.*

¹³⁵ FED. R. CIV. P. 23.1.

¹³⁶ *Id.*

¹³⁷ See DEL. CODE ANN. tit. 8, § 141(a) (2001); MODEL BUS. CORP. ACT § 8.01(b) (stating management of a corporation is vested in its board of directors).

¹³⁸ *Lewis v. Graves*, 701 F.2d 245, 247–48 (2d Cir. 1983).

¹³⁹ *Lewis v. Curtis*, 671 F.2d 779, 786 (3d Cir. 1982).

¹⁴⁰ RALPH C. FERRARA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 7.02 (2007).

the presumption of that doctrine, so long as the directors' decision is made in good faith and upon a reasonable investigation, it is almost unassailable.¹⁴¹

Second, once demand has been refused, the shareholder is also foreclosed from arguing that the demand requirement should have been excused as futile. According to Delaware law, by making the demand the shareholder has acknowledged that the board is free from conflicting bias.¹⁴² As one federal appellate court has put it, “[e]xcept in extraordinary cases . . . tendering a demand to the board puts the plaintiff out of court under Delaware law.”¹⁴³

2. *Excusing Demand*

It would therefore behoove a plaintiff shareholder, if possible, to avoid demand altogether. She can do so in Delaware and other jurisdictions that follow its lead by alleging that the demand requirement should be excused as futile.¹⁴⁴ Such is certainly the case if the board is too conflicted to take action against the wrongdoers. And it is also true if most of the directors were complicit in the illegality or under the control of the culpable parties.

Although the Federal Rules also contemplate that possibility,¹⁴⁵ there is another school of thought, advanced by

¹⁴¹ See *Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. 1990); see also *infra* notes 186–88 and accompanying text.

¹⁴² In *Spiegel*, the court also reasoned that the shareholder was estopped from claiming futility after making the demand because he was implicitly agreeing that the directors would act fairly. See *Spiegel*, 571 A.2d at 775; see also *Levine v. Smith*, 591 A.2d 194, 212 (Del. 1991). However, the Delaware Supreme Court seems to have indicated its willingness to reconsider that reasoning by a reference in *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996). In *Grimes*, the court stated that a plaintiff who makes a demand does not concede that the board “acted independently, disinterestedly or with due care” in the matter. *Id.* at 1219 (emphasis omitted).

¹⁴³ *Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90, 108–09 (1991). Professor John Coffee details many traps for a plaintiff facing the demand requirement, particularly those that may arise from his making a demand instead of alleging that it is futile. See John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1414 (1993).

¹⁴⁴ See *infra* notes 151–56 and accompanying text.

¹⁴⁵ Federal Rule of Civil Procedure 23.1, covering derivative suits, states in part:

The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority, and, if necessary, from the shareholders or

both the American Law Institute and the Model Business Corporation Act, that would require demand at all times.¹⁴⁶ Such an approach is justified as allowing the board a last clear chance to take corrective action and as recognizing its right, at least in theory, to control the firm's litigation.¹⁴⁷

However, the requirement of universal demand and the Delaware rule allowing it to be excused may amount to much the same thing.¹⁴⁸ In a universal demand jurisdiction, if a board refuses to sue after a demand, the plaintiff must show by particularized pleadings why her derivative suit should go forward.¹⁴⁹ That burden is just like the one facing a derivative plaintiff in Delaware who claims that demand should be excused. Shareholders in both situations must convince the court that the board should not be allowed the final say on the matter.¹⁵⁰

3. *The Standard in Both Jurisdictions*

The Delaware Supreme Court articulated its standard for demand futility in *Aronson v. Lewis*.¹⁵¹ As the court put it in less than straightforward language, for demand to be excused the plaintiff must plead facts raising a "reasonable doubt . . . that (1) directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid

members, and the reasons for the plaintiff's failure to obtain the action or
for not making the effort.

FED. R. CIV. P. 23.1 (emphasis added).

¹⁴⁶ MODEL BUS. CORP. ACT § 7.42 (1994); 2 PRINCIPLES OF CORPORATE GOVERNANCE § 7.03 (1994). The Author took a similar position in an earlier piece on derivative suits. See Morrissey, *supra* note 118, at 656. Nineteen states require this universal demand. Aronson et al., *supra* note 117, at 148.

¹⁴⁷ GEVURTZ, *supra* note 119, at 409–10; see also *supra* notes 137–39 and accompanying text.

¹⁴⁸ One possible benefit of requiring universal demand is that it could eliminate the trap whereby the plaintiff, by making demand, loses his opportunity to claim that it should be excused, and thus must meet a higher standard to maintain the action. See *supra* notes 142–43 and accompanying text. But see Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation—Texas Versus Delaware: Is It Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249, 316 (2001) (noting that corporate defendants may prefer a state requiring universal demand because it creates an additional hurdle to a shareholder suit).

