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The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay¹

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If any distinction in our law has survived the test of time, it is that between substance and procedure. That was true when I was a law student, and it is true today. The classic expression of that distinction is that substantive laws—whether statutory, administrative, or judge-made—are rules that are intended to guide the conduct of persons subject to the rule.

I. INTRODUCTION

Substantive rules typically state the rights and duties as among citizens, and disclose the circumstances where courts redress violations of those rights and duties. Procedural laws, on the other hand, are rules of procedure that have been adopted by courts and legislatures, and that instruct persons on how to bring a controversy before a court, and how to proceed in that court to obtain redress. A workable description of procedural rules is that they prescribe the mechanics of litigation.³

The substance-procedure distinction comes up in various areas of our law. Choice of law is a good example. Who can forget *Erie Railroad Co. v. Tompkins*⁴ from our first year of law school? In *Erie*, the U.S. Supreme Court held that where federal court jurisdiction is grounded on diversity of

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2. Justice, Delaware Supreme Court.

3. RICHARD H. FIELD & BENJAMIN KAPLAN, MATERIALS ON CIVIL PROCEDURE 3-4 (1953).

4. 304 U.S. 64 (1938).

citizenship, the federal court must apply the substantive law of the forum state as the rule of decision, and can apply federal common law only as to matters of procedure.⁵

The substance-procedure distinction arises in state courts as well. Suppose, for example, that a lawsuit is brought in a court of state A to enforce a cause of action arising under the law of state B. The choice of law rule is that the law of the forum state governs procedural matters while the law of the state where the cause of action arose governs substantive matters.⁶

Over the years, the substance-procedure distinction, although far from perfect, has, by and large, proved workable in most areas. Not surprisingly, where outcomes turn on choice of law matters, litigation inevitably has arisen over what issues are “procedural,” and which are “substantive.”⁷ But, in at least one area—corporate law—the distinction has begun to fray around the edges. That development has become problematic for reasons I will later explain.

The story that I come to tell is that, in the corporate law area, procedure has come to beget substance, and substance has begotten procedure. That development has unnecessarily complicated the efficient and speedy litigation of corporate and business law disputes. My message is that procedural rules are an important part of our legal dispute resolution system, and that for the system to operate satisfactorily, the crafting of procedural rules should be accomplished by an institutional process. Where possible, this process should remain separate from the articulation of substantive rules as part of the common law adjudication process.

At first blush this statement undoubtedly sounds abstract. To bring the subject closer to earth, I will discuss selected Delaware corporate cases to illustrate the thought that I am trying to convey. After that, I will argue why what I describe as the “vanishing distinction” between substance and procedure merits our attention. Thereafter, I will conclude with some modest suggestions.

II. PROCEDURE BEGETTING, THEN BLENDING INTO, SUBSTANCE

I start with a quintessentially procedural rule—Rule 23.1 of the Delaware Court of Chancery (Rule 23.1). That Rule, which governs derivative stockholder actions, is the substantially similar counterpart to Rule 23.1 of the

5. *Id.* at 78. See generally Note, *Erie R.R. v. Tompkins and the Federal Rules*, 62 HARV. L. REV. 1030 (1949).

6. See, e.g., *Cheff v. Athlone Indus., Inc.*, 233 A.2d 170, 173 (Del. 1967); *Connell v. Delaware Aircraft Indus.*, 55 A.2d 637, 640 (Del. Super. 1947); *Marshall v. Geo. M. Brewster & Son, Inc.*, 180 A.2d 129, 131 (N.J. 1962); *Commonwealth v. Sanchez*, 716 A.2d 1221, 1223 (Pa. 1998); *Sudol v. Gorga*, 31 A.2d 119, 120 (Pa. 1943).

7. See *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96-97 (1991) (holding demand doctrine of Federal Rule of Procedure 23.1 a rule of substance and not procedure); *Rales v. Blasband*, 634 A.2d 927, 932 n.7 (Del. 1993).

Federal Rules of Civil Procedure.⁸ Chancery Rule 23.1 directs that “[t]he complaint . . . shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority . . . and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.”⁹ Both federal and state courts have construed this language to mean that before filing a derivative action, a stockholder must make a demand on the board of directors to redress the wrong complained of.¹⁰ If no demand is made, then the plaintiff must plead in the complaint, with particularized facts, why making a pre-suit demand before filing suit would have been futile. If the plaintiff does not make a demand or plead demand futility, then the case, on motion by the defendants, can be dismissed at the pleading stage.¹¹

Although both the Federal and Delaware Rule 23.1 contemplate the making of a demand, in most Delaware stockholder derivative actions, no demand is ever made.¹² In most cases, after a derivative action is filed, the defendant moves to dismiss the complaint under Rule 23.1 on the ground that a demand was required but not made.¹³ In response, the plaintiff opposes the motion on the ground that a pre-suit demand on the board would have been futile because the board members would not have been motivated to sue their fellow directors.

The reason a plaintiff’s counsel usually does not make a demand is that doing so invites the board of directors to take the lawsuit out of counsel’s hands. Once a demand is made, the board may then either substitute the corporation as the plaintiff or redress the alleged wrong in other ways without litigation. Either approach would eliminate the opportunity for plaintiffs’ counsel to receive a court-awarded fee, which motivates most derivative lawsuits. Unwilling to take that risk, most plaintiffs’ counsel resort to their only other option: to argue that a demand would have been futile and, therefore, was not required.

