Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers

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STOCKHOLDER DERIVATIVE SUITS: DEMAND AND FUTILITY WHERE THE BOARD FAILS TO STOP WRONGDOERS

I. INTRODUCTION

One of the most compelling debates in modern corporate law concerns the extent to which shareholder derivative suits should be allowed to police the behavior of managers and directors. The controversial derivative action allows a shareholder to bring suit against wrongdoers on behalf of a corporation. Examples of actionable injuries to corporations include illegal activities of employees and outright self-dealing on the part of managers or directors. If a shareholder believes the corporation should sue a wrongdoer for compensation for an injury, and the corporation refuses the shareholder's demand that it bring suit, then the shareholder may commence a derivative action to rectify the wrong.

Derivative suits are praised for providing a single shareholder with a vehicle for forcing management to compensate the injured corporation. On the other hand, the suits are criticized for creating a way for plaintiffs' attorneys to collect substantial fees in strike suit settlements. Also, derivative suits may second-guess the business judgment of directors and officers, who occupy their positions because of their training and expertise.

1. While derivative suits are often brought against officers and directors, they can also be based on claims against controlling shareholders and third parties. DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 1:01 (1992).

2. The procedural rules for bringing derivative suits in most states are similar to those found in FED. R. Civ. P. 23.1. Only a few states vary significantly. See infra note 9 and accompanying text.

3. Since the corporation is the actual party of interest in a derivative suit, the wrongdoers are sued to compensate the corporation rather than the shareholder. Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, cert. denied 502 U.S. 974 (1991). Unlike the derivative suit, a direct action suit is brought by shareholders, both in their own right and as a class, asking for personal compensation from corporate wrongdoers. ROBERT C. CLARK, CORPORATE LAW § 15.1 (1986). This Comment, however, focuses only on shareholder derivative suits.

4. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (stating that when a corporation is faced with an injury by directors "a stockholder is not powerless . . . . The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management.").

5. Strike suits are not brought with the intention of benefitting the corporation and are based on reckless charges made by attorneys seeking "quick dollars." Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966).

STOCKHOLDER DERIVATIVE SUITS

The procedural aspects of the derivative suit are designed to give management an opportunity to decide whether it should bring suit against the wrongdoers.\(^7\) Laws in all states require a shareholder to demand that management bring suit, and the shareholder can only commence the derivative suit if management refuses the demand.\(^8\) Most jurisdictions allow an exception to the demand rule where the shareholder pleads that demand would have been futile since a majority of the directors are the wrongdoers.\(^9\) Shareholders prefer claiming that demand would have been futile because if demand is refused, most courts apply the business judgment rule. Those courts dismiss the action if the board used good faith and had a reasonable basis for deciding not to bring suit.\(^10\)

Courts have long struggled with the question of when demand should be excused for futility.\(^11\) Most jurisdictions have held that demand is futile when a majority of the board of directors have breached their duty of loyalty and have engaged in self-dealing.\(^12\) Courts are split over whether demand is futile when a violation of the duty of care is alleged, such as when a majority of the board failed to stop wrongdoers.\(^13\) Much of courts' time is taken up litigating the issue of whether breaches of the

\(^7\) The derivative suit was historically viewed as one action comprising two smaller suits. It occurred when "[t]he plaintiff (1) brought a suit in equity against the corporation seeking an order compelling it (2) to bring a suit for damages or other relief against some third person who had caused legal injury to the corporation." Clark, supra note 3, § 15.1. Today, the derivative action is considered a single suit, but the corporation is seen as a nominal defendant that can make objections to the action. Id.

\(^8\) In some derivative actions a shareholder may be required to make demand on the other shareholders of a corporation. DeMott, supra note 1, § 5:02; see Fed. R. Civ. P. 23.1. Legislative and judicial treatment of demand on shareholders is beyond the scope of this Comment.

\(^9\) Statutes in most jurisdictions establish the futility exception to the demand requirement in terms similar to those found in Fed. R. Civ. P. 23.1, which states: "The 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."


\(^10\) Cf. Spiegel v. Buntrock, 571 A.2d 767, 773-77 (Del. 1990) (noting that demand can be seen as conceding a board's independence).


\(^12\) Clark, supra note 3, § 15.2.1.

\(^13\) See infra text accompanying note 150.
duties of loyalty and care render demand futile. Courts, scholars, and legislatures are reconsidering the futility exception to the statutory requirement that shareholders make demand in derivative suits.

