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Judicial Removal of Directors: Denial of Directors' License to Steal or Shareholders' Freedom to Vote?

by
OLGA N. SIRODOEVA-PAXSON*

"If I only could, I surely would."¹ This is the answer that appears to be put into shareholders' mouths by a growing number of state corporate statutes. The question is: "Would you remove directors for misconduct?" In recent years, twenty-nine states² (two of them since 1997³) have adopted provisions empowering courts to remove directors elected by shareholders, apparently under the assumption that shareholders sometimes would like to, but cannot, remove directors themselves. This new removal power granted to courts is extraordinary in that it usurps the inherent voting rights of shareholders.⁴

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1. For a melodic rendering of this phrase, see SIMON AND GARFUNKEL, *El Condor Pasa (If I Could)*, on *BRIDGE OVER TROUBLED WATER* (Columbia Records 1970).

2. See MODEL BUS. CORP. ACT ANN. § 8.09 Statutes (Supp. 1997); IDAHO CODE § 30-1-809 (Supp. 1998); NEB. REV. STAT. § 21-2086 (1997); N.D. CENT. CODE § 10-19.1-41.1 (Supp. 1997).

3. See IDAHO CODE § 30-1-809 (Supp. 1998); N.D. CENT. CODE § 10-19.1-41.1 (Supp. 1997).

4. See, e.g., DEL. CODE ANN. tit. 8, § 216 (1991). Courts also view shareholders' rights to elect and remove directors as inherent. See, e.g., *Ross Sys. Corp. v. Ross*, No. CIV.A.10378, 1993 WL 49778, at *17-18 (Del. Ch. Feb. 22, 1993) (stating that only shareholders—not courts—are empowered to remove a director); see also Joe G. Davis, Jr., *Corporations—Stockholders' Right to Remove Directors*, 7 BAYLOR L. REV. 313 (1955) (describing many other authorities for the courts' recognition of shareholders' inherent powers to elect and remove directors); *infra* notes 22-26 and accompanying text.

The discord among various authorities concerning the judicial removal of directors is remarkable. The Model Business Corporation Act (the "Model Act") establishes a judicial right of removal,⁵ while the American Law Institute Principles of Corporate Governance (the "ALI Principles") do not contemplate such a remedy.⁶ The three leading states in the field of corporate law also prescribe different rules: New York authorizes courts to remove both directors and officers,⁷ California provides for judicial removal of directors only,⁸ and Delaware does not contemplate the judicial removal of either directors or officers.⁹

Nor have the courts agreed on when or how to invoke their removal powers. The standards in decided cases are deficient and the outcomes inconsistent. At one extreme, the court removes directors without regard for the possibility that shareholders might legitimately disagree with the court's perception of their preferences.¹⁰ In so ignoring shareholder prerogative, the court disenfranchises shareholders supposedly in order to protect them and their corporation.¹¹ At the other extreme, the court ratifies a decision of

5. MODEL BUS. CORP. ACT ANN. § 8.09 (Supp. 1997). The Model Business Corporation Act is approved by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association. It is designed to be a guide for the revision of state business corporation laws. In its various editions published over the past 50 years, it has been followed by most states and has influenced the development of corporate law in almost all states. The judicial removal remedy was introduced in the 1984 revision of the Model Act.

6. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) [hereinafter ALI PRINCIPLES]. The ALI Principles represent a fundamental effort by the American Law Institute to harmonize and determine new directions for corporate governance. Even though the entire second volume of this two-volume work is devoted to corporate law remedies, the ALI Principles do not endorse the removal remedy.

7. See N.Y. BUS. CORP. LAW §§ 706, 716 (McKinney 1986 & Supp. 1998).

8. See CAL. CORP. CODE § 304 (West 1990).

9. See generally DEL. CODE ANN. tit. 8 (1991 & Supp. 1996); see also *Ross Sys. Corp. v. Ross*, No. CIV.A.10378, 1993 WL 49778, at *17-18 (Del. Ch. Feb. 22, 1993). For a description of *Ross*, see *infra* notes 23-26 and accompanying text.

10. See, e.g., *Koshaba v. Koshaba*, 132 P.2d 854 (Cal. Ct. App. 1942). For a description of *Koshaba*, see *infra* note 294 and accompanying text.

11. This oxymoron is borrowed from Jayne W. Barnard, *The Securities Law Enforcement Remedies Act of 1989: Disenfranchising Shareholders in Order to Protect Them*, 65 NOTRE DAME L. REV. 32 (1989). Professor Barnard's article was devoted to the Securities and Exchange Commission's removal powers. The oxymoron is even more fitting for the judicial removal remedy in the pure corporate law context discussed in this article. The removal remedy under the securities laws disenfranchises the shareholders of a particular corporation in order to protect shareholders in the market generally. In contrast, the removal remedy under corporate statutes attempts to protect those same shareholders (and their corporation) whom it disenfranchises.

shareholder-directors who are guilty of wrongdoing to reelect themselves as directors.¹²

Three recent court decisions highlight the discrepancy in approach and confusion surrounding the removal remedy. In Delaware, the Chancery Court held that absent statutory authorization it lacked power to remove a director, while stating that it would have had the authority to appoint a receiver and effectively remove the entire board had the plaintiff requested such an action.¹³ In New York, the Southern District Court refused to remove a director for self-dealing, reasoning that the statute did not grant the corporation the right to bring a removal action to protect itself. The New York court nevertheless found that the attorney general would have standing to bring such an action for the benefit of the corporation.¹⁴ Lastly, in Massachusetts, the Superior Court removed a director even though it recognized his accomplishments as a manager.¹⁵

Despite the radical divergence in approach among legislatures and courts, no theory reconciling the conflicting positions with respect to the judicial removal remedy has yet been proposed.¹⁶ The goal of this article is not only to explore the merits and perils of the judicial

12. See *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 73-77 (Cal. Ct. App. 1952). For a description of *Remillard Brick*, see *infra* notes 138-42 and accompanying text.

13. See *Ross*, 1993 WL 49778, at *17-18. For a description of *Ross*, see *infra* notes 23-26 and accompanying text.

14. See *Management Techs., Inc. v. Morris*, 961 F. Supp. 640, 650-52 (S.D.N.Y. 1997). For a description of *Management Technologies*, see *infra* notes 257-59 and accompanying text.

15. See *Demoulas v. Demoulas*, No. CIV.A.90-2344, 1996 WL 511519, at *7 (Mass. Super. Ct. Oct. 1, 1996). For a description of *Demoulas*, see *infra* note 79.

16. Several drafters of the Model Act I interviewed confirmed that no analysis of the removal remedy was made when it was included in the Model Act. In contrast, Roswell B. Perkins, who was the President of the American Law Institute at the time the ALI Principles were prepared and adopted, responded that in his view, the judicial removal of directors would have been a contentious issue had it been proposed for inclusion in the ALI Principles. Interestingly, while one of the drafters of the Model Act was supportive of the remedy, another took a dissenting position with respect to the judicial removal provision in the Model Act and said that it should not have been there. However, it is there and is being widely followed by the states. In addition, the effects of this provision extend even beyond the confines of corporate law. For example, in the debates on granting the Securities and Exchange Commission rights to require removal of directors and officers and barring them from occupying similar positions, the existence of the removal remedy in the corporate context was mentioned as a given, and parity with shareholders' rights was suggested as an argument for giving similar rights to the SEC. See Barnard, *supra* note 11, at 51. These rights were later conferred upon the SEC in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified at 15 U.S.C. §§ 77t(e), 78u(d)(2) (1994)); see also *infra* note 102.

removal of directors, but also to resolve the conflict between the competing goals of corporate law reflected in the removal remedy, and from that theoretical basis to develop a workable test to be introduced by the courts or codified in the removal statutes.

Part I describes the history and nature of the judicial removal remedy. Part II offers a theory for the removal remedy. I identify three fundamental interests implicated by the removal remedy: interests of shareholder democracy, interests of the corporation, and those of the marketplace. There is often tension among these interests. The first fundamental interest, that of shareholder democracy, encompasses the shareholders' inherent right to elect and remove directors. If it were the only interest at stake, it would unconditionally prohibit judicial removal. However, the second interest, that of the corporation, invites judicial removal of misbehaving directors in disregard of shareholder prerogative where the removal would protect the corporation from continuing directorial wrongdoing. In order to reconcile these two fundamental interests, I introduce the concept of "impairment" to shareholder vote and define two situations in which judicial removal may be justified. In the first situation, a shareholder who controls voting halts removal because his interest does not coincide with that of the corporation ("divergence of interests impairment" to the removal of directors by shareholders). In the second situation, shareholders are unable to remove directors due to impediments of a procedural, rather than substantive, nature ("procedural impairment"). The third interest that must be evaluated is that of the market. This interest is aimed at deterring directorial wrongdoing in general, and may call for the removal of directors in disregard of both inherent shareholder rights and the interests of a particular corporation. After examining a formula of efficient deterrence, I conclude that a removal remedy designed to address a director's wrongdoing against a corporation is an inefficient deterrent and therefore should not be modified to harm the corporation in pursuit of deterrence.

Part III proposes an allocation of responsibilities to apply the removal remedy. Starting from the premise that the interests of the corporation are the proper goal of the removal remedy, I consider whether the removal power should be granted to the board of directors rather than to the court. I conclude that the power should rest with the court due to its unique ability to evaluate the severity of misbehavior and to preserve the existing balance of powers within the corporation. The board (acting through its disinterested members) should nevertheless enjoy a veto right with respect to the application of the removal remedy if it determines that removal would be contrary to the corporation's best interests. I argue further that an unusual rule allowing a shareholder holding an arbitrary percentage

of shares to bring a removal suit as a direct, rather than derivative, action deprives the board of its usual powers and should be eliminated.

Part IV proposes a test to be codified in the removal statutes or introduced directly by courts. I begin by identifying the inadequacies of existing tests and argue that an appropriate test must find a proper balance between the objective of protecting the interests of the corporation and the prerogatives of its shareholders. At the outset, I recommend that the right the board enjoys in a derivative action to halt lawsuits not in the corporation's best interests should also be available in a removal action. If the removal lawsuit is not halted by board action, the proposed test proceeds with a three-prong analysis. First, the court should make a finding of gross misbehavior. Second, the court should determine that removal would be in the best interests of the corporation (or adhere to the board's determination, if available and not wrongful). Finally, the court must find a "divergence of interests impairment" or "procedural impairment" to the exercise of the shareholders' voting rights. The test also stipulates how the finding of a particular type of impairment affects the manner in which the impairment could be cured and the scope of the remedy.

I. History and Description of the Removal Remedy

A. History of the Judicial Removal of Directors

As corporate law has evolved during this century, the process of removing directors from their positions has been simplified. This tendency began with a liberalization of standards for removal of directors by shareholders, and was later fortified by the development of judicial removal rules. Under the common law, directors had an entitlement to their position and could be removed by shareholders only for cause.¹⁷ Today, most statutes grant shareholders the right to remove directors with or without cause.¹⁸ Shareholders can require that a special shareholder meeting be called for this purpose.¹⁹

17. See MODEL BUS. CORP. ACT ANN. § 8.08 official cmt. (Supp. 1997). For a description of the history of the change from the removal "for cause" to the removal "with or without cause," see Gerschel v. Town and Country Management Corp., No. CIV.A. 6843, 1982 WL 17878, at *4 (Del. Ch. July 1, 1982), and Timothy F. Scanlon, *Corporations—Directors—Validity of By-Law Permitting Removal of Directors Without Cause*, 59 MICH. L. REV. 640 (1961). For an extensive theoretical discussion on the issue, see Arthur H. Travers, Jr., *Removal of the Corporate Director During His Term of Office*, 53 IOWA L. REV. 389 (1967).

18. See, e.g., MODEL BUS. CORP. ACT ANN. § 8.08 (Supp. 1997); DEL. CODE ANN. tit. 8, § 141(k) (1991). Some states make this rule imperative. See, e.g., *id.* Usually, however, the right to remove without cause can be waived in the articles of incorporation of a company. See MODEL BUS. CORP. ACT ANN. § 8.08(a) (Supp. 1997). Some state statutes

Although removing directors has become progressively easier, shareholders do not always remove even directors who engage in gross misconduct. There is no judicial consensus on whether courts have equitable power to remove directors in such circumstances absent statutory authorization. This may be surprising given that in the area of corporate law courts generally have a reputation for being anything but shy.²⁰ Some courts have lived up to this reputation by holding that because directors hold a position of trust, judicial power to remove them exists independently of statute.²¹ Nevertheless, most courts have exhibited remarkable modesty by stating that they have

contain a different default rule: removal without cause is permitted only if the articles of incorporation so provide. See, e.g., N.Y. BUS. CORP. LAW § 706(6)(b) (McKinney 1986). Statutes give special consideration to the removal of directors elected by cumulative voting or via a voting group in order to protect the rights of minority shareholders and preserve the balance of powers within the corporation. If a director is elected by a voting group of shareholders, only the shareholders of that voting group may participate in the vote to remove him. If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect him under cumulative voting is voted against his removal. See MODEL BUS. CORP. ACT ANN. § 8.08(b-c) (Supp. 1997); DEL. CODE ANN. tit. 8, § 141(k)(i). For a discussion of the rationale underlying special removal provisions in the context of cumulative voting, see John W. Hupp, *Corporations—Officers and Directors—Relationship Between Cumulative Voting and Removal Provisions*, 51 MICH. L. REV. 744 (1953); Harlowe E. Bowes and Ledlie A. De Bow, *Cumulative Voting at Elections of Directors of Corporations*, 21 MINN. L. REV. 351, 366-67 (1937); Note, *Cumulative Voting—Removal, Reduction and Classification of Corporate Boards*, 22 U. CHI. L. REV. 751 (1955). For a definition of voting groups and cumulative voting, see *infra* notes 104-05.

19. Ownership of 10% of the shares is usually required to call such a meeting. See MODEL BUS. CORP. ACT ANN. § 7.02(a)(2) (Supp. 1997). For a comparison of this 10% threshold with the 10% threshold for removal actions, see *infra* note 247.

20. See John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621-22 (1989).

[W]hat is most mandatory in corporate law is not the specific substantive content of any rule, but rather the institution of judicial oversight. Judicial activism is the necessary complement to contractual freedom In drafting the corporate contract, lawyers rely less on the model form provided by the legislature than on their expectation that courts will prevent either side from taking "opportunistic" advantage of the other.

Id. at 1621. Professor Coffee also refers to the former SEC Chairman Ray Garrett as one of the authorities for a similar approach: "In more modern terms, Garrett can be seen as defending the proposition that the courts' ex post monitoring role is a substitute for a fully complete contract which provides for all possible contingencies." *Id.* at 1622; see also Ray Garrett, Jr., *The Limited Role of Corporation Statutes*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1979 95, 101-02 (Donald E. Schwartz ed., 1979).

21. See, e.g., *Brown v. North Ventura Rd. Dev. Co.*, 30 Cal. Rptr. 568, 571 (Cal. Ct. App. 1963); *De Garmo v. Goldman*, 123 P.2d 1, 4 (Cal. 1942). Such reasoning is based on an analogy between corporate directors and trustees, since courts traditionally had equitable powers to remove trustees for fraud. For the underpinnings of such an analogy, see *infra* note 295 and accompanying text.

no power to remove directors absent statutory authorization (while sometimes, however, carving out exceptions for fraud).²²

For example, such judicial reticence was apparent in a recent Delaware case, *Ross Systems Corporation v. Ross*.²³ This case tells the story of the professional and personal failure of a famous periodontist, Dr. Ross, who invented a dental implant. Dr. Ross knowingly used the scanning electron microscopy photographs of the dental implant system of his competitors, instead of his own, as a basis for a scientific article advertising his invention. Dr. Ross became one of the shareholders and a director of the corporation created to implement his invention.²⁴ After the design failure of the implant invented by Dr. Ross became apparent and Dr. Ross' use of photographs of his competitors' implants turned into a scandal, a dispute arose between the shareholders. The court found that, in addition to the fraudulent use of the falsified photographs, Dr. Ross misappropriated various surgical tools and other equipment of the company valued at \$51,227.30 and took without payment implants and related materials valued at another \$59,570.17.²⁵ Dr. Ross could not be removed through the usual shareholder voting procedures because he owned 50% of voting shares in the corporation and effectively had a veto right with respect to his own removal. Nevertheless, the court refused to remove Dr. Ross as a director on the basis that the court lacked the power to remove a director even in the event of fraud.²⁶

22. See, e.g., *Webber v. Webber Oil Co.*, 495 A.2d 1215, 1221 (Me. 1985) (holding that the court has the power to remove a director only as expressly provided in the statute); *Feldman v. Pennroad Corp.*, 60 F. Supp. 716, 719 (D. Del. 1945), *aff'd*, 155 F.2d 773 (3d Cir.), *cert. denied*, 329 U.S. 808 (1946) (holding that in the absence of fraud a court has no inherent equitable power to remove a director); *Harkey v. Mobley*, 552 S.W.2d 79, 81 (Mo. App. 1977) (holding that absent express statutory authority or allegations of fraud, courts of equity have no general jurisdiction to remove directors or officers of a private corporation; that power rests in the corporation itself).

23. No. CIV.A. 10378, 1993 WL 49778 (Del. Ch. Feb. 22, 1993).

24. See *id.* at 5. Dr. Ross and Mr. Sang, an attorney, each held 50% of voting stock of the company. Several other shareholders held non-voting stock. Dr. Ross and Mr. Sang were the directors of the company. Mr. Sang was also the company's president and chief executive officer. See *id.*

25. See *id.* at 14-17. While the court found that the use of the falsified photographs did not constitute actionable fraud against the company (but constituted instead actionable fraud against Mr. Sang), it found that Dr. Ross committed conversion of the corporation's property. Under applicable law, conversion was defined as "an unauthorized act that deprives another of his identifiable property permanently or for an indefinite time."

26. See *id.* at 17-18.

The plaintiffs argue that because Dr. Ross defrauded the company, he is no longer fit to serve as a director, and that since Mr. Sang and Dr. Ross each control 50% of the company's voting stock, only a judicial decree will accomplish Dr. Ross' removal. . . . This claim is without merit. The only persons empowered

Historically, only a few state legislatures have responded to the courts' reluctance to use the removal remedy by granting courts express removal powers.²⁷ Only after the Model Act introduced the removal remedy for the first time in 1984²⁸ was the remedy recognized nationwide and adopted by a majority of the states.²⁹

Interestingly, while the judicial removal of directors is consistent with the tendency to simplify the process of removing directors, this tendency itself, together with judicial removal rules, is contrary to the more general tendency toward liberalization³⁰ in corporate law. This latter tendency has developed due to competition among the states led by Delaware and is characterized by enabling provisions minimizing the intrusion of legislatures and courts into corporate matters and, as some argue, by a pro-management, rather than pro-shareholder, bias.³¹ In light of this tendency, it is logical that

to remove a director are the corporation's shareholders. . . . [The appointment of a receiver for a solvent corporation] would have the incidental effect of displacing the entire board of directors. But the plaintiffs here do not ask the Court to appoint a receiver or trustee, and they are unable to point to any statute or other source of law that would empower this Court to remove a particular member of the corporation's board of directors. The Court lacks the power to grant the relief being requested.

Id. While this decision did not result in an injustice because, for unrelated reasons, the court ordered Dr. Ross to "buy out" Mr. Sang as a shareholder of the company, it nevertheless established an unfortunate precedent.

27. Variations of the removal remedy have existed for some time in a handful of state corporate statutes. *See, e.g.*, CAL. CORP. CODE § 304 (West 1990) (originally enacted in Stats. 1947, c. 1038, p. 2320, § 811); 15 PA. CONS. STAT. ANN. § 1726 (West 1995) (originally enacted in Act of May 5, 1933, P.L. 364, No. 106, § 405).

28. REV. MODEL BUS. CORP. ACT § 8.09 (1985).

29. Twenty-nine states have adopted judicial removal of directors provisions: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Idaho, Illinois, Iowa, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New York, North Carolina, North Dakota, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Washington, Wisconsin, and Wyoming. *See* MODEL BUS. CORP. ACT ANN. § 8.09 Statutes (Supp. 1997); IDAHO CODE § 30-1-809 (Supp. 1998); NEB. REV. STAT. § 21-2086 (1997); N.D. CENT. CODE § 10-19.1-41.1 (Supp. 1997). The removal remedy also exists in some other countries. For example, for a brief description of the removal remedy in Japan, see Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436, 1472 (1994).

30. In the context of corporate law, the term "liberalization" implies an enabling, non-regulatory approach. The provisions on judicial removal of directors are generally mandatory. Theoretically, however, judicial removal could instead be merely the default rule, in keeping with the liberalization trend. The most plausible justification for the mandatory nature of the rule is that judicial removal is a remedy for egregious misbehavior usually involving fraud, and the courts generally do not allow the parties to "opt out of" the duty of loyalty or the rules regarding good faith.

31. The tendency of liberalization results from competition among the states aimed at attracting the business of incorporation to their states in order to increase tax revenues. *See, e.g.*, CHARLES R. O'KELLY, JR., AND ROBERT B. THOMPSON, CORPORATIONS AND

Delaware is not following the judicial removal trend. In light of the similarity in approach to corporate law shared by the Model Act and Delaware,³² it is less obvious why the Model Act introduced such a remedy.

B. Snapshot of the Removal Remedy

Removal statutes are laconic. With varying degrees of faithfulness, most states follow the essential features of Section 8.09 of the Model Act, which is therefore the starting point for the analysis in this article. Section 8.09 of the Model Act provides:

- (a) The [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located may remove a director of the corporation from office in a proceeding commenced either by the corporation³³ or by its shareholders holding at least 10 percent³⁴ of the outstanding

OTHER BUSINESS ORGANIZATIONS 154 (1992). This tendency has been perceived from different standpoints at different times in legal academia and is debated to this day. In the 1950's, one of the drafters of the Model Act made the following accusation against Delaware: "The Delaware statute bids for the corporate business of promoters. It makes little or no effort to protect the rights of investors." Whitney Campbell, *The Model Business Corporation Act*, BUS. LAW., July 1956, at 98, 100-01. In the 1970's, Professor Cary made a famous suggestion to adopt federal standards with respect to corporate law in order to "cure the Delaware syndrome." William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701 (1974). However, at the end of the twentieth century, some argue that state competition is a positive development. See, e.g., ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

32. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 (1992); LARRY D. SODERQUIST & A.A. SOMMER, JR., *UNDERSTANDING CORPORATION LAW* 69-70 (1990).

33. Not all removal statutes permit the corporation to bring a suit itself. See, e.g., N.Y. BUS. CORP. LAW § 706(d) (McKinney 1986); see also *Purdy v. Humphry*, 82 N.Y.S.2d 92 (Sup. Ct. 1947), *aff'd*, 82 N.Y.S.2d 388 (N.Y. App. Div. 1948); *Management Techs., Inc. v. Morris*, 961 F. Supp. 640, 650 (S.D.N.Y. 1997). When a corporation has a right to bring a suit, suits are generally brought on its behalf by its board of directors or an authorized officer. The right to bring a suit on behalf of the corporation stems from the general authority of the board of directors and officers to act on behalf of the corporation. See, e.g., N.Y. BUS. CORP. LAW §§ 701, 715 (McKinney 1986). The Maine corporate statute contains a special requirement that a removal action could be brought only by the corporation itself, upon a decision of at least two-thirds of its directors. See ME. REV. STAT. ANN. tit. 13-A, § 707(6) (West 1981). Also, a shareholder has a general right to bring a suit on behalf of the corporation. Such action would be considered a "derivative" action. See MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997).