This approach created a dilemma, because in Delaware, the facts establishing demand futility must be pled in the complaint with particularity, yet no discovery is permitted to develop those facts at the Rule 23.1 stage. The

8. FED. R. CIV. P. 23.1.

9. DEL. CH. CT. R. 23.1. The corresponding Federal Rule 23.1 is identical, except that after the phrase “from the shareholders or comparable authority,” it goes on to state “and, if necessary, from the shareholders or members.” FED. R. CIV. P. 23.1.

10. See, e.g., *Stadin v. Union Elec. Co.*, 309 F.2d 912, 921 (8th Cir. 1962); *Stone v. Ritter*, 911 A.2d 362, 366 (Del. 2006); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

11. See *supra* notes 9-10 and accompanying text (explaining federal and Delaware rules and points of litigation).

12. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1758-59 (2004) (noting that as a practical matter, plaintiffs almost never make demand on board of directors). Instead, plaintiffs plead that a demand on the board would have been futile. See *id.* at 1759.

13. *Id.*

legal issue thus became: what level of factual specificity is required to plead successfully that a demand would have been futile? Until 1984, the case law provided no clear, definitive answer. Because the issue was procedural, one would expect that the answer would also be procedural, but that is not what happened. In 1984, the Delaware Supreme Court decided *Aronson v. Lewis*,¹⁴ providing an answer that was both substantive and procedural. *Aronson* also spawned an entirely new area of substantive law that further blurred the substance-procedure distinction.

Aronson was an appeal from a denial of a motion to dismiss a derivative action under Rule 23.1 for failure to make a pre-suit demand on the board of a company that owned a chain of parking lots.¹⁵ The directors approved a consulting agreement with the company's retired seventy-five year-old founder and former chief executive officer, who owned forty-seven percent of the corporation's stock and thus had effective control.¹⁶ Under the consulting agreement, he would receive \$150,000 per year for the first three years, \$125,000 for the next three years, and \$100,000 thereafter for life.¹⁷ The plaintiffs filed a derivative action, claiming that by approving this agreement, the directors had wasted corporate assets. The issue was whether a pre-suit demand on the board was required. If it was, dismissal would follow because the plaintiffs failed to make such a demand.¹⁸

The complaint alleged that a demand on the board was not required because: (1) all the directors had been named as defendants and were liable for the wrongs complained of; (2) the former CEO dominated and controlled the board; and (3) having the corporation bring the lawsuit would require the directors to sue themselves, which no rational board would ever do.¹⁹ The Court of Chancery found these allegations sufficient to establish demand futility, and denied the dismissal motion.²⁰ On appeal, the Delaware Supreme Court reversed.²¹

Although the demand requirement is part of a rule of *procedure*, the Delaware Supreme Court described the Rule 23.1 demand requirement as “a rule of substantive right, designed to give a corporation the opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise.”²² The Supreme Court grounded the demand requirement upon a substantive rationale—that the statutory power of a corporate board to “manage the business and affairs of the corporation” included the power to bring, or

14. 473 A.2d 805 (Del. 1984).

15. *Id.* at 807.

16. *Id.* at 808.

17. *Id.* at 808-09.

18. DEL. CH. CT. R. 23.1.

19. *Aronson*, 473 A.2d at 809.

20. *Aronson v. Lewis*, 473 A.2d 805, 817-18 (Del. 1984).

21. *Id.* at 818-19.

22. *See id.* at 809 (citing *Lewis v. Aronson*, 466 A.2d 375, 380 (Del. Ch. 1983)) (emphasis added).

refuse to bring, a lawsuit on the corporation's behalf.²³ Thus, the issue, as framed by the Delaware Supreme Court, was when may a court divest that decision-making power from the board and "re-vest" it in a stockholder. The *Aronson* court's answer was: only in cases where the board's decision not to sue would not be protected by the business judgment rule. Thus, to answer a procedural question—how to plead demand futility—a court would have to determine whether a doctrine of substantive law—the business judgment rule—would or would not apply to protect the complained of board action.

But how can the business judgment rule help a plaintiff's lawyer to draft a complaint that will pass the demand futility test? The *Aronson* court answered that the plaintiff must "allege facts with particularity which, taken as true, support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment."²⁴ Specifically, the pleaded facts must create a reasonable doubt either that "(1) the directors are disinterested and independent [or that] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment," meaning that the directors had either acted with appropriate due care, or that the transaction did not constitute corporate waste.²⁵

In adopting this test, the *Aronson* court blended together a procedural requirement with a substantive rule. It did so by characterizing the demand requirement as a substantive right and by infusing the term "demand futility" with substantive business judgment concepts such as disinterest, independence, and business judgment. Before *Aronson*, these substantive concepts had never been used as drivers of a Delaware procedural rule. After *Aronson*, these concepts acquired operative significance in determining whether a derivative action would be allowed to survive. Given the interests at stake, it was inevitable that in future derivative actions the meaning of these key terms—disinterest, independence, due care, and good faith—would be intensively litigated. And they were; during the next two decades, a new body of case law developed, centering on the question of whether a pre-suit demand on the board would have been futile.²⁶

Aronson had other impacts. One unforeseen consequence was that it spawned new motion practices that resulted in additional delay and expense in resolving corporate disputes. Aside from the complications of the demand requirement, many corporate cases are often over-litigated. Such cases typically involve a motion to dismiss for failure to state a claim, followed by discovery, then a motion for summary judgment, and then a trial or a settlement of whatever claims remain in the case. A demand excused motion added yet

23. *Id.* at 811 (quoting DEL. CODE ANN. tit. 8, § 141(a) (2007)).

