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SUING IN THE RIGHT OF THE CORPORATION: A COMMENTARY AND PROPOSAL FOR LEGISLATIVE REFORM

Lawrence A. Larose*

The shareholder suit is the subject of divergent opinions among laymen, attorneys, and the courts. The United States Supreme Court, for example, has variously described it as "the chief regulator of corporate management,"¹ and as the principal source of "vexatious litigation."²

If the duties of care and loyalty that managers owe to their corporations³ could be enforced only by the corporation itself, many wrongs would never be remedied. Where a majority of the corporation's shareholders benefit by the manager's breach of duty, they will normally continue to elect either the same managers or others who can be relied upon not to initiate litigation designed to remedy the wrong. Even where a majority of shareholders do not benefit by wrongdoing, in publicly held corporations the difficulty of organizing shareholders to oust the wrongdoers from office, and elect new directors who will bring suit against their predecessors, is often insuperable.⁴ From its incep-

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1. *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949).

2. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1974).

3. Because corporate directors and officers occupy a fiduciary position, they must exercise the utmost good faith in all transactions touching their duties to the corporation and its property. In their dealings with and for the corporation, they are held to the same strict rule of honesty and fair dealing between themselves and their principals as other agents. *Pepper v. Litton*, 308 U.S. 295 (1939). See also *Herald Co. v. Seawell*, 472 F.2d 1081 (10th Cir. 1972) (directors and officers must manage the corporate affairs in good faith, within the limits of applicable law, and give the corporate entity the benefit of their best business judgment and care). But see *Swanson v. American Consumer Indus.*, 288 F. Supp. 60 (S.D. Ill. 1968) (responsibility of directors requires fairness, reasonable judgment, and absence of fraud; it does not require "spoon feeding"), *rev'd*, 415 F.2d 1326 (7th Cir. 1969). See generally M. FEUER, *PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS* 28-42 (2d ed. 1974); *Officers' and Directors' Responsibilities and Liabilities*, *BUS. LAW.*, Feb. 1972, at 1.

4. Proxy contests raise intricate questions of both federal and state law. See 1 G. HORNSTEIN, *CORPORATION LAW AND PRACTICE* § 355 (1959); Loss, *The SEC Proxy Rules and State Law*, 73 *HARV. L. REV.* 1249 (1960).

tion in *Dodge v. Woolsey*,⁵ the derivative right of action has been utilized as a means by which individual shareholders may obtain redress for a managerial breach of trust. In our modern corporate society, the need for a method of policing the internal affairs of corporations has never been more acute. With the ever widening separation of corporate ownership and control first noted in 1932 by Professors Berle and Means⁶ and the increased autonomy conferred upon officers and directors by modern corporation codes,⁷ decisionmaking has, of necessity, become ever more centralized within corporate management. It is reasonable to assume that the ordinary shareholder in a modern public corporation purchases shares for the economic return he expects to realize, not for the chance to participate in the corporation's governance.⁸ An investor's ability to "vote with his money" is, however, an insufficient remedy for those investors whose justified expectations have been subverted by management misdeeds. It is therefore imperative to develop a sound public policy by which persons exercising decisional power can be held accountable for its use.⁹

The central problem presented by the derivative action is its dual character—it is at once substantive and procedural. The substantive nature of the action is reflected in the type of claims

5. 59 U.S. (18 How.) 331 (1856). In *Dodge*, the Supreme Court held that where the directors of a bank refused to take measures to resist the collection of a tax that the directors believed to be unconstitutional, the refusal amounted to a breach of trust that could be remedied by a shareholder derivative action.

6. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

7. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1974) (business and affairs of corporation to be managed by or under direction of board of directors); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1984-1985) (business of corporation shall be managed by board of directors); ILL. ANN. STAT. ch. 32, § 8.05 (Smith-Hurd 1983) (same); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1984-1985) (standard of care for director conduct); ILL. ANN. STAT. ch. 32, § 8.65 (Smith-Hurd 1983) (good faith of director as allowable defense).

8. See Werner, *Corporation Law In Search of Its Future*, 81 COLUM. L. REV. 1611, 1643 (1981) (arguing that separation of ownership and control was inherent in the earliest corporations and persists today as corporations pursue profitability and shareholders pursue private gain).

9. See Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 81 (1967).

Although accountability can be a vague and far-reaching concept, the Commentary to this Article's proposed Statute uses the term in a very narrow sense. The accountability intended to be enforced by derivative action is not against honest though ill-fated corporate decisionmakers. Market forces will undoubtedly hold such decisionmakers accountable in those instances. Where market forces are insufficient or inadequate to adjust equitably for violations of fiduciary duty or negligence, however, derivative actions are a useful means by which corporate decisionmakers may be held accountable for misuse of power. In this regard, the decisionmaker against whom the action is brought may be a director or officer of the corporation or a major shareholder who, because of the disproportionate influence conferred through ownership of a large percentage of the corporation's outstanding stock, is in a position to control corporate affairs.

that can be asserted derivatively,¹⁰ and its procedural nature is reflected in the numerous restraints that plaintiffs face when asserting such claims.¹¹ This dichotomy is perpetuated by state law which, for the most part, regulates the procedural aspects of the action by statute while leaving substantive issues to courts acting under the broad guidance of common law.¹²

Such a schizophrenic scheme inevitably has its limitations. Although the case-by-case analysis of courts is uniquely suited to the discovery and balancing of competing interests on the facts of particular situations, it is less competent in developing predictable procedures for the analysis of recurring problems. The case law relating to the contemporaneous ownership requirement,¹³ the demand requirement,¹⁴ and the competency of a board of directors to seek dismissal of a derivative action¹⁵ has produced an unsettled patchwork of procedural and substantive considerations that often fails to adhere to consistent underlying principles¹⁶ and, more importantly, fails to provide a workable framework for balancing the public interest in management accountability and the corporate interest in avoiding frivolous litigation. This Article argues that the judiciary is unlikely to achieve such a principled balance from the vague and often inconsistent standards of the common law. Given the central role of the derivative action in the enforcement of corporate law and the vital public policy issues that it inevitably raises, a comprehensive legislative solution is necessary.

Although this Article is not the first to propose a legislative approach, it differs from other efforts by proposing a comprehensive statutory scheme supported by analytical commentary. Recent developments in case law¹⁷ and proposals for reform em-

10. See *infra* notes 43-57 and accompanying text.

11. See *infra* notes 89-114 (the contemporaneous ownership rule), note 145 (the demand requirement), and notes 230-43 and accompanying text (security-for-expenses requirements).

12. See, e.g., FED. R. CIV. P. 23.1; ALASKA R. CIV. P. 23.1; COLO. R. CIV. P. 23.1.

13. See *infra* notes 89-114 and accompanying text.

14. See *infra* notes 144-58 and accompanying text.

15. See *infra* notes 122-77 and accompanying text.

16. Compare *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) and *Burks v. Lasker*, 441 U.S. 471 (1979) (judicial examination of board of directors' decision to dismiss derivative action on recommendation of committee of independent directors limited to examination of independence and good faith of committee), with *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) and *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983) (in examining board of directors' decision to dismiss derivative action on recommendation of committee of independent directors, court may exercise "business judgment").

17. See *infra* notes 134-58 and accompanying text.

anating from authoritative groups in the legal community¹⁸ suggest that an in-depth analysis of the derivative action is particularly timely.

This Article is premised on the belief that the derivative action is uniquely susceptible to strike suit litigation—that is, actions with little or no substantive merit but pursued to exploit the nuisance value inherent in litigation. Although there is historic support for the notion of “pernicious and vexing” derivative litigation,¹⁹ some modern evidence suggests that the vast majority of publicly held companies experience no derivative litigation.²⁰ Commentators, however, have questioned both the validity of the modern evidence and the conclusions derived from it.²¹ Despite these criticisms, observers of the present vitality of the derivative action, far from characterizing it as an effective litigation technique, opine that the action may face “extinction.”²² Because recent decisions such as *Burks v. Lasker*,²³ *Zapata Corp. v. Maldonado*,²⁴ and *Auerbach v. Bennett*²⁵ have witnessed courts deferring to board decisions to terminate ongoing derivative actions on the grounds that the actions were not in the corporation’s best interest, commentators suggest that directors may now possess a veto power over derivative claims.²⁶ In such a climate, “[t]he strike suit . . . may very well be no more than an over-the-hill dragon, puffed into life to frighten

18. See *infra* notes 21, 62 and accompanying text.

19. See, e.g., Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308 (1934). The Note persuasively demonstrates that the fear of strike suits is not academic:

The characteristics of strike suits may be illustrated by the activities of Clarence H. Venner, referred to as “an artificer of litigation and a menace to corporate society.” During his career he conducted at least 23 campaigns against [numerous corporations]. These campaigns involved at least 40 separate actions and have left over 100 cases in the reports. The campaign against the New York Central extended over 14 years, involved 12 suits in 4 jurisdictions, employed 4 nominal plaintiffs, left 29 cases in the reports, and reached the United States Supreme Court 5 times.

Id. at 1308 n.1.

20. See Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U.L. REV. 306, 312-13 (1980).

21. See American Law Institute, Code of Corporate Governance 229-32 (Tent. Draft No. 2, 1984) [hereinafter cited as ALI Code].

22. Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 261 (1981). See also Note, *Off the Bench and Into the Boardroom: Judicial Business Judgment after Zapata*, 70 GEO. L.J. 1025 (1982).

23. 441 U.S. 471 (1979).

24. 430 A.2d 779 (Del. 1981).

25. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

26. Coffee & Schwartz, *supra* note 22, at 262.

the courts away from deciding substantive issues.”²⁷

The ideal derivative suit statute would balance precisely the public concern for management accountability and the corporation's concern in avoiding frivolous and unfounded claims, while maintaining the derivative action as a viable method of enforcing accountability in the modern corporation. The Statute²⁸ and Commentary²⁹ proposed in this Article attempt to articulate such a balanced vision. The guiding force behind the myriad policy choices required by such an undertaking is the desire to maintain the derivative action as a viable legal institution available for protection of shareholder rights.

I. STATUTORY PROPOSAL

SECTION 1: DEFINITIONS

- (a) **“Direct Action” means a cause of action brought to assert rights and enforce duties belonging or owed to a holder of any equity interest in a Corporation individually, and may be brought on the holder's own behalf or on behalf of a class of similarly situated holders. A Direct Action also means a cause of action brought to assert rights and enforce duties belonging or owed to a Corporation and brought by the Corporation on its own behalf.**
- (b) **“Derivative Action” means a cause of action brought to assert rights and enforce duties belonging to or owed to a Corporation and may be brought on the Corporation's behalf as provided in this Title.**
- (c) **“Corporation” includes professional corporations and not-for-profit corporations.**
- (d) **“Qualified Interest” means:**
 - (i) **the interest of a person identified as a shareholder of record of the Corpora-**

27. W. CARY & M. EISENBERG, *CORPORATIONS: CASES AND MATERIALS* 888 (5th ed. unbridged 1980).

28. Part I of this Article presents a Statute to govern derivative actions initiated under state law.

29. Part II of this Article is a commentary that explains the Statute Part I proposes.

tion without regard to class, designation, or preference, *provided that* a group of persons identified as co-owners or co-fiduciaries shall each possess a Qualified Interest as defined in this subsection;

- (ii) the interest of a beneficial owner of shares of any class of stock of the Corporation held by a nominee, trustee, or any other fiduciary, unless the governing instrument under which such nominee, trustee, or other fiduciary holds such stock expressly denies the beneficiary the power to commence a Derivative Action, *provided that* in the case of any beneficial interest held collectively or jointly by ten or more persons, the Corporation has actual knowledge, prior to the time of the transactions alleged in the complaint, of the identity of all beneficial owners collectively or jointly holding the interest;
 - (iii) the interest of a person holding an unsecured debt instrument issued by the Corporation that is convertible or exchangeable immediately or at a future date, with or without consideration, into shares of any class of the Corporation's stock, or carrying a warrant or right to subscribe to or purchase shares of any class of the Corporation's stock.
- (e) "Due care violation" means a violation of a statutory duty of due care owed by an individual to the Corporation.
- (f) "Associate" of a person includes:
- (i) any corporation or other organization of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of fifty percent or more of any class of equity securities;
 - (ii) any trust or other estate in which such person has a substantial benefi-

- cial interest or as to which such person serves as trustee or in a similar capacity;
- (iii) any parent, child, or spouse of such person (other than a spouse legally separated under a decree of divorce or separate maintenance) including parents and children of such person's spouse.
- (g) "Close Corporation" means a corporation that:
- (i) has 35 or fewer record holders of its equity securities;
 - (ii) has \$3 million or less in total assets; and
 - (iii) has never undertaken an offering of its securities requiring registration pursuant to the Securities Act of 1933, as amended, or state law.

SECTION 2: CLASSIFICATION OF ACTIONS

- (a) An action shall be classified as a Derivative Action if alleged damage to a Qualified Interest in the Corporation is attributable to injury to the Corporation itself. An action shall be classified as a Direct Action if alleged damage to a Qualified Interest is attributable to injury to the holder.
- (b) If a transaction properly gives rise to both Direct and Derivative Actions, a holder of a Qualified Interest may commence and maintain such actions contemporaneously, and the restrictions and provisions of this Title pertaining to Derivative Actions shall not apply to any claims arising from the transaction.

SECTION 3: STANDING

To have standing to commence and maintain a Derivative Action, plaintiff must allege in the complaint and

prove by a preponderance of the evidence at trial that:

- (a) plaintiff is the holder of a Qualified Interest, and is capable of fully and fairly representing the class of persons injured by the transaction complained of; and**
- (b) unless plaintiff is the holder of a Qualified Interest in a Close Corporation, that plaintiff either:**
 - (i) acquired the Qualified Interest before disclosure, either to the public generally, as evidenced by the market price of the Qualified Interest, or to plaintiff personally, as evidenced by the purchase price of the Qualified Interest, of the wrongdoing of which plaintiff complains; or**
 - (ii) acquired the Qualified Interest by devolution of law from a person who acquired the Qualified Interest before disclosure, either to the public generally, as evidenced by the market price of the Qualified Interest, or to said person personally, as evidenced by the purchase price of the Qualified Interest, of the wrongdoing of which plaintiff complains; and**
- (c) the Qualified Interest required under subsection (a) was continuously held by the plaintiff or a predecessor in interest from the time of disclosure of the wrong complained of until the conclusion of the action.**

SECTION 4: DEMAND AND DISMISSAL

- (a) Demand upon the board of directors to initiate an action in favor of the Corporation shall not be required as a condition to the maintenance of a Derivative Action.**
- (b) Demand on shareholders to initiate an action in favor of the Corporation shall not be required as a condition to the maintenance of a Derivative Action.**
- (c) (i) A Derivative Action shall be dis-**

missed solely on the basis of a recommendation of a committee of independent directors, *provided that*:

- (A) the committee is composed entirely of independent directors and is duly appointed in accordance with the law of this state, and the board of directors expressly vests the committee with full authority to act with respect to the Derivative Action;
- (B) the independent directors conduct a thorough, independent, and good faith investigation into the allegations raised in the complaint; and
- (C) the independent directors make an express determination that a reasonable business justification exists for dismissing the Derivative Action, independent of the merits of the litigation.

The burden of proof under this subsection (i) shall be on the party moving to dismiss the Derivative Action.

- (ii) A Derivative Action shall not be dismissed pursuant to subsection (i) of this section if:

- (A) one or more of the named defendants are directors or officers of the Corporation in whose right the Derivative Action is asserted; and
- (B) facts are alleged with particularity which, if proven, could result in the imposition of civil liability or criminal punishment on a majority of the board of directors or on a person or persons who control a majority of the board of directors.

Derivative Actions to which this subsection (ii) applies shall be dismissed on the basis of a recommendation of a

committee of independent directors only if the provisions of subsection (i) of this section are complied with and the court, upon an independent review of the rationale and conclusions of the committee, determines that such conclusions are fair and reasonable to the Corporation and are not overridden by a countervailing public policy. The burden of proving the fairness and reasonableness of the committee's conclusions shall be on the party moving to dismiss the Derivative Action, and the plaintiff shall be afforded a reasonable opportunity to obtain discovery and to contest the committee's conclusions.

- (iii) In any Derivative Action dismissed pursuant to subsections (i) or (ii) of this section, the court shall state conclusions of law and fact sufficient to permit appellate review.**

SECTION 5: SETTLEMENT AND COMPROMISE

- (a) No Derivative Action shall be discontinued, compromised, or settled without the prior approval of the court exercising jurisdiction over the action, granted subsequent to a settlement hearing.**
- (b) Notice of the terms of the proposed settlement and the date, time, and place of the settlement hearing shall be given in whatever manner the court deems sufficient under the circumstances to all holders of Qualified Interests whom the court determines will be substantially affected by the proposed settlement.**
- (c) Upon request, holders of Qualified Interests objecting to the proposed settlement, or, in the court's discretion, a representative of such objecting holders, shall be permitted a reasonable opportunity to obtain discovery**

- prior to the settlement hearing and, at the settlement hearing, to present testimony and evidence and to cross-examine witnesses for the proponents of the settlement.
- (d) The court shall approve the discontinuance, compromise, or settlement of a Derivative Action if, based on evidence presented at the settlement hearing, such discontinuance, compromise, or settlement is reasonable under the circumstances.
 - (e) In determining the reasonableness of a proposed settlement, the court shall consider, without limitation, the following factors:
 - (i) the benefit of the proposed settlement to the Corporation,
 - (ii) the objections of holders of Qualified Interests,
 - (iii) any fees, costs, and expenses, including attorney's fees, requested by the plaintiff, and
 - (iv) any indemnification or litigation expenses of the defendants paid or to be paid by the Corporation.

In the absence of exact calculations of expenses, the parties shall estimate the maximum amounts of such payments. Payments in excess of such estimates shall be made only upon the showing that special circumstances exist that were not known or ascertainable at the time of the settlement hearing.