34. Most jurisdictions that have adopted removal statutes have the same ten percent requirement. See, e.g., CONN. GEN. STAT. ANN. § 33-743(a) (West 1997), N.Y. BUS. CORP. LAW § 706(d) (McKinney 1986). However, there are deviations from the 10% threshold in some states. See, e.g., S.C. CODE ANN. § 33-8-109(a) (Law. Co-op. 1977) (5% threshold); IOWA CODE ANN. § 490.809(1) (West 1991) (20% threshold). Any shareholder may bring a removal action on behalf of the corporation. See, e.g., N.Y. BUS. CORP. LAW § 626; see also MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp.

shares of any class³⁵ if the court finds that (1) the director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation³⁶ and (2) removal is in the best interest of the corporation.³⁷

(b) The court that removes a director may bar the director from reelection for a period prescribed by the court.³⁸

(c) If shareholders commence a proceeding under subsection (a), they shall make the corporation a party defendant.³⁹

The removal remedy under the Model Act applies only to the removal of directors, but some state statutes contain similar provisions regarding the judicial removal of officers.⁴⁰

Cases on directorial removal are not uniform. While most of them pertain to close corporations,⁴¹ public corporations are not immune from the circumstances that give rise to the removal

1997). However, a 10% shareholder may bring an action in its own right. *See* MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997). Part III will argue that removal statutes should be amended to eliminate the special treatment for the 10% shareholders.

35. The threshold may apply to the shares of any class or all outstanding shares. *Compare* AZ. REV. STAT. ANN. § 10-809(a) (West 1996) ("ten percent of the outstanding shares of any class") with N.Y. BUS. CORP. LAW § 716(c) (McKinney 1986 & Supp. 1998) ("ten percent of the votes of the outstanding shares, whether or not entitled to vote").

36. This elevated threshold for misbehavior is an important starting point for the application of the remedy, given the extraordinary nature of judicial removal. As explained below, it pays tribute to the primacy of the shareholder voting rights as the first fundamental interest pertinent to the removal remedy. All jurisdictions that provide for judicial removal of directors have a similar high standard, with minor variations. Some examples of such variations include: AZ. REV. STAT. ANN. § 10-809(a)(1) (West 1996) ("fraudulent conduct or intentional criminal conduct"); ALA. STAT. § 10.06.463 (Michie 1996) ("fraudulent or dishonest acts, gross neglect of duty, or gross abuse of authority"); MICH. COMP. LAWS ANN. § 450.1514 (West 1990) ("fraudulent, illegal, or dishonest conduct, or gross abuse of authority or discretion").

37. This element is essential in that it reflects the second major interest pertinent to the removal remedy. However, some states have disregarded it. *See, e.g.,* ALA. STAT. § 10.06.463 (Michie 1996).

38. Some jurisdictions limit this period. *See, e.g.,* AZ. REV. STAT. ANN. § 10-809(b) (West 1996) (limiting the bar to no more than five years). The test proposed in Part IV of this article will differentiate between situations where imposition of the bar is justified and situations where it is not.

39. Some removal statutes do not contemplate such a requirement. *See, e.g.,* N.Y. BUS. CORP. LAW § 716(c) (McKinney 1986 & Supp. 1998).

40. *See, e.g.,* N.Y. BUS. CORP. LAW § 716(c) (McKinney 1986 & Supp. 1998). The removal of officers raises issues distinct from those raised by the removal of directors (except where such officers are elected directly by shareholders rather than by the board of directors), and therefore is beyond the scope of this article.

41. *See, e.g.,* Ross Sys. Corp. v. Ross, No. CIV.A. 10378, 1993 WL 49778 (Del. Ch. Feb. 22, 1993); Demoulas v. Demoulas, No. CIV.A.90-2344, 1996 WL 511519 (Mass. Super. Ct. Aug. 20, 1996).

remedy.⁴² Removal actions are usually brought by minority shareholders,⁴³ but majority shareholders⁴⁴ or corporations themselves⁴⁵ sometimes need to resort to this remedy as well.

Unfortunately, the scarce legislative history of the removal remedy⁴⁶ and the cacophony among the cases⁴⁷ do not provide an adequate guide for understanding the interests implicated by the removal remedy or for the remedy's application. Part II will develop a philosophical foundation for the remedy by identifying and analyzing the competing interests implicated by the removal remedy and by explaining its place among other comparable remedies in corporate law.

II. Philosophy of the Removal Remedy: Three Fundamental Interests in Concert and at Odds

Three fundamental interests are key in fashioning a removal remedy.⁴⁸ The first is the shareholders' inherent right to remove directors. This right is the mirror image of the right to elect directors.⁴⁹ The rights shareholders enjoy to install or remove

42. See, e.g., *Management Techs., Inc. v. Morris*, 961 F. Supp. 640, 642 (S.D.N.Y. 1997) (the shares of Management Technologies, Inc. were traded on NASDAQ). For a description of *Management Techs.*, see *infra* notes 153-56, 257-59 and accompanying text.

43. See, e.g., *Atkins v. Hughes*, 282 P. 787 (Cal. 1929). For a description of *Atkins*, see *infra* notes 118-20, 146-50 and accompanying text.

44. See, e.g., *Markovitz v. Markovitz*, 8 A.2d 46 (Pa. 1939). For a description of *Markovitz*, see *infra* notes 108-11 and accompanying text.

45. See, e.g., *Management Techs.*, 961 F. Supp. at 642.

46. The Official Comment to section 8.09 of the Model Act is remarkably brief. See MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997). The legislative history of section 8.09 is mysterious. See *supra* note 16. The legislative history of state removal statutes is simple: the states follow the Model Act. See, e.g., ALA. CODE § 10-2B-8.09 cmt. 1 (1994).

47. See *supra* notes 10-15 and accompanying text; see also *infra* Part IV.A and the analysis of cases developed throughout the article.

48. While the reasons favoring the removal remedy in the context of not-for-profit corporations are even more compelling than in the business corporations context, the interests involved in crafting a removal remedy outside the business corporations context are different and will not be examined here. For a discussion of other interests conceivably relevant to the removal remedy, see *infra* note 79 (arguing that the situations where the interests of a particular shareholder—rather than those of the corporation—have been infringed upon require finding a different balance between the interests involved); *infra* note 169 (reaching a similar conclusion with respect to situations where the interests of the corporation's creditors, employees or other parties were violated); *infra* notes 163-65 and accompanying text (observing that there exist other remedies designed to protect certain interests outside of the corporate context, which also require a separate analysis).

49. This right has been named as one of the mandatory provisions of corporate law that have not been loosened even in the ultimately non-mandatory Delaware corporate statute. See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L.

directors constitute a form of corporate democracy. This interest is viewed as predominant in jurisdictions that do not authorize judicial removal.⁵⁰

The second fundamental interest is that of the corporation. Apparently, it is the need to protect corporate interests that inspired the recent proliferation of removal statutes. The best interests of the corporation imply the maximization of corporate profits and often coincide with shareholders' collective interests.⁵¹ From the corporation's standpoint, however, the mere fact that shareholders take no action to dismiss a director does not mean that retaining the director furthers the corporation's interests (or shareholders' collective interests), at least in the absence of shareholders' affirmative and unanimous decision to retain the misbehaving director. To protect the corporation against continuing abuse by the director, it may be necessary to remove him.⁵² Removal cases demonstrate that the spectrum of directorial misconduct that may create a need for such protection ranges from fraudulent diversion of corporate funds for the purposes of self-enrichment⁵³ to continuous demoralizing conduct apparently caused by a director's vanity and bad temper.⁵⁴

These two interests are associated with a particular corporation but develop in the context of the marketplace. The third fundamental interest, that of the market, may invite application of the judicial removal remedy in order to discourage other similarly placed executives from committing fraud at other companies.

When shareholders cure directorial wrongdoing by removing a director themselves, the three interests are in harmony and the judicial removal remedy is unnecessary. When, however, shareholders fail to take action to remove misbehaving directors, tension between these three interests arises. The first interest of shareholder democracy, if taken alone, unconditionally prohibits the judicial removal of directors. Such a postulate is in conflict with the

REV. 1549, 1553 (1989). This provision, however, in good company with many other provisions in corporate law, was discussed by Professor Romano from the opposite standpoint. For a challenge to the mandatory nature of corporate law rules, see Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1599-1600 (1989).

50. See *supra* note 4; see also *supra* notes 22-26 and accompanying text.

51. For a description of what constitutes the best interests of the corporation, see *infra* note 81 and accompanying text.

52. See *infra* notes 83-99 and accompanying text for a discussion of the underpinnings of other remedies with respect to directorial misconduct.

53. See, e.g., *O'Brocta v. O'Brocta*, No. CIV-88-527E, 1989 WL 19606, at *3 (W.D.N.Y. Feb. 24, 1989).

54. See, e.g., *Markovitz v. Markovitz*, 8 A.2d 46, 47 (Pa. 1939).

other two interests that favor removing directors without concerted shareholder action and suggest disregarding the shareholder prerogative to remove. The interest of shareholder democracy is in more profound conflict with the interests of the market than with the interests of the corporation because it is more logical to assume that shareholders may want to remove directors to protect the interests of their corporation than to serve the general interests of the market.

Yet there may also be tension between the interests of the corporation and those of the market. Indeed, one of these categories of interests fully encompasses, but also goes beyond, the other. The interests of the corporation constitute the more narrow category, and removal to pursue the interests of the market would cover all the cases where removal would be necessary in order to protect the interests of the corporation, but not vice versa. Removal to protect a corporation does not present a threat to the interests of the market, but instead furthers its goals—dismissal of the director acts as a signal to other potential wrongdoers not only within the company but also in other companies, bolsters a sense that the market is being policed and represents a form of punishment for wrongs committed.

However, the reasons for removal that investors in the marketplace as a whole might favor may be in conflict with the interests of a particular corporation. While a director who engaged in misconduct has injured the corporation in the past, his removal may be contrary to the interests of the corporation overall or in the future. For example, a director may have knowingly failed to disclose to the corporation his interest in a certain transaction from which he benefited but which did not cause the corporation noticeable harm. If such a director does not exhibit recidivist tendencies, has otherwise demonstrated managerial ability and maximizes the corporation's profits overall, removing him may not be in the corporation's best interests.

The *Remillard Brick* case⁵⁵ illustrates this principle and a comprehensive approach to the determination of the interests of the corporation. On the one hand, two clever and dishonest directors of affiliated brick manufacturing companies devised a scheme whereby they diverted the profits from the sale of bricks manufactured by these companies to a sales corporation owned by the two directors, used the equipment of the manufacturing companies for the benefit of their sales corporation, and engaged in other related misconduct. The trial court found that the directors breached their duties as directors and officers and committed fraud upon the manufacturing companies.⁵⁶ On the other hand, the profits of the manufacturing

55. *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. Ct. App. 1952).

56. *See id.* at 76.

companies skyrocketed during their directorship. As the appellate court noted, "[the] trial court was undoubtedly impressed by the fact that [the directors] did a first rate job in promoting sales and selling the products of the manufacturing companies, and in carrying out a rehabilitation program for those companies."⁵⁷ While it is conceivable that the interest of the market may have called for removal of talented but dishonest directors, the interests of the corporation appeared to compel the opposite outcome. The proven managerial ability of the two directors was one of the two grounds on which the court decided not to remove the two directors.⁵⁸ In a recent Massachusetts case, however, the court acknowledged a director's accomplishments, but removed him notwithstanding his managerial talents.⁵⁹

The approach proposed in this article will resolve the tension among these three interests.

A. The Interest of Shareholder Democracy (First Fundamental Interest)

Many forms of Government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of Government except all those other forms that have been tried from time to time.

—WINSTON CHURCHILL⁶⁰

A common foundation underlies both U.S. corporate law and society—that of *representative democracy*.⁶¹ This form of governance reconciles twin countervailing constraints. The first is that a large organization cannot function if managed directly in all respects by all its members. Thus, a government, a committee or a board is necessary for the "representative" function of the representative democracy. The opposite constraint is that the members should

57. *Id.*

58. *Id.* The other reason for retaining the directors used by the court (directors' vote to reelect themselves) appears invalid. See *infra* notes 138-44 and accompanying text.

59. See *Demoulas v. Demoulas*, No. CIV.A.90-2344, 1996 WL 511519, at *7 (Mass. Super. Ct. Oct. 1, 1996). The court, however, did not weigh the interests of the corporation versus the interests of the market or other interests. Indeed, while the court claimed to be protecting the interests of the corporation, it in fact was protecting the interests of certain shareholders. For a discussion of this issue, see *infra* note 79.

60. WINSTON CHURCHILL, *SPEECH IN THE HOUSE OF COMMONS* (Nov. 11, 1947), reprinted in 7 WINSTON S. CHURCHILL: *HIS COMPLETE SPEECHES 1897-1963*, at 7566 (Robert Rhodes James ed., 1974).

61. For a critical approach to the analogy between modern public corporations and democratic institutions, see Stephen M. Bainbridge, *Revisiting the One Share/One Vote Controversy: The Exchanges' Uniform Voting Rights Policy*, 22 SEC. REG. L.J. 175, 200-05 (1994). This criticism, however, is directed mostly at an analogy drawn between corporate democracy and direct, rather than representative, democracy.

participate in governing the organization to the extent necessary to ensure that their representatives serve the interests of the organization and its members. This is the "democracy" component of the representative democracy.

Corporate democracy is not unassailable. Critics of the concept have claimed that shareholders are largely apathetic voters, so that a "democratic" process in fact leads to the undemocratic result of self-controlling boards.⁶² While such criticism may be deserved, it constitutes insufficient grounds to invalidate the existing system of corporate governance. Indeed, the intimate involvement of shareholders in the corporate affairs of close corporations negates any claim of shareholder apathy. Moreover, in public corporations, shareholder apathy is mitigated by the recent trend of increased involvement of institutional investors in corporate governance.⁶³ In addition, the market for corporate control is predicated on shareholder voting.⁶⁴

Further, the system of corporate democracy rests on the principle that individuals are the best judges of their interests. This is the fundamental tenet upon which any market economy is based. Abdication of this principle would lead to corporate control mechanisms inconsistent with a market economy. In an extreme case, such an abandonment could imply transferring the functions of the corporate electorate to a regulatory authority such as the Securities and Exchange Commission. This seemingly absurd scenario is not the science fiction of corporate law: it has been tried in socialist economies and has failed. Thus, although less than ideal, corporate democracy should be entitled to share Churchill's indulgence of political democracy as being preferable to its alternatives.⁶⁵

Shareholder voting is one of the very few ways in which shareholders engage in corporate democracy.⁶⁶ This is perhaps the main reason why corporate law is generally very respectful of the

62. See, e.g., Christopher Stanley, *Corporate Personality and Capitalist Relations: A Critical Analysis of the Artifice of Company Law*, 19 CAMBRIAN L. REV. 97, 106 (1988); Harold Marsh, Jr., *If It Ain't Broke, Don't Fix It*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 293, 294 (Donald E. Schwartz ed., 1979).

63. See *infra* note 117 and accompanying text.

64. According to many scholars, the market for corporate control functions to reduce agency costs and improve the efficiency of corporations by replacing underperforming management. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 715-16 (1982); Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1672 (1985).

65. See *supra* text accompanying note 60.

66. In a representative democracy, the connection (or dividing line) between the representatives and the represented implies the existence of residual selection, policy-setting, ratifying, or monitoring powers in the principal-agent relationship. See Buxbaum, *supra* note 64, at 1671. These powers are exercised by shareholder voting. *Id.*

precept that electing and removing directors is an inherent right of shareholders.⁶⁷ By electing a director and not removing him after allegations of a misdeed, shareholders could be indicating a preference to keep the director. This indication is reinforced if shareholders actually reelect the director.

Should shareholders' rights to remove directors be honored even when directors have engaged in gross misconduct? Some may say that doing so would be tantamount to granting such directors a license to steal—a socially unwelcome concept and one that is seemingly incompatible with proper corporate governance. Others may assert that “nothing is wrong” with the judicial removal of misbehaving directors because under the criminal law a court may “remove” one guilty of gross violations all the way to prison.⁶⁸ Such arguments for removal go right to the heart of the removal remedy, to the very “Why?” of it. They would have merit if the removal remedy were designed primarily to punish and deter. If the remedy is not designed for this purpose (and Section C of this Part will argue that it is not), these arguments ring hollow.

If the goal of the remedy is instead to protect a corporation from misbehaving directors, and the corporation's owners have chosen not to exercise their power to “protect” the corporation in such a manner, then why should the court deny shareholders their right to chart for themselves the best course for their corporation by voting for or against removal?⁶⁹ It is their corporation, after all.

67. See, e.g., *Auer v. Dressel*, 118 N.E.2d 590, 593 (N.Y. 1954) (stating that stockholders who are empowered to elect directors have the inherent power to remove them for cause); *Ross Sys. Corp. v. Ross*, No. CIV.A.10378, 1993 WL 49778, at *17-18 (Del. Ch. Feb. 22, 1993) (stating that only shareholders—not courts—are empowered to remove a director). For a description of many other authorities for the courts' recognition of shareholders' inherent powers to elect and remove directors, see *Davis*, *supra* note 4.

68. See, e.g., *Barnard*, *supra* note 11.

There is nothing inherently “wrong” and certainly nothing unconstitutional, in the notion that a court, even in a civil case, may deprive a defendant of his means of livelihood. The constitution does not guarantee that a person can have the job of his choice, or even work in the profession of his choice. While the “right to practice one's profession is . . . precious,” it is by no means inviolate, as may be seen in any regulated profession for which barriers to entry have been established and upheld, or in any case in which a professional's license is revoked.

Id. at 46-47. Professor Barnard, however, criticizes the removal provisions in the Remedies Act on other grounds.

69. The role of shareholders as the corporation's owners who have an inherent right to elect and remove directors is somewhat undermined by the phenomenon of separation of ownership and voting rights in corporations. For an explanation of this phenomenon, see *infra* notes 121-23. If directors' misbehavior harms the corporation, but those with power to remove the directors fail to act because their voting rights are not connected to ownership interests in the corporation, the circumstances could justify a finding of a

Indeed, when courts interfere with corporate governance by removing duly elected directors, the intrusion may be more fundamental than a court's intervention in corporate affairs through a typical derivative action. A successful derivative action interferes with corporate authority—that of the board—by bypassing the board and advancing a claim to which the corporation is a party. In achieving the enforcement of a corporate contract, for example, the derivative action may cause only an external change to the corporation, leaving the essential corporate structure intact. Courts invariably exercise restraint in making such an external change if the board is capable of making the change itself.⁷⁰

By contrast, a successful judicial removal of directors interferes with corporate democracy by affecting the process by which shareholders elect their representatives. In exercising the removal remedy, the court usurps the shareholders' prerogative by disregarding the results of democratic elections and taking the liberty of revoking shareholders' representatives. More importantly, the removal effects an internal structural change within the corporation. In altering the composition of the authoritative body elected through corporate democracy and modifying the corporate bargain,⁷¹ the

"divergence of interests impairment" to shareholder voting and subsequent removal. See *infra* Part II.B.2. In the event directors' misbehavior harms a particular class of shareholders who have substantial ownership rights but not the corresponding voting rights (such as preferred shareholders), such misbehavior could be addressed by a different removal remedy. See *infra* note 79. Some further special tailoring of applicable rules might be necessary to effect removal where there is a profound separation of ownership and control.

70. This is the essence of the business judgement rule. For a description of the business judgement rule, see *infra* note 275 and accompanying text.

71. The contractual approach to corporate law (where a corporation is viewed as a "nexus of contracts") is widely accepted. For an overview of the discussion on this topic, see Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); see also William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982); Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984). But for recent critical theories, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989). The contractual approach has been used to justify contractual freedom of the parties in corporate law. See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

Why do investors entrust such stupendous sums to managers whose acts are essentially unconstrained by legal rules? The answers lie in, and help explain, the economic structure of corporate law. The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all; hence the 'enabling' structure of corporate law.

internal change may affect all corporate actions, not just one, and is more lasting and troubling than the external one.⁷² Thus, courts should exercise at least the same restraint in making the internal change as they do in making the external one.

One may take the position that such an internal change is beneficial to the corporation and that shareholders should be grateful to the court for performing the unpleasant task of removing a misbehaving director. This position, however, assumes that shareholders would have answered "I surely would" to the question of whether they would have removed the director for misconduct.

But would they? One author has argued that shareholders would not vote to retain a director or officer after they became aware that he violated securities laws, even if the corporation enjoyed a short-term benefit from the violation.⁷³ If this were true, then there would be even less reason for shareholders to retain a director who defrauded the corporation. However, there is precedent to show that dozens of directorial candidates each year disclose various misdeeds, such as indictment for money laundering, and that even corporate boards (which are expected to be wiser than shareholders) with full knowledge of managers' misdeeds reappoint managers guilty of tax evasion, forgery, and embezzlement at the companies where they served in a fiduciary capacity.⁷⁴ Nor is this phenomenon unknown in the political arena.⁷⁵

Shareholders may desire to retain a guilty director for the same legitimate reason that a court may decline to remove him: retaining

Id. at 1418.

72. In addition, voting rights may have value to shareholders. If so, an undue limitation on voting rights in the form of the judicial removal of directors may not be consistent with shareholders' wealth maximization as the main objective of corporate law. Voting rights might even be considered "property." See *United States v. Local 560 of Int'l Bhd. of Teamsters*, 780 F.2d 267, 281-82 (3d Cir. 1985) (holding that union members' right to elect their representatives is "property," the extortion of which may be in violation of the Hobbs Act), *cert. denied*, 476 U.S. 1740 (1986).

73. See W. Hardy Callcott, *Patterns of SEC Enforcement under the 1990 Remedies Act: Officer-And-Director Bars*, 21 SEC. REG. L.J. 347, 370 (1994).

74. See Jayne W. Barnard, *When is a Corporate Executive "Substantially Unfit to Serve"?*, 70 N.C. L. REV. 1489, 1500 (1992).

75. In 1998, polls showed a significant (almost 40%!) disparity between public belief in President Clinton's honesty and his job approval ratings. Commentators have attributed the President's high job approval ratings to the strong economy and have concluded that perceptions of honesty and personal integrity are not critical factors driving public opinion regarding whether or not the President should resign. See, e.g., David S. Broder and Claudia Deane, *Poll: Clinton Critics More Likely to Vote; But Public's Support for President, Disdain for Investigation May Trouble House GOP*, WASH. POST, Sept. 30, 1998, at A6; Will Lester, *Clinton's Job-Approval Rating Stays Above the Chaos Below*, ASSOCIATED PRESS, Sept. 14, 1998; Warren P. Strobel, *Experts Tie Clinton's Ratings to Healthy Economy*, WASH. TIMES, Aug. 6, 1998, at A13.

the director may be in the best interests of the corporation. Indeed, courts have recognized that there may be circumstances in which a director's managerial talents outweigh an instance of dishonesty.⁷⁶ Whether in making such a calculation or otherwise, however, shareholders may legitimately understand the best interests of the corporation differently than the court. More importantly, shareholders have no duty to justify their choice, and are free to endorse a dishonest director because of their forgiving nature, the director's charisma, or other idiosyncratic reasons not apparent to the court.

