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The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits

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Notes and Comments

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I. Introduction: An Overview of the Derivative Suit Dilemma

A shareholder derivative suit is an action brought by a corporate shareholder on behalf of the corporation to enforce a corporate right that the officers and directors of the corporation have failed to enforce.[1] In bringing a derivative suit, a shareholder is asserting that the corporation was harmed, that the corporate officers and directors failed to take action to redress that harm, and that the corporate cause of action has therefore accrued to the corporation's shareholders in place of its directors.[2]

The derivative action is one of the few means available to minority shareholders to protect the value of their investment and to enforce management's obligations to the corporation.[3]

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1. The federal rules of civil procedure define a derivative suit as an "action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it." FED. R. CIV. P. 23.1.

2. In Hawes v. Oakland, 104 U.S. 450 (1882), the Supreme Court delineated the classic test for when a shareholder may rightfully bring a derivative action: shareholders may bring suit on behalf of the corporation when the directors have exceeded their authority, are contemplating or have contemplated a fraudulent transaction, or are acting in their own self-interest to the detriment of the corporation. *Id.* at 460. The Court also recognized the right of minority shareholders to bring a derivative action when "the majority of shareholders themselves are oppressively and illegally pursuing a course in the name of the corporation, which is in violation of the rights of the other shareholders, and which can only be restrained by the aid of a court of equity." *Id.*

3. As the court pointed out in Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983), the cost to individual shareholders of bringing a direct action

Historically, derivative suits have played a significant role in deterring corporate abuses.[4] Indeed, the Supreme Court has called the derivative action "the chief regulator of corporate management."[5]

Despite the important function of derivative suits, they can also be subject to abuse by unscrupulous shareholders and their attorneys who may initiate litigation solely to compel a settlement and generate large legal fees.[6] Such suits, commonly called "strike suits," may be harmful to the corporation; ultimately their cost is borne by the shareholders, the very group derivative suits are designed to protect.[7]

To control the potential for abuse inherent in the derivative suit, courts and legislatures have developed procedural rules limiting the circumstances in which derivative suits may be

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for injury to the value of their investments would usually outweigh any benefit they could hope to realize. In addition, a multiplicity of such suits would be judicially inefficient and wasteful to the corporation. The cost of complying with the requirements for a class action might also be prohibitively high. *Id.* at 886-87. *See also* N. LATTIN, THE LAW OF CORPORATIONS § 115, at 457 (2d ed. 1971) ("The derivative suit is the minority shareholders' one effective remedy against management's abuse of its trusteeship.").

4. Cramer v. GTE, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979) ("[S]hareholders' derivative suits can be important weapons for remedying abuses of corporate management."). Dean Rostow has termed the derivative suit "the most important procedure the law has yet developed to police the internal affairs of corporations." Rostow, *To Whom and for What Ends is Corporate Management Responsible?*, in THE CORPORATION IN MODERN SOCIETY 48 (E. Mason ed. 1960). *See also* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 144-45 (1980) (Professor Dent views derivative suits as a positive alternative to increased governmental intervention as a means of deterring corporate abuses.).

5. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949).

6. *See* Joy v. North, 692 F.2d at 887; Cramer v. GTE, 582 F.2d at 275; Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See also* Note, *The Demand and Standing Requirements in Stockholder Actions*, 44 UNIV. CHI. L. REV. 168, 172 (1976).

7. Joy v. North, 692 F.2d at 887; Zapata Corp. v. Maldonado, 430 A.2d 779, 786-87 (Del. 1981). The *Zapata* court clearly stated the problem:

> If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. . . . If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result.

Id. at 786-87.

brought.[8] One of the oldest and most important of these procedural rules is the requirement that prior to instituting a derivative action a shareholder must make a demand on the board of directors to bring the suit.[9] Once demand has been made and rejected, the burden is on the plaintiff shareholder to show why the directors' decision not to take action should not be respected by the court.[10] Only rarely have courts allowed shareholders to

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8. For example, almost every jurisdiction has a contemporaneous ownership requirement permitting only shareholders at the time of the challenged transaction to initiate a derivative suit. *See, e.g.*, FED. R. CIV. P. 23.1; N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963); DEL. CODE ANN. tit. 8, § 327 (1983). In addition, the federal rules require that the plaintiff fairly and adequately represent the interests of similarly situated shareholders. FED. R. CIV. P. 23.1. In many jurisdictions, settlement of a derivative action must be approved by the court. *See, e.g.*, FED. R. CIV. P. 23.1; DEL. CODE ANN. Ch. Ct. R. 23.1 (1981); N.Y. BUS. CORP. LAW § 626(d) (McKinney 1963). Many states also have security for expenses statutes that require derivative plaintiffs to post security to cover the reasonable expenses, including attorneys fees, that the corporation may incur in the litigation. *See, e.g.*, N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1984-1985). Finally, some states have codified the principle that a successful shareholder plaintiff must account to the corporation for any proceeds from the suit. *See, e.g.*, *id.* § 626(e).

9. This requirement, commonly known as the demand requirement, was first articulated by the Supreme Court in Hawes v. Oakland, 104 U.S. 450 (1882):

> [B]efore the shareholder is permitted in his own name to initiate and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on its part, and this must be made apparent to the court. . . . And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.

Id. at 460-61.

In the federal courts, the demand requirement was originally codified in Federal Equity Rule 94, then in Federal Rule of Civil Procedure 23(b), which was incorporated into Federal Rule 23.1 in 1966. Currently, Federal Rule 23.1 requires that "[t]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and . . . the reasons for his failure to obtain the action or for not making the effort." FED. R. CIV. P. 23.1.

Every state now requires demand on the corporate board prior to initiation of a derivative suit. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 7.02, comment e, at 269 (Tent. Draft No. 1, 1982) [hereinafter cited as CORPORATE GOVERNANCE] ("The rule that demand must be made on the board of directors, unless it would be futile, is universally recognized by jurisdictions within the United States, either as a matter of statutory law or judicial interpretation.").