24. *Aronson*, 473 A.2d at 815.

25. *Id.* at 814.

26. See, e.g., *Grimes v. Donald*, 673 A.2d 1207, 1217-18, nn.19-20 (Del. 1996); *Grobow v. Perot*, 539 A.2d 180, 191 (Del. 1988); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003).

another round of briefing, argument, and judicial opinion—all at the pleading stage—that further prolonged the duration of the lawsuit. Further, any appeal taken from the demand ruling would add up to another year of delay before the parties could know whether the court would allow the lawsuit to proceed.

This Rule 23.1 motion practice also generated two procedural sideshows that further Balkanized derivative stockholder litigation practice. First, to avoid the delay and uncertainty of a Rule 23.1 motion, stockholder plaintiffs began to style their lawsuits as class actions, which are governed by a different procedural rule—Rule 23—that contains no demand requirement. In response, defense counsel would file a Rule 23.1 dismissal motion, arguing that the complaint, though styled as a class action, was substantively a derivative action that was subject to dismissal for failure to make a demand. These motions generated more litigation (and judicial opinions) over whether the claim was derivative or direct, and over how to tell the difference. Not until 2004 did the Supreme Court, in *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*,²⁷ provide some clarity to this somewhat muddled area of the law.²⁸

The second practice was an outgrowth of *Aronson's* requirement to plead particularized facts at a stage where no discovery is permissible, thus impeding the development of facts needed to establish demand futility.²⁹ One tactical solution was to institute a statutory proceeding to inspect corporate books and records under section 220 of the Delaware General Corporation Law.³⁰ Under section 220 and comparable statutes of other states, a shareholder has an enforceable right to inspect specified categories of corporate books and records if the shareholder can show a reasonable purpose related to his or her shareholder status.³¹ Although this approach helped mitigate somewhat the burdens of a process that required pleading specific facts without prior discovery, the section 220 proceeding had a downside in that it added another layer of litigation that took time and additional expense. One consequence of this problem was that it limited bringing derivative actions to cases where counsel already possessed the necessary facts or where the stakes were high enough to warrant filing a books and records inspection proceeding.³² I do not

27. 845 A.2d 1031 (Del. 2004).

28. *Tooley* did not entirely clarify this area of the law because litigants find reasons to litigate the meaning of the *Tooley* case. See *In re J.P. Morgan Chase & Co. S'holders Litig.*, 906 A.2d 766, 771 (Del. 2006); *Gentile v. Rossette*, 906 A.2d 91, 99-103 (Del. 2006).

29. See *Levine v. Smith*, 591 A.2d 194, 208-09 (Del. 1991) (holding shareholder not entitled to discovery before responding to motion to dismiss).

30. DEL. CODE ANN. tit. 8, § 220 (2007); see *Brehm v. Eisner*, 746 A.2d 244, 266-67 (Del. 2000); *Scattered Corp. v. Chicago Stock Exch.*, 701 A.2d 70, 78 (Del. 1997); *Grimes v. Donald*, 673 A.2d 1207, 1216 n.11, 1218 (Del. 1996); *Rales v. Blasband*, 634 A.2d 927, 934-35 (Del. 1993).

31. See *supra* note 30 (citing Delaware cases addressing shareholder records inspection).

32. See *Freund v. Lucent Tech., Inc.*, No. 18893, 2003 Del. Ch. LEXIS, at *13 (Del. Ch. Jan. 9, 2003) (noting public policy of encouraging stockholders to use section 220 before filing as a means of meeting heightened pleading standards of Rule 23.1); see also *Scattered Corp.*, 701 A.2d at 78; *Grimes*, 673 A.2d at 1218.

mean to suggest that this consequence was necessarily bad. Rather, my point is that no one would have predicted this result in 1984 when *Aronson* was decided.