Courts, therefore, should exercise restraint in removing directors. Indeed, the reluctance of courts to use the removal remedy absent statutory authorization and the establishment of a high behavioral threshold for directors' removal in corporate statutes should probably be attributed to judicial and legislative respect for the shareholders' inherent right to elect and remove directors.

B. Balance Between the Interest of the Corporation (Second Fundamental Interest) and the Prerogatives of its Owners

Lex semper dabit remedium.

—ROMAN ADAGE⁷⁷

(1) Interests of the Corporation as the Removal Remedy's Raison d'Etre

The need to protect the interests of the corporation from directorial⁷⁸ wrongdoing is the removal remedy's *raison d'être*. Of the

76. In *Remillard Brick Co. v. Remillard-Dandini Co.*, the court decided that while directors made improper profits in self-interested transactions, they could remain directors subject to the return of profits because they have demonstrated managerial ability. 241 P.2d 66, 77 (Cal. Ct. App. 1952). For a more detailed description, see *supra* notes 55-58 and accompanying text.

77. "The law will always give a remedy." BLACK'S LAW DICTIONARY 913 (6th ed. 1990).

78. While an individual director has fewer opportunities to inflict harm upon a corporation than does an officer, the harm that he can inflict is not negligible. In particular, directorial misbehavior can manifest itself in actions that are not the subject of informed decisions by the board of directors as a whole. Such actions might include misappropriation of corporate opportunities and various forms of self-dealing, failure to disclose conflicts of interests when a decision is submitted for consideration by the board, or disclosure of confidential information to third parties. While some of the same offenses can also be committed by officers and other employees, such employees can be terminated immediately upon the revelation of their misbehavior. Directors, however, cannot be removed without coordinated shareholder action. Hence the need to protect corporate interests through the judicial removal remedy. As to the balance between shareholder prerogative to remove and the need to protect the interests of the corporation, see *infra* Part II.B.2-3. In addition, in close corporations directors often perform the functions of officers, or hold positions as directors and officers simultaneously, thus having even

reasons to pursue a removal remedy in the face of shareholder inaction, upholding the interests of the corporation is the most intuitive, the most frequently used, and the most congruent with the goals of other corporate law remedies.⁷⁹ It is also a necessary condition to judicial removal under the Model Act and most of the removal statutes.⁸⁰

The interests of the corporation imply maximizing corporate profits. Determining whether a particular course of action is in the corporation's interests requires an analysis of whether the many repercussions of such a course of action will on balance contribute to maximize the profits of the corporation. In the context of removal, the principle of profit maximization means that if a director has special qualities that outweigh an instance of misconduct, his removal

greater opportunities for abuse. The analysis proposed in this article applies not only to directors, but also to officers who are elected directly by shareholders.

79. A possible avenue for the expansion of the removal remedy would be its application to situations where the director's wrongdoing is directed against some of the shareholders, rather than the corporation itself. Such a new remedy, however, should be subject to different rules, because it would be designed to address a different wrong.

The court in *Demoulas v. Demoulas* attempted to use the existing remedy for such a different injury. No. CIV.A.90-2344, 1996 WL 511519 (Mass. Super. Ct. Aug. 20, 1996). The court endorsed the goal of upholding the interests of the corporation in order to justify directorial removal, but interpreted corporate interests in an original way. The fraud at issue included redemption of some shareholders' stock in breach of the director's fiduciary duty and other similar stock manipulations. The director defrauded only certain shareholders, rather than the corporation itself. While recognizing the managerial abilities of the defendant director, the court announced that "it goes without saying that the best interests of a closely held family corporation cannot be advanced by a director who defrauds its shareholders." *Id.* at *8. As is often the case with such reasoning, it does not go without saying. Would the same reasoning apply if the director defrauded a 1% shareholder and the latter lost \$500, but the director maximizes corporate profits and \$1,000,000 of such profits are attributable to the director's activities? Could the interests of a public, as opposed to a close, corporation be advanced by a director who defrauds its shareholders? The court's justification of removal is appealing on an emotional level but intellectually troubling. The court was trying to stretch the interests of the corporation to accommodate the interests of some of its shareholders in order to avoid resolving the conflict between such interests.

The rules applicable to a removal remedy designed to protect the interests of a particular shareholder would be different. Such rules would need to reflect an appropriate balance between the shareholders' prerogative to remove directors, the interests of the corporation, the interests of a particular shareholder, and possible public policy interests. Since the injury would be suffered by a particular shareholder, the action brought by such a shareholder would be direct, rather than derivative, and the board should not have the right, *see infra* Part III.B, to preclude the advancement of such an action.

For a brief discussion regarding the use of the removal remedy to protect the interests of the corporation's creditors, employees and other corporate constituencies, *see infra* note 167.

80. *See, e.g.*, MODEL BUS. CORP. ACT ANN. § 8.09(a)(2) (Supp. 1997); ALA. CODE § 10-2B-8.09(a)(2) (1994).

would be against corporate interests. If, however, the director does not have such redeeming characteristics (as is more often the case), the corporation's interests require removing the director to protect the corporation from his continuing abuse.⁸¹

While the removal remedy overlaps slightly with other remedies in the courts' arsenal, it is by no means redundant.⁸² The other two main remedies that address similar wrongs and are intended to have a comparable effect are the appointment of a receiver for the corporation in the absence of insolvency⁸³ and an injunction restraining directors from taking certain actions.⁸⁴

The appointment of a receiver for the corporation has the effect of removing the entire board of directors and is usually labeled by courts as a "harsh measure" and "a remedy of last resort,"⁸⁵ to be used "only in a clear case of extreme necessity."⁸⁶ According to one court, "[A] receivership is the most drastic remedy and the most expensive luxury known to the realm of law."⁸⁷ In certain circumstances, for instance where only one director engaged in

81. The interests of the corporation generally coincide with shareholders' collective interests, assuming the shareholders' equal treatment and not taking into account any illegal or inappropriate benefits a particular shareholder may derive from the corporation. The board of directors is entrusted with the responsibility of determining and pursuing corporate interests. See *infra* Part III.B. For a description of the interests of the corporation's creditors, employees and other parties that have a stake in the corporation's well-being, see *infra* note 167.

82. Judicial removal is referred to in this article as a "removal remedy." In essence, the removal remedy is as much a right as it is a remedy. Perhaps it is a "remedial right"—this is how at least one author at the turn of the century termed certain remedies in the corporate context. See Augustus H. Fenn, *The Remedial Rights of Corporations Against Their Directors*, 3 YALE L.J. 111 (1894). Not all remedies in corporate law could be named "remedial rights." For the distinction between the appraisal remedy and the underlying shareholders' right to dissent, see H. Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985).

83. This remedy should be distinguished from the appointment of receivers for an insolvent corporation and receivers for certain assets of a corporation, but not the corporation as such. For a discussion regarding different types of receivers, see 16 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 7665-66 (1998).

84. For a general overview of most judicially imposed remedies used in corporate law, see ALFRED F. CONARD, CORPORATIONS IN PERSPECTIVE 379-415 (1976); see also 1 F. HODGE O'NEAL AND ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS, § 3:15 (2d ed. 1985); DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW & PRACTICE § 7:06 (1994).

85. 16 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7671 (1998) (citing *Mayhue v. Mayhue*, 485 A.2d 494 (Pa. Super. Ct. 1984)). For an overview of courts' reasoning with respect to appointments of receivers, see *Morse v. Metro. S.S. Co.*, 100 A. 219 (N.J. Ch. 1917).

86. *Youngstown Sheet & Tube Co. v. Patterson-Emerson-Comstock*, 227 F. Supp. 208, 216 (N.D. Ind. 1963).

87. *Furrer v. Nebraska Bldg. & Inv. Co.*, 189 N.W. 359, 364 (Neb. 1922).

misbehavior, appointing a receiver and thereby effectively replacing the entire board may be excessive, and removing only the misbehaving director would be a more appropriate cure.⁸⁸ Appointing a receiver can also have unwanted side effects, such as an adverse reaction on the part of customers and suppliers who refuse to do business with the corporation on the same favorable basis.⁸⁹

Although appointing a receiver is a more drastic remedy than removing a director, courts have exhibited confidence in their power to invoke it.⁹⁰ A more narrowly targeted, less expensive and less extreme removal remedy, however, is not always authorized by statute. In such circumstances, courts feel more comfortable either imposing an overly-inclusive, counter-productive remedy simply because it is authorized by law⁹¹ or denying the appropriate remedy only because it is not.⁹² Neither result is constructive.

While appointing a receiver may be an overinclusive remedy, an injunction may have the opposite drawback of being underinclusive. Injunctions are generally narrowly targeted at preventing specific transactions or actions from occurring.⁹³ An unusually broad injunction, which would have the effect of suspending a director from office for the remainder of his tenure, would be necessary to prevent general fraud and abuse by the director.⁹⁴ Accordingly, certain courts

88. In *Cumberland Publishing Co. v. Adams Real Estate Corp.*, 432 S.W.2d 808, 813 (Ky. Ct. App. 1968), the court reversed the appointment of a receiver even though the court acknowledged that majority shareholder's conduct was "tantamount to a fraud upon the minority stockholder." The court's position was that receivership should be denied where another adequate, less severe remedy is available. The alternative remedies suggested by the court, however, did not include removal of directors, possibly because no such remedy was authorized by the state statute.

89. For the negative consequences of appointing a receiver for a solvent corporation, see Steven C. Bahls, *Resolving Shareholder Dissention: Selection of the Appropriate Equitable Remedy*, 15 J. CORP. L. 285, 309 (1990).

90. See, e.g., *Cumberland Publ'g Co. v. Adams Real Estate Corp.*, 432 S.W.2d 808 (Ky. Ct. App. 1968) (reversing trial court's appointment of receiver). See *supra* note 88 for a complete description.

91. See *id.*

92. See *Ross Sys. Corp. v. Ross*, No. CIV.A.10378, 1993 WL 49778, at *17-18 (Del. Ch. Feb. 22, 1993). For a description, see *supra* notes 23-26 and accompanying text.

93. See 1 DAN B. DOBBS, *LAW OF REMEDIES* 223-26 (2d ed. 1993). Structural injunctions may be an exception to this rule. See *id.* at 225-26 (referring also to OWEN FISS, *THE CIVIL RIGHTS INJUNCTION* (1978)).

94. Sometimes courts do make strenuous attempts to address such behavior through injunctions. For instance, the court in *Management Technologies, Inc. v. Morris* held that it was unable to remove a director in a suit brought by the chief executive officer of the corporation in the absence of a statutory provision that the corporation itself may bring a removal action. The court then enjoined the director from entering the premises of the corporation absent prior written consent of the other directors or the chief executive officer, but clarified that the injunction did not extend to the director's attendance of

have taken the position that in the absence of statutory authorization to exercise removal, they cannot do indirectly what may not be done directly, and on that basis have refused to grant injunctions.⁹⁵ Thus, in a situation where there is a need to prevent a director from exercising his duties for an extended period of time, applying the removal remedy would be a more logical solution than stretching the injunction beyond its usual confines.

Certainly, the removal remedy is not intended to serve as a substitute for directors' liability (such as the return of an improper financial benefit or the payment of damages) for wrongful actions, but rather as a supplemental remedy that could accompany a suit for damages against a director⁹⁶ as well as be invoked independently. In the absence of the removal remedy, directors' financial liability may not always be a sufficient cure, since it addresses past wrongs on a case-by-case basis instead of preventing future abuse.⁹⁷ Perhaps the judicial removal remedy is not a panacea for directorial misbehavior. It does, however, preclude future wrongdoing by physically detaching the director from the position which enables him to indulge in abuse.⁹⁸ The removal remedy does not have the ambition of being

board meetings or discharging his duties as director. *Management Techs., Inc. v. Morris*, 961 F. Supp. 640, 650-52 (S.D.N.Y. 1997).

95. See *Bayless v. Orne*, 1 Free. Ch. 161, 176 (Miss. Ch. 1840) (holding that the court could not suspend an officer indefinitely and thus do indirectly that which may not be done directly); *Harkey v. Mobley*, 552 S.W.2d 79, 81 (Mo. Ct. App. 1977) (holding that courts do not have power, absent statutory authority, to grant injunctions restraining directors and officers from performing their corporate duties since this would have the same effect as removal).

96. Indeed, a suit for judicial removal is usually coupled with a suit for damages or disgorgement of profits. See, e.g., *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. Ct. App. 1952).

97. The argument that the deterrent effect of suits aspiring to impose financial liability on directors is ample and thus directors do not need to be removed since they will voluntarily stop misbehaving if caught once is not sustainable. The fact that not every instance of misbehavior would necessarily be detected and successfully litigated undermines the deterrence value of directors' financial liability. The imposition of punitive damages would be required in order to make a genuine quantitative difference in deterring directorial misbehavior. However, punitive damages are not used in actions against directors. See John C. Coffee, Jr., *Derivative Litigation under Part VII of the ALI Principles of Corporate Governance: A Review of the Positions and Premises*, in AMERICAN LAW INSTITUTE - AMERICAN BAR ASSOCIATION CONTINUING LEGAL EDUCATION, November 1995, at 237, 269, available in Westlaw, CA 53 ALI-ABA 237, 269. They are very rarely used against individuals in general. See E. Donald Elliott, *Why Punitive Damages Don't Deter Corporate Misconduct Effectively*, 40 ALA. L. REV. 1053, 1069 (1989); see also *infra* note 98.

98. Even in the law of tort, where punitive damages (unknown in suits against corporate directors) are employed precisely in order to achieve a higher level of deterrence, there is a consensus that there may be cases where an injunction as a means to prevent or interrupt the wrong may be a necessary remedy. The removal remedy operates

exclusive and can co-exist with any other remedies shareholders or the corporation may have.⁹⁹

Federal law has also given the judicial removal remedy sister removal remedies, in particular in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act")¹⁰⁰ and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA").¹⁰¹ However, because such remedies are exercised by federal agencies outside of the context of corporate law, they are not a substitute for the judicial removal remedy discussed in this article.¹⁰²

as the injunction equivalent in the corporate law context, where injunctions themselves may be ineffective. *See supra* notes 93-95 and accompanying text.

99. Certainly, a shareholder in a public corporation may simply sell his shares, and a shareholder in a close corporation may require the corporation to choose between dissolution and purchasing the shareholder's shares at fair value. *See* MODEL BUS. CORP. ACT ANN. §§ 14.30, 14.34 (Supp. 1997); *see also* J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977). However, the fact that a shareholder can leave does not mean that leaving should be his only option. The "love it or leave it" rationale is usually used in marriage (and partnership) rather than in a corporation. For an extended discussion on the "love it or leave it" concept, *see* Saul Levmore, *Love It or Leave It: Property Rules, Liability Rules, and Exclusivity of Remedies in Partnership and Marriage*, LAW & CONTEMP. PROBS. 221 (1995). Aggrieved shareholders may not necessarily want to leave the corporation. They may, for example, think that the price of their shares has been negatively affected by the director's misbehavior. In addition, confining the options of the shareholders opposing wrongdoing to exiting the corporation would effectively give carte blanche and even an incentive to abusive directors (and shareholders who elected them) to squeeze out minority shareholders. Therefore, the shareholders' right to leave the corporation does not render other corporate law remedies, judicial removal among them, dispensable.

100. Pub. L. No. 101-429, 104 Stat. 931 (codified at 15 U.S.C. §§ 77t(e), 78u(d)(2) (1994)).

101. Pub. L. No. 101-73, 103 Stat. 183 (1989).

102. Thus, the federal removal remedies will not be examined here, except where occasional analogies are warranted. The removal remedies in the Remedies Act and FIRREA extend well beyond those in state corporate statutes. The Remedies Act makes numerous powerful changes to the federal securities laws, including reaffirming the authority of the federal courts, in connection with injunctive actions brought by the Securities and Exchange Commission, to issue orders that prohibit an individual from serving either temporarily or permanently as an officer or director of publicly-held companies if such an individual violates either Section 17(a)(1) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934. For a general discussion of the Remedies Act, *see* Matthew S. Morris, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: By Keeping Up with the Joneses, the SEC's Enforcement Arsenal is Modernized*, 7 ADMIN. L.J. AM. U. 151 (1993). The Financial Institutions Supervisory Act of 1966 (FISA) granted sweeping powers to certain federal banking agencies to suspend and remove bank officials, in order to protect the interests of the federally insured depository banking system. These powers were significantly fortified and expanded by the enactment of FIRREA in the wake of the savings and loan disaster. FIRREA provides that once an official is removed from his position, he is automatically

Hence the removal remedy is not superfluous in light of other existing judicial remedies. Could it be superfluous in light of the shareholders' right to remove directors? The key question is: *Why should the court decide for shareholders what is in the best interests of the corporation, depriving them of the opportunity to decide for themselves?* As a RULE, it should not.¹⁰³

As an EXCEPTION to this rule, however, shareholder prerogative to remove directors should yield to the interests of the corporation where shareholders' inherent rights to remove are meaningless or have been subject to abuse. This Section suggests that there are two such situations of "impairment" to removal by shareholders that may justify a court's intervention and overruling of shareholders' choice to ignore or condone directorial misconduct.

(2) *"Divergence of Interests Impairment" to Removal by Shareholders*

The Official Comment to the Model Act uses the following example to illustrate the need for a judicial removal remedy:

In a closely held corporation, the director charged with misconduct is elected by voting group¹⁰⁴ or cumulative voting,¹⁰⁵ and the shareholders with the power to prevent his removal exercise that power despite the existence of fraudulent or dishonest conduct. The classic case is where the director charged with misconduct himself possesses sufficient votes to prevent his own removal and exercises his voting power to that end.¹⁰⁶

The description in the Official Comment captures typical removal cases involving fraud and dishonesty.¹⁰⁷ However, the same concern is applicable to a broader spectrum of cases. For example, in

subject to a total ban from the insured depository industry. For a general discussion of the removal remedy in FIRREA, see Robert J. Basil, *Suspension and Removal of Bank Officials under the Financial Institutions Reform Recovery and Enforcement Act of 1989* ("FIRREA"), 18 J. LEGIS. 1 (1991).

103. See the reasons set forth in *supra* Part II.A.

104. The term "voting group" is used in the Model Act to indicate a class of shares that has the right to vote separately from other classes on certain matters. See MODEL BUS. CORP. ACT ANN. § 1.40(26) (Supp. 1997).

105. Cumulative voting is a system whereby a shareholder may apply all its votes to vote for one candidate or spread them among several candidates. See, e.g., MODEL BUS. CORP. ACT ANN. § 7.28 (Supp. 1997). This system allows certain minority shareholders (who have a substantial amount, but not a majority, of votes) to have a guaranteed seat (or seats) on the board of directors.

106. MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997). A similar reason was advanced in the Senate's report in support of the Remedies Act: "[P]ublic shareholders may lack sufficient control to remove securities law violators from office or otherwise to protect their own interests." S. REP. NO. 101-337, at 22 (1990).

107. See, e.g., *Ross Sys. Corp. v. Ross*, No. CIV.A.10378, 1993 WL 49778, at *17-18 (Del. Ch. Feb. 22, 1993). For a description of *Ross*, see *supra* notes 23-26 and accompanying text.

Markovitz v. Markovitz,¹⁰⁸ the court found that Victor, a young and inexperienced director, harassed his fellow colleagues, employees and customers:

He became the shadow of . . . the general manager, standing beside him and humiliating him while he was transacting business with the employees and customers; . . . demoralizing the office force by making absurd requests for detailed information which he already possessed; . . . and making himself so personally objectionable to the officers, employees and customers of the company that its interests were jeopardized, and the morale of the organization . . . was impaired.¹⁰⁹

Although the plaintiffs held the majority of shares in the corporation, they could not remove Victor because the minority shareholders had elected him in exercise of their right to elect two directors out of five by cumulative voting.¹¹⁰ The minority shareholders apparently did not want to remove Victor from his directorship position because they were part of one family (Victor's mother, his brother, and Victor himself).¹¹¹ The court removed Victor from his position as a director and barred him from reelection for a period of two years.¹¹²

The above examples mask the existence of a more general, yet unarticulated, reason behind a shareholder's reluctance to remove a director. In such situations, the interests of an individual shareholder as an individual and as a shareholder diverge, thus impairing his willingness to remove a director. I call this occurrence the "divergence of interests impairment" to the removal of directors, to distinguish it from the conflict of interests concept widely applied in corporate law.¹¹³

Corporate law views shareholders as "owners" of the corporation.¹¹⁴ Since the best interests of a corporation imply maximization of corporate profits, stockholders' interests taken as a whole and those of the corporation should coincide and shareholders

108. 8 A.2d. 46 (Pa. 1939).

109. *Id.* at 47.

110. *See id.*

111. *See id.*

112. *See id.* at 48.

113. The notion of "divergence of interests" proposed here is broader than that of "conflict of interests" in that the latter implies the existence of a duty owed by the conflicted party, whereas shareholders generally owe no duty when they vote. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW 141 (1986); HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 637-44 (1983); BLACK'S LAW DICTIONARY 299 (6th ed. 1990).

114. *See, e.g.*, HENN & ALEXANDER, *supra* note 113, at 491 ("Inherent then in the corporate setup is the idea that shareholders 'own' the corporation, but the board of directors manages it.").

should be interested in increasing the corporation's profits.¹¹⁵ However, a particular shareholder would not necessarily be interested in increasing corporate profits to share them eventually with other shareholders, when the alternative is to divert a larger share of profits directly into that shareholder's pocket.¹¹⁶

Directorial election provides certain stockholders with such an opportunity. When a shareholder holds a substantial enough voting power in the company, it has the ability to elect "its" representatives to the board.¹¹⁷ This situation creates a temptation for the shareholder to elect a director who would act in the interest of his elector at the expense of the corporation. Indeed, conspiracies between shareholders and directors to take advantage of a corporation are not unknown. For example, in *Atkins v. Hughes*,¹¹⁸ the trial court found that the majority shareholders conspired to elect directors who were under their influence.¹¹⁹ The intent and purpose of the conspiracy was the adoption of resolutions by directors approving a construction project for the benefit of such majority shareholders, but at the cost and expense of the corporation.¹²⁰

The potential for abuse of voting powers is augmented by the delegation of shareholders' voting power to third parties, whether temporarily or permanently,¹²¹ and the existence of shares bearing voting rights that do not correspond to the underlying economic

115. Economists have even used this understanding of the shareholders' interest in increasing their corporation's profits as an argument in favor of expanding shareholders' role in the management of the corporation. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

116. Conflicts of interest between a shareholder and a corporation manifest themselves in various ways. One of them involves frivolous suits leading to collusive settlements. See, e.g., Franklin A. Gevurtz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits*, 46 U. PITT. L. REV. 265, 287-97 (1985). See also *infra* notes 202-06 and accompanying text.

117. The instances of use of such power by shareholders are expanding. For examples of such recent attempts on the part of institutional investors, see Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 842 (1992). In some other countries, this is a well established tradition. See generally Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993).

118. 282 P. 787 (Cal. 1929).

119. *Id.* at 789.