10. To maintain the suit despite director opposition, the shareholder must show that the suit satisfies the classic test for appropriate derivative action described in Hawes v. Oakland, 104 U.S. at 460. For a list of the *Hawes* criteria, see *supra* note 2. In addition, the Supreme Court and lower federal courts following it, have held that the

proceed with a derivative suit after a rejected demand.[11]

To prevent directors or controlling shareholders from blocking a derivative suit that implicates them in wrongdoing, courts developed the futility exception to the demand requirement.[12] Under this exception, the demand requirement has been excused when demand would have been "futile," "useless," or "unavailing."[13] In these circumstances, some courts have allowed shareholders to proceed with the derivative action, despite director opposition, on the theory that the directors in such cases were either too self-interested or too controlled by the alleged wrongdoers to make a valid business decision to dismiss the suit.[14]

The effectiveness of the futility exception as a device to prevent self- interested corporate defendants from using a rule of pleading to bar consideration of the merits of a derivative action

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decision whether to enforce a corporate cause of action in the courts is ordinarily a business decision that should be left to the discretion of the directors *unless* the directors are personally involved or interested in the alleged wrongdoing so that they stand in a "dual relation" to the corporation, which would impair their business judgment or reflect bad faith. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Ash v. IBM, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); Swanson v. Traer, 249 F.2d 854, 856 (7th Cir. 1957).

11. In Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983), the court denied the corporate board's motion to dismiss the suit after a rejected demand. In explaining its decision, however, the court described the case as one in which demand was not required. *Id.* at 888 n.7. For a discussion of the different analytical approach courts have taken in demand-excused cases, see *infra* text accompanying notes 13-14, 20-26. *See also* Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980). Although demand on the board was never formally made in *Galef*, the defendants did not raise that as an issue in the litigation. Instead, the directors moved for summary judgment on the ground that it was not in the corporation's best interests to pursue the suit. Describing the case as structurally similar to cases in which demand had been made and rejected, the court rejected the motion for summary judgment on the ground that the directors seeking to terminate the lawsuit stood in a "dual relation" to the corporation. *Id.* at 60-62.

12. Delaware & Hudson Co. v. Albany & Susquehanna R.R. , 213 U.S. 435 (1909). For a discussion of this case, see *infra* text accompanying notes 32-36.

13. Cathedral Estates v. Taft Realty Corp., 228 F.2d 85, 88 (2d Cir. 1955).

14. Lewis v. Curtis, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22 (1st Cir. 1978); Nussbacher v. Continental Ill. Nat'l Bank & Trust Co. of Chicago, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976); Liboff v. Wolfson, 437 F.2d 121 (5th Cir. 1971); Meltzer v. Atlantic Research Corp., 330 F.2d 946 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964); DePinto v. Provident Sec. Life Ins. Co., 323 F.2d 826 (9th Cir. 1963), *cert. denied*, 376 U.S. 950 (1964); Cathedral Estates v. Taft Realty Corp., 228 F.2d 85 (2d Cir. 1955); deHass v. Empire Petroleum Co., 286 F. Supp. 809 (D: Colo. 1968), *aff'd*, 435 F.2d 1223 (10th Cir. 1970).

has been limited by corporate boards' use of special litigation committees. These committees have been appointed by corporate boards threatened with derivative suits that implicate the directors in a wrongful transaction.[15] The committee, which is usually composed of disinterested directors and outside counsel, reviews the plaintiff's claims and decides whether it is in the best interests of the corporation to maintain the suit. In all cases the special litigation committee has recommended that it was not in the corporation's best interests to pursue the suit.[16]

The standard of judicial review that should be applied to a corporate board's motion to dismiss based on such a recommendation is still unsettled.[17] Some courts have presumed that the committee was unbiased and independent of the interested directors or controlling shareholders and have deferred to its recommendation, dismissing the suit on business judgment grounds without further judicial scrutiny.[18] Other courts have been more

15. Cases involving special litigation committees in this context include: Hasan v. Clevetrust Realty Investors, 729 F.2d 372 (6th Cir. 1984); Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982); Maldonado v. Flynn, 671 F.2d 729 (2d Cir. 1982); Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Cramer v. GTE, 582 F.2d 259 (3d Cir. 1978), *cert. denied.*, 439 U.S. 1129 (1979); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982); Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980); Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980); Rosengarten v. ITT Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

16. Cases are listed *supra* note 15. In two cases, rather than recommending outright dismissal of the derivative action, the committee suggested alternatives to the suit:

In Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983), the special litigation committee recommended that the suit be discontinued as to 23 of the defendants. In regard to the remaining seven directors who were senior officers of the corporation the committee recommended pursuit of a settlement. If a settlement was not reached, the committee said it would reconsider whether to recommend termination of that part of the suit as well. *Id.* at 884.

In Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982), the special litigation committee recommended that the company seek repayment of damages from the defendants. *Id.* at 1028.

17. The issue is controlled by the law of the state of incorporation. Burks v. Lasker, 441 U.S. 471, 486 (1979).

18. This approach, first adopted by the New York Court of Appeals in Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), has been followed by the courts in Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869

willing at least to examine a special litigation committee's independence and good faith before deciding whether to grant the board's request to dismiss.[19]

Most notably, the Delaware Supreme Court has gone the farthest in establishing standards for judicial scrutiny of a special litigation committee's recommendation to dismiss. In *Zapata Corp. v. Maldonado*,[20] the Delaware court developed a new two-part test for evaluating a corporate board's motion to dismiss based on the recommendation of a special litigation committee.[21] First, instead of presuming the committee's independence and good faith, *Zapata* places on the corporation the burden of proving that the committee acted independently and in good faith, and made a reasonable investigation of the plaintiff's allegations.[22] Second, once the board satisfies its initial burden, the court then applies "its own independent business judgment" to determine whether the request to dismiss should be granted.[23] In making this determination, the court would consider matters of law and public policy as well as the corporation's best interests.[24] The court noted that it adopted this approach to thwart the corporation's ability to prematurely terminate a shareholder action deserving of further consideration.[25] But in what has turned out to be a significant footnote, the *Zapata* court limited the application of the second step of its test to cases in which demand on the board has been excused.[26] Thus, to avail themselves of *Zapata's* standard of in-

(1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980); Rosengarten v. ITT Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976).

19. *E.g.*, Hasan v. Clevetrust Realty Investors, 729 F.2d 372 (6th Cir. 1984).

20. 430 A.2d 779 (Del. 1981).

21. *Id.* at 788-89.

22. *Id.* at 788.

23. *Id.* at 789.

24. *Id.*

25. *Id.*

26. *Id.* at 784 n.10. Cases that have analyzed or applied Delaware law after *Zapata* include Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); Abramowitz v. Posner, 672 F.2d 1025(2d Cir. 1982); Maldonado v. Flynn, 671 F.2d 729 (2d Cir. 1982); Mills v. Esmark, 573 F. Supp. 169 (N.D. Ill. 1983); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982); Stein v. Bailey, 531 F. Supp. 684 (S.D.N.Y. 1982); Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa

creased judicial scrutiny of a corporate board's request to dismiss, a derivative suit plaintiff must still jump the threshold demand hurdle.[27] As a result of *Zapata*, then, the crucial question for courts applying Delaware law is: when will demand be excused for futility?

