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NOTES

DEMAND ON DIRECTORS IN A SHAREHOLDER DERIVATIVE SUIT WHEN THE BOARD HAS APPROVED THE WRONG

Courts have long required a shareholder to exhaust all remedies available to him within the corporation before he may independently maintain a shareholder derivative suit.[1] To fulfill this requirement, the shareholder-plaintiff must make a demand on the board of directors that they bring the action.[2] In most jurisdictions a board's decision not to bring the derivative suit prevents the shareholder from continuing his suit.[3] The board's decision, moreover, is protected from judicial scrutiny by the business judgment rule.[4] By making a demand on the directors, therefore, the shareholder risks termination of his suit.[5]

Despite the general policy of the business judgment rule, courts have recognized that the interests of the directors will sometimes unfairly predispose the board against the derivative action.[6] When the board is unlikely to consider the shareholder's demand in good faith, courts have generally held that demand would be futile and need not be made.[7] Although the decision whether to waive the demand requirement is left to the trial

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[1] The common-law rule in the United States is at least as old as Hawes v. City of Oakland, 104 U.S. 450, 455 (1882), and is found in England as early as Foss v. Harbottle, 2 Hare 461, 490-91, 67 Eng. Rep. 189, 202 (Ch. 1843). This demand requirement is embodied in statutory law as FED. R. CIV. P. 23.1 and similar state provisions such as N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963) and DEL. CODE ANN., CH. CT. R. 23.1 (1981). Most jurisdictions have enacted provisions nearly identical to FED. R. CIV. P. 23.1, which states in part: "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 a comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort."

The unusual legal status of shareholder derivative suits is discussed *infra* notes 17-22 and accompanying text.

[2] To exhaust all intra-corporate remedies available the shareholder may also be required to make a similar demand on the other shareholders. *See* FED. R. CIV. P. 23.1. This note, however, will discuss only demand on directors.

[3] *See infra* notes 37-40 and accompanying text.

[4] Following the business judgment doctrine, a court will not interpose its judgment for a good faith business decision made by a director in the course of his corporate duties. *See infra* notes 32-36 and accompanying text.

[5] A shareholder who wants to proceed with his derivative suit after his demand has been rejected must bring a separate suit claiming that the board had not considered his demand in good faith. *See, e.g.*, Cramer v. General Telephone & Electronics Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Zapata v. Maldonado, 430 A.2d 779, 783 (Del. 1981).

[6] *See generally* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 753-54 (1960) [hereinafter cited as Harvard Note]; *see also infra* notes 41-45 and accompanying text.

[7] *See* Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1208 (9th Cir. 1980).

court's discretion,[8] the courts have universally agreed that certain circumstances, such as when the alleged wrongdoers constitute a majority of the board, warrant a presumption that demand would be futile.[9]

Courts have disagreed, however, about whether demand is presumptively futile when the board has approved or acquiesced to the alleged wrong that forms the cause of action.[10] A majority of courts have held that the plaintiff must allege a greater involvement in the wrong by the directors before a court may presume that the board would not consider the demand in good faith.[11] Other courts have criticized the majority position as requiring too much of the plaintiff[12] and as presenting an unrealistic view of how a board of directors can be expected to act toward a shareholder's demand.[13] These minority courts have ruled that the plaintiff's allegations that the board had approved or acquiesced to the alleged wrong is sufficient to warrant waiving the demand requirement.[14]

Despite the division of opinion in the courts and the frequent litigation of the issue of the futility of demand in the face of board approval of the wrongful corporate act,[15] the issue has received only a cursory treatment in legal literature.[16] This note will critically examine the majority position which holds that the shareholder-plaintiff should be required to make a demand in this situation. It will be shown that the majority position, grounded as it is in an overly optimistic assessment of the independence of corporate directors and an overly pessimistic view of the ability of corporations to defend themselves against meritless suits, places an unreasonable burden on the derivative plaintiff and should therefore give way to a rule waiving the demand requirement when the board has approved or acquiesced to the challenged wrong. The first part of this note will elaborate on the general application of the demand requirement and its futility exception. In the second part of this note the majority position will be presented. The third part of the note will evaluate the premises underlying the majority position and demonstrate that those premises fail to address the legal and practical realities of shareholder litigation. The note concludes that demand on the board of directors is futile in these cases and should be waived.

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[8] *See* Papilsky v. Berndt, 59 F.R.D. 95, 96-97 (S.D.N.Y. 1973), *cert. denied sub nom.* Affiliated Funds, Inc. v. Papilsky, 419 U.S. 1048 (1974); Harvard Note, *supra* note 6, at 747.

[9] *See infra* notes 41-45 and accompanying text.

[10] *See infra* notes 52-55 and accompanying text.

[11] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983).

[12] *See, e.g.*, Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (per curiam); *infra* text accompanying notes 179-209.

[13] *See, e.g.*, Barr v. Wackman, 36 N.Y.2d 371, 380-81, 329 N.E.2d 180, 187, 368 N.Y.S.2d 497, 507 (1975); *infra* text accompanying notes 114-176.

[14] *See, e.g.*, Papilsky v. Berndt, 59 F.R.D. 95, 97, *cert. denied sub nom.* Affiliated Funds, Inc. v. Papilsky, 419 U.S. 1048 (1974).

[15] In addition to the cases cited *infra* notes 55 and 57, the futility of demand issue is also dicussed in, for example, Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1208 (9th Cir. 1980); Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973, 977 (S.D.N.Y. 1977); Jones v. Equitable Life Assurance Soc'y, 409 F. Supp. 370, 373 (S.D.N.Y. 1975); Kusner v. First Pa. Corp., 395 F. Supp. 276, 284-85 (E.D. Pa. 1975).

[16] *See, e.g.*, Note, *The Demand and Standing Requirements in Shareholder Derivative Actions*, 44 U. CHI. L. REV. 168, 175-80 (1976) (concluding, with little discussion, that there are compelling reasons for requiring demand when the only allegation of futility is that the directors acquiesced to the wrong) [hereinafter cited as Chicago Note]. *But see* Note, *Demand upon Directors in a Shareholder's Derivative Suit Under Rule 23.1*, 8 SUFFOLK U. L. REV. 287 (1974) (article devoted entirely to this issue).

I. The Demand Requirement

In a shareholder derivative suit a shareholder brings a legal action to enforce a claim that the management group in control of the corporation has failed to enforce.[17] Although the corporate claim asserted by the shareholder arises from harm done to the corporation,[18] the plaintiff in a derivative action also names the corporation as a defendant for refusing to bring suit to protect the corporate interest.[19] The essence of a derivative suit is, nevertheless, that the cause of action belongs to the corporation rather than to the shareholder.[20] The corporation, furthermore, must refuse to bring the claim before the shareholder may proceed with the derivative suit.[21] Consequently, courts require the shareholder to afford the corporation with an opportunity either to assume control of the action or reject it.[22]

To give the corporation an opportunity to assume control, the shareholder, before filing his suit, must make a demand on the board of directors that they institute an action on the corporation's behalf.[23] If the directors decide to proceed with the suit, the corporation takes control of the litigation from the shareholder.[24] If, however, the directors refuse to bring the suit, the shareholder may be precluded from continuing with his claim unless he can show that the board's decision was made in bad faith.[25]

By allowing the board to assume control of the litigation, the demand requirement not only reflects the corporate nature of the cause of action, but serves five practical purposes as well.[26] First, the demand alerts the board of directors to the existence of the potential lawsuit and allows the directors to pursue means to avoid litigation that may not be available to the shareholder.[27] Second, demand allows the directors, whose knowledge of the transactions involved in the suit and whose access to pertinent information is greater than the shareholder's, to assess the merits of the case and terminate meritless

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[17] Ross v. Bernhard, 396 U.S. 531, 534-35 (1970).

[18] H. Henn, Handbook of the Law of Corporations 755 (2d ed. 1970) [hereinafter cited as Henn]. The harm may be committed by parties inside or outside the corporation. A shareholder's ability to institute an action to redress wrongs committed by corporate insiders makes the derivative suit an especially important remedy for minority shareholders seeking to call upon directors or controlling shareholders to account for mismanagement and fraudulent dealings. 13 W. Fletcher, Encyclopedia of the Law of Private Corporations § 5941.1 (rev. perm. ed. 1980) [hereinafter cited as Fletcher].

[19] Henn, *supra* note 18, at 750.

[20] Ross v. Bernhard, 396 U.S. 531, 538-39 (1970). Although in most cases the distinction is obvious, in some cases it may be difficult to decide if the shareholder is bringing suit based on harm to the corporation or to himself. *See generally* Note, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110 U. Pa. L. Rev. 1147 (1962) (advocating a result-oriented approach to decide hard cases).