120. See *id.*

121. This is achieved by rules permitting irrevocable powers of attorney, see, e.g., MODEL BUS. CORP. ACT ANN. § 7.22 (Supp. 1997), voting trusts contemplating the transfer of shares by shareholders to a trustee who is authorized to vote the shares on their behalf (§ 7.30), and voting or shareholder agreements whereby shareholders agree on the manner in which they will vote their shares (§§ 7.31, 7.32). Where this article refers to shareholders, such reference also encompasses, when applicable, shareholder appointees.

interests.¹²² These phenomena further widen the gap between the interests of the corporation and the interests of those who elect directors, thus seducing shareholder-director blocks into maximizing their own profits instead of the profits of the corporation.¹²³

The divergence of interests impairment can also manifest itself in other ways. Investors who fear losing corporate business have been known to adopt a pro-management bias that may result in their reluctance to vote for removal of directors.¹²⁴ There are other reasons why shareholders may wish to keep a culpable director even when financial benefit is not at issue, for example when the director is a relative or a friend.¹²⁵

When the potential for a divergence of interests exists, corporate law usually employs four main prophylactic or mitigating devices. First, certain persons are excluded from decision-making in conflict of interests situations. Thus, interested directors or shareholders are prohibited from voting with respect to a transaction where their interest in the corporation's well-being may be compromised.¹²⁶ Second, the decision-making process is shared among different levels. Officers, directors, and, with respect to certain critical decisions, shareholders, may have separate or joint rights to approve actions of importance to the corporation.¹²⁷ This power-sharing feature, by

122. For criticism of such separation of vote and ownership, see Louis Lowenstein, *Efficient Market Theory: Let the Punishment Fit the Crime*, 51 WASH. & LEE L. REV. 925, 940 (1994) and Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, in CORPORATE LAW AND ECONOMIC ANALYSIS 74-117 (Lucian Arye Bebchuk ed., 1990). For an approach defending such a rule, see Bainbridge, *supra* note 61, at 175-219.

123. For the possible hazards of "opting out" of voting rights, see Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1709 (1989). For an application of the removal remedy to situations where there is a gap between ownership and voting rights in corporations, see *supra* note 69.

124. Professor Black provides examples of how institutional investors that develop an anti-manager reputation may lose corporate business or find it harder to gain new business. He points out that such conflicts lead some institutions to vote pro-manager even when doing so is likely to decrease company value. See Black, *supra* note 117, at 826. See also Bernard S. Black and John C. Coffee, Jr., *Hail Britannia? Institutional Investor Behavior under Limited Regulation*, 92 MICH. L. REV. 2059-61 (1997) (describing a similar occurrence of compromised loyalty of institutional investors in the United Kingdom).

125. See *Markovitz v. Markovitz*, 8 A.2d 46 (Pa. 1939). It is obvious from the facts of the case that the director who was manifestly abusing a corporation was not removed because he was a family member of the shareholders who elected him. For a more detailed description, see *supra* notes 108-111 and accompanying text.

126. See, e.g., DEL. BUS. CORP. LAW § 144; see generally Kenneth B. Davis, Jr., *Approval by Disinterested Directors*, 20 J. CORP. L. 215 (1995).

127. See, e.g., HENN & ALEXANDER, *supra* note 113, § 180 at 466. The authors suggest that the distribution of management functions within a corporation is even more comprehensive: "Various functions in the organization and management of corporations

providing a system of checks and balances, can lower the likelihood of both poor and self-interested decisions. Third, where exclusion from decision-making or sharing of responsibility is impossible or insufficient, the law imposes a duty on the actors. Hence, directors have fiduciary duties to the corporation and shareholders, and even controlling shareholders have been held to owe duties to minority shareholders in some circumstances.¹²⁸ Finally, a derivative action can provide a check on the board's decisions.¹²⁹ Although these devices provide important controls necessary to ensure efficient corporate governance, they are not employed in the context of the corporate election and removal process.

Moreover, in their zealous protection of shareholder prerogatives, corporate law rules have the unfortunate side effect of creating an environment so conducive to self-interested voting as to invite corruption.¹³⁰ Not only is an "interested" shareholder permitted to elect "its" directors, but majority shareholders are expected to elect their representatives through the "one share-one vote" rule and minority shareholders are encouraged to do the same through cumulative voting.¹³¹ The mechanism of cumulative voting permits the election of shareholders' "own" representatives on the board regardless of how the votes of other shareholders are cast and expands the divergence of interests hazard to minority shareholders in addition to controlling shareholders.¹³² In addition, shareholders are permitted to elect their personal representatives via voting trusts and voting agreements.¹³³ Thus, a particular shareholder may be the

are performed by: (a) promoters, (b) incorporators, (c) subscribers, (d) shareholders, (e) directors, (f) officers, (g) other employees and agents, and occasionally (h) creditors." *Id.* at 466-67.

128. See, e.g., ROBERT CHARLES CLARK, CORPORATE LAW § 4.1 at 141 (1986). Professors Easterbrook and Fischel described this third device as follows: "The fiduciary principle is an alternative to direct monitoring. It replaces prior supervision with deterrence, much as the criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks." See Easterbrook & Fischel, *supra* note 64, at 702. They further state that such principles act "as a standard-form penalty clause in every agency contract." *Id.*

129. For a description of a derivative action, see *supra* note 33.

130. Encouragement of self-interested shareholder voting is intentional on the theory that individuals are the best judges of their own self-interest and pursuit of their own self-interest will result in the optimal allocation of resources. This system, however, does not take into account the possible abuse of such right to the detriment of others. See *supra* note 116 and accompanying text.

131. For a description of cumulative voting, see *supra* note 105.

132. For example, in *Markovitz v. Markovitz*, 8 A.2d 46 (Pa. 1939), the minority shareholders (who had elected the misbehaving director by cumulative voting) were blocking his removal. For a description of *Markovitz*, see *supra* notes 108-111 and accompanying text.

133. For a description of voting trusts and voting agreements, see *supra* note 121.

only actor with the power to elect and remove a particular director. No system of checks and balances exists in the corporate election and removal process. Moreover, shareholders have no duty either to elect directors who would best serve the corporation or to remove those who are harmful, and they are free to exercise their election right without justification or accountability.¹³⁴

The first three "anti-conflict" devices described above could not be introduced into the shareholder voting process without changing the fundamental principles of corporate law.¹³⁵ In contrast, the judicial removal of directors in narrowly defined circumstances could constitute a more focused corrective step which would not be unduly intrusive to the existing system of corporate governance. This step would provide a "check" on shareholders' decisions parallel to that placed on board decisions by derivative actions.

Some courts fail to recognize the divergence of interests impairment in removal cases and as a consequence adopt erroneous decisions.¹³⁶ Others reach correct results but decline to develop a theory for future use by courts.¹³⁷ As a result, the proper limits of corporate democracy in divergence of interests situations remain undefined.

In the *Remillard Brick* case,¹³⁸ the California Court of Appeal first correctly upheld a finding that two directors guilty of fraud were required to disgorge their ill-gotten profits.¹³⁹ Surprisingly, however, while also upholding the decision of the trial court that refused to remove the directors, the appellate court stated that the two directors

134. Certainly, directors do have fiduciary duties. However, the effectiveness of a duty depends upon the remedies that are available in the event it is breached. Absent a removal remedy, an offending director would be able to continue abuse even if sued for damages inflicted by some of his prior actions. See *supra* note 97 and accompanying text.

135. In addition, implementation of these measures is hardly feasible as a practical matter. For example, it is hard to imagine how "interested" shareholders could be excluded from voting for potentially unscrupulous candidates before their misconduct becomes apparent.

136. See *infra* notes 138-42 and accompanying text.

137. For example, the appeal court in *Brown v. North Ventura Road Development Co.* saw the shareholder's conflict of interest:

Whether the "stockholders" . . . be regarded as consisting only of the three incorporators, or whether they consisted (as we hold below) of the persons to whom shares were ultimately to be issued, it is clear that, over the opposition of plaintiff, the majority required by section 810 could not have existed.

30 Cal. Rptr. 568, 571 n.2 (Cal. Ct. App. 1963). However, the appellate court, affirming the removal of the director for misconduct, appears to contemplate that such removal would be effective only until the director was "properly elected." *Id.* No theory was developed by the court to support its *ad hoc* reasoning.

138. *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 73-76 (Cal. Ct. App. 1952).

139. *Id.*

"not only are directors of the manufacturing companies, but are [their] managing officers, and, for all practical purposes, control and have a contract to purchase five-eighths of the outstanding stock."¹⁴⁰ Thus, the court recognized that the directors had in effect elected themselves.¹⁴¹ It is obvious from the facts of the case that in the directors' reelections the minority shareholder who owned the only stock not controlled by the two directors did not vote for these particular directors.¹⁴² The court, however, adhered to the formal rule that a director shall not be removed for acts committed during his term of office if he is subsequently reelected.¹⁴³ In so holding, the court in effect decided that the directors' self-reelection in a situation where they had defrauded the corporation should be regarded as an acceptable exercise of corporate democracy immunizing them from liability.

When corporate democracy suffers a total breakdown because of self-interest and fraud, why should it be protected? This is the critical question that the *Remillard Brick* court failed not only to answer, but even to ask. By blindly following rules designed to preserve shareholder prerogatives, the court preserved abuse. While the outcome of the *Remillard Brick* case could perhaps be justified on the grounds that the directors demonstrated managerial ability,¹⁴⁴ the case nevertheless highlights the need to disregard corporate democracy and the import of judicial review when interested shareholders control the corporate election and removal process. Courts should disregard shareholder decisions to prevent removal or reelect directors when effected solely by the interested shareholders, if the interests of the corporation call for removal.¹⁴⁵

Because circumstances where controlling shareholders are affected by divergence of interests present the opportunity for recurring abuse, such situations may justify bars on reelection of guilty directors. In *Atkins v. Hughes*, the court found directors guilty of "fraud so apparent and manifest that it is unnecessary to go into any lengthy details . . . for so holding."¹⁴⁶ The two directors passed on to the corporation the construction costs for the water facilities for the private use of only two shareholders and misappropriated other

140. *Id.* at 77.

141. *See id.*

142. *See id.* at 68. This minority shareholder was the plaintiff in the case.

143. *See id.* at 77.

144. *Id.* at 76. For a description of the issue, see *supra* notes 58-59 and accompanying text.

145. Such cases should parallel the review of decisions of the board of directors that are tainted by conflicts of interest. *See infra* note 262 and accompanying text.

146. 282 P. 787, 790 (Cal. 1929). For details, see *supra* notes 118-120 and accompanying text.

funds from the company.¹⁴⁷ The court found more than a divergence of interests with respect to the two shareholders: it found a conspiracy between these shareholders and directors to take advantage of the corporation.¹⁴⁸ In these circumstances, removing these directors and barring their reelection appear to be not only appropriate, but necessary. However, while the trial court ordered the removal of the directors, it did not impose a bar on their reelection.¹⁴⁹ Apparently, the same two shareholders continued to reelect the same two directors (one of whom was himself one of these shareholders and the other of whom was fully dominated by them) annually.¹⁵⁰

The effect of divergence of interests impairment can still be cured if a majority of the shareholders that are not affected by divergence of interests impairment affirmatively decide, in accord with the interested shareholders, to retain or re-elect the misbehaving director. In this situation, a court's interference in internal corporate affairs by removing a director would be inappropriate.¹⁵¹

147. *See id.* at 789-90.

148. *See id.* at 789.

149. *See id.* at 787.

150. This follows from the appellate decision stating that because the defendant directors had been reelected twice, the removal issue became moot. *See id.* The court also noted that "being the owners of a majority of the capital stock, [the directors] were able to control the election of the board of directors." *Id.* at 790.

151. If the effect of the divergence of interests impairment can be cured before a judicial decision, in theory it could also be cured after such a decision, if disinterested shareholders later decide to reelect the director. Removal rules perhaps should take this possibility into account. For example, a court could prohibit counting the interested shareholder's vote to reelect the subject director (who was proven guilty of misbehavior), but stop short of an outright and absolute bar on reelecting him. To be effective, such a prohibition would need to be crafted to anticipate the possibility that the interested shareholder could transfer its shares to an equally-interested affiliate or another entity under its control. Otherwise, the outright bar on re-election has the benefit of being more difficult to circumvent. Such a bar could still be evaded if a shareholder who was previously in conspiracy with the misbehaving director would simply elect another misbehaving director. This scenario, however, assumes the unlimited supply of potential directors willing to engage in abuse. The removal remedy is certainly not designed to deal with organized crime. Outside this context, however, the possibility of a mischievous shareholder finding another director-wrongdoer, while conceivable, should not be taken for granted. Finding another director-wrongdoer is generally more difficult than using an affiliate dominated by the same shareholder, since only an individual could be a director, while an affiliate may be an *alter ego* of the same shareholder. Theoretically, the most effective remedy would probably be directed at the shareholder rather than only at the director and might involve a prohibition on the exercise of voting rights by the particular shareholder and his affiliates. Such a wide prohibition, however, would be a drastic remedy perhaps amounting to an expropriation.

(3) "Procedural Impairment" to Removal by Shareholders

Shareholder failure to remove a culpable director does not necessarily reflect an affirmative desire of the shareholders to retain such a director. Rather, stockholders may sometimes be procedurally handicapped from removing a director, even in the absence of an interested shareholder who controls the voting.

The Official Comment to the Model Act gives the following example of a situation calling for a removal remedy:

In a publicly held corporation, the director charged with misconduct declines to resign, though urged to do so, and because of the large number of widely scattered shareholders, a special shareholders' meeting can be held only after a period of delay and at considerable expense.¹⁵²

A recent New York case, *Management Technologies, Inc. v. Morris*,¹⁵³ illustrates this situation. Management Technologies, Inc. is a public corporation whose shares are traded on NASDAQ. Two of the directors allegedly were trying to put the company's offshore subsidiaries into bankruptcy in order to purchase their assets themselves at a discount.¹⁵⁴ Apparently, shareholders could not promptly remove these directors because the shareholders' meeting could not be scheduled immediately.¹⁵⁵ The court did not remove the directors due to the deficiency of the statutory provision.¹⁵⁶ In another case, *California Fruit Growers' Ass'n v. Superior Court*,¹⁵⁷ plaintiff shareholders claimed that most of the corporation's stock was fraudulently issued by the defendant directors. The court held that the removal of the directors by the shareholders was impracticable until the validity of the outstanding stock was determined.¹⁵⁸

152. MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997).

153. *Management Techs., Inc. v. Morris*, 961 F. Supp. 640, 650 (S.D.N.Y. 1997). For more details, see *infra* notes 159, 257-59 and accompanying text.

154. *Management Techs.*, 961 F. Supp. at 643.

155. *See id.* at 645.

156. *See id.* at 650. The court instead imposed an injunction restraining the directors from taking certain specific actions. *See id.* at 652.

157. *California Fruit Growers' Ass'n v. Superior Court*, 97 P. 769 (Cal. Ct. App. 1908).

158. The court in *California Fruit Growers* held: "The facts alleged were such as to develop the impracticability of effecting the removal... for until the validity of the outstanding stock was determined it would not be possible for the stockholders to correct the evils through the provisions relating to the removal and election of directors." *Id.* at 770. While it is easy to see why it would be "impracticable" to effect removal until the validity of the outstanding stock is determined, it is not clear whether the court's statement that the removal "would not be possible" implies an unstated concern about the situation where directors holding the stock (allegedly invalidly issued) would have the ability to prevent their own removal. If so, the case should fall instead into the "divergence of interests impairment" category, since a possible subsequent determination

These examples demonstrate that even if the democratic process within a corporation is not necessarily flawed during the election, it can be thwarted afterwards. This phenomenon may be called "procedural impairment" to the removal of directors by shareholders. A procedural impairment is caused by practical obstacles that are beyond the shareholders' immediate control and that prevent them from exercising their removal rights. Such an impairment constitutes a classic "If I only could" situation.

In such instances, it may be preferable to allow the court to second-guess the shareholders' preferences rather than allow dishonest directors to continue to serve unchallenged. The courts should draw a line separating "procedural impairment" from the normal operation of a corporation. At one end of the spectrum, procedural impairment could be said almost never to exist, absent highly unusual circumstances. At the other end of the spectrum, it could be said to exist in every public corporation whenever the annual meeting is far in the future. In fact, the example offered by the Official Comment to the Model Act seems to suggest such an approach.¹⁵⁹ While this approach may seem (and perhaps is) radical, it is not as groundbreaking and paternalistic as it initially appears. The law has long recognized the need for filling vacancies on the

that the outstanding stock was in fact validly issued would not cure such impairment to removal. The court's decision in favor of appointment of a receiver *ex parte* may support such a classification. *See id.*

159. MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997); *see also supra* note 106 and accompanying text. One may wonder whether a suit brought by a shareholder could be resolved before the next shareholder meeting. However, lawmakers' skepticism regarding the inefficiencies of the enforcement system should not be a ground for flatly depriving a plaintiff of the opportunity to assess for himself the rapidity of different methods of achieving the desired result, based on the particular circumstances. Further, while the court may always dismiss a case if it becomes moot, it is not a given that the procedural impairment will resolve itself before the court has time to act. Such an action by a court does not necessarily have to be a final decision. The filing of a lawsuit could provide a basis for a preliminary injunction suspending the director from performing his duties. While the need for such injunctions has occurred in practice, in the absence of a statutory authorization for removal, courts have been reluctant to grant injunctions (including preliminary injunctions) that would be tantamount to removal. *See, e.g., Management Techs.*, 961 F. Supp. at 640, 645 (granting a preliminary injunction restricting the directors' authority in several respects on April 21, 1997, when the shareholders' meeting was scheduled to take place on June 30, 1997, but refusing to remove the director or to grant a broader preliminary injunction due to the lack of statutory authorization for judicial removal). For a description of the case, *see infra* notes 257-59 and accompanying text. *See also supra* notes 93-95 and accompanying text.

The concern that the issue may become moot is not present in the divergence of interests impairment scenarios, because even if a director has been reelected before the court is able to consider the dispute, such a reelection should not prevent the director's subsequent removal and the imposition of a bar on his reelection.

board of directors to avoid the expense of a special shareholders' meeting.¹⁶⁰

Unlike "divergence of interests impairment," "procedural impairment" constitutes an impediment to the operation, rather than the substance, of corporate democracy, and as such is a more temporary phenomenon. Within one corporation, it may exist half a year before an annual meeting, but may attenuate as the meeting approaches. Thus, the corporate election process deserves greater respect in "procedural impairment" situations than in those of "divergence of interests impairment" and should prevail more often over judicial desire to determine independently what constitutes the best interests of the corporation.

Procedural impairment can be cured by the affirmative action of the shareholders. The reelection or retention of a director by shareholders who are apprised of the director's misbehavior should preclude judicial interference. Unlike divergence of interests impairment scenarios, a bar on reelection is unjustified in procedural impairment situations.

**C. Weighing the Interest of the Market (Third Fundamental Interest)
Against the Interests of a Corporation and the Inherent Rights of Its
Owners**

Le poids ne se sent fort que dans la balance.

—MALCOLM DE CHAZAL¹⁶¹

(1) Deterrence in Its Own Right

The interests of the corporation and those of the market are the two possible rival motivations for the judicial removal of directors.¹⁶² While removal to uphold the interests of the corporation is conducive to market-related interests, removal to pursue solely the interests of the market, on the contrary, presents a significant threat to the interests of the corporation. The tension between these two goals is best illustrated by the following question: Are there policy reasons to remove a director even in disregard of the corporation's best interests? The answer to this question may have a significant impact on the analysis of the removal remedy. If the interests of the market are sufficiently compelling to justify removal, perhaps neither

160. See, e.g., N.Y. BUS. CORP. LAW § 705(a).

161. "The weight's heft is proven upon the scale." Malcolm de Chazal, *Poèmes*, in LAROUSSE DES CITATIONS FRANÇAISES ET ÉTRANGÈRES 127 (1976).

162. The interests of corporations other than the one where removal takes place and of investors in such corporations are subsumed under the term "the interests of the market" for purposes of this discussion.

shareholders nor the board should have a say in removal proceedings, because neither group could be expected to act willingly contrary to its own and the corporation's interests in order to support a broader policy goal.

Indeed, shareholders do not have a say in every judicial action that may affect their voting rights. The removal remedy does not exist in a remedial vacuum. Other remedies enable courts to eliminate directors for different types of misconduct offending public policy, such as remedies targeting violations of securities laws, tax fraud or other crime.¹⁶³ The "elimination" itself may take different forms, from removal or even a permanent bar from occupying managerial positions at any public company to imprisonment.¹⁶⁴ In such instances, interests outside the corporation (such as interests of the state or the securities market) have been infringed upon, the action is usually initiated by a governmental agency, and shareholders must simply accept the consequences of the action in pursuit of a public goal.¹⁶⁵

By contrast, the removal remedy discussed in this article is designed to address misbehavior "with respect to the corporation,"¹⁶⁶ that is, wrongdoing from which only the corporation at issue and its shareholders as a group suffer, rather than the market, the environment or society in general.¹⁶⁷ Such a removal remedy is a

163. See *supra* note 102.

164. *Id.*

165. This was the rationale underlying the Remedies Act, which was designed to protect the interests of the market and shareholders in general, rather than only a particular corporation and its shareholders. The scenario where shareholders benefit from a director's wrongdoing was advanced as one of the justifications in support of the director removal and bar in the context of the Remedies Act. See Callcott, *supra* note 73, at 357, 370 (discussing, and disagreeing with, the Senate Report on the Remedies Act, S. Rep. No. 101-337, at 21 (1990)).

166. MODEL BUS. CORP. ACT ANN. § 8.09(a)(1) (Supp. 1997).

167. One might argue that the corporation's creditors, employees or other parties could be hurt by directorial misbehavior, and that such misbehavior may therefore become a public policy concern. However, such arguments would refer to a different wrong inflicted upon such parties directly rather than upon the corporation, and thus to a separate, even if similar, remedy. One might also argue that, in light of the trend in corporate law to recognize that the corporation's creditors, employees and others (collectively termed "other corporate constituencies") have a certain stake in corporate well-being, such parties should have a right to initiate removal actions. For a description of the "other corporate constituencies" phenomenon, see *infra* note 237. However, such other corporate constituencies do not have the right to participate in corporate governance by the traditional means of voting to elect and remove directors. Nor are they allowed to bring derivative actions on behalf of the corporation, whether against directors or otherwise. Their special interests are protected by different remedies (for example, fraudulent conveyance statutes and preferences in bankruptcy). Thus, overemphasizing the rights of such other corporate constituencies in the context of a removal action is unwarranted.

product of corporate, rather than securities, environmental or other law. Accordingly, the award of the removal remedy logically should only benefit the corporation and its shareholders.¹⁶⁸

Were the imposition of the removal remedy notwithstanding the interests of the corporation also to have a significant positive impact on the market, however, the removal remedy could perhaps mutate from a remedy for the benefit of a particular victim corporation to a remedy designed to serve a broader public goal of upholding the interests of the market. The latter remedy would then be indifferent to the interests of the particular corporation.