In an attempt to answer that question, this Comment examines the criteria for demand futility in the federal courts, Delaware, and New York. It suggests that the concept of demand futility itself is an inadequate and inappropriate means of preventing corporate directors and controlling shareholders from blocking derivative suits that implicate them in transactions alleged to be injurious to the corporation. Thus, this Comment suggests that the demand issue should be severed from the standard of scrutiny to be applied to a corporate board's motion to dismiss a derivative suit. In lieu of excusing demand, courts should extend the *Zapata* test to all cases alleging wrongdoing by directors or self-dealing by controlling shareholders, thereby directly limiting the application of the business judgment rule in the decision to dismiss such cases. This approach would be a more appropriate and effective means of balancing the interests of corporate management and shareholders.

1981).

There has been some inconsistency in how the courts in these cases have construed *Zapata*. For a discussion of the various interpretations these courts have given to *Zapata*, see Block, Prussin & Wachtel, *Dismissal of Derivative Action Under the Business Judgment Rule:* Zapata *One Year Later*, 38 BUS. LAW. 401 (1983).

27. Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982), provides a good example of the difficulties derivative suit plaintiffs face even after *Zapata*. In *Abramowitz*, the plaintiff shareholder filed a derivative suit against a Delaware corporation naming five of the corporation's 17 directors as defendants. Plaintiff alleged that the defendants had violated § 10-b of the Securities and Exchange Act of 1934, and had misappropriated corporate funds for their personal use. The plaintiff did not make a demand on the board, asserting that demand would have been futile. The district court rejected this assertion and required the plaintiff to make a demand. By the time she did so, the corporation had appointed an audit committee, which concluded that legal action was not in the corporation's best interests. Shortly thereafter, the corporation's board unanimously rejected the plaintiff's demand and moved to dismiss her complaint. Despite an amicus brief by the S.E.C. urging that courts carefully scrutinize the reasonableness of business judgment decisions to terminate derivative litigation asserting federal causes of action, Brief for Amicus Curiae at 4, Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982) (No. 81-7320), the Second Circuit affirmed the district court's decision to dismiss the suit. The court emphasized that under *Zapata* such judicial scrutiny would only be applied in demand excused cases. Abramowitz v. Posner, 672 F.2d at 1032-34.

II. Background: The Purposes of the Demand Requirement and the Origins of the Futility Exception

A. *The Purposes of the Demand Requirement*

Because of its relationship to the business judgment rule and the threshold hurdle it imposes on derivative plaintiffs, the demand requirement has been regarded as one of the safeguards against "strike suits."[28] An equally important rationale for the demand requirement is that because a derivative suit is brought on behalf of the corporation, it is the corporate board that should conduct the suit.[29] On a more practical level, management of the suit by the directors in lieu of the shareholder plaintiff may have the benefit of placing all of the corporation's assets — including its access to information, its personnel, its funds, and its counsel — behind the suit.[30] Finally, when demand on the board has been made, the board may be able to resolve the grievance without costly litigation through an alternative method of dispute resolution.[31]

B. *The Origins of the Futility Exception to the Demand Requirement*

The issue of demand futility was first addressed by the Supreme Court in *Delaware & Hudson Co. v. Albany & Susquehanna Railroad Co.*[32] In that case, officers and directors of the Susquehanna Railroad failed to collect rent owed to the corpora-

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28. *See supra* text accompanying notes 6-7.

29. Several courts have endorsed the statement in Brody v. Chemical Bank, 517 F.2d 932 (2d Cir. 1975):

> The very purpose of the 'demand' rule is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs.

Id. at 934, *quoted with approval in* Kaster v. Modification Sys., 731 F.2d 1014, 1023 (2d Cir. 1984); Lewis v. Graves, 701 F.2d 245, 247 (2d Cir. 1983); Elfenbein v. Gulf & Western Indus., 590 F.2d 445, 450 (2d Cir. 1978). *See also In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

30. Lewis v. Graves, 701 F.2d at 248; *see also* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 749 (1960).

31. Lewis v. Graves, 701 F.2d at 247; Cramer v. GTE, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Note, *supra* note 6, at 172.

32. 213 U.S. 435 (1909).

tion by the Delaware Company, and the shareholders brought a derivative suit against the Delaware Company for breaching the lease agreement.[33] Because a majority of the directors of the Susquehanna Railroad were also officers and directors of the Delaware Company,[34] the Court concluded that the antagonism between the corporate directors and the corporate interest was unmistakable.[35] In such a situation, the Court held, the demand requirement may be eliminated.[36]

Nearly a half century later, in *Cathedral Estates v. Taft Realty Corp.*,[37] the Second Circuit attempted to clarify the basic criteria for excusing demand. Demand, the court held, is presumptively futile and need not be made when the alleged wrongdoers control the board or when the directors themselves are "antagonistic, adversely interested, or involved in the transaction attacked."[38] Although subsequent courts have retained these same elements as a prerequisite for excusing demand, they have disagreed regarding what constitutes sufficient control, antagonism, involvement, and self-interest to excuse the demand requirement.

III. Criteria For Excusing Demand in the Federal Courts

A. *Self-Dealing by a Majority of the Board of Directors*

All courts that have considered the question have concluded that simply naming directors as defendants does not automatically excuse demand.[39] To construe the futility exception differently would encourage sham pleading by allowing plaintiffs to circumvent the demand requirement by naming all of the directors of a corporation as defendants in the derivative action.[40] In addition, most courts have refused to excuse demand when a

33. *Id.* at 450.
34. *Id.* at 443.
35. *Id.* at 447.
36. *Id.*
37. 228 F.2d 85 (2d Cir. 1955).
38. *Id.* at 88.
39. Lewis v. Graves, 701 F.2d 245, 249 (2d Cir. 1983); Weiss v. Temporary Inv. Fund, 692 F.2d 928, 943 (3d Cir. 1982), *vacated on other grounds*, 104 S.Ct. 989; Lewis v. Curtis, 671 F.2d 779, 785 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); Heit v. Baird, 567 F.2d 1157, 1162 (1st Cir. 1977).
40. Lewis v. Graves, 701 F.2d at 249.

majority of the board has merely acquiesced in or approved of an action alleged to be injurious to the corporation.[41] Indeed, most courts have excused demand for futility only when a majority of directors have personally benefited from the alleged wrongdoing.[42]

Courts in the First and Ninth Circuits have interpreted the demand requirement even more strictly, requiring plaintiff