¹⁴⁹ One commentator has thus recommended a fusion of the two approaches that would keep the requirement of universal demand but require a court to evaluate the reasonableness of the board's rejection. See Ferrell, *supra* note 118, at 276–80.

¹⁵⁰ See GEVURTZ, *supra* note 119, at 402.

¹⁵¹ 473 A.2d 805 (Del. 1984).

exercise of business judgment.”¹⁵² The two prongs are alternatives,¹⁵³ and the second one would seem the steeper hurdle because the plaintiff would have to show that the board acted in bad faith or was grossly negligent in failing to investigate the matter.¹⁵⁴

For a plaintiff to satisfy the easier first standard, she must show that the directors are not disinterested or independent. Another Delaware decision provided guidance there, noting, “[d]irectorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.”¹⁵⁵ And, as a later Delaware opinion added, such “[r]easonable doubt must be decided by the trial court on a case-by-case basis employing an objective analysis.”¹⁵⁶

Much the same type of showing is necessary for a shareholder suit to proceed upon board refusal in a universal demand jurisdiction. The plaintiff must counter assertions from the directors that they were not conflicted in the transaction or under the control of the culpable party.¹⁵⁷ In states like Delaware that allow demand to be excused, that must also be done by particular facts.

Thus, unlike a typical suit where notice pleading is sufficient,¹⁵⁸ courts in derivative actions require more detailed allegations if the case is to go forward. In 1995, Congress

¹⁵² *Id.* at 814.

¹⁵³ *See Levine v. Smith*, 591 A.2d 194, 197–98 (Del. 1991).

¹⁵⁴ *See infra* notes 202–20 and accompanying text. The chancellor further refined the second prong in *In re Walt Disney Co. Derivative Litigation*, ruling that for demand to be excused, “plaintiffs must plead particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision. 825 A.2d 275, 286 (Del. Ch. 2003).

To the surprise of some, the chancellor found that the facts as alleged could allow a conclusion “that the defendant directors’ conduct fell outside the protection of the business judgment rule.” *Id.* at 289. After a full trial, however, the chancellor found otherwise, and that finding was upheld on appeal. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff’d*, 906 A.2d 27 (Del. 2006); *see also infra* notes 211–20 and accompanying text.

¹⁵⁵ *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984).

¹⁵⁶ *Grobow v. Perot*, 539 A.2d 180, 186. (Del. 1988).

¹⁵⁷ *See supra* notes 148–50 and accompanying text.

¹⁵⁸ FED. R. CIV. P. 8; *see also Conley v. Gibson*, 355 U.S. 41, 47–48 (1957).

amended the federal securities laws to mandate similar heightened pleading standards in direct shareholder actions for fraud.¹⁵⁹ In the corporate area, it seems that policy makers are particularly concerned about the possibility of vexatious litigation,¹⁶⁰ so-called “strike suits” brought without evidentiary foundation to extract quick settlements from wealthy corporate executives who are said to be preoccupied by other matters.¹⁶¹ Yet the same claim could be made for many other types of suits, particularly various types of class actions.¹⁶² The real issue here, some have claimed, is that the principal beneficiaries of both derivative suits and direct shareholder suits are the lawyers who maintain them. They allegedly do so without much concern that the corporation or its shareholders really benefit.¹⁶³

Such suits, however, provide a much needed check on corporate corruption and malfeasance when, as is often the case, directors are too conflicted to police their own executives.¹⁶⁴ Courts seem to be trying to strike a balance between concerns that such actions may sometimes be less justified than others and a belief that they are also much needed when warranted. Judges are disposed to do that in corporate/securities suits, it appears, by prejudging the bona fide motivations of these actions in their early stages.

The real issue in both universal demand jurisdictions and those that will excuse it is simply this: how much detail should a plaintiff have to allege in her pleadings to overcome a presumption that the directors are capable of objectively

¹⁵⁹ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. See generally NAGY ET AL., *supra* note 110, at 395–405 (discussing the Act).

The U.S. Supreme Court recently reenforced the notion that pleadings in such actions must present cogent and compelling inferences that the defendants acted with scienter. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484, slip op. at 2 (U.S. June 21, 2007).

¹⁶⁰ In *Blue Chip Stamps v. Manor Drug Stores*, Justice Rehnquist stated, “There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.” 421 U.S. 723, 739 (1975). The Court held that there must be an actual purchase or sale of a security for there to be a claim under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. *Id.* at 730, 749.

¹⁶¹ See Romano, *supra* note 133, at 55–56.

¹⁶² See GEVURTZ, *supra* note 119, at 426.

¹⁶³ The financial success of William Lerach, one high-profile practitioner in this area, is cited to substantiate that point. See Toobin, *supra* note 109.

