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Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Bell

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Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball

Carol B. Swanson*

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INTRODUCTION

Called "ingenious"¹ and "uniquely complicated,"² shareholder derivative litigation has sparked considerable controversy since its inception 150 years ago.³ These remarkable suits permit shareholders to sue derivatively on their corporation's behalf.⁴ The litigation's controversial nature results from the competing tensions underlying such unusual relief. One perspective embraces derivative suits as an invaluable procedural vehicle permitting shareholders to champion their corporation's rights when corporate management refuses to do so. The opposing view cautions that corporations, not the courts, should resolve internal conflicts, and that derivative litigation necessarily raises the specter of shareholder strike suits⁵ and undue

1. ROBERT C. CLARK, *CORPORATE LAW* § 15.1 (1986) (calling the shareholder derivative suit "one of the most interesting and ingenious of accountability mechanisms for large formal organizations").

2. DEBORAH A. DEMOTT, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 1:01 (1987) (noting that "[d]erivative litigation is a uniquely complicated form of civil litigation, in part simply because the real party in interest in the litigation, the corporation, is not the plaintiff").

3. Shareholder derivative suits on behalf of joint stock corporations existed in nineteenth-century England. *Id.* § 1:03.

4. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (noting that the derivative shareholder "step[s] into the corporation's shoes"); *Hawes v. Oakland*, 104 U.S. 450, 460 (1881) (noting that derivative suits are "founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff"); HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 360, at 1044-45 (1983) (noting that shareholders sue derivatively "[w]hen the corporate cause of action is for some reason not asserted by the corporation itself").

5. "Strike suits" are "those based on reckless charges and brought for personal gain." CLARK, *supra* note 1, § 15.2.

judicial interference with the business judgments of management.

These competing views have spawned a variety of complex procedural requirements and equally complex judicial dilemmas regarding derivative litigation.⁶ The principal quandaries involve requirements for shareholder demand and the appropriate judicial review of corporate management's response to that demand. The shareholder demand requirement, perhaps the best known barrier to derivative suits, squarely presents "the struggle between shareholder control and director control over the corporation's power to bring and pursue a lawsuit."⁷ Virtually all United States jurisdictions require that a shareholder make a pre-suit demand, unless excused as futile, on the corporation's board of directors.⁸ Judicial confusion surrounding the application of the futility exception to the demand requirement has enjoyed disproportionate prominence in derivative litigation.⁹ In addition, courts have struggled over what degree of deference to accord management's response to shareholder demands.¹⁰ Courts are torn between acquiescence to the business acumen of boards seeking discontinuance of a suit and the desire to explore the shareholder's allegations of corporate wrongdoing on the merits.¹¹ Special litigation committees have only heightened the controversy by shifting the balance dramatically in management's favor.¹² These dilemmas have generated unprecedented legal developments over the past decade and remain "the focus of considerable discussion by academics and commentators, and in courtrooms, state legislatures, and boardrooms."¹³

Since 1978, the Corporate Governance Project of the American Law Institute ("ALI")—sometimes called the most elite

6. See DEMOTT, *supra* note 2, § 1:01.

7. CLARK, *supra* note 1, § 15.2.

8. *Id.*

9. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, § 7.03 cmt. e, at 655 (Proposed Final Draft 1992) [hereinafter ALI FINAL DRAFT] (noting that the futility doctrine creates threshold litigation collateral to the action's merits, slowing the pace and increasing the cost of derivative actions).

10. See *id.* at 596-98.

11. See *id.* at 587.

12. See James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 961.

13. See Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 469 (1990).

group of lawyers in the United States¹⁴—has labored over finding the appropriate balance between management and shareholder rights in derivative suits.¹⁵ Throughout this enormous task, competing business law factions vied to tip the scales in their own favor.¹⁶ After fourteen years of difficult deliberations, the ALI's struggles culminated in the Proposed Final Draft, approved in May 1992, which attempts to balance the competing perspectives.¹⁷ The unveiling of the Corporate Governance Project's recommendations provides an important opportunity to revisit the significant issues underlying shareholder demand and judicial review in derivative litigation.

Beginning with an analytical overview of the purposes and development of shareholder derivative suits, pre-suit demand, and judicial review, this Article plunges into the very complex ALI proposals. It evaluates the principal ALI derivative suit provisions in light of the Corporate Governance Project's stated purposes,¹⁸ including the Reporter's¹⁹ supporting analyses and

14. Jonathan R. Macey, *Naderite Mossbacks Lose Control Over Corporate Law*, WALL ST. J., June 24, 1992, at A21.

15. The ALI describes the conflict inherent in derivative litigation as follows:

[C]ompeting considerations need to be balanced. On the one hand, the availability of legal recourse is essential if management's obligations to its shareholders are to constitute more than a precatory body of law. Some judicial mechanism for the enforcement of fiduciary duties must therefore exist that is external to the corporation. On the other hand, few intracorporate transactions are not susceptible to differences of opinion; nor are courts infallible. Thus, the corporate director might have reason to view his position as exposed and vulnerable if every transaction or alleged omission subjected him to the prospect of significant liability at the behest of a single shareholder.

ALI FINAL DRAFT, *supra* note 9, at 587.

16. The "struggle," as described by Cornell law professor Jonathan R. Macey, was essentially between the "law and economics movement" and the traditionalists. Macey, *supra* note 14, at A21. The traditional view espoused by the "distinguished older scholars at the helm of the project" saw shareholders as "pawns ruthlessly exploited by management." *Id.* Those reflecting the new market-oriented perspective feared that any transference of authority from directors and markets to lawyers and courts would threaten the corporate free enterprise system. *Id.*

17. ALI FINAL DRAFT, *supra* note 9, at 587. At the 1992 annual meeting in Washington on May 12-15, the ALI members ratified the derivative suit sections with relatively minor amendments. See *ALI Wraps Up Corporation Law Project[,] Works on Lawyer Ethics, Complex Trials*, 60 U.S.L.W. 2727, 2727-28 (1992). Final approval by the ALI governing council is expected. *Id.* at 2727.

18. This Article will principally focus on those sections presenting the ALI's position on shareholder demand, ALI FINAL DRAFT, *supra* note 9, § 7.03, and judicial standard of review, *id.* §§ 7.07-10.

19. The Reporter for the relevant sections of the Corporate Governance

the resulting recommendations. The fourteen-year project represents a herculean effort; the immense volume²⁰ provides a comprehensive overview of important and complex business law issues. Since ALI principles serve as nonbinding recommendations for state legislatures and for courts applying state corporation law,²¹ the question now is the extent to which today's courts and legislatures will—and indeed should—follow the ALI's suggestions. Ultimately, this Article contends that the ALI's massive undertaking represents an opportunity lost. Although wisely advocating universal demand,²² the ALI's proposed standards for substantive review of management's recommendations are unworkable and too deferential to corporations.²³ Given the dissatisfaction with the ALI approach, then, the Article concludes by exploring what standards might guide most effectively the delicate balance between the rights of shareholders and boards of directors. Joining the strong modern trend of endorsing universal demand, the Article then proposes a simplified hybrid standard of judicial review. Like the Corporate Governance Project, the suggested approach attempts to balance the dangers of strike suits with the undeniable need for ensuring meaningful shareholder access to the courts. Unlike the ALI's final proposal, however, this Article advocates a unitary standard that promotes the important values of clarity and flexibility, thus permitting shareholders key access to the courts while providing the necessary deference to the recommendations of corporate management.

I. HISTORICAL CONTEXT FOR DERIVATIVE SUIT ISSUES

A. SHAREHOLDER DERIVATIVE SUITS

Derivative actions date from the early nineteenth century, when English courts began recognizing an equitable jurisdiction for shareholder suits.²⁴ Such litigation "has never existed in a

Project was John C. Coffee, Jr., professor of law at Columbia University. *Id.* at v.

20. The Proposed Final Draft of *Principles of Corporate Governance* runs 1068 pages; Part VII, Chapter 1 discussing derivative suits itself is 260 pages in length.

21. See *ALI Wraps up Corporation Law Project[,] Works on Lawyer Ethics, Complex Trials*, *supra* note 17, at 2727.

22. See ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. e, at 654-57.

23. Professor Macey concluded that the ALI report honestly reflected the "push and pull" of competing interests. See Macey, *supra* note 14, at A19.

24. DEMOTT, *supra* note 2, § 1:03. Historically, courts treated derivative

social or legal vacuum";²⁵ its creation directly responded to investors' needs resulting from the Industrial Revolution.²⁶ By 1855, the United States Supreme Court acknowledged that the existence of derivative suits could be "no longer doubted."²⁷

Derivative suits afford a truly extraordinary form of relief.²⁸ In shareholder derivative litigation, "an oppressed minority shareholder assumes the mantle of the corporation itself to right wrongs committed by those temporarily in control of the corporation's destiny."²⁹ Unlike direct actions in which plaintiffs seek redress for injuries they themselves have sustained, shareholders in derivative actions sue to redress injuries sustained by the corporation.³⁰ The corporation's injury has only a derivative impact on its shareholders, who own the busi-

suits as being "two suits in one"—the first by the plaintiff shareholder seeking an equitable order compelling the corporation to bring a second action for legal damages. This historical notion survives in the current custom of making the corporation a nominal defendant and permitting the corporation to raise various objections. CLARK, *supra* note 1, § 15.1.

25. DEMOTT, *supra* note 2, § 1:03.

26. *Id.* As England became increasingly industrialized, holdings in joint stock corporations became more dispersed, and the inevitable conflicts between shareholders and managers prompted judicial recognition of the need for representative suits. *Id.*; see also Bert S. Prunty, Jr., *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980, 982 (1957).

27. *Dodge v. Woolsey*, 59 U.S. (18 How.) 331, 341 (1855). Shareholder derivative suits in the United States are reported as early as 1832. DEMOTT, *supra* note 2, § 1:03 (citing *Robinson v. Smith*, 3 Paige Ch. 222 (N.Y. Ch. 1832)).

28. *Lewis v. Graves*, 701 F.2d 245, 247 (2d Cir. 1983). Derivative suits are an exception to the "usual rule that the proper party to bring a claim on behalf of a corporation is the corporation itself." Block et al., *supra* note 13, at 472 (quoting *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 531-32 (1984)).

29. 1 ROGER J. MAGNUSON, *SHAREHOLDER LITIGATION* § 8.01, at 2 (1992). These suits permit nominal plaintiffs to champion the cause of an artificial entity:

Such actions are rooted both in metaphysics and in common sense. The corporation as a person, albeit a fictitious one, has a life and interests distinct from those of its temporary managers. Those who control it must do so with good faith and exercise good stewardship. If they do not, a minority shareholder may come to the corporation's defense as a representative of its true interests.

Id.

30. This is the traditional common law distinction between derivative and direct suits. ALI FINAL DRAFT, *supra* note 9, § 7.01 cmts. a, c. Thus, a wrongful act that depletes corporate assets and thereby injures shareholders only indirectly, by reason of the prior injury to the corporation, should be seen as derivative in character; conversely, a wrongful act that is separate and distinct from any corporate injury, such as one that denies or interferes with the rightful incidents of share ownership, gives rise to a direct action.

Id. cmt. c. Although there are various tests for distinguishing between direct and derivative claims, courts generally reach substantially similar results. See

ness through their shares of stock.³¹ Thus, the corporation—the true party in interest—is not the plaintiff.³²

Shareholder derivative plaintiffs can assert legal rights against a variety of possible wrongdoers—directors, management, other shareholders, or even third persons who have damaged the corporate entity.³³ Often, the defendants are corporate insiders who have injured the business, either by intentional abuse of the corporate form for personal gain or by negligent “garden variety mismanagement.”³⁴

Given the tensions inherent in shareholder derivative litigation, both courts and commentators are understandably ambivalent about its overall social utility.³⁵ Viewed idealistically, judges naturally want to encourage noble “corporate knights” rushing to protect innocent shareholders from the “designing schemes and wiles of insiders who are willing to betray their company’s interests in order to enrich themselves.”³⁶ Actual experience has shown, however, that the social costs sometimes outweigh the benefits.³⁷

Shareholder derivative suits, like all tort actions, arguably serve two principal goals: compensation and deterrence. Absent derivative suits, individual shareholders would have no access to compensation for injuries directly inflicted on their corporation.³⁸ Thus, the ALI has recently acknowledged that “the derivative action may offer the only effective remedy in those circumstances where a control group has the ability to engage in self-dealing transactions with the corporation.”³⁹ Em-

id; John W. Welch, *Shareholders Individual and Derivative Actions: Underlying Rationales and the Closely Held Corporation*, 9 J. CORP. L. 147, 154 (1984).

31. Any damages recovery in a shareholder derivative suit accordingly goes to the corporate coffers, not to the individual shareholder plaintiff. See ALI FINAL DRAFT, *supra* note 9, § 7.01 cmt. d, at 606.

32. See DEMOTT, *supra* note 2, § 1:01, at 1.

33. See, e.g., *Ross v. Bernhard*, 396 U.S. 531, 538 (1970); see also Chester B. McLaughlin, *The Mystery of the Representative Suit*, 26 GEO. L.J. 878, 897 (1938).

34. 1 MAGNUSON, *supra* note 29, § 8.01, at 2. Typically, derivative suits target self-serving officers or directors for breaching their fiduciary duties in a variety of corporate settings. See *id.* § 8.04, at 8-9 (listing 14 “obvious examples” of wrongdoing in shareholder derivative actions). Direct shareholder suits, in contrast, include actions to enforce voting rights, to compel dividends, to prevent oppression of minority shareholders, and to compel dissolution. See ALI FINAL DRAFT, *supra* note 9, § 7.01 cmt. c, at 604.

35. 1 MAGNUSON, *supra* note 29, § 8.01, at 3.

36. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966).

37. ALI FINAL DRAFT, *supra* note 9, at 588.

38. See *Home Fire Ins. Co. v. Barber*, 93 N.W. 1024, 1034 (Neb. 1903).

39. ALI FINAL DRAFT, *supra* note 9, at 588.

pirical studies, however, paint conflicting pictures of how effectively shareholder derivative litigation compensates plaintiffs.⁴⁰ Although commentators generally agree that most shareholders ultimately succeed in the sense that they obtain some recovery,⁴¹ it is less clear whether the overall level of success is significant.⁴²

Regarding the deterrence goal, courts and commentators have advocated derivative suits as a way to curb managerial misconduct.⁴³ They have justified derivative suits on deterrence grounds even in the absence of provable money damages.⁴⁴ Because numerous factors provide deterrence pressures,

40. The ALI summarized the inconclusive statistics as follows:

The existing state of the empirical data does not answer many important questions. First, it does not tell us whether derivative actions yield on average a net compensatory benefit for the corporation Second, although the data shows little evidence of any recent explosion in the rate of shareholder litigation and suggests that such litigation only infrequently concerns business decisions not complicated by an alleged conflict of interest, it is possible that directors' perception of such litigation may be very different, and it is the perceived threat that may shape their willingness to serve on boards. Finally, recent institutional changes—such as the decreased availability of liability insurance and the increased incidence of takeover contests—may not be reflected in historical data.

ALI FINAL DRAFT, *supra* note 9, reporter's note at 596. See George D. Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CAL. L. REV. 123 (1944) (discussing findings which concluded that the costs of derivative suits outweighed their benefits); Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542, 545 (1980) (noting that shareholder plaintiffs obtain some relief in 75% of cases); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L., ECON. & ORG. 55, 84 (1991) (emphasizing the relative infrequency of derivative suits and the importance of settlement).

