

*Corporate Reform Movements and Corporate Law:
Lessons from the ALI's Principles of Corporate Governance*

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Eras of corporate reform typically culminate in legislation; the federal securities laws, Sarbanes-Oxley, and the recent Dodd-Frank bill are prominent examples. Following a series of corporate scandals in the 1970s, support for reforming corporate law and constraining the behavior of corporations ran higher than any period since the Great Depression. But the principal product of that reform movement was not legislation but instead the American Law Institute's *Principles of Corporate Governance*. That work stands as the most controversial and labor-intensive project in the history of U.S. corporate law. From the time the ALI authorized it in 1978 to the publication of the final approved version in 1994, the *Principles* went through eleven contentious drafts and were the subject of six published law review symposia. For all the controversy, did anyone pay attention? Certainly legal scholars have: the *Principles* continue to be heavily cited in legal scholarship and excerpted in casebooks. But what kind of impact have the *Principles* had on the content of corporate law? Have courts found them influential?

This Article attempts to gauge the legal impact of the *Principles* and does so in two ways: first by looking generally at how courts have cited the *Principles* and then by taking an in-depth look at how courts have used the *Principles*' guidance on special litigation committees. The evidence suggests that the *Principles*' have had deep influence in a very few areas, some influence in others, and almost no influence everywhere else.

The principal measure of influence used is citations to the *Principles*. The American Law Institute itself collects citations to the *Principles* and for each citation categorizes how the court has treated the *Principles*. For example, the ALI's annotation might note that a particular provision was "quoted in support" of a holding and "adopted" in a case. Or it may say the provision was "cited but not followed." In total, there are 426 citations to the *Principles* in 185 cases between 1982 and 2007. In six cases, a court adopted some provision from the *Principles*. Approximately 37% of the citations are positive. Citations to the *Principles* peaked in 1997 (46 citations) and cases citing them peaked in 1999 (17). Citations are not distributed evenly across the *Principles*. There are 99 sections of *Principles*, and fifty of them have been cited by courts, twenty-nine three or more times. Citations to the six most-cited sections account for approximately 58% of all citations to the *Principles*. Citations to the top fifteen sections account for 80% of all citations.

As a measure of influence, these basic descriptive statistics are uninformative. But the citation counts can be made more revealing in a few ways. A comparison of citations to the *Principles* against citations to corporate law treatises shows that the influence of the *Principles* peaked in 1999, when cases citing the *Principles* equaled 22% of all cases citing secondary corporate treatises. By 2007, the number was down to 5%, suggesting that in view of the ambitions behind the *Principles* their influence is now slight. That is, in 2006 and 2007 courts cited the *Principles* as frequently as they cited *Law of Corporations*, a treatise by Harry G. Henn and John R. Alexander.

Another way to use citation patterns to get at the influence of the *Principles* is by examining whether and how courts cite their "controversial" provisions. To identify "controversial" provisions, I turned to a book called the *Guide to the ALI's Principles of*

Corporate Governance, written after their completion by Charles Hansen. A persistent critic of the reformist impulse in the *Principles*, Hansen spoke on behalf of the defense bar and in his guide praised certain portions of the *Principles* and criticized others. In his guide, Hansen said he was focusing on the more important portions of the *Principles* and offered an opinion of 36 provisions; twenty of those were positive opinions, the rest negative. Negative comments from Hansen about a provision are taken to be a signal that the provision was controversial, at least from the defense bar's perspective. In general, provisions cited in a positive way by courts (what the ALI characterizes as "adopted" or "used in support") tend to be provisions that the corporate bar found praiseworthy. In other words, the portions are the *Principles* that are influential are not reform-minded ones. When broken down by treatment, the results are just as suggestive: Of the six cases adopting a provision from the *Principles*, only one case adopted any provision that was controversial.

The citation data also indicate (although weakly) that the *Principles* have been more influential in states with fewer corporations domiciled there. This finding of a "small state effect" is consistent with the predictions of many at the time.