¹⁶⁴ See *infra* notes 176–79 and accompanying text.

evaluating the merits of these suits?¹⁶⁵ On that point one thing is clear: merely naming a majority of the directors as defendants or suing a party who can control them is not enough to show such a conflict.¹⁶⁶ And even claiming that a majority of them are connected with the culpable party through business or social ties will not do it either.¹⁶⁷

C. A Second Obstacle: The Special Litigation Committee

1. How It Operates

Even if a shareholder-plaintiff can convince a court that the board, as a whole, is unsuited to manage the derivative litigation, clever defense counsel have devised another method for the company's management to take the suit away from her. That ploy is also premised on the directors' prerogative to manage the affairs of the company. It makes use of the well-established norm that boards can act through their committees.¹⁶⁸

Beginning in the late 1970s, defendant directors whose independence might be compromised began setting up special committees of the board to take charge of derivative litigation.¹⁶⁹ Those groups were usually composed of individuals who came onto the board after the questionable transactions occurred.

¹⁶⁵ In the case that established the Delaware test to excuse demand, *Aronson v. Lewis*, the board authorized payments and fees to a director who owned forty-seven percent of the corporation's outstanding stock. 473 A.2d 805, 808 (Del. 1984). The court found that neither the amount of stock owned by the directors alone nor the allegation that he selected all the directors was enough to excuse demand. *Id.* at 816-18; see also *GEVURTZ*, *supra* note 119, at 410-11.

¹⁶⁶ *Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983). For a case where a court found that the shareholder plaintiff had raised a reasonable doubt as to the disinterestedness or independence of at least six of the company's twelve directors, see *In re Limited Inc. Shareholders Litigation*, No. CIV.A. 17148-NC, 2002 WL 537692, at *4 (Del. Ch. Mar. 27, 2002). The *Limited Inc.* court goes through a director-by-director analysis of the bias that could result from each director being controlled by the majority shareholder. *Id.*

¹⁶⁷ In *Beam v. Stewart*, a shareholder of Martha Stewart's company brought a derivative action against her for breach of her fiduciary duties to the company in connection with her alleged insider trading and other illegal activity. 845 A.2d 1040, 1044 (Del. 2004). When the shareholder sought to have demand excused, his motion was denied because a majority of the board were outside directors deemed to be independent even though they were "longstanding personal friend[s]" of Ms. Stewart and she held ninety-four percent voting power in the company. *Id.* at 1051.

¹⁶⁸ DEL. CODE ANN. tit. 8, § 141(c)(2) (2001).

¹⁶⁹ This process was first approved by the Supreme Court in *Burks v. Lasker*, 441 U.S. 471, 480-83 (1979).

They therefore were arguably untainted by approving them. The new directors were best suited, it was said, to evaluate those actions not only because they were supposedly independent but also because they were empowered by their office to set policy for their firms.¹⁷⁰

With such a mandate, a special litigation committee (“SLC”) would investigate the allegations of a derivative suit filed against its company and almost always recommend its dismissal, finding that its maintenance was not in the firm’s best interest.¹⁷¹ The SLC would make such a report to the full board, which would then present it to the court as management’s business judgment¹⁷² and move for dismissal of the action.¹⁷³

2. *Concerns About Independence*

Soon after that approach was adopted, the New York Court of Appeals said that in reviewing such motions its judges should only scrutinize the independence of an SLC. If its members appeared free from conflicts, New York courts should grant motions sustaining the SLC’s business judgment, so long as the decision was ostensibly made with due care.¹⁷⁴ Even under such a limited standard of review, however, getting a court to accept an SLC’s dismissal recommendation may not necessarily be a “slam dunk.”¹⁷⁵ Two recent cases have shown that courts will take a hard look at the independence of SLC members.

In *Biondi v. Scrushy*, the court found that the SLC was “fatally compromised” because of the members’ strong

¹⁷⁰ See, e.g., DEL. CODE ANN. tit. 8, § 141(a); MODEL BUS. CORP. ACT § 8.30(b) (1994).

¹⁷¹ However, in one recent very prominent derivative suit arising out of the options backdating scandal, the special litigation committee of Mercury Interactive Corp. recommended that the shareholder suit go forward against one of the officers/defendants. Daniel J. Morrissey, *Options Backdating: Derivative Suits as Remedy*, NAT’L L.J., Oct. 16, 2006, at 26, 26.

¹⁷² The directors would cite section 141 of title 8 of the Delaware Code, empowering the board to run the affairs of a corporation.

¹⁷³ In upholding that process, the Supreme Court deferred to state corporate law to determine whether the business judgment of such a committee should be controlling on the issue of dismissal. *Burks*, 441 U.S. at 486.

¹⁷⁴ E.g., *Lewis v. Anderson*, 615 F.2d 778, 783 (9th Cir. 1979); *Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979).