Part II of this Comment describes the parties and their competing interests in shareholder derivative actions. Part II addresses the common judicial response to derivative suits and reviews various approaches to demand futility. Part III suggests that the futility exception be eliminated where the shareholder alleges that a majority of the board breached its duty of care by failing to stop wrongdoers.

II. THE DERIVATIVE SUIT

Since the nineteenth century, derivative suits have been used by shareholders in efforts to exact compensation from corporate wrongdoers. While shareholders have other options such as selling their stock or waging proxy battles to change the management or its practices, the derivative suit forces those who committed the wrong to compensate the corporation, and in the process employs the judiciary to bring about justice. A common concern is how much justice is really received from a derivative suit: the stock price usually shows only marginal improvement, and the lengthy and complicated suit often settles out for a fraction of the sought relief. The attorneys are the main beneficiaries. Moreover, the corporation may be contractually committed to indemnifying management for such suits where self-dealing is not involved, so wrongdoers do not personally pay and corporate insurance premiums increase.

One benefit of derivative suits, in addition to the potential financial restoration for the corporation, is to deter directors and officers from engaging in wrongful behavior in the future. The heat is turned up on

14. See, e.g., Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1209-10 (9th Cir. 1980) (discussing the application of demand futility).
16. An early derivative suit reached the United States Supreme Court and addressed the merits of the unusual action. Hawes v. City of Oakland, 104 U.S. 450, 455 (1881).
17. See PRINCIPLES, supra note 11, at 587-88.
20. Id. at 61, 63.
21. Id. at 62. See also DEMOTT, supra note 1, § 6:13 (focusing on the liability insurance of directors and officers).
those who control other corporations not to partake in foul play lest they get hit with a derivative suit. A problem with this deterrence purpose may be that management is also deterred from risk-taking and trying innovative ideas. Not only might a corporation suffer from a damaged reputation because of a derivative suit, it might also suffer from a loss of competitiveness due to an overemphasis on playing it safe and avoiding experimentation. In part to create a climate that promotes innovation, corporations often place a number of independent directors on the board. Those directors take no part in management but exercise their more impartial and disinterested judgment on management’s actions. It is before this board, which often includes a number of independent directors, that a shareholder brings demand for the corporation to take action against wrongdoers.

A. The Demand Requirement

A shareholder bringing a derivative suit is under statutory mandate to first demand that the corporation bring legal action against those who caused the harm. The corporation’s board of directors may consider the demand, unless too many of them are implicated in the charges. They may choose to expand the board to include independent directors who will form a special litigation committee to study the demand. If the board or the committee refuses the demand, or if they do not respond in a reasonable time, the shareholder may commence the derivative suit and plead that demand was made and refused, or that it went unanswered. In most states, a shareholder can file suit without making demand if the shareholder believes that the board was so involved in the wrongdoing that it could not make an unbiased decision or appoint an impartial committee. The shareholders must plead with particularity that they did not make demand because it would have been futile.
The reason for the demand requirement is that directors, not shareholders, are supposed to make major corporate decisions.\textsuperscript{35} Another purpose of demand is to give corporate management a chance to take corrective measures or persuade the wrongdoers to make right.\textsuperscript{36} Judicial economy is achieved by ending the need for a lawsuit.\textsuperscript{37} Likewise, the board may accept the demand, bring suit against the wrongdoer, and try to persuade the shareholder to step aside.\textsuperscript{38} The board might be concerned that, if allowed to bring suit, the shareholder might settle for an inadequate amount from the wrongdoers.\textsuperscript{39} Conversely, the board may find the lawsuit to be unmeritorious and reject the demand—perhaps aware that the suit’s legal fees would be more costly than the possible recovery from the defendants.\textsuperscript{40} Despite the possibility that a corporation may choose to accept demand and bring suit against the wrongdoers, the reality is that boards rarely do so.\textsuperscript{41} Typically, a shareholder files the derivative lawsuit and pleads to the court that demand was wrongfully refused.\textsuperscript{42} Next, the corporation usually moves to dismiss.\textsuperscript{43} In most jurisdictions, courts then decide whether the plaintiff raised reasonable doubt as to the rejecting board or committee’s independence or personal financial interest in the wrongdoing.\textsuperscript{44} If the decision makers were independent, their decision to reject the demand enjoys the protection of the business judgment rule.\textsuperscript{45} The Delaware Supreme Court has stated that this rule provides “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”\textsuperscript{46} If the shareholder cannot overcome this presumption, then the corporation’s motion to dismiss is granted.\textsuperscript{47} Otherwise, if the board or commit-