Citation counts are a blunt measure of influence and may fail to reflect unwritten ways that the *Principles* have shaped the development of corporate law. To investigate whether courts have moved in the direction of the *Principles* without mentioning them explicitly, I selected one area of law for a more in-depth investigation: the deference courts give to special litigation committees. The provision in the *Principles* addressing SLCs offers an off-the-shelf alternative for a court faced with the question of how much deference to afford an SLC recommendation. There were two already existing alternative legal rules: one from New York, which the ALI viewed as too permissive and explicitly disapproved of, and another from Delaware. Thus, examining at the extent to which courts select the ALI rule relative to the alternatives, particularly the criticized New York rule, can provide a sense of how influential the *Principles* have been.

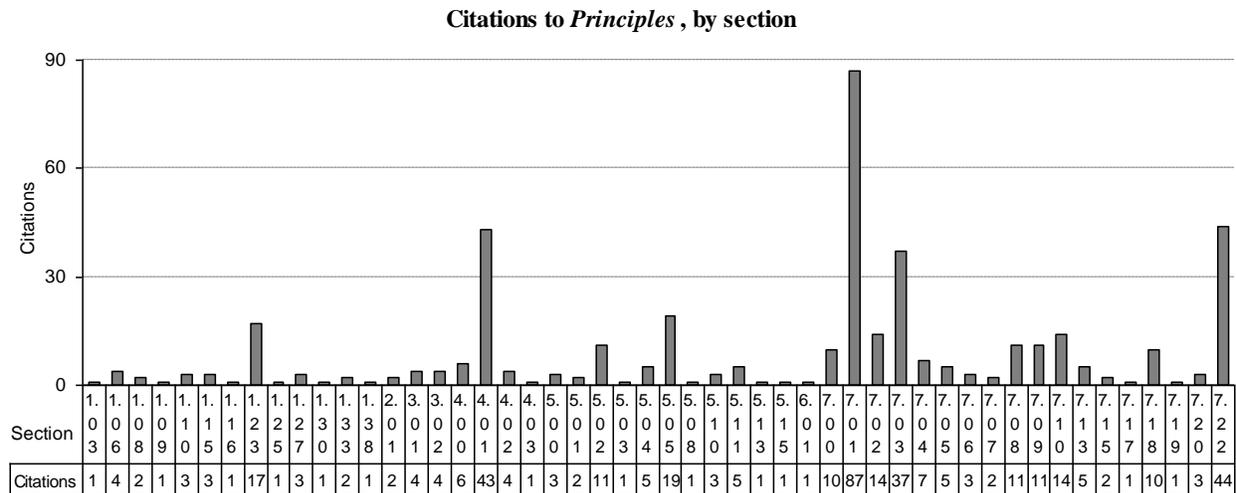
Since the *Principles* were adopted in 1994, courts in seven states have confronted the SLC issue. One of them—Pennsylvania—has explicitly adopted the ALI's position, and courts in a second state, New Jersey, have adopted that same position. By contrast, courts in four states—California, Colorado, Maryland, and Minnesota—have adopted the New York rule, the one singled out for criticism in the *Principles*. Those states do not even cite, let alone rely on, the *Principles*. Twice as many courts have gone directly against the *Principles*' recommendation as have followed it.

None of these measures alone is perfect, but taken together the picture that emerges is one of a document that has failed to live up to the aspirations of the movement that gave it birth. The *Principles* are cited roughly as often as a typical corporate law treatise, the provisions courts use are not generally the controversial ones, and those jurisdictions most apt to rely on the *Principles* are not important producers of corporate law. The pattern of citations—highly concentrated on a few sections of the *Principles*—indicates that at least a handful of sections have been influential. This uneven influence may ultimately be an unsung virtue of the *Principles*: The ALI project channeled the reformist energy of the 1970s into a document that was not mandatory law. It offered a set of legal rules that could stand or fall on their own merits. In that way, it may offer guidance for policy responses to current and future eras of reform.