[21] As stated by the Supreme Court, "one precondition for the suit was a valid claim on which the corporation could have sued; another was that the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions." Ross v. Bernhard, 396 U.S. 531, 534 (1970).

[22] *See* Harvard Note, *supra* note 6, at 748.

[23] Chicago Note, *supra* note 16, at 169. The board of directors has the primary responsibility for enforcing corporate rights. Fletcher, *supra* note 18, § 5963.

[24] *See* Chicago Note, *supra* note 16, at 171.

[25] *Id.* at 169. *See also infra* notes 32-40 and accompanying text.

[26] *See* Harvard Note, *supra* note 6, at 748-49.

[27] Cramer v. General Telephone & Electronics Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

suits.[28] Third, the board's ability to terminate shareholder's actions after demand has been made allows the corporation to defend itself against "strike suits" — meritless suits brought in the hope of settlement and large fees for the plaintiff's attorney.[29] Fourth, the corporation, with its superior financial resources and greater access to information, is able to pursue the action more effectively than the shareholder if the directors decide to take control of the suit after having been served with a demand.[30] Finally, the demand requirement also permits the board to terminate a suit that, while merited, would adversely affect an ongoing business relationship to the extent that the harm to the corporation would outweigh the gains.[31]

A board's good faith decision to reject a shareholder's demand is protected from judicial scrutiny under the business judgment doctrine.[32] This doctrine developed from a desire to protect directors from liability to the corporation arising from errors made through a good faith exercise of their discretion.[33] The protection of the doctrine rests upon the assumption that the directors must be given wide latitude in making decisions to manage the corporation properly and efficiently.[34] Accordingly, when a director makes a decision in the course of his corporate duties that he believes, erroneously but in good faith, to be in the best interests of the corporation, a court will not substitute its judgment for the judgment of the director or hold the director liable for any loss resulting from the honest mistake.[35] With respect to shareholder derivative suits, courts will not question the directors' good faith belief that pursuing the suit would not be in the best interests of the corporation.[36]

Courts disagree on the effect that the business judgment doctrine has on the shareholder's right to continue with his derivative suit.[37] A few courts have stated that the shareholder is entitled to persist in his action in spite of the board's rejection of his

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[28] *Id.*

[29] Chicago Note, *supra* note 16, at 172. Indeed the possibility of strike suits has been viewed as the primary impetus for restrictions placed on derivative suits. *See* Lewis v. Curtis, 671 F.2d 779, 787 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); HENN, *supra* note 18, at 749. Nevertheless, it has been suggested that the demand requirement is not needed to fulfill this function because strike suits no longer pose a significant threat to the corporation. *See* HENN, *supra* note 18, at 791; Note, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J. L. & SOC. PROB. 50, 65 (1968).

[30] Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); Brooks v. American Export Industries, Inc., 68 F.R.D. 506, 510 (S.D.N.Y. 1975).

[31] Cramer v. General Telephone & Electronics Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981). For example, the corporation may have a cause of action against a customer but may wish to continue doing business with him. In such a case the recovery from the suit may be less than the business lost as a result. *See Cramer*, 582 F.2d at 275.

[32] *Cramer*, 582 F.2d at 274. *See generally* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 98-105 (1980) (applying the rule to derivative suits) [hereinafter cited as Dent]; Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894 (1983) (questioning the validity of judicial assumptions of board impartiality); and Note, *The Continuing Visibility of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562 (1967) (recommending restraint in weakening the business judgment rule).

[33] *Cramer*, 582 F.2d at 274; Dent, *supra* note 32, at 101.

[34] *Cramer*, 582 F.2d at 274.

[35] HENN, *supra* note 18, at 482.

[36] Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir.), *cert. denied*, 449 U.S. 869 (1979).

[37] *See* Dent, *supra* note 32, at 100-03.

demand.[38] A majority, however, has held that the board's rejection of the shareholder's demand bars the shareholder from proceeding with his suit unless he can show that the board's decision is not entitled to the protection of the business judgment doctrine.[39] To meet this burden, the shareholder must show that the board's decision was not made in good faith.[40]

All courts recognize, however, that in some cases the board's interests so conflict with the interest of the shareholder that rejection of the demand is certain. In such cases courts have held that the shareholder's demand would be "futile."[41] A trial court has considerable discretion in determining whether demand is futile in a particular case, and no absolute rules can be found governing all situations.[42] Nevertheless, demand is generally held to be futile in certain common, recurring situations. These situations include: when the defendants constitute a majority of the board;[43] or control the board;[44] or when a majority of the board is self-interested in the transaction that forms the basis of the suit.[45] When a court determines that demand would be futile, it will waive the requirement and permit the shareholder-plaintiff to proceed with his suit without making a demand.[46] The shareholder-plaintiff need not obtain a court ruling of futility before he initiates his suit without making a demand. Generally he need only state in his complaint allegations supporting his assertion that demand would have been futile.[47] A plaintiff does not, however, avoid the demand requirement merely by alleging that demand would be futile.[48] Rule 23.1 of the Federal Rules of Civil Procedure ("Rule 23.1") and similar state rules require a shareholder-plaintiff who is alleging that demand would be futile to state "with particularity" the reasons for his allegation.[49] The defendant corporation may file a

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[38] *See, e.g.*, Papilsky v. Berndt, 503 F.2d 554, 556 (2d Cir.) (per curiam) (dictum), *cert. denied sub nom.* Affiliated Fund, Inc. v. Papilsky, 419 U.S. 1048 (1974).

[39] *See* Dent, *supra* note 32, at 102. *See also* United States Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917).

[40] Gall v. Exxon Corp., 418 F. Supp. 508, 515 (S.D.N.Y. 1976); Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1000-01, 419 N.Y.S.2d 920, 927 (1979). A showing of bad faith may include a demonstration of collusion between directors and wrongdoers, breach of trust, or inexcusable neglect. *See* Dent, *supra* note 32, at 102.

[41] Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1208 (9th Cir. 1980); *see* Chicago Note, *supra* note 16, at 173-82 (discussing common situations in which courts have held demand to be futile).

[42] FLETCHER, *supra* note 18, § 5965.

[43] *See* Heit v. Baird, 567 F.2d 1157, 1162 (1st Cir. 1977). A plaintiff cannot escape demand, however, merely by naming all the directors as defendants; he must be prepared to support his allegation. *Id.*

[44] *See, e.g.*, deHaas v. Empire Petroleum Co., 286 F. Supp. 809, 815 (D. Colo. 1968), *aff'd*, 435 F.2d 1223, 1228 (10th Cir. 1970) (defendants were two members of a five-man board who had chosen the other three members).

[45] *See, e.g.*,, Lewis v. Curtis, 671 F.2d 779, 786-87 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982) (to avoid a proxy battle the board of directors entered into a settlement agreement that used corporate funds to buy out a corporate raider).

[46] 3B J. MOORE & J. KENNEDY, MOORE'S FEDERAL PRACTICE ¶ 23.1.19 (2d ed. 1982).

[47] *See* FED. R. CIV. P. 23.1.

[48] *See In re* Kauffman Mutual Fund, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). A plaintiff generally wants to avoid making a demand because the business judgment rule may bar him from continuing with his suit after the board of directors has rejected his demand. *See supra* notes 32-40 and accompanying text.

[49] FED. R. CIV. P. 23.1. See *supra* note 1 for text of rule. *See also* FLETCHER, *supra* note 18, § 5963, (examples of similar state rules cited). When this note refers to Federal Rule 23.1 it also refers to similar rules in state jurisdictions.

motion challenging the plaintiff's failure to make the demand.[50] The trial court rules on the motion by deciding whether the plaintiff's allegations are sufficient to support a finding that demand would have been futile.[51]

Courts have disagreed about whether the plaintiff's allegations that the board of directors approved or acquiesced to the action challenged by the suit are sufficient to justify a finding of futility.[52] The majority view is that a court should not presume that a board of directors will refuse to correct a wrong merely because the board had approved or acquiesced to the wrong in the first instance.[53] Unless the plaintiff can allege that the directors were self-interested in the alleged wrong or had participated in it to a degree greater than simple approval, the majority of courts have found that demand on the directors would not have been futile.[54] Other courts, however, have waived the demand requirement, ruling that the board's approval of the alleged harmful transaction is sufficient involvement in the harm to render demand useless.[55]

Both the majority and minority positions have been criticized as giving one party an unfair advantage over the other. Critics of the majority position have denied that Rule 23.1 requires allegations of director involvement to support a finding of futility.[56] They assert that courts should be lenient in excusing the demand requirement.[57] In contrast, critics of the minority position have contended that excusing demand whenever the plaintiff can allege that the directors approved or acquiesced to the alleged wrong would entail excusing demand in so many cases that the demand requirement would lose its value as a protection for the corporation against harmful suits.[58] The following sections of this note will examine the majority position and minority criticism of it in greater detail.[59] The next section will present the majority position and its rationale for imposing the demand requirement. That rationale will be evaluated in the third part of the article.[60]

II. THE MAJORITY POSITION

Most courts have taken the position that board approval of the alleged wrong that forms the basis of the shareholder derivative suit is not by itself sufficient to render the shareholder's demand on the board futile.[61] In reaching this decision, these courts have

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[50] This motion takes the form of a motion to dismiss the complaint on the grounds that the plaintiff has failed to meet the requirements of Rule 23.1. *See* Elfenbein v. Gulf & Western Industries, Inc., 590 F.2d 445, 447 (2d Cir. 1978); *Kauffman*, 479 F.2d at 261-62.