- (f) A settlement of a Derivative Action shall preclude other Derivative Actions raising the same claims as the original action unless:
 - (i) reasonable notice of the settlement was not given to all holders of Qualified Interests whom the court determines will be substantially affected by the settlement; and
 - (ii) the interests of all holders of Qualified Interests were not fairly and adequately represented in the original action.

SECTION 6: SPECIAL RULES PERTAINING TO CLOSE CORPORATIONS

- (a) **An action otherwise classified as a Derivative Action shall be classified as a Direct Action if the Corporation at the time of suit and at the time of the transaction complained of is a Close Corporation and the rights of creditors and other shareholders of the Corporation are not prejudiced thereby.**
- (b) **In any Derivative Action brought in the right of a Close Corporation, the plaintiff must be a holder of a Qualified Interest at the time the action is brought and:**

 - (i) **a holder of a Qualified Interest at the time of the transaction complained of;**
or
 - (ii) **a holder of a Qualified Interest acquired by devolution of law from a person who was a holder of a Qualified Interest at the time of the transaction complained of.**

In the case of subsection (i) above, plaintiff's ownership of a Qualified Interest between the time of the transaction and the time of the suit must be uninterrupted.

- (c) **In any Derivative Action brought in the right of a Close Corporation, the court may award individual recovery according to the plaintiff's pro rata ownership of a Qualified Interest in the following situations:**

 - (i) **where the Derivative Action is against directors, officers, or other fiduciaries of the Corporation who have appropriated corporate assets, and the court determines that an individual recovery is necessary to prevent any award from reverting to the defendant's control;**
 - (ii) **where one or more holders of a Qualified Interest in the Corporation have personally benefited from the acts for**

which the suit seeks recovery, participated in the wrongful acts alleged in the suit, become barred by laches, acquiescence, waiver or release, or acquired their interest from a person falling within one of the foregoing classes; or

- (iii) where the Corporation is in the process of dissolution or has dissolved; *provided that* the interests of creditors and other holders of Qualified Interests of the Corporation are not prejudiced thereby.

SECTION 7: DAMAGES

- (a) Except as provided in Section 6(c) of this Title, upon judgment for the plaintiff in a Derivative Action, any damages shall be paid directly to the Corporation. Additionally or alternatively, the court may, in its discretion, grant equitable relief including, without limitation, a decree:
- (i) cancelling, altering, or enjoining any resolution or other act of the Corporation or any other party to the action; or
 - (ii) suspending or removing a corporate official or director from office.
- If entirely nonpecuniary relief is awarded, the court shall direct the defendant to pay the reasonable attorney's fees and expenses of the plaintiff.
- (b) If a defendant is adjudged liable in a Derivative Action based exclusively on a Due Care Violation, and the court expressly finds:
- (i) such person's liability is not based on misconduct, recklessness, or anything other than ordinary negligence; and
 - (ii) such person, or any Associate, has not directly or indirectly gained personally from such violation;
- then damages in such action shall not ex-

ceed the aggregate sum of directors' fees, salary, or other compensation received by the defendant from the Corporation, or the aggregate sum of the defendant's net taxable income before deductions for the five years preceding the Due Care Violation, whichever is greater.

SECTION 8: ABUSE OF PROCESS

In any action brought pursuant to this Title, the court may in its discretion award costs, including reasonable attorney's fees, at any time against any party's counsel or against any party if the court determines that counsel or a party committed an abuse of process, as defined by the laws of this state, or materially protracted the litigation by making a motion, defense, pleading, request for discovery, attempt to resist discovery, or appeal without reasonable cause or in bad faith.

II. COMMENTARY

A. *Statement of Purpose*

Recognizing the tension between the potentials for public benefit and abuse inherent in derivative litigation, this Commentary advocates a legislative approach designed to maximize public benefits, such as accountability of management, and to minimize public costs such as strike suits. This Commentary aims to articulate the primary purposes behind derivative litigation in order to assist interpretation of the Statute and increase the likelihood that these purposes will ultimately be achieved.

Two purposes underlie the derivative action: deterring misconduct by corporate decisionmakers and compensating the corporation and shareholders for harm caused by such misconduct. Most courts have assumed that a compensatory rationale is the primary foundation of the derivative action.³⁰ This Commentary

30. See, e.g., *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703, 717 n.14 (1974) (pointing out that unjust enrichment could result if deterrence alone justified the derivative action); *Home Fire Ins. Co. v. Barber*, 67 Neb. 644, 673, 93 N.W. 1024, 1035 (1903) ("[I]t is not the function of courts of equity to administer punishment

rejects compensation as the primary purpose of derivative litigation

because the function of such an action, unlike an ordinary tort or contract case, is not merely to compensate the plaintiffs 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 relates.³¹

This Commentary constructs a statutory scheme for derivative litigation around a deterrence rationale for a number of reasons. First, injured parties must be identified before compensation can be truly achieved. In many public corporations, the lightning pace of ownership changes in the secondary market for corporate securities³² makes identification of actual victims impossible. Even if a sufficiently accurate identification system could be practically developed, the miniscule personal benefit received from a corporate recovery by the average shareholder raises serious doubts that identification is a goal worthy of its cost.

Second, after an injury to the corporation has occurred, shareholders may sell their investment at a price discounted to reflect such injury. If a corporate recovery is later received, it is essentially a windfall to the new purchasers. The contemporaneous ownership requirement found in virtually all traditional derivative suit statutes³³ is an attempt at reconciling this observation with compensation theory. Because under traditional theory the corporation is viewed as the "victim" of management misconduct, the amount of damages recovered by the corporation is not reduced by the percentage of non-contemporaneous holders nor is a portion of the recovery distributed to those shareholders who sold at a discounted price. This approach produces an in-

. . . . A plaintiff must recover on the strength of his own case, not on the weakness of the defendant's case.").

31. *Diamond v. Oreamuno*, 24 N.Y.2d 494, 498, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969).

32. On Nov. 4, 1982, a record 149,350,000 shares were traded on the New York Stock Exchange. *Wall St. J.*, Nov. 5, 1982, at 1, col. 2.

33. The contemporaneous ownership rule requires that a plaintiff, in order to have standing to maintain a derivative action, be a stockholder at the time of the transaction complained of and at the time the action is brought. The requirement is found in virtually all jurisdictions. See, e.g., *Himmelblau v. Haist*, 195 F. Supp. 356 (S.D.N.Y. 1961); *Weinstock v. Kallet*, 11 F.R.D. 270 (S.D.N.Y. 1951); *Braasch v. Goldschmidt*, 41 Del. Ch. 519, 199 A.2d 760 (1964); *Gresov v. Shattuck Denn Mining Corp.*, 40 Misc. 2d 569, 243 N.Y.S.2d 760 (1963).

consistency between the reasoning and result of the traditional theory that belies its stated purpose.³⁴

The abolition of a contemporaneous ownership requirement in the Statute³⁵ reflects a rejection of the view that the corporation is a victim in need of compensation. This Commentary submits instead that, subject to certain restrictions designed to prevent abuse, a wide range of actors should be permitted to bring derivative actions to provide effective sanctions against wrongdoing.

Another critical shortcoming of a compensatory rationale is that the corporate injury resulting from management misconduct is very likely to be smaller, on a *pro rata* basis, than that suffered by individual shareholders. To the extent that a breach of duty is viewed as a potential weakness of the corporation or is likely to recur in the future, the market will discount the present value of corporate securities beyond the actual loss incurred by the breach.³⁶ All available evidence suggests that shareholder compensation does not necessarily flow from a corporate recovery.³⁷

The final problem of a compensatory rationale is that not only is shareholder recovery always indirect and frequently inadequate, it is, in most cases, *de minimus* on a per share basis. The drain on societal resources that lengthy and complex derivative litigation imposes cannot be justified by a recovery of a few cents per share. The only rational explanation for allowing these actions is that, by aggregating small individual losses into large, collective ones, derivative actions produce sanctions sufficient to deter.

34. As Professors Coffee and Schwartz note,

[t]o some degree, the anthropomorphic fallacy of viewing the corporation, rather than its shareholders, as the victim is probably a necessary fiction accepted by courts in order to avoid the potentially enormous problems involved in identifying the true victims. But to concede this is also to concede that courts are accepting an obvious fiction because they are less interested in compensation than in seeing that wrongdoers do not escape sanctions. In short, the fiction of compensation serves the reality of deterrence.

Coffee & Schwartz, *supra* note 22, at 303.

35. Statute § 3.

36. One example of the signaling effect that a particular transaction may have on the market can be observed in a self-dealing transaction between a parent corporation and its majority-owned subsidiary. If minority shareholders are successful in enjoining the transaction, the market value of their shares may not rise to its prior level because the parent has signaled its intent to deal unfairly with the minority and may do so in the future. Predictions of future losses are immediately reflected in a decline in present share value. See Coffee & Schwartz, *supra* note 22, at 304 n.238. See also Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

37. Coffee & Schwartz, *supra* note 22, at 304 n.240.

Although deterrence should be recognized as the primary rationale for the derivative action, deterrence, standing alone, conflicts with other legitimate concerns. The concern most frequently expressed is that the objective of deterring wrongdoers could lead to the unjust enrichment of shareholders not directly injured by management misdeeds.³⁸ In this context, the United States Supreme Court has stated that the deterrence argument

[p]roves too much. If deterrence were the only objective, then in logic any plaintiff willing to file a complaint would suffice. No injury or violation of a duty to a particular plaintiff would have to be alleged. The only prerequisite would be that the plaintiff agree to accept the recovery, lest the supposed wrongdoer be allowed to escape a reckoning.³⁹

This Commentary recognizes that there must be constraints on the deterrence concept. Accordingly, the Statute imposes certain substantive limitations that restrict the class of plaintiffs entitled to bring a derivative action. For example, section 3 of the Statute prevents holders acquiring an interest after public disclosure of wrongdoing from bringing a derivative claim. Additionally, through the definition of Qualified Interest in section 1(d), the Statute eliminates derivative actions by certain creditors and holders of attenuated beneficial interests. Although an unfettered adherence to the deterrence concept in these instances would require an unlimited class of potential derivative plaintiffs, the Statute's restrictions prevent frivolous litigation while promoting serious claims, thereby preserving rather than detracting from the fundamental utility of the derivative action as a deterrence mechanism.

Another limit on the deterrence rationale is that, because punitive damages are unavailable, the action can only achieve a cancellation of any expected gain from misconduct.⁴⁰ Because

38. See ALI Code, *supra* note 21, at 235 (introductory note); Coffee & Schwartz, *supra* note 22, at 305.

39. *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703, 717-18 (1974).

40. Damage to the "corporate image" resulting from adverse publicity generated by the prosecution of a derivative action may increase the action's deterrent effect. *Cf. Joy v. North*, 692 F.2d 880, 892 (2d Cir. 1982) (recognizing the possible negative effects of a derivative action on the corporate image). The limited amount of publicity the typical derivative action generates, the length of time necessary to bring it to a final determination, and the ability—and increasing inclination—of many corporations to mount image advertising campaigns, however, reduce the deterrent effect of adverse publicity to a *de minimus* level. See generally Comment, *Corporate Advocacy Advertising: When Busi-*

the potential gains from predatory acts such as self-dealing are enormous, cancellation of expected gain upon detection is not an effective deterrent.⁴¹ Most other types of corporate wrongdoing, however, present the potential for only limited gain. As Professors Coffee and Schwartz note, "due care violations typically involve little expected gain and frequently threaten enormous liabilities, and thus the potential deterrent threat posed by the derivative action in this context is significant."⁴²

In summary, the Statute attempts to balance principles of management accountability and deterrence from wrongdoing against the inherent dangers and public costs of derivative litigation. The ultimate goal of the Statute is to provide a method for regulating the litigation of legitimate intra-corporate disputes while establishing sufficient procedural safeguards to prevent exploitation.

B. *Classification of Actions*

The derivative action possesses a dual character—it is at once representative and derivative. It is representative in that the plaintiff undertakes to act not only for his own benefit but also on behalf of others with an interest in the corporation. It is derivative in that the wrong is not done to the plaintiff personally, but to the corporate entity. This dual nature has sometimes caused courts to blur the distinction between derivative and direct actions.⁴³ The distinction between the actions is crucial because of the implications it has on the prosecution of the claim. Characterization of a cause of action as derivative implicates all the procedural requirements embodied in the Statute. Additionally, any recovery on a derivative claim is paid to the corporation, not to individual plaintiffs. In contrast, direct actions suffer no extraordinary procedural requirements and allow individual

ness' Right to Speak Threatens the Administration of Justice, 1979 DET. C.L. REV. 623.

41. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (arguing that "punishment cost" must equal or exceed "expected gain" to deter an activity; where risk of apprehension is low, cancellation of gain alone has no deterrent value).

42. Coffee & Schwartz, *supra* note 22, at 307.

43. One court, for example, appears to have hopelessly confused the characterization of derivative and direct actions: "This is a representative action derived from the Interborough Rapid Transit Company. It is brought in behalf of the plaintiffs and all others similarly interested, as stockholders of said company, against the directors . . ." *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 10, 99 N.E. 138, 139 (1912).

plaintiffs to enjoy direct recovery on their claims.⁴⁴

Despite the importance of this distinction, however, many courts, including the Supreme Court, have had difficulty articulating the distinguishing features of a derivative versus a direct action. For example, Justice Frankfurter has written:

The contrasting difference between a stockholder's suit for his corporation and a suit by him against it, is crucial. In the former, he has no claim of his own; he merely has a personal controversy with his corporation regarding the business wisdom or legal basis for the latter's assertion of a claim against third parties. Whatever money or property is to be recovered would go to the corporation, not a fraction of it to the stockholder. When such a suit is entertained, the stockholder is in effect allowed to conscript the corporation as a complainant on a claim that the corporation, in the exercise of what it asserts to be its uncoerced discretion, is unwilling to initiate. This is a wholly different situation from what arises when the corporation is charged with invasion of the stockholder's independent right.⁴⁵

Justice Frankfurter's statement fails to identify the underlying distinguishing characteristics of derivative and direct actions. It merely describes the consequences that flow from the characterization.

In section 2 of the Statute, derivative and direct actions are broadly defined based upon the traditional common law criteria. A wrongful act that depletes or destroys corporate assets and thereby injures security holders indirectly only by reason of the direct injury to the corporation is derivative; conversely, a wrongful act that denies or interferes with the rightful incidents of security ownership gives rise to a direct action. This dichotomy, however, is not completely useful. Although under this rule a suit for decline in value of corporate shares caused by a director's breach of duty is derivative because the holders are harmed indirectly,⁴⁶ and a suit to force declaration of dividends is a direct action because it interferes with individual ownership

44. Plaintiffs, however, will not necessarily be disadvantaged by a finding that their cause of action is derivative. Prosecution of a claim in the right of the corporation may allow increased damage claims, thus qualifying the action under federal jurisdictional requirements, as well as recovery of attorney's fees.

45. *Smith v. Sperling*, 354 U.S. 91, 99 (1957) (Frankfurter, J., dissenting).

46. *See, e.g., Smith v. Hurd*, 53 Mass. (12 Met.) 371 (1847).

rights,⁴⁷ without more, classification of other situations could become haphazard. Sensitivity to the four main policy considerations underlying the derivative/direct dichotomy, however, should usually allow expeditious and consistent judicial classifications.

The first consideration is that the recovery in a derivative action goes to the corporation. Thus, creditors, shareholders, and others with a stake in the corporation share equally.⁴⁸ In contrast, direct recovery by one holder does not benefit the corporation, nor does it benefit other injured holders unless brought as a class action.

Second, because a judgment in a derivative action has res judicata effect on all other derivative claims arising from the same transaction, conclusion of a derivative action has a preclusive effect that prevents the multiplicity of suits that might otherwise be brought by individual security holders.⁴⁹

Third, attorney's fees are awarded to successful plaintiffs in a derivative action directly from the corporation. The plaintiff is entitled to attorney's fees even if nonpecuniary relief is awarded.⁵⁰ In a direct action, the same plaintiff must generally look to the fund created by the action, if any exists.

Fourth, to permit proportionate individual recovery to shareholders in a direct action may, in some circumstances, amount to a distribution of corporate assets either by dividend or partial liquidation. Such a judicially mandated distribution could conflict with other principles of corporate governance.⁵¹

Application of these principles will assist courts in determining classification of an action under section 2 of the Statute. Courts should consider whether the factual situation presented requires a corporate recovery to protect the interests of creditors or security holders not before the court, to avoid a multiplicity of suits on the same claim, to provide adequate recovery of expenses, or to protect corporate control over the disposition of invested capital.

47. See, e.g., *Doherty v. Mutual Warehouse Co.*, 245 F.2d 609 (5th Cir. 1957); *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717 (3d Cir. 1956); *Tankersley v. Albright*, 80 F.R.D. 441 (N.D. Ill. 1978).

48. See *Watson v. Button*, 235 F.2d 235, 237 (9th Cir. 1956); *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717, 720 (3d Cir. 1956); *Liken v. Shaffer*, 64 F. Supp. 432, 441 (N.D. Iowa 1946); *Niles v. New York Cent. & H. R.R.*, 176 N.Y. 119, 122-23, 68 N.E. 142, 143-44 (1903).

49. See *Watson v. Button*, 235 F.2d 235, 237 (9th Cir. 1956) (dictum).

50. Statute § 7(a).

51. See *Keenan v. Eshleman*, 23 Del. Ch. 234, 251, 2 A.2d 904, 911 (1938) (injured shareholder should not receive a greater dividend than financial condition of corporation permits).

There may be situations in which the action, though nominally a derivative one, may be better treated as a direct action because of a promise or expectation legitimately relied upon by an individual holder. For example, a holder may have a personal cause of action against a third person to recover damages for breach of contract even though a corporate cause of action results from the same wrongful act—such as mismanagement of the corporate business and diversion of assets in breach of an express contract with a shareholder.⁵²

In section 2(b), the Statute provides that an action may be classified as direct even though the principal injury is to the corporation. This provision allows a court, in its discretion, to provide a direct action when the injury is to the corporation and there is “also special injury to the individual stockholder.”⁵³ This special injury may arise from pledgor-pledgee relationships,⁵⁴ fiduciary relationships,⁵⁵ or contractual arrangements.⁵⁶

Some courts have allowed direct recovery under the special injury doctrine even when a derivative recovery for the benefit of

52. See, e.g., *Buschmann v. Professional Men's Ass'n*, 405 F.2d 659 (7th Cir. 1969) (where plaintiff and bank to which corporation owed money entered into contract with defendant, whereby plaintiff agreed to form new corporation, transfer assets in exchange for common stock, and guarantee indebtedness of corporation, and defendant agreed to operate and manage business of new corporation, and where defendant allegedly breached contract by mismanaging business and diverting assets; plaintiff had direct cause of action for breach of contract and corporation had cause of action for mismanagement arising out of the same wrongful acts).

