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ARONSON AND ITS PROGENY: LIMITING DERIVATIVE ACTIONS THROUGH DEMAND REQUIREMENTS

ANDREW EMERSON*

The shareholder's derivative action has long been recognized as an "extraordinary remedy" empowering the shareholder to assert the legal rights of the corporation when the board of directors wrongfully declines to do so.¹ The function and value of the derivative law suit in the preservation of managerial integrity and corporate efficiency has, in recent years, emerged as a focal point of controversy in the legal and business communities.² Disagreement has largely centered around the power which the corporate board should enjoy vis-a-vis shareholders and courts in controlling the institution and termination of derivative actions.³ More specifically, attention

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1. Fletcher, *ENCYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS*, see 13 W. §§ 5939-41.1 (Perm. ed. 1984).

2. Compare Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 WASH. U.L.Q. 311, 331 (1982) (suggesting the derivative lawsuit should not be a principal means of policing directors compliance with fiduciary duties) [hereinafter cited as *The Business Judgment Rule with Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. REV. 96, 96 (1980) ("Shareholders' derivative suits have long played a crucial role in assuring a modicum of integrity and competence in the management of corporations")] [hereinafter cited as *The Death of Derivative Suits*].

Defining the role of the derivative lawsuit is merely one issue in an extensive debate concerning generally the future of corporate governance. Much of the controversy concerns the degree of independence which corporate officers and directors should enjoy in governing the publicly held corporation. Many of the pertinent issues are raised in the American Law Institute's Proposed Restatement of Corporate Governance. *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* (DISCUSSION DRAFT No. 1, 1985); (Tent. Draft No. 4, 1985); (Tent. Draft No. 3, 1984); (Tent. Draft No. 2, 1984); *PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS* (Tent. Draft No. 1, 1982). The first draft forthcoming from the American Law Institute met with heavy criticism from the business community and elicited a response from the prestigious Business Roundtable. *STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S "PROPOSED PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS"* (1983) [hereinafter cited as *STATEMENT OF THE BUSINESS ROUNDTABLE*]. See generally *Battle Over the Board*, DUNS BUS. MONTHLY, Aug. 1983, at 53 (noting the Business Roundtable's contention that the ALI's initial draft would create inordinate legal exposure for the corporate director).

3. Compare *The Business Judgment Rule*, supra note 2, at 341 (the business judgment rule should insulate the decision of a disinterested minority of directors to dismiss a derivative action directed against other directors) with *The Death of Deriv-*

has focused upon the extent to which the board should retain its power to compel termination of a derivative action when a majority of the members of the board are allegedly implicated in the wrongdoing which the derivative action seeks to redress.⁴

In recognition of the fundamental tenet that the board of directors is, under normal circumstances, the body vested with power to assert the legal rights of any corporation,⁵ state and federal law generally requires the shareholder seeking to institute a derivative lawsuit to make a preliminary demand upon the board.⁶ In addition to preserving the managerial prerogatives of the corporate board, the demand requirement furthers corporate and judicial efficiency. Resort to intracorporate remedies may redress the perceived wrong to the corporation, and costly litigation is thereby avoided.⁷ When confronted with a shareholder's demand, the board is afforded the opportunity to institute litigation, and the board thereby places the resources of the corporation behind the action.⁸ The requirement of a shareholder's demand upon the board also serves the function of deterring those derivative actions which would result in a waste of corporate assets.⁹ Frequently the board of directors will conclude that the failure to pursue the proposed litigation best serves corporate interests.¹⁰ Similarly, the demand requirement serves as an impediment to the initiation of strike suits, those lawsuits instituted for the purpose of engendering a substantial fee for a plaintiff's counsel.¹¹

While courts have emphasized the importance and necessity of a demand upon the board, these same courts have also historically

ative Suits, *supra* note 2, at 122-23 (the board of directors should never be empowered to terminate a derivative action naming a majority of board members as defendants).

4. See Comparison of cited authorities *supra* note 3.

5. See Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Action*, 73 HARV. L. REV. 746, 748 (1960).

6. See, e.g., FED. R. CIV. P. 23.1; DEL. CH. CT. R. 23.1.

7. See *Galef v. Alexander*, 615 F.2d 51, 59 (2d Cir. 1980); *Smachlo v. Birkelo*, 575 F. Supp. 1439, 1443 (D. Del. 1983); *Evangelist v. Fidelity Management & Research Co.*, 554 F. Supp. 87, 90 (D. Mass. 1982); *Royston v. Eastern Empire Corp.*, 393 F. Supp. 1010, 1013 (E.D. Pa. 1975); Comment, *The Demand and Standing Requirement in Shareholder Derivative Actions*, 44 U. CHI. L. REV. 168, 171 (1976) [hereinafter cited as *The Demand and Standing Requirement*].

8. See Note, *supra* note 5, at 749. See *Kaster v. Mod. Sys.*, 731 F.2d 1014, 1017 (2d Cir. 1984); *Elfenbein v. Gulf & Western Industries, Inc.*, 590 F.2d 445, 450 (2d Cir. 1978); *Brody v. Chemical Bank*, 517 F.2d 932, 934 (2d Cir. 1975).

9. See *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 267 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

10. Judicial deference to a board's decision to not pursue the proposed action has frequently rendered the shareholder powerless to maintain the derivative action. See Cox, *Searching For the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 961 n.7 (1982).

11. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). See also Note, *supra* note 5, at 749.

recognized an exception to the demand requirement. Shareholders seeking to institute a derivative action are excused from making demand when it can be concluded that a request for remedial action would constitute a futile act.¹² As will be illustrated, courts have conceived divergent standards for determining whether or not demand is excused on the facts of any particular case.¹³ Conclusions of demand futility have, in the vast majority of cases, been premised upon allegations that the board is rendered incapable of considering the demand for two reasons.¹⁴ First, the board is incapable of considering the demand when the directors have been party to the wrongdoing that the derivative action seeks to redress.¹⁵ Second, the board is also rendered incapable of considering the demand because some adverse influence or interest destroys the board's power to objectively consider the demand.¹⁶

The demand requirement and the concept of demand futility have taken on new significance as a result of recent developments in Delaware corporate law. In light of the preeminent role of Delaware, as the state of incorporation for numerous publicly held corporations, recent pronouncements from the highest court of that state may significantly impact upon the future of corporate governance in America.¹⁷ In recent years, several state and federal courts have recognized that a corporate board, acting through a litigation committee composed of independent directors, retains its power to recommend dismissal of a derivative action even when a majority of the directors are named as defendants in the lawsuit.¹⁸ Significant controversy has been engendered concerning the committee member's capability, in such a setting, to overcome the natural tendency to protect the interests of fellow directors and objectively render a decision concerning continuation of the derivative action.¹⁹ Further-

12. See generally text accompanying notes 107-139 *infra*.

13. In *deHaas v. Empire Petroleum Co.*, 435 F.2d 1223, 1228 (10th Cir. 1970) the Tenth Circuit Court of Appeals noted that ". . . [c]ourts have generally been lenient in excusing demand." But see *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 267 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) (explicitly rejecting such a liberal approach to the demand requirement).