\textsuperscript{35} Kamen, 500 U.S. at 101.
\textsuperscript{38} Elfenbein v. Gulf W. & Indus., 590 F.2d 445, 450 (2d Cir. 1978) (per curiam).
\textsuperscript{39} PRINCIPLES, supra note 11, cmt. C, at 651 (noting that “it must be recognized that the corporation may have reason to fear an inadequate settlement that would preclude it from seeking further relief.”).
\textsuperscript{40} Cramer, 582 F.2d at 275.
\textsuperscript{41} PRINCIPLES, supra note 11, § 7.03 cmt. c, at 651.
\textsuperscript{42} See Block, supra note 24, at 1458-60.
\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{46} Aronson v. Lewis, 473 A.2d at 805 (Del. 1984).
\textsuperscript{47} Block et al., supra note 24, at 1461.
tee acted in bad faith or with gross negligence, the derivative action proceeds to the discovery stage.48 Commonly, courts then defer to the board's or special litigation committee's business judgment and dismiss the action.49 Aware of this deferential treatment to demand refusal, many plaintiffs now avoid demand by filing suit and pleading to the court that demand would have been futile.50

B. The Futility Exception and the Need to Plead with Particularity

A number of courts have held that when shareholders choose to make demand, they have conceded the absence of facts showing futility.51 Chances are then greater that a court will dismiss the suit in deference to the board or committee's business judgment.52 Thus, plaintiffs opt not to make demand but plead that it would have been futile.53 In response to the shareholder filing the lawsuit, the board of directors or a specially formed litigation committee typically reviews the situation and asks the court to both dismiss the suit due to the plaintiff's failure to make demand, and to find that demand is not excused.54

The response of courts in most jurisdictions to this procedural move was defined in Aronson v. Lewis,55 a 1984 case before the Delaware Supreme Court. In that case, a board awarded a very lucrative consulting contract to a retiring director who owned forty-seven percent of the corporation's stock.56 A shareholder brought a derivative action claiming the agreement was a misuse of corporate assets and that demand on the board of directors would have been futile since they were under the control of the retiring director.57 The Delaware Supreme Court found that the shareholder's allegation of control was merely conclusory.58 For

48. Stoner v. Walsh, 772 F. Supp. 790, 806 (S.D.N.Y. 1991) (noting that "bad faith in investigating a demand . . . would take the Board's decision outside the protection of the business judgment doctrine").
49. See Coffee, supra note 15, at 1411.
50. Id. at 1414.
52. See Levine, 591 A.2d at 212.
53. See Kamen v. Kemper Fin. Servs. Inc., 500 U.S. 90, 102 (1991) (observing that "[b]y permitting the shareholder to circumvent the board's business judgment on the desirability of corporate litigation, the 'futility' exception defines the circumstances in which the shareholder may exercise this particular incident of managerial authority").
56. Id. at 808-09.
57. Id. at 809.
58. Id. at 816-17.
a court to find demand was futile, the plaintiff must particularize the assertions.\(^5\)

In determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.\(^6\)

The Aronson court remanded the action because of the plaintiff's failure to make demand where demand was not excused.\(^5\)

The difficulty of the "demand-required demand-excused" rule, as addressed by the Aronson test, is that directors are not necessarily either completely independent or the actual wrongdoers.\(^6\) Along the continuum in between, a director might be a replacement for a director who was involved in the wrong.\(^6\) A director might have once approved of the questioned action using business judgment under the circumstances.\(^6\) A director may also be independent, but an associate of the wrongdoers.\(^6\) Further, a director may be under the control of the wrongdoers.\(^6\)

The Aronson test places a premium on characterizing the director's status with particularity if a judge is to be persuaded that the board is not in a position to receive and evaluate demand.\(^6\) If bad faith, control, or gross negligence are not found, the case will be dismissed, usually without prejudice, for the plaintiff to make proper demand.\(^6\) Often plaintiffs cannot meet the Aronson test, in large part because discovery is not allowed at this stage to help particularize why demand on the directors is futile.\(^6\) One reason discovery is not granted is that it would create the

\(^{59}\) Id. at 814.