¹⁷⁵ With apologies to George Tenet, who had to defend that comment about the ease of an American invasion of Iraq in his book, *At the Center of the Storm*. See Jeffrey Goldberg, *Woodward vs. Tenet*, NEW YORKER, May 21, 2007, at 32, 32.

friendship with a key defendant, inadequate delegation of authority to the SLC, and a premature statement by its chair that one key defendant would be exonerated.¹⁷⁶ Similarly, in *In re Oracle Corp. Derivative Litigation*, the court found an impermissible conflict in judgment because two SLC members were professors at Stanford, a university where all of the defendants had important ties.¹⁷⁷

3. *Beyond Independence*

From the early years of SLCs, Delaware and other tribunals that followed its lead not only scrutinized the independence of SLCs but also refused to give unqualified deference to their substantive recommendations. After all, members of an SLC are appointed by the very individuals who are defendants in the derivative suit, a process not unlike letting an accused select his jury.¹⁷⁸ Even beyond that, as the Delaware high court realistically observed, there exists a natural “there but for the grace of God go I” empathy between SLC members and their fellow directors.¹⁷⁹

Delaware therefore adopted a two-prong test for examining an SLC’s motion to dismiss. The first part, similar to that employed by New York, required the court to examine just the independence and good faith of the SLC.¹⁸⁰ But Delaware went beyond that in the second part of its standard of review. Its supreme court authorized trial judges to apply their own judgment to determine if dismissal of the action was in the company’s best interest. In doing so, said the high court, trial courts should evaluate all the ramifications of such matters, the “ethical, commercial, promotional, public relations, employee relations, fiscal [and] legal factors” involved.¹⁸¹

¹⁷⁶ *Brandi v. Scrushy*, 820 A.2d 1148, 1156–57 (Del. Ch. 2003)

¹⁷⁷ *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 947–48 (Del. Ch. 2003).

¹⁷⁸ The Supreme Court of Iowa saw that as a reason for disallowing SLCs altogether. *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983).

¹⁷⁹ *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981). As one commentator phrased on natural bias, “Because of group psychology, non-defendant directors normally will be sympathetic toward the defendant directors, and suspicious of the outsider plaintiff shareholder.” GEVURTZ, *supra* note 119, at 431.

¹⁸⁰ *Zapata Corp.*, 430 A.2d at 788.

¹⁸¹ *Id.* (quoting *Maldonado v. Flynn*, 485 F. Supp. 274, 285 (S.D.N.Y. 1980)).

The U.S. Court of Appeals for the Second Circuit quickly followed suit, reenforcing the two-pronged approach taken by Delaware.¹⁸² It also elaborated on the assessment that a court should employ in determining the efficacy of such actions. Unlike the typical situation involving the business judgment rule, where the law is reluctant to second-guess the purely commercial decisions of corporate leaders, derivative suits implicate more than just dollars and cents.

Along those lines, the court went out of its way to say that factors like the “negative impact on morale and upon the corporate image” should not be used as arguments for dismissal of the suit, “a spectacular fraud being generally more newsworthy and damaging to morale than a mistake in judgment as to the strength of consumer demand.”¹⁸³ Implicit in these remarks was the court’s support for the role that derivative actions play in exposing corporate wrongdoing.¹⁸⁴

There appears to have been no reported decision, however, where courts have reviewed whether the dismissal recommendation of an SLC was in the best interest of its corporation.¹⁸⁵ Rather, all the attention in derivative suits seems to be focused on whether demand should be excused. If the plaintiff can leap that hurdle, a court should be predisposed to find the board interested and not independent, making it harder for any dismissal recommendation from an SLC to pass judicial muster.

¹⁸² *Joy v. North*, 692 F.2d 880, 891–92 (2d Cir. 1982).

¹⁸³ *Id.* at 892.

¹⁸⁴ The Model Business Corporation Act (“MBCA”) and the American Law Institute (“ALI”) deal with SLCs in a nuanced fashion. The MBCA adopts the first part of Delaware’s test and then requires that members of an SLC be appointed by a majority of the independent directors. *See* MODEL BUS. CORP. ACT § 7.44 (1994). The ALI proposes different levels of judicial review for the recommendations of SLCs. The most stringent is that a court not dismiss suits where the defendants gained significant improper benefits unless the likely injury to the company from the suit significantly outweighs any impact on the public interest. 2 PRINCIPLES OF CORPORATE GOVERNANCE §§ 7.07–7.10 (1994).

¹⁸⁵ GEVURTZ, *supra* note 119, at 434.