14. See generally text accompanying notes 107-139 *infra*.

15. *Id.*

16. *Id.*

17. Noted corporate law commentator Bayless Manning recently referred to the Delaware Supreme Court as "the nation's high court of corporate jurisprudence. . . ." Manning, *Life in the Board Room After Van Gorkom*, 41 *BUS. LAW.* 1, 1 (1985).

18. See *Lewis v. Anderson*, 165 F.2d 777, 783 (3d Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); *Rosengarten v. Buckley*, 17 *SEC. REG. & L. REP.* (BNA) 1483 (D. Md. Jul. 26, 1985); *Roberts v. Ala. Power Co.*, 404 So. 2d 629, 639 (Ala. 1982); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785-86 (Del. 1981); *Aurebach v. Bennett*, 47 N.Y.S.2d 619, 623-24, 393 N.E.2d 994, 996 (1979).

19. Compare *The Business Judgment Rule*, *supra* note 2, at 339-40 (asserting that a director in such a setting can objectively decide whether or not to pursue de-

more, judges and commentators alike have differed on the standards that reviewing courts should employ in determining whether or not the committee's decision to forego litigation should be honored.²⁰

In May of 1981, the Supreme Court of Delaware in *Zapata Corp. v. Maldonado*²¹ recognized the power of the duly authorized corporate board committee to seek dismissal of the shareholder's derivative suit which named a majority of the board as defendants.²² The *Zapata* court did not, however, consider the issue of when it would be excusable to forego demand on the corporate board as a prerequisite for the filing of the derivative suit.²³ The formulation of a standard for determinations of demand futility remained a significant issue in the aftermath of *Zapata* because of the *Zapata* court's adoption of the demand requirement as a point of reference for determining the level of judicial scrutiny to be applied by a court reviewing a litigation committee's motion to dismiss a derivative action.²⁴ In the decision of *Aronson v. Lewis*,²⁵ the Delaware Supreme Court resolved this particular issue by framing a two part test for demand futility premised upon the notion that issues of demand futility are inextricably linked to the business judgment rule and the standards governing its application.²⁶

This article will review the recent impact which *Aronson* has had on derivative actions arising under Delaware law. Examination will also be made of the *Aronson* court's premise that issues of demand futility are best resolved through reference to standards governing application of the business judgment rule. In fashioning this test for demand futility the Delaware Supreme Court shows an interest in preserving managerial prerogatives in matters relating to proposed derivative litigation. The adoption of this apparently rigorous test for demand futility may be attributable to the reluctance of the Delaware Supreme Court to expand a particular strand of judicial intervention into corporate governance suggested earlier by the *Zapata* decision.²⁷ This article further asserts that *Aronson's* adop-

derivative litigation against fellow board members) with *The Death of Derivative Suits*, *supra* note 2, at 113-14 (noting "an inherent conflict of interest that arises when directors are asked to pass judgment on fellow directors . . .").

20. Compare *Roberts*, 404 So.2d 629, 639 (Ala. 1980) and *Aurebach*, 47 N.Y.S.2d 619, 623-24, 393 N.E.2d 994, 996 (1979) (committee's decision to dismiss litigation subject to the protection of the business judgment rule) with *Zapata*, 430 A.2d 779, 787-89 (Del. 1981) (in context of demand futility the committee's motion to terminate does not prevent a court from engaging in an independent decision concerning whether or not the action should be dismissed).

21. 430 A.2d 779 (Del. 1981).

22. *Id.* at 784-85.

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

24. 430 A.2d at 784. See *infra* notes 38-45 and accompanying text.

25. 473 A.2d at 805.

26. *Id.* at 812.

27. For a criticism of the judicial intervention suggested by *Zapata*, see *The*

tion of the business judgment rule as a guide to demand futility is defective in that demand could be required in situations where it serves no legitimate purpose.

INSTITUTION OF THE DERIVATIVE ACTION: AN OVERVIEW

In comprehending the relationship of *Aronson* and *Zapata* and the significance of the issues addressed by the respective decisions, it is beneficial to review the sequence of events preceding institution of the derivative lawsuit. Prior to filing an action a shareholder must initially determine whether or not to make a demand upon the board.²⁸ If the plaintiff elects to file a lawsuit without making a preliminary demand, he must plead particularized facts in the complaint as a basis for asserting demand futility.²⁹ In response to the initiation of the lawsuit that was not preceded by the filing of a demand, the board will frequently file a motion to dismiss based upon the plaintiff's failure to make the demand.³⁰ The board may also appoint a committee to investigate the allegations contained in the complaint.³¹ If the court denies the board's motion by concluding that demand was excused, the board will delegate its power to seek dismissal of the lawsuit to a special litigation committee composed of independent directors.³² The committee will undertake an independent investigation of the action which will usually culminate in

Business Judgment Rule, *supra* note 2, at 342-43.

28. In view of *Zapata's* pronouncement that when demand is required the business judgment rule insulates from judicial inquiry the board's subsequent motion to terminate the derivative action, a plaintiff now has a strong incentive to resist making demand. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.03 comment e (Discussion Draft No. 1, 1985). By making demand, the shareholder waives any right to argue that demand was futile. *Stotland v. GAF Corp.*, 469 A.2d 421, 423 (Del. Ch. 1983).

29. *Aronson*, 473 A.2d at 814. The requirement of particularity is established by Delaware Chancery Court Rule 23.1. For the text of the rule see *infra* note 108.

30. See, e.g., *Haber v. Bell*, 465 A.2d 353, 357-59 (Del. Ch. 1983).

31. See Block & Prussin, *Termination of Derivative Suits Against Directors on Business Judgment Grounds: From Zapata to Aronson*, 39 BUS. LAW 1503, 1513 n.65 (1984) [hereinafter cited as *Termination of Derivative Suits*]. The article by Block and Prussin suggests that under the holding of *Abbey v. Computers & Communications Technology Corp.*, 457 A.2d 368, 374 (Del. Ch. 1983), a board could empower a committee to merely investigate the derivative suit without waiving demand. *Termination of Derivative Suits*, *supra*. However, a board's delegation of authority to the committee to determine whether or not to seek termination of the derivative action would, under *Abbey*, constitute an admission that demand was waived. *Id.* For a comprehensive review of the *Abbey* decision, see Comment, *Abbey's Modification of Zapata—A Further Restriction on the Power of Special Litigation Committees: Abbey v. Computer & Communications Technology Corp.* 9 DEL. J. CORP. L. 105 (1984).