53. *Elster v. American Airlines*, 34 Del. Ch. 94, 100 A.2d 219, 222 (1953) (wrongs affecting individual rights of the shareholder plaintiff, such as preemptive or control rights, may be pleaded as direct actions) (dictum). See also *Ritchie v. McMullen*, 79 F. 522 (6th Cir.), cert. denied, 168 U.S. 710 (1897). In a recent opinion, the Delaware Chancery Court reiterated the *Elster* rule:

The fact that the corporation will suffer injury from the transaction which is challenged does not preclude the Plaintiff from suing for the protection of individual rights if the Plaintiff also suffers special injury which the corporation as a whole will not suffer.

Colonial Sec. Corp. v. Allen, No. 6778 (Del. Ch. Apr. 18, 1983).

54. See *Kono v. Roeth*, 237 A.D. 252, 261 N.Y.S. 1048 (1932) (where defendant/director pledged stock to plaintiff as security for indebtedness and defendant/director conspired to render stock worthless by destroying value of the corporation, plaintiff may maintain a direct action for violation of the pledgor-pledgee relationship).

55. See *Blakeslee v. Sottile*, 118 Misc. 513, 194 N.Y.S. 752 (1922) (where defendant/director holds stock as trustee for plaintiff and wrongfully acquires a corporate opportunity, plaintiff may maintain direct action).

56. See *Meyerson v. Franklin Knitting Mills*, 185 A.D. 458, 172 N.Y.S. 773 (1918) (plaintiff, who purchased defendant's stock pursuant to a contract whereby defendant agreed to deliver the stock to the plaintiff and to sell goods and extend credit to the corporation, had a direct cause of action against defendant for breach of covenants to sell goods and extend credit).

the corporation is available.⁵⁷ It is doubtful whether this potential multiple liability on directors and its concomitant windfall to injured shareholders is justifiable, notwithstanding its deterrent effect. Therefore, if direct recovery is allowed under the special injury doctrine, the plaintiff should be restricted to one recovery, be it direct or derivative. In most cases, this restriction will require inquiry into whether a derivative suit has been brought or is presently pending for the same alleged wrong. If the court determines that full recovery is likely to be accomplished derivatively, the direct action should be stayed or dismissed.

Of course, the above proviso is inapplicable when a wrongful act both depletes corporate resources and deprives a holder of a personal right attaching to his interest. In such a case, for example when voting rights are infringed and the underlying transaction is unfair to the corporation, section 2(b) allows both actions to be brought and maintained contemporaneously. This section does not contemplate any set-off of one recovery against the other, because each claim has an independent basis and dual recovery does not necessarily imply that any party is unduly enriched.

C. *Standing to Litigate*

Procedural requirements regulating the class of plaintiffs entitled to bring a derivative action are found in section 1(d) and section 3. In these sections, the Statute attempts to balance the policy and purposes supporting the derivative action. In particular, the Statute restricts the class of eligible plaintiffs based upon the extent of their interest in the corporation. The personal interest of a particular plaintiff in the ongoing well-being of the corporation is the touchstone in this regard, because if a plaintiff with only a *de minimus* interest in the corporation were allowed to sue derivatively, the action would be susceptible of abuse by frivolous litigation. A plaintiff with a remote or contingent interest is unlikely to represent fairly a class of holders actually injured by alleged misconduct.⁵⁸ Conversely, if the class of eligible plaintiffs is restricted to persons with the status of

57. See, e.g., *Cutler v. Fitch*, 231 A.D. 8, 246 N.Y.S. 28 (1930); *Blakeslee v. Sottile*, 118 Misc. 513, 194 N.Y.S. 752 (1922).

58. Even a holder with a large vested interest must be capable of fully and fairly representing a class of injured holders in order to have standing to litigate a derivative action. See Statute § 3(a); FED. R. Civ. P. 23.1.

shareholders, it is likely that a wide variety of persons would be unable to gain redress for injury to their interests, and the deterrent effect of the derivative action would be reduced.⁵⁹

Because of the complexity of these statutory requirements and their importance to the overall statutory scheme, a brief summary of their organization and operation is in order. A detailed analysis of each section and requirement follows.

Section 3 provides, with certain qualifications, that any holder of a Qualified Interest has standing to bring a Derivative Action. A Qualified Interest, as defined in section 1(d), means the interest held by shareholders of record and beneficial owners of corporate stock. The interest of beneficial holders can qualify under section 1(d) only if the requirements of section 1(d)(ii), relating to collective beneficial ownership and knowledge of the corporation, are met. Finally, the interests of convertible debt holders are included under section 1(d)(iii).

Section 3 also provides that a holder of a Qualified Interest can commence and maintain a Derivative Action only if the interest was acquired before disclosure of the wrongdoing complained of, or was acquired by devolution of law after that time.

1. *Section 1(d): Definition of Qualified Interest*— Through the definition of Qualified Interest, the Statute delineates potential plaintiffs whose interest in the corporation is sufficient to increase the probability that they are capable of fairly prosecuting an action on behalf of the corporation and reduces the likelihood of abuse.

Section 1(d)(i) embodies the traditional common law standing requirement: shareholders of record in any corporation possess an economic interest in the enterprise sufficient to support an action brought on its behalf.⁶⁰ This section, however, affirmatively rejects the common law doctrine that individual co-owners lack independent standing to sue derivatively.⁶¹ Because no minimum number or value of shares is required to attain individual shareholder standing, it is incongruous to hold that co-owner rights are not equal to those of sole owners. Accordingly, section 1(d) invests each co-owner or co-fiduciary with an independent right to maintain a derivative action. Section 1(d)(ii) is the heart

59. See *infra* notes 60-88 and accompanying text.

60. See, e.g., ARIZ. REV. STAT. ANN. § 10-049 (1977); MONT. CODE ANN. § 35-1-514 (1985); NEB. REV. STAT. § 21-2047 (1983); N.M. STAT. ANN. § 53-11-47 (1983); WASH. REV. CODE ANN. § 23A.08.460 (1969); MODEL BUS. CORP. ACT § 49 (1971).

61. Cf. *May v. DuPont*, 42 Del. Ch. 570, 216 A.2d 870 (1967) (co-executor has standing to bring action on behalf of estate only if other executor agrees or on leave of the court).

of the Qualified Interest definition. It adopts the holding of numerous cases that beneficial owners of corporate shares are entitled to sue derivatively.⁶² Extending the class of potential derivative suit plaintiffs to beneficial owners, however, may be insufficient to fully protect the action's deterrent effect. Because of the convenience provided by brokerage services, many investors—both large and small—allow brokers to hold stock in “street name” for the benefit of their account. Traditional beneficial ownership rules do not reach this substantial amount of securities, even though beneficiaries of street name accounts bear all the risks attendant to their investments.⁶³

In recognition of the inconsistency that inheres in the traditional approach, section 1(d)(ii) provides that a Qualified Interest includes the interest of a beneficial owner of shares held by a nominee, trustee, or other fiduciary. This provision is similar to that of Section 49 of the revised Model Business Corporation Act (MBCA),⁶⁴ with two important differences. First, section 1(d)(ii) covers not only the broker holding stock as a nominee, but also the bank or other institution acting as a trustee. Second, the section recognizes that a grantor may wish to deny the beneficiary the right to sue derivatively. These two differences—one that enlarges the class of potential plaintiffs and one that restricts it—are necessary to reflect realistically the present state of stock ownership in the marketplace while allowing latitude for individuals to construct their own transactions.

a. Attenuated interests— Once the class of potential plaintiffs is expanded, the danger arises that the right to sue derivatively will be conferred on persons whose beneficial interest in the corporation is so attenuated that no real personal stake in the controversy exists. If the value of a plaintiff's interest in the corporation is *de minimus*, the plaintiff is more likely to engage

62. See, e.g., *Stephenson v. Landegger*, 464 F.2d 133 (2d Cir.), *cert. denied*, 409 U.S. 1039 (1972); *Arfsten v. Higby*, 372 P.2d 166 (Colo. 1962); *Jones v. Taylor*, 348 A.2d 188 (Del. Ch. 1975); *LaHue v. Keystone Inv. Co.*, 496 P.2d 343 (Wash. 1972); Report, *Proposed Revisions of the Model Business Corporation Act Affecting Actions by Shareholders*, 37 Bus. Law. 261 (1981) [hereinafter cited as MBCA Revisions].

63. *Coffee & Schwartz*, *supra* note 22, at 311.

64. MBCA Revisions, *supra* note 62, at 262. The revised § 49 provides in pertinent part:

No action shall be brought in this State by a shareholder in the right of a domestic or foreign corporation unless (1) the plaintiff was a shareholder of record or the beneficial owner of shares held by a nominee or the holder of voting trust certificates at the time of the transaction of which he complains

Id. The Committee drafting the revisions erroneously concluded that the above provision was sufficient to include all street name accounts. See *id.* (“Street name ownership is increasingly common, and should not be penalized.”).

in litigation for reasons relating to settlement value and attorney's fee awards rather than for redress of an injury to the corporation. Because a derivative action is designed to be brought in the right of the corporation and all its holders of Qualified Interests, it is also likely that the holder of a *de minimus* interest will be incapable of fairly representing the class of injured holders. In such a situation, the potential for frivolous and unnecessary litigation so outweighs any deterrent value that some restriction is necessary. For example, if beneficial owners were allowed to sue derivatively without limitation, an individual with vested pension rights could sue a corporation whose shares are held by the fund, even though his economic interest in the fund as a whole is miniscule and the interest possessed by the fund in the corporation sued equally small. Such cases present a situation in which the potential for excessive litigation of claims with little chance of success is very real. To address these cases, a limitation on standing is appropriate.

Professors Coffee and Schwartz have proposed to limit the class of potential derivative suit plaintiffs to holders of a beneficial interest in trust corpus "exceeding ten percent of the value of such corpus."⁶⁵ Although the Coffee and Schwartz proposal succeeds in establishing a threshold level below which economic interests may become too attenuated to support derivative suit standing, the proposal presents severe administrative difficulties. To the extent that securities are not traded on an organized exchange or relate to a closely held or non-public corporation, valuation of interests in such enterprises poses considerable difficulty.⁶⁶

To avoid valuation problems, the Statute adopts an indirect measure of the holder's interest in the corporation. In a proposal modeled after the proxy requirements of the California Corporation Code⁶⁷ and the ALI Code of Corporate Governance,⁶⁸ section 1(d)(ii) requires that if a beneficial interest is collectively or jointly held by ten or more persons, such an interest is a Qualified Interest only if the corporation has *actual knowledge* of all beneficial owners of the interest. This provision serves as an indirect measure of the holder's interest in the corporation for two reasons. First, it provides a measure above which an interest is presumed to be qualified. If a beneficial interest is held collec-

65. Coffee & Schwartz, *supra* note 22, at 332.

66. See Hardy, *The Valuation of a Closely-Held Business*, ALI-ABA COURSE MATERIALS J., June 1981, at 35.

67. CAL. CORP. CODE § 605 (West Supp. 1985).

68. ALI Code, *supra* note 21, § 1.

tively by fewer than ten persons, the Statute presumes that the value of any one of their holdings is sufficient to maintain a derivative action. This conclusion can, of course, be rebutted by a showing that the plaintiff is incapable of fairly and adequately representing the class of injured parties.⁶⁹

If a beneficial interest falls below the measure, knowledge by the corporation of the identity of actual holders of its securities distinguishes the interest from an attenuated or cursory interest attained merely to support frivolous litigation. If the beneficial holders have put the corporation on notice of their interest in the enterprise before allegations of wrongdoing occur, the individual holders should be allowed to protect their interests through derivative litigation.

Because size and value, as they relate to a beneficial interest, are relative terms, they say nothing about the likelihood of injury to the particular interest involved. The interests of some holders, though small in relation to the enterprise, may nevertheless be significant in relation to the holder. Thus, the right to sue derivatively should not turn on size or value of a beneficial interest alone. It is doubtful whether many collective interests would comply with the statutory restriction—the expense of providing notice of beneficial interests held in large pension funds, to continue the above example, is likely to outweigh the benefits of protecting derivative rights; but where compliance is met, genuine interest in the enterprise has been manifested clearly, and the possibility of frivolous litigation is insufficient to prevent the maintenance of a derivative claim.

b. Debt instruments— Section 1(d)(iii) includes within the definition of Qualified Interest any unsecured debt security convertible into stock or carrying warrants or subscription rights. This provision codifies the result in *Hoff v. Sprayregan*,⁷⁰ conferring standing on holders of convertible debentures. The Statute maintains the view that when an investor acquires an unsecured debt instrument convertible into stock, he also acquires an interest in the corporation's future prospects and management integrity arising both from his right of repayment of principal and interest and from his contingent right to equity participation in the enterprise.

A number of judicial decisions have refused to permit holders

69. Statute § 3(a).

70. 52 F.R.D. 243 (S.D.N.Y. 1971). See also *Brooks v. Weiser*, 57 F.R.D. 491 (S.D.N.Y. 1972).

of convertible debentures to sue derivatively.⁷¹ In *Harff v. Kerkorian*,⁷² for example, the Delaware Court of Chancery refused to allow holders of convertible debentures to sue derivatively because of the court's view that all debenture holders, regardless of conversion rights, are "creditors" of the corporation whose "rights are determined by their contracts."⁷³ This Commentary argues that the restrictive view of the status of convertible debenture holders evinced by the *Harff* court fails to comport with the view of both holders of convertible securities themselves and many corporate managers.

The holder of a convertible security is unlikely to view himself solely as a creditor of the corporation for two reasons. First, the performance of the corporation while the conversion option remains viable determines whether the holder will reap a profit beyond return of investment. Second, the purchaser of convertible securities pays a premium for the conversion feature by accepting an interest rate significantly lower than non-convertible issues of the same type.⁷⁴

Corporate managers are likewise unlikely to view convertible security holders as mere creditors. Under the typical convertible security agreement, the corporation has a duty to reserve a sufficient amount of shares to effect conversion of all outstanding convertible securities as long as they remain viable.⁷⁵ From the standpoint of financial planning, management is aware that use of a convertible issue facilitates capital formation by both delaying and reducing dilution of outstanding common stock.⁷⁶ Convertibles allow management to keep up reported per share earnings, thus maintaining the market value of currently outstanding

71. See, e.g., *Kusner v. First Penn Corp.*, 395 F. Supp. 276 (E.D. Pa. 1975), *rev'd in part*, 531 F.2d 1234 (3d Cir. 1976); *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

72. 324 A.2d 215 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

73. 324 A.2d at 219.

74. See Note, *Hoff and Harff: Does the Convertible Debenture Holder Have Standing to Maintain a Shareholder Derivative Action?*, 26 SYRACUSE L. REV. 730, 748 (1975) (citing H. HENN, *LAW OF CORPORATIONS* § 156 (2d ed. 1970)). The attractiveness of a particular investment depends upon both its expected rate of return and its risk. C. HALEY & L. SCHALL, *THE THEORY OF FINANCIAL DECISIONS* 93-105 (1973). A debenture holder's "rate of return" is the interest rate to be earned on the investment; his "risk" is measured by the rates that he may possibly earn. *Id.* at 102-03. The possibility of equity participation in the corporate enterprise positively affects the former while not affecting the latter. A lower fixed interest rate paid on convertible securities, therefore, produces investor satisfaction equal to the higher rate paid on its non-convertible counterpart.

75. Katzin, *Financial and Legal Problems in the Use of Convertible Securities*, 24 BUS. LAW. 359 (1969).

76. *Id.* at 362.

equity securities, while enjoying an influx of capital. Future conversions occur, it is hoped, at a time when higher earnings or a larger capital base compensate for any dilutive effect.

Because of these obvious and fundamental differences between straight debt securities and convertible securities, decisions basing derivative rights on the distinction between "proprietary" and "creditor" interests are unrealistic and inequitable. Section 1(d)(iii), therefore, provides that holders of convertible securities are qualified to bring a derivative suit in the right of the issuing corporation.

Sound policy reasons support the extension of derivative rights to convertible security holders. First, the protection currently afforded convertible security holders under the law of contracts and negotiable instruments⁷⁷ is insufficient to compensate adequately for corporate misdeeds. For example, should officers or directors of the corporation engage in self-dealing transactions or usurp corporate opportunities, the result could be a significant decline in the market value of the corporation's stock and, concomitantly, a decrease in the value of the conversion option.⁷⁸ If the corporate fund is depleted to the point at which principal or interest cannot be paid or a conversion is wrongfully disallowed, the convertible security holder has an adequate remedy for a portion of the injury. Unless the corporation or a shareholder brings an action to correct the wrong, however, the convertible security holder is without a remedy for injury to a significant part of his investment. Even a token adherence to a compensatory rationale, therefore, mandates the extension of derivative rights.

Second, although in many ways the interest of the convertible security holder in the well-being of the corporation is commensurate with that of holders of the corporation's stock, the convertible security holder's input into corporate affairs is far more limited. The convertible security holder does not possess voting rights, appraisal rights,⁷⁹ or any of the other proprietary aspects

77. See 6A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 2695, 2728, 2745 (perm. ed. 1968); H. HENN, *supra* note 74, § 155, at 277.

78. In the usual case, the convertibility feature allows the conversion or exchange of the security for a fixed number of shares of stock of the corporation. If the value of the stock is less than the value of the security, the conversion possesses no economic utility. Moreover, if the outlook for the stock shows little chance of reaching the point at which conversion is economically meaningful, the value of the conversion feature is negligible.