41. *See, e.g.*, Lewis v. Graves, 701 F.2d at 248; Weiss v. Temporary Inv. Fund, 692 F.2d at 943; Grossman v. Johnson, 674 F.2d 115, 124 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982); Lewis v. Curtis, 671 F.2d at 785; Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1210 (9th Cir. 1980); Heit v. Baird, 567 F.2d at 1160; *In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 265 (1st Cir.), *cert. denied* 414 U.S. 857 (1973). *But see* Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (The complaint that was held to fully meet the requirements of Rule 23.1 alleged only that "[t]he majority of said directors participated, approved of and acquiesced in said transaction."); Papilsky v. Berndt, 59 F.R.D. 95, 97 (S.D.N.Y. 1973), *appeal dismissed*, 503 F.2d 554 (2d Cir.), *cert. denied*, 419 U.S. 1048 (1974) (The allegation that the directors participated *or* acquiesced in the challenged transaction was held sufficient to excuse demand.); Meltzer v. Atlantic Research Corp., 330 F.2d 946, 948 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964) (Demand was excused where three of five directors approved of or negligently tolerated blatant misuses of corporate funds for the personal benefit of the other two directors.).

In Daily Income Fund, Inc. v. Fox, 104 S. Ct. 831 (1984), the Supreme Court held that the demand requirement of Rule 23.1 did not apply to actions, such as *Grossman* and *Weiss*, brought under § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (1983), because such actions are not really derivative under the terms of the statute. Although *Daily Income Fund* overrules *Grossman* and *Weiss* with regard to the demand requirement, the Court's analysis of the criteria for excusing demand are, nevertheless, still applicable to shareholders' derivative suits brought under other statutes.

42. *See* Lewis v. Graves, 701 F.2d at 249 (demand not futile where only five of 11 directors were alleged to have received impermissible grants of stock); Weiss v. Temporary Inv. Fund, 692 F.2d at 943 (demand not futile where four of the six directors, who approved allegedly excessive advisory fees, were not "interested" under the terms of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (1983)); Grossman v. Johnson, 674 F.2d at 123-24 (demand not futile where only three of the eight directors were affiliated with the investment advisor charged with profiting from excessive fees paid by a mutual fund); Greenspun v. Del E. Webb Corp., 634 F.2d at 1210 (demand not excused where none of the alleged wrongdoings particularly favored any member of the board); Heit v. Baird, 567 F.2d at 1160 (1st Cir. 1977) (demand not excused where only three of seven directors were alleged to have benefited from the improper issuance of new stock); *In re* Kauffman Mut. Fund Actions, 479 F.2d at 264 (demand not excused where a majority of the directors were not affiliated with investment advisors alleged to have received excessive management fees). *But see* Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22, 23 (1st Cir. 1978) (demand excused where two of the four trustees of a mutual fund were principal owners of an investment advisor alleged to have received excessive fees from the fund); Meltzer v. Atlantic Research Corp., 330 F.2d at 948 (demand excused where only two of the five directors personally profited from blatant misuse of corporate funds, which was approved of or negligently tolerated by the other three directors).

shareholders to show not only that the challenged transaction benefited the majority directors, but also that it was "completely undirected to a corporate purpose."[43] Thus, in *Heit v. Baird*,[44] for example, the First Circuit Court of Appeals placed on the plaintiff the burden of proving that the sale of over $350,000 worth of stock to three board members for an initial outlay of only $10,750 had been effected solely to thwart a potential contest for control of the corporation by a minority stockholder.[45] The court termed conclusory the plaintiff's allegations that the directors had authorized the stock issue in order to retain control of the corporation.[46] Moreover, the court itself suggested a number of permissible reasons the corporation may have had for issuing the stock.[47] Perhaps, the court posited, the transaction had been designed to increase the loyalty and commitment of the directors who benefited from the favorable financing arrangement while discouraging a "raid" by individuals who might harm the corporation.[48] Quoting an earlier First Circuit case, *In re Kauffman Mutual Fund Actions*,[49] the court described the sale of stock as a transaction that, although potentially vulnerable to criticism, could be thought to serve the interests of the company.[50]

In *Lewis v. Curtis*,[51] the Third Circuit specifically rejected the *Heit* approach.[52] The *Lewis* court noted that the shareholder's complaint described in detail a scheme, including a $750,000 payoff to an outside "raider," by all of the directors of Hammermill Paper Company to retain control of the corporation.[53] The court said that the plaintiff shareholder need not allege the transaction could not, under any circumstances, have

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43. Heit v. Baird, 567 F.2d at 1161; *In re* Kauffman Mut. Fund Actions, 479 F.2d at 265; Greenspun v. Del E. Webb. Corp., 634 F.2d at 1210.
44. 567 F.2d 1157 (1st Cir. 1977).
45. *Id.* at 1161-62.
46. *Id.* at 1161.
47. *Id.*
48. *Id.*
49. 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).
50. *Id.* at 265.
51. 671 F.2d 779 (3d Cir.), *cert denied*, 459 U.S. 880 (1982).
52. *Id.* at 786. "To the extent that *Heit* requires that it be alleged that a majority of directors be involved in a facially improper transaction before demand will be excused, we decline to follow it." *Id.*
53. *Id.* at 784.

been the product of business judgment.[54] Rather, the court concluded, in such a situation demand should be excused and "trial — or at least embarking on the road to trial — is required. To impose the bar of the demand requirement would largely be to create a pleading defense to a fact dispute."[55] To proceed with the suit without demand, the plaintiff shareholder would still be required to show that a majority of the directors had been involved in and profited from the challenged transaction and that the transaction was harmful to the corporation; the plaintiff would not have to show that the transaction could not have served a legitimate corporate purpose in the business judgment of the directors.[56]

B. *Self-Dealing by a Controlling Shareholder*

The Supreme Court's discussion in *Delaware & Hudson* indicated that, even absent specific allegations of self-dealing by a majority of the board, the Court would excuse demand for futility if the plaintiff shareholder could demonstrate control of the board by the alleged wrongdoers.[57] The issue of control, however, is "an intensely factual one."[58] In most cases, courts have not found sufficient evidence of control to warrant excusing demand.[59] Most recently, in *Kaster v. Modification Systems*,[60] the Second Circuit Court of Appeals refused to recognize demand futility when the alleged wrongdoer not only owned seventy-one percent of the closed corporation's stock, but also nominated all but one of the corporation's directors, and was President and Chairman of the Board.[61]

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54. *Id.* at 786.