32. In view of the *Abbey* decision, the board should not delegate its power to consider the merits of the derivative action to a litigation committee until a judicial decision is rendered on the demand issue. See *Termination of Derivative Suits*, *supra* note 31, at 1513 n.65.

the committee's filing of a motion for dismissal of the action.³³ The court will thereafter engage in an independent determination of whether or not termination of the derivation suit best serves the corporate interests.³⁴

Alternatively, the shareholder initially may elect to make a demand upon the board before instituting the derivative action. In such a setting the board will, in all likelihood, choose not to delegate to a special litigation committee its power to act on the demand.³⁵ In the event that the board fails to act promptly upon the demand or refuses to institute suit, the shareholder will frequently proceed to file the derivative suit.³⁶ The court will thereafter rule upon any motion filed by the board seeking dismissal of the action.³⁷ A denial by the court of the board's recommendation for dismissal recognizes the shareholder's standing to maintain the derivative action.

THE BACKGROUND OF ZAPATA

In concluding that the board of directors' independent committee retains the power to dismiss a derivative action directed against a majority of the board of directors,³⁸ the *Zapata* court recognized the well-established principle that the business judgment rule represents judicial acknowledgment of, and deference to, the expertise of corporate directors.³⁹ The *Zapata* decision, however, also recognized

33. See Comment, *supra* note 31, at 107 n.14; Cox, *supra* note 10, at 961 n.7.

34. See, e.g., Kaplan v. Wyatt, 484 A.2d 501 (Del. Ch. 1984).

35. Under the holding of *Abbey* delegation of the matter to a litigation committee, even when demand had been made, will constitute the board's admission that demand was futile. *Termination of Derivative Suits*, *supra* note 29, at 1513 n.65. When demand futility is present, a subsequent recommendation for dismissal forthcoming from the board or litigation committee is not insulated from judicial review. *Zapata Corp.*, 430 A.2d at 788.

36. See, e.g., *Abbey*, 457 A.2d at 370.

37. Assuming that demand upon the board was required, the court will simply determine whether the directors' decision to terminate meets the requirements for protection under the business judgment rule. *Zapata Corp.*, 430 A.2d at 787.

38. *Id.* at 785-86.

39. *Id.* Defining the purposes underlying the business judgment rule is a critical factor in determining the extent to which corporate committee decisions to dismiss derivative litigation against board members should be sheltered from judicial review. Some legal commentators suggest that the primary function of the business judgment rule is to immunize directors and officers from liability for their corporate decisions. See Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 281 (1981). Adoption of this view leads to the conclusion that the rule should not prevent a court from overturning a corporate committee's decision to dismiss derivative litigation; the committee members would not be subject to significant liability by virtue of such judicial action. *Id.* at 281-82. Another commentator perceives the business judgment rule not merely as a device for shielding corporate officials from liability, but suggests that the rule also precludes the judiciary from undertaking decisions best left to corporate management. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. REV. 913, 938 (1982) ("By

the tendency for a corporate director to protect fellow board members' interests and the resulting impact of this tendency on the corporate committee's decisions concerning the pursuit of derivative litigation.⁴⁰ The director's natural empathy for the fellow board member who is a target of derivative litigation was stated in the following terms:

Moreover, notwithstanding our conviction that Delaware law entrusts the corporate power to a properly authorized committee, we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee directors. 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.⁴¹

The court's reservations, which concerned the ability of a corporate board committee to objectively decide the dismissal of derivative litigation directed against fellow board members, were reflected in the articulation of standards for a court to apply in reviewing a committee's motion to dismiss derivative litigation.⁴² If the derivative litigant is required to make demand upon the board, the court merely determines whether the committee's decision to dismiss was the product of "independence, good faith, and reasonable investigation."⁴³ The *Zapata* court, however, proceeded to pronounce a stricter standard of judicial review for such committee decisions in the demand futility setting. The court held that when demand upon the corporate board is excused and a recommendation for dismissal is forthcoming from the board committee, the court will engage in an independent inquiry to determine whether dismissal of the derivative action is appropriate.⁴⁴

preventing second-guessing of management's business decisions, the rule serves the salutary purpose of ensuring that these decisions will be made by those most competent to do so at the lowest cost." See generally Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?* 37 Bus. Law. 27, 38-62 (1981) (reviewing the business judgment rule's evolution from a defensive tool to an offensive weapon empowering the corporate board to dismiss derivative actions against directors).

40. See *Zapata Corp.*, 430 A.2d at 787-89; Cox, *supra* note 10, at 1009.

41. *Zapata Corp.*, 430 A.2d at 787.

42. *Id.* at 787-89.

43. *Id.* at 787.

44. *Id.* at 788-89. The court actually engages in a two-step analysis in such a situation. The court first determines whether the committee was independent, exercised good faith in its decision, and whether a reasonable basis existed for the decision. If the corporation fails to prove these elements, the motion to dismiss is denied. *Id.* If the corporation carries its burden of proof on these points, the court proceeds to the second tier of analysis which allows an independent judicial inquiry into the correctness of a committee's motion for dismissal. *Id.* at 789. The *Zapata* court's creation of a second tier of analysis is largely premised upon the court's recognition of

The significance of the Delaware Supreme Court's construction of the demand requirement, as set forth in *Aronson*, is readily viewed in the light of *Zapata*. Under the bifurcated approach of *Zapata*, strict judicial scrutiny of committee decisions to dismiss derivative actions is appropriate only when the derivative litigant has been excused from making demand upon the corporate board.⁴⁵

THE FACTUAL BACKGROUND OF ARONSON

Three years after the *Zapata* decision, the Delaware Supreme Court confronted the issue of demand futility as presented in the factual setting of *Aronson*. In *Aronson*, Leo Fink owned forty-seven percent of the outstanding stock of a Delaware corporation. The Delaware corporation, named Meyers Parking Systems, was initially a wholly owned subsidiary of Prudential Building Maintenance Corporation.⁴⁶ In 1979, Prudential Building distributed its shares in Meyers Parking to Prudential Building shareholders.⁴⁷ Prudential Building, prior to 1981, had entered into an employment agreement with Fink.⁴⁸ This agreement provided that Fink would continue as a consultant to Prudential Building for a ten year period following his retirement.⁴⁹ In April 1980, Fink retired, and an agreement was entered into between Meyers Parking and Prudential Building which provided both corporations would share Fink's consultation services and Meyers Parking would reimburse Prudential Building for twenty-five percent of the fees paid to Fink. Pursuant to this agreement, Meyers Parking paid Prudential \$48,322 in 1980 and \$45,832 in 1981.⁵⁰

In 1981, the Meyers Parking board approved an agreement with Fink under which he was to be employed for a five-year period with an automatic renewal for one-year periods thereafter. Under this agreement, Fink was to receive a base salary of \$150,000 per year and a bonus of five percent of Meyers Parking's pre-tax profits of over \$2,400,000. Included in this contract was an agreement that upon termination, Fink would become a consultant for Meyers Parking and receive compensation of \$150,000 yearly for three years, \$125,000 yearly for the following three years, and \$100,000 every year thereafter for life.⁵¹ Furthermore, it was agreed that the com-

the problem of directorial bias. *Id.* at 787.