The interests of the market must be identified before they can be pursued. An argument could be advanced that removing a misbehaving director would promote investors' confidence in the integrity of the market, even if such removal harms the corporation itself.¹⁶⁹ This could be a valid reason only if the retention of misbehaving directors, when dictated by the corporation's interests and consistent with the shareholders' will, would nevertheless be disturbing for investors in the market. However, rational investors may perceive removal as a double-edged sword and weigh the obscure benefits of policing corporations in general against the drawbacks of judicial infringement upon the investors' voting rights in corporations in which they have invested and upon the interests of such corporations.¹⁷⁰ As a result of such a calculation, investors would be more likely to resent, rather than welcome, judicial removal of a director where the interests of the corporation require his retention, unless such removal offers tangible benefits to the investors in the way of deterrence. Thus, the application of the removal remedy notwithstanding the interests of the corporation may undermine, rather than support, investors' confidence in the market.¹⁷¹

168. In addition, relying on plaintiff shareholders as private attorneys general to guard the interests of the market while injuring their own corporation may present a serious collusive settlement problem similar to the one widely observed in the context of derivative actions. See *infra* notes 204-06 and accompanying text.

169. A rationale for supporting investors' confidence in the integrity of the market was stated in the ALI Principles with respect to derivative actions. See ALI PRINCIPLES, *supra* note 6, § 7.10 cmt. d. For an overview and critical discussion of the arguments leading to the adoption of such a public policy rationale in the ALI Principles, see MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 346-49 (1995).

170. See *supra* Part II.B.

171. While punishment of wrongdoers might be seen as another possible reason for removing directors, this reason has been largely avoided outside the province of criminal law. For the rejection of punishment as one of the justifications for punitive damages in tort cases, see Thomas C. Galligan, Jr., *Augmented Awards: The Efficient Evolution of Punitive Damages*, 51 LA. L. REV. 3 (1990). For the distinction between the objectives of

Deterrence of directorial misconduct is a more concrete potential interest of the market, and the one that has been advocated in the context of derivative actions. Proponents of the deterrent function of derivative actions justify pursuing such actions for deterrent purposes even where the action involves a net loss to the corporation.¹⁷² They draw analogies between the deterrent purpose of criminal law and that of a derivative action to support a conclusion that the interests of the corporation are not paramount in a derivative action,¹⁷³ while critics of this approach accuse its proponents of unjustifiably assuming that corporations have no internal mechanism to deter misbehavior,¹⁷⁴ or characterize the pursuit of deterrence as the imposition of a "litigation tax" on the corporation.¹⁷⁵ This Section will review the merits of deterrence as a possible objective of the removal remedy and will conclude that because the deterrent effect of the removal remedy is in all probability low and in any event unproven, the deterrent goal should not trump the interests of the corporation or the prerogatives of its shareholders.

In order to draw a meaningful distinction between the concepts of the interests of the corporation and deterrence, it is necessary to differentiate between deterrence in its general sense, where misdeeds are deterred in corporations on an industry or market level, and a more restrictive sense, where directorial misbehavior is deterred in the corporation where the removal remedy is sought. Indeed, the latter, more narrow type of deterrence can be subsumed under the "interests of the corporation" concept, because deterrence within the

deterrence and punishment, see Gary T. Schwartz, *Deterrence and Punishment in the Common Law of Punitive Damages: A Comment*, 56 S. CAL. L. REV. 133 (1982).

172. See John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 286-87 (1981); Coffee, *supra* note 97, at 263. But see Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 539-40 (1989). A net loss occurs when the corporation's direct and indirect litigation costs exceed the benefits to the corporation in whose name the action is brought. Because litigation costs in such actions are paid by the corporation, these costs are a benchmark against which the benefits to the corporation are assessed. Since plaintiffs in derivative actions usually seek the recovery of damages or disgorgement of profits, possible recovery is easily measurable and allows a comparison with expected litigation costs for purposes of determining whether pursuing the action would be in the interests of the corporation. For an interesting proposal for reform suggesting that a more important role be given to the corporation's interests in derivative suits, see Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994).

173. See Coffee, *supra* note 97, at 263.

174. See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (arguing that most monitoring takes place internally by the board and by management itself).

175. See Dooley & Veasey, *supra* note 172, at 539.

corporation is generally in the corporation's best interests.¹⁷⁶ In contrast, deterrence in the abstract sense could be pursued independently of the corporation's interests and even to the detriment of such interests,¹⁷⁷ for example by removing a director

176. The court in *Markovitz v. Markovitz* removed a director in order to improve the atmosphere in the company (interests of the corporation) and deter the defendant from misbehavior if ever elected again as a director of the same company (essentially also in the interests of the corporation). "[The period of the bar] will undoubtedly afford a reasonable time for the existing friction and dissention to disappear, and will serve as a warning that a repetition of such misconduct, while acting as a director of the corporation, may afford in the future grounds for further disqualification to hold the office." *Markovitz v. Markovitz*, 8 A.2d 46, 48 (Pa. 1939).

177. The proponents of the deterrence objective of derivative actions argue that the goal of deterrence should trump the interests of the corporation. See *supra* notes 172-173 and accompanying text.

Courts have sometimes favored public policy objectives to the detriment of the interests of the corporation in certain specific circumstances related to derivative actions. Such circumstances, however, are only marginally, if at all, relevant to removal actions. For example, a public policy rationale was allowed to prevail over the interests of the corporation in narrow circumstances where the majority of the board was interested in a transaction ("demand excused" situations) in a test set forth in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). The court in *Zapata* established the principle that in certain circumstances, courts may look beyond the board's decision and apply a public policy analysis to decide whether to pursue a derivative claim. *Id.* at 789. In *Zapata*, an independent committee of the board followed all the procedures prescribed by law and determined that the pursuit of the derivative litigation at issue would not be in the best interests of the corporation. *Id.* at 781. The court established a two-prong test. The first prong requires an inquiry into the independence and good faith of the committee and the bases supporting its conclusions. If the court is satisfied that the committee's decision was taken appropriately, it may proceed to the second prong and apply its own business judgment as to whether to dismiss the case. See *id.* at 789. In doing so, the court may consider matters of law and public policy in addition to the corporation's best interests, and balance legitimate corporate claims as expressed in a shareholder suit against the corporation's interest as expressed in the findings of the committee. See *id.* at 788-89. While the court does not specifically list deterrence as an appropriate matter of public policy, one may expect that it would qualify as such. Some commentators have viewed *Zapata* as one of the decisions recognizing the deterrent impact of derivative action. See Alex Elson & Michael L. Shakman, *The ALI Principles of Corporate Governance: A Tainted Process and a Flawed Product*, 49 BUS. LAW. 1761, 1789 (1994). The *Zapata* case, however, is inapplicable to removal actions in general because it applies solely to narrow "demand excused" situations.

Another example where a shareholder action advancing a policy objective has been permitted to proceed in disregard of the interests of the corporation is found in early court decisions addressing specific instances of criminal violations by a corporation. Such decisions granted relief even when the criminal conduct was not contrary to the interests of the corporation. For example, in *Roth v. Abrams*, an amusement park bribed individuals who threatened to prevent the park from operating in violation of state Sunday closing laws. 118 N.Y.S. 351 (N.Y. Sup. Ct. 1909). Although the park benefited from this arrangement, the court upheld judgment against the park on the grounds that the bribe not only violated a criminal statute, but affronted the business community's moral standards. See *id.* at 353. In another case, *Abrams v. Allen*, the court suggested that in a

who once has succumbed to an improper temptation and caused an insignificant harm to the corporation, but who over the course of his tenure has benefited the corporation overall.¹⁷⁸ Therefore, this Section will discuss deterrence in its broad sense only.

(2) *Deterrence Formula*

Any consideration of whether a deterrent rationale can support a removal action will depend on the effectiveness of such an action as a deterrent.¹⁷⁹ No empirical studies are available to show the deterrent effect of removal actions. However, studies that have been conducted in the context of derivative litigation, which also often addresses directorial misbehavior, show that the deterrent effect of shareholder actions is difficult to ascertain.¹⁸⁰ Some commentators highlight methodological and statistical barriers to collecting relevant evidence, acknowledging that the known data fail to measure the deterrent value of derivative suits.¹⁸¹ The proponents of the deterrence

case where a corporation dismantled and removed its plants to punish employee efforts to organize unions, illegal conduct alone would be sufficient to find its perpetrator liable. 74 N.E.2d 305, 306 (N.Y. 1947). Under the prevailing rule today, however, a plaintiff in a derivative suit must establish not only that a knowing criminal act caused an economic loss to the corporation, but also that the resulting loss exceeded the competitive benefits gained through the violation. See generally James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 764-75 (1985) (criticizing the early cases for reflecting a philosophy that a deterrence objective should predominate where a compensatory purpose is lacking). The preference of courts for a public policy rationale in the criminal violation context does not apply to removal actions. Assuming deviations from the modern "benefits to the corporation" rule may be justified on the basis that shareholders themselves should not benefit from illegal activity, this justification is absent in a removal case because the basis for judicial removal at the request of a shareholder is misbehavior with respect to the corporation, from which misbehavior shareholders presumably suffer rather than benefit.

178. For the details of this example, see *supra* notes 58-59 and accompanying text.

179. Other areas of law, especially those contemplating liability, call for similar inquiries. See, e.g., Mark F. Grady, *A New Positive Economic Theory of Negligence*, 92 YALE L.J. 799, 800 (1983) (stating that the positive theory must ascertain which liability rules minimize social cost and whether the actual liability rules that courts employ do so).

180. The two most sophisticated and famous studies on the empirical effects of derivative suits on corporate performance have been conducted by Professors Fischel and Bradley and, more recently, by Professor Roberta Romano. See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991) (challenging the assumption that shareholder derivative suits have a deterrent effect); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986).

181. For a discussion, see Larry E. Ribstein, *Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies under the ALI Proposals: Law and Economics*, 71 CORNELL L. REV. 357, 373-81 (1986). Also, according to Professor Demsetz:

Stock prices should fall when a court dismisses a derivative suit if such dismissals cause investors to revise their earnings expectations downward. However, the

objective of derivative actions admit that deterrence is difficult to assess,¹⁸² but argue that the fact that the deterrent effect cannot be proven by empirical evidence does not mean it does not exist. Their opponents counter that if the deterrence effect cannot be proven, the law should not assume its existence.¹⁸³ In the absence of empirical evidence showing the effectiveness of the removal remedy as a deterrent, a theoretical examination of the issue is warranted.

In order to analyze the deterrent effect of removal actions, the components of deterrence must be identified. In general, the deterrent effect of a legal action depends on its ability to raise the cost of the undesirable behavior to the defendant (that is, the "penalty," whatever form it takes) and the probability that the defendant will have to incur this cost (that is, the probability that the defendant will be caught, sued and forced to pay the penalty). This relationship can be expressed algebraically as follows. GC ("general cost") is the cost of the defendant's behavior to the plaintiff and other parties injured by the behavior, DC ("defendant cost") is the cost of the behavior imposed on the defendant, and P ("probability") is the probability that the defendant will incur the defendant cost. To achieve an optimal level of deterrence, the general cost of the defendant's behavior should equal the cost imposed on the defendant multiplied by the probability that the defendant will incur such cost:¹⁸⁴

dismissal should not necessarily be linked to a downward revision in expected earnings. The suit may be ill-founded, or it may be a nuisance suit, in which case its dismissal may lead investors to revise their earnings expectations upward. . . . An assessment of the impact of the dismissal of a derivative suit on earnings expectations is difficult to make absent some basis for judging the validity of the suit.

Harold Demsetz, *A Commentary on Liability Rules and the Derivative Suit in Corporate Law*, 71 CORNELL L. REV. 352, 353-54 (1986).

182. See Coffee, *supra* note 97, at 263, 267-68.

183. See Dooley, *supra* note 32, at 509-12.

184. Variations of the same formula apply to other areas of law. Such deterrence calculus with respect to criminal law was set forth in Gary S. Becker, *Crime and Punishment, An Economic Approach*, 76 J. POL. ECON. 169, 178-79 (the number of offenses is a function of the probability of conviction per offense and the punishment per offense; other factors were also mentioned). Professor Elliott points out swiftness as another important factor increasing the deterrent effect of sanctions in criminal law. See Elliott, *supra* note 97, at 1062-63 (1989) (referring to J. WILTON & R. HERRNSTEIN, *CRIME AND HUMAN NATURE* 397-401 (1985)). With respect to efficient violations (such as negligence), under Judge Hand's formula, the expected loss (probability of occurrence times cost) should equal the cost of loss avoidance. See *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947). For an illustration of Judge Hand's formula, see Dorsey D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1, 23-33 (1982).

$$GC = P \times DC^{185}$$

To the extent the product of "defendant cost" multiplied by "probability" is lower than "general cost," underdeterrence will occur. Conversely, overdeterrence will result if the product of this multiplication exceeds "general cost."¹⁸⁶

(3) "*P*": the "Probability" Parameter of the Deterrence Formula

Detecting, catching, and convicting wrongdoers (or, using the language of the deterrence formula, "imposing costs on the defendant") is never an easy task. Judging from the experience of derivative actions, this task is particularly difficult as applied to violations of the duty of loyalty by corporate directors, in contrast to lawsuits outside the ambit of corporate law. Removal actions face the same obstacles.

It is a consequence of the separation of ownership and control in a modern public corporation¹⁸⁷ that wrongs done to the corporation are more difficult to detect than those inflicted on victims in other areas. As a rule, even a moderately alert owner, simply in the course of "using" his property, is in a good position to notice damage to his property without exerting any special effort. A victim of a traffic accident or a crime can hardly ignore the effects of a collision or battery. Shareholders, however, being remote from their "property," do not have occasion to "use" it and thus may never detect damage

185. For instance, if the cost of a director's misbehavior to the corporation is \$1 million, and the probability of the director being caught and penalized is 0.2 (1 chance out of 5), then the penalty imposed on the director should be \$5 million: $\$1,000,000 = 0.2 \times \$5,000,000$. Alternatively, the probability of deterrence could be raised to keep the \$1 million balance.

186. The desirability of overdeterrence depends on whether or not the violation is efficient. As applied to efficient violations (i.e., useful but hazardous activity), overdeterrence is undesirable, since it causes actors to forego activities that have net social benefits: for instance, if people are overdeterred from driving too fast, too frequently, and too far, they may start driving too slowly, too infrequently, and not far enough. See David D. Haddock et al., *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 CAL. L. REV. 1, 8 (1990). Fraud and other gross misconduct by a director of a corporation, however, is an inefficient violation. For such violations, it has been said that "[i]f we are certain enough that some kinds of conduct are always inappropriate . . . no penalty is too high." FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 323 (1991). The authors, however, suggest two caveats for such a statement. First, the "if we are certain" portion of the statement must take into account the possibility of mistakes made in ascertaining that it was the defendant who committed the wrong. Second, the "no penalty is too high" portion may be an overstatement since, if a small lie is punishable by a large penalty, the wrongdoer may be inclined to tell a big lie instead. *Id.*

187. See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

inflicted upon the corporation by its directors.¹⁸⁸ Efficient market theory might suggest that stock price fluctuations would signal potential violations by corporate directors. However, a decrease in the price of the stock of a corporation may be attributable to a number of factors unrelated to the honesty or aptitude of its directors. A price decrease would form a poor pretext to call directors to account from an economic perspective and an even less adequate basis for a lawsuit from a legal standpoint.

Moreover, while the system of disclosure in U.S. companies is rather comprehensive,¹⁸⁹ the realities of modern stock portfolio ownership render a shareholder's knowledge of the affairs of any one corporation impracticable and make ignorance efficient even as applied to the reading of the materials for the annual shareholders' meeting received by mail and necessary for voting.¹⁹⁰ Since the desire of stockholders in public companies to review the annals of the corporation's management is doubtful even when those annals are brought to them on a silver platter, they cannot be expected to investigate vigorously possible violations by managers and directors. In addition, the law itself limits the right of shareholders to inspect corporate records, except for the most basic ones, by requiring a showing of "reasonable purpose."¹⁹¹ The impediment to deterrence in the form of a shareholders' "information deficiency" is magnified by the existence of information asymmetry vis-à-vis management, since "information efficient" wrongdoers, by virtue of their agency position, are well-placed to perpetuate an abuse.¹⁹² The invisibility of managerial abuse is the same whether the shareholder seeks removal of a director or some other remedy.

Even if a management violation were to become known to shareholders, they would be unlikely to bring an action. Most shareholders' stakes in a given public corporation are comparatively small, the "proceeds" for a shareholder seeking removal would be

188. The occasions when nobody knows about a violation lead to a phenomenon that has been termed "recurring wrongs." See generally Saul Levmore, *Probabilistic Recoveries, Restitution, and Recurring Wrongs*, 19 J. LEGAL STUD. 691 (1990).

189. See generally Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335 (1996).

190. See CLARK, *supra* note 128, §§ 9.5-9.5.3 at 389-94. Dean Clark describes three systematic difficulties pertinent to shareholders' collective action: the "rational apathy problem," the "free rider problem," and the "fairness problem." See also MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION* 18-29 (1976).

191. See, e.g., MODEL BUS. CORP. ACT ANN. § 16.02 (Supp. 1997).

192. For a discussion of information asymmetry, see Cox, *supra* note 177, at 747.

subject to dilution, and the shareholders' impetus to bring suit against a malefasant director should be commensurate.¹⁹³

In addition, a shareholder's unlikely desire to bring a removal action may be circumvented by hurdles the law has intentionally (and, in many respects, justifiably) placed in the path of derivative lawsuits mainly in order to preserve the authority of the board¹⁹⁴ and prevent strike suits.¹⁹⁵ These impediments include "security for expenses" statutes,¹⁹⁶ which require that a plaintiff post a bond for the payment of a successful defendant's expenses, the demand requirement,¹⁹⁷ where a suit's merit must be decided by the board before the plaintiff is allowed to proceed, the contemporaneous ownership rule,¹⁹⁸ which denies standing to sue to a plaintiff who was not a shareholder at the time the alleged wrong was committed, and the right of the board to dismiss derivative suits.¹⁹⁹ Under current removal statutes, a removal suit is free from these hurdles only if brought directly by a shareholder owning over 10% of shares.²⁰⁰ Besides the fact that the probability factor of a removal action is not likely to skyrocket as a result of suits brought by 10% shareholders, the 10% rule exists due to arbitrary statutory language rather than any substantive reason and could be (and should be) eliminated with the stroke of a pen.²⁰¹

Furthermore, and in apparent contrast to the considerations above, a successful plaintiff in a removal action (at least when brought as a derivative claim) will receive attorney's fees from the

193. For a description of the deterrence problem where there is "slight harm to many," see Thomas C. Galligan, Jr., *Augmented Awards: The Efficient Evolution of Punitive Damages*, 51 LA. L. REV. 3, 39 (1990). For a description of such problems in the context of corporate law, and for original solutions, see Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982). For a description of monitoring problems even on the part of institutional investors, see Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

194. The efficient management of the corporation demands freedom from the interference of manifold shareholders. According to Professor Dooley, the rules are designed to protect the authority of the board and thereby protect shareholders from themselves. See Dooley, *supra* note 32, at 470. See also *infra* notes 273-76 and accompanying text.

195. See *infra* note 249 and accompanying text.

196. *Id.*

197. See *infra* notes 260, 273 and accompanying text.

198. See, e.g., Gordon H. Pearce, *Recent Developments in the California Law of Shareholders' Derivative Suits*, 1 UCLA L. REV. 79 (1953) (discussing the reasons for adopting the contemporaneous ownership rule in California).

199. See *supra* note 266 and accompanying text.

200. See *supra* note 34, *infra* notes 244-46 and accompanying text.

201. See *infra* Part III.B for a discussion concluding that a removal suit brought by a 10% shareholder is a poor candidate for an unimpeded shareholder action.

company.²⁰² The prospect of receiving attorneys' fees gives an incentive to attorneys to induce shareholders to bring suits and removes the burden of litigation costs from the shoulders of the plaintiff shareholder.²⁰³ The derivative action would then seem to have the built-in potential to enforce the underlying legal rights of the corporation that the action seeks to redress. Unfortunately, however, this system in practice tends to operate more as an encouragement to bring frivolous suits and settle than as a brake on wrongdoing.²⁰⁴ The enthusiasm of zealous litigation attorneys in this regard has been frowned upon in legal academia.²⁰⁵ Proponents of the deterrence function of derivative actions view the problem of collusive settlements as one of the main barriers preventing the derivative action from serving as an effective deterrent.²⁰⁶

Admittedly, the above factors reducing the probability parameter of the deterrence equation are mitigated in the context of a close corporation. Unlike their counterparts in public corporations, shareholders in close corporations are more inclined to defend the interests of their corporation.²⁰⁷

However, an important factor reducing the probability of deterrence is shared by the shareholders in both public and close corporations. The removal remedy usually requires a showing of fraud and deception, rather than the more objective standard of self-dealing used in derivative actions for violation of the duty of loyalty.²⁰⁸ It is generally recognized that the elements of fraud are difficult to prove, and the need to assert fraud would discourage

202. Courts' treatment of removal actions for the purposes of awarding attorneys' fees has not been consistent. *See infra* note 244.

203. Litigation costs are instead borne by the shareholders as a class.

204. According to an empirical study conducted by Professor Romano, out of 128 resolved shareholders' suits (both direct and derivative, involving almost twenty percent of a randomly selected sample of over 500 public companies), 83 lawsuits settled. Only 11 derivative action settlements resulted in any monetary recovery, while attorneys' fees were awarded in 90% of settled cases. *See Romano, supra* note 180, at 59-64.

205. *See, e.g., Dooley, supra* note 32, at 509-12.

206. *See, e.g., Coffee & Schwartz, supra* note 172, at 326-27.

207. Shareholders in close corporations usually have better information with respect to the business of the corporation and a larger stake in it. In addition, they may be exempt from the legal impediments to bringing such actions. *See infra* note 246.

208. *See Tarin v. Pellonari*, 625 N.E.2d 739 (Ill. App. Ct. 1993). The court held that the elevated standard of clear and convincing evidence, rather than preponderance of the evidence (the usual standard for self-dealing), should be used in removal actions. In rejecting the plaintiff's claim that the directors should be removed because they engaged in self-dealing, the court announced: "Whether or not the defendants have engaged in self-dealing is not the relevant inquiry under this statute. The statute does not authorize the [trial] court to remove directors who engage in self-dealing; instead, it requires the trial court to find proof of fraud." *Id.* at 748.

potential removal action plaintiffs and reduce the probability parameter of the removal action even further.²⁰⁹

(4) "DC": the "Costs to Defendant" Parameter of the Deterrence Formula

Even with a low probability parameter, effective deterrence could still be achieved if costs to the defendant were high. However, this is not the case in removal actions. The relevant defendant costs in an action against a director are financial penalties, damage to reputation and social stigma.²¹⁰ The financial loss imposed by a successful removal action is limited to a loss of future director's fees. Further, unlike disgorgement of profits, the removal remedy is forward-looking and therefore the future loss of remuneration is partially compensated by future relief from the responsibilities and time commitment connected with directorship.²¹¹ Moreover, because most directors in public companies have a full-time occupation outside the corporation and frequently hold directorships in several companies,²¹² they do not rely on their positions as directors for income.²¹³

209. See, e.g., Ellis, *supra* note 184, at 25-26.

210. See Coffee, *supra* note 97, at 263; Elson & Shakman, *supra* note 177, at 1789.

211. This reasoning, however, has been rejected in a close corporation context by the court in *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976). The court held that majority shareholders in a close corporation against whom a minority shareholder brought action for breach of fiduciary duty when they removed him from his directorship and from his position as a salaried officer could not claim that the minority shareholder's damages should be diminished due to the fact that the majority shareholders or their representatives performed duties which had previously been performed by the minority shareholder. See *id.* at 664.