[51] *See* Elfenbein v. Gulf & Western Industries, Inc., 590 F.2d 445, 451 (2d Cir. 1978); *Kauffman*, 479 F.2d at 263.

[52] Chicago Note, *supra* note 16, at 175. Approval or acquiescence by the directors includes directors having knowledge of the alleged wrongdoing and failing to stop it. Cohen v. Industrial Fin. Corp., 44 F. Supp. 491, 495 (S.D.N.Y. 1942).

[53] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); Heit v. Baird, 567 F.2d 1157, 1162 (1st Cir. 1977); *Kauffman*, 479 F.2d at 264.

[54] *See Kauffman*, 479 F.2d at 265.

[55] *See, e.g.*, Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (per curiam); Papilsky v. Berndt, 59 F.R.D. 95, 97 (S.D.N.Y. 1973), *cert. denied sub nom.* Affiliated Funds v. Papilsky, 419 U.S. 1048 (1974).

[56] *See, e.g.*, Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (per curiam).

[57] *See* 3A J. MOORE & J. LUCAS, MOORE'S FEDERAL PRACTICE ¶ 23.1.19 (2d ed. 1982).

[58] Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); *Kauffman*, 479 F.2d at 265.

[59] *See infra* text accompanying notes 61 to 242.

[60] *See infra* text accompanying notes 61 to 112.

[61] *See supra* note 53 and accompanying text.

refused to presume that the board would have treated the demand in bad faith unless the plaintiff can show that a majority of the directors were self-interested in the wrongful transaction.[62] Some majority courts have also viewed Rule 23.1 as requiring a greater degree of specificity than other rules of pleading and have therefore placed an extra pleading burden on the shareholder-plaintiff who alleges futility.[63] Finally, some of these courts have expressed concern that waiver of the demand requirement in all board approval situations would unduly weaken corporations' ability to protect themselves from harmful shareholder suits.[64]

The United States Circuit Court of Appeals for the First Circuit clearly articulated the majority position in deciding *In re Kauffman Mutual Fund*.[65] In *Kauffman*, a shareholder in four mutual funds brought a derivative suit against the directors of the funds and the trade association of the mutual fund industry[66] alleging that the defendants had violated antitrust laws by conspiring to set excessive management fees.[67] The plaintiff initiated his action without making a demand on the board of directors, asserting that demand would be futile because, *inter alia*, "[a]ll of the defendants . . . have acquiesced, encouraged, cooperated and assisted in the effectuation and maintenance of the . . . conspiracy."[68] The First Circuit rejected the plaintiff's futility claim and affirmed the decision of the district court dismissing the suit for failure to make a demand in compliance with Rule 23.1.[69] In rejecting the allegations of futility the court employed a three-part analysis. First, the court discussed how directors can be expected to act when confronted with a shareholder demand to bring a derivative suit.[70] Second, it examined the procedural requirements of Rule 23.1 and the sufficiency of the plaintiff's allegations.[71] Third, the court analyzed the effect that waiver would have on the efficacy of Rule 23.1 as a defense against meritless suits.[72]

In the first part of its analysis the First Circuit refused to accept the plaintiff's assumption that the board of directors would necessarily oppose the demand simply because they had originally approved the disputed management fees.[73] Instead, the court stated that any assumption about what the board would do should be based on the nature of the particular wrongdoing alleged in the case at hand.[74] The court also distinguished between transactions that can only be viewed as unrelated to any legitimate corporate purpose and those transactions that can be viewed as serving the interests of the corpora-

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[62] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); Grossman v. Johnson, 674 F.2d 115, 124 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982); Heit v. Baird, 567 F.2d 1157, 1160-61 (1st Cir. 1977).

[63] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 247 (2d Cir. 1983); Heit v. Baird, 567 F.2d 1157, 1160 (1st Cir. 1977).

[64] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); *Kauffman*, 479 F.2d at 265.

[65] 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

[66] *Id.* at 261.

[67] *Id.*

[68] *Id.* at 263 n.2 (quoting from the complaint).

[69] *Id.* at 267.

[70] *Id.* at 265.

[71] *Id.* at 263-67.

[72] *Id.* at 265.

[73] *Id.* There was some question whether the composition of the board at the time of the suit was the same as when the management fees were approved. The court stated, however, that "[e]ven if we could assume that there had never been a change in the complement of the boards of directors . . . it would not follow that mere prior participation would excuse making the demand." *Id.*

[74] *Id.*

tion.[75] If the disputed transaction benefits a minority of the board with no apparent benefit to the corporation, the *Kauffman* court concluded that the approval of the transaction by the rest of the board will be suspect even though the majority did not themselves benefit.[76] In such a case, the court said, the approval of the "disinterested" directors is "prima facie inexplicable"[77] and a court may assume that the "disinterested" directors are controlled by the directors who benefited.[78] The court further noted that it would assume that the controlled directors would remain under the wrongdoers' control when the board votes on the plaintiff's demand.[79] When the board has approved a transaction that is related to a legitimate corporate purpose, however, the First Circuit asserted that it would not assume that the board of directors would be antagonistic to the demand merely because some of the directors benefited.[80] Although conceding that such transactions may be criticized as representing poor business judgment, the court noted that they do not compel an assumption of wrongdoing as a transaction unrelated to a corporate purpose would.[81] Accordingly, where the directors have merely made a possible error in judgment, and a shareholder makes a demand that they bring a suit to correct the harm, the *Kauffman* court saw no justification for assuming that a director would "refuse to do [his] duty on behalf of the corporation if [he] were asked to do so."[82] The First Circuit concluded that to demonstrate futility the plaintiff who is challenging a transaction facially related to a legitimate corporate purpose must show some self-interest or bias on the part of a majority of the directors supporting the assumption that the board will not treat his demand in good faith.[83]

In the case before it, the *Kauffman* court observed that the transaction being challenged, the compensation of investment managers, was obviously related to a corporate purpose and was therefore not presumptively improper.[84] Consequently, it refused to assume that the directors would have acted on the shareholder demand in bad faith unless the plaintiff could allege that a majority of the board had an interest in the compensation decision or had been biased against the suit.[85] Although the plaintiff had alleged that some of the directors had been self-interested in the compensation decision, he had not alleged any self-interest or bias on the part of a majority of the directors.[86] The First Circuit therefore rejected the plaintiff's claims of futility, stating, "[w]here mere approval of the corporate actions, absent self-interest or other indication of bias, is the sole basis for establishing the directors' 'wrongdoing' and hence for excusing demand on them, plaintiff's suit should ordinarily be dismissed."[87]

In the second part of its analysis, the *Kauffman* court supported its decision by asserting that Rule 23.1 is an "extraordinary rule" of procedure.[88] The court argued that

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[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.* (quoting Bartlett v. New York, N.H. & H.R.R., 221 Mass. 530, 536, 109 N.E. 452, 455 (1915)).
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.* at 262.
[87] *Id.* at 265.
[88] *Id.* at 263.