55. *Id.*

56. *Id.*

57. Delaware & Hudson Co. v. Albany and Susquehanna R.R., 213 U.S. 435, 449 (1909).

58. Vernars v. Young, 539 F.2d 966, 968 (3d Cir. 1976).

59. *See, e.g.*, Kaster v. Modification Sys., 731 F.2d 1014, 1017-18 (2d Cir. 1984); Greenspun v. Del E. Webb Corp., 634 F.2d at 1209; Elfenbein v. Gulf & Western Indus., 590 F.2d 445, 450-51 (2d Cir. 1978); Cramer v. GTE, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Vernars v. Young, 539 F.2d at 968; *In re* Kauffman Mut. Fund Actions, 479 F.2d at 264. *But see* deHaas v. Empire Petroleum Co., 286 F. Supp. 809, 815 (D. Colo. 1968), *aff'd*, 435 F.2d 1223 (10th Cir. 1970).

60. 731 F.2d 1014 (2d Cir. 1984).

61. *Id.* at 1015-16. In a strong dissent to the majority opinion, Judge Friendly as-

C. *Antagonism to the Suit by the Board*

Although *Delaware & Hudson* indicated that antagonism between corporate directors and derivative suit plaintiffs was a ground for excusing demand, only one appellate court has excused demand for that reason.[62] The difficulty, it seems, is in finding a standard by which antagonism can be measured. Both the First and Third Circuits have refused to find antagonism to the derivative action in the board of director's resistance to the suit.[63] Thus, in *In re Kauffman Mutual Fund Actions*[64] the First Circuit Court of Appeals termed it "classic bootstrap" to infer hostility from the directors' efforts to seek dismissal of the suit.[65] Similarly, in *Weiss v. Temporary Investment Fund, Inc.*,[66] the Third Circuit Court of Appeals reaffirmed its decision in *Cramer v. General Telephone & Electronics Corp.*,[67] and stated that "futility . . . 'must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight.' "[68]

IV. Criteria for Excusing Demand in Delaware and New York

A. *Delaware*

Although *Zapata* requires greater scrutiny of a corporate board's motion to dismiss a derivative suit in demand-excused cases than in demand- refused cases,[69] *Zapata* left unanswered the crucial threshold question: when may demand be excused for

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sessed the allegations of the plaintiff and concluded that "[i]f ever there were a case for applying the futility exception . . . this is it." *Id.* at 1023.

62. Nussbacher v. Continental Ill. Nat'l Bank & Trust Co., 518 F.2d 873, 878 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976) (demand excused where the board took action to dismiss an identical suit in a different jurisdiction). The court asserted that "the message is loud and clear that under no circumstances would the board of directors have approved the corporation bringing the action." *Id.* at 879.

63. Weiss v. Temporary Inv. Fund, 692 F.2d at 943; Cramer v. GTE, 582 F.2d at 276; Heit v. Baird, 567 F.2d at 1160; *In re* Kauffman Mut. Fund Actions, 479 F.2d at 264.

64. 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

65. *Id.* at 264.

66. 692 F.2d 928 (3d Cir. 1982), *vacated on other grounds*, 104 S. Ct. 989.

67. 582 F.2d 259 (3d Cir. 1978), *cert denied*, 439 U.S. 1129 (1979).

68. Weiss v. Temporary Inv. Fund, 692 F.2d at 943 (quoting Cramer v. GTE, 582 F.2d at 276).

69. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). *See supra* note 27 and text accompanying notes 20-27.

futility?[70] It was not until three years after *Zapata*, in *Aronson v. Lewis*,[71] that the Delaware Supreme Court answered that question.[72] In *Aronson*, the Delaware Supreme Court established a strict standard for interpreting the demand requirement and linked their analysis of the demand issue to the business judgment rule.[73] Demand will not be excused for futility, the court held, unless the facts alleged in the complaint create a reasonable doubt that a majority of the directors were disinterested and that the challenged transaction resulted from the valid exercise of their business judgment.[74]

Aronson involved a derivative suit that challenged agreements providing interest-free loans and a lifetime consulting contract to a director who not only owned forty-seven percent of the corporation's stock, but also had selected each of the corporation's officers and directors.[75] The court rejected plaintiff's contention that this director so dominated and controlled the board that demand would have been futile.[76] The court held that mere board approval of a transaction benefiting a substantial, but nonmajority, shareholder will not vitiate the presumption under the business judgment rule that the board's actions were taken in good faith and in the best interests of the corporation.[77] Thus, in Delaware the business judgment rule enables directors to require that demand be made in almost all cases, and then once demand is made and rejected the business judgment rule allows directors to dismiss the derivative suit without further court review.

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70. Aronson v. Lewis, 473 A.2d 805, 807 (Del. 1984).

71. 473 A.2d 805 (Del. 1984).

72. Aronson v. Lewis, 473 A.2d at 807-08. Prior to *Aronson*, the Delaware Chancery Court dealt with the demand issue in three cases: Haber v. Bell, 465 A.2d 353 (Del. Ch. 1983); Bergstein v. Texas Int'l Co., 453 A.2d 467 (Del. Ch. 1982) *appeal denied*, 461 A.2d 695 (Del. 1983); Stepak v. Dean, 434 A.2d 388 (Del. Ch. 1981). All of these cases adopted the standard, similar to the standard adopted by the majority of federal courts, that in order to excuse demand a majority of directors must have personally benefited from the challenged transaction.

73. Aronson v. Lewis, 473 A.2d at 812.

74. *Id.* at 814.

75. *Id.* at 808-09.

76. *Id.* at 810.

77. *Id.*

B. *New York*

New York courts have been more lenient than Delaware courts in excusing demand for futility.[78] In the leading case, *Barr v. Wackman*,[79] the New York Court of Appeals specifically rejected the proposition that allegations of director fraud or self-interest are prerequisites for excusing demand in a shareholder derivative suit.[80] Even when a majority of the directors have not personally profited from the challenged transactions, the court stated, such directors may still be held liable for breach of their duties of due care and diligence to the corporation.[81] In these instances, it would be unlikely for them to prosecute an action that might raise questions concerning their liability.[82] Thus, the court concluded that specific allegations of board participation in or approval of a wrongdoing may suffice to excuse demand.[83] This approach to the demand issue is very different from that taken by Delaware and the majority of federal courts, in which more than board acquiescence in or approval of an alleged wrongdoing is required to excuse demand.[84]

V. The Inadequacy of the Concept of Demand Futility

A. *A Critique of New York's Liberal Approach to Demand Futility*

Liberalizing the requirements for excusing demand, as New York has done,[85] may be one possible method of avoiding the "death sentence"[86] for the derivative suit that almost always occurs when demand on the board is not excused.[87] There are, however, several problems with this approach. First, it ignores some of the useful purposes that demand may serve, even when some of the directors have allegedly acquiesced in or approved

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78. *See* Barr v. Wackman, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975).