212. It has become a well-accepted practice in recent decades in public companies to form the majority of the board from outside directors, who by definition do not hold managerial positions in the corporation. The New York Stock Exchange and NASDAQ require a minimum of two directors independent of management for listed companies. The Corporate Director's Guidebook and the ALI Principles recommend that a majority of the board should be comprised of independent directors. See ALI PRINCIPLES, *supra* note 6, § 3A.01(a). See also W.F. Rockwell, *Putting the Knowledge and Know-How of Outside Directors to Work*, in THE CORPORATE DIRECTOR, NEW ROLES AND RESPONSIBILITIES 55 (1975).

213. This fact has caused fear that outside directors may simply be reluctant to serve as directors and has often been advanced as an argument in favor of limitation on liability of outside directors. See, e.g., Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 445 (1993). For an example of how easily outside directors resign and a relevant discussion, see Alfred F. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1472-75 (1984).

In a close corporation, directorial fees might constitute a greater source of income for a shareholder-director,²¹⁴ and the cost of removal could be higher for such a director. However, the cost to the defendant in removal actions involving both public and close corporations is limited by current corporate statutes, which do not grant courts the right to bar directors from occupying similar positions in other companies or different positions in the company from which they have been removed. Such a "universal bar" does exist in federal law, under which plaintiff government agencies such as the Securities and Exchange Commission may seek to bar individuals for life or for a definite period of time from officerships and directorships in public companies for serious violations of legislation they are charged with enforcing.²¹⁵

(5) *Frustration of the Deterrence Equation*

As demonstrated above, both the defendant cost and probability parameters of the deterrence equation are low in a removal action. Because both parameters are low, their product is too low to create a significant deterrent effect on directorial wrongdoing. Our deterrence equation in this case becomes an inequality:

$$GC > P \times DC$$

While this low level of deterrence is certainly regrettable on its face, it invites an inquiry into whether strengthening the right side of the inequality is justified.

By itself, an increase in the probability that a defendant will bear the costs associated with removal could have perverse results. If removal were perceived as a penalty that is not very costly, but frequent or easy to impose, a rational but dishonest director might believe that any misdeed, great or small, will lead to dismissal sooner or later. Therefore, such a director might be inclined to take advantage of an opportunity for quick enrichment and in general seek to derive as much profit as possible in his limited time at the

214. The consequences to a director might be more severe if he serves as both a director and officer of a single close corporation, and if his removal as a director also leads to his dismissal as an officer.

215. See Morris, *supra* note 102 (discussing the Remedies Act); Basil, *supra* note 102 (discussing FIRREA). The deterrent effect of the universal permanent bar was made clear by Judge Timbers in the famous Posner case: "The Posners seem to be shocked by what they see as the draconian remedy of eternal boardroom banishment. We intend our affirmation of Judge Pollack's judgment in this respect as a sharp warning to those who violate the securities laws that they face precisely such banishment." SEC v. Posner, 16 F.3d 520, 522 (2d Cir. 1994).

corporate trough, rather than hope for a longer tenure of more subdued wrongdoing.²¹⁶

Even if this scenario of rational corporate piracy were not borne out, mathematics teaches that if any quantity is multiplied by *zero*, the result is also *zero*, no matter how large the first number is. Accordingly, where the cost to the defendant is very small, as in the case of current removal statutes, efforts to increase the probability of successful removals will need to be colossal in order to achieve a meaningful level of deterrence. Yet because reinforcing the probability parameter by removing key and competent directors harms the corporation, zeal in such reinforcement is not appropriate.

An increase in the cost of removal to the defendant is another avenue for increasing the deterrent effect of the removal remedy. However, such a path is controversial in itself. It has been proposed that where the probability of imposing defendant cost is inherently low, higher penalties for violations are justified.²¹⁷ "Higher penalties" in the removal context are bound to emulate federal precedent and take the form of industry-wide bars, whether permanent or temporary. Yet these measures have been called "draconian" by both the defendant bar and the courts, and should therefore not be enacted lightly.²¹⁸ This is especially true in light of the fact that the removal remedy, even in its current form, is relatively new and insufficiently tested, and enhancing it with an industry-wide bar would be premature.²¹⁹ In addition, in cases of the most outrageous one-time violations, the deterrent effect of removal and bar may be completely undermined by the defendant's indifference to such penalties, even the highest ones.²²⁰

216. This is a mirror reflection of a behavioral pattern with respect to large penalties. As Professors Easterbrook and Fischel presented it, if a small lie is punishable by a large penalty, then this would encourage a big lie to be made too. See EASTERBROOK & FISCHEL, *supra* note 186, at 323.

217. For such a suggestion within the framework of corporate law, see Bernard Black and Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1972 (1996). The authors proposed introducing higher sanctions in emerging markets where enforcement is inherently low; however, due to other considerations, the authors did not include high penalties in the Russian Joint Stock Company Law that they drafted.

218. See *supra* note 215. Interestingly, parity with shareholders' removal rights was suggested as an argument for granting the Securities and Exchange Commission removal rights in the context of the Remedies Act. See Barnard, *supra* note 11, at 51. The same parity argument might be used to justify granting courts powers to impose a "universal bar" on directorships and officerships for misconduct with respect to a corporation at a shareholder's request.

219. For a powerful criticism of "universal bar" powers of the SEC under the Remedies Act, see Barnard, *supra* note 11, at 53-68.

220. It has been recognized that directors and officers who have a chance to achieve unprecedented wealth through a single misdeed have less concern for their continued

Because each instance of removal solely in pursuit of deterrence entails sacrificing the interests of the corporation, two factors need to be proven before a significant increase in the use of such a remedy solely to achieve deterrence would be warranted. First, compelling evidence would need to be shown that the removal action, armed with a deterrence goal, will indeed materially increase the deterrence of managerial violations.²²¹ No empirical evidence has proven such a deterrent effect. The above theoretical analysis demonstrates that such an effect is at best uncertain in the removal action.

While the deterrent effect of directorial removal in a close corporation may be higher than in a public corporation, its benefits do not necessarily outweigh its harm to the interests of a particular corporation. Indeed, the very reason the removal remedy may have a greater deterrent effect in close corporations is also responsible for depriving shareholders in such corporations of the benefits of deterrence. The reason for a possibly higher deterrent effect in close corporations is that shareholders typically hold a large stake in a particular close corporation and therefore have a greater interest in monitoring the corporation and pursuing litigation to remedy perceived wrongdoing. This type of shareholding is exclusive—shareholders do not hold a diversified portfolio of shares in close corporations (and to the extent they do, or to the extent shareholders in close corporations also hold shares of public corporations, they should be viewed as shareholders in public corporations for purposes of the deterrence analysis, since such diversification would reduce their interest in monitoring any specific corporation).

According to advocates of deterrence, the major benefit of disregarding the interests of the corporation in favor of deterrence is based on the phenomenon of diversification. These scholars argue that because shareholders typically hold diversified portfolios of stock in several companies, they benefit from a derivative action that deters potential wrongdoers at other companies even if the action involves a net loss to the particular corporation at issue.²²² Shareholders in close

affiliation with the firm that provided them with such a once-in-a-lifetime opportunity. See Cox, *supra* note 177, at 753-54. In general, market controls for corporate managers (such as the employment market, including the threat of a shift in corporate control) may be inadequate to deal with one-time defalcations, when the agent concludes that the opportunities of the moment exceed any subsequent penalties in the employment market. See Easterbrook & Fischel, *supra* note 64, at 701.

221. A similar call with respect to derivative actions was made by Professor Cox. See Cox, *supra* note 177, at 782-83.

222. See Coffee, *supra* note 97, at 263. The second principal argument in support of the deterrence objective is related to the failure of the compensatory function of the derivative action and is equally inapplicable to close corporations. According to advocates of the deterrence goal, derivative actions may be seen to provide inadequate

corporations, however, do not benefit from diversification. Rather than enjoying the benefit of litigation having a small cost relative to their investment but a salutary effect on the sizeable remainder of their holdings, such shareholders instead run the risk of seeing the large part of their investment consumed in an action that harms the interests of their corporation for the putative benefit of deterring misconduct elsewhere. Moreover, shareholders in public corporations, who are typically diversified, would not enjoy the deterrent effect spurred by removal litigation in close corporations because, as discussed above, such litigation is less frequent and less threatening to directors in public corporations, and therefore is unlikely to deter misconduct there.

Further, before the removal remedy could be used solely to achieve deterrence, it would need to be shown that the other remedies that have a higher or similar deterrent potential, but do not have the same detrimental effect on the interests of the corporation, are unavailable or insufficient. A traditional derivative action for breach of the director's duty of loyalty may be such a remedy. It has a higher probability of imposing the costs on defendant directors because the standard of proof is lower in such an action.²²³ It might also have a similar or higher potential for increasing the severity of the "penalty" imposed on directors.²²⁴ Most importantly, the interests of the corporation would suffer less when a director whose continued affiliation with the corporation would be beneficial to it pays damages to the corporation than when such a director is instead removed.²²⁵

compensation to the corporation because (i) the constant change in the corporation's ownership makes it impossible to assess who is harmed and how much, and therefore to determine adequate compensation, (ii) loss to the corporation is different from loss to its shareholders, in that market fear of the repetition of a misdeed may impact the corporation's stock price in a way that will harm shareholders to a greater extent than the mere economic loss to the corporation stemming from the misdeed itself, and (iii) the large number of stockholders in a typical corporation means that any individual shareholder's compensation will be *de minimis*. See Coffee & Schwartz, *supra* note 172, at 302-10. The authors conclude that "the fiction of compensation serves the reality of deterrence." *Id.* at 303.

223. See *supra* Part II.B.3.

224. See *supra* Part II.B.4.

225. Even when a director pays damages to the corporation, a derivative action might not be in the interests of the corporation if the litigation fees are higher than the amount of damages paid as a result of a successful derivative action. See *supra* note 172 and accompanying text. However, litigation fees are likely to be even higher in a removal action, due to the higher standard of proof. See *supra* notes 208-09 and accompanying text. Most importantly, when removal is pursued against the interests of the corporation, the "remedy" by definition is harmful to the corporation.

It may be argued that if the removal action increases the chances of revealing directors' misbehavior, it would increase the chances for the return of profits from the wrongdoers and collection of damages from them accordingly. In that case, however, the

Since the showing of a substantial deterrent effect is absent in a removal action and a deterrent less harmful to the interests of the corporation may be available, invoking public policy arguments to justify removal where it is not beneficial to the corporation may do more harm than good.

The above analysis underlines the significance and appropriateness of selecting the interests of the corporation as a condition to removal by the Model Act and other removal statutes. There are other "removal" remedies outside the context of corporate law which are specifically designed to eliminate directors in order to achieve specific policy goals.²²⁶ However, absent a clearly defined public policy goal that would be well served by the judicial removal remedy, a corporate law remedy designed to protect a corporation should not be modified so as to injure it.

III. Practical Realization of the Removal Remedy: When Two Cooks in the Kitchen Are Better than One

A. Protecting Shareholders' Prerogative: Court over Board

(1) Board as a Candidate to Effect Removal

When the removal of directors is sought in the interests of the corporation, there are two possible "candidates" to effect such a removal besides the shareholders: the board of directors and the court. In deciding between the two candidates, arguments could be made that if the goal of the removal remedy is the "prompt and efficient elimination of dishonest directors,"²²⁷ the board would obviously be in a position to remove directors faster and at less expense than the court. Furthermore, the board is entrusted with pursuing the interests of the corporation, and removing a misbehaving director in order to protect such corporate interests conforms with that mission.

Generally, the board of directors does not have the right to remove its members even for cause.²²⁸ Some states, however, empower the board to remove a director who is of unsound mind or meets other specified conditions.²²⁹ Further, a handful of states do

law should build mechanisms to encourage the latter suits directly, and not through the back door of the removal action.

226. See *supra* note 165 and accompanying text.

227. This is the objective set forth in the Official Comment to the Model Act. See MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997).

228. See MODEL BUS. CORP. ACT ANN. § 8.08 Statutory Comparison (Supp. 1997).

229. California, North Carolina, Ohio and Pennsylvania statutes contain such provisions. See *id.*

indeed empower the board to remove a director for the same misconduct that triggers a judicial removal remedy, without the need for judicial intervention.²³⁰ This Section will argue that the removal of its own members by the board (as opposed to the board's right to initiate or dismiss removal proceedings) is inappropriate, and the removal power should be left to the courts instead.

(2) *Danger of Redistribution of Powers Within a Corporation*

Granting the board the right to remove its own members would alter the balance of powers in the corporation on two levels.

One level involves the correlation between the authority of the shareholders and that of the board of directors. The system of separation of powers, initially devised by the founding fathers of representative democracy²³¹ and widely accepted in the modern world, is replicated in a modern corporation. Usurpation by the board of the shareholder prerogative to remove directors is not consistent with this principle of separation of powers.²³² The danger of violating this principle is exacerbated by the fact that the board of directors already has powers to appoint directors to fill vacancies on the board.²³³

On another level, unlike most other types of corporate litigation, the outcome of a removal action may change dramatically the balance of powers not only between the shareholders and the board, but also among shareholders. This result occurs because directors are shareholders' representatives, and a removal decision may destroy the equilibrium between majority and minority representatives on the board. The current powers of the board to fill vacancies enhance the possibility of a power shift at this shareholder-shareholder level, in addition to the shareholder-board level. The judiciary has pointed out the danger of the redistribution of powers within a corporation resulting from a removal action.²³⁴ This danger may stem from the

230. For example, Massachusetts and Missouri statutes contain such provisions. See *id.*

231. See generally 1 MONTESQUIEU, *THE SPIRIT OF LAWS* 8-13 (Thomas Nugent trans., Colonial Press 1899) (1748).

232. The court in *Bruch v. National Guarantee Credit Corp.*, 116 A. 738, 742 (Del. Ch. 1922) held that the various powers that a corporation may exercise are distributed among the directors, officers and shareholders, and the power to remove a director rests with the shareholders and not the board. See also *supra* note 127. For a discussion of shareholders' inherent right to remove directors, see Part II.A.

233. See, e.g., N.Y. BUS. CORP. LAW § 705.

234. The court in *Laughlin v. Geer*, 121 Ill. App. 534 (Ill. App. Ct. 1905) reasoned that if the board could remove a director for disloyalty, then a power dangerous to the minority shareholders would be lodged with the majority shareholders which would enable them, through action of the directors chosen by them, to reconstitute the board of directors as completely as if they owned all the shares of stock.

fact that directors do not have a duty to protect the special interests of minority shareholders to the same extent they have a duty to take actions in the best interests of the corporation and all shareholders.²³⁵ Moreover, in practice directors may feel that they owe a greater duty to the particular shareholder who elected them.²³⁶

Not having a well-defined duty to minority shareholders, directors may neglect preserving the balance of power within the corporation and protecting shareholders' prerogatives in favor of upholding the "best interest of the corporation." Even if they did have a well-defined duty to minority shareholders, serving two masters with different interests would pose uneasy choices for directors: should they act as monitors of the balance of powers among the shareholders, or pursue the interests of the corporation?²³⁷ Directors are more likely to be supporters of the more identifiable and familiar interests of the corporation in such a situation. Courts, on the other hand, are not so inhibited in seeking the adequate protection of the rights of minority shareholders.²³⁸ From this

235. While in the most outrageous circumstances directors may be held to have a duty to the minority shareholders, the violation of such a duty is not likely to be found in the delicate context of directorial election and removal.

236. See *supra* note 117 and accompanying text.

237. Corporate directors have been put into a difficult position of serving two and more masters before. See, e.g., *Paramount Communications v. Time, Inc.*, 571 A.2d 1140 (Del. 1989) (resolving the conflict between directors' duty to the corporation and its shareholders). For the difficulty of ascertaining the beneficiary as the main reason for inadequacy of the trust metaphor in connection with the duties of corporate directors, see Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1449-50 (1989). For establishing directors' duties to other constituencies, such as employees, customers and creditors, see N.Y. BUS. CORP. LAW § 717. This issue prompted the famous Berle-Dodd debate regarding corporate constituency statutes. See A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). However, the fact that directors have been faced with such choices before is no reason for making directors' choices even more difficult in the future.

238. The court in *Markovitz v. Markovitz*, affirming the removal and a two-year bar from re-election of a director elected by cumulative voting, set forth in its reasoning that the decision adequately provides for minority representation on the board of directors. See *Markovitz v. Markovitz*, 8 A.2d 46, 48 (Pa. 1939). For the details of the case, see *supra* notes 108-11 and accompanying text. In *Gershel v. Town & Country Management Corp.*, however, the court demonstrated a surprising disregard for minority shareholder interest in having a representative on the board:

Plaintiff also contends that if the shareholders' meeting is not stayed and if he were removed as a [director], he would not have the opportunity as he does now to protect his huge investment. The unfortunate and truly regrettable fact is that Plaintiff never had that control in the first place. He is now one of 6 directors. Five directors have expressed their desire to control the corporation without him. Under those circumstances, what meaningful effect would his one vote have?

standpoint, courts are better situated to determine whether the removal remedy is appropriate.

(3) *Court's Expertise*

Efficiency of the procedure for the removal of directors hinges not only on promptness and low cost, but also on the ability of the removing authority to reach a correct result. There are situations where the board is allowed to make decisions similar to those involved in the removal remedy, such as the removal of officers or employees for cause, where the finding of misconduct is made without recourse to judicial proceedings. However, this authority flows from the board's right to appoint officers, and often extends even to removal without cause. Discharging an appointee is more justifiable than discharging an equal.

The removal remedy at issue is at the crossroads of three concepts that coexist uncomfortably in one litigation: the finding of fraud or other similar gross misconduct, the determination of whether removing a director would be in the best interests of the corporation and the finding of "impairment" to removal by shareholders. The issues of the existence of misconduct and impairment to removal are matters of law and fact, for which the court is better equipped than the board. Moreover, the competence of the court to determine whether the wrong justifies a particular sanction is a basic judicial function and one for which the board is unevenly qualified. Courts' expertise is thus another argument against granting the board the authority to remove directors for misconduct without recourse to judicial process.

The discussion in Section B below will argue that the board, on the other hand, should have the power to halt a removal action upon a determination that removal would not be in the best interests of the corporation, as well as the power to file a suit for removal.

B. Protecting the Interests of the Corporation: Board over Court

(1) *An Unusual Distinction Between Direct and Derivative Actions*

One issue that dramatically affects the ability of the board to participate in an action concerning a corporation is whether a shareholder suit is brought as a direct or derivative action. The main consequence of characterizing the suit as derivative is that various impediments to bringing the suit are triggered. The requirement that a shareholder first should make a demand on the board before

No. CIV.A.6843, 1982 WL 17878, at *4 (Del. Ch. July 1, 1982). This case, however, concerned the removal of directors by shareholders, rather than by the court.

bringing an action and the right of the board to dismiss derivative suits are safeguards designed to fortify the role of the board in pursuing corporate interests.²³⁹

The removal remedy does not fit comfortably into the definition of either a direct or a derivative action. The traditional distinction between these actions is drawn depending on the identity of the injured party.²⁴⁰ If the injury is to a shareholder as such, the action is direct. A direct action is brought by a shareholder in his own name and for his own benefit. A direct action could also be brought by a class of injured shareholders as a class action. If the injury is to the corporation, however, the action is brought by one or more shareholders in the name and for the benefit of the corporation, and therefore is derivative.

On the one hand, the right to elect and remove directors belongs to the shareholders, and an action to enforce voting rights has traditionally been considered direct.²⁴¹ Consequently, solely from this standpoint, a suit to remove a director resembles a direct action.

On the other hand, the "fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation"²⁴² standard that gives rise to the removal remedy is by definition an injury to the corporation rather than to any particular shareholder or group of shareholders. In addition, a plaintiff shareholder does not need to (and hardly can) claim that his voting rights were violated, because he has already voted and the grievance at issue is the subsequent misbehavior of a person who was duly elected. Moreover, the owners of non-voting shares, who obviously could not assert a violation of their voting rights, have the same rights to sue for removal under the removal statutes as the owners of voting shares.²⁴³

The Model Act attempts to solve the direct versus derivative dilemma, albeit in a unique and arbitrary way, in the Official Comment to Section 8.09: removal actions initiated by shareholders

239. Other hurdles to bringing derivative actions include "security for expenses" statutes and the contemporaneous ownership rule. For a brief description of these impediments to a derivative action, see *supra* notes 194-99 and accompanying text. Another consequence of characterizing a suit as derivative is the payment of the plaintiff's attorney's fees by the corporation in a successful action.

240. For a description of problems in classifying shareholders' suits as direct or derivative in general and for examples of the attempts of clever plaintiffs and defendants to characterize their suits as direct or derivative depending on the possible benefits of such characterization, see CLARK, *supra* note 128, at 662-64.

241. See *id.* at 662.

242. MODEL BUS. CORP. ACT ANN. § 8.09(a)(1) (Supp. 1997); *supra* note 36.

243. See, e.g., MODEL BUS. CORP. ACT ANN. § 8.09 (Supp. 1997). N.Y. BUS. CORP. LAW § 706(d) (McKinney 1986).

holding less than 10% of shares are brought derivatively, while actions initiated by the holders of 10% of shares or more are brought directly.²⁴⁴ The basis for the former part of the rule apparently is the fact that the statutes give the corporation itself standing to bring a suit for removal, and under general rules any shareholder can always bring an action on behalf of the corporation. The basis for the latter part of the rule is perplexing.

Does a shareholder holding less than 10% of a corporation's shares need to show injury to the corporation if the action is indeed derivative? And does a shareholder holding more than 10% of the shares need to show injury to himself as a shareholder in order to support a direct action? Certainly, upon the magical 10% threshold, the nature of the injury does not mutate and an injury to the corporation does not become an injury to a particular shareholder. The Model Act has already answered the question regarding the nature of the action by providing that the improper conduct complained of should be with respect to the corporation rather than its shareholders: the nature of the action is derivative.²⁴⁵ The Model Act then disguises the action as direct if brought by a shareholder holding an arbitrary amount of shares.²⁴⁶

244. MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997). Because most state statutes providing for the removal remedy contain virtually the same language as Section 8.09 of the Model Act, the same distinction between direct and derivative removal actions appears to be followed by the states. Certain states have even restated the Official Comment to the Model Act when adopting the removal remedy. See, e.g., IDAHO CODE § 30-1-809 official cmt. Court decisions with respect to this issue, however, are inconsistent. For example, the court in *Koshaba v. Koshaba*, 132 P.2d 854, 858-59 (Cal. Ct. App. 1942), implied that the demand requirement pertinent exclusively to derivative actions was applicable to the removal action brought by the owner of over 10% of shares, but held that demand on the board of directors would have been futile in the circumstances. The court in *Edward Sidebotham & Son, Inc. v. Chandler*, 7 Cal. Rptr. 216, 222 (Cal. Ct. App. 1960), determined that an action brought by an owner of more than 10% of shares was derivative in nature. The court in *Starbird v. Lane*, 21 Cal. Rptr. 280, 284-85 (Cal. Ct. App. 1962) referred to a demand on the board requirement where the suit was brought by an owner of over 10% of shares, thereby implying that the action was nevertheless derivative. This demand requirement is strange in light of the fact that the corporation itself did not have the right to bring a removal action under the then-existing statute, and thus the demand could not possibly have resulted in the commencement of the removal action by the corporation. The court in *Ross v. 311 North Central Avenue Building Corp.*, 264 N.E.2d 406 (Ill. App. Ct. 1970), classified the action as a class action (i.e. direct action), but treated it as a derivative action in awarding attorneys' fees. Under the rationale of the Official Comment to the Model Act, it logically follows that in the states where statutes do not grant the corporation the right to bring a removal action, a shareholder's derivative action for removal is not possible. See *Purdy v. Humphry*, 82 N.Y.S.2d 92 (Sup. Ct. 1947), *aff'd*, 82 N.Y.S.2d 388 (App. Div. 1948).