the rule should not be regarded in the context of the liberal requirements of notice pleading embodied by the rest of the Federal Rules of Civil Procedure.[89] Instead, the court viewed Rule 23.1 as fulfilling a purpose different from notice and requiring a different judicial approach.[90] The First Circuit noted that by instigating a suit without making a demand, a plaintiff is trying to put himself in a position that rightfully belongs to the board.[91] Before a plaintiff is allowed to usurp the board's function by controlling the suit, the court reasoned, the rule requires him to show that his case is "exceptional."[92] In addition to the usual requirements of pleading a cause of action, the *Kauffman* court concluded that the derivative plaintiff must also establish that he has a right to bring the action.[93] A plaintiff accomplishes this, the court stated, by showing that the board is incapable of doing its duty or that an inherent antagonism exists between the interests of the board and the interests of the corporation.[94] The First Circuit also asserted that Rule 23.1 mandates that the plaintiff plead in detail.[95] Unlike the "notice" tenor of Rule 8, which requires only a "short and plain statement" of what is to be plead,[96] the court observed, Rule 23.1 requires that the complaint "allege with particularity" the reasons for not making the demand.[97] The *Kauffman* court interpreted this clause to mean that courts should require a higher degree of specificity from pleadings that fall under Rule 23.1.[98] Accordingly, the court concluded that the derivative plaintiff must plead facts that demonstrate that his demand would have been futile.[99] He may not, according to the *Kauffman* court, make merely conclusory statements or plead in general terms hoping that later he may be able to substantiate his claims.[100]

Finally, the First Circuit in *Kauffman* also expressed its concern that the effectiveness of Rule 23.1 as a legitimate corporate defense against harmful shareholder suits would be seriously attenuated by excusing demand whenever the board had approved the challenged transaction.[101] It noted that most derivative suits arise from an allegedly harmful transaction that has been sanctioned or approved by the board of directors.[102] The court worried that if the demand requirement were waived in these cases, few instances would be left to which the demand requirement applied.[103] Furthermore, if the demand were excused because the directors had approved or acquiesced to the alleged wrong, the First

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[89] *Id.* To the extent that the discussion contrasts Federal "notice" pleading with Rule 23.1, *see infra* text accompanying notes 95-100, it does not apply to similar state rules. Similar questions concerning the degree of specificity mandated by the demand requirement occur, nevertheless, in state courts as well. *See, e.g.*, Barr v. Wackman, 36 N.Y.2d 371, 379, 329 N.E.2d 180, 186, 386 N.Y.S. 497, 506 (1975).

[90] *Kauffman*, 479 F.2d at 263.

[91] *Id.*

[92] *Id.*

[93] *Id.* The *Kauffman* court quoted Bartlett v. New York, N.H. & H.R.R., 221 Mass. 530, 538, 109 N.E. 452, 456 (1915), which stated, "[i]t is not a technical rule of pleading, but one of substantive right." *Kauffman*, 479 F.2d at 263.

[94] *Kauffman*, 479 F.2d at 263.

[95] *Id.*

[96] *Id.*; *see also* FED. R. CIV. P. 8.

[97] *Kauffman*, 479 F.2d at 263; *see also* FED. R. CIV. P. 23.1.

[98] *Kauffman*, 479 F.2d at 263.

[99] *Id.*

[100] *Id.*

[101] *Id.* at 265.

[102] *Id.*

[103] *Id.*

Circuit was concerned that demand could then be excused whenever the directors merely failed to oppose the wrong or later failed to bring suit to correct it.[104] The *Kauffman* court hypothesized that a plaintiff could then avoid the demand requirement simply by alleging that a wrong had been committed and no action had been taken to right it.[105] In this way, the court deduced, the shareholder would be entitled to show that he had a right to maintain a derivative action solely be alleging that a wrong had been committed.[106] The result, the *Kauffman* court concluded, would be that Rule 23.1 would become "virtually meaningless."[107] Applying this analysis to the pleading before it, the court held that the plaintiff in *Kauffman*, by alleging only director approval of the management fees without self-interest, had not met his burden of particularity under Rule 23.1.[108]

The *Kauffman* decision represents the majority position.[109] When a plaintiff's only allegation to support his claim that demand on the board of directors would be futile is that the board had approved of the alleged wrong, the majority position views this allegation as insufficient to waive the demand requirement. The holdings of the majority courts are generally grounded on the three premises found in the *Kauffman* analysis. First, courts will not assume, under the majority view, that the board would have treated the shareholder demand in bad faith unless the plaintiff has shown that a majority of the directors were self-interested in the challenged transaction.[110] Second, courts adopting the majority position regard Rule 23.1 as an "extraordinary rule" requiring the plaintiff to demonstrate futility with a greater degree of specificity than is required by common notice pleading.[111] Third, the demand requirement must be maintained in board approval cases, according to the majority view, to protect corporations from harmful, meritless shareholder suits.[112] Although accepted by a majority of courts, these premises do not withstand close scrutiny. The next section of the note will present the reasoning of courts that have rejected the majority view and evaluate the majority's premises in light of the realities of corporate management and shareholder litigation.

III. Criticism of the Majority Position

Neither the holding nor the reasoning of *Kauffman* has been universally accepted. Some courts have held that the shareholder's allegations that the directors had approved the corporate action challenged in the derivative suit is sufficient to support a finding that demand would have been futile.[113] These courts and other critics, moreover, have questioned the validity of the first two premises underlying the *Kauffman* decision and the

[104] *Id.*

[105] *Id.*

[106] *Id.*

[107] *Id.*

[108] *Id.* at 266.

[109] *See* Chicago Note, *supra* note 16, at 176-77.

[110] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); Grossman v. Johnson, 674 F.2d 115, 124 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982); Heit v. Baird, 567 F.2d 1157, 1160-61 (1st Cir. 1977).

[111] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 247 (2d Cir. 1983); Heit v. Baird, 567 F.2d 1157, 1160 (1st Cir. 1977).

[112] *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); *see also*, Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); Zapata Corp. v. Maldonado, 430 A.2d 779, 786-87 (Del. 1981).

[113] *See, e.g.*, Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (per curiam); Barr v. Wackman, 36 N.Y.2d 371, 381, 329 N.E.2d 180, 188, 368 N.Y.S.2d 497, 507-08 (1975).

majority position. Specifically, they are skeptical about the validity of the assumption that disinterested directors will act in good faith toward a shareholder demand; a skepticism supported by studies of corporate boards indicating that they are unlikely to be sympathetic toward shareholder derivative suits. The critics also object to the obstacles placed in the path of the derivative plaintiff by the majority view that Rule 23.1 is an "extraordinary rule." Both state and federal procedural rules provide corporations with ample protection against strike suits without resort to the demand requirement.

A. *Good Faith and the Disinterested Director*

The minority courts, which have waived the demand requirement when the board has approved the challenged transaction, have viewed boards of directors very differently from the majority. Generally, courts espousing the minority position have regarded as unrealistic the majority's presumption that the directors who had previously approved of a transaction would later vote to bring a suit against themselves or other directors for their involvement in the challenged transaction.[114] One court has observed that, "it would be the height of folly to entrust the conduct of the litigation, either directly or indirectly, to the very same people who are responsible for the wrongs."[115]

Other courts have expressed similar reservations: In *Barr v. Wackman*,[116] for example, the court concluded that demand would be futile because the directors' potential liability for lack of due care would prejudice them against the shareholder suit even if they were not personally involved in the wrongdoing. In *Barr*, a shareholder of Talcott National Corporation commenced a derivative suit against Talcott and its board of directors.[117] According to the complaint, Talcott had conducted merger negotiations with Gulf & Western Industries that resulted in a merger "agreement in principle" whereby Gulf & Western would purchase Talcott stock at $24.00 per share.[118] After this agreement had been reached, three of the Talcott directors ("the interested directors") allegedly entered into a plan with Gulf & Western to help Gulf & Western acquire Talcott on terms that were much less favorable to Talcott and its shareholders.[119] In return, the three interested directors were to receive certain pecuniary benefits including future employment contracts with a Gulf & Western subsidiary.[120] The favorable merger agreement was then allegedly replaced with a tender offer in which a Gulf & Western subsidiary would buy Talcott stock at $20.00 per share.[121] The Talcott board of directors, the majority of which were disinterested, approved the tender offer and recommended it to the Talcott shareholders.[122] The plaintiff brought suit seeking a judgment, requiring the interested directors to account for the profits they gained by their acts and damages sustained by Talcott.[123]

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[114] *See* Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (per curiam); Nussbacher v. Chase Manhattan Bank (N.A.), 444 F. Supp. 973, 977 (S.D.N.Y. 1977); James v. Microwave Communciation, Inc., 57 F.R.D. 18, 21 (N.D. Ill. 1972).

[115] Cohen v. Industrial Fin. Corp., 44 F. Supp. 491, 495 (S.D.N.Y. 1942).

[116] 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975).

[117] *Id.* at 375, 329 N.E.2d at 184, 368 N.Y.S.2d at 502.

[118] *Id.*

[119] *Id.*

[120] *Id.* at 375-76, 329 N.E.2d at 184, 368 N.Y.S.2d at 502-03.