79. 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975).

80. *Id.* at 380, 329 N.E.2d at 187, 368 N.Y.S.2d at 507.

81. *Id.*

82. *Id.*

83 *Id.* at 381, 329 N.E.2d at 188, 368 N.Y.S.2d at 508.

84. *See supra* notes 41-42 and accompanying text.

85. *See supra* text accompanying notes 78-83.

86. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 997.

87. *See supra* notes 10-11 and accompanying text.

of the challenged transaction.[88] Demand gives the directors notice of shareholder grievances and thus provides them with the opportunity to redress those grievances. In addition, the New York approach ignores the possibility that even directors who have acquiesced in or approved of corporate wrongdoing may still do their duty on behalf of the corporation if asked to do so.[89] As many courts have declared, directors who are not themselves accused of self-dealing should be given the option of taking over a derivative suit and occupying their normal position as conductors of the corporation's affairs.[90] If the board decides that a derivative suit is not in the best interest of the corporation, it should at least be given the opportunity to articulate the reasons for that decision before costly litigation is initiated.

B. *Demand Futility in the Federal Courts and Delaware: A Threshold to Dismissal*

Although New York's liberal approach to excusing demand is an undesirable method of preventing interested directors from terminating derivative suits implicating them in wrongdoing, the approach taken by the federal courts and Delaware is inadequate to protect the interests of shareholders. The high degree of self-interest required to excuse demand in these jurisdictions,[91] coupled with the application of the business judgment rule to a board's request to dismiss when demand has not been excused,[92] have prevented most shareholder suits from proceeding beyond the pleading stage to a discussion of the merits.[93]

88. *See supra* text accompanying notes 30-31.

89. *In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 265 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); Brooks v. American Export Indus., 68 F.R.D. 506, 511 (S.D.N.Y. 1975).

90. *See* cases cited *supra* note 29. As one court noted, underlying the demand requirement is the "notion that a shareholder's suit is to be resorted to as a last alternative, and that the corporation is given every possibility to sue in its own name." Gartenberg v. Merrill Lynch Asset Mgmt., 91 F.R.D. 524 (S.D.N.Y. 1981) (quoting 3B J. Moore, W. Taggert & J. Wicker, Moore's Federal Practice ¶ 23.1.19 (2d ed. 1980)).

91. *See supra* text accompanying notes 39-77.

92. *See supra* notes 10-11 and accompanying text.

93. *See supra* notes 10-11 and accompanying text. This result contrasts sharply with the goals of Federal Rule 23.1, which governs the procedural aspects of derivative suits in the federal courts, as expressed by the Supreme Court in Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966). In *Surowitz*, which dealt with the verification requirement of Rule 23(b) (now Rule 23.1), the Court said:

Thus, if the purpose of the futility exception to the demand requirement is to prevent self-interested corporate defendants from using a rule of pleading to bar consideration of the merits of a derivative action implicating them in a wrongdoing, it has failed to accomplish this goal.

In this regard, the difficulties faced by derivative plaintiffs have been compounded by the ability of defendant directors to circumvent a plaintiff's allegation of demand futility by appointing a special litigation committee to review the shareholder's request that suit be brought against them. The problem with special litigation committees is that they are inherently affected by a structural bias that makes their independence and good faith more theoretical than real.[94] Inside directors, who are also corporate officers, may depend on named defendants to de-

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> The basic purpose of the Federal Rules is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits.

Id at 373.

94. Hasan v. Clevetrust Realty Investors, 729 F.2d 372, 376-77 (6th Cir. 1984). In Joy v. North, 692 F.2d 880 (2d Cir. 1980), *cert. denied*, 460 U.S. 1051 (1983), the Second Circuit Court of Appeals stated:

> Special litigation committees created to evaluate the merits of certain litigation are appointed by defendants to that litigation. It is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism. Indeed, if the involved directors expected any result other than a recommendation of termination at least as to them, they would probably never establish the committee. The conflict of interest . . . is hardly eliminated by the creation of special litigation committee.

Id. at 888.

The Delaware Supreme Court also clearly articulated its concern with the possibilty of structural bias in Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981): "[W]e must be mindful that directors are passing judgement on fellow directors in the same corporation. . . . The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role." *Id.* at 787. Commentators who have also voiced concern about the structural bias of special litigation committees include: Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 217, 283 nn.124-26 (1981); Cox, *supra* note 86, at 962-63, 972, 1009-11; Dent, *supra* note 4, at 110-17; Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 619-22 (1980).

termine their salaries, fringe benefits, and future promotions.[95] The independence of outside directors or supposedly detached and disinterested special committee members may also be questionable, especially when they have been appointed to their positions by defendants named in the lawsuit.[96] Even when they have not been appointed by the defendants, outside directors may be dependent on the alleged wrongdoers for information.[97] Moreover, outside directors, who are usually corporate executives themselves, may be reluctant to approve a suit against colleagues with whom they may have future business dealings.[98] As the Second Circuit recognized in *Lasker v. Burks*,[99] "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned."[100]

VI. Stricter Scrutiny of the Request to Dismiss a Derivative Suit: The ALI Proposal

The American Law Institute has analyzed the unique problems presented by derivative litigation, and proposed a solution that attempts to balance the corporate directors' need to retain control of corporate management with the shareholders' interest in corporate accountability.[101] The proposal is aimed at preventing a corporate board from obtaining summary dismissal of derivative actions that implicate the officers or directors in

95. Dent, *supra* note 4, at 111.

96. Joy v. North, 692 F.2d at 888. *See supra* note 94; Dent, *supra* note 4, at 112.

97. For example, in deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968), *modified and aff'd*, 435 F.2d 1223 (10th Cir. 1978), the court found that the three outside directors had taken only a limited interest in the corporation and had little knowledge of the value or nature of its assets, and the extent of its earnings and liabilities. The outside directors, the court concluded, were thus dependent on the defendant — who was chairman of the board, president, and chief executive officer of the corporation — for information. *Id.* at 814. *See also* L. RIBSTEIN, BUSINESS ASSOCIATIONS § 5.08, at 5-82 (1983) ("Management's power over the flow of information is just as significant in controlling the outside directors as it is in controlling public shareholders.").

98. Dent, *supra* note 4, at 112.

99. 567 F.2d 1208 (2d Cir. 1978), *rev'd on other grounds*, 441 U.S. 471 (1979).

100. *Id.* at 1212.