245. MODEL BUS. CORP. ACT ANN. § 8.09 (Supp. 1997).

246. Allowing a claim derivative in nature to be brought as a direct action is not unprecedented. Such a deviation from the traditional test has surfaced in other contexts

Neither the laconic language of the Official Comment to the Model Act nor other relevant sources explain the rationale underlying the 10% threshold in a removal action. Apparently, the threshold is based on an assumption that ownership of 10% of a company's shares represents a sufficient stake to indicate the legitimacy of the shareholder's action, and the hurdles of the derivative action become unnecessary.²⁴⁷ This assumption, plausible on its face, invites two inquiries. First, if this assumption were true, it would be puzzling why the same reasoning would not then hold in any

for reasons that do not apply here. For example, certain court decisions and the ALI Principles set forth a rule that in a closely held corporation, the court in its discretion may treat an otherwise derivative action as a direct one, subject to the satisfaction of certain tests. See, e.g., *Donahue v. Rodd Electrotypes Co.*, 328 N.E.2d. 505 (Mass. 1975); ALI PRINCIPLES, *supra* note 6, § 7.01(d). The purpose of this rule is to overcome impediments to bringing derivative actions (such as the demand on the board and security for expenses requirements that oblige plaintiffs in a derivative action to request that the board bring the suit before the plaintiff is allowed to proceed himself and to post a bond for the payment of expenses in an unsuccessful suit, respectively). See *supra* notes 194-99 and accompanying text for a description of such impediments. This exception to the derivative action procedure is supported by various policy considerations, including the low likelihood that the board of a closely-held corporation will be disinterested. See ALI PRINCIPLES, *supra* note 6, § 7.01 cmt. e. Such policy considerations are not always applicable with respect to the removal remedy, however, because the removal remedy is designed to apply to both closely-held and public corporations. See MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997). Even if the removal remedy were applicable only to close corporations, it could be subject to general rules for derivative suits in close corporations, such as those contemplated by the ALI Principles, and there would be no need for inventing special rules for the removal remedy. See ALI PRINCIPLES, *supra* note 6, § 7.01 cmt. e.

247. Interestingly, 10% is also the percentage of shares required to call a special shareholder meeting at which the protesting shareholder may present its case to the others. See MODEL BUS. CORP. ACT ANN. § 7.02(a)(2) (Supp. 1997). On the surface, it may seem that since any number would be arbitrary, "10%" is not a bad candidate for such a number, and if the number is reasonable for calling a special shareholder meeting to remove a director, it would be logical to use the same number for bringing a lawsuit. However, this is not the case.

In calling a shareholder meeting, the importance of the threshold is that a 1% shareholder cannot call it, but a 10% shareholder can. In removal actions, however, any shareholder can bring a suit for removal, since any shareholder can bring a derivative action on behalf of the corporation. See *supra* note 33. The main effect of the 10% threshold is that the suit becomes direct instead of derivative, which means that the board becomes detached from the removal process.

Upon the shareholder's exercise of his right to compel a meeting to present his case to other shareholders, the issue of removal remains within the system of shareholder democracy, and the interests of the corporation are not threatened by outside interference. In the context of the removal remedy, however, the removal issue leaves the boundaries of the corporation and enters the judicial system, which may harm the interests of the corporation. The board's participation in this process, aimed at protecting the interests of the corporation, is essential. See *supra* Part III.B.3-5. The need for such participation does not depend on the number of shareholders bringing the suit.

other shareholder suit. Those who urge more extensive judicial review of corporate decisions may see in such a threshold a bright future for the expansion of shareholder lawsuits. Second, while a share ownership threshold that would allow a shareholder's action to bypass the procedural hurdles of the derivative action may become a valid object of study in corporate law in its own right, is this rule a valuable feature in the removal remedy? Regardless of whether such a threshold is justifiable for derivative actions in general, there are two reasons why the removal remedy may be less suited to launch such procedural bifurcation than other derivative actions. These reasons will be described in more detail in the remainder of this Section B.

(2) *More Shares Do Not Mean More Legitimacy*

There is some logic underlying the idea that the legitimacy of a derivative action is proportional to the percentage of shares owned by the plaintiff. It is precisely such a rationale that led to the adoption of "security for expenses" statutes²⁴⁸ which required plaintiffs holding less than a minimum percentage of shares in the corporation to post security for the payment of the defendant's reasonable expenses in the event the court found for the defendant. These statutes were designed to curtail "strike suits"—frivolous derivative claims aimed at forcing settlements, brought by plaintiffs with minor stakes in the corporation.²⁴⁹

However, there is no persuasive reason to believe (or empirical evidence to show) that the removal remedy is any likelier to induce strike suits than any other corporate law remedy. "Fraudulent or dishonest conduct," the relevant standard in a removal action, is more difficult to prove or even assert than the simple violation of duty of loyalty or duty of care which is usually the focus of the derivative action, thereby making this task more difficult for ill-intentioned plaintiffs. Moreover, as described in Section C of Part II above, the consequences to directors are apt to be less serious in the event of a removal than in other actions for a violation of the duty of loyalty. It therefore seems reasonable to speculate that directors would be no

248. See, e.g., N.Y. BUS. CORP. LAW § 627 (McKinney 1986).

249. "Security for expenses" statutes were adopted by a number of states after the increase in derivative actions brought by dissatisfied shareholders following the Great Depression. In particular, they were prompted by a report prepared by the New York Chamber of Commerce in 1944 (the Wood Report) that revealed that only 8% of the nearly 1300 derivative actions produced corporate recovery and concluded that most actions were brought by "strike suitors." For a description of the history of "security for expenses" statutes, see CLARK, *supra* note 128, at 652-55.

more (and probably less) willing to settle with a plaintiff in a removal case than in a typical derivative action.

Interestingly, the arbitrary 10% threshold may have an effect opposite to that intended. Large shareholders may be more likely than minor ones to bring frivolous actions for the removal of a director. Indeed, a removal action could be used by shareholders as an effective and relatively cheap tool in a corporate power struggle or even a hostile takeover, to eliminate the directors who resist the power shift.²⁵⁰ Only persons with substantial shareholdings would be involved in power struggles and thus interested in using the removal process for such purposes. While larger shareholders would not be immune from the requirement to prove fraud, facilitating removal suits for such shareholders might encourage the use of such suits on the corporate control battlefield. The mere filing of a suit, however frivolous, by a company engaging in a takeover would serve to intimidate uncooperative directors of the target corporation,²⁵¹ and intimidation is one of the weapons commonly used in power struggles.²⁵²

Thus, removal actions brought by a large shareholder may in fact be less legitimate than those brought by a small shareholder and as such should not be encouraged with excessive enthusiasm.

250. The Official Comment to the Model Act recognizes this danger by making a general statement that the removal remedy "is not intended to permit judicial resolution of internal corporate struggles for control except in those cases in which a court finds that the director has been guilty of wrongful conduct of the type described." MODEL BUS. CORP. ACT ANN. § 8.09 official cmt. (Supp. 1997). Takeover attempts frequently trigger both entrenchment by the target corporation's management and attempts by acquirors to dislodge target management. For example, in *Dataproducts Corp. v. DPC Acquisition Partners*, No. CIV.A.10839, 1989 WL 155469 (Del. Ch. Dec. 26, 1989), potential acquirors were soliciting written shareholder consents to remove and replace the target corporation's board of directors, and the target corporation unsuccessfully sought to prevent such removal. For a discussion of the potential inefficiencies of corporate takeovers with respect to the corporation's management, see John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1020-23 (1993). For a discussion of the conflict of interests between management and shareholders in the tender offer context, see Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 819-31 (1981).

251. There is evidence that officers and directors feel threatened by takeovers, probably due to the fear of losing their positions. See, e.g., Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931, 1958-59 (1991).

252. See, e.g., RALPH C. FERRARA ET AL., TAKEOVERS ATTACKS AND SURVIVAL 64 (1987):

[A] "bear hug" strategy . . . involves a (more or less) "friendly" overture by the bidder to the target's management and which may be followed by a more coercive and aggressive approach if management rebuffs the embrace. . . . [T]he "bear hug" may serve as an opening move in a hostile game that puts pressure on the target's management in the hope that management will make a mistake.

(3) *Principal Board Powers in Litigation*

One of the hallmarks of U.S. corporate law is that the business and affairs of the corporation are managed by, or under the direction of, its board of directors.²⁵³ Thus, in corporate governance, the board is the body specifically entrusted with the pursuit of the best interests of the corporation. Under this principle, the board of directors should have an active role in removal actions since the goal of the removal remedy is to protect the interests of the corporation. However, the primary effect of making removal actions direct, rather than derivative, is to limit the board's role in the litigation.

As the affairs of the corporation are managed by the board of directors, it is the board (or in certain instances committees or officers empowered by the board) that takes the following actions: (i) deciding whether to file a claim for damages or other relief against a third party, a fellow director or an officer of the corporation;²⁵⁴ (ii) considering the demand (served on the board by a shareholder) to file suit and then either taking charge of the litigation or rejecting the demand, thereby barring the advancement of the action; and (iii) requiring the dismissal of the derivative suit. However, as explained in more detail below, extant statutes and court decisions largely deny the board these prerogatives in the context of a removal action.

The first of the above powers is self-explanatory. Surprisingly, with respect to a removal action, laws of some states even fail to name the corporation as a possible plaintiff.²⁵⁵ Accordingly, court decisions in such states hold that the corporation itself does not have power to

253. See MODEL BUS. CORP. ACT ANN. § 8.01(b) (Supp. 1997); N.Y. BUS. CORP. LAW § 701 (McKinney 1986); DEL. CODE ANN. tit. 8, § 141(a) (1974).

254. Structural bias theory, however, holds that a system that calls upon the board to pass judgment on its own members is fundamentally suspect. Proponents of this view suggest that directors are subject to social and psychological pressures that make them reluctant to sanction their fellow board members. For example, while an outside director may openly oppose another board member on a transaction he feels is unfair, he may feel less free to tell that director that he believes a suit against him has sufficient merit to proceed. See Coffee & Schwartz, *supra* note 172, at 283. For a discussion of structural bias in the board, see Coffee & Schwartz, *supra*; Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 944-45 (1983); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS., Summer 1985, at 83; Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894 (1983). The structural bias theory, however, has not been followed by courts or legislatures and is not accepted by most academics.

255. See e.g., N.Y. BUS. CORP. LAW § 706(d) (McKinney 1986). Some states do not even require a corporation to be joined as a party to the removal action. See, e.g., CONN. GEN. STAT. ANN. § 33-743 (West 1997).

protect its own interests by filing a removal suit.²⁵⁶ For example, in a recent New York case, *Management Technologies, Inc. v. Morris*,²⁵⁷ the corporation (represented by its chief executive officer) filed a suit seeking, among other relief, the removal of two directors. The plaintiff claimed that the directors had been engaged in a scheme to purchase for themselves certain assets of the company's British subsidiaries at bargain prices, had caused these subsidiaries to default on obligations to British Inland Revenue in order precipitate a liquidation of those entities and purchase their assets, and had even sought to gain access to the company's London offices with an axe in order to remove papers revealing their alleged wrongdoing and threatened the security guards!²⁵⁸ The court was sympathetic to the plaintiff and granted a preliminary injunction partially limiting the directors' authority, but announced that it was unable to remove the directors due to the lack of a statutory provision allowing the corporation itself to bring a removal action.²⁵⁹ It is difficult to discern any legitimate reasons for such discrimination against a corporation in favor of minority shareholders where the corporation's interests are at stake.

The second power of the board represents a well-settled rule of corporate law that before bringing a derivative suit, a shareholder must first file a demand on the board of directors requesting the board to take action to remedy the situation that is the subject of the shareholder's complaint.²⁶⁰ The demand requirement, however, is not applicable when demand would be "futile." Demand is usually considered futile if the majority of the board has a personal financial interest in the subject transaction, since such interest may impair the board's objectivity on the matter.²⁶¹ A rejection of the shareholder's demand by the independent directors prevents the shareholder from asserting the corporation's cause of action, unless the shareholder demonstrates that the refusal of the demand was "wrongful." Refusal may be proven wrongful by showing that the directors adopting the decision were not truly independent, that the procedures used in adopting the decision were flawed, or that the decision was otherwise not a product of valid business judgment.²⁶² Therefore, unless a

256. See, e.g., *Management Techs., Inc. v. Morris*, 961 F. Supp. 640, 650 (S.D.N.Y. 1997) (for a description, see *infra* notes 257-59 and accompanying text); *Purdy v. Humphry*, 82 N.Y.S.2d 92 (Sup. Ct. 1947), *aff'd*, 82 N.Y.S.2d 388 (App. Div. 1948).

257. 961 F. Supp. 640.

258. See *id.* at 643, 650 & n.16.

259. See *id.* at 650-52.

260. See, e.g., MODEL BUS. CORP. ACT ANN. § 7.42 (Supp. 1997).

261. See *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984).

262. See, e.g., *Issner v. Aldrich*, 254 F. Supp. 696, 699 (D. Del. 1966); *Pogostin v. Rice*, 480 A.2d 619, 624-25 (Del. 1984).

shareholder can demonstrate that demand should be excused or that the refusal of the demand was wrongful, the shareholder cannot proceed with the lawsuit. This is a universally accepted rule in all jurisdictions.²⁶³ The Model Act and the ALI Principles adhere to the demand procedures and even expand them by adopting a "universal demand" requirement.²⁶⁴ Under the Model Act and similar state provisions, however, in proceedings for the removal of a director for misbehavior toward the corporation, a suit for the removal of directors filed by a holder of at least 10% of the corporation's shares is filed as a direct action.²⁶⁵ Thus, the demand requirement applicable to derivative actions becomes inapplicable to such removal proceedings.

The third power traditionally reserved for the board relates to the dismissal of derivative suits. If a shareholder's derivative suit is able to bypass the board, the corporation can nevertheless file a motion to dismiss the action based on a finding of the independent directors, or a committee formed by them, that proceeding with the suit will not be in the best interests of the corporation.²⁶⁶ Only a minimum standard of review generally applies, whereunder the court will defer to the decision of the committee unless there was a showing that it was not truly independent, did not act in good faith, or did not pursue its tasks diligently.²⁶⁷ Since a removal action brought by a 10% shareholder is direct, in such an action the board is deprived of its power and duty to dismiss a lawsuit contrary to the interests of the corporation.

Thus, the role of the board embodied in most removal statutes and court decisions in removal proceedings initiated by the holders of at least 10% of a corporation's shares appears to be limited as follows: The corporation (and, accordingly, the board) has the right to intervene in litigation and express its opinions on the matter, but does not have the opportunity to consider the demand or the power to dismiss the suit. The court will then be willing to hear the board's

263. See, e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). For an overview of cases on demand in various jurisdictions, see MODEL BUS. CORP. ACT ANN. 7-278 to 7-288 (Supp. 1997).

264. In accordance with this requirement, demand is not necessary only if "irreparable injury" to the corporation would result if the proceedings are delayed in order to comply with the demand procedures. See MODEL BUS. CORP. ACT ANN. § 7.42(2) (Supp. 1997); ALI PRINCIPLES, *supra* note 6, § 7.03(b).

265. See MODEL BUS. CORP. ACT ANN. § 8.09 official cmt.

266. See, e.g., MODEL BUS. CORP. ACT ANN. § 7.44 (Supp. 1997).

267. See *Auerbach v. Bennett*, 393 N.E.2d 994, 1002-03 (N.Y. 1979). Moderate judicial scrutiny was established in the Delaware Supreme Court case *Zapata Corporation v. Maldonado* for demand-excused situations. 430 A.2d 779 (Del. 1981). Even the *Zapata* test, however, contemplates deference to the decision of the independent directors with respect to the determination of the best interests of the corporation. See *supra* note 177.

arguments, but does not need to defer to its decisions, and will determine the merit of the case itself.²⁶⁸

Such a statutory stance is a striking deviation from the usual rules requiring demand on the board and granting the board the power to dismiss derivative actions. It is noteworthy that the Model Act itself promotes the demand requirement and requires the court to dismiss a derivative proceeding upon a finding by independent directors that litigation is not in the best interests of the corporation.²⁶⁹ The standard of judicial scrutiny of the determination of independent directors under the Model Act is rather low. Moreover, in general the Model Act has usually been viewed as a staunch supporter of board authority. As such, it has even been characterized as the "Authority Model" (as opposed to the "Responsibility Model," embodied in the ALI Principles and aimed at diminishing the authority of the board by increasing its accountability).²⁷⁰ And, in most respects, the Model Act deserves this label.

Section 8.09 of the Model Act, the judicial removal of directors provision, however, is out of character. Honoring the authority of the board on all other accounts, the Model Act goes further than the ALI Principles,²⁷¹ and incomparably further than Delaware, in its denial of the board's right to be the main player in litigation where the best

268. While the removal statutes imply that the determination of the corporation's best interests should be made by the court, they do not state such a requirement and therefore do not specifically prohibit the court's deference to board decisions regarding such interests. It is now the turn of the courts to develop a doctrine of deference to board determinations regarding the best interests of the corporation, as they did in the past when developing a business judgment rule, demand requirement, and deference to the findings of special litigation committees.

269. MODEL BUS. CORP. ACT ANN. § 7.42, § 7.44 and official cmt. (Supp. 1997).

270. See generally Michael Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992).

271. The ALI Principles propose higher judicial oversight to scrutinize the board's refusal to proceed with litigation where a derivative action is brought against a director for violation of the duty of loyalty. However, the ALI Principles do not eliminate the demand requirement when suits for the violation of the duty of loyalty are brought by a certain minimum number of shareholders. Even with a higher standard of judicial review, they still preserve the court's deference to the board's decision to reject demand and dismiss a derivative action. With respect to the demand refusal, deference is sustained unless the complaint pleads with particularity facts that, if true, raise a significant prospect that either the disinterested directors who rejected the demand did not satisfy the requirements of the business judgment rule or the disinterested directors could not reasonably have determined that rejection of the demand was in the best interests of the corporation. See ALI PRINCIPLES, *supra* note 6, §§ 7.04(a)(2)(C), 4.01(c)(2). With respect to the determination to dismiss a suit, the test is whether the board or committee was adequately informed and reasonably determined that dismissal was in the best interests of the corporation, "based on grounds that the court deems to warrant reliance." *Id.* § 7.10(a)(2). For an adoption of the approach set forth in the ALI Principles, see *Cuker v. Mikalauskas*, 692 A.2d 1042, 1048-49 (Pa. 1997).

interests of the corporation are at issue. The appearance of Section 8.09 in the Model Act in its present form is unexplained and unexplainable.²⁷²

Something inherently peculiar and dangerous about removal proceedings would need to be demonstrated to justify such a deviation from the rule of conventional derivative actions. Ironically, however, the nature of removal proceedings justifies more judicial deference to the board's decisions, not less.

(4) *Common Grounds for the Board's Role in Conventional Derivative and in Removal Proceedings*

Numerous justifications have been advanced for the demand requirement in derivative litigation.²⁷³ Perhaps the most important is that the demand requirement helps implement the basic principle that the business and affairs of the corporation are managed by the board of directors and not the shareholders. The board's prerogative includes the determination of whether a lawsuit would be in the best interests of the corporation. The demand requirement provides directors with an opportunity to reject a demand or require early dismissal of the case if they determine the suit not to be in the best interests of the corporation.²⁷⁴

The principal justification for the board's right to dismiss a derivative suit is very similar to this first reason for the demand requirement. The decision whether to pursue a lawsuit against a third party is a business judgment like any other. One of the foundations of the business judgment rule, in turn, is that courts do not consider themselves competent to decide business matters.²⁷⁵ The drafters of

272. See *supra* note 16.

273. The analysis in this Section employs the classification of reasons for the demand requirement set forth in CLARK, *supra* note 128, at 641. For alternative classifications of justifications for demand, see ALI PRINCIPLES, *supra* note 6, § 7.03 cmt. c; Thomas P. Kinney, *Comment, Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 176 (1994).

274. However, the ALI Principles note that not all states concur with Delaware's view that the demand rule effectuates a "substantive allocation of power to the board to dismiss a derivative litigation." ALI PRINCIPLES, *supra* note 6, § 7.03 cmt. c.

275. See, e.g., *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979). Also, as Chancellor Allen said, the business judgment rule "reflects the fact that ours is an economic order in which investment choices and implementing business decisions are chiefly made by private persons, not by government functionaries or judges. . . . [I]n our social order courts are . . . not thought to be very good institutionally at making such judgments." William T. Allen, *Investment Bankers' and Judicial Review of Corporate Action to Defeat Hostile Takeovers: Comments on Chapter 6*, in THE BATTLE FOR CORPORATE CONTROL: SHAREHOLDER RIGHTS, STAKEHOLDER INTERESTS, & MANAGERIAL RESPONSIBILITIES 131, 134-35 (Arnold W. Sametz & James L. Bicksler eds., 1991), *quoted in* Dennis J. Block et al., *Chancellor Allen's Jurisprudence: Chancellor Allen, the Business Judgment Rule, and the*

the Model Act themselves maintain that the requirement of dismissal of the derivative action upon the determination by the independent directors that pursuing the lawsuit is not in the best interests of the corporation "confirms the basic principle that a derivative suit is an action on behalf of the corporation and therefore should be controlled by those directors who can exercise an independent business judgment with respect to its continuance."²⁷⁶

One may argue that the origin of the removal right is what distinguishes removal proceedings from conventional derivative proceedings. In a typical derivative action, the claim belongs to the corporation, and the corporation, acting through its board of directors, files a lawsuit if the board finds it meritorious. In contrast, the right to remove directors inherently belongs to the shareholders and thus, one may assert, it might be more appropriate for a shareholder to bring action with respect to a right in his own domain. This argument, however, is not sustainable for the following reason.

The right to elect directors belongs to all shareholders collectively and can only be exercised through appropriate voting procedures. A 10% shareholder is not a better representative of all the shareholders than is the board.²⁷⁷ On the contrary, it may be argued that the holders of the remaining 90% of the shares did not elect the 10% shareholder purporting to act as their representative, but did collectively elect the board, which is therefore in a better position to represent the shareholders' collective preferences. If the right to remove directors were indeed regarded as the unconditionally inalienable right of the shareholders, then neither a 10% shareholder,

Shareholders' Right to Decide, 17 DEL. J. CORP. L. 785, 790 (1992). For a criticism of this justification of the business judgment rule, and for a description of other justifications, see Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993). See also Coffee & Schwartz, *supra* note 172, at 280-84. For an overview of court decisions on the business judgment rule, see Cuker v. Mikalauskas, 692 A.2d 1042, 1045-47 (Pa. 1997).