III
CORPORATE ACCOUNTABILITY AND THE BUSINESS JUDGMENT
RULE

A. The Rule That Isn't a Rule

1. The Classic Statement

Front and center in all these matters is the issue of how deferential courts should be to decisions by corporate executives. That issue implicates management's best friend, the business judgment rule. The business judgment rule is a cornerstone principle of corporate law that protects business officials for improvident decision making. It holds that so long as directors are not personally interested in the subject matter of decisions, courts should uphold them.¹⁸⁶

Even though corporate officials are expected to exercise due care in running their companies,¹⁸⁷ the law has never evaluated their decision making by ordinary tort principles. Business is risky, choices have to be made, and some do not turn out so well. To hold executives responsible for purely commercial judgments, so the reasoning goes, would expose them to a Pandora's box of potential liability. Rather, the law should respect management's business decisions and exempt them from legal accountability, even if those decisions have been wrong and have had harmful consequences for a company.¹⁸⁸

¹⁸⁶ See generally *id.* at 278–88 (discussing business decisions and the business judgment rule). For the ALI's codification of these principles, see 2 PRINCIPLES OF CORPORATE GOVERNANCE § 4.01.

Two good recent articles on the business judgment rule are Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, and D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure and Executive Compensation*, 81 TUL. L. REV. 829 (2007). Telman discusses three conventional reasons for the rule: (1) deference to the board's expertise, (2) the need to protect entrepreneurs, and (3) a belief that shareholders will ultimately hold the board accountable for their decisions. He finds none of them convincing. *Id.* at 841–65.

¹⁸⁷ E.g., MODEL BUS. CORP. ACT § 8.30(a).

¹⁸⁸ See Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Care and the Business Judgment Rule, a Commentary*, 41 BUS. LAW. 1237, 1238–42, 1247 (1986). Two classic cases applying the rule are *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684–85 (Mich. 1919) (expressing the court's reluctance to review the firm's dividend policy, but doing so anyway because of the large amounts of cash the company had accumulated), and *Shlensky v. Wrigley*, 237 N.E.2d 776, 780–81 (Ill. App. Ct. 1968) (declining to upset management's decision not to install lights in

2. Smith v. Van Gorkom

In the mid 1980s, however, Delaware put a new spin on that old logic. In the landmark case of *Smith v. Van Gorkom*, a majority of the Delaware Supreme Court found that a board of distinguished business leaders had failed to make an informed, deliberate decision in approving the sale of the company.¹⁸⁹ Rather, the board had merely rubber-stamped the wishes of their firm's dominant chief executive officer who presented the matter to them as a *fait accompli*.

In finding the directors liable for breaching their fiduciary duty, the Delaware court held that the business judgment rule would not protect boards that acted in such a grossly negligent fashion.¹⁹⁰ It was not the board's decision in *Van Gorkom* itself that so troubled the court, but the way it was made. The business judgment rule would still protect the substantive strategies of management from judicial review, so long as they were taken after informed consideration. The corporate decision-making process, said *Van Gorkom*, was the true focus of the business judgment rule and the dominant aspect of management's duty of care.¹⁹¹

3. Legislative Reaction

Ever eager to maintain its preeminence as America's foremost state of incorporation, Delaware quickly acted to assuage any fears that management might have after *Van Gorkom*. It amended the law governing the internal affairs of its corporate citizens by adding Section 102(b)(7), giving corporations the prerogative to change their certificates of incorporation to eliminate or limit directors' liability for monetary damages.¹⁹²

a major league baseball park). In *Dodge*, the court made this classic statement of the discretion afforded the board to run the business:

There is committed to the discretion of directors, a discretion to be exercised in good faith, the infinite details of business, including the wages which shall be paid to employees, the number of hours they shall work, the conditions under which labor shall be carried on, and the prices for which products shall be offered to the public.

Dodge, 170 N.W. at 684.

¹⁸⁹ *Smith v. Van Gorkom*, 488 A.2d 858, 864 (Del. 1985).

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 873.

¹⁹² DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

Such exculpation, however, could only extend to violations of a director's duty of care. It could not exclude liability for breaches of the duty of loyalty, or for acts or omissions not taken in good faith or involving intentional misconduct or knowing violations of the law. It also could not excuse liability for wrongly declared distributions or for transactions from which a director derived an improper personal benefit.

Section 102(b)(7) became known as the "raincoat" provision. A similar article was added to the Model Business Corporations Act,¹⁹³ and soon it was included in the corporate laws of almost all the states.¹⁹⁴ But an influential Delaware jurist held that the provision would not give directors a blank check to avoid all responsibility for neglect of their duties. In *In re Caremark International Inc. Derivative Litigation*,¹⁹⁵ Chancellor Allen, approving the settlement of a derivative suit, ruled that "a sustained or systematic failure of the board to exercise oversight . . . will establish [a] lack of good faith."¹⁹⁶

B. *The Disney Proceedings*

1. *A Major Ruling*

The strains in derivative suits and business judgment litigation came to a head in 2006 in a significant case from Delaware, *In re Walt Disney Company Derivative Litigation*.¹⁹⁷ Shareholders alleged that directors of the famed entertainment company breached their fiduciary duty in two aspects of a hiring situation. They first blindly approved an employment agreement that the

¹⁹³ MODEL BUS. CORP. ACT § 2.02(b)(4) (1994).