41. Most derivative suits are ultimately dismissed or settled. DEMOTT, *supra* note 2, § 1:01. Compensation, of course, means more than the receipt of money. The shareholder plaintiff's victory might consist of management's agreement to reform the corporation's structures or policies to redress plaintiff's grievances.

42. See ALI FINAL DRAFT, *supra* note 9, reporter's note at 592-96.

43. The ALI has recently noted that "properly structured derivative suits may enhance management accountability by: (1) ensuring a measure of judicial oversight, (2) providing for a remedy that does not depend upon the ability of widely dispersed shareholders to take coordinated action, and (3) protecting the market for corporate control from unreasonable interferences." *Id.* at 588. Derivative actions may also serve key educational and socializing functions by clarifying the duties of corporate management in a variety of contexts. *Id.* reporter's note at 596-97; see also George D. Hornstein, *Future of Corporate Control*, 63 HARV. L. REV. 476 (1950) (noting that the availability of derivative suits deters managerial wrongdoing).

44. ALI FINAL DRAFT, *supra* note 9, reporter's note at 597. The New York Court of Appeals expressed this deterrence benefit in the following way:

however, commentators disagree about the role derivative suits play. Stating that "the derivative action is neither the initial nor the primary protection for shareholders against managerial misconduct,"⁴⁵ the ALI concludes that derivative actions enjoy "only a limited role . . . as a mechanism of corporate accountability."⁴⁶ Regardless of how effective their deterrent impact, derivative suits nonetheless may reduce efficiently the average agency costs that shareholders must incur to hold management accountable.⁴⁷

[D]amages to the corporation . . . ha[ve] never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty This is because the function of such an action . . . is not merely to compensate the plaintiff for wrongs committed by the defendant but . . . "to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates."

Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (quoting *Dutton v. Willner*, 52 N.Y. 312, 319 (1873)); see also *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 396 (1970) (recognizing that shareholder litigation renders "substantial service to the corporation and its shareholders" even if the benefit has no monetary value). The goal of deterrence, however, should not permit a plaintiff's unjust enrichment. See ALI FINAL DRAFT, *supra* note 9, reporter's note at 598-99 (quoting *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.*, 417 U.S. 703, 717 (1974) ("If deterrence were the only objective, then in logic any plaintiff willing to file a complaint would suffice.")).

45. ALI FINAL DRAFT, *supra* note 9, at 587. The ALI acknowledged that other forces may be at least as effective in deterring corporate management misconduct:

A variety of social and market forces also operate to hold corporate officials accountable: the professional standards of managers, oversight by outside directors, the disciplinary power of the market, and shareholder voting—all these mechanisms plus the regulatory authority of governmental agencies would constitute significant protections in the absence of private litigation. Even if dissatisfied shareholders had no other recourse than to sell their shares, such action, taken collectively, might also inhibit managerial overreaching, to the extent it depressed the value of the corporation's stock, which management typically also holds. Yet, no single technique of accountability (including market and legal remedies) is likely to be optimal under all circumstances.

Id. at 587-88.

46. *Id.* at 589.

47. *Id.* reporter's note at 599-601. The ALI describes this reduction of agency costs as follows:

Both because the plaintiff's attorney is typically a specialist in such litigation and because shareholder coordination is not necessary in the case of the derivative action, it seems reasonable to believe that the availability of this action economizes on costs that otherwise would be necessarily incurred if shareholders were required to take collective action In this light, the derivative action has been viewed as an efficient solution to the intractable organizational problem that would

In contrast to these potentially substantial benefits, courts and commentators have also long stigmatized derivative litigation as the "refuge of strike suit artists specializing in corporate extortion."⁴⁸ Thus, courts rather grudgingly recognize the benefit of derivative suits while often reciting their dangers.⁴⁹ Opinions often also recite the judicial inclination to permit the derivative remedy only under extraordinary circumstances where a plaintiff has no other means of redress.⁵⁰

In addition to inviting strike suits, intracorporate litigation necessarily entails significant social costs. The ALI's Corporate Governance Project considers these costs to be serious, noting that private enforcement by shareholders might "reduce managerial incentives to take business risks" and that even meritorious actions may motivate inadequate or collusive settlements that fail to benefit the corporation.⁵¹

The resulting tension between shareholder rights and deference to management has given rise to the imposition of significant procedural restrictions on derivative suits. Although courts created the shareholder derivative action, statutes now play a prominent role in authorizing and regulating such actions.⁵² The statutorily-imposed procedural restrictions in

otherwise arise were it necessary to allocate the costs of opposing management proportionately among all shareholders.

Id. at 600.

48. 1 MAGNUSON, *supra* note 29, § 8.01, at 3; see also Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308 (1934).

49. 1 MAGNUSON, *supra* note 29, § 8.01, at 3 (citing *Jones v. Taylor*, 348 A.2d 188 (Del. Ch. 1975); *Harff v. Kerkovian*, 324 A.2d 215 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. 1975) (per curiam); *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106 (Del. Ch. 1948); *Shapiro v. Magaziner*, 210 A.2d 890 (Pa. 1965)).

50. *Id.* (citing *Bell v. Arnold*, 487 P.2d 545 (Colo. 1971); *Winter v. Farmers Educ. & Coop. Union*, 107 N.W.2d 226 (Minn. 1961)).

51. ALI FINAL DRAFT, *supra* note 9, at 588-89. The ALI described the danger of inappropriate settlements in the following manner:

Even in meritorious cases, a private enforcer can reach an inadequate or even collusive settlement that exchanges a low corporate recovery for a high award of attorneys' fees that is paid by the corporation. Unlike most other forms of litigation, where the plaintiff's gain essentially comes at the defendant's expense, the derivative action is a three-sided litigation with three necessary parties: plaintiff, defendant, and the corporation. As a practical matter, the first two parties can pass the costs of the litigation onto the third by reaching a settlement that maximizes their own interests, but does not benefit the corporation.

Id. at 589 (citation omitted). Judicial oversight of derivative suit settlements reduces the severity of this problem. *Id.*

52. 1 MAGNUSON, *supra* note 29, §§ 8.02-03; Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 80 (1967). The statutes can

shareholder derivative actions are multifold;⁵³ the most important, however, is the shareholder demand requirement.⁵⁴

B. SHAREHOLDER DEMAND AND THE FUTILITY EXCEPTION

1. The Demand Requirement

All jurisdictions require that shareholders make a demand on the corporation's board of directors before a derivative suit can be brought.⁵⁵ Most jurisdictions will excuse this requirement only when making a demand would be futile.⁵⁶ The demand requirement is typically embodied in a procedural rule such as Federal Rule of Civil Procedure 23.1, which provides that a derivative suit complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action . . . or for not making the effort."⁵⁷ Courts have repeatedly noted that the demand requirement is more than a mere procedural formality; it is a critically important element of substantive corporate jurisprudence.⁵⁸

The purposes underlying the demand requirement all relate to the advantages arguably inherent in giving the corporation notice of the shareholder's allegations prior to litigation. Perhaps most importantly, demand reflects corporate law's "fundamental tenet," which holds that directors, not individual shareholders, manage the business and affairs of corporations.⁵⁹ A demand gives management the opportunity to address the

be found in state business corporation acts and civil procedure rules. See FED. R. CIV. P. 23.1; MAGNUSON, *supra* note 29, §§ 8.02-.03; Ernest L. Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875, 929-30.

53. See 1 MAGNUSON, *supra* note 29, § 8.02. The statutes of most jurisdictions include such requirements as contemporaneous stock ownership, verification of pleadings, and security for the corporation's defense expenses. *Id.* In addition, many jurisdictions require shareholder notice and court approval for any settlement, dismissal or compromise of derivative actions. DEMOTT, *supra* note 2, § 1:01.

54. See CLARK, *supra* note 1, § 15.2.

55. See ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. a. Although courts initially required that derivative plaintiffs also make demand upon shareholders, the modern approach eliminates the need for such demand.

56. *Id.* § 7.03 cmts. a, d.

57. State procedural rules often closely follow the language of Federal Rule of Civil Procedure 23.1. In addition, the states' business corporation statutes may also expressly address the demand requirement.

58. Block et al., *supra* note 13, at 471; see, e.g., Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984) (noting that the demand requirement is a rule of substantive right).

59. Aronson, 473 A.2d at 811; see, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

shareholder's allegations. If corporate management believes the claims have merit, it may choose to pursue corrective actions or take charge of the litigation.⁶⁰ If management disagrees with the shareholder's contentions, the demand requirement gives the corporation the chance to reject the proposed action and, if necessary, seek early dismissal of any related derivative court suit.⁶¹ Regardless of whether the corporation rejects or supports the shareholder action, the demand may at least motivate the board to consider difficult issues not previously given serious attention.⁶²

Thus, requiring pre-suit demand "allows directors to make a business decision about a business question: whether to invest the time and resources of the corporation in litigation."⁶³ Judge Easterbrook recently described why management's response to shareholder demand should be considered just another business decision:

Firms must make operational decisions; if these misfire, they must decide what to do next. Each decision must be made with the interests of the corporation at heart. Whether to buy a particular combination of services at a particular price is a business decision. So too the decision to file a lawsuit about the price or pursue a different course, such as renegotiating the contract, changing the level of services, even finding a new adviser If the directors run the show, then they must control litigation (versus other remedies) to the same extent as they make the initial business decision.⁶⁴

According to Easterbrook, business executives—not judges—are trained to make this significant business judgment.⁶⁵

60. See *Elfenbein v. Gulf W. Indus.*, 590 F.2d 445, 450 (2d Cir. 1978) (per curiam). Although they almost never choose to do so, corporations may take charge of the litigation because of concern that the shareholders will not obtain adequate relief. ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. c, at 651.

61. See *Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del. 1990).

62. ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. c, at 652 (explaining that demand may induce board to consider issues and crystalize policies); see also *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d 928, 941 (3d Cir. 1982), *vacated on other grounds*, 465 U.S. 1001 (1984); Robert K. Payson, *Dismissal of Derivative Actions: The Debate*, 6 DEL. J. CORP. L. 522, 527 (1981).

63. *Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338, 1342 (7th Cir. 1990) (Easterbrook, J.) (citing *Hawes v. Oakland*, 104 U.S. 450, 457, 461-62 (1881)), *rev'd*, 111 S. Ct. 1711 (1991); see also Deborah A. DeMott, *Demand in Derivative Actions: Problems of Interpretation and Function*, 19 U.C. DAVIS L. REV. 461, 484-88 (1986); Daniel R. Fischel, Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 171-72 (1976).

64. 908 F.2d at 1342-43; see also Block et al., *supra* note 13, at 471-72 (citing *Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1173-74 (7th Cir. 1989) (Easterbrook, J., concurring)).

65. 908 F.2d at 1343; see also Richard W. Duesenberg, *The Business Judg-*

Shareholder demand may also serve the interest of judicial economy.⁶⁶ In theory, the demand requirement promotes intra-corporate dispute resolution that avoids unnecessary litigation.⁶⁷ If management's response addresses the shareholder's concerns, then the corporation will have successfully resolved the conflict without implicating the already overburdened judicial system.⁶⁸

Finally, the demand requirement may also have value insofar as it discourages strike suits.⁶⁹ Because making a demand on the board of directors is procedurally quite simple,⁷⁰ however, it is unclear how effectively the requirement discourages meritless shareholder actions.

2. Excusing Demand

Most jurisdictions excuse the demand requirement if the shareholder can establish that presenting a demand to management would be futile.⁷¹ The standards for determining futility vary widely from jurisdiction to jurisdiction;⁷² in fact, futility issues have clogged the courts for decades. As a general rule, some level of directorial involvement in a challenged transaction excuses demand.⁷³ Courts disagree, however, about how to apply this basic principle.⁷⁴ The excuse determination some-

ment Rule and Shareholder Derivative Suits: A View from the Inside, 60 WASH. U. L.Q. 311, 314 (1982) (the court is "neither trained nor competent" to second-guess management's business judgment).

66. Block et al., *supra* note 13, at 472-73.

67. See *Starrels*, 870 F.2d at 1173 (describing demand as initiating a "form of alternative dispute resolution"); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) (demand requirement "promote[s] intracorporate dispute resolution").

68. See *Hawes v. Oakland*, 104 U.S. 450, 460-61 (1881) (stockholder plaintiff must first exhaust "all the means within his reach to obtain, within the corporation itself, the redress of his grievances"); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978) (demand requirement "enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation"), *cert. denied*, 439 U.S. 1129 (1979).

69. Block et al., *supra* note 13, at 473; see also *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984) (describing the demand requirement as a "safeguard against strike suits").

70. Making a demand requires nothing more than sending a letter describing the allegations. See 1 MAGNUSON, *supra* note 29, § 8.10, at 30-31 (describing what a demand should include).

71. The underlying rationale is that a shareholder need not engage in fruitless behavior.

72. See DEMOTT, *supra* note 2, § 5.03.

73. ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. d, at 652.

74. *Id.*

times turns on whether all directors are named as defendants,⁷⁵ whether the alleged wrongdoers constitute a majority of the board,⁷⁶ or whether a demand would likely prod the directors into corrective action.⁷⁷ Even among these general approaches, each state jurisdiction tends to have a slightly different formula.⁷⁸

Delaware has applied a particularly complex test for determining demand futility.⁷⁹ The determination presents alternative inquiries, as the Delaware Supreme Court recently articulated: "(1) whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts; and, if not, (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment."⁸⁰ The latter standard, which has been called the "reasonable doubt" test,⁸¹ invites a certain amount of judicial subjectivity in determining futility.⁸²

75. See *Abramowitz v. Posner*, 672 F.2d 1025, 1033 (2d Cir. 1982); *Joy v. North*, 692 F.2d 880, 887-88 (2d Cir. 1982), *cert. denied sub nom.* *City Trust v. Joy*, 460 U.S. 1051 (1983).

76. See 13 WILLIAM M. FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5965, at 155 (perm. ed. 1991). Cases of this type include ones in which plaintiff alleges that most directors had personal economic interests in the challenged transaction—interests in conflict with those of the shareholders. See, e.g., *Lewis v. Graves*, 701 F.2d 245, 248-49 (2d Cir. 1983); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1210 (9th Cir. 1980); *In re Kauffman Mut. Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Grobow v. Perot*, 526 A.2d 914, 924-25 (Del. Ch. 1987), *aff'd*, 539 A.2d 180 (Del. 1988).

77. See *Lewis v. Curtis*, 671 F.2d 779, 785-87 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982). This more liberal standard permits a finding of futility whenever a substantial number of directors has participated in approving the underlying transaction. See, e.g., *Barr v. Wackman*, 36 N.Y.2d 371 (1975) (excusing demand where a majority of directors allegedly participated in and approved of acts involving bias and self-dealing by minority); *Miller v. Kastner*, 473 N.Y.S.2d 656 (App. Div. 1984) (mem.) (futility established where defendant majority shareholder had power to remove other directors).

78. ALI FINAL DRAFT, *supra* note 9, § 7.03 reporter's note 1 (demand cases "continue to divide, and each state jurisdiction tends to have a different formula."); see, e.g., *Winter v. Farmers Educ. & Coop. Union*, 107 N.W.2d 226 (Minn. 1961) (board's inactivity excuses demand); *Miller*, 473 N.Y.S.2d at 656 (futility where defendant majority shareholder had power to remove other directors).