The Delaware Rule 23.1 demand jurisprudence may fairly be described as an example of a body of *substantive* law that evolved from a judicial interpretation of a purely *procedural* rule. That result was not preordained; in some jurisdictions courts treat a pre-suit demand as a procedural requirement rather than as a rule of substance.³³ In states that have adopted the Model Business Corporation Act, for example, a demand is required in every case before a derivative suit is filed.³⁴ The American Law Institute's Principles of Corporate Governance impose a similar universal demand requirement.³⁵ Under both the Model Act and ALI approaches, at the pleading stage, a court would not decide whether a pre-suit demand is required. Instead, parties would litigate that issue as a defense on a fully developed record, either on a motion for summary judgment or at trial.³⁶ This is not to suggest that Delaware should have adopted that process. Indeed, an important purpose of the *Aronson* approach to the demand requirement is to screen out, at the earliest stage, derivative litigation that will likely prove to be groundless. Another purpose is to avoid subjecting corporate defendants to the expense and disruption of needless discovery and a merits determination.³⁷

III. SUBSTANCE BEGETTING, THEN BLENDING INTO, PROCEDURE

The Rule 23.1 demand scenario exemplifies procedure begetting, and then blending into, substance. The opposite scenario has also arisen in corporate law where substance has begotten, and then blended into, procedure. The classic example of this latter development is *Smith v. Van Gorkom*,³⁸ where the Delaware Supreme Court held the board of directors of a public company monetarily liable for breaching their fiduciary duty of care. In *Van Gorkom*, the CEO had negotiated a sale of the corporation without the directors'

33. See *In Re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 980 (9th Cir. 1999).

34. See MODEL BUS. CORP. ACT § 7.42 (1999).

35. PRINCIPLES OF CORP. GOVERNANCE § 7.03 cmt. C (1992). ("Delaware views the demand rule as effecting a substantive allocation of power to the board to dismiss derivative litigation. Not all jurisdictions concur in this view.")

36. See *supra* notes 34-35.

37. The United States Supreme Court appears to be moving in the same direction with respect to motions to dismiss under Federal Rule of Civil Procedure 12(b)(6). In the recent decision, *Bell Atlantic v. Twombly*, decided after I delivered this lecture, the Court increased the plaintiffs' pleading burden to avoid a Rule 12(b)(6) dismissal. 127 S. Ct. 1955, 1983 (2007). The Court held that "something beyond the mere possibility of [a claim] must be alleged, lest a plaintiff with 'a largely groundless claim' be allowed to 'take up the time of a number of other people with the right to do so representing an *in terrorem* increment of the settlement value.'" *Id.* at 1966 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975)).

38. 488 A.2d 858 (Del. 1985).

knowledge or prior approval.³⁹ Relying solely on information from the CEO, the directors approved the merger without independent oversight of the process and without an independent valuation of the company to determine whether the proposed merger price was financially fair.⁴⁰

Van Gorkom had two distinct but related impacts.⁴¹ First, it unsettled the corporate community, because until then, no corporate board had been held monetarily liable solely for breaching its duty of care. Before *Van Gorkom*, courts imposed liability on the board only where it had approved a corporate transaction in which the directors either had a conflicting financial interest or had approved a scheme they knew to be wrongful.⁴² In *Van Gorkom*, however, the directors, all of whom were highly distinguished members of the business community, had not acted disloyally or in bad faith. At worst, they could be faulted for having acted without due care. Thus, on the director liability front, the case broke new ground.⁴³

Van Gorkom's second impact was to create a national directors and officers (D&O) liability insurance crisis. The insurance industry reacted to the decision by raising the cost of D&O liability insurance to almost prohibitive levels, and in some cases, stopped providing D&O insurance altogether. This loss of affordable insurance coverage threatened to trigger mass resignations from public company boards—a development no business community would long tolerate.

The solution, first adopted by Delaware in 1986 and thereafter by many other states, was to enact so-called director exculpation statutes.⁴⁴ These statutes authorize a corporation to adopt a charter provision exculpating directors from money damages liability that results solely from an adjudicated violation of the duty of care.⁴⁵ Delaware's exculpation statute, popularly referred to as "Section 102(b)(7)," accomplished that result somewhat baroquely.⁴⁶ The statute sets down the blanket rule that a corporation may exculpate a director from monetary liability for breach of fiduciary duty as a director.⁴⁷ It then carves out a series of exceptions encompassing every violation of duty for which a director could be held liable—except the duty of

39. See *id.* at 864-70 (detailing facts of transaction).

40. *Id.*

41. See generally William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review*, 96 NW. U. L. REV. 449 (2002) (detailing *Van Gorkom* and criticizing its misapplication of Delaware's substantive policy judgments underlying the gross negligence standard for liability of corporate directors).

42. *Id.* at 458.

43. While purporting to apply a gross negligence standard of review, *Van Gorkom* was the first case to apply an ordinary negligence standard. *Id.*

44. See Allen, Jacobs, & Strine, *supra* note 41, at 458 n.36.

45. DEL. CODE ANN. tit. 8, § 102(b)(7) (2007); MODEL BUS. CORP. ACT. § 2.02(b)(4) (1999).

46. Tit. 8, § 102(b)(7).

47. See *infra* note 48 (quoting statute).

care.⁴⁸

It is difficult to characterize this statute as anything other than substantive. The logic is simple: if a statute that creates a *basis* for liability is substantive (as it surely must be), then so too must be a statute that creates *exemptions* from liability. The substantive character of the statute was not problematic. The problem lay in what the statute did not do. Specifically, although Section 102(b)(7) was intended to protect directors against adjudicated dollar liability, it failed to prescribe a procedure for its implementation in court. Nor did the courts adopt any procedural rule to instruct the bench and bar how the statute should be applied in a court proceeding involving an exculpation defense. This omission spawned a host of procedural issues that could only be resolved by litigation that, in turn, led to unforeseen issues that begat additional litigation, as the following examples illustrate.