276. MODEL BUS. CORP. ACT ANN. ch. 7, subch. D, introductory cmt. (Supp. 1997). The Official Comment to the Model Act continues as follows: "At the same time, the court is required to assess the independence and good faith of the directors and the reasonableness of their inquiry and, if a majority of the board is not independent, the burden is placed on the corporation to prove each of these elements." *Id.* For a skeptical approach to courts' deference to the findings of litigation committees, see James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959.

277. The situation where the shareholder seeks to remove the director that it alone elected through cumulative voting may be an exception. However, as demonstrated by the existing cases, the likelihood of such a situation arising in practice is very low. Moreover, the same situation may arise with respect to a holder of less than 10% of shares. If an exception needs to be carved out for this particular case, it needs to be tied to the fact that the shareholder has elected the directors by cumulative voting and not to the number of shares owned by the shareholder.

nor the board, nor the court could claim to represent shareholders in a removal action. However, the law makes an exception to this right in order to allow removal without asking the shareholders' opinion if the misbehavior was truly egregious and if the removal is in the best interests of the corporation. This latter requirement closes the circle and brings us back to the original purpose of the demand and dismissal rules. This purpose is fully applicable in the removal situation: the business and affairs of a corporation are managed by its board of directors, it is the board that determines the best interests of the corporation, and it is the board that should determine such interests in a removal action, as it does in a derivative action.²⁷⁸

The second common argument in favor of the demand requirement is that it may promote judicial economy, because some demands may lead to corrective action short of suit, and therefore judicial consideration of the dispute may not be necessary. This is no more or less true in the case of removal proceedings than in other derivative proceedings. A common example of the application of the judicial economy principle is that the board may choose to dismiss an employee instead of suing him for damages.²⁷⁹ In a removal proceeding, the board might decide to take a different but equally appropriate action, for example, to proceed with a suit for damages or disgorgement of profits but not the removal of the director,²⁸⁰ or perhaps simply to reprimand the director.

Finally, the demand requirement protects directors from the harassment of litigious shareholders and generally discourages "strike suits."²⁸¹ It likewise discourages unmeritorious "power struggle" suits, which could be brought by large shareholders seeking to gain greater control over the corporation.²⁸² Overall, there is no fundamental difference between a suit for a director's removal and a derivative action against a director that would warrant granting the board demand and dismissal rights in the derivative but not the removal setting.

278. Commentators have affirmed the unique ability of the directors to determine business matters even when the board is interested: "Although some faint aura of legitimacy accrues to the plaintiff's attorney to represent the corporate interest when the demand requirement has been excused, that aura is no substitute for the unique capability of the board of directors to analyze the costs and benefits of the suit from the corporate perspective." Cox, *supra* note 276, at 960-61 (footnote omitted).

279. See, e.g., *Cramer v. Gen. Tel. & Elec. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978).

280. This was precisely the outcome reached by the court in the *Remillard Brick* case. *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 77 (Cal. Ct. App. 1952). For a brief description of the *Remillard Brick* decision, see *supra* notes 138-42 and accompanying text.

281. See CLARK, *supra* note 128, at 641. For a description of the concept of strike suits, see *supra* note 249 and accompanying text.

282. See *supra* Part III.B.2.

(5) *Greater Need for the Board's Involvement in Removal Proceedings*

In removal proceedings, the board's role is even more justified than in a typical derivative action. One of the reasons courts advance as a basis for the business judgment rule is the fact that the board is better positioned than the judiciary to decide business issues.²⁸³ In contrast, however, where the propriety of deference to the board's decision to reject a demand or dismiss a derivative action is at issue, some courts and commentators have argued that judges do have the expertise to analyze the merits of a lawsuit because the appropriateness of litigation is as much a legal question as a business one.²⁸⁴ This recognition does not mean that courts will no longer afford special litigation committees of the board the benefit of the business judgment rule. For instance, in *Auerbach v. Bennett* the court held that while the judicial system is well equipped to make determinations with respect to lawsuits, the ultimate decision not to pursue litigation

falls squarely within the embrace of the business judgment doctrine, involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. To this extent, the conclusion reached by the special litigation committee is outside the scope of our review.²⁸⁵

The ALI Principles, on the other hand, used the court's aptitude to evaluate the merits of a lawsuit as one of the justifications for increased judicial scrutiny of board decisions to dismiss derivative suits.²⁸⁶

To determine whether the removal of a particular director is in the interests of the corporation, in addition to the above considerations pertinent to typical derivative actions, the professional qualifications of the director, the importance of the director for the business of the company, the availability of persons with similar qualifications, and other relevant business factors should be taken

283. See, e.g., *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979). For a description of the business judgment rule, see *supra* note 275 and accompanying text.

284. See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668, 688 (Mich. 1919); *Auerbach v. Bennett*, 393 N.E.2d 994, 1002 (N.Y. 1979); ALI PRINCIPLES, *supra* note 6, § 7.10 cmt. d (citing *Joy v. North*, 692 F.2d 880, 892 (2d Cir. 1982)). An interesting observation was made by Professor Dooley and Justice Veasey with respect to this argument: "To claim that courts are more competent to decide questions of law has a surface appeal, but is ultimately tautological because it amounts to saying that a court is better able to predict how it is likely to rule on a given matter if asked." Dooley & Veasey, *supra* note 172, at 536. This observation, however, may be viewed to make the argument even stronger: if the court knows better than anybody else how it would rule with respect to the derivative action, why should the board be encouraged to second-guess the court?

285. *Auerbach v. Bennett*, 393 N.E.2d 994, 1002 (N.Y. 1979).

286. ALI PRINCIPLES, *supra* note 6, § 7.10 cmt. d.

into account. While the courts may have a special aptitude to consider the merits of lawsuits for disgorgement of profits or damages, as may be the case in a typical derivative lawsuit, they do not have the same aptitude to assess the qualifications of a director.²⁸⁷ Therefore, the removal proceeding makes a better case for judicial deference to the expertise of the board that decided to retain a director than a typical derivative action.

The second reason supporting deference to the board of directors in a removal action lies in the philosophy of corporate governance. Because only the shareholders have the inherent power to elect and remove directors, the fact that they have elected directors and not subsequently exercised their power to remove them should be honored. Judicial removal is an extraordinary power of the court that intrudes on shareholders' rights. Lawmakers have made a correct half-step by providing that directors may not be judicially removed unless their removal would be in the best interests of the corporation. The missing half-step is to allow the board to make a determination of the best interests of the corporation. Such a mechanism would create a check on the usurpation of shareholders' prerogative by the court.

The law often imposes safeguards where a judicial decision may dramatically impact someone's rights, for instance, by establishing a higher standard of proof,²⁸⁸ trial by jury,²⁸⁹ or a more extensive appeal process.²⁹⁰ The criminal law, for example, prefers underpunishment to the castigation of the innocent.²⁹¹ While the violation of rights is certainly less dramatic in the removal context than in the criminal context, removal nevertheless constitutes an extreme interference with shareholder prerogatives. Accordingly, the law should prefer honoring the choice of shareholders too much rather than too little.

Thus, the unfounded statutory rule that a shareholder holding an arbitrary amount of shares may bring a removal action as a direct suit should be eliminated. The general veto rights of the board pertinent to derivative litigation should be present in a removal action irrespective of the amount of shares owned by the plaintiff

287. It is a well established principle that courts are not well suited to evaluate managerial performance and acknowledge such lack of expertise. See Elizabeth Bartholet, *Application of Title VII to Jobs in High Places*, 95 HARV. L. REV. 945, 979-80 (1982).

288. See WAYNE R. LAFAVE & AUSTIN W. SCOTT, JR., CRIMINAL LAW 16-17 (1986).

289. See CHARLES E. TORCIA, CRIMINAL PROCEDURE 574-616 (1991).

290. See *id.* at 809-78; LAFAVE & SCOTT, *supra* note 288, at 16-17.

291. See LAFAVE & SCOTT, *supra* note 288, at 16. See also *In re Winship*, 397 U.S. 358 (1970) (holding that the Constitution requires the government to prove a defendant's fault beyond a reasonable doubt before criminal penalties may attach). This approach is reflected in the doctrine of presumption of innocence, one of the hallmarks of criminal procedure.

shareholder. These veto rights take the form of preventing the advancement of a lawsuit by rejecting the demand on the board and dismissing the lawsuit by determining that it is not in the best interests of the corporation. Certainly, in situations where the board is interested, the court should use the concepts of "futile" demand and "wrongful rejection" of demand and not adhere to the board's determination. For example, in *Koshaba v. Koshaba*,²⁹² the court correctly stated that, like in any derivative action, the 25% shareholder seeking to remove a director would generally need to serve a demand on the board. However, in that particular case the board was dominated by the defendant director. The court therefore resolved that since the demand would have been futile, the plaintiff did not need to await a formal refusal by the board to proceed with the removal action.²⁹³

The actual decision to remove directors for misconduct, however, should always be taken by the court rather than the board. This approach would strike an appropriate balance between the respective expertise of the court and that of the board, allowing each to contribute its special skills in determining the outcome of the removal action.

IV. Suggested Test

A. Inadequacy of Tests Contained in Court Decisions

At present, there are no coherent or workable tests for courts to use in removal cases. Rather than seek to articulate such a test, courts are often preoccupied with whether they have the power to remove a director, and ignore the key issues of whether removal would be in the best interests of the corporation and why the shareholders did not themselves remove the director.²⁹⁴ This

292. *Koshaba v. Koshaba*, 132 P.2d 854 (Cal. Ct. App. 1942). See *infra* note 294 for more details on this case.

293. *Koshaba*, 132 P.2d at 858-59.

294. In *Koshaba v. Koshaba*, one may hypothesize as to why the shareholders did not remove the misbehaving director themselves. Perhaps the unpublished trial court decision contains the key to this puzzle, which the appellate court left unanswered. It is conceivable and even likely that the director was the controlling shareholder of the corporation, but the court failed even to mention this fact (possibly because it was not mentioned in the plaintiff's brief). While the court found that the misbehaving director dominated the existing board, it did not identify the roots of such domination and seemed to surmise that if the defendant were removed as a director, his dominance over the board would cease. The court removed the director and barred him from being reelected as a director for a period of ten years. It appointed a receiver for the corporation for the purposes of running it until a new director was elected and of calling a shareholders'

approach may be an atavism from the times when a distinction was not yet drawn between directors of business corporations and those of not-for-profit or municipal corporations or trustees.²⁹⁵ Historically, not-for-profit, municipal corporations and trusts involved a simple non-business operation and as such perhaps justified an assumption that removing a dishonest director would automatically be in the best interests of the corporation. The structure of such corporations may also explain obliviousness to the shareholder prerogative, since no similar constituency with residual interests was generally extant in these contexts.

Nahikian v. Mattingly is perhaps the only case where the court attempted to set forth a standard for the application of the removal remedy.²⁹⁶ Yet the test suggested by the *Nahikian* court exemplifies the pitfalls of inadequate consideration of the key interests pertinent to the removal remedy. The court suggested that the defendant director should be removed if the fraud was "of such nature that . . . shareholders should have removed him and have failed to do so upon request, or that demand of such action by . . . stockholders would have been futile."²⁹⁷ This test has surface appeal: if a director does something truly awful, and those with power to remove him either do not take action or it is useless even asking them, then the court should remove the director itself.

While this test might aspire to establish a universal standard with respect to the propriety of removal, it is in fact unworkable. The proper test must strike a balance between a compelling reason for removal (such as the protection of the interests of the corporation) and the shareholders' prerogative to remove. As to the former consideration, *Nahikian's* grounds for removing the director are flawed. Presumably, the first prong of the *Nahikian* test, which states that a director should be removed if the fraud was "of such nature

meeting to elect a new director. See *Koshaba v. Koshaba*, 132 P.2d 854 (Cal. Ct. App. 1942); *Ross v. 311 N. Cent. Ave. Bldg. Corp.*, 264 N.E.2d 406 (Ill. App. Ct. 1970).

295. See Travers, *supra* note 17, at 393-94 (discussing the lack of distinction by early writers between corporations serving very different functions; referring also to Williston, *The History of the Law of Business Corporations Before 1800*, in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 195 (Association of American Law Schools ed., 1909)). See also John C. Coffee, Jr., *Lecture, No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 950 (1988) (observing that corporation principles come from the law of trusts and distinguishing between the preservation of capital as the goal of a trust and risk-bearing activity as a purpose of a corporation). For the application of the removal remedy to not-for-profit corporations, see *supra* note 48.

296. *Nahikian v. Mattingly*, 251 N.W. 421 (Mich. 1933). The court, however, did not apply this test, since it decided the case on other grounds before the test could have come into play.

297. *Id.* at 424.

that directors or shareholders should have removed him" implies a concern for protecting the interests of the corporation. However, the decision whether to remove the director should depend not only on the "nature" of the fraud, but also on other considerations such as the director's management ability and other factors pertinent to the interests of the corporation, which the court fails to take into account.

The second prong of the *Nahikian* test denies the shareholder prerogative to remove directors by urging removal where shareholders "have failed to [remove] upon request, or that demand of [such] action by . . . stockholders would have been futile."²⁹⁸ This prong resembles the classic standard in a derivative action requiring demand on the board to proceed with the action on behalf of the corporation, except where demand would be futile. However, it is different from this derivative action standard in that it fails to ask whether the board's decision to reject demand should be reversed by a court because such rejection was wrongful, because, for example, the directors were interested and therefore incompetent to make the decision.²⁹⁹ Thus, the second prong does not ask *why* those with the removal power did not remove the director: is it because they represent an interested block that cannot be circumvented, in which case removal would be justified, or are they a group of unaffiliated shareholders who denied removal for some other reason, whether wise or idiosyncratic, in which case the court should bow to their wishes? Under the *Nahikian* test, the fact that shareholders said "No" to removal triggers a "Yes" by the court, instead of prompting an inquiry into the circumstances of the corporate decision-making process that could justify respecting the shareholders' will.

At the other extreme, a court's rubber-stamp of the shareholders' "No" would be equally unacceptable. The *Remillard Brick* court's ratification of interested shareholders' self-re-election is an example of this phenomenon.³⁰⁰

B. A Proposed Test

A proper test for the removal remedy's application should find a way to protect both the interests of the corporation and the prerogatives of its shareholders.³⁰¹ The test should establish an efficient mechanism for determining the best interests of the corporation and for preventing the removal of directors when their removal would not be in the best interests of the corporation. The

298. *Id.*

299. See *supra* notes 261-62 and accompanying text.

300. See *supra* notes 138-42 and accompanying text.

301. As discussed in Part II, the interests of the market are not sufficiently compelling to trump either of these premises.

test should also fix the boundaries of corporate democracy by deciding when the inherent rights of shareholders should be honored and when they should be disregarded.

Identifying the interests of the corporation implies recognizing that the board is the body that not only is entrusted with determining and ensuring, but is also best suited to determine and ensure, the corporation's best interests. Thus, the right to halt lawsuits not in the corporation's best interests that the board enjoys in a derivative action should also be available in a removal action. The court should uphold the board's rejection of a shareholder's demand or the board's decision to dismiss the removal action on the basis that the removal action would not be in the best interests of the corporation. Certainly, the votes of the directors to be removed should not count, and in general such a board determination could be deemed unnecessary or overruled on similar grounds as in derivative actions, for example when a majority of the directors adopting the decision were interested. Such a resurrection of the board's role would require the elimination of the unfounded statutory rule that a 10% shareholder may bring a removal action as a direct suit. To accomplish such an objective, all removal actions brought by shareholders should be designated as derivative.

After affording the board an appropriate opportunity to halt the proposed suit, courts must weigh the competing interests at stake in removal actions. This could be accomplished through a three-prong test.

The first and obvious prong, which is already explicit in statutes and court decisions, is the finding of gross misbehavior of a director: that "the director engaged in fraudulent and dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation."³⁰² This prong aligns with both premises of the removal remedy. In conditioning the removal remedy upon directorial misconduct, it upholds, on its face, the best interests of the corporation. This prong is also minimally intrusive upon shareholder prerogative because it limits the court's interference to certain presumably rare circumstances. However, this prong only defines a minimum threshold for judicial intervention, necessary as a matter of statutory drafting but insufficient to guide courts in exercising their discretion. Thus, the next two prongs are necessary.

The second prong seeks to promote the interests of the corporation. Since the determination of the interests of the corporation should be made in light of the director's qualifications and other complex business considerations, the court should endorse

302. MODEL BUS. CORP. ACT ANN. § 8.09 (Supp. 1997).

the board's finding that removal of the subject director is in the corporation's best interests. Only if the court could not adhere to the board's determination (if, for example, the determination was made by interested directors or was not made at all) should the court reach its own conclusion regarding the best interests of the corporation. In no event should the court merely assume that removal would be beneficial to the corporation, and only a positive determination of this issue should lead to removal.

The third prong focuses on shareholders' prerogative to elect and remove directors. It requires a showing by the plaintiff of what was termed above as an "impairment" to the exercise of shareholder voting. "Impairment" could be found either in a broadly defined conflict of interest on the part of a shareholder who controls votes necessary to remove a director ("divergence of interests impairment") or in the shareholders' inability to effect the removal due to a defective operation of the voting process ("procedural impairment"). If no impairment is found, the court's interference in corporate governance by effecting the removal remedy is unwarranted.

In applying the third prong, courts should be cognizant of the fact that impairment to removal could be cured or disproved by shareholder action. In cases of supposed procedural impairment, where shareholders through proper voting procedures have reelected or affirmatively voted to retain a director whom they know to have committed a misdeed, such action shows the absence or cessation of procedural impairment. Upon such an occurrence, the court's interference becomes unfounded.³⁰³ For a divergence of interests impairment to be disproved, a majority of the shareholders unaffected by the impairment would need to decide affirmatively, in accord with the interested shareholders, to retain or reelect the misbehaving director. The mere reelection of directors by the interested shareholders, however, should not prevent judicial removal.

Because circumstances where the decisions of controlling shareholders are impaired by their divergence of interests present the opportunity for recurring abuse, the court could entertain imposing a bar on reelecting guilty directors. However, bars on the reelection of

303. Indeed, this conclusion is consistent with the rule proposed in the ALI Principles which requires the dismissal of a derivative suit upon a concerted shareholders' action. See ALI PRINCIPLES, *supra* note 6, § 7.11. A removal action, however, makes a much better case for adherence to shareholders' action than a typical derivative action because removal of directors is a prerogative of the shareholders acting as a group, unlike an action in the name of the corporation which is within the domain of the board.

directors are not warranted in procedural impairment situations because procedural impairment is nearly always transitory.

This suggested test still leaves the discretion to the court to decide whether or not to remove a director. For example, even if the court determines that gross misbehavior has taken place, that impairment to removal by shareholders exists, and that removal is in the best interests of the corporation (perhaps adhering to the board's determination on the last point), it may decline to remove the guilty directors if there is a compelling reason to keep them on the board. While the existence of such a reason may be unlikely, it is nevertheless conceivable. For example, the court's determination that removal would unduly affect the balance of powers in the corporation might form a basis for such a decision. However, the proposed test would confine the court's discretion to the circumstances where removal would not unduly harm the interests of the corporation or deprive the shareholders of their inherent rights. On the other hand, the test would liberate the court's discretion in situations where, according to existing precedents, improper shareholder actions (such as self-reelection of guilty directors) were considered to deprive the court of its powers. The proposed test, which could be introduced judicially or codified by statute, would place judicial reasoning on a more solid foundation and be more consistent and likely to reach correct results.

Conclusion

No theory that would reconcile the conflicting approaches of various authorities to the removal remedy has been developed by legislators, judges or academics. This article proposes such a theory and a test for applying the remedy.

The theoretical approach to the judicial removal remedy should be based on two conflicting interests, the relation between which determines the propriety of the remedy. The first interest, that of shareholder democracy, if taken alone, perceives the judicial removal remedy as totally unwarranted because voting to elect or remove a director is the prerogative of the shareholders. In contrast, the second interest, that of the corporation, requires the court to intrude upon such shareholder rights if necessary to protect the corporation from continuing directorial wrongdoing.³⁰⁴ These two interests,

304. A third possible interest would view certain public policy objectives, most importantly the deterrence of directorial misbehavior in the marketplace, to be important enough to justify ignoring both the best interests of the corporation and the wishes of its shareholders. This third interest, however, is a poor basis for the removal remedy, both because the removal remedy has no noticeable market-wide deterrent effect and because alternative remedies exist that could have a similar or greater deterrent effect but would

however, can be reconciled to support a judicial removal remedy. In particular, the court should intervene to uphold the interests of the corporation where the shareholders' exercise of their voting rights is "impaired" either because removal is unduly blocked by an interested shareholder who controls the voting ("divergence of interests impairment" to the vote) or because the voting mechanism is unavailable or otherwise procedurally impeded ("procedural impairment" to the vote).

The allocation of responsibilities in applying the removal remedy should be based on the theory set forth above. When the shareholders fail to remove directors because of the existence of a procedural or divergence of interests impairment, the court and the board should both participate in ascertaining the propriety of removal in accordance with their respective areas of competence. Determining whether removing a director is in the best interests of the corporation, in light of a director's qualifications and other business considerations, constitutes a business judgment that is in the proper purview of the board. The court, however, remains better suited to determine the legitimacy of disregarding the shareholders' prerogative to remove directors by finding an "impairment" to shareholder voting and to gauge the gravity of the wrong committed by the director. The court would also be a better guard of the balance of powers within the corporation that may be affected by removal than the board.

The test proposed in this article upholds both shareholder rights and the interests of the corporation. At the outset, the test takes into consideration the relative competence of the court and the board described above by recommending that a safeguard available in derivative actions, the authority of the board to halt lawsuits that are not in the corporation's interests, should also be afforded to the board in a removal action. An unfounded statutory rule that deprives the board of such authority when a suit is brought by a shareholder holding an arbitrary number of shares should be eliminated. Certainly, such a board determination could be deemed unnecessary or overruled on similar grounds as in derivative actions, for example when a majority of the directors adopting the decision was interested.

If a removal lawsuit has not been halted by board action, the proposed test proceeds with a three-prong analysis. First, the court

not inflict the same harm upon the interests of the corporation. Certainly, other established removal remedies outside the corporate law context could address directorial misbehavior that adversely impacts areas of public policy concern (e.g., those related to the environment, taxation or the securities markets). Thus, a removal remedy designed to address wrongdoing against a corporation should not be modified to harm the corporation in pursuit of deterrence.

should consider whether an actionable wrong has been committed by the director. Second, the court should determine whether removing the director will be in the best interests of the corporation, which means adhering to the determination of the board, if available and not wrongful. Third, the court should ask whether an instance of procedural or divergence of interests impairment to shareholder voting exists. If all three criteria are met, then the misbehaving director may be removed, unless the court, in its discretion, finds that other considerations, such as the objective of preserving the present balance of powers within a corporation, are sufficiently compelling to justify retaining the director. The finding of a particular type of impairment to shareholder voting should also affect the scope of the remedy: a bar on reelecting directors may be justified when the impairment stems from divergence of interests, but not when it is merely procedural. The proposed test could be codified in the corporate statutes or introduced directly by courts.

Remedies help some and hurt others. The removal remedy can be sweeping in its application and hurt unintentionally by taking away from everyone. From shareholders, their inherent rights. From boards of directors, their inherent authority. From corporations, their directors. From directors, their jobs. Under the approach proposed in this article, the removal remedy will grant relief, but hurt less.