79. Delaware's position on corporate law issues usually has a significant impact on other jurisdictions eager to benefit from the Delaware courts' business acumen. Block et al., *supra* note 13, at 480.

80. See *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991).

81. See *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

82. In fact, several recent federal court decisions applying Delaware law

Commentators have almost universally criticized the judicial confusion surrounding the various applications of the futility exception.⁸³ The volume of shareholder derivative suits clogging court dockets has been surprisingly high, especially during the 1980s. Distressingly, most of these actions turned on the definition of futility rather than on a substantive examination of the alleged wrongdoing.⁸⁴

3. Universal Demand

In light of the recurring dissatisfaction with the futility exception's unnecessary prominence in shareholder derivative suits, the modern trend has been decidedly towards requiring pre-suit demand in virtually every instance.⁸⁵ Commentators have almost unanimously supported such a move for many years.⁸⁶ In fact, both the ALI⁸⁷ and the American Bar Associa-

found "reasonable doubt" excusing demand under circumstances that might not have constituted futility in Delaware state court. *See* RCM Sec. Fund, Inc. v. Stanton, 928 F.2d 1318, 1330-35 (2d Cir. 1991) (reasonable doubt existed where corporate benefits had no reasonable relation to enhanced costs from challenged transaction); *Brickman v. Tyco Toys, Inc.*, 731 F. Supp. 101, 106-07 (S.D.N.Y. 1990) (reasonable doubt existed that a majority of directors were interested); *see also* Block et al., *supra* note 13, at 474-75 (describing how the *Aronson* decision prompted courts nationwide to consider more frequently the underlying allegations in determining futility).

83. The ALI recently expressed its criticism in the following way:

All these [futility] formulations are somewhat inexact and reflect a largely outmoded view of the function of the demand rule. If the test is simply whether all directors are named as defendants, plaintiffs will predictably frame their complaint in exactly this manner in order to avoid the demand requirement. The exception would then swallow the rule. Similarly, excusing demand whenever a majority of the board is alleged to have been negligent could trivialize the demand rule. Finally, [asking] whether demand on directors would "prod them to correct a wrong" assumes that there is a wrong to be corrected. The director's antagonism to an action may well be justified and flow from a sound judgment that the action is either not meritorious or would otherwise subject the corporation to serious injury.

ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. d. at 653.

84. The ALI has suggested, however, that while case law on demand has been very unclear, "even the most cursory examination of the cases suggests that courts have regularly considered the merits of the action (in addition to the composition and involvement of the board) in determining whether to require or excuse demand." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.08 cmt. a, at 117 (Tent. Draft No. 8, 1988) [hereinafter ALI 1988 TENTATIVE DRAFT].

85. ALI FINAL DRAFT, *supra* note 9, § 7.03 reporter's note 1. The only viable excuse to pre-suit demand would be a showing of irreparable injury. *See id.* reporter's note 4. No court cases to date have interpreted this particular point. *Id.*

86. *See, e.g.,* Note, *Demand on Directors and Shareholders as a Prerequi-*

tion⁸⁸ advocate universal demand.

The Corporate Governance Project articulates the principal policies supporting universal demand.⁸⁹ First, and perhaps most importantly, universal demand eliminates much of the troublesome threshold litigation regarding application of the futility doctrine.⁹⁰ In addition, demand is indisputedly easy to make.⁹¹ Considering the many advantages often cited in support of demand,⁹² the benefits seem to outweigh the minimal

site to a *Derivative Suit*, 73 HARV. L. REV. 746, 754 (1960) (stating that irreparable injury alone should excuse demand).

87. Section 7.03 of the ALI's Proposed Final Draft requires that shareholders first make written demand upon the board, requesting that it either prosecute the action or take suitable corrective measures. ALI FINAL DRAFT, *supra* note 9, § 7.03(a). The demand itself must describe "with reasonable specificity . . . the essential facts" supporting each claim. *Id.* The only excuse obviating the pre-suit requirement would be "a specific showing that irreparable injury to the corporation would otherwise result." *Id.* § 7.03(b). In such instances, plaintiff must still make a demand "promptly after commencement of the action." *Id.*

88. Section 7.42 of the Model Business Corporation Act provides that:

No shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action; and (2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90 day period.

MODEL BUSINESS CORP. ACT § 7.42 (1991). Florida and Georgia have adopted the Model Act's universal demand approach. See FLA. STAT. ANN. § 607.0741(2) (West 1993); GA. CODE ANN. § 14-2-742 (Michie 1989).

89. The drafters of § 7.42 of the American Bar Association Section of Business Law Committee on Corporate Laws' Model Business Corporation Act articulated similar policies. See MODEL BUSINESS CORP. ACT § 7.42 official cmt. (1991); Block et al., *supra* note 13, at 484-86; Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Derivative Proceedings*, 44 BUS. LAW. 543 (1989).

90. ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. e, at 655. Judge Easterbrook highlighted this significant concern in a recent federal decision:

In practice the futility exception to the demand rule has produced gobs of litigation. It is this exception that has sapped the potential role of the demand requirement as an alternative dispute resolution mechanism. Hundreds of cases opine on whether demand is or is not futile. Difficulties in sorting cases into demand-required and demand-excused bins are not worth incurring, once we sever the link between demand and the standard of review

Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1344 (7th Cir. 1990), *rev'd*, 111 S. Ct. 1711 (1991).

91. In other words, "making demand on the board is a relatively costless step" and "places little burden on the plaintiff." ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. e, at 655.

92. See *supra* text accompanying notes 59-70. Even in circumstances in which the board is arguably disqualified due to interest, the corporation still

time and effort required. Third, universal demand arguably simplifies the standard for judicial review.⁹³ Delaware, for example, varies the applicable review standard depending upon whether the plaintiff can establish futility.⁹⁴ The ALI openly criticizes Delaware's double standard, finding no logical connection between demand futility and substantive judicial review.⁹⁵

Although support for universal demand and its potential benefits has been strong, some commentators still fear the unknown, concerned that courts might take advantage of a fluid situation to substitute their business judgments for those of management.⁹⁶ Indeed, the adoption of universal demand would necessarily create a fluid situation in places like Dela-

possesses a possibly beneficial range of options when faced with demand. After all, the interested board may appoint a disinterested subgroup of the board or create a special litigation committee to address the shareholder concerns. Thus, requiring pre-suit demand to a biased board is not necessarily futile and may in fact yield fruitful results. See ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. e, at 657.

93. *Id.* at 655-56.

94. In a demand-excused setting, Delaware allows the court to substitute its business judgment for that of the corporation. See *infra* text accompanying notes 159-65. If demand is required, the Delaware approach essentially applies the business judgment rule. *Id.*

95. ALI FINAL DRAFT, *supra* note 9, § 7.03 cmt. e, at 655-56 (noting that the link between demand and judicial review is unfortunate since the issues are "logically very distinct"). Judge Easterbrook similarly criticized Delaware's two-prong approach recently:

When the standard of review depends on the existence of a demand, plaintiffs have extraordinarily strong reasons not to make a demand, and corporations extraordinarily strong reasons to insist on one. Demand then becomes a threshold issue in every derivative suit, one that must be resolved in advance of discovery and on the basis of a good deal of speculation about what the board might do. . . . [T]he plaintiff will assert that the board is unreasonable. Why ask persons with closed minds? The board will proclaim that Solomonic wisdom would be applied if only plaintiff would ask, while simultaneously asserting that the suit has no conceivable merit. It is not a pretty picture, but it is an extended and expensive one, made more so by some peculiarities in the way Delaware phrases its standards.

Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1343-44 (7th Cir. 1990) (advocating that federal common law adopt universal demand), *rev'd*, 111 S. Ct. 1711 (1991). The Supreme Court's reversal required federal courts to follow the applicable state demand requirement, rather than federal common law. Since the decision was limited to the conflict of laws question, the Supreme Court declined to address the wisdom of adopting the universal demand rule "[w]hatever its merits as a matter of legal reform." 111 S. Ct. at 1720. In fact, the Supreme Court did acknowledge the "high collateral litigation costs associated with the demand futility doctrine." *Id.* at 1721.

96. See Block et al., *supra* note 13, at 486, 508 (stating that universal demand rule might be beneficial, but that such a change should not be made at the expense of the appropriate standard of review).

ware that currently link demand to judicial review. Without any remaining distinction between demand-required and demand-excused cases, courts in such jurisdictions would have to find alternate criteria for determining which suits deserve closer scrutiny. They would have to face directly the more delicate and appropriate inquiry of what is the appropriate standard of review when corporate management rejects a shareholder's demand.

C. JUDICIAL REVIEW OF MANAGEMENT'S RESPONSE TO SHAREHOLDER DEMAND

1. Management's Response: Special Litigation Committees and the Specter of Structural Bias

Although the legal history of the board of directors' power to end derivative litigation is complex, most jurisdictions agree that plaintiffs in demand-required cases⁹⁷ face dismissal absent proof that management's rejection of the shareholder demand was wrongful.⁹⁸ Prior to the development of special litigation committees nearly two decades ago, this rule did not greatly hinder plaintiffs. Even in demand-required cases, courts were often willing to review the merits of plaintiff's allegations when considering whether management's rejection was wrongful.⁹⁹

Beginning in the mid-1970s, however, corporate management began using special litigation committees to fend off shareholder derivative suits.¹⁰⁰ Once a shareholder filed suit, the board would create a committee¹⁰¹ of supposedly disinterested directors to investigate the plaintiff's claims and recommend action. The appointed committee would, "after a suitable

97. Obviously, in demand-excused cases, an interested board's post-suit rejection of plaintiff's contentions would carry no weight. See DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 497 (3d ed. 1989) (courts have historically held that directors may not terminate cases alleging that a majority of the board breached a fiduciary duty). Prior to the creation of special litigation committees, many regarded shareholder demand as "little more than a formal requirement" and excuse was readily shown. ALI FINAL DRAFT, *supra* note 9, § 7.10 reporter's note 5, at 762.

98. ALI FINAL DRAFT, *supra* note 9, § 7.10 reporter's note 4, at 760-61.

99. See *id.* at 761-62; see also Note, *supra* note 86, at 759-60 & n.81 (noting that in deciding whether management's refusal to sue was reasonable, court may consider the merits of plaintiff's allegations).

100. CLARK, *supra* note 1, § 15.2.3, at 645.

101. The committee might have two or three members, usually directors. Sometimes the committee may contain a non-director "consultant" such as a retired judge or law professor. See *id.*

display of investigative activity and collective deliberation,"¹⁰² produce a report concluding that the derivative suit was not in the corporation's "best interest."¹⁰³ Based on that finding, the corporation would then move to dismiss the lawsuit.¹⁰⁴ In *Burks v. Lasker*,¹⁰⁵ the Supreme Court agreed that a disinterested¹⁰⁶ group of corporate directors could terminate pending derivative litigation.¹⁰⁷ This case buttressed the trend among management defendants of appointing special litigation committees to consider the issues raised in derivative suits.¹⁰⁸

The growth of special litigation committees has had a substantial impact on shareholder derivative litigation. Management's use of this device has motivated courts to find demand futility only infrequently and to defer to the committee's determination more often.¹⁰⁹ This effect, which renders the plaintiff's position particularly difficult, could virtually eliminate

102. *Id.*

103. *Id.*

104. *Id.*

105. 441 U.S. 471 (1979) (holding that disinterested directors of an investment company could unilaterally dismiss an action filed under the Investment Company Act and Investment Advisors Act). The first case to approve expressly the special litigation committee procedure was *Gall v. Exxon Corp.*, 418 F. Supp. 508, 516-17 (S.D.N.Y. 1976). ALI FINAL DRAFT, *supra* note 9, § 7.10 reporter's note 2, at 759.

106. The "disinterested" requirement obviously excludes those who financially benefitted from the subject transactions, but it may not necessarily exclude even named defendants not having a financial stake in the outcome. 1 MAGNUSON, *supra* note 29, § 8.17 at 59; see *Lewis v. Anderson*, 615 F.2d 778, 782-83 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980). Case decisions indicate a judicial inclination not to find a prohibitive interest unless the committee member is a "hard-core malefactor or a significant target of the derivative action." 1 MAGNUSON, *supra* note 29, § 8.17, at 59.

107. The termination must be consistent with state law and the underlying policy considerations of the applicable federal law. See 441 U.S. at 486.

108. Interestingly, the vast majority of states has not even considered the availability or the legitimacy of the special litigation committee procedure. ALI FINAL DRAFT, *supra* note 9, § 7.08 reporter's note 2, at 706. By early 1992, the only states having statutes specifically authorizing the procedure were Alaska, Indiana, Minnesota, North Dakota, and Virginia. *Id.*; see also BLOCK ET AL., *supra* note 97, at 503-06 (describing statutory provisions). One jurisdiction has apparently rejected the legitimacy of so-called special litigation committees. See *Miller v. Register & Trib. Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983) (en banc) (holding that corporate directors may not delegate to certain special litigation committees the power to determine the corporation).

109. In other words, courts will more likely apply the business judgment rule's presumption of deference to insulate management using the special litigation committee device. See ALI FINAL DRAFT, *supra* note 9, § 7.10 reporter's note 5, at 762.

shareholder derivative litigation altogether.¹¹⁰

Some commentators cite the "common cultural bond," "natural empathy," and "collegiality" most directors share to argue that special litigation committees are structurally biased in favor of management, making their "independence" inherently more apparent than real.¹¹¹ After all, making an adverse judgment about a colleague's behavior is "distasteful at best."¹¹² Particularly if management selects the committee after suit has been instigated, the highly-charged circumstances motivate defendants to hand select committee members most sympathetic to the cause.¹¹³ From the committee member's perspective, one can readily imagine an eagerness to "curry favor with" fellow directors or with the business community generally.¹¹⁴

Some reject the structural bias theory as "pop-psychology," an unprovable hypothesis that broadly and illogically attributes interested motives to all corporate directors.¹¹⁵ Arguing that the theory, if true, lacks any rational ending point,¹¹⁶ these commentators criticize the structural bias theory as undermining the integrity and independence generally recognized and appreciated in outside directors.¹¹⁷

Regardless of the theory's validity, plaintiffs' allegations in practice virtually never impress special litigation committees; in only a handful of cases has a committee recommended anything other than discontinuance of the action.¹¹⁸ In doing so, the

110. See Cox, *supra* note 12, at 961 (describing special litigation committees as the "latest threat" to derivative suits).

111. *Id.* at 962; see also John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977); George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96 (1980).

112. Cox, *supra* note 12, at 962.

113. *Id.*

114. *Id.*

115. See Block et al., *supra* note 13, at 505; Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 534 (1989).

116. Block et al., *supra* note 13, at 534-35 (asserting that structural bias theory suggests a wholesale abandonment of the business judgment rule).

117. *Id.* at 535; see also *Burks v. Lasker*, 441 U.S. 471, 485 (1979) (noting that outside directors are intended to be helpful "watchdogs" in Investment Act cases).

118. 1 MAGNUSON, *supra* note 29, § 8.17, at 58 & n.13; Cox, *supra* note 12, at 963 (noting that after more than a score of special litigation committee cases, all but one committee concluded that the suit was not in the corporation's best interest); Jerold S. Solovy et al., *The Role of Special Litigation Committees in Shareholder Derivative Litigation*, 25 TORT & INS. L.J. 864, 864 (1990).

committees usually recount the same generalized and conclusory justifications for dismissal.¹¹⁹ Thus, regardless of the extensive commentary and court opinions championing the importance of permitting corporate management the opportunity to evaluate shareholder allegations fully and fairly,¹²⁰ the statistics seemingly belie that lofty sentiment.¹²¹ Given the opportunity to consider plaintiff's grievances, management will, most typically, flatly reject the plaintiff's concerns.