\(^{60}\) Id.

\(^{61}\) Id. at 818.

\(^{62}\) See DeMott, supra note 1, § 5:12.

\(^{63}\) In re Kauffman Mut. Fund Actions, 479 F.2d 257, 267 (1st Cir. 1973) (Coffin, J., concurring).

\(^{64}\) Id. at 265.

\(^{65}\) The independence of directors has also been questioned where the directors received pensions and fees from the wrongdoers. Samuel M. Feinberg Testamentary Trust v. Carter, 652 F. Supp. 1066, 1074 (S.D.N.Y. 1987).

\(^{66}\) E.g., deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1228 (10th Cir. 1970).

\(^{67}\) Aronson v. Lewis, 473 A.2d 805, 914 (Del. 1984).

\(^{68}\) See Kauffman, 479 F.2d at 263.

possibility of people filing unmeritorious claims and going through corporate files hunting for signs of wrongdoing.\textsuperscript{70}

While the \textit{Aronson} test sets up a significant hurdle for plaintiffs who see demand as futile, the wording of the test, such as "whether . . . a reasonable doubt is created,"\textsuperscript{71} opens the door for a potential measure of judicial review.\textsuperscript{72} Shareholders cast their claims against the directors in as dramatic terms, hoping to alert the court to the seriousness of the issue.\textsuperscript{73} The reasonable doubt concept is somewhat subjective, and a court may choose to find that demand is futile, allowing the suit to move forward.\textsuperscript{74}

At this juncture a corporation may establish a special litigation committee to consider the merits of the suit.\textsuperscript{75} Since demand was not made earlier, and the corporation has not yet had a chance to name a committee and develop a report, a court will likely grant the corporation's motion for a stay of the proceedings while an investigation is made.\textsuperscript{76} After an exhaustive study, the committee will likely recommend the suit's dismissal.\textsuperscript{77} On motion of the plaintiff, the court may then grant limited discovery to determine if the special litigation committee was truly independent.\textsuperscript{78} The court will then be in a position to hold a hearing about the special litigation committee's recommendation to dismiss.\textsuperscript{79}

To reach its decision, the court may use any one of a number of approaches. Jurisdictions that employ the Delaware model use the test developed in \textit{Zapata Corp. v. Maldonado},\textsuperscript{80} a 1981 Delaware Supreme Court case. In that case, an interested board appointed a two person litigation committee which the board purported to be disinterested.\textsuperscript{81} The court found that, although it was possible for such a board to create a disinterested committee,\textsuperscript{82} a two-step test needed to be applied in de-
ciding whether to accept the committee’s recommendation. The Zapata test places the burden on the corporation to show that the special litigation committee was independent, acted in good faith, and had a reasonable basis for its decision. If the corporation meets that burden, then the court, in its discretion, can choose to terminate the suit based on fairness to the corporation. Additionally, the court could employ its own “independent business judgment” to deny the motion to terminate.

The Zapata test, used where demand had earlier been excused for futility, has been subject to criticism for allowing a court to go beyond the business judgment rule and apply too much of its own discretion. Some believe that giving deference to a court’s independent business judgment to deny the corporation’s motion, allows the court to usurp a role that is more appropriately performed by directors and officers. Despite the concerns of the business community, courts have rarely chosen to exercise such business judgment, and the Zapata test has not been disproportionately plaintiff-friendly.

New York uses a more conservative test than that suggested in Zapata where demand has been excused for futility. In 1979, the New York Court of Appeals held in Auerbach v. Bennett that a court’s response to a special litigation committee’s recommendation to dismiss should focus on the committee’s independence. The court is not to decide whether the committee made an appropriate decision. If the committee used reasonable procedures, then the court cannot second-guess the committee’s conclusion.