[121] *Id.* at 375, 329 N.E.2d at 184, 368 N.Y.S.2d at 502.

[122] *Id.*

[123] *Id.* at 377, 329 N.E.2d at 185, 368 N.Y.S.2d at 504.

The shareholder-plaintiff commenced his derivative action without making a demand on the Talcott board of directors.[124] He alleged that a demand would have been futile because "the board of directors participated in, authorized and approved the challenged acts and its members are themselves subject to liability and, therefore, cannot be expected to sue themselves."[125] Three of the defendants moved to dismiss the complaint on the grounds that the plaintiff's allegations were insufficient to justify excusing the demand requirement; the trial court denied the motion, the Appellate Division affirmed, and the defendants appealed.[126] The New York Court of Appeals agreed with the reasoning of the lower courts, holding that the plaintiff's allegations were sufficient to withstand the defendants' motion to dismiss.[127]

In its ruling, the *Barr* court rejected the *Kauffman* proposition that a derivative plaintiff must allege self-dealing by a majority of the board as a prerequisite to a waiver of demand.[128] It noted that directors have a duty of due care and diligence to the corporation that they do not fulfill merely by avoiding self-dealing.[129] The court observed that directors have an obligation to investigate any corporate act they approve to ensure that it is not harmful to the corporation.[130] Had the disinterested directors investigated the tender offer, the *Barr* court reasoned, they would have discovered the self-dealing of the interested directors and prevented the damage to Talcott.[131] The court maintained that the disinterested directors' failure to investigate made them vulnerable to liability for these omissions even though they had not themselves profited.[132] In light of the potential liability of the directors, the *Barr* court concluded that the directors were unlikely to prosecute the action.[133] The New York Court of Appeals held, therefore, that the plaintiff's failure to make a demand on the board was warranted.[134]

Other courts have also questioned the propriety of leaving the decision of whether to litigate to the board of directors. The decision in *deHaas v. Empire Petroleum Co.*[135] suggests that directors may lack the independence needed to correct wrongs. In *deHaas*, the plaintiffs had been shareholders in Inland Development Corporation, which had merged with Empire.[136] Prior to the merger Empire had owned a controlling interest in Inland and the president of Empire had also been the president and a director of Inland.[137] According to the plaintiffs, the president dominated and controlled both companies.[138] The plaintiffs further alleged that Inland had issued proxy statements designed to

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[124] *Id.* at 373, 329 N.E.2d at 182, 368 N.Y.S.2d at 500. The demand requirement is codified in New York in section 626(c) of the Business Corporation Law, which is nearly identical to Rule 23.1. It states: "In any such action, the complaint shall set forth with particularity the efforts of such action by the board or the reasons for not making such efforts." N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963).

[125] *Barr*, 36 N.Y.2d at 373, 329 N.E.2d at 182, 368 N.Y.S.2d at 500.

[126] *Id.* at 373, 329 N.E.2d at 182-83, 368 N.Y.S.2d at 500-01.

[127] *Id.* at 381, 329 N.E.2d at 188, 368 N.Y.S.2d at 507-08.

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

[129] *Id.*

[130] *Id.* at 380, 329 N.E.2d at 187, 368 N.Y.S.2d at 506.

[131] *Id.*

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

[133] *Id.* at 380, 329 N.E.2d at 187, 368 N.Y.S.2d at 506.

[134] *Id.*

[135] 286 F. Supp. 809 (D. Colo. 1968), *modified and aff'd*, 435 F.2d 1223 (10th Cir. 1970).

[136] *Id.* at 811-12.

[137] *Id.*

[138] *Id.* at 812.

mislead Inland shareholders into believing that Empire was financially sound and that the merger would be advantageous when in fact Empire had two subsidiaries that were losing money and apparently wanted Inland's assets to compensate.[139] After the merger Empire continued to send encouraging letters to the shareholders.[140] The plaintiffs did not become aware of the deception until three years later when Empire's board of directors was compelled by a court order to send an annual report and financial statement to all shareholders.[141] The plaintiffs commenced a derivative suit against Empire seeking damages for a violation of Rule 10(b)-5 under the Securities Exchange Act of 1934.[142] They made no demand on the board, alleging that such a demand would have been futile.[143] Although the majority of the directors had neither participated in nor profited from the misleading proxies,[144] the plaintiffs contended that the board was so controlled by the president that a demand would not have been acted upon in good faith.[145]

The district court agreed with the plaintiffs' allegations regarding the control of the board and waived the demand.[146] After an examination of the directors' depositions, the court concluded that it would have been "extremely unlikely" that the disinterested directors would have taken meaningful action on the demand.[147] The depositions revealed that the directors had been elected by the president and had taken little interest in the corporation.[148] Moreover, the directors had little knowledge of the corporation's affairs or financial situation.[149] The trial court also found that the directors had at least once acquiesced to the management and approved a transaction that they were convinced would fail.[150] The *deHaas* court concluded that the directors lacked the independence necessary to be "the kind of active and aggressive majority that would be likely to undertake the difficult and demanding task of prosecuting a lawsuit for fraud against those who elected them."[151] Accordingly, the court held that to require a demand would have been unrealistic.[152]

Similar conclusions regarding the behavior of boards of directors appear in other sources as well. Business commentators have suggested that the lack of independence found in *deHaas* is widespread among corporate directors. Professor Myles Mace, in his study of American boards of directors,[153] rejects the common perception that the board of

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[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] *Id.* at 811.

[143] *Id.* at 813.

[144] The complaint alleged that Empire's president did profit from the merger by purchasing stock options in one of the failing subsidiaries at the pre-merger price. *Id.* at 812.

[145] *Id.* at 814.

[146] *Id.*

[147] *Id.*

[148] *Id.*

[149] *Id.* None of the directors had ever seen a financial statement of the corporation and one of the directors was not aware that the corporation had public stockholders. *Id.*

[150] *Id.*

[151] *Id.*

[152] *Id.* The United States Court of Appeals for the Tenth Circuit affirmed the decision of the trial court while modifying certain parts of the decision not related to the demand requirement. *See* 435 F.2d 1223, 1228.

[153] M. MACE, DIRECTORS: MYTH AND REALITY (1971) [hereinafter cited as MACE]. Professor Mace has updated his work, *see* Mace, *Directors: Myth and Reality — Ten Years Later*, 32 RUTGERS L. REV. 293 (1979), but his conclusions remain essentially unchanged: "[M]y conversations with corporate direc-

directors manages the corporation.[154] To the contrary, he insists that the powers of control in a normal, medium to large corporation belong exclusively to the management.[155] Professor Mace notes that the majority of directors on most boards are "outside" directors — directors who are not full-time employees of the corporation.[156] These outside directors, Mace found, have full-time positions elsewhere and may sit on several boards.[157] Mace's study further reveals that the management looks to the board for advice and expertise in making business decisions,[158] but the decisions themselves are made by the management and the board is expected to rubber stamp them.[159] Although the outside directors theoretically could oppose the management, Professor Mace found that they rarely do.[160]

Commentators offer several reasons to explain why the outside directors almost always follow management. First, the outside directors tend to hold points of view similar to those of management.[161] They are chosen by the management and are often drawn from the same clubs, civic associations, and colleges as the managing directors.[162] Second, many outside directors have very close business ties to the corporation.[163] While none of these reasons would absolutely prevent an outside director from challenging the management, such a challenge would be considered a breach of etiquette by the rest of the board and the offender would be asked to resign.[164] Even if an outside director is independent enough to want to challenge the management, his ability to do so is severely limited.[165] One limiting factor is that the directors are often involved with several boards and cannot devote much time to any given company.[166] Outside board members, moreover, lack sufficient staff to mount a strong challenge against the management.[167] Another factor is that outside directors have no independent access to information. The information they receive about the company is filtered through the management, which controls its quality, quantity, and content.[168]

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tors and CEO's and a reading of the literature has led me to the conclusion that boards of directors operate pretty much as they did ten years ago." *Id.* at 297.

[154] *See* MACE, *supra* note 153, at 94.

[155] *See id.*

[156] *Id.* at 10.

[157] *Id.*

[158] *Id.* at 13-22.

[159] *See id.* at 15. The management consists of the officers of the corporation. Some, if not all, of the officers usually serve as "inside" directors, i.e., those directors who are full-time employees of the corporation. The management group generally constitutes only a minority of the board. *See id.* at 10-13.

[160] *Id.* at 47.