2. The Business Judgment Rule: Management's Usual Presumption of Protection

The business judgment rule creates a presumption that corporate directors make business decisions "on an informed basis, in good faith and in the honest belief that the action taken [is] in the best interests of the company."¹²² The rule's hallmark is that "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'¹²³ This common law principle dates back more than 150 years¹²⁴ and arguably meets four basic goals.¹²⁵ First, the business judgment rule encourages competent indi-

119. These justifications include concerns that the derivative action's continuation would undermine employee morale, create an adversarial relationship between the board and management, create public stigmatization and loss of goodwill, and result in corporate liability for indemnification and related expenses. ALI FINAL DRAFT, *supra* note 9, § 7.10 reporter's note 8, at 765; see also Kon S. Kim, *The Demand on Directors Requirement and the Business Judgment Rule in the Shareholder Derivative Suit: An Alternative Framework*, 6 J. CORP. L. 511 (1981).

120. See, e.g., Block et al., *supra* note 13.

121. In fact, apparently because of the difficult procedural barriers underlying derivative suits, such actions have become relatively rare. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 510 n.185 (1992); Romano, *supra* note 40, at 84.

122. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citations omitted)); see also *Gall v. Exxon Corp.*, 418 F. Supp. 508, 515-16 (S.D.N.Y. 1976). Although once believed to be virtually impenetrable, the business judgment rule has recently left management surprisingly vulnerable. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (gross negligence creates personal liability).

123. 493 A.2d at 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

124. Block et al., *supra* note 13, at 489-90 (quoting *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (La. 1829) ("The test of [directorial] responsibility should be, not the certainty of wisdom in others, but the possession of ordinary knowledge.")).

125. *Id.* at 490-91.

viduals to serve as corporate directors.¹²⁶ Second, the rule also gives directors the broad discretion to formulate company policy without fear of judicial second-guessing.¹²⁷ Third, the rule protects courts from becoming embroiled in complex corporate matters.¹²⁸ Finally, the business judgment rule ensures that management remains in the hands of directors, rather than shareholders, perhaps "protecting stockholders from themselves."¹²⁹

Plaintiffs can overcome the presumption of good business judgment only by establishing that the directors acted either in bad faith or in a grossly negligent fashion. The difficulty of meeting this burden often means that the application of the business judgment rule effectively determines the litigation's outcome.¹³⁰

Corporate management is not, however, always entitled to the business judgment rule's important protections. Because of the "omnipresent specter" that the board may act primarily for itself instead of for the corporation and its shareholders, "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."¹³¹ Thus, when management decisions require directors to confront conflicts of interest, making objective resolution difficult, the court will not presume good business judgment until the board initially establishes its good faith and reasonable investigation.¹³²

One significant example of corporate management's heightened burden is in the context of responding to challenges to corporate control.¹³³ The Delaware Supreme Court in *Unocal*

126. See *Air Line Pilots Assoc. v. UAL Corp.*, 717 F. Supp. 575, 582 (N.D. Ill. 1989), *aff'd*, 897 F.2d 575 (7th Cir. 1990).

127. See, e.g., *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

128. See, e.g., *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989). In fact, "[courts] are admittedly ill-equipped to handle" sophisticated corporate decision making. Block et al., *supra* note 13, at 490.

129. Dooley & Veasey, *supra* note 115, at 522.

130. See Block et al., *supra* note 13, at 491 (quoting *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1989)).

131. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

132. See *id.* at 955.

133. Interestingly, the ALI considered and rejected the application of *Unocal's* enhanced business judgment rule to management's conduct when blocking hostile tender offers. See ALI FINAL DRAFT, *supra* note 9, § 6.02 cmt. a, at 549-50 (§ 6.02 significantly varies from the "so-called *Unocal* test" by placing burden on person attacking management's actions). Challenges to management's handling of control transactions, however, do require the board to es-

*Corp. v. Mesa Petroleum Co.*¹³⁴ held that:

... before the business judgment rule is applied to a board's adoption of a defensive measure, the burden will lie with the board to prove (a) reasonable grounds for believing that a danger to corporate policy and effectiveness existed; and (b) that the defensive measure adopted was reasonable in relation to the threat posed. Directors satisfy the first part of the Unocal test by demonstrating good faith and reasonable investigation.¹³⁵

Directors carry a heightened burden, according to the Delaware court,¹³⁶ because their conduct in defending against takeovers bears the implicit appearance of self-interest. Because effective takeover defenses help corporate boards remain entrenched, courts naturally fear that the directors' desire to retain control, rather than concerns for shareholders' welfare, might motivate the directors' conduct.¹³⁷

3. Current Standards of Review

a. Overview

Considerable confusion surrounds the appropriate degree of judicial scrutiny to apply when reviewing management's response to a shareholder's demand. Derivative litigation usually implicates two levels of management conduct. The first level, alleged management wrongdoing,¹³⁸ forms the basis for the shareholder's complaint. The second level, which has more fre-

establish that it was adequately informed, that it was disinterested and acted in good faith, and that it rationally believed its action to be in the corporation's best interests. *Id.* § 6.01 cmt. e, at 531-37.

134. 493 A.2d 946 (Del. 1985). The *Unocal* case involved a selective stock repurchase in the face of a two-tier, highly coercive tender offer coupled with the threat of greenmail. *Id.* at 956. Despite the court's adoption of a heightened standard, the board met its burden and escaped liability. *Id.* at 958-59.

135. *Paramount Comms., Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. 1990) (citing *Unocal*, 493 A.2d at 946). The court does not substitute its business judgment for that of corporate management; rather, the court works to ensure the disinterested and reasonable environment in which the business decision was reached. *Id.* at 1153. Management can more easily establish good faith and reasonable investigation by showing that "a board comprised of a majority of outside independent directors" approved the underlying decision. *Unocal*, 493 A.2d at 954-55.

136. Other jurisdictions have been unwilling to follow Delaware's lead. Shortly after the *Unocal* decision, several states adopted statutes ensuring the application of the standard business judgment rule even in takeover contexts. See IND. CODE § 23-1-35-1(f) (1992); OHIO REV. CODE ANN. § 1701.59(C) (1992); 15 PA. CONS. STAT. § 1715(d) (1992).

137. See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980); *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975); see also ALI FINAL DRAFT, *supra* note 9, § 6.02 cmt. a, at 548-51.

138. Of course, shareholder derivative litigation can involve allegations

quently dominated derivative litigation for more than a decade, involves management's decision when faced with a shareholder demand. Judicial review turns on the issue of whether courts should limit their inquiry to the second level or proceed to evaluate the underlying merits. Because courts generally prefer to defer to management's business judgment,¹³⁹ and management routinely uses special litigation committees, judicial inquiry has been deflected almost exclusively into the second level.

Two main positions emerge out of the considerable litigation generated on this second level.¹⁴⁰ The so-called "minimalist position"¹⁴¹ applies the traditional business judgment rule, thereby permitting only minimal review of management's response to a shareholder demand. The second major approach is Delaware's bifurcated test, which essentially applies the business judgment rule in demand-required cases, yet permits courts to supplant the committee's business judgment in demand-excused cases.¹⁴² Several relatively recent decisions¹⁴³ have adopted moderate approaches somewhere between the Delaware and minimalist approaches. Finally, the Model Business Corporation Act now reflects a slight variation on the deferential business judgment rule standard of review. Each approach will be examined in turn.

b. *The Deferential Business Judgment Rule Standard*

Many courts follow the deferential business judgment rule approach to reviewing management's response to a shareholder demand.¹⁴⁴ As expressed in the oft-cited New York case *Auerbach v. Bennett*,¹⁴⁵ the inquiry is confined to an examination of the board's independence and good faith, areas tradition-

against third parties, but the typical case is one against corporate insiders. See *supra* text accompanying notes 33-34.

139. See *supra* notes 122-29 and accompanying text.

140. See CLARK, *supra* note 1, § 15.2.3, at 646.

141. *Id.*

142. See *id.*

143. See *infra* notes 170-81 and accompanying text.

144. According to recent commentary, approximately half the states apply the business judgment rule standard of review, at least in cases in which shareholder demand is excused as futile. See Block et al., *supra* note 13, at 492-97; see also Houle v. Low, 556 N.E.2d 51, 55 (Mass. 1990) (listing courts following *Auerbach v. Bennett*); Cox, *supra* note 12, at 973 (noting that most courts adhere uncritically to the business judgment rule when they review the special litigation committee's recommendation).

145. 47 N.Y.2d 619 (1979); see Cox, *supra* note 12, at 973 (stating that *Auerbach* reflects "quintessential expression" of business judgment rule doctrine).

ally subject to review under the business judgment rule.¹⁴⁶ Although this inquiry permits challenges to the special litigation committee's procedures,¹⁴⁷ the business judgment rule shields the substantive bases for the committee's recommendation from any judicial inquiry.¹⁴⁸

This minimalist treatment handles management's rejection of derivative suit demands just like any other business decision.¹⁴⁹ The plaintiff must overcome the business judgment rule's presumption that management acted properly in rejecting the shareholder demand.¹⁵⁰ Consequently, the business judgment rule becomes management's most potent defense to derivative suits.¹⁵¹ Through it, the special litigation committee's business discretion ironically enables management to dispatch derivative actions alleging illegal or oppressive board conduct, even though the business judgment rule would normally not apply to a *board* decision in such a setting.¹⁵²

Not surprisingly, corporate counsel have largely endorsed

146. 47 N.Y.2d at 623-24.

147. *Id.*

148. See Cox, *supra* note 12, at 973. The nature of the underlying conduct is not directly at issue:

[The decision] . . . not to pursue the claims advanced in the shareholders' derivative actions . . . falls squarely within the embrace of the business judgment doctrine, involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. . . . Thus, the courts cannot inquire as to which factors were considered by that committee or the relative weight accorded them in reaching that substantive decision.

Auerbach, 47 N.Y.2d at 633.

149. The Supreme Court has described this business decision as follows:

Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors Courts interfere seldom to control such discretion intra-vires the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment

....

United Copper Secs. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917).

150. Plaintiff meets this burden by establishing that the decision maker was interested, acted in bad faith, or was so ill-informed as to be grossly negligent.

151. 1 MAGNUSON, *supra* note 29, § 8.17, at 57.

152. *Id.* at 58. Courts have struggled with the application of the insular business judgment rule to derivative lawsuits challenging particularly egregious management misconduct. As one commentator put it, "Courts [do] not want to give carte blanche either to the corporate crook or to the strike suit artist." *Id.* at 60.

the *Auerbach* approach, arguing that the business judgment rule should protect management's decision to discontinue derivative litigation.¹⁵³ Given the important policies surrounding the application of the business judgment rule in routine business law cases,¹⁵⁴ this support is understandable. In addition, as a unitary approach, it does reflect desirable simplicity in application.

The business judgment rule's simplicity, however, comes at too high a price. First, many contend that corporate management does not deserve the rule's protection in the derivative suit setting. Critics of *Auerbach* often cite the structural bias doctrine, contending that inherent bias necessarily taints management's hand-picked decision-making body and makes a disinterested recommendation virtually impossible. Although this theory obviously does not establish actual bias in every situation,¹⁵⁵ it reasonably suggests the appearance of bias for the reasons suggested earlier.¹⁵⁶ In any event, regardless of the structural bias doctrine's viability, statistics show that litigation committees almost inevitably reject shareholder demands while ritualistically using conclusory and generalized justifications for dismissing the derivative suits.¹⁵⁷

Moreover, given the nature of derivative litigation, the business judgment rule imposes too substantial a barrier on plaintiffs lacking the necessary tools to meet that burden. The rule operates to protect management's recommendation, a layer removed from the alleged wrongdoing. The plaintiff shareholder accordingly must refute the business judgment of conduct separate from that underlying the lawsuit—conduct orchestrated by corporate management and peculiarly within its realm. Shareholders lack access to the facts necessary to undercut the litigation committee's protected business judgment.

Thus, although the traditional business judgment rule makes good sense in a variety of corporate law contexts, it is too deferential to management in derivative suits. The development and use of special litigation committees has exacerbated an already difficult situation. Although commentators

153. See ALI FINAL DRAFT, *supra* note 9, § 7.10 reporter's note 7, at 765; see also Duesenberg, *supra* note 65, at 312 (defending "expansive application" of business judgment rule).

154. See *supra* text accompanying notes 124-29.

155. See *supra* text accompanying notes 115-17.

156. See *supra* text accompanying notes 111-14.

157. See *supra* notes 118-21 and accompanying text.

have cautioned about the "death knell" of derivative litigation due to procedural constraints for almost fifty years,¹⁵⁸ those fears may now be coming to fruition. The business judgment rule, when coupled with the special litigation committee device, may eliminate the derivative remedy altogether.

c. *Delaware's Demand-Dependent Bifurcated Standard*

Judicial review under Delaware's relatively complex, bifurcated standard varies depending on whether the shareholder establishes futility of demand. Often called the "demand required, demand excused" rule,¹⁵⁹ the standard applies the deferential business judgment rule in cases requiring demand,¹⁶⁰ but permits broader scrutiny if demand is excused.¹⁶¹ In *Zapata Corp. v. Maldonado*,¹⁶² the Delaware Supreme Court stated that it would uphold the board's decision in demand-excused cases if the special litigation committee established its independence and good faith in thoroughly investigating the alleged misconduct, giving a reasonable basis for its conclusions, and the court, in the discretionary exercise of *its own* business judgment, determined that dismissal was in the corporation's best interest.¹⁶³

Recognizing the beneficial deterrent impact of bona fide derivative actions, the court sought a balancing point between appropriate stockholder power to bring corporate causes of action and the corporation's ability to eliminate detrimental litigation.¹⁶⁴ The court rejected a more deferential approach

158. See Hornstein, *supra* note 40.

159. ALI FINAL DRAFT, *supra* note 9, § 7.10 cmt. a, at 729.

160. See *id.* Noting that shareholders lack any independent, absolute right to continue a derivative suit for breach of fiduciary duty over the corporation's objection, *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981), the *Zapata* court concluded that it should respect board decisions to dismiss a derivative suit in demand-required actions—so long as the board decision was not wrongful. *Id.* at 784.

161. To establish futility, plaintiff shareholder must show either that a majority of the board is "interested" or that the pleadings support a reasonable doubt that the challenged transaction was the product of valid business judgment. See ALI FINAL DRAFT, *supra* note 9, § 7.10 cmt. a, at 728.

162. 430 A.2d 779 (Del. 1981).

163. *Id.* at 789.

164. *Id.* at 786-87. As one commentator has noted, "the court attempted to walk a middle line between giving unrestricted authority to directors to dismiss such actions regardless of their merit, and permitting plaintiff shareholders to bring and control such suits regardless of their lack of merit." 1 MAGNUSON, *supra* note 29, § 8.17, at 60.

because of the "abusive potential of structural bias."¹⁶⁵ A small number of other jurisdictions, following Delaware's always impressive lead, have adopted the *Zapata* two-pronged test.¹⁶⁶

Almost unanimously, however, academic commentary has criticized the "demand required, demand excused" distinction applied in *Zapata*.¹⁶⁷ Many courts have also been critical, noting the practical difficulties posed by layering the judiciary's business judgment onto the already burdensome process of sorting out minority shareholder rights.¹⁶⁸ Critics also contend that conditioning different levels of review depending on the presence of futility of demand only motivates shareholders to assert that demand is always futile in hopes of procuring judicial review of the underlying allegations.¹⁶⁹

165. Cox, *supra* note 12, at 975. The *Zapata* court voiced its structural bias concerns in the following manner:

[W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role.