79. In most jurisdictions, statutes confer on individual shareholders the right to receive the cash value of their stock when they dissent to certain corporation action—such as consolidation, merger, reorganization, sale or transfer of assets, or certain alterations of preferential or voting rights. See, e.g., DEL. CODE ANN. tit. 8, § 262 (1984) (appraisal

of stock ownership designed to afford input into corporate affairs.⁸⁰ The goal of deterrence is thus effectively served by the extension of derivative rights to convertible security holders who, without such rights, are virtually impotent to object to corporate actions affecting their ownership interests.

Finally, the danger of strike suits and collusive litigation does not appear to be higher among holders of convertible securities than non-convertible securities. The same devices adopted throughout the Statute to avoid these dangers, therefore, are equally adequate in the case of convertible security holders.

The convertibility feature provides the justification for the extension of derivative rights to convertible security holders, but no practical or policy grounds support the extension of such rights to all holders of debt securities.⁸¹ As an initial proposition, it is unclear that holders of debt securities are injured by the failure to enforce a corporate cause of action. Until a default on the payment of interest or principal occurs, there is no cognizable injury. Although any depletion of the corporate fund increases the risk that such a default will occur,⁸² debt security holders are typically protected from such risks by restrictive indenture⁸³ or security⁸⁴ provisions. When default occurs, the debt

rights); ILL. ANN. STAT. ch. 32, §§ 11.35 (merger or consolidation), 11.60 (sale, lease, or exchange of assets), 11.65 (right to dissent) (Smith-Hurd 1985); N.Y. BUS. CORP. LAW § 910 (McKinney Supp. 1984) (merger, consolidation or sale, lease or exchange of assets). See generally 12B W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 5906.1-17 (perm. ed. 1984).

80. Non-shareholder investors are not afforded the protection of state corporate law regarding the duties of care and loyalty owed by directors to the corporation. See *supra* note 3 and accompanying text.

81. For an articulate presentation of the arguments supporting the extension of derivative rights to all corporate creditors, see Note, *Creditors' Derivative Suits on Behalf of Solvent Corporations*, 88 YALE L.J. 1299 (1979).

82. See *id.* at 1306 (arguing that creditors should be compensated for any increases in risk over the life of the security).

The depletion/increased risk argument, when strictly applied, proves too much. Normal corporate distributions such as dividend payments deplete the corporate fund, and thus increase the risk of default, in the same way mismanagement does. From the viewpoint of debt security holders, neither is significant unless it results in a default.

83. An indenture, sometimes referred to as a trust agreement or deed of trust, is a contractual agreement between the debtor corporation and a trustee for the security holders. Indentures, with minor exceptions, must be qualified under and are subject to the terms of the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1981). To qualify under the Act, the indenture must provide for an independent trustee, typically a financial institution, that is subject to affirmative duties to protect the security holders. The typical indenture contains numerous and elaborate covenants designed to protect the debtor's assets from dissipation or encumbrance during the life of the security. These covenants often limit corporate borrowings and pledge of assets, impose working capital and liabilities-to-assets margins, restrict dividend payments, restrict redemption of outstanding stock, impose reserve requirements, and limit new issues of securities. See

security holder is protected by equitable remedies⁸⁵ and a priority position in insolvency proceedings.⁸⁶ In addition, when default occurs because of corporate mismanagement, many jurisdictions recognize an action by creditors against corporate officers for negligence,⁸⁷ and personal liability for corporate debts may be imposed by statute.⁸⁸ The extension of derivative rights would add nothing to existing protections, while creating an unsettling and perhaps burdensome change in the traditional debtor/creditor relationship.

2. Ownership requirements—

a. *Contemporaneous ownership rule*— The contemporaneous ownership rule requires that a plaintiff in a derivative action own his interest in the corporation at the time of the wrong of which he complains, or to thereafter have acquired his interest

AMERICAN BAR FOUND., COMMENTARIES ON INDENTURES 326-467 (1971); Garret, *A Borrower's View of the Model Corporate Debenture Indenture Provisions*, 21 BUS. LAW. 675, 680-81 (1966); Rodgers, *The Corporate Trust Indenture Project*, 20 BUS. LAW. 551 (1965).

84. The creditor can gain additional protection through the use of a mortgage bond—a bond secured by a mortgage or lien on specific property of the debtor corporation.

85. In addition to the remedies provided by the law of contracts and negotiable instruments, see *supra* text accompanying note 77, the creditor's bill is available in many jurisdictions as an additional or alternative means of obtaining relief. The theory is that the corporate right of action against its fiduciary is a chose in action and therefore an equitable asset that can be reached by creditors upon insolvency of the corporation. See, e.g., *A.B. Gochenour v. George & Francis Ball Found.*, 35 F. Supp. 508 (S.D. Ind. 1940), *aff'd*, 117 F.2d 259 (7th Cir.), *cert. denied*, 313 U.S. 566 (1941); *Michelsen v. Penney*, 10 F. Supp. 537 (S.D.N.Y. 1934); *Pritchard v. Myers*, 174 Md. 66, 197 A. 620 (1938); *Pennsylvania Bank v. Hopkins*, 111 Pa. 328, 2 A. 83 (1886). Insolvency is not required when the corporate fiduciary has acted with an actual intent to defraud creditors. See UNIFORM FRAUDULENT CONVEYANCE ACT § 7, 9A U.L.A. 93 (1951). For a general discussion of the creditor's bill, see 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1180, 1182 (rev. perm. ed. 1975).

86. See Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 507, 726 (1982).

87. See *supra* note 85 discussing creditor's bill.

88. 3A W. FLETCHER, *supra* note 85, § 1200. Fletcher notes that the various statutory schemes employ one or more of the following remedial approaches: (1) creating liability where conditions precedent to right to do business have not been complied with, or where all or part of the capital stock has not been subscribed for or paid in; (2) creating liability for violation of certain provisions of the corporate statute; (3) creating liability to creditors or others for negligence or breach of duty; (4) creating liability where debts exceed a statutorily imposed formula; (5) creating liability where dividends are wrongfully paid; (6) creating liability for failure to file required reports and for the filing of false reports. *Id.* See DEL. CODE ANN. tit. 8, § 174 (1983) (directors liable to corporation and to creditors in event of insolvency, for unlawful dividend payments, stock purchases, or redemptions); N.Y. BUS. CORP. LAW §§ 719(a), 720 (McKinney 1963 & Supp. 1984) (directors liable under certain circumstances for loans, dividends, stock repurchases, and other distributions to shareholders, misappropriation of corporate assets, and negligent mismanagement).

by devolution of law.⁸⁹ The rule has existed in substantially the same form since its adoption under federal law in *Hawes v. Oakland*,⁹⁰ and under state law in *Home Fire Insurance Co. v. Barber*.⁹¹ Both the Federal Rules of Civil Procedure⁹² and a majority of states have adopted the rule as a prerequisite to a derivative action.⁹³

By definition, the contemporaneous ownership rule requires that the plaintiff be a shareholder in order to have standing to commence a derivative action.⁹⁴ Only California and Pennsylvania expressly provide exceptions to this requirement.⁹⁵

The primary policy supporting the contemporaneous ownership rule is that a plaintiff should not be allowed to purchase a lawsuit through the acquisition of a corporate interest after the occurrence of injury because to do so may result in his unjust enrichment.⁹⁶ The main thrust of the rule, therefore, is to prevent a plaintiff from purchasing an interest at a price that already reflects the injury to the corporation and then bringing

89. For a general discussion of the contemporaneous ownership rule, see 13 W. FLETCHER, *supra* note 85, at § 5981; H. HENN, *supra* note 74, at 263. See also *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703 (1974).

90. 104 U.S. 450 (1881).

91. 67 Neb. 644, 93 N.W. 1024 (1903).

92. See FED. R. CIV. P. 23.1 (1984).

93. See, e.g., DEL. CODE ANN. tit. 8, § 327 (1974 & Supp. 1984); ILL. ANN. STAT. ch. 32, § 7.80(a) (Smith-Hurd 1985); MASS. ANN. LAWS ch. 156B, § 46 (Michie/Law. Co-op. 1979 & Supp. 1985); OHIO CIV. R. 23.1; NEB. REV. STAT. § 21-2047 (1983); N.J. STAT. ANN. § 14A:3-6 (West 1969); N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963 & Supp. 1984); PA. STAT. ANN. tit. 15, § 1516(A) (Purdon 1967 & Supp. 1985). See also ALI Code, *supra* note 21, at 255; MBCA Revisions, *supra* note 62, at 262-63; Coffee & Schwartz, *supra* note 22, at 312.

94. See, e.g., ARIZ. REV. STAT. ANN. § 10-049 (1977); MONT. CODE ANN. § 35-1-514 (1985); NEB. REV. STAT. § 21-2047 (1983); N.M. STAT. ANN. § 53-11-47 (1978); R.I. GEN. LAWS § 7-1.1-43.1 (1969); WIS. STAT. ANN. § 180.405 (West 1957 & Supp. 1985).

95. CAL. CORP. CODE § 800(b)(1) (West 1977 & Supp. 1985) (requiring that (a) there is a strong prima facie case in favor of the claim asserted; (b) no other action has been or is likely to be asserted; (c) the defendant would otherwise retain a gain derived from a willful breach of a fiduciary duty; and (d) relief will not unjustly enrich the plaintiff); PA. STAT. ANN. tit. 15, § 1516(A) (Purdon 1967 & Supp. 1985) (court, in its discretion, may permit derivative action to continue despite lack of contemporaneous ownership if there is a strong prima facie case in favor of claim and if, without allowance of the claim, "serious injustice" would result). See *infra* notes 109-14 and accompanying text.

96. See *Home Fire Ins. Inc. v. Barber*, 67 Neb. 644, 661-62, 93 N.W. 1024, 1030-31 (1903); *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703, 711 (1974).

The policy behind Rule 23.1 of the Federal Rules of Civil Procedure is directed additionally or alternatively at another evil: collusive transfer of stock to nonresidents to invoke the diversity jurisdiction of the federal courts. See Harbrecht, *Contemporaneous Ownership Rule in Shareholders' Derivative Suits*, 25 UCLA L. REV. 1041, 1042 (1978). Obviously, a state law rule is not concerned with the federal anti-collusive policy and instead focuses on the evil of purchased litigation.

suit to restore the corporate fund, thereby recovering a windfall.

This Commentary argues for two reasons that the contemporaneous ownership rule is an inappropriate vehicle for addressing these policy concerns. First, the rule is unnecessarily overbroad and excludes from derivative actions two classes of plaintiffs capable of presenting meritorious claims: certain shareholder plaintiffs and all nonshareholder plaintiffs.⁹⁷ As for shareholder plaintiffs, the underlying assumption of the contemporaneous ownership rule that all persons acquiring an interest after the occurrence of a corporate injury are necessarily aware of such injury, or acquire the interest at a price that fully reflects the injury, is unsupported. In fact, available evidence indicates that this assumption is unrealistic and fallacious.

Even assuming that United States capital markets are efficient so that market prices fully reflect currently available public information,⁹⁸ evidence suggests that access to nonpublic or quasi-public information, such as information concerning corporate injury of a type effectively redressed in a derivative action, is generally limited to corporate insiders and financial specialists.⁹⁹ Additional evidence suggests that these two groups can and do exploit such nonpublic information to their advantage.¹⁰⁰ It is likely, therefore, that such exploitation at best delays, and at worst prevents, accurate reflection of the injury by the market price of the corporation's securities.

To illustrate, assume that a corporate insider or financial specialist, upon learning of rumors of corporate mismanagement or of facts suggesting the likelihood of management misconduct, sells his interest to a buyer lacking access to such information or without the knowledge or ability to evaluate such information, at a price equivalent to, or nearly equivalent to, the market price before any injury occurred. When the corporate injury becomes evident, the buyer is prevented by the contemporaneous ownership rule from bringing a derivative action because he was not an owner at the time of the occurrence of the injury.¹⁰¹ Thus, the rule denies derivative rights to shareholders with meritorious claims who purchase at a nondiscounted price after a corporate injury, even though there is no danger that the noncon-

97. See Coffee & Schwartz, *supra* note 22, at 313; ALI Code, *supra* note 21, § 7.02 comment, at 266-67.

98. See generally Note, *supra* note 36.

99. *Id.* at 1053-54.

100. *Id.*

101. See *Russell v. Louis Melind Co.*, 331 Ill. App. 182, 72 N.E.2d 869 (1947).

temporaneous plaintiff would recover a windfall.¹⁰²

The same analysis applies to a nonshareholder owner of a Qualified Interest, as defined in the Statute.¹⁰³ If the Qualified Interest was purchased after the corporate injury occurred, but before such injury was effectively reflected in the price of the Qualified Interest, the contemporaneous ownership rule precludes the holder from initiating a Derivative Action. Moreover, the rule operates to deny standing to *all* nonshareholder owners of Qualified Interests. The anomalous results thus produced by the contemporaneous ownership rule supply cogent reasons for its modification.

Furthermore, the rule's adherence to a strict cutoff point to measure standing magnifies the difficulty involved in determining the exact time of occurrence of corporate injury. For example, assume the corporation enters into a long-term property lease with its controlling shareholder at an unfair rental before the plaintiff purchases the corporation's stock. Although the corporation entered into the agreement before the plaintiff purchased his interest, its obligation to pay rent continues after plaintiff has acquired his interest. Arguably, the time of the wrong occurred when the corporation entered into the lease, and thus, because such time was before the shares were purchased, plaintiff would be precluded by the contemporaneous ownership rule from maintaining a derivative action. On the other hand, one could argue that each period of accrued rent represents a separate wrong. Under this interpretation, the plaintiff qualifies as a contemporaneous owner for at least a portion of the injury. The contemporaneous ownership rule thus fails to provide a clear test for deciding standing, relegating the most important issues to the vagaries of individual determinations. The result is an unacceptable waste of time and money on procedural litigation.

To counter the negative effects of the contemporaneous ownership rule, three states have adopted by statute the "continuing wrong" doctrine.¹⁰⁴ Under that doctrine, a plaintiff who purchases his interest after the initial occurrence of the wrong of which he complains may maintain a derivative action if the al-

102. Conversely, a person who purchased corporate shares with the expectation that the corporation would redress the injury, which expectation results in a higher purchase price, is equally unable to effect recovery. See Harbrecht, *supra* note 96, at 1062.

103. For a discussion of the Statute's concept of Qualified Interest, see *supra* notes 60-88 and accompanying text.

104. CAL. CORP. CODE § 800 (West 1977 & Supp. 1985); OHIO CIV. R. 23.1; WIS. STAT. ANN. § 180.405 (West 1957 & Supp. 1985).

leged wrong is continuing at the time of purchase.¹⁰⁵ Other jurisdictions have adopted the continuing wrong doctrine through judicial decision.¹⁰⁶

Although the continuing wrong doctrine partially alleviates the overbreadth of the contemporaneous ownership rule by permitting owners who purchased in the interval between commencement and termination of the wrong to maintain a derivative action, it does not completely cure the problem. Under the doctrine, a plaintiff purchasing his interest after termination of the wrong but before disclosure is still denied standing. Thus, assuming the market does not effectively discount the price of plaintiff's interest before disclosure, a plaintiff with a meritorious claim may lack a remedy.

Moreover, the continuing wrong doctrine does not address the problems inherent in pinpointing the time of occurrence of a corporate injury, and the time when such injury ceases. Such problems are exacerbated in certain jurisdictions that have judicially adopted the doctrine but continue to apply it in a cautious manner. Such jurisdictions often refuse to extend derivative rights in any but the most obvious cases of continuing injury.¹⁰⁷

Another deficiency in the continuing wrong doctrine is that it does not provide a clear test for determining what portion of the wrong necessitates derivative recovery. For example, applying the doctrine to the hypothetical of the long-term lease, it is unclear whether derivative relief should encompass only those rental payments made after the plaintiff acquired his interest or should extend to all injury proximately caused by the unfair agreement. Finally, the continuing wrong doctrine may operate to permit the very evils it was designed to prevent: purchased litigation and unjust enrichment. The doctrine would permit suit by a plaintiff who purchased his interest at a price reflecting the present value of a continuing injury in circumstances in which the injury continued long after public disclosure, thus allowing purchased litigation. The deterrence rationale must be tempered to prevent the possibility of champerty once public or

105. Dykstra, *supra* note 9, at 95.

106. See, e.g., *Palmer v. Morris*, 316 F.2d 649 (5th Cir. 1963) (under Federal Rules of Civil Procedure, plaintiff allowed to maintain derivative action where transaction complained of occurred before plaintiff's purchase of stock and injurious acts continued after purchase); *Gluck v. Unger*, 25 Misc. 2d 554, 202 N.Y.S.2d 832 (Sup. Ct. 1960) (plaintiff allowed to maintain derivative action alleging unfair settlement of corporate claim arising from merger where merger was consummated before plaintiff purchased interest, but suit that resulted in alleged unfair settlement occurred after such purchase).