[161] *See id.* at 78; Solomon, *Restructuring the Corporate Board of Directors: Fond Hope — Faint Promise?*, 76 MICH L. REV. 581, 584 (1978) [hereinafter cited as Solomon]; Brudney, *The Independent Director — Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 612 (1982) [hereinafter cited as Brudney]. *See generally* HEIDRICH & STRUGGLES, INC., PROFILE OF THE BOARD OF DIRECTORS (1971) and Leach & Mundheim, *The Outside Director of the Public Corporation*, 31 BUS. LAW. 1799 (1976).

[162] *See* MACE, *supra* note 153, at 97-101; Solomon, *supra* note 161, at 584-85; Brudney, *supra* note 161, at 612-13.

[163] *See* MACE, *supra* note 153, at 10-11; McAlmon, *The Corporate Boardroom: A Closed Circle*, BUS. AND SOC'Y REV., Winter, 1974-75, at 65, 66 [hereinafter cited as McAlmon].

[164] *See* MACE, *supra* note 153, at 80; Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1900 (1983) [hereinafter cited as Note, *Judicial Deference*].

[165] MACE, *supra* note 153, at 30. *See* Solomon, *supra* note 161, at 585; McAlmon, *supra* note 163, at 66.

[166] *See* MACE, *supra* note 153, at 30.

[167] *See* McAlmon, *supra* note 163, at 66.

[168] *Id. See also* MACE, *supra* note 153, at 31; Solomon, *supra* note 161, at 585.

As a result of the outside directors' cohesiveness with management and their lack of independent information, they will usually vote with the management; which means that they will usually vote against the derivative suit.[169] Because most of what the board approves is suggested by the management, rarely will a time arise when the directors approve a corporate action not supported by the management. Accordingly, when a shareholder challenges a corporate act that the board has approved or acquiesced to, his demand will usually be refused by the outside directors.

Commenting on the position of inside directors, Professor George Dent, Jr. has noted that they, as corporate employees, are even less able to oppose the management.[170] Dent has observed that, although they have greater access to information than outside directors and more time to spend on corporate affairs, inside directors are even more reliant on the management for their employment because their seats on the board are their principal jobs.[171] Inside directors also rely on management for promotions and salary increases, Dent has observed, neither of which is likely to be favorably affected by a challenge to management's authority.[172] Dent therefore questions whether a director will dispassionately consider a demand to bring a suit against his fellow board members.[173]

Courts and commentators have thus expressed doubt regarding the validity of the *Kauffman* court conclusion that, absent a showing of self-interest on the part of a majority of directors, a court should assume that a board would act in good faith toward a shareholder demand. In *Barr*, the New York Court of Appeals noted that directors may be liable for damages caused by a harmful transaction that they had approved.[174] The *Barr* court concluded that a director was not likely to vote to bring a suit that could expose him to liability.[175] Other sources indicate that directors, though disinterested, lack the independence required to bring an action challenging a corporate action they had approved or management had done at their acquiescence.[176]

The second *Kauffman* premise stressed that Rule 23.1 is an extraordinary rule with special requirements of particularity.[177] Even if the proposition that the demand can be futile when a majority of the board had not benefited from the challenged transaction is accepted, *Kauffman* would still require the plaintiff to demonstrate, with specific allegations, that the demand would, in fact, have been futile.[178] The following section will consider criticisms of this aspect of the majority position articulated in *Kauffman*.

B. *The "Extraordinary Rule" Requirements of Particularity*

Courts have disagreed about how much particularity the plaintiff's allegations of futility must contain for a court to waive the demand requirement. The *Kauffman* court stated that Rule 23.1 is an "extraordinary rule" that requires more specificity than

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[169] Brudney, *supra* note 161, at 620; Note, *Judicial Deference*, *supra* note 164, at 1906-07.

[170] Dent, *supra* note 32, at 125.

[171] *Id.* at 111; *see also* Solomon, *supra* note 161, at 584.

[172] Dent, *supra* note 32, at 111.

[173] *Id.* at 110.

[174] *See supra* notes 128-31 and accompanying text.

[175] *See supra* notes 131-34 and accompanying text.

[176] *See deHaas*, 286 F. Supp. at 814; MACE, *supra* note 153, at 47; Solomon, *supra* note 161, at 584-85.

[177] *See Kauffman*, 479 F.2d at 263.

[178] *Id.*

ordinary notice pleading.[179] Accordingly, the First Circuit ruled that the derivative plaintiff must plead facts that demonstrate that the demand would have been futile.[180] Allegations that demand would have been futile because the directors had approved or acquiesced to the alleged wrongs were not enough, the court held, to meet the requirements of Rule 23.1.[181]

While most courts have agreed with *Kauffman*,[182] others have rejected the *Kauffman* court's strict "extraordinary rule" requirements. In *Liboff v. Wolfson*,[183] for example, the plaintiff had initiated a shareholder derivative suit without making a demand on the board of directors.[184] The complaint alleged that a demand would have been futile because the majority of the directors participated, approved of and acquiesced in the challenged transaction.[185] The plaintiff further alleged that the directors would not have diligently prosecuted the suit because they would have had to bring an action against themselves.[186] The trial court dismissed the complaint for failure to comply with Rule 23.1.[187] The United States Court of Appeals for the Fifth Circuit reversed, ruling that the plaintiff's allegations were sufficient to meet the requirements of Rule 23.1.[188]

Although Rule 23.1 contains special pleading requirements, the *Liboff* court decided that the general approach to rules of pleading is to minimize requirements of specificity.[189] In the instant case, the court noted, the plaintiff had made an allegation of fact[190] to support his claim that demand would have been futile.[191] Under the language of Rule 23.1, the court held that the plaintiff had alleged "with particularity" the "reasons for his failure" to make a demand.[192] Consequently, the court concluded that the plaintiff's allegations of board approval of the harm fully satisfied the requirements of the rule.[193]

Similar leniency in waiving the demand requirement was shown in *Jannes v. Microwave Communications, Inc.*[194] The shareholder-plaintiff in *Jannes* brought suit against the members of the board of directors of Microwave Communications, Inc. ("MCI") for damages sustained by the corporation due to alleged violations of section 10(b) of the Securities Exchange Act of 1934.[195] The complaint alleged that two of the directors had been the chief conspirators in misrepresentations involved in the sale of MCI stock to insiders.[196] The plaintiffs also alleged that demand on the board would have been futile because the remaining directors, or some of them, had participated in the misrepresenta-

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[179] *See supra* notes 88-100 and accompanying text.
[180] *See supra* notes 95-100 and accompanying text.
[181] *Kauffman*, 479 F.2d at 265.
[182] *See supra* note 111.
[183] 437 F.2d 121 (5th Cir. 1971) (per curiam).
[184] *Id.* at 121-22.
[185] *Id.* at 122.
[186] *Id.*
[187] *Id.* at 121-22.
[188] *Id.* at 122.
[189] *Id.*
[190] *Id.* The defendants conceded that the plaintiff's allegations were true insofar as they characterized the board, without conceding the truth of the conclusions that a wrong had been done or that demand would have been futile. *Id.*
[191] *Id.*
[192] *Id.*
[193] *Id.*
[194] 57 F.R.D. 18 (N.D. Ill. 1972).
[195] *Id.* at 20.
[196] *Id.* at 21.

tions.[197] The defendants brought a motion to dismiss for failure to comply with Rule 23.1.[198] In denying the motion to dismiss, the *Jannes* court noted that the decision of when a waiver of demand is justified is within the "sound discretion" of the trial court.[199] The proper standard to be used on a motion to dismiss, the court stated, is "whether any set of facts can be shown which would prove futility is applicable."[200] Upon the instant facts, the trial court held that the plaintiffs' failure to make a demand was excused because the plaintiffs had alleged facts which, if proved, would be sufficient to waive the demand requirement.[201]

Other critics have also advocated leniency in accepting the derivative plaintiff's allegations of futility.[202] They have noted that shareholders have little independent access to material information relating to the operations of the corporation.[203] Lacking such access, the plaintiff must often commence his suit with little information and may be unable to meet strict pleading requirements early in the proceedings.[204] Although the *Jannes* approach of generally accepting the plaintiff's allegations of futility as true may seem susceptible to abuse,[205] it has been suggested that this is preferable to dismissing meritorious suits, thereby negating important shareholder rights.[206]

The minority critics have, therefore, also rejected the strict pleading requirements of the *Kauffman* "extraordinary rule" premise. The *Liboff* court, noting that modern notice pleading tends to minimize requirements of specificity, ruled that Rule 23.1 only required the plaintiff to make an allegation of fact that would support his claim of futility.[207] Similarly, the *Jannes* court stated that demand should be excused if any set of facts can be shown to demonstrate futility.[208] Other critics have suggested that leniency in waiving demand may be more fair to the derivative plaintiff who usually has only limited access to corporate information.[209] The majority position also contends that the demand requirement is needed to protect corporations from meritless, harassing suits. In the next section of the note, procedural devices which achieve the goal of protecting corporations without intruding on a shareholder's ability to bring a good faith suit are discussed.