Assume that a stockholder sues a corporation's directors for damages for breaching their duty of care. The corporation's charter has an exculpation provision, but the derivative complaint does not plead or otherwise refer to that provision. The defendants move to dismiss for failure to state a claim, arguing that the complaint alleges only a duty of care violation, for which the exculpation clause bars monetary damages liability. This illustration raises the question of whether the court can take cognizance of the exculpation provision on a Rule 12(b)(6) motion to dismiss. The black letter law states that in deciding a Rule 12(b)(6) motion, the court may consider only what is pleaded in the complaint, yet our hypothetical complaint does not plead the exculpation clause.⁴⁹ Of course, the defendants could formally place the exculpation clause of record and bring it before the court in that manner. However, by doing that, the defendants would risk converting the dismissal motion into a motion for summary judgment; that conversion would subject the directors to expensive and unnecessary discovery in a case where, under the exculpation clause, dismissal is pre-ordained.⁵⁰

This problem arose in several lawsuits, where, without any guidance from a corporate statute or court rule, the Court of Chancery solved the problem by

48. Tit. 8, § 102(b)(7). Section 102(b)(7), adopted as an amendment to Delaware's General Corporation Law, pertinently provides that the certificate of incorporation *may* contain:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [for improper payment of dividends]; or (iv) for any transaction from which the director derived an improper personal benefit.

Id.

49. FED R. CIV. P. 12(b)(6).

50. *See supra* note 48 (quoting exculpation provision).

taking judicial notice of the company's exculpation clause.⁵¹ The question then became whether that approach is procedurally permissible on a motion to dismiss. Before the Delaware Supreme Court would have an opportunity to speak definitively on that subject, more litigation was required. The Delaware Supreme Court ultimately answered that question in three parts: (1) the trial court can either take judicial notice of the exculpation provision on a motion to dismiss; *or* (2) the defendants can plead the exculpation provision in their answer and then move for judgment on the pleadings; *or* (3) the issue could be decided on a motion for partial summary judgment, with discovery limited to what is essential to resolve the exculpation defense.⁵²

Section 102(b)(7) spawned a second procedural problem: under what circumstances can a breach of fiduciary duty complaint against corporate directors be dismissed in its entirety on statutory exculpation grounds? The cases held that if the complaint alleged only due care claims, then the case could be dismissed on exculpation grounds at the pleading stage.⁵³ That happened infrequently, however, as savvy plaintiffs' counsel bundled into a single complaint multiple due care and loyalty claims arising out of the same core facts. Counsel who were skillful enough draftsmen to combine the due care claims so inextricably with the loyalty claims that the two could not easily be sorted out at the pleading stage, would often be allowed to proceed to discovery and, perhaps, a trial. This tactic increased the cost (and settlement value) of cases ultimately found to involve only claims for breach of the duty of care.

Related problems arose in *Emerald Partners v. Berlin*,⁵⁴ where the Delaware Supreme Court held that an exculpation provision was "in the nature of an affirmative defense" that the directors have the burden to establish.⁵⁵ That burden required the defendant directors to disprove all of the carved out categories of conduct that were exceptions to exculpation under the statute. Thus, directors charged with breaching only their duty of care would be required to show that their conduct was not disloyal, in bad faith, and an intentional violation of law, and did not involve receiving an improper personal benefit. This burden effectively amounted to an implied presumption that the directors had engaged in one or more of those non-exculpable categories of conduct. Such a result appeared to turn the law on its head, as normally it is the plaintiff's burden to establish that the directors engaged in conduct that was disloyal, in bad faith, an intentional violation of law, or involved an improper

51. See, e.g., *In re BHC Commc'n Inc. S'holder Litig.*, 789 A.2d 1, 9 (Del. Ch. 2001); *McMillan v. Intercargo Corp.*, 768 A.2d 492, 501 (Del. Ch. 2000); *Green v. Phillips*, No. 14436, 1996 WL 342093, at *6 n.7 (Del. Ch. June 19, 1996).

52. *Malpiede v. Townson*, 780 A.2d 1075, 1092 (Del. 2001).

53. *Id.* at 1094.

54. *Emerald Partners v. Berlin*, 726 A.2d 1215, 1218 (Del. 1999).

55. *Id.* at 1223.

personal benefit. This “reverse presumption” was an unforeseen consequence of deriving a procedural rule from a substantive statute through a case-by-case judicial process, rather than by the more systematic administrative or legislative process in which procedural rules are normally crafted.

Section 102(b)(7) spawned an additional procedural issue, which also arose in *Emerald Partners v. Berlin*. That case involved a “going private” merger of a corporation into a company that was 100% owned by the corporation’s controlling stockholder.⁵⁶ The merger was negotiated and approved by a committee of three unaffiliated, independent directors.⁵⁷ A lawsuit for money damages was brought against the controlling stockholder and the three disinterested, independent directors who approved the deal.⁵⁸ The plaintiffs claimed that the merger was unfair to the minority shareholders.⁵⁹ After the lawsuit was filed, the controlling stockholder went bankrupt, leaving as defendants the three independent directors who constituted the committee that had negotiated and approved the transaction, yet had not profited from it.⁶⁰

Because the merger was a self-dealing transaction, the three defendant directors had the burden of proving that the merger was entirely fair, as to both process and price. The trial judge ruled in favor of the director defendants, finding that the plaintiffs failed to establish that the directors had acted disloyally or in bad faith.⁶¹ The case showed that if the three independent directors had breached any duty in approving the transaction, it could only have been the duty to exercise due care. Because the corporation had an exculpatory charter provision, it was unnecessary to determine whether the merger was entirely fair. Even if it was not, the unfairness was at most the result of a due care violation, from which the directors were statutorily exculpated from monetary damage liability.