430 A.2d at 787.

166. Federal courts construing Connecticut, Georgia, Maryland, and Virginia law have also followed the *Zapata* approach; see BLOCK ET AL., *supra* note 97, at 522.

167. ALI FINAL DRAFT, *supra* note 9, § 7.10 reporter's note 7, at 764-65 (citing extensively to legal commentary); see, e.g., Cox, *supra* note 12, at 975 (noting that *Zapata*'s two-tiered analysis provides only an "illusory improvement" over the business judgment rule). Commentators advocating heightened judicial scrutiny, however, were initially excited that *Zapata*'s inquiry permitted greater review than the overprotective business judgment rule. See *id.* at 974 & n.57; E. Norman Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions*, 37 BUS. LAW. 1247, 1266, 1273 (1982) (commending *Zapata* as the end of judicial abdication).

168. See Kaplan v. Wyatt, 484 A.2d 501, 511-12 (Del. Ch.), *aff'd*, 499 A.2d 1184 (Del. 1984) (criticizing *Zapata* for "setting up a form of litigation within litigation"); see also 1 MAGNUSON, *supra* note 29, § 8.17, at 68 (discussing *Kaplan*).

169. The shareholder's dilemma has been described as follows:

Given the continued viability of the *Zapata* rationale, plaintiff should consider whether it might not be better to ignore making a demand on the board of directors and allege that such a demand would be futile. . . . [S]uch a tactic gives the plaintiff two bites at the apple. First, he can challenge the independence and good faith of the determination. Second, he may find that the judge, while grudgingly acknowledging the independence and good faith of the board seeking dismissal of the action, differs with their business judgment and refuses to dismiss the case anyway. . . .

1 MAGNUSON, *supra* note 29, § 8.17, at 66-67.

d. *Miscellaneous Standards Attempt a Balance*

Facing the choice of applying either an *Auerbach*-type business judgment rule or a *Zapata*-type two-pronged analysis, some jurisdictions have rejected both in favor of their own variations. The trend appears to be towards heightened judicial inquiry on the merits, at least in demand-excused cases.¹⁷⁰ In each of these jurisdictions, the courts permit greater review than the deferential business judgment rule would allow. Some courts even extend the inquiry beyond *Zapata*.

For example, the North Carolina Supreme Court in *Alford v. Shaw*¹⁷¹ adopted a "modified *Zapata* rule,"¹⁷² endorsing "thorough judicial review" before dismissing or settling a shareholder derivative suit.¹⁷³ Rejecting the more deferential business judgment rule,¹⁷⁴ the court permitted an extensive inquiry into the special committee's report, as well as all the other facts and circumstances underlying the plaintiff's allegations.¹⁷⁵ Exceeding *Zapata*, this broad standard applies in both demand-required and demand-excused cases.¹⁷⁶

Massachusetts permits less extensive review. In *Houle v. Low*,¹⁷⁷ a demand-excused case,¹⁷⁸ the court determined that the corporation bears the burden of establishing the litigation committee's independence, lack of bias, good faith, and the thoroughness of its investigation.¹⁷⁹ Even if the corporation shows that the committee's process was fair, the court still must determine whether the committee reached a reasonable

170. See *Alford v. Shaw*, 358 S.E.2d 323, 325-26 (N.C. 1987); Note, *Derivative Actions—Presumed Good Faith Deliberations by Special Litigation Committees: A Major Hurdle for Minority Shareholders—Alford v. Shaw*, 22 WAKE FOREST L. REV. 127, 139-44 (1987).

171. 358 S.E.2d at 323.

172. *Id.* at 326.

173. *Id.*

174. Interestingly, the North Carolina Supreme Court in *Alford* initially decided to adopt a modified *Auerbach* approach, then opted to permit a broader inquiry. Withdrawing its earlier decision, which had been reported at 349 S.E.2d 41 (1986), the court rejected "slavish adherence to the business judgment rule," expressing concern about the inherent structural bias underlying corporate committee decisions. 358 S.E.2d at 326.

175. 358 S.E.2d at 328.

176. *Id.* at 327. At one point, the ALI complimented the "relative wisdom of *Alford*'s approach." See ALI 1988 TENTATIVE DRAFT, *supra* note 84, § 7.08 cmt. a, at 119.

177. 556 N.E.2d 51 (Mass. 1990).

178. *Id.* at 53 n.3.

179. *Id.* at 58.

and principled decision.¹⁸⁰ Although Massachusetts law does not allow the court to substitute its own business judgment, as the *Zapata* standard permits, the review does involve an evaluation of the substantive merits of plaintiff's allegations.¹⁸¹

The *Alford* and *Houle* approaches suggest interesting twists on an old theme, but neither one provides the delicate balance essential to judicial review of management's response. First, the North Carolina rule, which is broader than the *Zapata* approach, permits judicial review of the underlying merits in every instance. This tips the scale too far in the plaintiffs' favor by allowing no deference to even a reasoned, disinterested, good faith committee recommendation to dismiss. The *Houle* standard, in contrast, appears more balanced, but since the *Houle* case involved demand futility, it would not provide the necessary guidance if universal demand were to become the rule.

e. *Model Business Corporation Act § 7.44: A New Look for an Old Rule*

The Model Business Corporation Act ("MBCA") only recently specified how a court should handle corporate management's rejection of a shareholder demand.¹⁸² Pursuant to section 7.44(a), the court shall dismiss the derivative proceeding on the corporation's motion if management's decision maker¹⁸³ "determined in good faith after conducting a reasonable inquiry¹⁸⁴ on which its conclusions are based that the mainte-

180. *Id.* at 59.

181. *Id.* Plaintiff can "point out factors not considered by the committee" or show "why those relied upon by the committee do not support its conclusion." *Id.* Interestingly, in formulating this standard, the Massachusetts Supreme Court cited the earlier unitary standard of review initially adopted by the ALI. *See id.* (citing ALI 1988 TENTATIVE DRAFT, *supra* note 84, § 7.08). A recent Tennessee case adopts a similar standard, but applies it in both demand-required and demand-excused cases. *See Lewis v. Boyd*, 838 S.W.2d 215 (Tenn. App. 1992) (requiring management to establish "committee's independence, good faith, and procedural fairness, as well as the soundness of the committee's conclusions and recommendations").

182. *See* MODEL BUSINESS CORP. ACT § 7.44 official cmt. (1991).

183. Sections 7.44(b) and (f) specify what groups can make management's determination. The corporation can appoint a disinterested "panel" of independent directors, § 7.44(b), or the court may appoint one, § 7.44(f). The § 7.44 procedures, however, are not exclusive; in some instances, a decision to commence an action may fall within a corporate officer's authority depending upon the claim amount and the identity of potential defendants. *See id.* § 7.44 official cmt.

184. The ABA deliberately chose the word "inquiry" rather than "investigation" to make it clear that the scope of the court's review "will depend upon

nance of the derivative proceeding is not in the best interests of the corporation."¹⁸⁵ The burden of proving these requirements depends upon the independence of the corporation's decision maker. If a majority of the board was independent when the board made the determination, the plaintiff bears the burden; otherwise, the corporation must establish management's good faith and reasonableness.¹⁸⁶ The shareholder bears the initial burden on the issue of whether the board is not independent.¹⁸⁷

The MBCA's new review standard essentially applies the old business judgment rule to protect the determination of disinterested boards acting in good faith and with due care.¹⁸⁸ The Model Act eliminates the business judgment rule's deferential presumption, however, if the shareholder can prove the board's lack of independence. By shifting the burden depending on the independence of the corporate decision maker, the MBCA retains the demand-required, demand-excused distinction of the *Zapata* approach. Unlike *Zapata*, however, the Model Act never permits the court to substitute its own business judgment for that of the corporation—even in a demand-excused setting.

The MBCA's unitary standard provides a pleasing simplicity, but restricts judicial inquiry too greatly. The Model Act favors management insofar as shareholders always bear the initial burden of convincing the court that the corporate decision maker was not independent. If the shareholder fails to meet that burden, then the plaintiff must additionally establish that the directors' determination was not in good faith or that the inquiry was not reasonable. Although this approach pro-

the issues raised and the knowledge of the group making the determination with respect to the issues." *Id.* § 7.44 official cmt., at 205.

185. *Id.* § 7.44(a). The section "does not authorize the court to review the reasonableness of the [corporate decision maker's] determination." *Id.* § 7.44 official cmt., at 208. Rather, it limits judicial review "to whether the determination has some support in the findings of the inquiry." *Id.* Both the decision maker's inquiry and determination must be in good faith. *See id.* at 205-06. In evaluating the quality of that inquiry, the court should consider "the spirit and sincerity with which the investigation was conducted, rather than the reasonableness of its procedures or basis for conclusions." *Id.* at 206 (quoting *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 800 (E.D. Va. 1982)).

186. *See Id.* § 7.44(e).

187. *Id.* § 7.44 official cmt., at 207; *see also* *Consumers Power Co. Derivative Litig.*, 132 F.R.D. 455, 464 n.27 (E.D. Mich. 1990); Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Derivative Proceedings*, 44 BUS. LAW. 543, 553 (1989).

188. *See* 132 F.R.D. at 465 (MBCA treats dismissal recommendation as corporate business judgment); Block et al., *supra* note 13, at 499-501 (MBCA's business judgment rule standard consistent with current law).

vides slightly more flexibility than the *Auerbach* traditional business judgment rule standard, the MBCA does not go far enough. To the extent courts abandon the Delaware approach in favor of MBCA section 7.44, shareholders will find the maintenance of derivative suits even more difficult than before.

II. JUGGLING DIVERSE PERSPECTIVES: THE ALI'S PROPOSALS FOR JUDICIAL REVIEW

A. GUIDING PRINCIPLES FOR JUDICIAL REVIEW

The general considerations underlying the Corporate Governance Project include the basic belief that, while derivative suits can enhance corporate accountability, private enforcement has social costs that sometimes outweigh the benefits.¹⁸⁹ As a result, the ALI assigns derivative actions only a limited role in assuring corporate accountability¹⁹⁰ and concludes that certain fundamental principles should delimit such suits. First, the ALI distinguishes between cases involving duty of care and duty of fair dealing.¹⁹¹ In essence, the ALI concludes that due care cases demand less judicial intervention, finding that such cases rarely yield a significant recovery to the corporation,¹⁹² and that other means of accountability are available.¹⁹³ In contrast, actions alleging a breach of the duty of fair dealing require closer judicial scrutiny.¹⁹⁴

The ALI's next guiding principle is the need for "expeditious means for screening and dismissing non-meritorious litigation (but without overbroadly precluding meritorious actions as well)."¹⁹⁵ Similarly, for actions surviving this efficient screening process, the ALI seeks to evaluate the suit's overall impact on the corporation by focusing on "the board or committee's evaluation of the action, not simply the plaintiff's allegations."¹⁹⁶

Thus, the ALI, like others, attempts to "steer a middle

189. See *supra* note 51 and accompanying text.

190. ALI FINAL DRAFT, *supra* note 9, intro. note at 588-89.

191. *Id.*

192. *Id.* at 589; see *id.* reporter's note at 592-96 (examining empirical evidence relating to recovery).

193. *Id.* at 589-90.

194. *Id.* at 590. The ALI authorizes heightened substantive review because of the "greater need for judicial oversight in an area where other mechanisms of accountability may be less able to prevent unfair self-dealing and other potential fiduciary abuse." *Id.*

195. *Id.*

196. *Id.* at 591.

course between excessive reliance on litigation remedies and the abolition of any judicial recourse for the shareholder," noting a special concern for "the danger of overdeterrence and the impact of even the potential risk of litigation on the willingness of outside directors to serve."¹⁹⁷ Acknowledging the turbulent past two decades of shareholder derivative litigation, the ALI hopes to smooth and focus that judicial turbulence.¹⁹⁸

B. DUELING STANDARDS

Throughout the initial Tentative Drafts, the ALI advocated a unitary standard¹⁹⁹ of judicial review for shareholder derivative suits. That standard focused on one central inquiry—"whether the board or committee reasonably concluded, based on adequately supported findings that the court deems to warrant reliance, that dismissal was in the best interests of the corporation."²⁰⁰

The Proposed Final Draft, however, reflects an about-face

197. *Id.*

198. The ALI expressed its goals regarding the development of meaningful judicial review as follows:

In overview, the law governing derivative litigation has undergone a period of volatile fluctuations over the last two decades. . . . [A] decade ago dismissals of derivative actions based on the board's rejection of the action were unusual. Within recent years, however, this mode of dismissal has become more and more frequent, and in some jurisdictions substantive judicial review of the basis for such dismissal is only authorized under special and limited circumstances. Although [this project] does not seek to reverse the trend toward use of board or committee review and evaluation as a basis for dismissal, it does aim to ensure that this procedural mechanism will develop and frame the central issues in the litigation for judicial examination in a manner that is both reliable and efficient. The end result should be that the board's or committee's determinations serve as a procedural vehicle by which an early screening of the action's probable merit and its likely impact upon the corporation is achieved.

Id. at 591-92.

199. Interestingly, some confusion exists regarding whether the ALI truly considered the initial standard to be unitary. Although the Reporters recently characterized the approach as "unitary," see Memorandum from the Reporters for Corporate Governance to Members of the American Law Institute 9 (March 24, 1992) (on file with author) [hereinafter Reporters' Memorandum], the comments to Tentative Draft No. 8, in describing the arguably "unitary" approach of § 7.08, stated that: "Section 7.08 is premised on the judgment that this issue cannot be satisfactorily resolved by any mechanical or unitary formula, because it depends heavily on the relative need for a litigation remedy, which differs depending on the context and the legal rights at issue." ALI 1988 TENTATIVE DRAFT, *supra* note 84, § 7.08 cmt. c, at 120.

200. Reporters' Memorandum, *supra* note 199, at 9; see also ALI 1988 TENTATIVE DRAFT, *supra* note 84, § 7.09(b).

on the substantive standard of review. The new bifurcated standard varies the level of judicial review depending upon the nature of the plaintiff's underlying allegations. The Reporters summarized these significant changes for the ALI members before the annual meeting in May 1992:

Under this bifurcated standard: (i) If the gravamen of the complaint is that the defendant violated either a duty under Part IV (Duty of Care) other than a knowing and culpable violation of law, or a duty under Part V (Duty of Fair Dealing) that would be reviewed under the business judgment rule in the absence of a board or committee recommendation, then the substantive standard of review of the board or committee recommendation should also be the business judgment rule. (ii) In other cases governed by Part V, or to which the business judgment rule is not applicable, including cases involving a knowing and culpable violation of law, the substantive standard of review of a board or committee recommendation is whether the board of committee "reasonably determined" that dismissal is in the best interests of the corporation, based on grounds that the court deems to warrant reliance.²⁰¹

The ALI bases this bifurcated approach "on the traditional distinction between the minimal role of the courts in relation to business decisions, on the one hand, and their greater role in matters involving alleged self-dealing, on the other."²⁰²

Before delving more deeply into the complexities of the ALI's bifurcated standard, it should be noted that as a threshold matter the ALI elsewhere provides another, simpler basis for determining the applicable standard of review. Section 7.07 focuses on the defendants' identities. For actions against third parties—persons²⁰³ other than directors,²⁰⁴ senior executives,²⁰⁵ those controlling the corporation,²⁰⁶ or an associate²⁰⁷ of any such person—the court will apply the business judgment rule²⁰⁸

201. Reporters' Memorandum, *supra* note 199, at 9-10.

202. ALI FINAL DRAFT, *supra* note 9, § 7.10 cmt. c, at 730. The ALI supports this approach in part by its conclusion that derivative suits historically have been "more effective, and less controversial, in enforcing the duty of fair dealing than the duty of care." *Id.* This perhaps is "because litigation is often the only practical recourse where substantial self-dealing is involved, while market and other forces have proven more effective in promoting" adherence to duty of care. *Id.* at 730-31.