45. *Zapata Corp.*, 430 A.2d at 787.

46. *Lewis v. Aronson*, 466 A.2d 375, 379-80 (1983), *rev'd and remanded*, 473 A.2d 805 (Del. 1984).

47. *Aronson*, 466 A.2d at 379-80.

48. *Id.*

49. *Aronson*, 473 A.2d at 805-808.

50. *Id.*

51. *Id.*

pensation would be paid to Fink regardless of any inability on his part to perform services for Meyers Parking. Fink was, in fact, seventy-five years old at the time of the board's approval of this agreement. Finally, the board of Meyers Parking made interest-free loans to Fink of \$225,000.⁵²

Thereafter, a stockholder in Meyers Parking instituted a lawsuit naming the entire board of the corporation as defendants.⁵³ The complaint alleged that the board had participated in and approved the transactions with Fink and that the transactions were wasteful and had no legitimate business purposes.⁵⁴ The complaint asserted that demand on the board was futile in view of three factors: (i) each of the directors had participated in or approved the wrongdoing, (ii) Fink dominated and controlled the board and officers of Meyers, and (iii) the nature of the allegations required the directors to sue themselves.⁵⁵

The defendants moved to dismiss the complaint asserting the plaintiff had failed to make the necessary demand on the board. The trial court concluded that the plaintiff was properly excused from demand in this instance.⁵⁶ In establishing the futility of demand, the vice chancellor held that the plaintiff "must only allege facts which, if true, show that there is a reasonable inference that the business judgment rule is not applicable for purposes of considering a pre-suit demand pursuant to Rule 23.1."⁵⁷

On interlocutory appeal, the Supreme Court of Delaware reversed the court of chancery's denial of a motion to dismiss and articulated a more restrictive test for when demand would be excused. A court will find that demand is excused if, on the basis of alleged, particularized facts, "a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."⁵⁸ On review, the Delaware Supreme Court concluded that the plaintiff's allegations failed to provide particularized facts sufficient to fulfill either requirement.⁵⁹

RECENT DEVELOPMENTS IN THE BUSINESS JUDGMENT RULE

In evaluating the *Aronson* court's adoption of the business judgment rule as a guide in demand futility issues, it is valuable to re-

52. *Id.* at 809.

53. *Aronson*, 466 A.2d at 380.

54. *Aronson*, 473 A.2d at 809.

55. *Id.*

56. *Aronson*, 466 A.2d at 384-86.

57. *Id.* at 381.

58. *Aronson*, 473 A.2d at 814.

59. *Id.* at 818.

view the purposes underlying the business judgment rule and the requirements that a director or officer must fulfill in order to claim its protection. An overview of two distinct aspects of the business judgment rule addressed in recent judicial decisions will thereafter be presented. First, a review of recent Delaware cases defining the requisite elements of the business judgment rule and its applicability to various corporate transactions will be undertaken. Thereafter, consideration will be given to several recent federal cases considering the relationship of the demand requirement and the business judgment rule.

The business judgment rule is a doctrine of judicial restraint; a court will not substitute its business judgment for that of corporate directors nor hold the directors personally liable for those managerial decisions made with due care and in compliance with fiduciary duties.⁶⁰ The rule implicitly recognizes that the powers of corporate management are vested in the board of directors and "that court are ill-equipped to evaluate business judgment decision."⁶¹ In shielding directors from liability for erroneous business decisions, the rule serves as an incentive for qualified individuals to assume positions on the corporate board.⁶²

The Corporate Director's Guidebook defines the essential components of the business judgment rule in the following terms:

For the Business Judgment Rule to apply, a director must have acted in good faith, and with a reasonable basis for believing that the action authorized was in the lawful and legitimate furtherance of the corporation's purposes, and must have exercised his honest business judgment after due consideration of what he reasonably believed to be the relevant factors. The Business Judgment Rule will not apply in situations where a conflict of interest or other breaches of loyalty are present.⁶³

The business judgment rule has assumed a position of prominence in current corporate governance debates.⁶⁴ Division has arisen among commentators in both the articulation and interpretation of the various elements of the rule.⁶⁵ Critics suggest that judicial appli-

60. H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 242 (3d ed. 1983).

61. Sparks, *Recent Developments in Substantive Business Judgment Rule*, 61 N.C.L.REV. 534, 534 (1983).

62. See Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 97 (1979).

63. 33 BUS. LAW. 1591, 1604 (1978).

64. See, e.g., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 4.01 & comments (Tent. Draft No. 4, 1985).

65. See, e.g., *PRINCIPLE OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 4.01 comment f (Tent. Draft No. 4, 1985) (justification for "rational belief" requirement adopted for business judgment rule and contrasted with other standards such as "reasonable belief" or simply "good faith").

cation of the standard of care which directors must meet in claiming the protection of the rule has been historically lax.⁶⁶ Disagreements have also been engendered concerning the extent to which directors must have deliberately focused upon the decision for which business judgment protection is sought.⁶⁷ Recent decisions from the Delaware Supreme Court have reflected the present struggles surrounding clarification of the requisite elements of the business judgment rule.⁶⁸ *Aronson* is but one in a series of recent Delaware cases which sought to define with greater precision the elements of the business judgment rule and its application scope. The *Aronson* decision is significant not only in its conclusion that issues of demand futility are "inextricably bound to issues of business judgment and the standards governing its application," but also in its articulation of the standard of directorial care incorporated in the business judgment rule.⁶⁹ The court concluded that directors' liability is predicated upon the standard of gross negligence as opposed to "simple negligence."⁷⁰ While this pronouncement concerning the standard of care suggested that the business judgment protection afforded directors is quite extensive, the court cautiously noted that in order to enjoy such protection the directors must "inform themselves prior to making a business decision, of all material information reasonably available to them."⁷¹

SUBSEQUENT DEVELOPMENT IN DELAWARE BUSINESS JUDGMENT: VAN GORKOM AND BEYOND

In the aftermath of *Aronson* the Supreme Court of Delaware further clarified the contours of the business judgment rule in *Smith v. Van Gorkom*.⁷² In *Van Gorkom* a shareholder of the Trans Union Corporation brought a class action suit against directors of the company challenging their approval of a cash out merger.⁷³ The Trans Union board approved the merger, which the corporation's chief executive officer had orally proposed, after a meeting which lasted approximately two hours.⁷⁴ Despite the distinguished credentials of the directors of the Trans Union board,⁷⁵ the court rejected the direc-

66. See, e.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 683 (1974).

67. See STATEMENT OF THE BUSINESS ROUNDTABLE, *supra* note 2, at 48-49.

68. See, e.g., *Aronson*, 473 A.2d at 812 & n.6 (liability under Delaware business judgment rule is predicated on the standard of gross negligence).