The plaintiffs appealed to the Delaware Supreme Court, claiming that the trial court had improperly used the exculpation statute to bypass entire fairness review.⁶² The plaintiffs argued that because the merger was an interested transaction, the trial court was required as a matter of law to determine whether the merger was entirely fair.⁶³ Only if the merger was found not to be fair could the court then decide whether the directors were exculpated from monetary liability.⁶⁴

There were two problems with this argument. The first was that it found no

56. *Berlin v. Emerald Partners*, 552 A.2d 482, 484 (Del. 1988).

57. *Id.* at 485.

58. *Id.* at 487.

59. *Id.* at 488.

60. *Berlin v. Emerald Partners*, 552 A.2d 482, 488 (Del. 1988).

61. *Emerald Partners v. Berlin*, No. Civ. A. 9700, 2001 WL 115340, at *28 (Del. Ch. Feb. 7, 2001). It should be noted that I was the trial judge in this matter.

62. *Emerald Partners v. Berlin*, 787 A.2d 85, 87 (Del. 2001).

63. *Id.*

64. *Id.*

support in the language of the exculpation statute or in any rule of procedure. The plaintiffs' position was essentially a policy argument that the inherently interested nature of the merger was "inextricably intertwined with issues of loyalty[,] and that loyalty violations cannot be exculpated."⁶⁵ Stated differently, the argument was that by not conducting an entire fairness analysis in which the board's decision-making process and the transaction price would be intensively scrutinized, the court might somehow fail to identify a duty of loyalty violation, which would be otherwise visible if scrutinized under the magnifying glass of entire fairness analysis.

A second problem with the argument was that the approach being advocated would increase both the cost of litigation and the judge's workload, with little discernable benefit. Suppose that after a full trial, involving the assessment of live witness credibility, the judge finds no violation of the duty of loyalty and no bad faith conduct by the directors. By process of elimination, the only possible fiduciary violation would be a breach of the duty of care. For such a violation, the directors of companies with Section 102(b)(7) charter provisions are exculpated from monetary liability. It therefore seemed unnecessary to engage in the costly and intricate analysis required by entire fairness review because, however the fairness issue may be decided, no monetary liability would result. This practical approach would also enable the court to resolve some cases without a trial, i.e., on a summary judgment record. If, on the other hand, the trial judge were always required to perform an entire fairness analysis, that invariably would require a full trial, and significantly increase the number and difficulty of the issues the judge must decide.⁶⁶

The Delaware Supreme Court disagreed with this reasoning. It reversed the judgment for the defendants and remanded the case for a second decision.⁶⁷ The Delaware Supreme Court held that, in cases where the self-interested nature of a transaction requires that it be reviewed for entire fairness *ab initio* (from the outset), the trial court must perform a fairness analysis.⁶⁸ If the court finds that the transaction was entirely fair, then it will dismiss the case.⁶⁹ If the court finds that the transaction was not entirely fair, it must then decide whether the director conduct that resulted in the unfair transaction was exculpable.⁷⁰ That is, the court would have to decide whether the unfair transaction was the product of director disloyalty, bad faith, or intentional violation of law, or was solely the product of a failure to exercise due care. If the former, the directors

65. *Id.* at 93.

66. It would also increase the costs of litigation due to complex corporate valuation issues requiring the parties to retain financial experts to testify at trial.

67. *Emerald Partners v. Berlin*, 787 A.2d 85, 98 (Del. 2001).

68. *See id.* at 92 (citing *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001)).

69. *Id.*

70. *Id.*

lose, because disloyal and bad faith conduct is not exculpated.⁷¹ If the latter, the directors win because they are exculpated from monetary liability for duty of care violations.

Because the case required a new post-trial opinion, the Delaware Supreme Court remanded *Emerald Partners* for a decision de novo under the entire fairness standard.⁷² Whereas the original decision was over eighty typed pages, the opinion on remand, which involved a full-blown fairness analysis, was 120 pages.⁷³ The result, however, was the same—judgment for the defendants.⁷⁴ Again an appeal was taken, but this time the judgment was affirmed.⁷⁵

IV. REMEDYING THE BLURRED DISTINCTION

By this point any discerning listener (or reader) will likely ask: what lessons, if any, am I to draw from this anecdotal narrative? I suggest that it raises three larger questions. The first is the proverbial “so what?” question: even if Delaware corporate law decisions have blended together matters of substance and procedure, why should that be of concern? Second, if there is a case for keeping separate matters of substance and procedure, how should courts go about doing that? Third, does the answer to the preceding question have sufficient analytical clarity to provide guidance to courts in specific cases? What follows is my best effort to respond to these questions.