107. See, e.g., *Maclary v. Pleasant Hills, Inc.*, 35 Del. Ch. 39, 109 A.2d 830 (1954); *Goldie v. Yaker*, 78 N.M. 485, 432 P.2d 841 (1967).

private disclosure of corporate injury has occurred.¹⁰⁸ For all of these reasons, the contemporaneous ownership rule as modified by the continuing wrong doctrine is an inadequate and ill-conceived solution to the evils that attend derivative litigation.

b. Alternatives to the contemporaneous ownership rule—There are two statutory alternatives to the traditional contemporaneous ownership requirement.¹⁰⁹ These alternatives require contemporaneous ownership, but permit suit by a noncontemporaneous owner if certain conditions are satisfied.¹¹⁰

The California Corporation Code permits suit by a noncontemporaneous owner if the following five conditions are met:

- (i) there is a strong *prima facie* case in favor of the claim asserted on behalf of the corporation, (ii) no other similar action has been or is likely to be instituted, (iii) the plaintiff acquired the shares before there was disclosure to the public or to the plaintiff of the wrongdoing of which plaintiff complains, (iv) unless the action can be maintained the defendant may retain a gain derived from defendant's willful breach of a fiduciary duty, and (v) the requested relief will not result in unjust enrichment of the corporation or any shareholder of the corporation.¹¹¹

Pennsylvania permits such actions if "there is a strong *prima facie* case in favor of the claim asserted on behalf of the corporation and . . . without such suit serious injustice would result."¹¹²

Although the Pennsylvania and California approaches cure the overbreadth and timing problems created by the contemporaneous ownership rule by permitting noncontemporaneous owners to sue under certain conditions, they are undesirable for contrasting reasons. The California requirement is unwieldy in application because it is overly specific. In the words of one commentator, "It is so encumbered with conditions and restrictions that it would appear to be virtually meaningless, although a case may arise now and then in which the plaintiff may be able to satisfy all of [the] conditions."¹¹³ The Pennsylvania requirement, on the other hand, relies too heavily on a judicial determination of standing rather than on a statutory standard. To determine

108. See *infra* notes 115-21 and accompanying text.

109. See *supra* note 95 and accompanying text.

110. In addition, Professors Coffee and Schwartz advocate an approach based loosely on the California scheme. See Coffee & Schwartz, *supra* note 22, at 313, 332.

111. CAL. CORP. CODE § 800(b)(1) (West 1977 & Supp. 1985).

112. PA. STAT. ANN. tit. 15, § 1516(A) (Purdon 1967 & Supp. 1985).

113. 17 H. MARSH, CALIFORNIA CORPORATION LAW & PRACTICE § 14.31 (1985).

whether a noncontemporaneous plaintiff has a "strong *prima facie* case"¹¹⁴ a Pennsylvania court is required to hold a mini-hearing on the merits at the outset of the litigation. Thus, because of its generality, the Pennsylvania approach unreasonably burdens the court and the parties with procedural litigation.

c. *Proposed standards*— The ownership requirements of section 3 of the Statute are unique in that they do not adopt any variation of the contemporaneous ownership rule.¹¹⁵ The Statute substitutes a new three-part requirement for the rule.¹¹⁶ Initially, section 3(a) requires that the plaintiff hold a Qualified Interest in the corporation.¹¹⁷ Second, section 3(b)(i) requires the plaintiff to have acquired the Qualified Interest before the alleged wrong to the corporation is disclosed either publicly, as evidenced by market price, or privately to the plaintiff, as evidenced by purchase price. Thus, instead of focusing on the elusive moment when corporate injury actually occurs or when it ceases, the cutoff point for standing to maintain a derivative action is the time of public or private disclosure of the injury.

Section 3(b)(i) provides two objective standards for determining whether disclosure has occurred. First, if information concerning the alleged wrong is made generally available to the public, and, on the basis of such information, the market discounts the value of the interest purchased or otherwise reacts to the information, public disclosure for the purpose of the Statute has occurred. Thus, until the public information is reflected in the price of the corporate interest purchased, public disclosure within the meaning of section 3(b) has not occurred. For example, disclosure of corporate injury in an obscure publication, having no impact on the market price of the corporation's securities, does not constitute section 3(b) public disclosure.¹¹⁸ Second, even if there has been no public disclosure of the corporate injury, any private disclosure to the plaintiff before acquiring an interest constitutes disclosure under the personal disclosure standard of section 3(b), so long as the price paid for the interest reflects the disclosed information.

114. PA. STAT. ANN. tit. 15, § 1516(A) (Purdon 1967 & Supp. 1985).

115. Section 3 of the Statute is a unique hybrid of approaches found in certain state statutes and academic commentaries. See CAL. CORP. CODE § 800(b)(1) (West 1977 & Supp. 1985); ALI Code, *supra* note 21, § 7.02(a)(ii); Coffee & Schwartz, *supra* note 22, at 312-33.

116. See Statute § 3(a)-(c).

117. See *supra* notes 60-88 and accompanying text.

118. The intent of this section is to create an objective standard based on a concept of public disclosure similar to that employed to enforce the insider trading prohibitions of the federal securities laws. See generally Securities & Exch. Comm'n v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968).

Section 3(b)(ii) allows plaintiffs whose interests devolved upon them by operation of law to maintain derivative actions, provided that the person from whom the interest was acquired would have qualified under either of the foregoing tests. Under section 3(b)(ii), the disclosure inquiry shifts from the plaintiff to his predecessor in interest. To maintain the action, therefore, the plaintiff must plead and prove that his predecessor acquired the interest before the time of public or private disclosure.

Holders of Qualified Interests in closely held corporations are exempt from the requirements of section 3(b).¹¹⁹ By definition there is no market for the shares of a closely held corporation, so public disclosure of injury is irrelevant. In addition, the time of private disclosure standard of section 3(b) is not suitable for shareholders of closely held corporations, because it requires evidence of an effect on the purchase price related to disclosure of the wrong. Again, because there is no market for closely held shares, the measurement and valuation problems persist. Consequently, section 6 applies special standing requirements to closely held corporations.

The final ownership requirement of the Statute, found in section 3(c), requires the plaintiff to have held his Qualified Interest continuously from the time of disclosure of the injury complained of until the last appeal of the action has elapsed. This requirement reflects the same policy concern as section 3(a)'s requirement that the plaintiff be capable of fully and fairly representing the class of persons injured by the alleged wrong—namely, that the plaintiff is acting in the best interests of the corporation and not solely for personal benefit.

To illustrate, if plaintiff divests himself of his interest during the litigation, he no longer has an incentive to make decisions in the best interests of the corporation, but instead may make decisions on the basis of personal interests. Although key decisions relating to the continuation of the derivative suit are subject to court approval,¹²⁰ numerous important decisions relating to the prosecution of the action are made by the plaintiff and his attorney in the normal course of litigation. To discourage collusion and subterfuge, therefore, it is desirable that the plaintiff retain a personal stake in the corporation throughout the action.

119. Statute §§ 3(b), 6. Section 1 of the Statute defines a "close corporation," to which § 6 is applicable. See *infra* notes 203-09 and accompanying text.

120. See *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 547-50 (1949); *Schupack v. Covelli*, 498 F. Supp. 704, 705 (W.D. Pa. 1980).

Section 3(c) is also designed to discourage "purchased litigation" in that an individual holding a Qualified Interest at the time of corporate injury but before disclosure of such injury could sell the interest at the prevailing market price and, after disclosure, acquire another Qualified Interest at a price reflecting the injury. Without the section 3(c) requirement of continuous ownership, such a holder would have standing to bring and maintain a derivative action, because he acquired his original Qualified Interest before disclosure. The plaintiff in this case, however, is no better qualified to maintain the action than any person disqualified by the requirements of section 3(b).¹²¹ The continuous ownership requirement is thus supported by the same policies underlying section 3(b) and is, in fact, necessary to maintain the integrity of that section.

D. Dismissal

The unique character of the derivative suit as a cause of action brought in the right of the corporation raises important issues regarding who speaks for the corporation in the prosecution of the action. Put directly, should a holder of a Qualified Interest be allowed to prosecute a corporate claim that the directors have determined should not be pursued? Corporations are turning with increasing frequency to committees of independent directors to evaluate derivative claims and to provide the basis for dismissal of such claims. Section 4 of the Statute addresses the issue of when, and under what circumstances, a derivative cause of action may be dismissed on the recommendation of a committee of independent directors.

1. *The basis of corporate control*— In *Wolf v. Barkes*,¹²² the Second Circuit unequivocally held that a corporation may obtain an involuntary dismissal of a derivative claim on the basis of a settlement between the corporation and the named defendants.¹²³ The court evidently believed that the corporation should have control of the corporate cause of action, even if styled as a derivative claim. The natural progression of this rationale is dismissal based on the recommendation of a committee of independent directors. In fact, because the members of the commit-

121. See Statute § 5 (Derivative Action to be settled, compromised, or discontinued only upon court approval after settlement hearing). See also *infra* notes 178-93 and accompanying text.

122. 348 F.2d 994 (2d Cir.), cert. denied, 382 U.S. 941 (1965).

123. *Id.*

tee are "independent," it can be argued that dismissal on their recommendation is preferable to the out-of-court settlement in *Wolf*.¹²⁴

The central point to remember in discussing the termination of a derivative cause of action by the corporation is that the vast majority of such actions are brought against persons in positions of influence or control in corporate management. One of the main functions of the derivative action is to provide an effective mechanism to deter misconduct by management and those in nominal control of the corporation. To conclude, therefore, that the board of directors is empowered in all circumstances to engineer the dismissal of derivative claims would eviscerate the action's utility as a deterrence mechanism.

The *Wolf* court recognized that structural bias¹²⁵ may corrupt any corporate decision regarding a derivative action against its own officers or directors: "[S]ome suspicion may attach to a settlement made by a board of directors that has shown no inclination to collect corporate claims until its hand is forced by the start of a derivative suit."¹²⁶ The presumption of propriety, independence, and good faith normally accorded management decisions and embodied in the business judgment rule¹²⁷ is, therefore, called into question in the present context. The real question is not *whether* the corporation is empowered to dismiss actions brought on its behalf—*Wolf* unequivocally establishes its right to do so—but what *judicial standard of review* will apply to such decisions.

2. *The doctrine of deference—Auerbach v. Bennett*—The initial judicial consideration of a board of directors' decision to seek dismissal of a derivative action based on the recommendation of a committee of independent directors resulted in a holding that courts must defer to the business judgment rule in reviewing the recommendation of an independent committee. In

124. The *Wolf* court opined that the out-of-court settlement, even if collusive, would be subject to attack by disgruntled shareholders in a subsequent proceeding for fraud or waste of corporate assets. *Id.* at 996-97.

125. Structural bias has been defined as "an attitude that attaches to a directorship and rests on cultural ties that antedate the director's election or appointment, which combine to draw the directors to the defendants' side." Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 1010.

126. 348 F.2d at 997.

127. The law traditionally gives directors and executive officers wide latitude in which to exercise their discretion. No liability will attach for good faith errors or mistakes of judgment. See, e.g., *Briggs v. Spaulding*, 141 U.S. 132 (1891) (citing cases); *Kaplan v. Centex Corp.*, 284 A.2d 119 (Del. Ch. 1971). This notion is commonly referred to as the business judgment rule.

Auerbach v. Bennett,¹²⁸ New York's highest court held that under the business judgment rule a court is powerless to evaluate the legal, ethical, commercial, or economic grounds supporting a committee's recommendation that a derivative suit be dismissed.¹²⁹ The *Auerbach* court reasoned that these considerations are exclusively within the domain of the board of directors and that the court's examination is limited to areas that have traditionally remained open to inquiry under the business judgment rule: the directors' independence and good faith.¹³⁰ The court allowed that, under certain circumstances, the limited areas of permissible inquiry may include challenges to the adequacy and appropriateness of the committee's procedures,¹³¹ but held that the substantive bases of the committee's recommendation are entitled to uncritical judicial deference.

This Commentary argues that the doctrine of deference created by *Auerbach* is inappropriate. First, the foundation of the doctrine, the business judgment rule, is inapposite in the context of a recommendation of dismissal by a special litigation committee. The business judgment rule is premised on the realization that investors assume the risk of bad business judgment by management, and that it is in the interests of investors that the law not create incentives for overly cautious management by second-guessing corporate decisions and holding risk-taking managers liable, in hindsight, for bad decisions. The rule extends, however, only so far as its underlying rationale.¹³² In the context of a special committee's recommendation, it cannot reasonably be said that investors assume the risk of breaches of fiduciary obligations by management to the same extent that they assume the risk of commercial decisions. The overwhelming deference the business judgment rule accords to decisions involving commercial transactions is, therefore, unwarranted. In addition, closer scrutiny of the committee's recommendation is not likely to subject committee members to potential liability for improper decisions, because a court's rejection of the recommendation nullifies its adverse impact on the corporation.

Second, because the issue of terminating derivative litigation

128. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

129. *Id.* at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.

130. *Id.* at 623-24, 393 N.E.2d at 996, 419 N.Y.S.2d at 922.

131. *See id.*

132. *See* McDonnell v. American Leduc Petroleum, Ltd., 491 F.2d 380 (2d Cir. 1974) (corporate decision a result of management failure to exercise oversight and supervision); Singer v. Magnavox, 380 A.2d 969 (Del. 1977) (business judgment rule inapplicable where corporate decision lacks business purpose); Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918) (corporate decision tainted by conflict of interest).

requires the weighing of probabilities of success on the merits and recovery of damages, the committee's recommendation is not strictly within the board's expertise. It is an area in which the expertise of the court is more appropriately applied.¹³³ For these reasons, this Commentary argues that the deference accorded to the special litigation committee by the *Auerbach* court is unwarranted. The court must take an active role in evaluating such recommendations under certain circumstances to maintain the credibility of the derivative action as a deterrence mechanism.

3. *Step-by-step—Zapata Corp. v. Maldonado and Aronson v. Lewis*— In *Zapata Corp. v. Maldonado*,¹³⁴ the Delaware Supreme Court took a very different view from that of the *Auerbach* court of the power of an independent committee of directors to terminate derivative litigation.¹³⁵ The *Zapata* court held that, where a derivative action has been properly commenced without prior demand on the board of directors, an action may be terminated on the basis of a recommendation of a committee of independent directors when: (1) the committee has determined, reasonably and in good faith, that prosecuting the action is not in the best interest of the corporation, and (2) the court has determined, in the exercise of its own business judgment, that there is no reason why the action should be continued.¹³⁶ In exercising such judgment, the court is to consider not only the corporation's "best interests"¹³⁷ but also matters of "law and public policy."¹³⁸

The Delaware Supreme Court specified a two-step procedure to be followed in evaluating the committee's recommendation. First, the court must satisfy itself that the committee was genu-

133. See, e.g., *Joy v. North*, 692 F.2d 880, 889 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983). When considering the standard of review under Connecticut law of a recommendation of a committee of independent directors to dismiss a pending derivative action, the Second Circuit noted: "A court is not ill-equipped to review the merits of that conclusion. Even when the Committee recommendation arises from the fear of further damage to the corporation . . . courts are not on unfamiliar terrain." *Id.*

134. 430 A.2d 779 (Del. 1981).

135. *Id.* at 788-89. *Zapata* involved a claim that controlling officers and directors of the corporation breached their fiduciary duty by accelerating the exercise date of certain stock options they owned in part. The plaintiff contended that by permitting exercise of the options immediately prior to the announcement of an issuer tender offer—which had the effect of increasing the market price of the corporation's shares—the defendants reduced the amount of capital gain realized by the option holders and thereby reduced the tax deduction available to the corporation.

136. *Id.* at 789.

137. *Id.*

138. *Id.*

inely independent, that it acted reasonably and in good faith, and had reasonable "bases" for its recommendation.¹³⁹ The burden of proof on these issues lies with the defendant.¹⁴⁰ Second, the court must determine whether a corporate interest or matter relating to the public interest warrants a continuation of the derivative action.¹⁴¹ In making this determination, the court may disagree that the corporation's interest would be best served by dismissal, or may determine that public policy considerations override the corporation's interest in dismissal.¹⁴²

In creating this step-by-step analysis, the Delaware Supreme Court displayed a keen sensitivity to balancing the corporation's need to dispose of burdensome derivative actions expeditiously with the policy goal of maintaining the derivative action as an effective means of deterring misconduct. By seeking a middle course between a deferential and a stringent standard of review, the court was motivated by a desire to avoid the abusive potential of structural bias inherent in corporate decisionmaking.¹⁴³

The *Zapata* court found the business judgment rule inappropriate for addressing these concerns. Thus, requiring the committee to prove its independence and good faith and the reasonableness of its conclusions is, in effect, a surrogate investigation of the committee's structural bias. The judicial activism embodied in *Zapata's* second level of analysis is a striking contrast to the passivity of the *Auerbach* approach and reveals that in certain cases the court is best positioned to determine the fate of the action. The test the *Zapata* court developed, however, suffers from serious structural flaws.

The most serious flaw in the *Zapata* test is its focus on the demand requirement. The two-step analysis applies only to

139. *Id.* at 788-89. The *Zapata* court likened this first step of review to a motion for summary judgment, because the motion is denied if genuine factual issues exist. *Id.* The court suggests, however, that the review may go further by actually resolving factual disputes through a mini-trial. *Id.* at 788 n.15.

140. *Id.* at 788-89. This holding effectively shifts the burden placed in pre-*Zapata* cases. See, e.g., *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); *Abbey v. Control Data Corp.*, 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Cramer v. GTE*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Rosengarten v. ITT Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979).

141. 430 A.2d at 789.

142. *Id.*

143. The court stated:

[W]e must be mindful that directors are passing judgment on fellow 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. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

Id. at 787.

cases in which demand on the board is excused; it does *not* apply when demand is required and rejected.¹⁴⁴ The result of this focus shifts analysis from a rational resolution of the problems posed by dismissal on a committee's recommendation to the technical resolution of the demand required/demand excused dichotomy.

The demand requirement is essentially a device to assure that intra-corporate remedies are exhausted before a derivative action is brought.¹⁴⁵ It is not probative of the question of whether the recommendation of a special litigation committee should be honored.¹⁴⁶ The *Zapata* court, therefore, artificially embosses the demand required/demand excused dichotomy on the question of the capacity of a special litigation committee to engineer the dismissal of a derivative action. In so doing, the Delaware court promotes confusion and shifts the inquiry to subsidiary questions.¹⁴⁷

144. *Id.* at 784 n.10. The two-step analysis is also applicable to cases in which demand was actually made, but under circumstances in which it could be legitimately excused. *See, e.g., Joy v. North*, 692 F.2d 880, 888 n.7 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); *Alford v. Shaw*, No. 8426SC371, slip op. at n.2 (N.C. Ct. App. Feb. 5, 1985).