69. *Id.* at 812.

70. *Id.* at 812 n.6.

71. *Id.* at 812.

72. 488 A.2d 858 (Del. 1985).

73. *Id.* at 863.

74. *Id.* at 869.

75. *Id.* at 880. The dissenting opinion of Justice McNeilly sets forth the distinguished business credentials of the various board members. *Id.* at 894 (McNeilly, J.,

tors' contention that the business judgment rule protected the merger approval.⁷⁶ In concluding that the board did not reach an informed business decision, the court emphasized that the board members were given no documentation to support the adequacy of the sale price, and the court also emphasized that the board members failed to make reasonable inquiries on the officers who had proposed the sale and who had prepared a preliminary study.⁷⁷

The *Van Gorkom* decision stirred the legal and business communities by suggesting that Delaware courts would not as readily defer to the decisions of a corporate board. One commentator perceived *Van Gorkom* as a departure from Delaware's historic jurisprudence of business judgment, and criticized the decision as an unjustified limitation on business judgment protection.⁷⁸ Its impact on the future development of the Delaware business judgment rule remains somewhat uncertain.⁷⁹ At a minimum *Van Gorkom* is a warning to the business community that to claim business judgment protection in the context of certain major corporate transactions, directors will be required to demonstrate that they have consulted with financial experts and corporate management and that they have reviewed key documents to an extent sufficient to justify a conclusion that their subsequent decisions were truly "informed."⁸⁰ *Van Gorkom* may, therefore, be indicative of an evolution in Delaware's business judgment rule.⁸¹

dissenting).

76. *Id.* at 874.

77. *Id.* at 874-75.

78. See generally Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985).

79. Perhaps the most viable interpretation of the court's pronouncements in *Van Gorkom* is that the decision simply prescribes a methodology which directors should adhere to in approving major corporate transactions. See Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 3 (1985) [hereinafter cited as *Practical Tips on Life in the Boardroom*]. For example, in approving cash out mergers, board members should preliminarily consult with an investment banker and be provided with copies of the merger agreement for review. *Id.* at 8-9. This "procedural" interpretation of *Van Gorkom* is substantiated by the court's subsequent decisions in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (1985) and *Moran v. Household International, Inc.* No. 37, 1985 (Del. Nov. 19, 1985). In both decisions business judgment protection was extended to anti-takeover actions taken by corporate boards. See, e.g., *Unocal*, 493 A.2d at 950-51. See also *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1985).

80. See *Practical Tips on Life in the Boardroom*, *supra* note 79, at 6-14.

81. One commentator has recently noted the "striking and rapidly developing changes in the substantive corporation law of the duty of care, the duty of loyalty, and the business judgment rule in the context of major business transactions." Veasey, *Further Reflections on Court Review of Judgments of Directors: Is the Judicial Process Under Control?* 40 BUS. LAW. 1373, 1373 (1985). It should be noted, however, that another commentator, while observing the recent erratic development in Delaware's business judgment rule, suggests that *Van Gorkom* "can be fitted . . . into the mainstream of business judgment rule jurisprudence." *Practical Tips on Life in the Boardroom*, *supra* note 79, at 4.

Two other recent Delaware cases construing the applicational parameters of the business judgment are noteworthy. In *Unocal Corp. v. Mesa Petroleum Company*,⁸² the board of directors of Unocal, in response to a hostile tender offer made by minority shareholder Mesa Petroleum Company, approved Unocal's self-tender offer for its own stock.⁸³ The lower court initially enjoined the exchange offer which excluded Mesa.⁸⁴ In assessing whether the action of the Unocal board was subject to the protection of the business judgment rule, the Delaware Supreme Court noted that the directors contemplated the purchase of shares with corporate funds.⁸⁵ In view of this proposed action, the court was required to initially determine whether the directors "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."⁸⁶ A showing of good faith and reasonable investigation on the part of the board fulfilled this burden.⁸⁷ Furthermore, the partial tender offer constituted a reasonable response to the threat that Mesa posed.⁸⁸ The court found that the board decision fell within the protection of the business judgment rule despite the fact that the plan was expeditiously adopted in the course of meetings held only two days apart.⁸⁹

More recently, in *Moran v. Household International, Inc.*,⁹⁰ the Supreme Court of Delaware held that a board's adoption of a Preferred Share Purchase Rights Plan as an anti-takeover device was subject to the protection of the business judgment rule.⁹¹ Under the Rights Plan the Household shareholders were entitled to the issuance of one right per common share in the event that either a tender offer for thirty percent of the outstanding stock was made or if a single entity purchased twenty percent or more of Household's stock.⁹² The court initially found the board was authorized under

82. 493 A.2d 946 (Del. 1985).

83. *Id.* at 950-51.

84. *Id.* at 952.

85. *Id.* at 955. The court initially determined that the board had authority under Delaware law to adopt such a defensive measure even though it required the board to deal selectively with shareholders of the corporation. *Id.*

86. *Id.*

87. *Id.* at 954-55.

88. *Id.* at 950-51, 955.

89. *Id.*

90. *Moran v. Household Int'l, Inc.*, No. 37, 1985 (Del. Nov. 19, 1985) (available on LEXIS).

91. *Id.*

92. The court described the workings of the plan in the following terms:

If an announcement of a tender offer for 30 percent of Household's shares is made, the Rights are issued and are immediately exercisable to purchase 1/100 share of new preferred stock for \$100 and are redeemable by the Board for \$.50 per Right. If 20 percent of Household's shares are acquired by anyone, the Rights are issued and become non-redeemable and are exercisable to purchase 1/100 of a share of preferred. If a right is not exercised for preferred, and

Delaware law to adopt such a plan.⁹³ Applying the principles enunciated in *Unocal*, the court held that the plan was "reasonable in relation to the threat posed."⁹⁴ The court further concluded that in contrast to the *Van Gorkom* setting, the directors' adoption of the plan constituted an informed business decision.⁹⁵ The directors were provided with notebooks summarizing the plan, and the directors fully discussed the defensive measures with the attorneys and the investment brokers who formulated the plan.⁹⁶ The decisions in *Unocal* and *Moran* can be collectively viewed as fortunate sequels to *Van Gorkom*. Specifically, they suggest that corporate boards, in adopting anti-takeover devices, are conforming to the methodological prescriptions articulated by the court in *Van Gorkom*.⁹⁷ Furthermore, they intimate that *Van Gorkom* may not constitute a significant limitation upon the extensive protection enjoyed by directors under the Delaware business judgment rule.