Relative to what? The typical law review article or treatise on corporate law? By that standard, the *Principles* must be quite influential. But the aspiration was one that grew out of the 1970s and was designed to build on the enthusiasm generated by ambitious reform proposals from the likes of William Cary and Ralph Nader. Both proponents and critics of the ALI's corporate governance project must have believed that the product of that project would be similarly influential. The proponents believed so because this was the culmination of a groundswell of anti-corporate fervor that had been domesticated into a legal reform movement. The ferocity of the critics response to the early drafts of the *Principles* is evidence enough that they believed it would be influential.

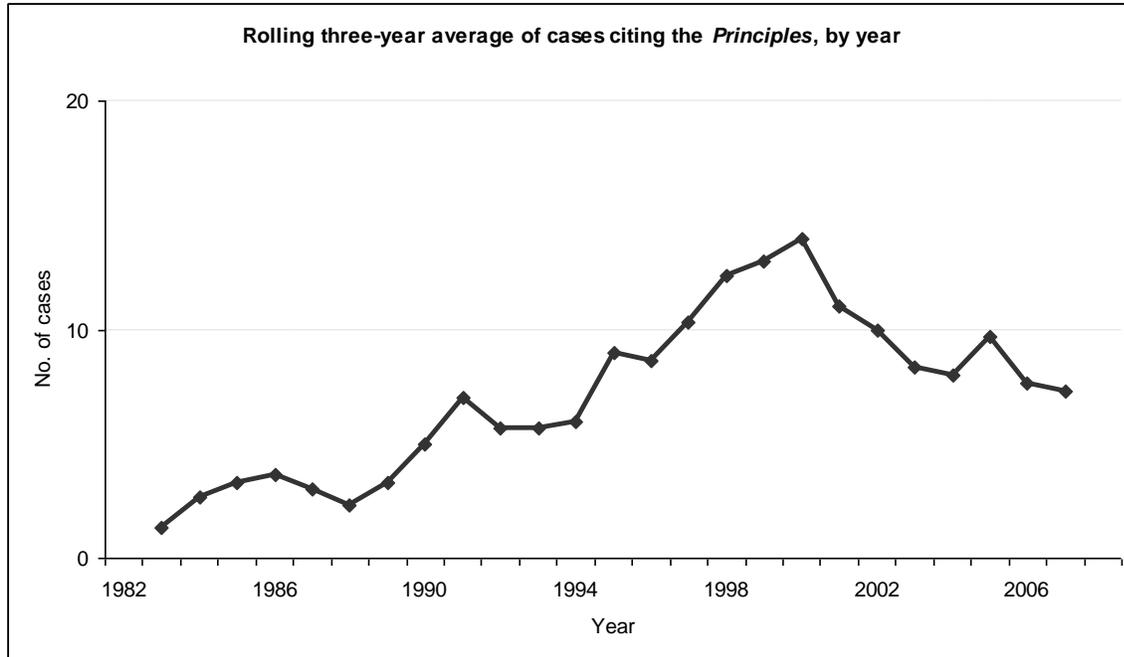
The influence on black-letter corporate law rules has been exceedingly modest.

The citations are not distributed evenly across the *Principles*. There are 99 sections of principles. Fifty have been cited by courts, and 29 sections were cited three or more times. Citations to the top six sections account for approximately 58% of all citations to the *Principles*. Citations to the top fifteen sections account for 80% of all citations.



Section 7.01, cited 87 times, distinguishes between direct and derivative shareholder actions. Section 7.22, cited 44 times, outlines standards courts should apply in determining the fair value of shares in an appraisal action. Section 4.01, cited 43 times, details the duty of care and business judgment rule. Section 7.03, cited 37 times, sets out the Principles approach to the demand rule. Section 5.05, cited 19 times, contains the rules on corporate opportunity and section 1.23, cited 17 times, defines the term “interested.”

To gauge



How have courts used the Principles?

Cited sources are used in a variety of ways, and merely tabulating citations does not reflect

does not reveal the ways in which courts The ALI sifts through the citations and characterizes the treatment of the ALI product.