A. *Causes for Concern*

First, I submit that the blending of substance and procedure in judicial decision making creates problems that lawyers and legislators ought to address. In our society, litigation is the mechanism by which we resolve, in a peaceful and orderly way, disputes between citizens, and those between citizens and government. But litigation has costs, which, over the years, have increased at an alarming rate.⁷⁶ One important purpose of procedural rules is to minimize these costs by enabling the efficient enforcement of substantive rights without unreasonably taxing the parties and the legal system as a whole.⁷⁷ Cases such as *Emerald Partners* undercut that purpose where substantive legislation has

71. See *supra* note 48 (quoting statutory language exempting from exculpation violations of the duties of loyalty and good faith).

72. *Emerald Partners*, 787 A.2d at 98.

73. *Emerald Partners v. Berlin*, No. Civ. A. 9700, 2003 WL 21003437, at *44 (Del. Ch. Apr. 28, 2003).

74. *Id.*

75. *Emerald Partners v. Berlin*, 840 A.2d 641, 641 (Del. 2003).

76. See E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1404-08 (2005) (detailing litigation generating cases and themes in Delaware corporate law). See generally David Rosenberg & Steven Shavell, *A Simple Process to Halve Litigation Costs*, 91 VA. L. REV. 1721 (2005) (proposing solution to escalating costs of litigation).

77. See Rosenberg & Shavell, *supra* note 76, at 1726 n.10.

been enacted, but no procedural rules are adopted to implement the legislation, thereby forcing the courts to work out (under the rubric of statutory interpretation) the procedural implications of the statute on a case-by-case basis.⁷⁸ That same conclusion applies to cases such as *Aronson*, where substantive doctrine is used to construe a procedural rule.⁷⁹ The blended judicial construction becomes, in effect, a new judge-made procedural rule, crafted for a specific case; that generates other issues that in turn will require additional complex and expensive litigation to resolve.

My thesis is that procedural rulemaking through the common law adjudication process is inefficient, because it often results in a product that necessitates further litigation to provide clarity that can be obtained by less costly means; namely, the administrative rulemaking process. The blending together of substance and procedure in judicial decision-making creates uncertainty and increases the costs of litigation. Therefore, my ultimate proposal is that in deciding cases, courts should, to the extent possible, keep matters of substance and procedure separate.

B. *How to Bolster the Distinction*

The second question is can matters of substance and procedure realistically be kept separate, and if so, how? The answer is complicated because it may not be possible to maintain the substance-procedure distinction in every specific case. The goal is achievable, however, post-decision, if courts craft procedural rules by deferring to the administrative rulemaking process. But, to interpret a rule of procedure in a specific case, the court may out of necessity have to utilize doctrines of substance.

After the case is decided, the court should then stay its hand and deliberately invoke its administrative rulemaking process to accomplish two tasks. The first would be to draft, or, more precisely, re-draft, the procedural rule to assimilate the court's ruling, which will often be case-specific, with imprecise future application. The second would be to identify and address the procedural issues that foreseeably will flow from that redrafted rule.⁸⁰

In *Aronson*, for example, because Rule 23.1 gave no guidance to the bench and bar on how properly to plead demand futility, the Delaware Supreme Court had little choice but to fill in that gap through common law adjudication.⁸¹ The

78. See *supra* notes 56 and accompanying text (detailing *Emerald Partners* as example of substance blending into procedure).

79. See *supra* notes 24-25 and accompanying text (detailing *Aronson* as example of court using substantive doctrine to interpret a wholly procedural rule).

80. In Delaware, as in many other states, the drafting of procedural rules is referred to the rules committee of the trial court whose rule is being affected. Thus, in Delaware, any changes to Court of Chancery Rule 23.1 would be referred to the Court of Chancery Rules Committee and would be subject to modification and approval, first by the Court of Chancery, and ultimately, by the Delaware Supreme Court.

81. *Aronson v. Lewis*, 473 A.2d 805, 805 (Del. 1984).

Court found it necessary to articulate the business judgment rule—a substantive law doctrine—as the doctrinal basis for the demand requirement.⁸² To that extent, the application of substantive law to interpret a rule of procedure was unavoidable. The result was a blended substantive-procedural ruling that, in order to establish demand futility, a plaintiff must plead facts sufficient to overcome the presumption that the board’s rejection of a demand would be protected by the business judgment rule.⁸³ The Court elaborated its ruling by articulating a two-step test, requiring that the pleaded facts must create a reasonable doubt as to: (1) the disinterestedness or independence of the board; or (2) that the decision was otherwise the product of an informed business judgment.⁸⁴

For the *Aronson* Court to decide the case, the application of substantive law to construe a procedural rule may have been unavoidable. What was avoidable, I submit, was its adoption of unnecessary additional procedural requirements that effectively amounted to a judicial redrafting of Rule 23.1. For example, *Aronson* added two refinements; namely that (1) the pleaded facts must create a “reasonable doubt” as to whether the business judgment rule would protect the challenged decision (without defining what “reasonable doubt” meant); and (2) that no discovery would be allowed on a Rule 23.1 motion.⁸⁵ Rather than a court making these refinements as part of the adjudication process, the Court should have (in my view and admittedly with perfect hindsight) restricted its substantive interpretation to what was required to decide the case and then submitted Rule 23.1 to the appropriate rules committee for redrafting. The committee, through its separate process, would then redraft the rule to implement the substance of *Aronson* and identify and address any foreseeable procedural issues resulting from that decision.