101. *See* CORPORATE GOVERNANCE, *supra* note 9, §§ 7.02-.03.

wrongdoing. First, the ALI suggests that the demand issue should be severed from the standard of scrutiny to be applied to a corporate board's motion to dismiss a derivative suit.[102] Next, it urges courts to adopt a strict standard for excusing demand.[103] Finally, even when demand is made and refused, in all cases alleging wrongdoing by a corporate fiduciary or self-dealing by a controlling shareholder, the ALI would require a corporate board that requests dismissal to bear the burden of justifying its request.[104] In such cases, the court would apply its own business judgment to determine whether to grant the request.[105] Thus, the ALI proposal adopts the approach to dismissal of derivative suits taken by the Delaware Supreme Court in *Zapata Corp. v. Maldonado*,[106] but it extends both steps of the *Zapata* test to demand-refused as well as demand-excused cases.

A. *Analysis of the ALI Proposal*

1. *The Demand Requirement*

The ALI proposal relies heavily on the analytical framework provided by the Second Circuit Court of Appeals in *Galef v. Alexander*.[107] *Galef* distinguishes between the decision to excuse demand and the decision to grant a board's request to dismiss a derivative suit: "A determination that directors are not so interested in the underlying transaction as to excuse demand on them does not mean that they are so disinterested as to enable them to eliminate the lawsuit."[108] This approach encourages demand, providing dutiful directors with an opportunity to take remedial action without foreclosing the possibility that a shareholder could still pursue a derivative suit if the directors fail to

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102. *Id.* § 7.02, comment e, at 270.

103. *Id.* at 271.

104. *Id.* § 7.03(c).

105. *Id.* § 7.03(c)(ii).

106. 430 A.2d 779 (Del. 1981). *See supra* text accompanying notes 20-25.

107. 615 F.2d 51 (2d Cir. 1980).

108. *Id.* at 59. The First Circuit, which has taken a strict approach to excusing demand, also recognized the distinction when it said: "Resort to the board, even assuming the directors should turn down plaintiff's demand, would not necessarily preclude suit thereafter. Participation that is insufficient to excuse demand may nonetheless disqualify directors from barring a derivative suit." Heit v. Baird, 567 F.2d 1157, 1162 n.6 (1st Cir. 1977).

take action after demand is made. As the *Galef* court observed, "[t]he rationale of the cases holding that demand must be made even if the directors have been or may be made defendants, is not that the directors can *preclude* suit despite being defendants, but rather that they might cause the corporation to *pursue* the suit despite being defendants."[109]

2. *The Business Judgment Rule in the Context of the Board's Motion to Dismiss a Derivative Suit*

The concept of judicial scrutiny of a board's request to dismiss a derivative suit alleging wrongdoing by a corporate fiduciary or self-dealing by a controlling shareholder is central to the ALI proposal.[110] Several commentators and some courts have suggested that "[t]he considerations that support judicial deference to a commercial decision of the board are not present when the directors' decision pertains to the continuation of a derivative suit."[111]

Traditionally, the business judgment rule has been a means of insulating corporate directors and officers from liability for business decisions made with due care and in good faith.[112] In this sense, the business judgment rule has been termed a "defense." Because the issue in evaluating a board's motion to dismiss a derivative suit is the *propriety* of the directors' decision to terminate the suit, not their *liability* for that decision, the business judgment rule should be irrelevant to the court's evaluation.[113] Moreover, the policies underlying the rule — the need

109. Galef v. Alexander, 615 F.2d at 59.

110. CORPORATE GOVERNANCE, *supra* note 9, § 7.03(c), at 298-300. The ALI correctly distinguishes between derivative actions against third parties or low level corporate employees and actions alleging wrongdoing by corporate fiduciaries or self-dealing by a controlling shareholder. The ALI recognizes that the former present little potential for abuse, and the Institute therefore proposes a "business judgment standard" of review for decisions by corporate boards to terminate such actions. *Id.* comment a, at 304.

111. Cox, *supra* note 86, at 1009. *See also* Coffee & Schwartz, *supra* note 94, at 280-84; Dent, *supra* note 4, at 135-36; Note, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CALIF. L. REV. 885, 886 n.4 (1981).

112. Cramer v. GTE, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Galef v. Alexander, 615 F.2d at 57.

113. Zapata Corp. v. Maldonado, 430 A.2d at 782. *See also* Coffee & Schwartz, *supra* note 94, at 281; Dent, *supra* note 4, at 135; Note, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CALIF. L. REV. 885, 885 n.4 (1981).

to encourage entrepreneurship and commercial risk-taking — are only peripherally related to a board's decision to seek termination of a derivative suit.[114] Perhaps most important, the decision whether to dismiss a derivative suit does not require the same specific business or economic expertise that would be required to assess other more strictly commercial decisions that have traditionally been protected by the business judgment rule.[115] On the contrary, determining whether a lawsuit should proceed has always been the province of the courts.[116] Indeed, as the Delaware Supreme Court observed in *Zapata*, " '[u]nder our system of law, courts and not litigants should decide the merits of litigation.' "[117]

3. *The Burden of Proof Issue*

Another possibly controversial aspect of the ALI's proposal is its suggestion that the burden of proof should be on the corporation to show the business justification for its request to dismiss.[118] This position seems consistent, however, with the general rule in all other types of litigation that the party moving to dismiss bears the burden of persuasion with regard to that motion.[119] On a more practical level, this approach to the burden of

114. Professors Coffee and Schwartz point out that the business judgment rule evolved to protect ordinary business decisions made under time pressure. The rule acknowledges the uncertainties of the marketplace and recognizes that in business, excessive prudence can sometimes be detrimental. In contrast to ordinary business decisions, the decision whether to terminate a lawsuit can and should be made with greater deliberation, and therefore does not need the protection of the business judgment rule. Coffee & Schwartz, *supra* note 94, at 281-83. The ALI has also evaluated the business judgment rule in the context of ordinary business decisions. *See* Principles of Corporate Governance and Structure: Restatement and Recommendations § 4.01-.03 (Tent. Draft No. 3, 1984).

115. Joy v. North, 692 F.2d 880, 888-89 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

116. As the Second Circuit noted in Joy v. North, 692 F.2d at 888, "it can hardly be argued that terminating a lawsuit is an area in which courts have no special aptitude."

Indeed, in *Zapata*, the Delaware Supreme Court noted that the court deals regularly and competently with fiduciary relationships, disposition of trust property, approval of settlements — issues that are similar to those raised by the request to dismiss a derivative suit. Zapata Corp. v. Maldonado, 430 A.2d at 788.