The

Table XX		
Court's treatment of <i>Principles</i>	Citations (n=426)	Cases (n=245)
Adopted	15 (3.5%)	6 (2.4%)
Used for support	143 (33.6%)	81 (33.1%)
Noted in discussion	159 (37.3%)	88 (35.9%)
Noted in footnote	78 (18.3%)	52 (21.2%)
Distinguished	12 (2.8%)	8 (3.3%)
Declined to follow	8 (1.9%)	5 (2.0%)
Other	11 (2.6%)	5 (2.0%)

Which courts cite to the *Principles*?

Sixty-seven different courts—34 state courts and 33 federal courts—have cited the *Principles*. Cases citing the *Principles* by court are set out in Table XX.

Cases citing the Principles, by court			
<i>State</i>		<i>Federal</i>	
<i>Court</i>	<i>Cases</i>	<i>Court</i>	<i>Cases</i>
Delaware	18	Seventh Circuit	11
Indiana	11	Third Circuit	5
Massachusetts	11	S.D. New York	3
Oregon	8	Second Circuit	3
New Jersey	7	D. Massachusetts	3
CT, MS, MN	5	E.D. Pennsylvania	3
CO, KS, ME, NY, UT	4	Sixth Cir., D.C. Cir., E.D. Va., D. Kan.	2
AZ, IL, MD, PA	3	Supreme Court, 5 circuit courts, 17 district courts	1
IA, NC, ND, OH, WY	2		
AR, CA, FL, NE, NH, NM, SD, TN, TX, VA, WA, WI	1		
34 state courts	124 cases	33 federal courts	61 cases

Judge Frank Easterbrook, himself a preeminent scholar of corporate law, is the author of seven of the eleven Seventh Circuit cases citing the *Principles*.

Do this by cites and treatment too.

The Small State Hypothesis

At the conclusion of the ALI’s corporate governance project, a common prediction was that the *Principles* would be more useful to states with less developed corporate law doctrine.¹ Others have suggested that small states more apt to rely on ALI Restatements generally.²

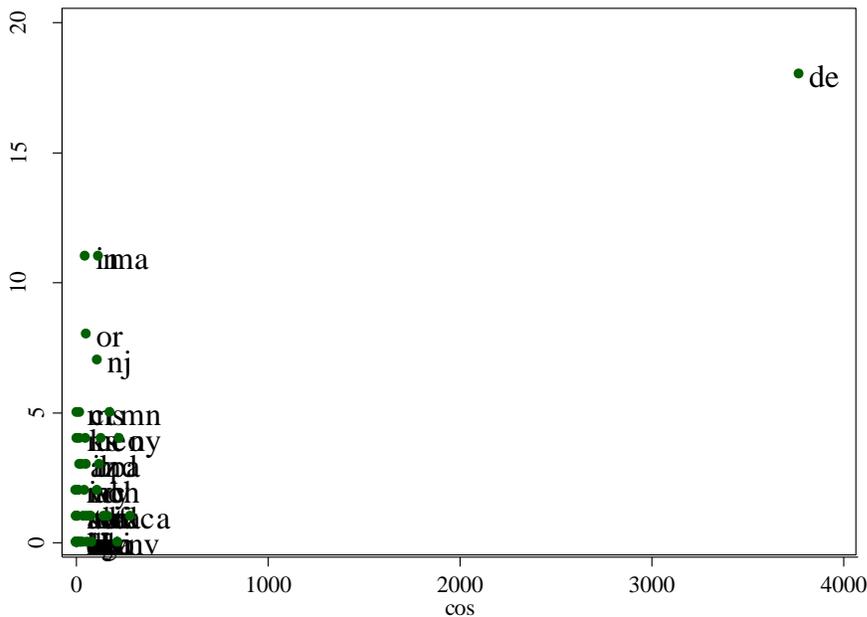
¹ Roswell Perkins, President of the ALI for most of the corporate law project, said that “[i]n cases of first impression in a particular jurisdiction, . . . courts will be aided by the analysis contained in the *Principles*.” Roswell B. Perkins,

While there is no metric for the robustness of a state's corporate law doctrine, a useful proxy is the number of publicly-traded corporations incorporated in a particular state.