203. *Id.* § 1.28 (defining "person").

204. *Id.* § 1.13 (defining "director").

205. *Id.* § 1.33 (defining "senior executive").

206. *Id.* § 1.08 (defining "persons in control").

207. *Id.* § 1.03 (defining "associate").

208. Section 4.01 addresses the application of the business judgment rule. That section provides that directors and officers have fulfilled their duty to the corporation if they (1) are "not interested . . . in the subject of the business judgment; (2) [are reasonably well] informed with respect to the subject of the

to management's determination²⁰⁹ that a shareholder action should be discontinued. Citing a "trilogy of Supreme Court decisions,"²¹⁰ the Reporters conclude that shareholder suits to compel corporate action against third parties are not significant to the overall system of corporate governance.²¹¹ Thus, since "little basis exists for a court to dispute the judgment of the board,"²¹² the ALI advocates a "minimal standard"²¹³ of judicial review in this context.

The vast bulk of shareholder derivative suits, however, proceed beyond the threshold, since they involve actions against corporate insiders rather than third parties. For these more serious suits, "[s]ection 7.08 outlines an integrated framework for judicial review of a decision by a board, or a committee thereof, to seek dismissal of a derivative action brought in the name or right of their corporation."²¹⁴ The outline provides that the court should dismiss a derivative suit at the behest of management if the board or delegated committee, having followed the procedural requisites of section 7.09,²¹⁵ determines

business judgment . . . [and] (3) rationally believ[e] that the business judgment is in the best interests of the corporation." *Id.* § 4.01(c). Anyone challenging a director's or officer's conduct bears the burden of establishing that management did not act within the above guidelines. *See id.* § 4.01(d).

209. The business judgment rule applies regardless of whether the determination was by the board or by an appointed committee. *See id.* § 7.07(a)(1).

210. *See United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903); *Hawes v. City of Oakland*, 104 U.S. 450 (1881).

211. According to the ALI Reporters:

Boards are better equipped and positioned than are courts to determine whether litigation against a stranger to the corporation is justified. In addition, litigation against a person other than a senior corporate official generally has little significance to the overall system of corporate governance. Actions against such strangers to the corporation neither enable shareholders to hold management accountable nor perform any other oversight function that management cannot be relied upon to carry out in a superior fashion.

ALI FINAL DRAFT, *supra* note 9, § 7.07 cmt. c, at 698-99.

212. *Id.* at 698.

213. *Id.* at 699.

214. *Id.* § 7.08 cmt. a, at 703.

215. Section 7.09(a) sets forth

four prerequisites to an objective [judicial] inquiry . . . : (1) a disinterested decisionmaker 'capable of objective judgment under the circumstances'; (2) the assistance of counsel and other agents as may be reasonably necessary . . . ; (3) an evaluative process that meets the standard[s] of § 7.10; and (4) the preparation of a [writing detailing] the . . . determinations . . . sufficient[ly] to enable meaningful judicial review.

Id. § 7.09 cmt. a, at 708-09. If the board or committee does not satisfy these

that the action is contrary to the corporation's best interests, and management's determination satisfies the standard of review set forth in section 7.10.

In most derivative suits, therefore, the complex standards of review found in section 7.10 will apply. Section 7.10 is the heart of the ALI's proposed judicial standard of review, covering more than forty pages in the Final Proposed Draft.²¹⁶ Under this section, courts must first consider whether dismissal would permit a defendant (or associate) to retain a "significant improper benefit."²¹⁷ If so, the court will not dismiss based on a board or committee motion seeking dismissal.²¹⁸ If, however, the action does not involve retaining an improper benefit, the applicable standard of review will depend on the character of the alleged misconduct—whether the "gravamen" of plaintiff's claim relates to duty of care or duty of fair dealing.²¹⁹ A looser

procedural requirements, the court "should permit" an opportunity to rectify the situation. *Id.* § 7.09(b).

216. *See id.* § 7.10, at 725-66.

217. *Id.* § 7.10(b). Plaintiff bears the burden of establishing that the defendant retaining the significant improper benefit "possesses control . . . of the corporation," or that the benefit was obtained fraudulently or without advance authorization or the requisite ratification. *Id.*

218. Although plaintiff bears the burden of establishing the existence of an improper benefit, the corporation can still obtain dismissal by showing that the suit's continuation would cause severe corporate injury that "convincingly outweighs" any injury to the public interest from dismissal. John C. Coffee, Jr., *The ALI Corporate Governance Project*, N.Y. L.J., June 9, 1992, at 1, 5, 6 n.21 (noting that this test reflects amendments approved on the floor of the 1992 Annual Meeting).

219. *See* ALI FINAL DRAFT, *supra* note 9, § 7.10(a). More specifically, the ALI states in § 7.10(a)(1) that the business judgment rule should apply to the board's or committee's determinations whenever

the gravamen of the claim is that the defendant violated a duty set forth in Part IV (Duty of Care), other than by committing a knowing and culpable violation of law, that is alleged with particularity, or if the underlying transaction or conduct would be reviewed under the business judgment rule under §§ 5.03, 5.04, 5.05, 5.06, 5.08, or 6.02.

Id. § 7.10(a)(1). Thus, courts should apply the business judgment rule in a variety of settings, mainly involving "Part IV" violations of duty, which are essentially problems of neglect and mismanagement. The ALI Reporters describe the important protections afforded by the business judgment rule in the following way:

The basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation, and other creative entrepreneurial activities. Shareholders, with expectations of greater profit, accept the risk that an informed business decision — honestly undertaken and rationally believed to be in the best interests of the corporation — may not be vindicated by sub-

standard of review, the business judgment rule, will apply to ordinary duty of care cases, whereas greater scrutiny is permitted for duty of fair dealing cases.²²⁰

Several basic assumptions underlie this dual structure. First, the ALI Reporters conclude that duty of fair dealing violations represent a more serious threat to the integrity of the corporate system than violations of the duty of care.²²¹ Similarly, the ALI finds the potential for litigation abuse to be "much lower" in self-dealing situations, "because self-interested transactions occur less frequently."²²² As a result, the ALI willingly advocates more rigorous controls for duty of loyalty problems.

The heightened review standard for duty of loyalty cases is

sequent success. The special protection afforded business judgments is also based on a desire to limit litigation and judicial intrusiveness with respect to private-sector business decisionmaking.

Id. pt. IV, intro. note a, at 176. After all, the directors' and officers' duty of care is "to act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management." *Id.* pt. IV, intro. note c, at 179 (quoting *The Corporate Director's Guidebook*, 33 BUS. LAW 1591, 1599-1600 (1978)). In addition, § 7.10 triggers the business judgment rule's application when the underlying "misconduct" is the authorization or ratification of certain management decisions, or consists of conduct on behalf of management "associates" or actions blocking unsolicited tender offers. These include executive compensation decisions, use of corporate property or position to obtain financial benefit, taking advantage of corporate opportunities, and acts in competition with the corporation. *See id.* §§ 5.03-06, 5.08, 6.02.

Pursuant to § 7.10(a)(2), a different, more stringent standard applies to "other cases governed by Part V (Duty of Fair Dealing) or to which the business judgment rule is not applicable." *Id.* § 7.10(a)(2). In contrast to the duty of care cases, duty of fair dealing claims implicate the "basic principle . . . that the director should not use his corporate position to make a personal profit or gain other personal advantage . . ." *Id.* pt. IV, intro. note c, at 179 (quoting *The Corporate Director's Guidebook*, *supra*, at 1599-1600). Duty of loyalty claims include "fraud, self-dealing, misappropriation of corporate opportunities, improper diversions of corporate assets, and other similar matters" implicating conflicts between management's interest and the corporation's welfare. *Id.* at 179-80. In addition to the duty of fair dealing cases, the heightened standard also applies to any "knowing and culpable violation of law in breach of Part IV's" duty of care. *Id.* § 7.10(a)(2).

220. *See id.* The ALI formulated this dual standard upon reaching the following judgments about two "competing considerations": first, "[e]arly review and screening of derivative actions" is essential to avoid undesirable incentives for plaintiff to bring suits possessing only marginal merit; and second, judicial review of corporate management's decision is also essential to ensure that their fiduciary obligations remain meaningful. *Id.* cmt. c, at 730.

221. *Id.* § 7.10 cmt. d, at 732.

222. *Id.* at 733. In contrast, duty of care concerns are "constant and pervasive" in business, "and some business decisions will necessarily prove unwise." *Id.*

actually the same unitary standard that the ALI Reporters advocated for all cases through the earlier Tentative Drafts.²²³ Under section 7.10(a)(2), "the court should dismiss the action if the court finds . . . that the board or committee was adequately informed under the circumstances and reasonably determined that dismissal was in the best interests of the corporation, based on grounds that the court deems to warrant reliance."²²⁴ In essence, "the court is . . . looking to whether dismissal of the action would be fair to the corporation."²²⁵ This standard of review focuses on management's reasoning in requesting dismissal²²⁶ and may take account of structural and procedural matters underlying the decision.²²⁷ In addition, the court must evaluate whether management's determinations "warrant reliance."²²⁸ Thus, courts must engage in more probing inquiry than a simple application of the business judgment rule.²²⁹ Rather than requiring de novo consideration or detailed judicial fact-finding, however, this standard contemplates flexible judicial scrutiny, which may include examination of a variety of specified factors.²³⁰

C. PLAINTIFFS' FORMIDABLE BURDENS OF PROOF

As a result of these dueling standards and other provisions included in the Proposed Final Draft, plaintiffs proceeding under the ALI's recommended approach face multiple, formidable burdens of proof. They first must meet a heightened pleading requirement added as a last-minute amendment to

223. See *supra* notes 199-200 and accompanying text.

224. See ALI FINAL DRAFT, *supra* note 9, § 7.10(a)(2).

225. *Id.* § 7.10 cmt. e, at 737.

226. Section 7.10(a)(2) requires that the reviewing court receive the actual justifications for the decision, rather than letting the court speculate about what those justifications might have been. See *id.* at 738.

227. *Id.*

228. *Id.* § 710(a)(2).

229. See *id.* § 7.10 cmt. f, at 740.

230. These factors include:

- (1) whether the issue involved is one of law or fact and whether business considerations are primarily involved;
- (2) the plausibility of the reasons given for dismissal in the report of the board or committee;
- (3) the adequacy of the board's or committee's investigation (where the facts are unknown or uncertain);
- (4) the involvement, or lack thereof, of the board in the challenged transaction or incident; and,
- (5) the nature of the underlying claim (i.e., whether it involves conduct or a transaction as to which the defendant bore the burden of proving fairness).

Id. cmt. e, at 739.

section 7.04 at the ALI's annual meeting in 1992.²³¹ Plaintiffs must plead particular facts raising a "significant prospect"²³² that the alleged conduct is unprotected by the business judgment rule or by subsequent approvals.²³³ In addition, should the corporation inform the plaintiffs that disinterested directors have rejected their demand, then the plaintiffs can avoid dismissal only by alleging particularized facts that negate the corporation's statement of disinterest or establish that the rejection failed to satisfy the business judgment rule or was not reasonable in the corporation's best interests.²³⁴ The plaintiffs are not entitled to discovery to help them uncover the particularized facts necessary to meet section 7.04's heightened pleading requirements.²³⁵

Once past this pleading requirement, the plaintiffs still must overcome the business judgment rule's presumption in management's favor should the court determine, in a case involving the duty of care, that judicial review pursuant to section 7.10(a)(1) is appropriate. Even in a duty of loyalty case demanding heightened judicial scrutiny, the corporation will sometimes enjoy the protection of the business judgment rule.²³⁶ Here, at least, upon the appropriate showing, the plaintiff is entitled to limited discovery before the corporation's dis-

231. The ALI's acceptance of the "Smith Amendment" was a compromise reached between warring factions at the annual meeting. See *ALI Wraps Up Corporation Law Project*, *J Works on Lawyer Ethics, Complex Trials*, *supra* note 17, at 2728; Coffee, *supra* note 218, at 1; Barnaby J. Feder, *A Brawl Breaks Out Over Corporate Law*, N.Y. TIMES, May 8, 1992, at D6.

232. Professor John Coffee, the ALI reporter on this matter, acknowledges that the interpretation of "significant prospect" is unclear on its face. Professor Coffee has indicated that the commentary to this section will disclose a balancing approach under which weak allegations will require relatively weak justification for rejection, and stronger allegations will demand something more substantial. See Coffee, *supra* note 218, at 1.

233. See ALI FINAL DRAFT, *supra* note 9, § 7.04(a) (plaintiff must state facts showing "that the conduct or transaction complained of did not meet the applicable requirements of Parts IV (Duty of Care and the Business Judgment Rule), V (Duty of Fair Dealing), or VI (Role of Directors and Shareholders in Transactions in Control and Tender Offers) in light of any approvals of the conduct or transaction communicated to the plaintiff by the corporation").

234. See Coffee, *supra* note 218, at 6 (setting forth text of amended § 7.04, a "convoluted sentence that only an indenture trustee could love").

235. *Id.*

236. For example, if a disinterested board rejects a corporate opportunity after appropriate disclosure, thereby permitting an insider to take advantage of that opportunity, the business judgment rule protects the board decision. Judicial review is pursuant to § 7.10(a)(1). See ALI FINAL DRAFT, *supra* note 9, § 7.10 cmt. f(ii), at 742-43; see also *id.* § 7.13(d) & cmt. d, at 784-85 (detailing burdens of proof for plaintiffs and the corporation under various motions).

missal motion is resolved.²³⁷

D. COMPETING PRESSURES PUSH THE PROJECT

During the fourteen years of the Corporate Governance Project,²³⁸ divergent views pushed and pulled the creation of the massive final product. Along the way, commentators debated the relative merits of the proposed unitary standard, which some thought gutted the important protections of the business judgment rule²³⁹ and others thought made key advances towards allowing essential judicial oversight.²⁴⁰ In addition, some commentators criticized the ALI's emphasis on the distinction between duty of care cases and duty of loyalty cases as misplaced.²⁴¹ Still other commentators followed the project

237. *Id.* § 7.13(c). Plaintiff must demonstrate "that a substantial issue exists whether the applicable standards" have been met and that the information is not otherwise available "without undue hardship." *Id.*

238. ALI President Roswell Perkins has written an in-depth discussion of the origins and purposes of the Corporate Governance Project. See Roswell B. Perkins, *The Genesis and Goals of the ALI Corporate Governance Project*, 8 CARDOZO L. REV. 661 (1987); see also Donald E. Schwartz et al., *Genesis: Panel Response*, 8 CARDOZO L. REV. 687 (1987) (panel discussion regarding Corporate Governance Project's origins, goals, and progress).