I advance this argument because common law adjudication, which by its nature occurs on a case-by-case basis, is not an efficient way to craft rules of procedure. The process by which procedural rules are adopted is quasi-legislative, and as such, is specifically designed to take into account the concerns of affected constituencies other than the court and the parties to a specific lawsuit. Courts are not institutionally equipped to proceed in that fashion. Procedural rules, like legislation, are “big picture” instructions to courts and parties to litigation and are designed to address a broader set of procedural problems confronting litigants. Unlike the ad hoc adjudicative process, procedural rules are typically crafted in a systematic process that involves extensive review and comment by the segments of the Bar affected by the proposed rule, and sometimes also by legislatures.⁸⁶ Courts are also

82. *Id.* at 811-13.

83. *Id.* at 818.

84. *Id.* at 814.

85. *Aronson*, 473 A.2d at 810-11, 815.

86. The intricate process of amending the Federal Rules of Civil Procedure is an example of intensive

involved in this process. In Delaware, as in several other states, once lawmakers complete the rule drafting process, the Delaware Supreme Court has the final adopting authority.

It may not be possible to maintain the separateness of substance and procedure in every specific case. It is possible, however, to accomplish this post-decision, by referring the task of redrafting the procedural rule that is the subject of the decision to the rulemaking process, so as to implement the ruling and identify and address the problems that may foreseeably arise in future cases.

C. *Guidance to Courts in Specific Cases*

The final question is whether the model I propose is capable of providing guidance to courts on how to proceed in future cases. I think that it is. Under my approach, *Aronson* would have been decided the same way, except that the Delaware Supreme Court would have stopped short of articulating doctrine beyond what was necessary to decide that specific case. The Court could then have identified, either in its opinion or privately to the appropriate rule-making body, the procedural issues that might foreseeably arise in future demand-related cases and then referred the matter to the appropriate rule-making body to implement the decision. That body would then address all identified “future” issues, in a comprehensive redrafted procedural rule.

Although *Emerald Partners* presented a different procedural problem, my suggested approach would be essentially the same. The problem was that a substantive statute, Section 102(b)(7), had been enacted with no procedural rules for its implementation. Because its implementation could only occur in future lawsuits, it was foreseeable that the statute would generate other procedural issues. Under my proposal, the first case that involved the procedural implications of the statute would, of necessity, be decided by the court.⁸⁷ Once decided, the case would have alerted the court to the likelihood that other procedural issues would arise in future litigation, prompting the court to refer, to the appropriate administrative rulemaking process, the task of drafting appropriate procedural rules to implement the statute. The drafting process would include identifying and addressing the various procedural issues that foreseeably would arise in future cases.

The harder question is whether this approach, if followed, would have

legislative involvement. See Carl Tobias, *The Transformation of Trans-Substantivity*, 49 WASH. & LEE L. REV. 1501, 1503-06 (1992) (detailing federal rulemaking process). Although proposed amendments to the Federal Rules are drafted by a blue ribbon committee under the aegis and subject to the approval of the United States Supreme Court, the final product requires Congressional approval. *Id.*

87. The first procedural case involving Section 102(b)(7) to come before the Delaware Supreme Court, *Malpiede v. Townson*, 780 A.2d 1075 (2001), presented the issue of whether a Section 102 (b)(7) defense was cognizable on a Rule 12(b)(6) motion to dismiss, where the complaint did not plead the existence of the exculpatory charter provision. See 780 A.2d at 1090.

avoided the need for the courts to decide the procedural questions that actually arose in *Emerald Partners*. My approach would have resolved some, but not all, of these issues. For example, two purely procedural issues were possibly avoidable: (1) whether due care claims can be dismissed on a Rule 12(b)(6) motion (on the basis that they are exculpated) where those claims are intermixed with loyalty and/or good faith claims all based on the same core facts; and (2) whether at the summary judgment or trial stage, the directors who seek exculpation must carry the burden of negating the exceptions to Section 102(b)(7) to establish the exculpation defense. Other exculpation-related issues that were partly substantive and not purely procedural might not have been avoidable.⁸⁸

V. CONCLUSION

There may be no perfect solution to the problem of how to keep separate the issues of substance and procedure. But, the perfect should not be the enemy of the good. The problem is solvable; if not perfectly, then at least workably, so long as courts are willing to acknowledge their limited competency to craft procedural rules through the common law adjudication process and defer to a more institutionally competent body for that limited purpose. Even if that approach falls short of perfection, it would improve, however modestly, our increasingly burdened litigation system.

88. I have in mind the ultimate question decided by the Delaware Supreme Court in the many appeals taken in the *Emerald Partners* case: whether an interested merger must be reviewed for entire fairness where the court has found, as fact, that at most, the directors who approved the merger violated only their duty of care and were not guilty of any conduct constituting an exception to the exculpation statute. *Emerald Partners v. Berlin*, 787 A.2d 85, 97-98 (Del. 2001).