The

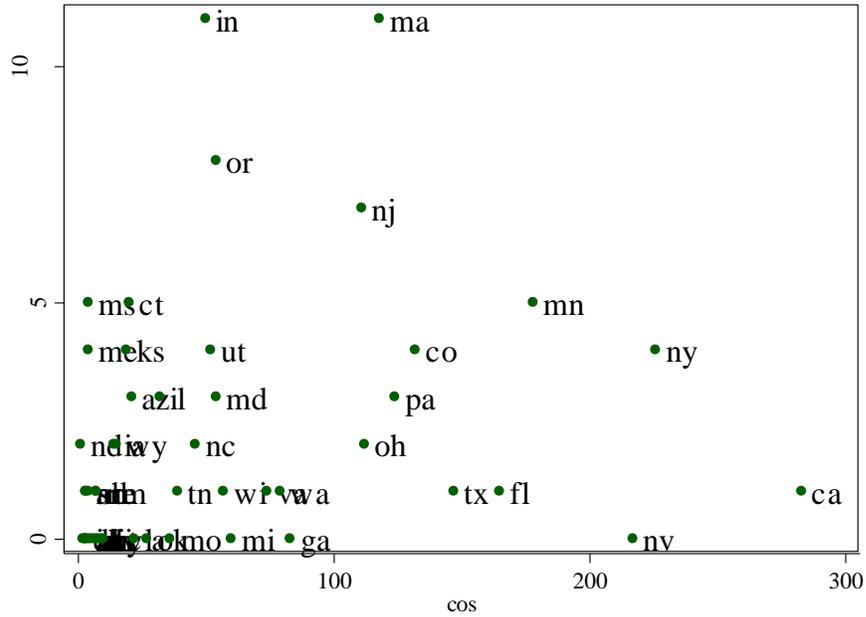
Data on the number of publicly-traded corporations that were incorporated in each state as of 2000. In the Bebchuk data, Nebraska had zero publicly-traded companies incorporated. To allow for calculations, that value was replaced with 1.

Bebchuk Vigorous Race or Leisurely Walk, YLJ, at 567.



Thanks, Myth, and Reality, 48 BUS. LAW. 1313, 1316-17 (1993). Charles Hansen made a similar prediction: “Many issues treated in detail in the Principles are complicated and involve sophisticated analysis. Busy courts, particular those who face these issues only infrequently, will almost necessarily turn to positions adopted by the highly respected American Law Institute for Guidance.” CHARLES HANSEN, A GUIDE TO THE AMERICAN LAW INSTITUTE CORPORATE GOVERNANCE PROJECT 7 (1995).

² See Peter Tiersma, *The Textualization of Precedent*, 82 NOTRE DAME L. REV. 1187, 1241 (2007) (“Not surprisingly, it appears to be the less populated states (which tend to have a less fully developed case law) that are particularly inclined to incorporate provisions of the Restatements into their law.”).



The top 16 states for incorporations. They comprise 90% of all publicly-traded corporations.

. ttest cases, by(lotsco)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
0	35	1.857143	.422364	2.498739	.9987959	2.71549
1	16	3.6875	1.210092	4.840368	1.10825	6.26675
combined	51	2.431373	.4852773	3.465573	1.456664	3.406081
diff		-1.830357	1.02359		-3.887338	.2266237

Degrees of freedom: 49

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0
t = -1.7882

Ha: diff != 0
t = -1.7882

Ha: diff > 0
t = -1.7882

P < t = 0.0400 P > |t| = 0.0799 P > t = 0.9600

When adjusted, the results are different.

. ttest caseperco, by(lotsco)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
0	35	.2004	.069444	.410836	.0592729	.3415271
1	16	.0201875	.0062903	.0251614	.0067799	.0335951
combined	51	.1438627	.0489291	.3494234	.0455858	.2421396
diff		.1802125	.1033618		-.0275008	.3879258

Degrees of freedom: 49

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
t = 1.7435	t = 1.7435	t = 1.7435
P < t = 0.9562	P > t = 0.0875	P > t = 0.0438

Correlation between number of companies and citations per company is -0.13 with Delaware included and -0.32 with Delaware excluded.