239. See, e.g., Block et al., *supra* note 13, at 504-07 (stating that the ALI's proposed judicial review would discourage directors from serving and would cause overcautious decision making); Dooley & Veasey, *supra* note 115, at 514-15 (ALI's proposals would strip board of important protections and would result in intrusive judicial inquiry); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 52-54 (1987) (ALI approach fails to deter frivolous suits); Bryan F. Smith, *Corporate Governance: A Director's View*, 37 U. MIAMI L. REV. 273, 291 (1983) (ALI approach would require too much of busy directors); E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 BUS. LAW. 2065, 2074 (1990) (ALI "exalts concepts of structural bias and departs significantly from traditional business judgment rule treatment"); see also *ALI Wraps Up Corporation Law Project[,]* *Works on Lawyer Ethics, Complex Trials*, *supra* note 17, at 2727 (noting that lawyers aligned with the business community objected throughout the Corporate Governance Project).

240. See, e.g., Cox, *supra* note 12, at 994-1011 (endorsing ALI objectives and urging more flexible standards for judicial review); Perkins, *supra* note 238, at 680 (unitary standards provide important judicial flexibility); Schwartz, *supra* note 238, at 689 (ALI struck proper balance between burdens and benefits of derivative suits); Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 943-46 (1983).

241. Interestingly, even the earlier "unitary" standard reflected that distinction. See ALI 1988 TENTATIVE DRAFT, *supra* note 84, § 7.08(c). Commentators have attacked this distinction, arguing that directors are not likely to approach the two types any differently and that the two categories sometimes blur. See Block et al., *supra* note 13, at 507; Dooley & Veasey, *supra* note 115, at 540; see also Dooley, *supra* note 121, at 508 (criticizing the distinction as ill-founded and difficult to apply).

with less enthusiasm, finding that the ALI proposals only reflected current law.

Even the Proposed Final Draft, with its more conservative bifurcated standard, continues to spark controversy. At the ALI's sixty-ninth annual meeting in May 1992, corporate practitioners threatened to "outbalance" other factions during the all-important vote.²⁴² Representatives of the Business Roundtable sought to amend the Proposed Final Draft to substitute a business judgment standard that would apply to all termination decisions.²⁴³ The *New York Times* predicted that the various business law factions would undoubtedly "brawl" at the annual meeting.²⁴⁴ Ultimately, however, the ALI overwhelmingly approved the Principles of Corporate Governance, subject to certain amendments supported by the Reporters.²⁴⁵ As Professor Jonathan Macey pointed out, "the controversy surrounding the project forced more democracy upon the ALI."²⁴⁶

With approval of the Proposed Final Draft, commentators can now begin to weigh the pros and cons of the bifurcated review standard. Some contend that the ALI proposals tip the balance too far in management's favor, calling the outcome a victory for the business lobby.²⁴⁷ These voices argue that the

242. In his letter to the ALI members on April 13, 1992, ALI President Roswell B. Perkins stressed the importance of high attendance at the Corporate Governance Sessions, saying:

A major campaign is underway to assure high attendance on May 12 and 13 by members who are corporate practitioners. Such an attendance is to be applauded, since the corporate bar clearly has expertise and special insights into the issues. However, it is important that this effort not result in an imbalance of representation at the meeting. The ALI has been built on the premise that generalists, such as judges and general practitioners, and also practitioners and academics who may concentrate in other fields, are critical in formulating balanced Institute positions.

Accordingly, I urge that all members make every possible effort to attend and to be present when the most important issues are discussed and voted on

Letter from Roswell B. Perkins, President of the American Law Institute, to Members 1-2 (April 13, 1992) (on file with author).

243. Coffee, *supra* note 218, at 5.

244. See Feder, *supra* note 231, at D6.

245. Coffee, *supra* note 218, at 1.

246. Macey, *supra* note 14, at A21.

247. See, e.g., Kenneth Jost, *Business Lawyers Win Showdown Vote in ALI: Tough Line on Shareholder Suits*, *LEGAL TIMES*, May 18, 1992, at 2. Professor Coffee notes that although the derivative suit sections "had long been a lightning rod for criticism from those who feared that it liberalized the standards," the "most original provisions . . . probably have the opposite impact." Coffee, *supra* note 218, at 5.

shareholder plaintiff faces overly rigorous hurdles at the pleading stage and, even if that is surmounted, again when the corporation recommends dismissal.²⁴⁸

From the opposing perspective, some criticize the ALI's recommendations as too pro-plaintiff. For example, Professor Dooley contends that the ALI has effectively transferred ultimate decision-making authority from the board "to any shareholder willing to sign a complaint."²⁴⁹ Those seeking greater management control generally prefer the universal application of the business judgment rule, resisting the ALI's allowance of heightened judicial scrutiny in duty of loyalty cases.²⁵⁰

Professor John Coffee, who served as Reporter to the project, calls the proposal "modest"; when responding to critics who fear that the Draft permits too extensive a judicial inquiry, he humorously chides that "Chicken Little's fears were more realistic."²⁵¹ Furthermore, even if the ALI compromise works to plaintiffs' disadvantage, that might be viewed as "the price of giving the board a serious role in the process before the plaintiff is permitted to conscript the corporation."²⁵²

The ultimate impact of the ALI Corporate Governance Project remains to be seen.²⁵³ Indicating its likely importance,

248. See Coffee, *supra* note 218, at 6. Another key concern is the absence of discovery before plaintiff must meet the particularized pleading requirements. See *id.*; *ALI Wraps Up Corporation Law Project[,] Works on Lawyer Ethics, Complex Trials*, *supra* note 17, at 2728 (citing Professor Joel Seligman's concerns that the enhanced pleading requirement, in the absence of discovery, "would permit corporations to defeat meritorious claims").

249. Michael P. Dooley, *Not in the Corporation's Best Interests*, A.B.A. J., May 1992, at 45. Professor Dooley was also concerned that the ALI proposal, by making the standard of judicial review somewhat dependent upon the nature of plaintiff's allegations, puts too much power in the hands of plaintiff's attorney. See *id.*

250. See Coffee, *supra* note 218, at 5.

251. John C. Coffee, *A Watchdog for the Guardians*, A.B.A. J., May 1992, at 44.

252. Coffee, *supra* note 218, at 6. In any event, Professor Coffee believes that the bifurcated standard ultimately preserves a greater measure of judicial discretion by permitting the courts to get beyond mere procedural issues to the substantive merits in the most important cases. *Id.*

253. Professor Coffee characterized this uncertainty as follows:

Now that the ALI Corporate Governance Project, which began in 1978, has completed its 14-year odyssey, should anyone care? Will it have any impact, or sink like a stone in the deep sea of proposed legal standards? . . . [I]s there any reason for the corporate lawyer to review and become familiar with this 1000-plus page document, which cannot claim to state the settled law of any specific jurisdiction?"

Id. Professor Coffee suggests that the Project's most significant effect probably is that it provides "the only authoritative, comprehensive codification of fi-

however, some courts have already cited the derivative suit sections.²⁵⁴

E. THE CONFUSING ALI COMPROMISE APPROACH: TIPPING THE BALANCE TOWARD MANAGEMENT

Through its Corporate Governance Project, the ALI had a unique opportunity to provide clarity and balance to shareholder derivative litigation, a field long in serious disarray. Divergent review standards result in uncertain judicial application. The competing tensions underlying management and shareholder rights create a see-saw battle in which courts precariously juggle deference to management's business judgments with a desire to permit substantive review of plaintiff's allegations. The increased use and acceptance of special litigation committees has exacerbated the situation by virtually eliminating meaningful substantive review of shareholder allegations.

Given the fragile, ailing condition of derivative litigation,²⁵⁵ the ALI faced an enormous task. Fourteen years in the making, the Proposed Final Draft of the massive Corporate Governance Project has been long debated and awaited. The Corporate Governance Project could have both resolved the tremendous judicial confusion surrounding review standards and provided a more even balance between management and shareholder rights.²⁵⁶ Unfortunately, the Proposed Final Draft effectively does neither. Its standards of review are so procedurally convoluted as to be unworkable, and are substantively premised on faulty distinctions. Moreover, the ALI's recommendations ultimately favor management to the detriment of

duciary duties to which either a court or a practitioner can turn today for bottom line answers." *Id.*; see also Perkins, *supra* note 238, at 683-84.

254. See, e.g., Greenfield v. Hamilton Oil Corp., 760 P.2d 664, 667 (Colo. Ct. App. 1988); Miller v. Register & Trib. Syndicate, Inc., 336 N.W.2d 709, 717 (Iowa 1983); Alford v. Shaw, 358 S.E.2d 323, 327 (N.C. 1987). Of course, these cites were to the Tentative Drafts prior to the Final Proposed Draft released in 1992.

255. See Cox, *supra* note 12, at 994-97 (characterizing the ALI project as a thoughtful and sweeping review of what ails the derivative suit); John C. Coffee & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 261 (1981) (declaring that the derivative suit "faces extinction").

256. Although the underlying purposes of the Project have been subject to some debate, Reporters Coffee and Schwartz initially envisioned reforms that would restrict the availability of special litigation committees while expanding the court's watchdog role. See Cox, *supra* note 12, at 994; Coffee & Schwartz, *supra* note 255, at 326, 330-36.

important shareholder rights.²⁵⁷

The unitary standard originally advocated by the ALI would have permitted a court to dismiss a derivative suit if corporate management reasonably concluded dismissal to be in the corporation's best interests "[b]ased on adequately supported findings that the court deems to warrant reliance . . ."²⁵⁸ The fact that the court could decide whether management's findings warranted reliance heightened the judicial inquiry from mere deference to an informed business judgment to a more searching evaluation of the basis for management's determination. The corporation had the burden of establishing the key elements, regardless of whether a disinterested body recommended dismissal.²⁵⁹ This initial ALI proposal permitted greater judicial scrutiny than either MBCA section 7.44 or *Auerbach*, and it seemingly exceeded even the much-criticized Delaware two-pronged approach. It permitted substantive inquiry into the underlying merits even in a case that Delaware might normally view as demand-required. The ALI's unitary standard, however, did not permit, as *Zapata* does, the wholesale substitution of the court's business judgment for that of corporate management.

The ALI's original proposal contained much to commend. It applied universally to all types of derivative actions²⁶⁰ and retained the flexibility necessary to permit the courts important discretion in a variety of settings.²⁶¹ This flexibility to examine whether management's recommendation warranted reliance would presumably permit judicial review of the underlying allegations even if the committee could show that it acted reasonably and in a disinterested fashion. For this very reason, business interests attacked the proposed unitary standard as

257. The shareholder derivative sections do, however, provide a comprehensive overview of the current legal approaches. This itself is an important contribution to the existing commentary underlying shareholder derivative issues.

258. ALI 1988 TENTATIVE DRAFT, *supra* note 84, § 7.08(b).

259. *See id.* § 7.11(b). Plaintiff did bear the burden if attempting to establish the retention of an improper benefit pursuant to § 7.08(d). *See id.*

260. The earlier Tentative Drafts did retain, however, the distinction between suits against third parties and those against corporate insiders. *See id.* § 7.07.

261. This flexibility did not come without guidance. For example, the ALI listed expansive considerations that might justify management's recommendation, *see id.* § 7.08(b), and also suggested greater judicial deference in duty of care settings, *see id.* § 7.08(c).

permitting excessive judicial intrusion even beyond the hated *Zapata* dual approach.

Ultimately, the ALI project opted for its two-pronged approach applying a different standard depending upon the "gravamen" of the plaintiff's complaint. The ALI now reserves the more intrusive "warrant[s] reliance" standard for cases implicating the duty of fair dealing and applies the business judgment rule in duty of care cases. Making the principal distinction the difference between duty of care and duty of loyalty cases is a poor choice. Although the nature of defendants' misconduct should play some role in judicial review,²⁶² this factor should not control the applicable standard. For one thing, in a multiple allegation case, the gravamen may not be readily understood. Very few cases involve pure violations of due care without implicating the duty of loyalty.²⁶³ Rather than wallowing in difficult futility determinations, courts will instead find themselves litigating and relitigating what constitutes the gravamen of a shareholder's complaint. In addition, the distinction might well motivate clever pleaders to find a colorable claim of self-interest in virtually every setting. Even if courts are able to resolve this threshold characterization issue, the distinction lacks compelling support. The injury to plaintiff shareholders is just as palpable when directors breach their duty of care as it is when they violate their duty of loyalty. Moreover, it may not be rational to assume that management's determination will more likely lack integrity in breach of loyalty cases than in other types of conflicts.²⁶⁴

Another flaw in the ALI's final proposed standard is the burden plaintiffs face due to their diminished opportunity for discovery. As the debate at the ALI's annual meeting reflected,²⁶⁵ there was considerable support for permitting plaintiffs some limited discovery before requiring detailed pleadings. Management controls all relevant facts in the corporate setting;

262. For example, the nature of the underlying allegations could be one factor when considering whether the committee acted reasonably and in the corporation's best interests. In fact, the ALI's earlier drafts treated the due care/duty of loyalty distinction in this manner. *See id.* § 7.08.

263. *See* Dooley, *supra* note 121, at 508 (noting that there are very few "pure" due care cases).

264. Professor Michael Dooley expressed this conclusion in the following colorful manner: "Unless one assumes that cheating is a communicable disease against which only judges have been inoculated, the nature of the individual actor's conduct is not a sufficient reason to change tribunals and transfer the traditional authority of independent directors to the courts." *Id.* at 506.

265. *See supra* note 248 and accompanying text.

plaintiff shareholders will be hard-pressed to support their suspicions with particularized facts in the absence of discovery. The actual applicable standard of judicial review may be a moot question if the plaintiff cannot produce adequate particularized pleadings.

Finally, from a practical perspective, the multi-layered rule, which is cross-referenced over numerous sections and described in more than one hundred pages, will be extremely difficult to interpret and apply. In its effort to be comprehensive and to cut a compromise across diverse business interests, the ALI has created a virtually unworkable set of interrelated standards that raises more questions than it answers. The sections themselves are sometimes difficult to follow,²⁶⁶ and the references to other sections equally lengthy and complex will likely make application of these standards quite daunting. Should a court face multiple claims raising both duty of due care and duty of loyalty issues, one can only imagine the difficulties of tracking the appropriate standards through the ALI provisions.