¹⁹⁴ ROBERT W. HAMILTON & JONATHAN R. MACEY, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 699 (9th ed. 2005).

¹⁹⁵ 698 A.2d 959, 971 (Del. Ch. 1996).

¹⁹⁶ *Id.* at 971. As recently as 2006, the Supreme Court of Delaware elaborated that bad faith may be shown where

the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006) (quoting *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006)).

¹⁹⁷ 906 A.2d 27 (Del. 2006).

firm's CEO, Michael Eisner, made appointing his longtime friend Michael Ovitz the company's president.¹⁹⁸ Second, after a year of lackluster and contention-filled performance by Ovitz, the directors then allegedly made matters worse by consenting to his termination without cause, costing the company approximately \$130 million in prenegotiated severance pay.¹⁹⁹

The original complaint in the derivative action was dismissed for failure to make demand because the plaintiffs had not demonstrated why demand would be futile. Plaintiff shareholders, the chancellor ruled, were unable to satisfy either prong of the *Aronson* test.²⁰⁰ On appeal, the Delaware Supreme Court sustained the chancellor's ruling that no reasonable doubt existed as to the board's independence, but it gave the shareholders leave to replead as to *Aronson's* alternative grounds for excusing demand,²⁰¹ i.e., that the decision was other than a valid exercise of the board's business judgment.

2. *Preliminary Findings Excusing Demand*

After the plaintiff shareholders filed an amended complaint, the chancellor denied the defendants' motions to dismiss, holding that demand could be excused.²⁰² He found that the new complaint alleged particularized facts showing a "knowing or intentional lack of due care"²⁰³ in the employment decisions at issue. And the chancellor ruled that his finding was not precluded by the company's exonerating raincoat provision because the Disney directors implicitly failed to "act in good faith and meet minimal proceduralist standards of attention."²⁰⁴

Elaborating on that conclusion, the chancellor noted that Disney's board had summarily approved the lush employment arrangement, and "did not ask any questions about the details of Ovitz's salary, stock options, or possible termination."²⁰⁵ He

¹⁹⁸ *Id.* at 46.

¹⁹⁹ *Id.* at 46, 57. Eisner himself was ousted by a revolt of Disney's shareholders in 2005. Laura M. Holson, *From Hollywood to Eternity*, N.Y. TIMES, May 20, 2007, § 9, at 1.

²⁰⁰ *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 364–65 (Del. Ch. 1998).

²⁰¹ *Brehm v. Eisner*, 746 A.2d 244, 262 (Del. 2000).

²⁰² *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003).

²⁰³ *Id.* at 278.

²⁰⁴ *Id.*

²⁰⁵ *Id.* at 281.

then recounted Ovitz's short, unimpressive performance as president and his falling out with Eisner and the rest of Disney's top management.²⁰⁶ That falling out led to Ovitz's no-fault termination and netted him "enormous financial benefits,"²⁰⁷ which the court laid out in detail.

The chancellor characterized the attitudes of both the full board and the compensation committee as an "ostrich-like approach," because they were neither consulted nor gave their approval to Ovitz's termination.²⁰⁸ While declaring his hesitancy to "second guess the business judgment of a disinterested and independent board of directors,"²⁰⁹ the chancellor nevertheless held that those alleged facts "belie[d] any assertion" that Disney's boards "exercised *any* business judgment or made *any* good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders."²¹⁰

The court preliminarily found that "the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."²¹¹ In such a situation, the chancellor said, "the directors' actions are either 'not in good faith' or 'involve intentional *misconduct*.'"²¹²

3. *A Stunning Reversal at Trial, Affirmed on Appeal*

The initial ruling by the chancellor seemed to confirm, in the words of one observer, that the "business judgment rule [was] skat[ing] on thin ice."²¹³ As the "demand excused" procedure required,²¹⁴ the chancellor had pre-tried the case and found the egregious behavior of the Disney directors outside the raincoat's shelter. Apparently sensing that any dismissal recommendation from an SLC would be futile, the defendants made no attempt to

²⁰⁶ *Id.* at 288.

²⁰⁷ *Id.* at 290.

²⁰⁸ *Id.* at 288–89.

²⁰⁹ *Id.* at 286–87.

²¹⁰ *Id.* at 287.

²¹¹ *Id.* at 289.

²¹² *Id.* at 290. In finding potential liability, the court cited Delaware Corporation Code section 102(b)(7)(ii), which precludes a board from absolving itself of liability in such circumstances. *Id.*

²¹³ James F. Carroll, Letter, *Author's Update*, FLA. BAR J., Oct. 2006, at 4, 4.