EXPLORING THE RELATIONSHIP OF THE BUSINESS JUDGMENT RULE AND THE DEMAND REQUIREMENT

Consideration of the interrelationship of the business judgment rule and the demand requirement did not originate with *Aronson*.⁹⁸ A review of selected federal decisions manifests divergent pronouncements concerning the correlation of business judgment and demand futility.⁹⁹ In its 1973 decision of *In re Kauffman Mutual Fund Actions*,¹⁰⁰ the United States Court of Appeals for the First Circuit rejected the notion that the directors' approval of a transaction alleged to have caused injury to the corporation established demand futility. In dismissing the contention that such allegations established demand futility, Judge Aldrich made these observations:

Where mere approval of the corporate action, absent self-interest or other indication of bias, is the sole basis for establishing the directors' "wrongdoing" and hence for excusing demand on them, plaintiff's suit should ordinarily be dismissed.

thereafter, a merger of consolidation occurs, the rights holder can exercise each Right to purchase \$200 of the common stock of the tender offeror for \$100. This "flip-over" provision of the Rights Plan is at the heart of this controversy.

Id.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. For articulation of the methodology of *Van Gorkom*, see *Practical Tips on Life in the Boardroom*, *supra* note 79, at 8-14.

98. See *Lewis v. Curtis*, 671 F.2d 779, 785-86 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983).

99. Compare *Lewis*, 671 F.2d at 785-86 (business judgment test for demand futility deemed appropriate), with *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977) (considerations of business judgment protection deemed relevant to demand issue).

100. 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

. . . In this respect, the nature of the alleged misconduct must be considered. Logic suggests a sharp distinction between a transaction completely undirected to a corporate purpose and one which, while perhaps vulnerable to criticism, is of a character that could be thought to serve the interest of the corporation.¹⁰¹

Kauffman indicated that a relevant factor in the determination of demand futility was whether the directors' approval of the transaction which formed the basis of the derivative action was subject to the protection of the business judgment rule.¹⁰² In the subsequent decision of *Heit v. Baird*,¹⁰³ the plaintiff asserted that demand futility was present because the greater part of the present board of directors had approved the alleged wrongful transaction. In rejecting this contention, the court in *Heit* again placed heavy reliance on the potential applicability of the business judgment rule to the transaction which formed the basis of the lawsuit:

In the absence of more particularized allegations indicating such gross inadequacy in the consideration as to manifest an abuse of the directors' power to set a price for the stock, the complaint cannot be read as alleging more than "an erroneous business judgment in connection with what was plainly a corporate act, if that." . . . An allegation of the latter sort would be insufficient to excuse a failure to make a demand on the directors.¹⁰⁴

In *Lewis v. Curtis*¹⁰⁵ the United States Court of Appeals for the Third Circuit examined, and explicitly rejected, the First Circuit's application of the business judgment rule to issues of demand futility:

We do not think that, to excuse demand, plaintiff must allege that the transaction could not under any circumstances ultimately be considered the product of business judgment. Rather, the court, in determining whether demand is necessary, should consider whether a demand on the directors would be likely to prod them to correct a wrong.¹⁰⁶

ANALYSIS OF DEMAND FUTILITY IN THE CONTEXT OF ARONSON

The *Aronson* court's rejection of the plaintiff's three bases for demand futility provides a convenient framework for a general discussion of certain Delaware and federal judicial applications of the

101. *Id.* at 265.

102. *Id.*

103. 567 F.2d 1157, 1160-62 (1st Cir. 1977).

104. *Id.* at 1162.

105. 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).

106. *Id.* at 786. The Seventh Circuit Court of Appeals in the earlier decision of *Nussbacher v. Continental Ill. National Bank & Trust*, 518 F.2d 873, 877-78 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976), similarly rejected the concept of business judgment as being relevant to determinations of demand futility.

demand requirement. The *Aronson* court¹⁰⁷ noted the similarity of Rule 23.1 of the Delaware Chancery and Rule 23.1 of the Federal Rules of Civil Procedure.¹⁰⁸ In view of that similarity, a review of federal decisions is valuable in analyzing the demand futility test formulated in *Aronson*.¹⁰⁹ The least persuasive ground for demand futility that the shareholders in *Aronson* had asserted was the fact that the institution of the suit would require the directors to sue themselves.¹¹⁰ The court dismissed the argument noting that acceptance of such logic "would effectively abrogate Rule 23.1 and weaken the managerial power of the directors."¹¹¹ The court's rejection of such an assertion of demand futility is correct. Plaintiffs could otherwise regularly circumvent the demand requirement by simply naming a majority of the board as defendants.¹¹² The part filing a derivative action would be generally absolved of the duty to plead particularized facts indicating the futility of demand.

A more plausible argument for demand futility in *Aronson* is found in the plaintiff's allegation that Fink dominated and controlled every member of the board and every officer of Meyers Parking.¹¹³ The court refused to conclude that such control was established merely by Fink's ownership of forty-seven per cent of the outstanding stock.¹¹⁴ Election or nomination of a director by one controlling the outcome of the election was not deemed sufficient to

107. *Aronson*, 473 A.2d at 808 n.1.

108. Delaware Chancery Rule 23.1 provides in pertinent part:

In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share of membership thereafter devolved on him by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort. (Emphasis added).

Aronson, 473 A.2d at 808 n.1.

109. Federal courts frequently are called upon to resolve issues of demand futility. See *Kaster v. Modification Systems*, 731 F.2d 1014, 1017-18 (2d Cir. 1984); *Lewis v. Graves*, 701 F.2d 245, 247-50 (2d Cir. 1983); *Lewis v. Curtis*, 671 F.2d 779, 785-86 (3d Cir.), cert. denied, 459 U.S. 880 (1982); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263-65 (1st Cir.), cert. denied, 414 U.S. 857 (1973); *Reilly Mortg. Group v. Mt. Vernon Sav. & Loan Ass'n*, 568 F. Supp. 1067, 1075-78 (E.D. Va. 1983); *Gen. Elect. Co. v. Bucyrus-Erie Co.*, 563 F. Supp. 970, 974 (S.D.N.Y. 1983); *Clark Enterprises Inc. v. Holywell Corp.*, 559 F. Supp. 1308, 1310-12 (E.D. Va. 1983); *Brick v. Dominion Mortgage & Realty Trust*, 442 F. Supp. 283, 293-96 (W.D.N.Y. 1977); *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809, 813-15 (D. Colo. 1968), modified, 435 F.2d 1223 (10th Cir. 1970).

110. See *Aronson*, 473 A.2d at 818.

111. *Id.*

112. See *Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983).

113. *Aronson*, 473 A.2d at 815.