83. Id. at 788-89.
84. Id.
85. Id. at 789.
86. Id. Zapata described the second part of the two step test as follows: “The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation’s best interests as expressed by an independent investigating committee.” Id.
87. See CLARK, supra note 3, § 15.2.3.
88. Id.
89. See Carol B. Swanson, Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball, 77 MINN. L. REV. 1339, 1390 (1993).
90. The New York approach has been called a “minimalist position” because it endorses only a minimal review by courts. CLARK, supra note 3, § 15.2.3.
92. Id. at 1001.
93. Id. at 1002.
94. Id. at 1002-03.
Critics of the *Auerbach* approach point to the dangers of relying on special litigation committee reports and suggest that the committees suffer from structural bias in favor of the corporation. When a court dismisses a case against alleged wrongdoers, it does so on the advice of a group appointed by the corporation, and perhaps the wrongdoers themselves. The committee may consist of business colleagues of the directors or those who for other reasons have sympathy for the corporation's position, despite the fact that they are called "independent." Such criticism has been countered by the observation that the committees do not necessarily suffer from what may subjectively be seen as structural bias. If a court finds a committee to be independent and not under the control of alleged wrongdoers, it should respect the committee's conclusion to dismiss the case.

The opposite approach of *Auerbach* is used in North Carolina and is based on the holding in *Alford v. Shaw*. In that jurisdiction, judicial review must always be applied to the board or special litigation committee's recommendation. The *Alford* rule applies both to circumstances where demand was refused and to where demand was excused for futility. Unlike *Auerbach*, under the *Alford* rule it does not matter whether the special litigation committee was independent or if it used reasonable procedures. While *Alford* is criticized as moving too far astray from the business judgment rule, others see its focus on giving the court broader judicial review as a strength.

**C. Universal Demand**

The jurisdictions governed by the rules in *Zapata*, *Auerbach*, and *Alford* share the idea that in some circumstances demand may be excused.

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96. Id.
97. Id.
99. Id.
100. 358 S.E.2d 323 (N.C. 1987).
101. Id. at 326. The court in *Alford* also stated: "We conclude from our analysis of the pertinent statutes that a modified *Zapata* rule, requiring judicial scrutiny of the merits of the litigation committee's recommendation, is most consistent with the intent of our legislature and is therefore the appropriate rule to be applied in our courts." Id.
102. Id. at 327.
103. See id.
104. For additional discussion of *Alford*, see Swanson, *supra* note 89, at 1367-68.
for futility. In recent years, a different approach has been examined that would effect a dramatic departure from the demand-required demand-excused method. A handful of state legislatures have now adopted the idea of eliminating the futility exception to the demand requirement, a concept advocated by the American Bar Association. The American Law Institute also favors ending the futility exception, but it suggests a more expansive standard of judicial review.

1. The Model Business Corporation Act Approach

The American Bar Association has proposed in its Model Business Corporation Act (MBCA) that instead of excusing demand for futility, demand should be required in all derivative actions. Even if a shareholder doubts that the directors are disinterested or independent or that the wrongdoing was so egregious that the board could not use its business judgment not to sue, demand would still have to be made in the limited number of jurisdictions that have embraced universal demand. A primary reason for ending the futility exception is that litigating the demand issue where futility is pleaded occupies a disproportionate amount of time in derivative actions. Demand litigation is very complex and is, in a large sense, peripheral to the ultimate issue of compensating a corporation for the harms of a wrongdoer. For instance, in Delaware, procedural hurdles for a derivative suit may include both a motion to dismiss for failure to make demand that is put to the Aronson test, and later a special litigation committee's motion to dismiss that is put to the Zapata test. The MBCA recommends the more simplified route of requiring demand and addressing the corporation's special litigation committee report.

Advocates of retaining the futility exception emphasize that, especially where a majority of directors allegedly breached their duty of loyalty by self-dealing, demand is a truly futile exercise. They point out that

105. See supra notes 87, 90, 102 and accompanying text.
107. See supra note 9 and accompanying text.
110. MBCA, supra note 108, § 7.42 official cmt.
111. See supra note 9 and accompanying text.
112. MBCA, supra note 108, § 7.42 official cmt.
113. PRINCIPLES, supra note 11, § 7.03 cmt. e, at 655.
114. MBCA, supra note 108, § 7.44 official cmt.
115. Id. §§ 7.42, 7.44 official cmt.
demand deprives the shareholder of both money and time. The commencement of the lawsuit is unduly postponed when there is little chance that the board would accept demand and bring suit against the wrongdoers.

Despite the criticism, the MBCA provides a streamlined approach to the derivative action. Under the MBCA, a shareholder cannot bring suit until 90 days after making written demand. Exceptions include corporations that refuse the demand within 90 days, and corporations that will suffer irreparable injury if suit is not brought earlier. Typically, the board or a special litigation committee refuses demand or conducts a lengthy study that comes to the same result. The shareholder then commences suit and pleads that demand was wrongfully refused.