C. *Procedural Defenses Against Meritless Suits*

Adherents of the majority view have maintained that requiring demand in board approval cases provides the corporation with a necessary defense against meritless suits.[210] The lure of such suits for a shareholder-plaintiff is that the corporation, faced with the

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[197] *See id.*
[198] *Id.* at 20.
[199] *Id.* at 21.
[200] *Id.*
[201] *Id.*
[202] *See, e.g.*, Dent, *supra* note 32, at 142.
[203] Dent, *supra* note 32, at 131. *See also* Galef v. Alexander, 615 F.2d 51, 62 (2d Cir. 1980).
[204] Dent, *supra* note 32, at 131.
[205] *See Kauffman*, 479 F.2d at 265.
[206] Dent, *supra* note 32, at 142.
[207] *Liboff*, 437 F.2d at 122.
[208] *Jannes*, 57 F.R.D. at 21.
[209] *See supra* note 203.
[210] *See* Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); Cramer v. General Telephone & Electronics Corp., 582 F.2d 259, 275 (3d Cir. 1978); *Kauffman*, 479 F.2d at 265; Dent, *supra* note 32 at 137.

prospect of an expensive and disruptive litigation,[211] would rather settle privately with the shareholder and his attorney than contest the allegations.[212] According to the majority view, these "strike suits," as they are called,[213] would be controlled by requiring demand, thus giving the board an opportunity to terminate them.[214] Nevertheless, the examination of the operation of corporate boards presented previously in this note[215] shows that when the board has approved of the challenged wrong, the demand requirement threatens meritorious suits as well.

Procedural rules other than strict pleading requirements are available to serve this defensive function as well as the demand requirement, without discouraging bona fide shareholder suits. The Federal Rules of Civil Procedure restrict the ability of parties in derivative actions to reach an improper settlement[216] and require the plaintiff and his attorney to "verify" pleadings.[217] Another federal statute punishes attorneys for filing frivolous pleadings,[218] and states have erected procedural defenses as well.[219]

Rule 23.1 of the Federal Rules of Civil Procedure prohibits the "dismissal or compromise" of a shareholder derivative suit without the approval of the trial court.[220] The rule seeks to discourage strike suits by removing the potential for illegitimate gain from a coerced settlement.[221] Settlements of derivative suits are still permitted, but only at the discretion of the court which must act to safeguard the interests of shareholders not involved in the suit.[222] The proponents of the settlement bear the burden of showing that

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[211] Meritless suits can be expensive in time as well as money, distracting the board and management from the day-to-day operations of the corporation. *See* Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

[212] *See* Lewis v. Curtis, 671 F.2d 779, 787 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); Handek, *The Settlement and Dismissal of Stockholders' Actions — Part I*, 22 Sw. L. J. 767, 768-70 (1968); Chicago Note, *supra* note 16, at 172; HENN, *supra* note 18, at 749. The potential for private settlement is especially attractive to plaintiffs' attorneys who may be able to receive an inflated fee as part of the settlement in exchange for agreeing to a negligible recovery for the corporation. *See* W. CARY & M. EISENBERG, CORPORATIONS 979-81 (5th ed. 1980); Wolf v. Barkes, 348 F.2d 994, 996 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965).

[213] *See supra* note 29 and accompanying text.

[214] *See supra* notes 37-40 and accompanying text.

[215] *See supra* text accompanying notes 153-73.

[216] FED. R. CIV. P. 23.1. *See infra* notes 220-29 and accompanying text.

[217] FED. R. CIV. P. 11. *See infra* notes 230-36 and accompanying text.

[218] 28 U.S.C. § 1927 (1982). *See infra* notes 237-40 and accompanying text.

[219] *See infra* notes 241-43 and accompanying text.

[220] FED. R. CIV. P. 23.1 reads, in pertinent part: "The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs." This part of FED. R. CIV. P. 23.1 has also been adopted in many states. *See, e.g.*, N.Y. BUS. CORP. LAW § 626(d) (McKinney 1963); DEL. CODE ANN., CH. CT. R. 23.1 (1981).

[221] Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966). In *Surowitz* the United States Supreme Court, in deciding a motion brought under Rule 23(b), the predecessor of Rule 23.1, stated:

> [The settlement restriction] was originally adopted and has served since in part as a means to discourage "strike suits" by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them.

Id.

[222] Greenspun v. Bogan, 492 F.2d 375, 378 (1st Cir. 1974) (affirming approval of settlement); United Founders Life Ins. Co. v. Consumers National Life Ins. Co., 447 F.2d 647, 655-57 (7th Cir. 1971) (affirming approval); Norman v. McKee, 431 F.2d 769, 773 (9th Cir.), *cert. denied*, 401 U.S. 912 (1970) (affirming disapproval).

it is in the best interests of all the affected parties,[223] but the settlement hearing is not intended to become a trial on the merits.[224] Nevertheless the court must allow persons objecting to the settlement to have a meaningful participation in the hearing, including the right to discourage, to cross-examine, and to develop a record.[225] Once all parties have been heard, the court decides whether the settlement is "fair, reasonable, and adequate."[226] The court considers several factors, including the probability of success of the claim and the complexity, expense and likely duration of the litigation.[227] Even if the court approves the settlements, objectors, though not parties to the litigation, may appeal the decision.[228]

A principled application of this process would deter strike suit plaintiffs by halting settlements of meritless claims. Plaintiffs and attorneys with unfounded claims would not expend the time and money on a suit that had no hope of success at trial and no hope of producing an extortionate settlement. By removing the reward for bringing strike suits the rule removes the danger that they will be brought against a corporation.[229] Accordingly, the demand requirement is obsolete in its corporate defense function. Moreover, the corporation is further defended by other procedural restraints on frivolous litigation.

Rule 11 of the Federal Rules of Civil Procedure attempts to check frivolous legal maneuvering by assigning responsibility for the content of a legal filing to the party or attorney who offers it.[230] The rule requires an attorney to sign "every pleading, motion and other paper" that he presents to the court in the course of a litigation. The signature of the attorney is construed as his representation of his belief, formed after reasonable inquiry, that the filing is well grounded in fact and law and is not introduced to harass the opponent, delay the proceedings or needlessly increase the cost of the litigation. The rule thus imposes an affirmative duty on the attorney to investigate the law or facts contained

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[223] Greenspun v. Bogan, 492 F.2d 375, 378 (1st Cir. 1974).

[224] *Id.* at 381; United Founders Life Ins. Co. v. Consumer National Life Ins. Co., 447 F.2d 647, 657 (7th Cir. 1971); Lewis v. Newman, 59 F.R.D. 525, 527 (S.D.N.Y. 1973).

[225] Girsch v. Jepson, 521 F.2d 153, 157 (3d Cir. 1975).

[226] Lewis v. Newman, 59 F.R.D. 525, 528 (S.D.N.Y. 1973); West Virginia v. Chas. Pfizer & Co., 314 F. Supp. 710, 740 (S.D.N.Y. 1970).

[227] Protective Comm. v. Anderson, 390 U.S. 414, 424-25 (1968). *See* City of Detroit v. Grinnell Corp., 495 F.2d 448, 463 (2d Cir. 1974) (setting out eight factors to be considered).

[228] 3B J. MOORE & J. KENNEDY, FEDERAL PRACTICE ¶ 23.1.24[3] (1984).

[229] One commentator argues, however, that strike suits are better controlled by ethical canons and rules against solicitation. *See* Note, *Verification as a Safeguard Against Abuse of Stockholders' Derivative Suits*, 18 STAN. L. REV. 1221, 1225 (1966).

[230] FED. R. CIV. P. 11 states, in pertinent part:

> Every pleading, motion, and other paper of a party represented by an attorney shall be signed by at least one attorney . . . . The signature of an attorney or party constitutes a certificate by him that he has read the pleading, motion or other paper; that to the best of his knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.

FED. R. CIV. P. 11.