²¹⁴ *Supra* notes 151–57 and accompanying text.

constitute such a subcommittee. They nevertheless fought the matter all the way. After a lengthy trial, the chancellor, in a startling about-face, ruled that the defendants' conduct was protected by the business judgment rule after all, and his findings were upheld on appeal.²¹⁵

While their actions fell short of "best practices,"²¹⁶ said the chancellor, the board's compensation committee was adequately informed about the enormity of Ovitz's potential payout when they approved it.²¹⁷ Likewise, the Disney board had knowledge of Ovitz's difficulty working with the rest of management and the likelihood that he could not be fired "for cause."²¹⁸ In the chancellor's final assessment, therefore, the directors had enough facts to substantiate their approval of Ovitz's no-fault termination.

Both rulings were sustained on appeal against a claim of insufficient evidence.²¹⁹ The board's decisions were thus protected by the business judgment rule, and that presumption relieved them from any need to account to the shareholders for their actions.²²⁰ They therefore did not have to prove that Ovitz's lush payments were fair to the company.

The Delaware Supreme Court's opinion in *Disney* makes clear that the business judgment rule will stand as a barrier to judicial review of even grossly negligent board actions, so long as they are raincoat protected. Yet the court failed to give directors an absolute carte blanche from legal responsibility.

The court found that breaches of the duty of loyalty, improper personal benefits, and intentional misconduct cannot be sanitized by section 102(b)(7). In addition, the court allowed that "bad faith," another matter outside the raincoat's pale,

²¹⁵ *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

²¹⁶ Professor Telman has rightly pointed out that this approach allows officers and directors "to tread very delicately near the line that separates poor management from wasteful mismanagement and thereby nullifies any incentive they might have to perform better." Telman, *supra* note 186, at 886–87.

²¹⁷ *Walt Disney Co.*, 907 A.2d at 697.

²¹⁸ *Id.* at 729.

²¹⁹ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 36 (Del. 2006).

²²⁰ If the business judgment rule is rebutted, Delaware shifts the burden to defendant directors to prove the entire fairness of the challenged transaction to shareholders. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *decision modified on reargument*, 636 A.2d 956 (Del. 1994).

could encompass something less than patently derelict behavior. For instance, it might apply to situations where directors are recklessly indifferent to the interests of the company or hold them in deliberate disregard.²²¹

4. *Delaware Jurisprudence After Disney*

One could explain away the *Disney* result by saying that the defendants did a better job of demonstrating their minimally sufficient involvement in the Ovitz matter at trial than at the pleading stage. Or perhaps the court, upon hearing the evidence, came to believe that the entertainment industry is *sui generis* a law unto itself when it comes to compensating putative talent hunters.

Alternately, the Delaware Supreme Court in *Disney* just might not have felt up to the task of challenging the practices of the business world as it once did in *Smith v. Van Gorkom*, where the court famously called a complacent board to account. But in the aftermath of the *Disney* decision, it becomes a fair question whether Delaware law, under the rubric of the business judgment rule, will allow corporate operations to exist totally outside legal scrutiny.

C. *The Business Judgment Rule in Options Backdating*

1. *A Time to Reassess the Standard*

Unless society is content to cede directors a free pass no matter how neglectful they are of their duties, such renegade behavior will have to once again be declared unacceptable.²²² The options backdating scandals present courts with a superb opportunity to step in and call a halt to a board's outrageous disregard of its oversight responsibilities.

One highly publicized case of options backdating shows how deeply involved directors may have typically been in this odious

²²¹ *Walt Disney Co.*, 906 A.2d at 99–102.

²²² As one observer succinctly put it, “Even when directors and officers are acting loyally and are properly incentivized to maximize profits, the company can struggle, and possibly go under, if corporate strategy is not properly tended to and if particular business opportunities are not properly evaluated.” Troy Paredes, *Sarbanes-Oxley & the New Corporate Governance*, CTR. FOR INTERDISC. STUD. (Wash. Univ. Law, St. Louis, Mo.), Winter 2006–07, at 10, 12, available at <http://law.wustl.edu/centeris/magazine/2006/fullversion.pdf>.

practice. Mercury Interactive, a Silicon Valley high-tech firm, issued a report finding that three of its former top executives “knew or should have known” that the options backdating that benefited them was “contrary to the options plan and proper accounting.”²²³ Further, the *New York Times* reported that three outside directors on the Mercury Interactive Board’s compensation committee were complicit in that corrupt practice since they “signed off” on the backdated options.²²⁴

It is yet to be determined how pervasive such brazen directorial misconduct was. Governmental and private investigations are now pending in over 100 companies under suspicion for this practice.²²⁵ As Chancellor Chandler of Delaware recently found, however, “[b]ackdating options qualifies as one of those ‘rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.’”²²⁶

2. *Two Delaware Decisions on Options Fraud*

Chancellor Chandler made those comments in *Ryan v. Gifford*, a case containing allegations that three members of a board approved backdated options and another director accepted them.²²⁷ The action was brought as a derivative suit and came before the court on a motion to dismiss for the plaintiff’s failure to make demand. The court denied the motion, finding that the pleadings were sufficient to raise doubt about the disinterestness of the board and its inability to consider such a demand with impartiality.²²⁸

²²³ Dash, *supra* note 59.