The shareholder must argue that a majority of the decision makers were not independent under the MBCA. A director may be found to be independent even if the director was elected by the alleged wrongdoers, was named in the suit, or approved of the wrong but did not personally benefit from it. If a majority of the board that rejected the demand is found to be independent, then the plaintiff has the burden of showing that the decision was not made in good faith. The plaintiff may also argue that the board had no reasonable basis to determine that a suit against the wrongdoers was not in the best interest of the corporation. Conversely, if a majority of the board was not independent, then the corporation has the burden of demonstrating that the decision was made in good faith and on a reasonable basis. The effect of the MBCA approach is that if a majority of the board or committee is independent—and the corporation is likely to have ensured that it is—then the court will dismiss the derivative suit.

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116. Opponents of the futility exception, perhaps envisioning plaintiffs who would simply write a letter to make demand, point out that the actual process of making demand may cost little. PRINCIPLES, supra note 11, § 7.03 cmt. e, at 655.

117. See supra note 41 and accompanying text.

118. MBCA, supra note 108, § 7.42.

119. PRINCIPLES, supra note 11, § 7.03 cmt. c, at 651.

120. Id.

121. MBCA, supra note 108, § 7.44(d).

122. Id. § 7.44(c).

123. Id. § 7.44(e).

124. Id.

125. Id. § 7.44.
2. The American Law Institute (ALI) Approach

The ALI's Principles of Corporate Governance: Analysis and Recommendations (Principles), which was completed in 1992, also proposes that the futility exception to the demand requirement be eliminated and replaced with universal demand.\(^{126}\) Unlike the MBCA, it seeks to expand the judicial standard of review beyond the bounds of the business judgment rule.\(^{127}\) The result is an increased chance that derivative suits will survive motions to dismiss.\(^{128}\)

Under the Principles, a plaintiff must plead that the board was not independent and must also present particular facts that show a likelihood that the wrongdoing was unprotected by the business judgment rule because it was not made in good faith or on a reasonable basis.\(^{129}\) In evaluating a corporation's motion to dismiss, the court is to apply a balancing test.\(^{130}\) The test requires that the more serious the wrongdoing, the less particularized the allegations need be that the rejection was unreasonable.\(^{131}\) Also, the more conclusory the corporation's reply, the less weight it is given.\(^{132}\) On the other hand, the less serious the wrongdoing, the more particularized the allegations must be as to why demand should have been accepted.\(^{133}\)

If the court decides to deny the motion to dismiss, it then awaits a detailed report of the corporation's special litigation committee.\(^{134}\) If the gravamen of the action pertains to a breach of duty of care on the part of the wrongdoer, then the benefit of the business judgment presumption is given to the committee's recommendation to terminate the suit.\(^{135}\) However, if the issue is breach of loyalty, then the court makes

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126. Principles, supra note 11, § 7.03 cmt. e, at 654-57. The theory of universal demand is in part based on the following critique of the futility exception:

[R]estricting the availability of judicial review to circumstances in which demand is excused has had a predictable consequence: some courts have expanded the futility exception in order to preserve their ability to assess the merits of the action to some degree. As a result, this linkage of the issues of demand and the standard of judicial review has tended to confuse the law on both questions.

Id. at 656.


128. See Block, et. al., supra note 24, at 1476.

129. See Coffee, supra note 15, at 1418.

130. Id. at 1419.

131. Id.

132. Id. at 1420.

133. See id. at 1419-20.

134. The requirements for a special litigation committee's composition and report is included in Principles, supra note 11, § 7.09.

135. Id. § 7.10.
its decision based on what it sees as the best interests of the corporation. The court will not dismiss the case if it would result in the wrongdoer retaining what the court may regard as a significant improper benefit.

A criticism of the Principles approach is that it departs at a number of points from the business judgment rule in favor of broader judicial review. Since under this approach courts will likely allow more derivative suits to cross the procedural hurdles than under the Delaware or the MBCA approaches, the effect may be to encourage more derivative suits. While management will be all the more deterred from wrongdoing, it will also take less risks, engage in less innovation, and spend more time laying down paper trails for fear of future litigation. People may be discouraged from sitting on boards of directors, and insurance rates will rise. The Principles method is not much less complicated than the dominant approach among jurisdictions of allowing exceptions to demand for futility. The redeeming value of the Principles approach is primarily seen by those who believe that deterring would-be corporate wrongdoers is a higher priority than preventing strike suits and relieving a court system congested with litigation.