The correlation between companies and cases is 0.66. Without Delaware it is 0.19.

. ttest total, by(lotsco)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]
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0	21	6.809524	1.464857	6.712816	3.753886	9.865161
1	13	12.61538	3.783463	13.64147	4.371926	20.85884
-----+						
combined	34	9.029412	1.742049	10.1578	5.485187	12.57364
-----+						
diff		-5.805861	3.492645		-12.92015	1.308425

Degrees of freedom: 32

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
t = -1.6623	t = -1.6623	t = -1.6623
P < t = 0.0531	P > t = 0.1062	P > t = 0.9469

. ttest citesperco, by(lotsco)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
0	21	.6169857	.2020525	.925921	.1955115	1.03846
1	13	.0834666	.0304336	.1097298	.0171576	.1497757
-----+						
combined	34	.4129931	.1320907	.7702144	.1442526	.6817336
-----+						
diff		.5335191	.2594145		.005109	1.061929

Degrees of freedom: 32

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
t = 2.0566	t = 2.0566	t = 2.0566
P < t = 0.9760	P > t = 0.0480	P > t = 0.0240

Griffin Bell, Afterword to Hansen book, 192 (“While Mr. Hansen correctly takes issue with the *Principles* in a number of areas . . ., he is also quick to point out subject matter as to which he believes the *Principles* make a meaningful and constructive contribution to the law.”).

After the adoption of the final version of the Principles, Charles Hansen a persistent critic of the reformist impulse in the *Principles*, wrote a monograph evaluating the final product. He praised certain portions of the report and criticized others. Hansen generally spoke on behalf of the defense bar and his criticisms reflect an affection for the status quo of Delaware law – that is, contrary to both the reformist impulse of the Reporters and also to the takeover law reforms proposed by the law-and-economics crowd.

In his Guide, Hansen offered an opinion of 36 provisions of the Principles. Hansen said he focused on the more important portions of the Principles.

The citation data bear this out.

The 33 provisions he evaluated have been cited more frequently than other portions of the Principles.

Hansen evaluation

No Hansen evaluation

Evaluated by Hansen		
Not evaluated by Hansen		

. ttest totalcites, by (hnsncmit)

Two-sample t test with equal variances

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Group |  Obs   Mean  Std. Err.  Std. Dev.  [95% Conf. Interval]
-----+-----
  0 |   24   3.625  .9608505   4.707187   1.637329   5.612671
  1 |   32   6.6875  2.773884  15.69146   1.030127  12.34487
-----+-----
combined |   56   5.375  1.638728  12.26312   2.090915   8.659085
-----+-----
diff |      -3.0625  3.315854           -9.710387  3.585387
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Degrees of freedom: 54

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
t = -0.9236	t = -0.9236	t = -0.9236
P < t = 0.1799	P > t = 0.3598	P > t = 0.8201

. ttest totalcites, by (praise)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
0	40	4.05	.8733593	5.523609	2.283464	5.816536
1	16	8.6875	5.336758	21.34703	-2.687531	20.06253
combined	56	5.375	1.638728	12.26312	2.090915	8.659085
diff		-4.6375	3.606109		-11.86731	2.592312

Degrees of freedom: 54

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
t = -1.2860	t = -1.2860	t = -1.2860
P < t = 0.1020	P > t = 0.2039	P > t = 0.8980

. ttest totalposcites, by (praise)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
0	40	2.95	.6303743	3.986837	1.674948	4.225052
1	16	7.375	4.555102	18.22041	-2.333971	17.08397
combined	56	4.214286	1.375036	10.28983	1.458652	6.969919
diff		-4.425	3.012226		-10.46415	1.61415

Degrees of freedom: 54

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
t = -1.4690	t = -1.4690	t = -1.4690
P < t = 0.0738	P > t = 0.1476	P > t = 0.9262