At least one court has interpreted the two-step analysis as *not* limited to demand excused cases. In *In re Continental Ill. Sec. Litig.*, 572 F. Supp. 928 (N.D. Ill. 1983), the court, while applying Delaware law, held that the two-step analysis of *Zapata* applies even in a demand required case and that step two is in the discretion of the court. *Id.* at 930. *See also Mills v. Esmark*, 544 F. Supp. 1275, 1283 n.4 (N.D. Ill. 1982) ("Although the *Zapata* opinion does distinguish between demand and non-demand cases, we hesitate to draw [a] bright line . . .") (dictum). The weight of precedent, *see, e.g., Abramowitz v. Posner*, 672 F.2d 1025 (2d Cir. 1982); *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); *Maldonado v. Flynn*, 671 F.2d 729 (2d Cir. 1982); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), and commentary, *see, e.g., Cox, supra note 125; Block & Prussin, The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27 (1981), is against this interpretation of *Zapata*.

145. *See* 3B J. MOORE, FEDERAL PRACTICE § 23.1 (2d ed. 1979); 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE & PROCEDURE § 1831 (1972).

146. *Galef v. Alexander*, 615 F.2d 51, 59 (2d Cir. 1980):

A determination that directors are not so interested in the underlying transaction as to excuse demand on them does not mean that they are so disinterested as to enable them to eliminate the lawsuit. The rationale of the cases holding that demand must be made even if the directors have been or may be made defendants, is not that the directors can *preclude* suit despite being defendants, but rather that they might cause the corporation to *pursue* the suit despite being defendants.

147. The outcome determinative nature of the Delaware focus on the demand requirement is illustrated by comparing two decisions of the same panel of the United States Court of Appeals for the Second Circuit. In *Abramowitz v. Posner*, 513 F. Supp. 120 (S.D.N.Y. 1981), *aff'd*, 672 F.2d 1025 (2d Cir. 1982), shareholder plaintiffs asserted derivative claims against five directors based on Delaware law and § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982 & Supp. II 1984), alleging misappropriation of corporate funds and related misleading disclosures. Prior to the commencement of the derivative action, a civil suit brought by the Securities and Exchange Commission was settled by a consent decree establishing audit committees to determine

The direct result of *Zapata* is an increased emphasis on the demand requirement. Because the applicability of any substantive judicial review of a dismissal recommendation hinges on the demand issue, demand futility¹⁴⁸ has become a central issue in Delaware derivative litigation. Realizing the impact of this re-

whether the corporation should pursue legal action against the five directors. Following their investigation, the audit committees advised the board not to bring suit if the five directors made restitution to the corporation in a stated amount. Despite such reimbursement having been made, plaintiffs made a demand that the corporation prosecute the action. By a vote in which the interested defendant-directors did not participate, the demand was rejected and defendants sought dismissal of the suit based on the audit committees' recommendation. The lower court granted the motion. 513 F. Supp. at 121-24.

In *Maldonado v. Flynn*, 448 F. Supp. 1032 (S.D.N.Y. 1978), *aff'd in part, rev'd in part*, 597 F.2d 789 (2d Cir. 1979), and *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980), *aff'd in part, rev'd in part*, 671 F.2d 729 (2d Cir. 1982), plaintiff claimed that certain officers and directors had violated Delaware common law fiduciary duties and § 14(a) of the Securities Exchange Act of 1934 by accelerating the exercise date of certain stock options, thereby bestowing financial gain on themselves to the detriment of the corporation. 448 F. Supp. at 1034-36. The board established a special litigation committee comprised of two outside directors elected to the board after the alleged wrongdoing. The committee determined that the action was not in the best interest of the corporation, and the lower court granted defendant's motion for summary judgment. 485 F. Supp. at 277-78.

Focusing on the dichotomy created by the Delaware approach, the Second Circuit upheld dismissal of the action in *Abramowitz* because a demand had been made and rejected, 672 F.2d at 1032, but reversed the dismissal in *Maldonado*, where a demand was excused on the grounds of futility, 671 F.2d at 731. The Second Circuit remanded *Maldonado* to the lower court to apply the second step of the *Zapata* test. *Id.* at 732.

The reasoning for these differing results is not persuasive. The central concern of the *Zapata* court, structural bias, is evident in the committees' recommendation in *Abramowitz*. In reaching the decision that suit was not warranted if the directors reimbursed the corporation to a stated amount, the committees in *Abramowitz* betrayed an overwhelming bias towards the directors:

The amounts which the Audit Committees have recommended should be reimbursed may not necessarily be the maximum amounts which the companies could obtain from such officers or directors in an action naming them as defendants, where the full range of judicial procedures for the ascertainment of facts would be available, or if presumptions arising from the absence of appropriate records were utilized to determine the amounts due.

513 F. Supp. at 124.

The committees rationalized that, because of the vagaries of litigation, their recommendation was nevertheless "fair and equitable." 672 F.2d at 1028. As one commentator has noted, "[i]f [the court] had examined the case under *Zapata's* . . . analysis, the court would have required a more fully developed report of these possibilities in place of the committees' glib recognition of the uncertainties of litigation." Cox, *supra* note 125, at 981. The case is an anomaly, produced by the misplaced focus on the demand requirement.

148. Under Delaware law, a demand on the board of directors is not required as a prerequisite to the maintenance of a derivative action if it is apparent from facts alleged with particularity that demand would be futile, because the act complained of was done by a majority of the stockholders or otherwise by defendants who have control over the corporation and are hostile or adverse in interest to the plaintiff's demand. See *Brody v. Chemical Bank*, 482 F.2d 1111 (2d Cir. 1973).

sult, the Delaware Supreme Court proceeded to formulate a new step-by-step analysis for the demand issue.

In *Aronson v. Lewis*,¹⁴⁹ the Delaware court ruled that for a failure to make demand to be excused for futility, the complaint must allege facts with particularity that create a reasonable doubt that the challenged transaction was a product of business judgment.¹⁵⁰ The court, accepting the plaintiff's particularized allegations as true, is to determine whether the business judgment rule is unavailable because those allegations raise a reasonable doubt as to: (1) whether the board majority was disinterested and independent¹⁵¹ or (2) whether the majority, even though disinterested and independent, did not validly exercise its business judgment. The court makes this determination on the following criteria: (a) the directors must *inform* themselves, prior to making the business decision, of "all material information reasonably available to them;"¹⁵² (b) the directors must *act* with requisite care in the discharge of their duties;¹⁵³ and (c) if the directors have abdicated their functions and failed to act, the business judgment rule is inapplicable.¹⁵⁴

Zapata and *Aronson* together require that, in all but the most egregious cases, a Delaware plaintiff must pass muster under a six-step analysis to survive a motion to dismiss based on the recommendation of a special litigation committee.¹⁵⁵ Such a proce-

149. 473 A.2d 805 (Del. 1984).

150. *Id.* at 814.

151. A director is interested, according to the *Aronson* court, if he appears on both sides of a transaction or expects to derive personal benefit from it in the sense of self-dealing. The court opined that an expectation of benefit devolving upon the corporation or all stockholders generally is not sufficient to make a director interested. *Id.* at 813.

152. *Id.* at 812.

153. *Id.* The court determined that the requisite standard of liability was gross negligence. *Id.* This holding departed from earlier Delaware cases that articulated a number of other standards, although all required more than simple negligence. *See, e.g.,* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) ("fraud or gross overreaching"); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970) ("gross and palpable overreaching"); Warshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. 1966) ("bad faith"); Moskowitz v. Bantrell, 190 A.2d 749, 750 (Del. 1963) ("fraud"); Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) ("reckless indifference to or a deliberate disregard of the interests . . . of stockholders").

154. 473 A.2d at 813. A conscious decision to refrain from acting may, however, be a valid exercise of business judgment so long as it is taken with appropriate investigation and care. *Id.*

155. Assuming the defendant can carry its burden of showing the disinterestedness and good faith of the committee, the plaintiff must prove that demand is excused as futile under the four-step *Aronson* analysis. The steps of the *Aronson* analysis are: (1) Was the board majority disinterested? (2) Was the board majority independent? (3) Did the board inform themselves of all material information available to them? (4) Did the board exercise the requisite care? In addition to proving that demand is excused as futile, the plaintiff must also persuade the court that the action is not frivolous under the

dural gauntlet is hardly conducive to promoting the scrutiny that *Zapata* implied is necessary to minimize the effects of structural bias.¹⁵⁶ In fact, it is not surprising that the second level of review under *Zapata* is almost never reached¹⁵⁷ and that the net result of the complicated Delaware approach is similar to the deferential posture of *Auerbach*.¹⁵⁸

standard of *Zapata*'s first step. Only then may the court evaluate the merits of the recommendation under *Zapata*'s second step.

156. At least two courts have expressed dissatisfaction with the *Zapata* formulation in this regard. In *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983), the Supreme Court of Iowa analyzed the *Zapata* rationale and concluded that the test formulated by the court failed to adequately guard against structural bias. *Id.* at 716. The Iowa court opined that "it is unrealistic to assume that the members of independent committees are free from personal, financial or moral influences which flow from the directors who appoint them." *Id.* The court concluded that the only effective means of avoiding the potential for structural bias in some cases is by removing the opportunity for structural bias in all cases. Accordingly, the Iowa court held that directors who are parties to derivative litigation are without power to delegate authority with respect to such litigation to an independent committee. *Id.* at 718. In a recent North Carolina case, *Alford v. Shaw*, No. 8426SC371 (N.C. Ct. App. Feb. 5, 1985), the Court of Appeals adopted a similar rule as the law of that state.

Although the Iowa and North Carolina courts have demonstrated a refreshing sensitivity to the reality of structural bias, the medicine they propose may be worse than the disease. If the entire board are named defendants in a derivative action, under the Iowa/North Carolina approach the corporation is powerless to appoint an independent committee. The only alternative is to petition the court, in the exercise of its equity powers, to appoint such a committee. *Miller*, 336 N.W.2d at 718; *Alford*, slip op. at 7. Such an approach encourages plaintiffs to craft claims against the entire board in order to hamstring the corporation, and fails to acknowledge the corporation's need to fairly and expeditiously rid itself of nonmeritorious claims.

In addition, the Iowa/North Carolina approach fails to address the ability of the board to effectively appoint a committee when a minority of the board are named defendants, or when wrongdoing by a person in control is alleged.

157. To date, there exists only one reported decision in which a trial court applied both steps of the *Zapata* analysis in ruling on a motion to terminate a derivative action made by defendants on the basis of a committee recommendation. See *Abella v. Universal Leaf Tobacco Co., Inc.*, 546 F. Supp. 795 (E.D. Va. 1982). After applying its own independent business judgment under step two of the *Zapata* test, the *Abella* court agreed with the committee recommendation that the suit should be dismissed. *Id.*

In the first and only case to date of the Delaware Chancery Court ruling on a motion to terminate under the *Zapata* test, the court undertook an exhaustive review of the *Zapata* test and granted the motion to dismiss under step one. See *Kaplan v. Wyatt*, No. 6361 (Del. Ch. Nov. 5, 1984). Although the *Kaplan* court stated that it was "unnecessary" to proceed to the second step of *Zapata* where the committee has demonstrated good faith, disinterestedness, and reasonable basis, the court nevertheless proceeded to analyze the merits of the suit to determine whether it "deserves further consideration through the device of derivative litigation." *Id.* Given the *Kaplan* court's opinion that the *Zapata* test is a "legal mouthful . . . fraught with practical complications," *id.*, it is not surprising that the court elected to "cut the matter off at step one of the *Zapata* procedure." *Id.*

158. Although a number of reported cases purport to adopt the *Zapata* test in one form or another, or purport to decide a motion to dismiss under such test, see, e.g., *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); *In re Continental Ill. Sec. Litig.*, 572 F. Supp. 928 (N.D. Ill. 1983); *Abella v. Universal Leaf Tobacco*

4. *The statutory standard of review*— The standard of review embodied in section 4 of the Statute attempts to counteract the effects of structural bias by increasing the court's involvement in the review of dismissal recommendations, while preserving the committee mechanism as an expedient method of terminating frivolous actions. In addition, the section seeks to eliminate the preclusive effect of the demand requirement by creating a uniform standard of review.

The most provocative aspect of the standard in section 4 is its elimination of the demand requirement in all cases.¹⁵⁹ The purpose of the section is to avoid the artificial dichotomy created by the *Zapata* test¹⁶⁰ and to create a single review process applicable in varying degrees to all cases.

In its proposed Code of Corporate Governance, the ALI seeks to promote the same goals as the Statute but nevertheless retains the demand requirement.¹⁶¹ Under the ALI Code, if a demand is made and rejected, the directors' decision is subject to judicial review under the identical standards used to review a committee's recommendation of dismissal.¹⁶²

The ALI approach reduces the demand requirement to a nullity, and ignores the realities of modern corporate actions. If, as the reporters of the ALI Code suggest, a mechanism is necessary "to give the board an opportunity to take over the litigation or pursue internal reforms or sanctions,"¹⁶³ it is unclear that the demand requirement is the proper mechanism. Demands are rejected in nearly all cases¹⁶⁴ and no empirical evidence demon-

Co., 546 F. Supp. 795 (E.D. Va. 1982); *Mills v. Esmark, Inc.*, 544 F. Supp. 1275 (E.D. Ill. 1982); *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311 (S.D. Iowa 1981); *Abramowitz v. Posner*, 513 F. Supp. 274 (S.D.N.Y. 1980), *aff'd*, 672 F.2d 1025 (2d Cir. 1982); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980), *modified*, 671 F.2d 729 (2d Cir. 1982); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *Kaplan v. Wyatt*, No. 6361 (Del. Ch. Nov. 5, 1984), no court has actually denied a motion to dismiss under the *Zapata* test.

In fact, the only case to date in which a motion to dismiss based on a committee's recommendation was denied, *Swenson v. Thibaut*, 39 N.C. App. 77, 250 S.E.2d 279 (1978), was decided under traditional business judgment rule criteria. The court denied the motion because it found that the committee lacked disinterestedness. *Id.*

159. Statute § 4(a)-(b).

160. See *supra* notes 134-58.

161. ALI Code, *supra* note 21, § 7.02(b).

162. *Id.* § 7.03(a)(ii). Under the ALI Code, a court is required to make its own independent determination that the business justification advanced in support of the decision: (A) is not outweighed by the probable recovery or other relief that the court determines is likely to result from the litigation, (B) does not frustrate any authoritatively established public policy, and (C) is advanced in good faith. *Id.* § 7.03(c)(ii).

163. *Id.* § 7.03 comment at 315.

164. See *Cox*, *supra* note 125, at 961 n.7.

strates that demand promotes intra-corporate remedies. If, however, the standard of review encourages the use of a special committee as a direct mechanism for dismissal in proper cases, the board will be encouraged to establish such a committee and to undertake remedial measures necessary to provide the basis of a dismissal recommendation likely to pass judicial scrutiny. The special litigation committee mechanism has, in fact, "revolutionized the process of derivative suit resolution"¹⁶⁵ and has become a generally accepted mechanism in modern corporate practice. Because the demand requirement discourages direct resort to such mechanisms while providing no countervailing advantages, it is rejected as an outmoded procedural requirement.

While promoting direct resort to the special committee mechanism, the Statute responds to the threat of structural bias by establishing a dual standard of review for the committee's recommendation. The Statute avoids the flaw of *Zapata* by making each standard of review independent of the other, and avoids the restrictiveness of the ALI formulation by mandating a moderate standard of review in the majority of cases and reserving intensive judicial review for cases with a high probability of structural bias.

Section 4(c)(i) of the Statute provides, in essence, that a derivative action may be dismissed solely on the recommendation of a special committee if the committee carries the burden of proving independence, good faith, thorough investigation, and reasonable business justification. The intent of this provision is to establish a level of review for most cases that is more vigorous than *Zapata's* first step of analysis, while less intrusive than *Zapata's* second step. The level of judicial inquiry anticipated at this stage is more than whether the committee's recommendation has a reasonable factual basis. The committee report should be subjected to a searching judicial inquiry into its legal and factual bases, and the committee's recommendation followed only if proven to be justified under all the circumstances.¹⁶⁶

165. Block, Prussin & Wachtel, *Dismissal of Derivative Actions Under the Business Judgment Rule: Zapata One Year Later*, 38 BUS. LAW. 401, 418 (1983).

166. The proposed standard is considerably more stringent than the first level of analysis under *Zapata*, which merely requires "reasonable bases" for the committee's recommendation. 430 A.2d at 789. As one commentator has noted:

Under the conventional reasonable basis test, directors may choose with impunity from mutually exclusive alternative courses of action as long as they have satisfactory factual or authoritative support for the course they choose to take. Cox, *supra* note 125, at 979. Under the proposed standard, the proponents of the committee recommendation must prove that it is more than plausibly supported—they must prove that among the range of choices available under the circumstances the committee's

Under *Zapata's* second level of analysis, the reviewing court is allowed wide discretion to apply its independent judgment to the committee's recommendation.¹⁶⁷ Although often cited as the most creative, and certainly the most controversial, aspect of the decision,¹⁶⁸ *Zapata's* second level of analysis is more formidable in theory than in fact. Because a second-level review is available only in those cases that the court finds, under the first level of analysis, are not frivolous,¹⁶⁹ the court is free to apply its own judgment to a committee recommendation only when no plausible explanation supports the committee's conclusions.

Apparently reacting to the limitations inherent in the *Zapata* formulation, the proposed ALI standard requires in *all* cases that the court determine, in its own "independent judgment,"¹⁷⁰ that the reasons advanced in support of the committee recommendation are not outweighed by the probable recovery to result from the action, do not "frustrate any authoritatively established public policy" and are "advanced in good faith."¹⁷¹ Although the ALI proposal is certainly a far clearer version of the *Zapata* test and succeeds in preventing corporations from "wrest[ing] bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism,"¹⁷² by submitting all cases to the highest level of judicial scrutiny it fails to address the corporation's need to expeditiously rid itself of strike suits. As commentators have noted, "[T]he ALI proposal . . . fails because it does not provide a practical alternative to litigating to death on the merits."¹⁷³

The Statute attempts to strike a reasoned compromise position. Although the vast majority of cases are subject to limited judicial scrutiny, actions that could result in the imposition of

recommendation is in the best interests of the corporation. *Cf. Hasan v. Clevetrust Realty Investors*, 729 F.2d 372 (6th Cir. 1984) (burden of proving disinterestedness and good faith is on defendants; error to apply presumption of good faith).