Although the actual impact of the ALI's recommendations may not be clear for years,²⁶⁷ one result is immediately apparent. The Corporate Governance Project represents an opportunity lost. Rather than clarifying muddled legal doctrine that all too often keeps plaintiff shareholders out of court because of irrational procedural restrictions, the ALI recommendations themselves lack clarity and allow the delicate balance between management and shareholder rights to slip too far in the corporate board's favor. The difficult political climate in which the ALI operated may explain the Corporate Governance Project's convoluted compromise. After all, the business lobby threatened to vote for the more deferential business judgment rule standard had the ALI Reporters not been flexible enough to accommodate corporate management's concerns.²⁶⁸ Certainly, a unitary business judgment rule standard would be far worse than the flexibility now permitted under section 7.10. Unfortunately, the daunting burdens imposed on plaintiffs significantly undercuts that flexibility. Thus, the ALI standards fall far short of expectations, but this result may have been the unfortunate price of achieving a compromise acceptable to all ALI factions.²⁶⁹

266. See, e.g., *supra* note 234.

267. See *supra* note 253 and accompanying text.

268. See *supra* text accompanying note 243.

269. See *supra* note 252 and accompanying text.

III. ACHIEVING A MEANINGFUL BALANCE BETWEEN SHAREHOLDER RIGHTS AND STRIKE SUITS

A. THE FRAMEWORK FOR CREATING MEANINGFUL REVIEW

The intricate balance to be struck between management's ability to govern and a shareholder's right to accountability looms large in the 1990s.²⁷⁰ The ingenious and uniquely complicated remedy that is shareholder derivative litigation lies in disarray. As this Article demonstrates, the tensions underlying derivative suits have created a diverse assortment of inconsistent standards relating to shareholder demand and judicial review. Every jurisdiction requires demand, yet most excuse the requirement under unpredictable circumstances.²⁷¹ Special litigation committees have developed into a uniquely powerful voice for corporate boards seeking dismissal of derivative suits, yet the judicial review of committee recommendations ranges from total deference to nonrecognition.²⁷² Given this perplexing legal treatment, shareholder derivative suits may not be dead, but their value is at least seriously diminished.²⁷³

Nonetheless, shareholder derivative litigation does have unique significance and must be encouraged so long as its attendant costs are reasonably monitored and contained. Derivative suits supply a special opportunity that general shareholder litigation does not offer. Although the role of derivative litigation should not be idealized, this extraordinary remedy has been the last and only resort of shareholders seeking to redress corporate wrongs. Unless shareholders retain an effective

270. Three commentators recently described this significant controversy:

As the 1990s begin, the business judgment rule's application to the demand requirement and to decisions by disinterested directors acting in good faith and with due care to refuse such shareholder demands remains the focus of considerable discussion by academics and commentators, and in courtrooms, state legislatures, and boardrooms. The ultimate resolution of the rule's proper role in shareholder litigation will in large measure determine the extent to which shareholder grievances concerning corporate decisions that go awry or which do not please all shareholders will be resolved by directors elected by the majority of the corporation's shareholders, and to what extent such disputes will be decided by the courts at the behest of minority shareholders.

Block et al., *supra* note 13, at 469.

271. See *supra* notes 72-84 and accompanying text.

272. See *supra* text accompanying notes 138-43.

273. See generally Cox, *supra* note 12, at 959-60 ("Like the heroine in a Saturday matinee, the derivative suit has repeatedly appeared to be at the cliffs of disaster . . . [The] latest threat to the derivative suit is the special litigation committee . . .").

method for judicial review of alleged corporate wrongdoing, no remedy will exist. Corporations, as separate entities created by the states to generate and carry out commerce throughout this country, deserve some meaningful mechanism for preventing managerial pillaging. Derivative suits specifically target conduct that exclusively injures the corporation itself; they protect this state-generated entity that lacks a voice of its own.²⁷⁴

Equally valuable, however, are the significant policies supporting the business judgment rule and the corresponding conclusion that courts should defer to management's business judgment that derivative actions be dismissed. Unwarranted judicial intrusion is ineffective and undesirable for corporations and courts alike. A proposed review standard must accommodate management's legitimate concerns, as well as those of plaintiff shareholders.

Regardless of which side of the debate seems more supportable in theory, statistics demonstrate that management almost inevitably rejects shareholder demands, and shareholders bring derivative suits only infrequently.²⁷⁵ Assuming, then, that the balance has swung out of shareholders' reach, any new substantive standard should allow greater meaningful judicial intervention while preserving the important principle of permitting corporate management to reach informed business judgments without undue interference.

Apart from seeking a substantive balance between the two key competing interests, an improved standard should meet certain important procedural goals as well. For example, a standard of judicial review should reflect clarity and ease of application. A clear and straightforward rule encourages ready adoption by the courts, as well as predictable and effective application. These goals appear to support a unitary over a multi-pronged standard. Perhaps the best example of how a unified rule can resolve unnecessary judicial confusion in the context of shareholder derivative suits is the recent movement towards universal demand.

B. UNIVERSAL DEMAND: A DESIRABLE REFORM NECESSITATING A NEW LOOK AT BALANCED REVIEW

The universal demand approach is now supplanting the fu-

274. Although other means of deterrence do exist, they do not eliminate the need for the extraordinary remedy provided by derivative litigation. See *supra* notes 43-47 and accompanying text.

275. See *supra* notes 118-21 and accompanying text.

tility doctrine, after decades of struggle over the exception's application and interpretation.²⁷⁶ Important issues of corporate governance have hinged on the procedural questions of whether the shareholder first made an appropriate demand and, if not, whether that demand was excused. The judicial maelstrom swirling around these procedural points obscured the more serious issues surrounding the claimed management misconduct that gave rise to the litigation in the first place. Since commentators and the courts have almost uniformly criticized the morass of litigation surrounding the futility doctrine in recent years, a unified procedural approach seems a natural resolution.

Indeed, universal demand is the clear modern trend, and strong policies support the new standard. As noted earlier, many significant purposes support the making of demand,²⁷⁷ even if corporate management rarely responds supportively.²⁷⁸ The benefits outweigh the relatively low cost associated with shareholders submitting a demand to the board. Eliminating the futility exception reduces the tortured judicial inquiries in this area, and accordingly necessitates a different judicial review standard in those jurisdictions previously following the much-maligned "demand required, demand excused" distinction.²⁷⁹ Both the MBCA and the Corporate Governance Project adopt universal demand with a proviso that permits shareholders to avoid making a demand by showing irreparable injury.²⁸⁰

276. See *supra* notes 83-84 and accompanying text.

277. Courts endlessly stress the traditional notion that boards of directors govern, and that courts should not needlessly displace their judgment. Thus, allowing boards the first chance to address shareholder concerns makes good sense from both a business and policy perspective. In addition, courts themselves would benefit from an approach that enlarges the possibility that business disputes might be resolved short of the courthouse steps. See *supra* notes 59-69 and accompanying text.

278. See *supra* notes 118-21 and accompanying text.

279. Most commentators agree that judicial review should not hinge on whether a shareholder sent a demand letter first to the board of directors. In an absurd twist to an already ill-founded approach, shareholders can be penalized for mistakenly making a demand where futility could have been shown. Once demand is made, some courts have found a waiver of the futility exception and have applied the "demand required" standard of judicial review. Although the Delaware approach arguably is designed to prevent interested directors from benefiting from the business judgment rule, the anomalous waiver result demonstrates the weaknesses inherent in even the best reasons underlying this dual standard.

280. See MODEL BUSINESS CORP. ACT § 7.42 (1991); ALI FINAL DRAFT, *supra* note 9, § 7.03. Although it is unclear what shareholders must demon-

C. A PROPOSED STANDARD

With the universal demand approach leading the way for substantial reform in shareholder derivative litigation, an effective review standard must now be created to complement the new demand requirement's advantages. Reviewing the current issues surrounding the appropriate standard of judicial review makes apparent the need for radical change. Given the confusing diversity of existing standards, the inconsistent range of deference accorded management's decision that derivative litigation must be discontinued, and the assorted bases separating the applicable standards, it is no small wonder that derivative suit participants face a puzzling and dissatisfying array of options. Assuming that a major change is necessary, then, the next consideration is the appropriate form such change should take.

Although the problems underlying judicial review in this area are indeed complex, a unitary standard would best address these complexities, absent some compelling argument supporting bifurcation. No such argument appears to exist. Assuming that universal demand is the rule, review obviously can no longer vary depending on whether shareholders are required to present a demand to the board, as the *Zapata* standard in Delaware now holds.²⁸¹ Nor does the creation of a dual standard based upon the "gravamen" of a plaintiff's claim, as the ALI advocates, appear optimal. The difficulties associated with sorting out the "gravamen" reduces any advantages such an approach might otherwise offer.

A modified business judgment rule may accommodate the competing policies underlying shareholder derivative litigation. The key feature of this proposal is that the corporation, not the shareholder, would have to meet an initial burden of proof. Courts would have to dismiss a shareholder derivative suit in accordance with management's recommendation so long as the corporation could establish that the decision maker acted reasonably, in good faith, and in a disinterested fashion. This proposed standard somewhat resembles the first prong of

strate, the option does allow the investor to resort to immediate court involvement in the face of extraordinary circumstances.

281. The ABA somewhat retained this distinction through the burden-shifting device in § 7.44. See MODEL BUSINESS CORP. ACT § 7.44 & official cmt. 2 (1991). Although the presence of self-interest can be important to judicial review, it should not provide a separate basis for bifurcation.

Delaware's *Zapata* rule.²⁸² Unlike *Zapata's* second prong, however, the suggested standard would not permit the court to substitute its own business judgment for that of management.²⁸³ In determining whether the corporation has met its burden, the court would be able to consider all relevant justifications for management's determination, including the seriousness and weight of the plaintiff's allegations. Naturally, the proposed standard would omit the heightened pleading obligation appearing in the amended MBCA section 7.04, opting instead for the usual notice pleading requirements. This rule would protect corporate management by disallowing judicial intrusion into the substantive allegations except to the minimal extent necessary for the corporation to meet its burden.

Placing the burden on the corporation makes good sense. After all, corporate management possesses all the relevant information and facts surrounding the determination to discontinue the derivative litigation. The corporation should be able to present the requisite showing in a cost-effective manner. In response to a shareholder's demand, the corporation will presumably conduct a reasonable inquiry assembling relevant underlying facts.²⁸⁴ Moreover, the standards of good faith and reasonableness are quite low and should be readily met. Given the general judicial reluctance to meddle in the corporate sphere, this proposed standard should not overly concern corporate practitioners.

The proposed review standard is also consistent with the ALI's procedural rules requiring judicial oversight of derivative suit settlements because of possible collusion among the parties.²⁸⁵ Given that possibility of impropriety, the proponents of settlement bear the burden of showing that it warrants approval and is consistent with public policy.²⁸⁶ The broad judicial discretion underlying settlement approval has already been used as the basis for extensive review of management's dismissal recommendations.²⁸⁷

282. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981). See *supra* notes 159-69 and accompanying text.

283. See *supra* notes 162-63 and accompanying text.

284. The ALI contemplates the necessity of a written report summarizing the decision maker's considerations. See ALI FINAL DRAFT, *supra* note 9, § 7.09(4) (management must prepare a written report sufficient to permit § 7.10 review). The MBCA does not require a written report. See MODEL BUSINESS CORP. ACT § 7.44 official cmt. 2.

285. See ALI FINAL DRAFT, *supra* note 9, § 7.14 cmts. a, c, at 797-800.

286. See *id.* reporter's note 1, at 808.

287. See *Alford v. Shaw*, 258 S.E.2d 323, 327 (N.C. 1987).

The suggested standard, including the proposed corporate burden, is also analogous to the "proportionality rule" seen elsewhere in corporate law.²⁸⁸ Management's handling of shareholder demands in derivative suits suggest an appearance of bias similar to management's adoption of takeover defense strategies when faced with the threat of takeover. Although board decisions of this type have normally been subject to a simple business judgment rule analysis, courts gradually have become conscious of the potential bias of boards protecting their own positions when defending against aggressor entities. Acknowledging this inherent underlying conflict, the Delaware court imposed a modified standard of review requiring the corporation to establish its good faith, reasonableness, and more.²⁸⁹ In the derivative suit context, the appearance of bias should similarly impose upon corporations the relatively benign burden of establishing the business judgment rule prerequisites.

Although the business lobby will undoubtedly oppose this proposed standard as too intrusive, a quick review of similar concerns demonstrates that such fears are unfounded. For example, despite numerous dire predictions following the *Zapata* decision, no subsequent court following Delaware law has actually applied the much-dreaded second prong, which allows courts to substitute their business judgment for that of the corporation. Similarly, the application of the more onerous proportionality rule in the takeovers context only rarely results in a ruling against management.

Those supporting a heightened level of judicial inquiry will likely criticize the proposed standard for not extending far enough. After all, the rule does not permit review beyond the procedural soundness of the corporate committee's decision to recommend dismissal of the shareholder's suit. In almost all instances, restricting review to that level does provide the best possible result for the courts and for shareholders alike. Given the high likelihood that management can meet its burden and enjoy the business judgment rule's protection, the question remains as to whether the court should retain some degree of flexibility to pass on particularly egregious suits otherwise beyond reach. Despite this legitimate policy concern, the advantages supporting the business judgment rule and a straightforward review standard preclude caveats permitting

288. See *supra* notes 133-37 and accompanying text.

289. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 946 (Del. 1985).

heightened review in particular circumstances.²⁹⁰

Consistent with the desire for simplicity, the proposed standard of review would remain constant despite the presence of other variables. For example, the basic rule would not change regardless of the gravamen of plaintiffs' claims. As a practical matter, however, the inclusion of substantive self-interest allegations should naturally make the corporation's burden of proof more difficult to establish. In contrast, the corporation could more easily show the reasonableness of its decision maker's determination in the face of mere allegations of corporate mismanagement implicating duty of care. Similarly, this proposed standard would apply regardless of the defendants' identities. On the one hand, where the defendants are third parties rather than corporate insiders, management's burden will be easily satisfied. On the other hand, claims against management should necessarily make the corporation's burden of proof more difficult. Thus, the one standard provides the inherent flexibility essential to the broad range of possible shareholder derivative claims.

At this point, given the divergent views espoused by the ABA and the ALI, it is unclear what cues the courts will take. Both well-respected bodies have strong effects on how judicial opinion and legislation shape corporate law. Legal scholars and practitioners alike may agree that the ultimate goal is to construct a sophisticated procedural gate that permits meritorious shareholder suits to proceed to the merits, while shutting out strike suits. Unfortunately, in attempting to juggle the diverse interests of corporate management and shareholders, the Corporate Governance Project allows that gate to close too far. A modified business judgment rule would provide the sensitive balance satisfactory to the policy needs of both factions.

CONCLUSION

In this controversy-plagued area of the law, commentators have quarreled for decades over the need for change and what form change might take. In recent times, the American Bar Association, through its Model Business Corporation Act, and especially the American Law Institute, in its 1992 Corporate Governance Project, have contributed thoughtful commentaries

290. An example of a caveat increasing judicial flexibility is the ALI's § 7.10(b), which permits plaintiff to avoid dismissal by establishing the retention of a significant improper benefit. ALI FINAL DRAFT, *supra* note 9, § 7.10(b).

and meaningful suggestions about how shareholder derivative suits might be handled and reviewed by the courts. Although both suggestions provide helpful direction, neither one is on the mark.

Assuming that courts must require universal demand of shareholders, the appropriate judicial review of the corporation's subsequent refusal of that demand should be clear-cut and must meet a delicate balance. Although the courts must not encourage shareholder strike suits, they also must not discourage meritorious derivative litigation from the courthouse steps. The Model Act does not strike the appropriate balance; it merely restates the status quo, protecting corporations under the business judgment rule's shield whenever shareholders cannot disprove management's independence. Although the ALI's more recent proposals allow for broader judicial inquiry, the suggested standards are so convoluted and the burdens imposed on plaintiffs so rigorous, they make the recommendations unworkable and undesirable.

By reviewing the corporate decision maker's determination under this Article's proposed modified business judgment rule should provide the appropriate unitary mechanism for satisfying the diverse policy tensions underlying this complex area of business law. Restricting judicial inquiry to the procedural correctness of management's determination should satisfy the business lobby's concerns that the courts not become too activist in derivative suits. Shifting the burden to require the corporation, not the plaintiff shareholder, to make the threshold showing of reasonableness and disinterest should permit plaintiffs more meaningful access to the courts. Coupling this suggested approach with universal demand should clarify and redirect shareholder derivative litigation in very constructive ways.