III. WHEN THE BOARD FAILS TO STOP WRONGDOERS: AN ALTERNATIVE APPROACH

There is a key within the debate over how to best approach derivative suits that could reduce procedural litigation and at the same time maintain the deterrence value of the derivative action. The method was used for years by a number of federal courts until 1991, when the United States Supreme Court in Kamen v. Kemper Fin. Servs., Inc. determined that federal courts should abide by the procedural rules of

136. Id.
137. Id.
138. Block, supra note 24, at 1480.
139. Cf. id. at 1483 (referring to "the litigation [expected to be] fostered by the change in the law contemplated by the [PRINCIPLES]").
140. Id.
141. Id. at 1480.
142. Cf. Swanson, supra note 89, at 1392 (concluding that "the suggested standards [in the PRINCIPLES] are so convoluted and the burdens imposed on plaintiffs so rigorous, they make the recommendations unworkable and undesirable").
143. Block, et. al., supra note 24, at 1482-83.
144. Those developing proposals to improve the law of shareholder derivative actions believe that there should be a reduction in the occurrence of strike suits and unnecessary litigation. Swanson, supra note 89, at 1391.
the state of incorporation in derivative suits. The Court did not criticize the old federal approach, and some state and federal courts continue to use the method as long as it is not precluded by state laws such as those requiring universal demand. The approach divides derivative suits into two categories. The futility exception is maintained when a majority of the board is alleged to have breached a duty of loyalty. However, futility is eliminated when a majority of the board allegedly breaches a duty of care, such as when it fails to stop wrongdoers. Today, a number of courts are making their decisions along this "fault line," and are finding that it is supported by sound policy.

This proposal bears some similarity to the approach used in Delaware and most states since courts using the *Aronson* futility test often divide along this line. This proposal is more rigid than the *Aronson* test because it does not allow any pure duty of care cases to be dismissed for futility, as courts using the *Aronson* test sometimes allow. The effect of this proposal will find futility less often than under the *Aronson* test and will require demand more often. Corporations will likely reject those demands, and there will be an increase in the number of cases resolved by the business judgment rule—usually in the corporations' favor.

A. A Futility Exception for Breach of Loyalty

Demand should be excused for futility only when a majority of the board commits the wrong or has personal financial interests in the wrongdoing. Making demand is truly futile when most directors have engaged in self-dealing, and it would be a waste of the shareholder's time and money to do so. Directors that are personally interested in the transaction in question are not likely to bring suit against themselves. Courts have a long history of policing such conflicts of interest and find them to be especially odious because they are self-perpetuating and can cause serious harm to corporations. Of course, an independent spe-

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146. See id. at 108-09.
147. Id. at 104.
148. See PRINCIPLES, supra note 11, § 7.03 reporter's notes 1, 3, at 662-65.
149. See id. at 662-63.
150. See id.
151. See id.; James O. Pearson, Jr., Annotation, Negligence, Nonfeasance, or Ratification of Wrongdoing as Excusing Demand on Directors as Prerequisite to Bringing of Stockholder's Derivative Suit on Behalf of Corporation, 99 A.L.R. 3d. 1034, 1043-45 (1980).
152. See supra note 60 and accompanying text.
153. See supra note 116 and accompanying text.
cial litigation committee could still present reasons to the court why the
suit would do more harm to the corporation than good, but that issue
can still be heard after demand is excused for futility. The futility ex-
ception, therefore, is both useful and effective where a majority of the
board has breached its duty of loyalty.

B. Eliminating the Futility Exception for Breach of Care

When a board of directors is alleged to have breached its duty of care
by approving a wrong, the plaintiff should not be allowed to plead that
demand is futile. The board’s ratifying of the wrongdoing is largely
protected by the business judgment rule as an erroneous business judg-
ment. The board should be given a chance to decide whether bringing
suit against the actual wrongdoers is in the corporation’s best financial
interest.

This proposition covers situations where a board did not know and
should not necessarily have known of the wrong. Courts have long held
that demand is not futile in such situations because the shareholder’s and
board’s interests are fully aligned in protecting the corporation. But
courts have not been in such agreement where the board ratifies wrong-
doing in the course of its business decision making. Here, also, this
proposal would not allow a futility exception.