167. 430 A.2d at 789.

168. *See, e.g., Block & Prussin, supra* note 144; *Coffee & Schwartz, supra* note 22; *Cox, supra* note 125; *Note, supra* note 22.

169. Such cases do not have "reasonable bases" for the committee's conclusion that the suit is frivolous. 430 A.2d at 789. *See also Kaplan v. Wyatt*, No. 6361 (Del. Ch. Nov. 5, 1984). *But see Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983). The Second Circuit, while purporting to apply *Zapata* under Connecticut law, ignored the "reasonable bases" aspect of the *Zapata* test and implied that a court should apply its own business judgment in all cases. *Id.* at 891.

170. ALI Code, *supra* note 21, § 7.03(c)(ii).

171. *Id.*

172. 430 A.2d at 786.

173. *Block, Prussin & Wachtel, supra* note 165, at 416.

personal liability¹⁷⁴ on a majority of the board, or on persons who control a majority of the board, are subject to more vigorous review.¹⁷⁵ In such cases, the court is empowered to apply its own judgment to determine if the committee's conclusions "are fair and reasonable . . . and are not overridden by a countervailing public policy."¹⁷⁶ The Statute assumes that structural bias is inherent in *all* decisionmaking, but that unless the action specifically calls into question the integrity of the board, the threat of such bias is insufficient to justify a more lengthy and intrusive judicial review.¹⁷⁷

E. Settlement and Compromise

Section 5(a) of the Statute provides that a Derivative Action shall not be discontinued, compromised, or settled without prior approval of the court. The Federal Rules of Civil Procedure¹⁷⁸ and many state statutes¹⁷⁹ contain a similar requirement.

The prohibition on private settlements is intended to discourage both the filing of unmeritorious claims and strike suits commenced solely to obtain an early settlement. One commentator has called the private settlement a "buy-off: the class plaintiff or his lawyer is paid to drop his suit or to abandon its prosecu-

174. Just as it is reasonable to assume that a man will not willingly vote to pursue an action against himself, *Smith v. Spaulding*, 354 U.S. 91 (1957), it is reasonable to suppose that forces of structural bias are likely to be brought to bear in such a situation to prevent the same result through an "independent" committee.

175. Statute § 4(c)(ii).

176. *Id.*

177. The Second Circuit perceptively noted that structural bias is likely to infect committee decisions relating to the potential liability of fellow directors:

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

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

For the higher standard of review embodied in Section 4(c)(ii) to be meaningful, the plaintiff must be afforded a reasonable opportunity to conduct discovery and contest the committee's conclusions. See *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311 (S.D. Iowa 1981). See also *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Rosengarten v. ITT*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976).

178. FED. R. CIV. P. 23.1.

179. See, e.g., *Mich. Bus. Corp. Act*, MICH. COMP. LAWS § 450.1492 (1979); *N.Y. Bus. Corp. Law* § 626(d) (McKinney 1963); *N.C. Bus. Corp. Act*, N.C. GEN. STAT. § 55-55(c) (1982).

tion—the class or corporation gets nothing.”¹⁸⁰ The primary purpose of court approval of settlements is, of course, to guard the interests of the corporation and its investors.¹⁸¹

Section 5(b) requires notice to be given to holders of Qualified Interests whose interests the court determines will be substantially affected by a proposed settlement. One of the purposes of notice is to ensure a full debate of the fairness of a proposed settlement, and to provide the court access to differing views as to such fairness.¹⁸²

Notice shall be given in a manner sufficient to inform the holders of the terms of the proposed settlement, and the date, time, and place of the settlement hearing.¹⁸³ Normally, notice can be expected to take the form of a court order that informs holders that a derivative action is pending, that a settlement has been proposed, and that a copy of the settlement is enclosed. The notice should indicate that holders may show cause at the settlement hearing why such settlement should not be approved. The notice should further inform the holders that the pleadings, depositions, documents, and other exhibits are on file with the court and may be inspected.¹⁸⁴

Section 5(c) provides that an objecting holder shall be permitted a reasonable opportunity to obtain discovery, to present evidence and testimony, and to cross-examine the witnesses for proponents of the settlement. This provision essentially codifies the common practice in most jurisdictions.¹⁸⁵

In determining the amount of investigatory tools to be af-

180. Haudek, *The Settlement and Dismissal of Stockholders' Actions—Part II: The Settlement*, 23 Sw. L.J. 765, 816 (1969).

181. See *Masterson v. Pergament*, 203 F.2d 315 (6th Cir. 1953).

182. In addition, the Supreme Court in *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974), implied that the right of shareholders to be heard regarding the fairness of a class action settlement may implicate constitutional due process concerns. *Id.* at 173-77. At the very least, the giving of notice increases the likelihood that a settlement will be upheld if subsequently challenged. See *Papilsky v. Berndt*, 466 F.2d 251 (2d Cir. 1972).

183. Statute § 5(b).

184. The manner of giving notice is left to the discretion of the court. *Id.* Although actual notice by mail is the preferred alternative, constructive notice by publication may be appropriate under the circumstances, particularly when the magnitude of the proposed settlement is small compared to the expense of mailing individual notices. See, e.g., *Blau v. Allen*, 171 F. Supp. 669 (S.D.N.Y. 1959).

The cost of giving notice is not specifically addressed in the Statute. Although such expense is traditionally paid by the beneficiary corporation, Haudek, *supra* note 180, at 788, at times one or more of the named defendants bears the costs. See, e.g., *Glickin v. Bradford*, 35 F.R.D. 144, 150 (S.D.N.Y. 1964). The preferred practice is for the cost of notice to be an item of negotiation among the parties, and then stipulated in the proposed settlement.

185. See *Coffee & Schwartz*, *supra* note 22, at 335.

forded an objecting holder, the court may consider, *inter alia*, the extent of investigation requested by the objector, the complexity of the underlying issues, and the amount and relevance of the evidence produced in support of the settlement by its proponents. In short, the court should balance the "usefulness of the additional evidence against the burden in time and expense of securing and receiving it."¹⁸⁶

Although the court should consider all relevant objections in determining the merits of a proposed settlement, it should not automatically assume that a lack of objections is necessarily an indication of the settlement's fairness. The Supreme Court has noted in the class action context that silence does not relieve the court of its duties to absent members of the class, but instead adds to its responsibility to reach an independent and objective judgment.¹⁸⁷ Similarly, the court is charged with the responsibility of reaching an independent judgment as to the reasonableness of a derivative suit settlement.¹⁸⁸ Although the court's inquiry may be aided by the presentation of objectors, the absence of such objectors is not, in itself, an indication of reasonableness.

Section 5(e) delineates some of the factors the court shall consider when determining the reasonableness of a proposed settlement. These factors include the benefit of the proposed settlement to the corporation, objections of holders of Qualified Interests, and fees and expenses to be paid by the corporation. It is anticipated that the court will compare the value of the proposed settlement—including any nonpecuniary benefit¹⁸⁹—minus expenses, to the value of any probable recovery if the action were litigated to a conclusion. In conducting this comparison the court must take into account expense estimates prepared by the parties, the risk attendant to continuing litigation, and the likelihood of collecting any damage award.¹⁹⁰

Finally, section 5(f) regulates the continuing effect of the settlement of a derivative action. Court approval of the settlement gives it *res judicata* effect, and binds the corporation, its shareholders, and all other holders of Qualified Interests, and is sub-

186. Haudek, *supra* note 180, at 795.

187. *Protective Comm. v. Anderson*, 390 U.S. 414, 435 (1968).

188. Statute § 5(d).

189. Examples of nonpecuniary benefit include the election of new directors under court supervision, the institution of new accounting practices and the appointment of independent auditors, and the cancellation of management claims against the corporation. See *Heddendorf v. Goldfine*, 167 F. Supp. 195 (D. Mass. 1958); *Bysheim v. Miranda*, 45 N.Y.S.2d 473 (N.Y. Sup. Ct. 1943).

190. See *Desimone v. Industrial Bio-Test Laboratories, Inc.*, 83 F.R.D. 615 (S.D.N.Y. 1979).

ject to attack only on the basis of defective notice¹⁹¹ or inadequate representation of class members.¹⁹² This provision essentially follows the *Restatement (Second) of Judgments* and modern case law.¹⁹³

F. *Special Rules Pertaining to Close Corporations*

In publicly held corporations operating on a national or international scale, minority shareholders may feel vulnerable at the hands of directors, majority shareholders, or management. The derivative action is designed to give such individual shareholders a method to protect their interest despite a lack of bargaining power.

As impotent as the small shareholder may feel in a public corporation, comparable investors in closely held corporations live perhaps an even more precarious existence. Like the vast majority of public corporation shareholders, close corporation minority shareholders frequently are unable to influence management and may be denied any meaningful input into corporate affairs. But unlike investors in public corporations with a ready market for their securities, the victimized investor in a close corporation can be, and nearly always is, "locked in"—that is, unable to liquidate his holdings either because there is no ready market for his securities or because of legal¹⁹⁴ or contractual¹⁹⁵ restrictions that permit sale only to a limited group at a disadvantageous price.¹⁹⁶

191. Statute § 5(f)(i).

192. Statute § 5(f)(ii).

193. See RESTATEMENT (SECOND) OF JUDGMENTS §§ 48.1, 86 (1982). Cf. *Stella v. Kaiser*, 218 F.2d 64 (2d Cir. 1954) (settlement accorded same preclusive effect as final judgment, provided that no collusion or fraud is shown).

194. The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1982 & Supp. II 1984), prohibits the resale of unregistered securities, except under very limited circumstances. See Securities Act of 1933, Rule 144.

195. Such restrictions often take the form of a right of first refusal, see *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 152 A. 723 (1930); *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 141 N.E.2d 812, 61 N.Y.S.2d 404 (1957), or a limitation upon alienation of shares to parties other than current shareholders. See *Alexy v. Kennedy House, Inc.*, 507 F. Supp. 690 (E.D. Pa. 1981); *Carpenter v. Dummit*, 221 Ky. 67, 297 S.W. 695 (1927). But see *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 2 A.2d 249 (1938) (restriction forbidding all sales except to issuer corporation invalid restraint on alienation); *Stech v. Panel Mart, Inc.*, 434 N.E.2d 97 (Ind. Ct. App. 1982) (provision for the automatic transfer of shares upon the death of the shareholder); *Ginsberg v. Coating Prods., Inc.*, 152 Conn. 592, 210 A.2d 667 (1965) (same).

196. The dilemma of protecting minority investors in close corporations has been summarized by the Supreme Court of California in the following way:

The Statute recognizes that the unique position of investors in close corporations may render derivative recovery inequitable or ineffective. Therefore, two methods of recovery unique to close corporations are provided: (1) discretionary characterization as a direct action; and (2) discretionary individual *pro rata* recovery on derivative claims.¹⁹⁷

Some courts have recognized that derivative actions on behalf of closely held corporations present special considerations. The leading case in this regard is the Ninth Circuit opinion in *Watson v. Button*.¹⁹⁸ Because the corporation involved in *Watson* had only two shareholders, the Ninth Circuit implied that the policy reasons supporting a derivative characterization were inapplicable: multiplicity of actions could not result; creditors could not be injured because both shareholders were individually liable for corporate debts; and no other shareholders could be prejudiced by allowing a direct recovery.¹⁹⁹ Subsequent cases have expanded the *Watson* reasoning to include corporations with many more shareholders.²⁰⁰

The Statute endorses a *Watson*-type recovery to be utilized in the discretion of the court in an action brought in the right of a close corporation, as defined in section 1(g).²⁰¹ If the court does not elect to exercise such discretion, the derivative action will be

The increasingly complex transactions of the business and financial communities demonstrate the inadequacy of traditional theories of fiduciary obligation as tests of majority shareholder responsibility to the minority. These theories have failed to afford adequate protection to minority shareholders . . . in closely held corporations whose disadvantageous and often precarious position renders them particularly vulnerable to the vagaries of the majority.

Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 112, 460 P.2d 464, 473, 81 Cal. Rptr. 592, 601 (1969).

197. Statute § 6(a), (c).

198. 235 F.2d 235 (9th Cir. 1956).

199. *Id.* at 237.

200. See, e.g., *Dresden v. Willock*, 518 F.2d 281 (3d Cir. 1975); *Kirk v. First Nat'l Bank*, 439 F. Supp. 1141 (M.D. Ga. 1977); *Johnson v. Gilbert*, 127 Ariz. 410, 621 P.2d 916 (1980); *Masinter v. Webco Co.*, 262 S.E.2d 433 (W. Va. 1980).

One court aptly summarized the relevant issues *Watson* presented:

The substantive concerns caused by the presence of other injured former shareholders are that a *Watson*-type theory of recovery would generate a multiplicity of suits and would prejudice other former shareholders by diminishing the assets available for compensation of their injuries. However, both of these concerns are present in any class action type situation, where less than all injured parties request relief, and relief is not denied because of concern over multiplicity and diminution of assets Consequently . . . this court can hardly conclude that those same concerns would prompt Georgia to reject plaintiffs' equitable theory of relief, a terribly burdensome result.

Kirk, 439 F. Supp. at 1149.

201. Statute §§ 1(g), 6(a).

subject to the procedural requirements of sections 6(b) and (c).²⁰²

1. *Section 1(g): Definition of close corporation*— Before the court may exercise its discretion to treat a derivative claim as a direct action under section 6(a), a finding must be made that the corporate entity involved is a Close Corporation as defined in section 1(g). The following three-pronged test is embodied in section 1(g)(i)-(iii). A Close Corporation: (i) has 35 or fewer record holders of its equity securities; (ii) has \$3 million or less of total assets; and (iii) has never undertaken an offering of its securities requiring registration pursuant to the Securities Act of 1933, as amended, or state law.

These three factors—number of shareholders, value of assets, and non-public character of stock—delineate as closely as possible the distinguishing characteristics of a close corporation. The precise formulation of these factors derives from the registration requirements of the Securities Exchange Act of 1934²⁰³ and the private offering exemption of the Securities Act of 1933.²⁰⁴

States do not employ a uniform definition of a close corporation. California, for example, defines a close corporation as one that has thirty-five or fewer stockholders and that elects to be so classified.²⁰⁵ Delaware's definition is more precise because it states that a close corporation is one with a charter that limits the number of shareholders of all classes to a minimum of thirty and forbids a public offering as described in the Securities Act of 1933.²⁰⁶ Illinois includes the requirement that all issued stock be subject to one or more transfer restrictions,²⁰⁷ while at least four states employ definitions based in whole or in part on the number of shareholders.²⁰⁸

Definitions employed by the courts have been equally varied and difficult to apply beyond their particular facts.²⁰⁹ Therefore,

202. The American Law Institute endorses direct treatment, in the discretion of the court, if the corporation "is not a publicly held corporation" and the court "finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors in the corporation, or (iii) interfere with a fair distribution of the recovery . . ." ALI Code, *supra* note 21, § 7.01(d).

203. See 15 U.S.C. § 781(g) (1982); 17 C.F.R. § 240.12g-1 (1985).

204. See 15 U.S.C. § 77d(2) (1982); 17 C.F.R. §§ 230.501-506 (1985).

205. CAL. CORP. CODE § 158 (West Supp. 1985).

206. DEL. CODE ANN. tit. 8, § 342(a) (1984).

207. ILL. ANN. STAT. ch. 32, § 1203(a) (Smith-Hurd Supp. 1985).

208. CAL. CORP. CODE § 158(a) (West Supp. 1985); DEL. CODE ANN. tit. 8, § 342(a) (1983); KAN. STAT. ANN. § 17-7202(a) (1981); ME. REV. STAT. ANN. tit. 13-A, § 102(5) (1985).

209. See, e.g., *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975).

the Statute adopts a precise definition based on realistic business criteria, such as size and qualification under the securities laws, to be applied strictly by the courts. A bright-line rule based on the realistic criteria of number of shareholders, assets, and security registration will serve the planning needs of business and the operational needs of the court.

2. *Section 6(b): Contemporaneous ownership requirement*—Section 6(b) provides that if an action brought in the right of a corporation described in section 1(g) is treated as a derivative action, then provisions relating to contemporaneous ownership will apply. Section 6(b) is *not* discretionary. If a derivative action is prosecuted in the right of a close corporation, a contemporaneous ownership requirement *will* apply.

Section 3 adopts a knowledge standard, in lieu of the traditional contemporaneous ownership requirement for all corporations other than close corporations.²¹⁰ The rationale underlying section 3 is inapplicable in the context of a close corporation, because information transfer and efficient market factors are likely to be minimal. Accordingly, the traditional contemporaneous ownership requirement is retained for close corporations.

3. *Section 6(c): Individual recovery on derivative claims*—For reasons outlined in the discussion of section 7(a),²¹¹ individual recovery on derivative claims is not permitted by the Statute in the normal case. But because a minority investor is more likely to be “locked-in” to his holdings in a close corporation,²¹² and because controlling investors are more likely to be involved in and benefiting from wrongdoing, the Statute embodies a provision authorizing individual *pro rata* recovery on derivative claims brought in the right of a closely held corporation.²¹³

G. Damages

1. *Judgment and equitable relief*—Section 7(a) directs that judgment for plaintiff in any derivative action be paid directly to the corporation.²¹⁴ Based on three factors, section 7(a) rejects by implication the notion developed in some cases that individual

210. See *supra* notes 89-120 and accompanying text.

211. See *infra* notes 214-27 and accompanying text.

212. See *supra* notes 194-95 and accompanying text.

213. See Statute § 6(c). See also Note, *Individual Pro Rata Recovery in Stockholders' Derivative Suits*, 69 HARV. L. REV. 1314 (1956).

214. Statute § 7(a). See also *Keenan v. Eshleman*, 23 Del. Ch. 234, 2 A.2d 904 (1938).

recovery should be allowed on a derivative claim.²¹⁵ The first factor is that in derivative actions involving large publicly held corporations it is practically impossible to provide adequate redress for all injured interests on a *pro rata* basis. Many shareholders are unlikely to know of the suit, or, knowing of it, may rely on its derivative nature to protect their interests. Therefore, *pro rata* recovery detracts from the derivative action's deterrent effect by encouraging directors to obtain releases from other investors and to secure individual settlements from those who threaten to sue.²¹⁶ Second, by awarding individual judgment in a derivative action, the court is, in effect, forcing the distribution of a dividend to a limited number of holders. Such a forced distribution of corporate assets should be disfavored by the law. Finally, individual recovery may endanger creditors' interests because, unlike corporate recovery, it wipes out the corporation's claim without substituting or replenishing corporate assets.