. ttest totalposcites, by (hansneg)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
0	43	4.348837	1.757403	11.52406	.8022547	7.89542
1	13	3.769231	1.246296	4.493585	1.053784	6.484677
combined	56	4.214286	1.375036	10.28983	1.458652	6.969919
diff		.5796064	3.285909		-6.008244	7.167457

Degrees of freedom: 54

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
t = 0.1764	t = 0.1764	t = 0.1764
P < t = 0.5697	P > t = 0.8606	P > t = 0.4303

. ttest totalcites, by (hansneg)

Two-sample t test with equal variances

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
0	43	5.27907	2.060902	13.51424	1.120002	9.438137
1	13	5.692308	1.959149	7.063812	1.423689	9.960926
combined	56	5.375	1.638728	12.26312	2.090915	8.659085
diff		-.4132379	3.916776		-8.265901	7.439426

Degrees of freedom: 54

Ho: mean(0) - mean(1) = diff = 0

Ha: diff < 0	Ha: diff != 0	Ha: diff > 0
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t = -0.1055 t = -0.1055 t = -0.1055
P < t = 0.4582 P > |t| = 0.9164 P > t = 0.5418

General acceptance:

Arizona: An Arizona intermediate court has said the *Principles* “qualif[y] for the deference we traditionally grant to the Restatements of the ALI.” *AMERCO v. Shoen*, 184 Ariz. 150, 155, 907 P.2d 536, 541 (Ariz. Ct. App. 1995).

“An enthusiastic Arizona court has gone so far as to declare that ‘[t]his court, when not bound by previous decisions or legislative enactments, follows the Restatement of the Law.’” Tiersma, 1241 (quoting *Pilafas v. Ariz. Zoological Soc'y*, 836 P.2d 420, 423 (Ariz. Ct. App. 1992)).

Pennsylvania: Cuker

Massachusetts: “In determining the common law applicable to corporations, we may look to the [*Principles*].” American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994). See *Demoulas v. Demoulas Super Markets, Inc.*, 424 Mass. at 523-530, 677 N.E.2d 159, citing the final draft of *Principles of Corporate Governance*; *Houle v. Low*, 407 Mass. 810, 819, 556 N.E.2d 51 (1990), applying selected provisions of tentative draft No. 8 (1988) of *Principles of Corporate Governance*; *Dynan v. Fritz*, 400 Mass. 230, 241, 508 N.E.2d 1371 (1987), applying selected provisions of tentative draft No. 5 (1986).

Not happy with it:

In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 967 n. 15 (Del. Ch. 1996) (suggesting that the *Principles* formulation of the business judgment rule misunderstands the duty of care).

Special litigation committee procedure

Some states do more than Auerbach but less than Zapata. In Tennessee, for example, the court may scrutinize the committee’s reasoning but may not substitute its own judgment for the committee’s.

Twenty-one states have adopted the MBCA, which has its own detailed approach to reviewing special litigation committee recommendations.

One of the first state high courts to confront the issue was the New York Court of Appeals in *Auerbach v. Bennett*. Auerbach involved an SLC that had moved to dismiss derivative claims brought by a shareholder, and the Court of Appeals argued that the decision should be subject only to business judgment review.

The case received a large degree of criticism for ignoring the potential that directors on SLCs would not view the claims against their fellow directors impartially.

Delaware

In 1979, John Coffee wh

Over twenty states have adopted the Model Business Corporation Act, which sometimes has superseded cases on special litigation committees.

ca	auerbach	2003
co	auerbach	1999
in	auerbach	1986
md	auerbach	2007
mn	auerbach	2008
oh	auerbach	1990

Courts in five states have adopted Auerbach. Ohio in 1990, Colorado in 1999, California in 2003, Maryland in 2007, and Minnesota in 2008.

One statute has adopted the Auerbach standard. Indiana 1986.

Others have called for a higher standard of review similar to the Delaware standard.

Miller (1983).

North Carolina (1987).

Massachusetts (1990).

Tennessee (1992)

Pennsylvania (1997) (adopting the ALI).

Kentucky (1998)

New Jersey (2002).