117. Zapata Corp. v. Maldonado, 430 A.2d at 789 n.18 (quoting Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. Ch. 1980)).

118. CORPORATE GOVERNANCE, *supra* note 9, § 7.03, comment a, at 308.

119. In some respects, the board's assertion of a business justification for dismissal

proof question recognizes that at the pre-discovery stage, when the motion to dismiss is made, the corporation has greater access than the plaintiff shareholder to the information required to substantiate or disprove the board's justification for dismissal.[120]

4. *The Concern with Strike Suits*

Beneath the deference given to corporate requests for dismissal of derivative suits is the desire to discourage "strike suits."[121] Perhaps the strongest argument against deferring to a corporation's decision to seek dismissal of a derivative suit as a method of deterring strike suits is that it allows the directors, who are themselves a party to the suit, to determine whether the suit is indeed a "strike suit." Moreover, various restrictions have already been placed on derivative suits to prevent their abuse.[122]

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is similar to the assertion of an affirmative defense, which the defendant has the burden of pleading. McCormick on Evidence § 337, at 948 (3d ed. 1984). ("In most cases, the party who has the burden of pleading a fact will have the burdens of producing evidence and of persuading the jury of its existence as well.") Some courts have compared the board's motion to dismiss with a motion for summary judgment in which the moving party has the burden of proof. Joy v. North, 692 F.2d at 892; Zapata Corp. v. Maldonado, 430 A.2d at 788.

120. Cox, *supra* note 86, at 1008; McCormick, *supra* note 120, at 950 ("A doctrine often repeated by the Courts is that where the facts with regard to an issue lie peculiarly in the knowledge of a party, that party has the burden of proving the issue.").

121. *See supra* text accompany note 8. *See also* Dent, *supra* note 4, at 137-40.

122. Not all of these restrictions are effective or desirable. One restriction that has been critized by some commentators is the requirement, adopted in a substantial minority of states, that plaintiffs post security at the outset of litigation to cover the reasonable expenses, including attorney's fees, that may be incurred in the action. *See, e.g.*, Ariz. Rev. Stat. Ann. § 10-049 (1977); Ark. Stat. Ann. § 64-223 (1980); Colo. Rev. Stat. § 7-4-121(3) (1973) (excludes attorneys' fees); Fla. Stat. Ann. § 607.147(3) (West Supp. 1985); Neb. Rev. Stat. § 21-2047 (1983); N.J. Stat. Ann. § 14A: 3-6(3) (West Supp. 1983- 1984); N.Y. Bus. Corp. Law § 627 (McKinney Supp. 1984-1985); Pa. Stat. Ann. tit. 15, § 1516B (Purdon Supp. 1984-1985); Tenn. Code Ann. § 48-1-718(f) (1984); Tex. Bus. Corp. Act. Ann., art. 5.14(c) (Vernon 1980); Wash. Rev. Code Ann. § 23A.08.460 (1969); W. Va. Code § 31-1-103 (1982); Wis. Stat. Ann. § 180.405(4) (West 1957); Wyo. Stat. § 17-1-141.1 (Cum. Supp. 1984). In 1982, the security for expenses provision was deleted from the Model Business Corporation Act. Henn & Alexander, Laws of Corporations § 372, at 1089 n.1 (1983).

The ALI has criticized security for expenses statutes because: (1) they tend to chill meritorous as well as non-meritorious suits, (2) they often do not curb the abuses they were intended to curtail because they can be easily circumvented, and (3) they discriminate unfairly between large and small shareholders because generally their provisions do not apply to shareholders owning more than five percent of the outstanding shares of any class. Corporate Governance, *supra* note 9, § 7.02, comment g, at 275-77. *See also* Cof-

Thus, for example, in the federal courts, as well as in many state courts, settlement of a derivative suit must be approved by the court.[123] In addition, in the majority of derivative actions, recovery accrues to the corporation, not to the individual shareholder.[124] New York and Wisconsin have codified the principle that plaintiff shareholders must account to the corporation for any proceeds resulting from a compromise, settlement, or judgment in any derivative action.[125]

VII. Conclusion

The basic task of the courts in shareholder litigation is to balance the right of the corporate board to manage the affairs of the corporation with the right of the shareholders to protect their interests without being "unfairly trampled on by the board of directors."[126] Currently, the high degree of self- interest required to excuse demand, combined with the deference given to a board's request for dismissal of a derivative suit when demand has not been excused, have shifted the balance in favor of corporate directors who can effectively use a procedural rule to preclude any consideration of the merits of a shareholder action. As a result, shareholders with legitimate grievances may be denied access to the courts to protect their corporate interests. Applica-

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fee & Schwartz, *supra* note 94, at 314-15; Note, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J.L. & SOC. PROBS. 50 (1968).

123. Fed. R. Civ. P. 23.1 provides that "the action shall not be dismissed or compromised without the approval of the court."

124. *See, e.g.*, Keenan v. Eshleman, 23 Del. Ch. 234, 253-54, 2 A.2d 904, 912-13 (1938) ("Generally, where the action is a derivative one, brought for the benefit of a going corporation, equitable principles demand that the theory of the action be recognized and that the whole recoverable amount be decreed to be paid to the corporation . . . .").

In limited circumstances, such as when the corporation is no longer in existence or when an award to the corporation would revert to the wrongdoers, courts have awarded individual shareholders a pro rata share of the recovery in derivative actions. *See, e.g.*, Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955) *cert. denied*, 349 U.S. 952 (1955). *See generally* Grenier, *Pro Rata Recovery by Shareholders on Corporate Causes of Action as a Means of Achieving Corporate Justice*, 19 WASH. & LEE L. REV. 1965 (1962); NOTE, *Individual Pro Rata Recovery in Stockholders' Derivative Suits*, 69 HARV. L. REV. 1314 (1956); Note, *Shareholders' Right to Direct Recovery in Derivative Suits*, 17 WYO. L.J. 208 (1963).

125. N.Y. BUS. CORP. LAW § 626(e) (McKinney 1963); WIS. STAT. ANN. § 180.405(3) (West 1957).

126. Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981). *See supra* note 7.

tion by the courts of a strict standard for excusing demand, coupled with greater scrutiny of all requests to dismiss derivative actions alleging wrongdoing by corporate directors or self-dealing by controlling shareholders, would help to restore the delicate balance between the rights of the shareholders and the rights of corporate management. Most important, such an approach would enable the derivative suit to retain "its generally-recognized effectiveness as an intra-corporate means of policing boards of directors."[127]

Carole F. Wilder

127. *Id.* at 786.