114. *Id.*

establish domination.¹¹⁵ The shareholder "must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.'"¹¹⁶

Derivative litigants frequently have used, as a basis for asserting demand futility, allegations of board domination by a shareholder who owned a significant portion of the corporation's outstanding stock.¹¹⁷ The divergency of views over the facts which will justify a conclusion of "domination or control" is manifested in recent federal decisions. In *Kaster v. Modification Systems*,¹¹⁸ for instance, the Third Circuit Court of Appeals rejected a conclusion of demand futility despite the fact that a defendant both had owned seventy-one percent of the corporation's outstanding shares and had nominated all but one of the corporate board's members.¹¹⁹

In contrast to the stringent application of the demand requirement in *Kaster*, a federal district court in *Abbe v. Goss*¹²⁰ concluded that demand futility was established by virtue of the fact that a defendant and his family owned forty-four percent of the corporation's common stock.¹²¹ The *Aronson* court's conclusion that Fink's stock ownership did not establish domination and control finds support in the earlier Delaware Chancery court decision of *Kaplan v. Centex Corp.*¹²² The court in *Kaplan* held that an individual's ownership of less than a majority of corporate shares does not establish control.¹²³

The existence of an alleged wrongdoer who owns a substantial percentage of outstanding stock presents one of the more difficult settings for resolving whether or not demand is required. When the defendant owns sufficient stock to elect a majority of the board members there are compelling justifications for a conclusion of demand futility. It is a fair inference that the board would comply with the shareholder's wishes.¹²⁴ Nevertheless, *Aronson's* additional requirement of alleged facts indicating that directors have complied with the wishes of the shareholder is quite defensible. Election of a board member by an alleged wrongdoer does not conclusively establish that the director is incapable of independent action on behalf of

115. *Id.* at 816.

116. *Id.* (quoting *Kaplan v. Centex Corp.*, 284 A.2d 119, 123 (Del. Ch. 1971)).

117. *See, e.g.*, *Kaster v. Modification Systems*, 731 F.2d 1014, 1019 (2d Cir. 1984); *Clark v. Lomas & Netleton Fin. Corp.* 625 F.2d 49, 53 (5th Cir. 1980); *cert. denied*, 450 U.S. 1029 (1981); *Clark Enterprises, Inc. v. Holywell*, 559 F. Supp. 1307, 1309-12 (E.D. Va. 1983); *McKee v. Rogers*, 18 Del. Ch. 81, 156 A. 191, 192-93 (1931).

118. 731 F.2d 1014 (2d Cir. 1984).

119. *Id.* at 1019.

120. 411 F. Supp. 923 (S.D.N.Y. 1975).

121. *Id.* at 924-25.

122. 284 A.2d 119 (Del. Ch. 1971).

123. *Id.* at 122-23.

124. *Abbe*, 411 F. Supp. at 924-25.

the corporation.¹²⁵ Determination of whether the director is more than the "alter ego" of the controlling shareholder is best made on a case by case basis through examination of the director's past course of conduct in corporate matters which directly affect the interest of the shareholder.¹²⁶

The plaintiff in *Aronson* also asserted that demand futility was established because the directors "expressly approved and/or acquiesced in, and are personally liable for, the wrongs complained of. . . ."¹²⁷ Directors' participation in alleged wrongdoing has frequently formed the basis for conclusions of demand futility in both Delaware and federal decisions.¹²⁸ Directors engaged in conduct injurious to the corporation are deemed incapable of either investigating allegations of such wrongdoing or instituting a lawsuit against themselves.¹²⁹ The applicability of this uniformly accepted principle to particular factual settings necessarily depends upon a court's conclusions concerning the level of directorial participation in an allegedly wrongful transaction which necessarily destroys the board member's ability to subsequently act upon a shareholder's demand for remedial action.¹³⁰ When a director is engaged in self-dealing or knowingly participates in a scheme to defraud the corporation, clearly he should be deemed incapable of acting upon a subsequent demand.¹³¹ A review of several Delaware cases finding demand futility on the basis of directorial wrongdoing suggests that the directors were knowing participants in the alleged wrongs to the corporation.¹³²

A different issue is present when it is alleged that directors

125. See *Kaster*, 731 F.2d at 1020 (suggesting the director will frequently have other motivations for resisting control of the dominant shareholders such as a threat of personal liability or protection of a personal interest in stock of the corporation).

126. See *The Demand and Standing Requirement*, *supra* note 7, at 174. Admittedly, this is impossible in the case of newly elected board members.

127. *Aronson*, 473 A.2d at 809.

128. See, e.g., *Reilly Mortg. Group v. Mount Vernon Sav. & Loan Ass'n*, 568 F. Supp. 1067, 1076 (E.D. Va. 1983); *Dann v. Chrysler Corp.* 140 Del. Ch. 103, 174 A.2d 696, 700 (1961).

129. *Dann*, 140 Del. Ch. 103, 174 A.2d at 700.

130. See *The Demand and Standing Requirement*, *supra* note 7, at 176 (noting split among courts on issue of whether directors' passive participation or acquiescence in alleged wrongdoing is sufficient to excuse demand).

131. See *The Demand and Standing Requirement*, *supra* note 7, at 179-80.

132. See *Miller v. Loft Inc.*, 17 Del. Ch. 301, 153 A. 861, 862 (Del. Ch. 1931) (demand futility not established with regard to board, but statements of court support conclusion asserted in text); *Sohland v. Baker*, 15 Del. Ch. 84, 141 A. 277, 282 (1927) (self dealing by corporate officer with board approval); *Fleer v. Frank H. Fleer Corp.* 114 Del. Ch. 282, 125 A. 411, 414 (1924) (two of four directors alleged to have "wrongfully secured the corporate stock and captured the corporation to the exclusion of the majority"); *but see Dann*, 140 Del. Ch. 103, 174 A.2d at 700 (passive participation of directors in a wrongful transaction is sufficient to excuse demand even where the directors are merely guilty of gross negligence as opposed to being knowing participants).

merely approved or acquiesced in the wrongs. Allegations of a director's approval or acquiescence in a wrongful transaction should not form the basis for a conclusion of demand futility.¹³³ Since directors must necessarily approve all major corporate transactions, recognition of such a basis for demand futility would render the demand requirement a virtual nullity.¹³⁴ The *Aronson* court rejected the directors' approval of the agreements with Fink as a basis for demand futility, and the court noted that: "In Delaware mere directorial approval of a transaction, absent particularized facts supporting a breach of fiduciary duty claim, or otherwise establishing the lack of independence or disinterestedness of a majority of the directors, is insufficient to excuse demand."¹³⁵

While correctly concluding that the board's mere approval of the compensation agreements with Fink did not establish demand futility, the *Aronson* court's adoption of the business judgment rule as a guide to demand futility is nevertheless disturbing. As is noted in the conclusion to this article, the court's linking of the business judgment rule with the demand requirement suggests that a board's mere approval or acquiescence in a wrongful transaction could conceivably form the basis for a conclusion of demand futility.¹³⁶ Such a result could be premised upon a plaintiff's pleading of particularized facts which would indicate that the board's approval of the transaction was the product of gross negligence.¹³⁷

One final justification for demand futility which the plaintiff in *Aronson* did not assert merits attention. One noted commentator has suggested that demand should be excused when a clear conflict of interests impairs the board's ability to consider the demand.¹³⁸ The first prong of the *Aronson* demand test, which focuses upon the independence and disinterestedness of the board, contemplates such a basis for demand futility. Subsequent review of cases which have applied the *Aronson* test will indicate that alleged conflicts of interest may frequently provide a basis for excusing demand.¹³⁹

133. See *The Demand and Standing Requirement*, *supra* note 7, at 178-80 (noting directors frequently retain an impetus to take remedial measures after acquiescing in a wrong); see also *H.M. Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1213 (9th Cir. 1980).