The 1983 amendment to the rule expressly increased the scope of the rule from covering only "pleadings" to covering "every pleading, motion and other paper." In addition, the 1983 amendment introduced the duty of reasonable inquiry, the representation that the filing is not frivolous, and certain sanctions that are discussed *infra* text accompanying notes 233-34.

in the filing.[231] The rule is also obviously aimed at the kind of unjustified, harassing pleadings that concern the courts when dealing with the demand requirement for derivative actions.[232] Sanctions are imposed for failure to comply with Rule 11.[233] An unsigned filing will be stricken unless the party or attorney promptly signs it after due notice. A party or attorney who signs a filing that violates the rule faces stiffer penalties and may be required to compensate the opposing party for the costs, including attorney fees, incurred because of the filing.[234]

Although the effectiveness of Rule 11 in preventing frivolous pleadings has been criticised in the past,[235] it certainly has the potential to become a powerful tool in combatting meritless pleadings. The recent amendments, moreover, may serve to rejuvenate the rule and increase both its use and usefulness.[236] In the derivative action context, a vigorous Rule 11, by punishing the filing of frivolous claims, would seriously deter shareholder-plaintiffs and their attorneys from initiating strike suits. Yet because Rule 11 does not put the fate of the litigation in the hands of the board of directors as the demand requirement does, it does not threaten good faith derivative suits. Thus Rule 11 can provide protection from strike suits for the corporation without creating a barrier against shareholder-plaintiffs who have meritorious claims.

Another federal procedural protection against frivolous litigation is 28 U.S.C. § 1927.[237] This section allows a court to impose opposing party's costs, including attorney

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[231] *See* Anderson v. Cryovac, Inc., 96 F.R.D. 431, 432 (D. Mass 1983). In *Anderson*, the plaintiff alleged that the defendants had contaminated the water supply in Woburn, Massachusetts. The court held that plaintiff's counsel could have properly relied on a report prepared by the EPA and the opinion of an environmental engineer brought in as a consultant in preparing the complaint. *Id.*

This duty to investigate was recognized under the rule prior to the 1983 amendments. *See* Rhinehart v. Stouffer, 638 F.2d 1169, 1171 (9th Cir. 1979) (implying a duty to investigate from Rule 11).

[232] *See* Galef v. Alexander, 625 F.2d 51, 66 n.24 (1980) ("We recognize the possibility that stockholders may assert meritless . . . claims . . . [b]ut this risk should be lessened by FED. R. CIV. P. 11.").

[233] FED. R. CIV. P. 11. Rule 11 provides in pertinent part:

> If a pleading, motion, or other paper is not signed, it shall be stricken unless it is signed promptly after the omission is called to the attention of the pleader or movant . . . . If a pleading, motion, or other paper is signed in violation of this rule, the court, upon motion or upon its own initiative, shall impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay the other party or parties the amount of reasonable expenses incurred because of the filing of the pleading, motion, or other paper, including a reasonable attorney's fee.

Id.

[234] Although the rule purports to mandate specific sanctions when the signed filing violates the rule, the court has broad discretion in imposing sanctions. *See* Badillo v. Central Steel & Wire Co., 717 F.2d 1160, 1166-67 (7th Cir. 1983).

[235] Risinger, *Honesty in Pleading and Its Enforcement: Some "Striking" Problems with Federal Rule of Civil Procedure 11*, 61 MINN. L. REV. 1 (1976). Professor Risinger cites the difficulty of articulating a standard to judge the movant's knowledge and belief, *id.* at 9; the problems of enforcement, *id.* at 114-17; and the hesitancy of courts to make use of the rule, *id.* at 34-37.

[236] To give the rule more vitality was the purpose of the 1983 amendments. *See* Advisory Committee's Note to 1983 Amendments of FED. R. CIV. P. 11. The Advisory Committee Note states, "[t]he new language is intended to reduce the reluctance of courts to impose sanctions by emphasizing the responsibilities of the attorney and reinforcing those obligations by the imposition of sanctions." *Id.* (citations omitted).

[237] The full text of 28 U.S.C. § 1927, as amended, is as follows:

fees, on an attorney who "unreasonably and vexatiously" "multiplies the proceedings" in a lawsuit.[238] Note that section 1927 places its sanction on the responsible attorney, not the litigant for whom the attorney is acting.[239] The "costs" imposed include any reasonable excess costs incurred by the attorney's misconduct. As such, section 1927 provides a strong disincentive to an attorney tempted to file a derivative strike suit. Any potential for gain from a quick settlement is negated by the possibility of being held personally liable for his opponent's costs.[240]

States have also erected defenses for corporations against strike suits. In addition to enacting procedural rules on the model of Rule 23.1, some states require a shareholder-plaintiff to give security for expenses as a condition to the continued maintenance of an action.[241] The policy behind these statutes is to dissuade potential strike plaintiffs from bringing suit by forcing them to commit assets which might later be lost if the suit is found to be frivolous.[242] Although these statutes have been criticised for failing to distinguish between meritorious and unmeritorious actions,[243] they nevertheless present another obstacle to the strike suit plaintiff and his attorney.

In light of the variety of procedural safeguards available, the concern of the majority position favoring retention of the demand requirement for derivative suits is unfounded. Adequate protection for the corporate defendant exists in both the federal and state forum. This protection is, moreover, less intrusive on the rights of good faith shareholder-plaintiffs than the demand requirement when the directors approved of or acquiesced in the wrong and are thus hostile to the suit. In derivative suits involving board approval the courts should waive the demand requirement and rely on the procedural devices outlined in this note to weed out strike suits.

CONCLUSION

Courts have not generally waived the demand requirement for a shareholder-plaintiff who alleges that demand would be futile because the board of directors had approved or acquiesced to the conduct that is challenged in the derivative suit. The rationale for requiring demand is tripartite: first, that Rule 23.1 is an "extraordinary rule" which mandates that the futility of demand be plead with unusual specificity; second, that the board of director's approval or acquiescence is not sufficient for a court to presume

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> Any attorney or other person admitted to conduct cases in any court of the United States or any Territory thereof who so multiplies the proceeding's in any case unreasonably and vexatiously may be required by the court to satisfy the excess costs, expenses, and attorney's fees reasonably incurred because of such conduct.

28 U.S.C. § 1927 (1982)

[238] *Id.* Section 2 of the Antitrust Procedural Improvement Act of 1980 (Pub. L. No. 96-349, § 3, 94 Stat. 1156 (1980)) amended section 1927 to include attorney fees explicitly among the costs for which an attorney who institutes frivolous proceeding may be personally liable.

[239] *See* Knorr Brake Corp. v. Harbil, 556 F. Supp. 484 (C.D. Ill. 1983); McKirdy, *28 U.S.C. 1927 — Counselor Beware,* 71 ILL. B. J. 708, 709 (1983).

[240] Although the section has not been applied to derivative suits, there is nothing in the language or case law of section 1927 that would prevent its application in this context.

[241] N.Y. BUS. CORP. LAW § 627 (McKinney 1963); N.J. STAT. ANN. § 14A: 3-6 (West 1969); PA. STAT. ANN. tit. 15 § 433 (Purdon 1967).

[242] *See* Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and A Proposal for Legislative Reform,* 81 COLUM L. REV. 261, 314 (1981).

[243] *Id.* This criticism is true insofar as both good faith and frivolous plaintiffs may be required to post security. Ideally, however, only the frivolous plaintiff would lose the security permanently.

that the board will treat the plaintiff's demand with bad faith; and third, that demand is a necessary means of protecting the corporations from strike suits. Yet other courts have asserted that Rule 23.1 is not "extraordinary" and should not be read in a way that burdens unfairly plaintiffs who may have limited access to relevant information. Additionally, studies of corporate boards reveal that a board of directors, having approved or acquiesced to the challenged action, would probably not give proper consideration to a shareholder's demand to bring suit. Finally, procedural rules of both state and federal courts provide adequate protection for the corporation against meritless claims.

If the board of directors is prejudiced against a shareholder suit then the demand requirement, combined with the judicial deference afforded by the business judgment rule, serves as a means of terminating valid derivative actions along with frivolous ones. Unless demand is essential to guard the corporation from strike suits, it should be waived when the board is likely to be hostile to the shareholder suit. When the board has approved or acquiesced to the alleged corporate wrong, it probably will act to terminate the suit even if the suit has merit. Because of the protection from strike suits provided to the corporation by other procedural devices, the Rule 23.1 restrictions on settlements, the sanctions of Rule 11 and 28 U.S.C. § 1927, and state strike suit defenses, the demand requirement can be dispensed with safely in these situations. Therefore, to prevent unfair termination of shareholder suits, and consequently, to maintain the valuable check that such suits impose on corporate actions, courts should waive the demand requirement when the board of directors has approved or acquiesced to the conduct challenged by the derivative plaintiff.

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