In the 1986 case of In re E.F. Hutton Banking Practices Litigation, the
district court for the Southern District of New York held that de-
mand was not futile for a duty of care claim where a majority of directors
approved of Hutton receiving interest-free use of money through a prac-
tice of excessive overdrafting. Neither the fact that all directors were
named in the suit nor the charge of their “passive acquiescence” was
sufficient in Hutton to excuse the demand required under Rule 23.1 of

156. For the opposing argument that demand is futile when the directors have approved the
wrong, see David P. Curtin, Note, Demand on Directors in a Shareholder Derivative Suit
When the Board Has Approved the Wrong, 26 B.C. L. Rev. 441, 451-55 (1985).
159. Where the board did not know of the wrong, demand is appropriate because the
corporation should be given the opportunity to effect internal remedies such as demoting or
dismissing an errant employee. See PRINCIPLES, supra note 11, § 7.03 cmt. a, at 651.
160. CLARK, supra note 3, § 15.2.
162. Id. at 268, 270.
the Federal Rules of Civil Procedure. The principle that demand is not futile where the board fails to stop the wrongdoers could become established in all jurisdictions that do not have a universal demand statute through judicial interpretation of procedural rules such as Rule 23.1, as done by the Hutton court.

A criticism of eliminating futility for breach of care while retaining futility for breach of loyalty is that plaintiffs may recast their allegations to portray the directors as the wrongdoers that personally profited from the actions. This problem could be minimized by the courts recognizing in the pleadings that unspecific duty of loyalty charges are being made that thinly veil duty of care situations. More frivolous charges should be answered by Rule 11 sanctions or the state court equivalent.

This proposal of eliminating demand futility only for breach of care cases represents an improvement over automatically applying the Aronson test because courts would no longer be preoccupied with threshold litigation about demand where the board has failed to stop wrongdoers. The idea is otherwise similar to most states' common law because traditional tests such as those involving the business judgment rule for motions to dismiss would remain in force.

The proposal is also more appropriate than the MBCA universal demand method because when the duty of loyalty is breached, demand is aptly cast as futile because such directors are likely to be biased. Furthermore, the proposal differs from that of the ALI Principles concerning universal demand and the procedural hurdles that expand judicial review at the expense of the traditional business judgment rule. This proposal is better than the Principles approach because under this proposal a decision to reject demand is subject to the business judgment rule. The Principles method tends to trust the board less under its more

163. Id. at 270, 272.
165. PRINCIPLES, supra note 11, § 7.03 cmt. d, at 653-54.
166. See, e.g., Hutton, 634 F. Supp. at 271 (noting that duty of loyalty or self-dealing charges sometimes are overstated: "It follows that receipt of a bonus, the size of which is tied to the overall profitability of the Corporation, does not substantiate a claim of self-dealing absent a specific allegation that the voting of the bonuses themselves or the calculation thereof involved some form of self-dealing.").
167. See Fed. R. Civ. P. 11 (requiring that attorneys sign their pleadings and motions to certify that the documents are grounded in fact and not brought to harass, delay, or increase litigation costs).
168. See supra note 108 and accompanying text.
169. See cases cited supra notes 45-48.
170. See Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983).
171. Block, et. al., supra note 24, at 1476.
pro-plaintiff system of evaluating motions to dismiss. Essentially, this proposal preserves the futility exception where it is effective while eliminating the futility exception when it is not viable: when the board fails to stop wrongdoers.

IV. Conclusion

Shareholder derivative suits, as valuable as they may be in deterring corporate managers from engaging in wrongdoing, nonetheless present problems of tying up courts with complex litigation and often leaving corporations having lost more than they have gained. The challenge is to find more efficient ways for courts to deal with derivative suits that maintain the action as a check against wrongdoers but properly defer to the business judgment of boards of directors where appropriate. The futility exception to the demand requirement is often pointed to as a weak link in the derivative suit procedure. A significant improvement in the way that jurisdictions approach derivative suits would be to recognize that demand may be futile where the duty of loyalty is breached, but not with the duty of care. Demand should not be excused for futility where breach of the duty of care, such as failure to stop wrongdoers, is claimed against a majority of the directors. Previous error in business judgment does not mean that the board cannot use good faith and sound reasoning in the present to decide if suit should be brought by the corporation. If the derivative suit is to continue to serve a useful function, it must shift away from litigating futility where a board’s business judgment deserves the opportunity to be heard.

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