This Commentary argues that the three factors outweigh the negative effects of windfall derivative recoveries to management wrongdoers.²¹⁷ On those rare occasions when management wrongdoers may benefit from a derivative recovery, a court should grant equitable relief pursuant to section 7(a) to promote deterrence and prevent unjust enrichment.

Section 7(a) borrows principles from the corporate dissolution area to illustrate that, in some cases, equitable relief is appropriate either in lieu of or in addition to money damages.²¹⁸ Were the derivative action viewed as strictly compensatory in nature, equitable relief would clearly be inappropriate. Because the derivative action should deter as well as compensate, however,²¹⁹ the court should not hesitate to award a full range of equitable remedies. Section 7(a) is intended to suggest available remedies, but is not exhaustive in its description of the form equitable relief may take. Some courts have held that unless monetary damages are awarded, the plaintiff is not entitled to litigation expenses and attorney's fees because the corporation does not

215. See, e.g., *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955); *Di Tomasso v. Loverro*, 250 A.D. 206, 293 N.Y.S. 912, aff'd, 276 N.Y. 551, 12 N.E.2d 570 (1937); *Eaton v. Robinson*, 19 R.I. 146, 31 A. 1058 (1895).

216. See *Harris v. Rogers*, 190 A.D. 208, 179 N.Y.S. 799 (1919); *Hornstein, Problems of Procedure in Stockholder's Derivative Suits*, 42 COLUM. L. REV. 574, 583-84 (1942).

217. See *Perlman v. Feldmann*, 219 F.2d 173, 179 (2d Cir.), cert. denied, 349 U.S. 952 (1955) (court reasoned that direct recovery in derivative action necessary to prevent windfall to wrongdoers).

218. *Id.* See also S.C. CODE ANN. § 33-21-155 (Law. Co-op. Supp. 1984) (equitable relief available upon involuntary dissolution of corporation).

219. See *supra* notes 30-42 and accompanying text.

share in the recovery.²²⁰ In many cases, however, the corporation can directly benefit from an equitable recovery. Actions seeking equitable relief should not be discouraged by the withholding of expenses and fees. Section 7(a) specifically provides that if exclusively nonpecuniary relief is awarded the defendant shall be directed to pay the reasonable attorney's fees and expenses of the plaintiff.

2. *Damage cap for Due Care Violations*— If the Derivative Action is to be an effective deterrent, damages must be assessed against wrongdoers in amounts likely to prevent future misconduct. Courts and juries, however, might become reluctant to enforce penalties that appear disproportionate to the culpability of the underlying behavior. This phenomenon has been well-documented in the context of criminal law,²²¹ and in the context of private enforcement of the federal antitrust laws.²²²

Because the potential liability for damages proximately caused by the negligent action or inaction of a director of a major corporation is enormous, absent some sort of damage ceiling "the civil liability for conduct not involving any element of scienter or willfulness may exceed the highest authorized fine for any criminal felony."²²³ Potential liability in such proportions is unnecessary to promote the deterrence concept, and may produce a counterintuitive result by discouraging qualified persons from accepting directorships. In the worst case, courts may be tempted to distort the law by finding grounds not to impose crushing liability.

Therefore, the Statute places a damage cap on all Derivative Actions based on Due Care Violations.²²⁴ As defined in section 1(e) and limited in section 7(b)(i), the damage cap extends only to instances of ordinary negligence involving no self-dealing, scienter, willfulness, or personal gain.²²⁵

If the court determines that the action is one to which section 7(b) applies, damages must be limited to the statutory ceiling.²²⁶

220. See, e.g., *Di Tomasso v. Loverro*, 250 A.D. 206, 293 N.Y.S. 912, *aff'd*, 276 N.Y. 551, 12 N.E.2d 570 (1937).

221. See, e.g., *Hall, Strict or Liberal Construction of Penal Statutes*, 48 HARV. L. REV. 748, 750-51 (1935).

222. See, e.g., *Block & Sidak, The Cost of Antitrust Deterrence: Why Not Hang a Price Fixer Now and Then?*, 68 GEO. L.J. 1131 (1980).

223. *Coffee & Schwartz, supra* note 22, at 317.

224. Statute § 7(b).

225. For the damage cap to apply, no personal gain may accrue to any Associate of any defendant as defined in section 1(f). This provision is designed to prevent indirect benefits for negligent conduct.

226. Statute § 7(b).

The ceiling is designed to give the court flexibility in setting damages keyed to the financial circumstances of the individual defendants. The rationale of the statutory ceiling is that it is equitable to assess damages based upon fees, salary, or other compensation paid to the defendant by the corporation, because the defendant, having been found negligent, has failed to earn such compensation. Defendants, however, are not necessarily equal among themselves. Some defendants may be more culpable than others. Therefore, the court has discretion to set damages up to the defendant's aggregate net taxable income for the five years preceding the Due Care Violation.²²⁷ The range of damages allowable under the ceiling permits the court to recognize degrees of responsibility for negligent conduct, while safeguarding defendants from damage assessments out of proportion to the blameworthiness of their conduct.

H. Abuse of Process

When characterizing abuses peculiar to derivative actions, commentators generally focus on abuses perpetrated by plaintiffs and their counsel, specifically, strike suits brought solely for personal gain rather than corporate benefit.²²⁸ Plaintiffs and their counsel, however, are not the only parties guilty of derivative suit abuse. Defendants and their counsel may adopt dilatory tactics and abuse the discovery process, hoping to wear down plaintiffs to the point of financial exhaustion. To remedy derivative suit abuses by both plaintiffs and defendants, the Statute embodies an abuse of process provision.²²⁹ It is designed to deter abuses by enabling the court to impose costs upon any party or its counsel.

Section 8 differs markedly from the traditional remedy directed at derivative suit abuse. The traditional view is that such abuses are best addressed by means of a security-for-expenses requirement.²³⁰ At best, this approach discourages plaintiffs

227. *Id.*

228. *See, e.g.,* Dykstra, *supra* note 9, at 75; Note, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J.L. & SOC. PROBS. 50 (1968).

229. Statute § 8.

230. *See, e.g.,* ARIZ. REV. STAT. ANN. § 10-049 (1977); ARK. STAT. ANN. § 64-223 (1980); COLO. REV. STAT. § 7-4-121 (Supp. 1984); FLA. STAT. ANN. § 607.147 (West Supp. 1984); NEB. REV. STAT. § 21-2047 (1983); N.J. STAT. ANN. § 14A:3-6 (West 1969); N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1984); WASH. REV. CODE ANN. § 23A.08.460 (1969); W. VA. CODE § 31-1-103 (1982); WIS. STAT. ANN. § 180.405 (West 1957). Four states allow the court discretion in determining when security is necessary. CAL. CORP. CODE § 800(e)

from bringing strike suits. It does nothing, however, to deter plaintiffs' counsel, defendants, or defendants' counsel from derivative suit abuse once the suit is in progress. In contrast, section 8 applies to all parties and counsel, and thus more thoroughly responds to the evils of derivative suit abuse, regardless of their origin.

Security-for-expenses requirements generally provide that the corporation is entitled to require a plaintiff to post security for the reasonable expenses the corporation incurs in defending the action should plaintiff lose.²³¹ These requirements are often supplemented with an exemption for plaintiffs owning shares at or above a specified market value or percentage.²³² The provisions vary widely from state to state. In some jurisdictions, for example, any defendant can move for security,²³³ while other jurisdictions allow only the corporation to request security.²³⁴

Although security-for-expenses statutes have been in existence in various forms since 1944, there is little consensus among commentators regarding their practical effects.²³⁵ These statutes, however, are a minor factor in the prosecution of derivative suits.²³⁶ Indeed, security for expenses is not effective in deterring strike suits, because clever plaintiffs may generally avoid the requirement by joining other plaintiffs to the cause of action to increase the percentage or value of stock ownership so as to qualify for an exemption.²³⁷

Assuming that security for expenses is effective in preventing or terminating frivolous actions in at least some cases, it nevertheless suffers from three insuperable problems. First, the requirement has the same problem as the contemporaneous own-

(West Supp. 1984); PA. STAT. ANN. tit. 15, § 1516 (Purdon Supp. 1985); TENN. CODE ANN. § 48-1-718 (1984); TEX. BUS. CORP. ACT ANN. art. 5.14(c) (Vernon 1980).

231. 13 W. FLETCHER, *supra* note 79, § 5971.1.

232. *Id.*

233. *See, e.g.*, CAL. CORP. CODE § 800(c) (West Supp. 1984).

234. *See, e.g.*, N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1984).

235. Compare Bowes, *Should New York's "Security for Expenses" Act Be Amended?*, 2 SYRACUSE L. REV. 37 (1950) and Note, *Security for Expenses Legislation—Summary, Analysis, and Critique*, 52 COLUM. L. REV. 267 (1952) (criticizing security-for-expenses statutes), with Carson, *Further Phases of Derivative Actions Against Directors*, 29 CORNELL L.Q. 431 (1944) (defending security-for-expenses statutes).

236. *See Cox, supra* note 125, at 965.

237. *See supra* note 232 and accompanying text. If the original plaintiff does not meet the criteria for the exemption, he usually may obtain a stay after the motion is made for security, during which he may obtain the corporation's shareholder list and attempt to join other shareholders as plaintiffs to satisfy the ownership requirement. Because most corporations prefer to avoid widespread access to their shareholder list and would likely prefer to avoid the widespread publicity attendant to the solicitation for plaintiffs, motion for security is seldom made.

ership rule: it is overbroad.²³⁸ Because security may be demanded in any derivative suit, the requirement fails to distinguish between meritorious and nonmeritorious actions, and thus tends to chill both. For example, at least one security-for-expenses provision awards the proceeds of the security bond to the corporation whenever the plaintiff loses the derivative action, whether or not the action was meritorious.²³⁹ Thus, the security requirement would probably deter any plaintiff not reasonably certain of winning the derivative suit, even if such suit were meritorious, because the plaintiff would not want to risk losing the proceeds of the bond. Because discouragement of meritorious plaintiffs from bringing derivative actions is inconsistent with the deterrence principle, security for expenses should be rejected on this ground alone.

The second problem is that security-for-expense provisions are discriminatory. The statutes often exempt security holders of large amounts of the corporation's securities from posting security yet require small security holders to post such a bond.²⁴⁰ This discriminatory aspect of the requirement is both unfair to minority interest holders and wholly unnecessary.

The third and final problem with the security provision is that it may penalize the wrong party. For example, plaintiff's attorney rather than plaintiff may be the person seeking a strike suit recovery, yet the provision imposes a sanction on plaintiff alone. This result is particularly inequitable in the case in which plaintiff in good faith believes that a meritorious claim exists based on his attorney's representations. In sum, the obvious flaws of the security statutes outweigh their benefits. Accordingly, the Statute does not impose a security-for-expenses requirement.²⁴¹

The Statute attempts to address the concerns underlying traditional security-for-expenses requirements by enacting sanctions for abuse of process.²⁴² The abuse of process provision of the Statute is novel in that no presently enacted statutory

238. See *supra* notes 96-102 and accompanying text.

239. Model Business Corporation Act § 49 (1971). The revised Model Act has eliminated the security-for-expenses requirement.

240. See *supra* note 232 and accompanying text.

241. Four states have enacted modified security-for-expenses requirements. See *supra* note 230. These modified statutes provide that defendants may move for security, but allow the court discretion in determining whether to impose it. *Id.* By allowing the court discretion to impose a security requirement, these statutes solve some of the overbreadth and unfairness problems of the traditional statutes. Because the modified requirements mandate a mini-hearing to determine the merits of a security request, however, they may succeed only in burdening courts with frivolous procedural litigation.

242. Statute § 8.

scheme attempts to prevent derivative suit abuse by means of costs imposed directly on the offending party.²⁴³

Section 8 grants the court discretion to award costs against a party or its counsel²⁴⁴ for abuse of process or material protraction of the litigation.²⁴⁵ The court's authority to award costs extends throughout the course of the litigation and encompasses

243. The ALI recognized the appropriateness of such a requirement in its proposed Code of Corporate Governance. ALI Code, *supra* note 21, § 7.02(e).

244. Because attorneys are subject to regulation by their profession, it can be argued that specific sanctions against attorneys in the derivative suit context are unnecessary. Specifically, attorneys are required to conform their conduct to the Code of Professional Responsibility, which provides for a system of discipline and sanctions against attorneys who file suit merely to harass or who knowingly advance a claim that is unwarranted under existing law. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(A)(1)-(2) (1979). It is generally recognized, however, that "the bar has almost no ongoing regulation of attorney performance or competence . . . [and] its disciplinary machinery for dealing with misconduct is seriously defective." Marks & Cathcart, *Discipline Within the Legal Profession: Is It Self-Regulation?*, 1974 U. ILL. L.F. 193, 203-04 (footnote omitted).

245. Section 8 sets out two standards for court determination of whether a party or its attorney committed an abuse of process or materially protracted the litigation. The first, "without reasonable cause," is based on § 49 of the Model Business Corporation Act, which allows a court to require plaintiff to pay defendants' costs if the court finds the action was brought without reasonable cause. Section 8 expands the reach of the MBCA reasonable cause standard, however, by applying it to any abuse of process and to both counsel and parties. The term "reasonable cause" means a legally sufficient reason for taking or refraining from action. Thus, a plaintiff or his attorney who brings a derivative suit in good faith but without adequate investigation may not have reasonable cause for the action. *Cf.* ALI Code, *supra* note 21, § 7.02 comment at 280. A determination of reasonable cause depends upon the circumstances of the individual case, and lies largely in the discretion of the court. *See* Wilson v. Morris, 369 S.W.2d 402, 407 (Mo. 1963).

The second standard, "bad faith," derives from the common law exception to the "American rule" that each party must bear its own legal expenses. *See* Roadway Express, Inc. v. Piper, 447 U.S. 752 (1980); Fleischmann Corp. v. Maier Brewing Co., 386 U.S. 714, 717-18 (1967). According to the bad faith exception, a court has inherent power to assess attorney's fees when the losing party acts in bad faith, vexatiously, wantonly, or for oppressive reasons. *Vaughan v. Atkinson*, 369 U.S. 527 (1962). In at least one case, the Supreme Court has held that "'bad faith' may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation." *Hall v. Cole*, 412 U.S. 1, 15 (1973). In practice, some New York courts have imposed costs against attorneys who delay litigation. *See, e.g., Kahn v. Stamp*, 52 A.D.2d 748, 382 N.Y.S.2d 199 (1976); *Moran v. Rynar*, 39 A.D.2d 718, 332 N.Y.S.2d 138 (1972).

The term "bad faith" connotes affirmative ill will or the conscious doing of a wrong because of dishonest purpose. BLACK'S LAW DICTIONARY 127 (rev. 5th ed. 1979). The bad faith standard is necessary to encompass those situations in which a party or its attorney may have reasonable cause in taking an action, but nonetheless willfully abuses process. For example, requesting discovery may be an action taken with reasonable cause, but requesting hard-to-find, superfluous material as part of the discovery may be in bad faith. Traditionally, courts have found bad faith only when there has been a finding of "'unreasonable, obdurate obstinacy,' or persistent 'defiance of law.'" *Brewer v. School Bd.*, 456 F.2d 943, 949 (4th Cir.), *cert. denied*, 406 U.S. 933 (1972). In comparison, the reasonable cause standard allows the court greater discretion and authority to impose costs than does the narrower bad faith standard.

every phase of the derivative action that entails an appearance before the court—including final judgment, settlement, dismissal or appeal.²⁴⁶

Section 8 has three purposes. First, it discourages both plaintiffs and their attorneys from bringing strike suits. Second, it discourages derivative actions brought primarily to harass the corporation's management. Finally, because "neither side has a monopoly on virtue,"²⁴⁷ the section discourages defendants and their counsel who may abuse legal process in an attempt to exhaust the plaintiff financially.

The court traditionally has the authority, in limited circumstances, to impose sanctions on parties and counsel for abuse of process. Examples of such sanctions include contempt of court and dismissal of the action.²⁴⁸ By adopting express cost sanctions for abuse of process, the Statute does not intend to preclude application of such other sanctions as the court deems appropriate. Thus, established sanctions derived from court rules or case law²⁴⁹ should remain available to the court in addition to the cost sanction embodied in section 8.

CONCLUSION

The drafting of a statutory proposal implicating controversial legal concepts is, at best, a risky endeavor. Opinions differ on virtually all of the policy decisions supporting the Statute proposed in this Article. It is doubtful, however, that a comprehensive approach to the problems posed by the derivative cause of action could avoid facing the issues discussed herein.

So long as the means of corporate ownership and control remain separate, the need for mechanisms to enforce management accountability will remain. The derivative action has survived a tumultuous history as one of the principal methods of enforcing such accountability. The challenge today is to preserve its utility in that role while answering the needs of management. Although it is possible that the judiciary could strike a satisfactory balance of the competing interests involved, the task is better

246. Cf. ALI Code, *supra* note 21, § 7.02(e)(i)-(ii); Coffee & Schwartz, *supra* note 22, at 334 (providing separate sanctions during litigation and upon final judgment).

247. ALI Code, *supra* note 21, § 7.02 comment at 280.

248. See 5 J. MOORE, J. LUCAS & J. WICKER, MOORE'S FEDERAL PRACTICE, §§ 38.83, 41.12 (2d ed. 1985); Fendler v. Westgate-Cal. Corp., 527 F.2d 1168 (9th Cir. 1975).

249. See, e.g., FED. R. CIV. P. 37(b); Roadway Express v. Piper, 447 U.S. 752 (1980).

suitable to a statutory solution that clearly defines the role of the derivative action in corporate governance.