²²⁴ *Id.*

²²⁵ See *supra* note 101 and accompanying text. As of January 26, 2007, between 120 and 170 companies were implicated in lawsuits or investigations for this practice. See *Ryan v. Gifford*, 918 A.2d 341, 350 n.15 (Del. Ch. 2007).

²²⁶ *Ryan*, 918 A.2d at 355–56 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)).

²²⁷ As evidence that the options were backdated, the plaintiff showed that the return on the options granted to management averaged 243% per year over a five year period, ten times higher than that of the company’s stock during the same period. *Id.* at 347.

²²⁸ See *id.* at 352–54.

In addition, the chancellor ruled that the allegations were more than just a challenge to the board's duty of care. They also posed charges of a per se violation of its duty of loyalty. They constituted, the court said, "intentional violations of a shareholder approved stock option plan, coupled with fraudulent disclosures [in proxy statements] regarding the directors' purported compliance with that plan."²²⁹ As such, the chancellor found that conduct to be "disloyal to the corporation and . . . in bad faith."²³⁰

Chancellor Chandler decided the second Delaware case²³¹ on the same day as *Ryan*. Among other things, it involved charges that a board approved spring-loaded options, which the court called a "much more subtle deception" than options backdating.²³² There, according to the pattern,²³³ several "well-timed" options grants were made right before the announcement of highly favorable news that caused a jump in the company's stock price.²³⁴ The options were duly issued in compliance "with the strict letter" of a stock incentive plan approved by shareholders requiring that the exercise price be no lower than the fair market value of the stock on the day the options were granted.²³⁵

The chancellor found that this practice, "without explicit authorization from shareholders, clearly involves an indirect deception."²³⁶ He elaborated, "A director who intentionally uses inside knowledge . . . in order to enrich employees . . . cannot . . . be said to be acting loyally and in good faith as a fiduciary."²³⁷

IV

CONCLUSION

There are valid reasons for the business judgment rule. Corporate officials run dynamic enterprises, and the market is a

²²⁹ *Id.* at 358.

²³⁰ *Id.*

²³¹ *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563 (Del. Ch. 2007).

²³² *Id.* at 592.

²³³ *See supra* notes 60–62 and accompanying text.

²³⁴ *Tyson Foods*, 919 A.2d at 576.

²³⁵ *See id.* at 592–93.

²³⁶ *Id.* at 592.

²³⁷ *Id.* at 593.

notoriously fickle place to make a profit. So business people should not be unduly restricted in taking initiatives for fear that they will suffer personal losses if their projects do not prove successful.

Shareholders and society at large, however, have a legitimate expectation that corporate officials will do their jobs, i.e., that they will be faithful to the responsibilities of their offices whether such conduct is called acting with due care, with loyalty, or in good faith. In the ultimate reckoning, then, the business judgment rule cannot give a blank check to either full boards or to their hand-picked special litigation committees. One great twentieth-century president knew well the potential for some business leaders to act unscrupulously when he called them “malefactors of great wealth.”²³⁸ That charge does not seem at all inappropriate today when applied to corporate executives who have backdated options and directors who have allowed such a corrupt practice to flourish.

The derivative suit has proven its worth as a mechanism for holding corporate officials responsible for their actions, and it again bears the most promise to rectify such derelict behavior as options backdating. As Holmes put it at the beginning of the twentieth century in his famous address *The Path of the Law*, “A man who cares nothing for an ethical rule which is believed and practiced by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money”²³⁹

Delaware and other jurisdictions must step back from the permissive attitude of the *Disney* case. Early rulings finding directors liable in the option backdating scandal, such as *Ryan* and *Tyson Foods*, are showing the way. There lies the true path of corporate law in the twenty-first century.

²³⁸ MICHAEL E. MCGERR, *A FIERCE DISCONTENT: THE RISE AND FALL OF THE PROGRESSIVE MOVEMENT IN AMERICA, 1870–1920*, at 177 (2003) (quoting Theodore Roosevelt at the dedication of a memorial to the Pilgrims at Provincetown, Massachusetts, in August 1907).

²³⁹ Holmes, *supra* note 2, at 459. President Theodore Roosevelt appointed Justice Holmes to the U.S. Supreme Court. James M. Morton, Jr., Address at a Memorial Service for Oliver Wendell Holmes at a Special Session of the Massachusetts Supreme Judicial Court (Oct. 9, 1937), *in* 298 MASS. 575, 594 (1937).