134. See *The Demand and Standing Requirement*, *supra* note 7, at 179.

135. *Aronson*, 473 A.2d at 817. The court also rejected this as a basis for demand futility because the plaintiff failed to allege particularized facts indicating that the transactions entered into with Fink constituted wrongs to the corporation. *Id.*

136. See *infra* notes 215-18 and accompanying text.

137. See *infra* notes 215-18 and accompanying text.

138. See *The Demand and Standing Requirement*, *supra* note 7, at 174-75.

139. See *infra* notes 140-64 and accompanying text.

SUBSEQUENT APPLICATION OF ARONSON'S DEMAND FUTILITY TEST

A review of six recent cases which have applied the test for demand futility articulated in *Aronson* suggests that the derivative litigant has retained a difficult burden in establishing demand futility. In view of the overriding importance of particularized facts in the resolution of demand issues, the plaintiff's allegations in each case will be recounted in detail.

*Allegations of Directors' Interest in the Challenged Transactions:
Anti-takeover Transactions*

Three of the cases which applied the *Aronson* test have involved challenges to a board's implementation of an anti-takeover device or its rejection of a tender offer. In *Good v. Texaco, Inc.*,¹⁴⁰ the plaintiff filed a derivative suit which alleged that the company wasted corporate assets when it purchased 25 million shares of outstanding stock.¹⁴¹ The shareholder alleged that Texaco's board of directors approved both the company's purchase of 13 million shares of stock and the exchange of preferred stock for 12 million shares of common stock.¹⁴² Through the exchange agreement, Texaco's board allegedly controlled the voting rights over the preferred shares exchanged.¹⁴³ The complaint further charged that the Texaco board repurchased the common stock at a twelve percent premium over prevailing market prices.¹⁴⁴ The plaintiff also alleged that Texaco's management sought amendments to the certificate of incorporation

140. 16 SEC. REG. & L. REP. 979 (BNA) (Del. Ch. June 1, 1984). It should be noted that aside from *Good*, this survey of *Aronson*'s application is based upon a review of reported cases. Other applications of *Aronson* may be found in unreported decisions not herein reviewed.

141. *Id.* Texaco repurchased the shares of Bass Brothers in order to fend off takeover attempts by Bass. *Id.* The Bass Brothers began acquiring Texaco stock in 1982 and had acquired 9.9 per cent of Texaco's outstanding shares by January of 1984. *Good v. Texaco Inc.*, slip. op. No. 7501 (Del. Ch. Feb. 19, 1985) (decision approving settlement of the case). Bass Brothers dramatically increased their acquisition of stock in the aftermath of Texaco's agreement to acquire ownership of Getty Oil Company. *Id.* The *Good* case concluded with a settlement including Texaco's payment of plaintiff's attorneys' fees in the amount of \$700,000. *Id.*

142. *Good v. Texaco, Inc.*, 16 SEC. REG. & L. REP. at 979 (BNA) (Del. Ch. June 1, 1984).

143. *Id.* Subsequent to the filing of the *Good* lawsuit, Texaco's board modified the repurchase agreement with Bass on May 17, 1984. *Good v. Texaco Inc.*, slip. op. No. 7501 (Del. Feb. 19, 1985). By virtue of the modification, Texaco gave up the right to control the votes on the 12.6 million preferred shares. *Id.* In approving the settlement of the case, the vice chancellor noted that through discovery, plaintiffs attorneys were persuaded that Texaco's repurchase was protected by the business judgment rule. The only remedy that plaintiffs believed they could obtain was modification of the original voting rights agreement on the preferred shares—an issue rendered moot by the modification agreement. *Id.*

144. *Good v. Texaco, Inc.*, 16 SEC. REG. & L. REP. 979 (BNA) (Del. Ch. June 1, 1984).

which would require an eighty percent vote of Texaco shareholders to either remove directors from office or to approve certain business combinations not otherwise sanctioned by the board of directors.¹⁴⁵

The *Good* court found the plaintiff's allegations sufficient to support a conclusion of demand futility under the standard of *Aronson*.¹⁴⁶ The complaint indicated that the board had, at corporate expense, acquired the right to control the vote of five percent of Texaco's outstanding shares.¹⁴⁷ The *Good* court noted that the board's acquired voting rights could be used in seeking passage of the proposed amendments.¹⁴⁸ The plaintiff's allegations concerning the board's purchase of shares, when coupled with the board's proposed amendments, created a reasonable doubt concerning the disinterestedness of the board members.¹⁴⁹ Specifically, the complaint indicated that all of the directors retained an interest in the transaction because they had acquired, at corporate expense, the right to vote certain shares which they did not own.¹⁵⁰

The conclusion of demand futility in the *Good* case is the correct one. While demand should not necessarily be deemed futile whenever a board seeks to shield the corporation from a hostile takeover, the alleged purchase of the shares at a premium price, when viewed in conjunction with the proposed amendments, raised a clear doubt about the board's disinterestedness. Also noteworthy in the resolution of the demand issue was the vice chancellor's refusal to consider any of the plaintiff's proffered facts other than those contained in the complaint.¹⁵¹ *Good* thereby reaffirms the overwhelming importance of specific pleading for the plaintiff seeking a finding of demand futility. Omissions in the plaintiff's pleadings which undermine his claim of demand futility will not be subject to rehabilitation through discovery or affidavits.¹⁵²

In *Moran v. Household International, Inc.*,¹⁵³ a Delaware Chancery Court also resolved a demand futility issue. The *Moran* court

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.* The plaintiff argued that the Texaco directors retained an interest in the challenged transactions because they wanted "to preserve their lucrative compensation and benefits of office in disregard of the interests of Texaco and its public shareholders." *Id.*

152. *Id.*

153. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, slip. op. No. 37, 1985 (Del. Nov. 19, 1985). For a review of the factual setting of the *Moran* case and the Delaware Supreme Court's holding in this matter see *supra* notes 90-96 and accompanying text. While the Delaware Chancery Court found demand futile in the *Moran* case, the Supreme Court did not address the issue on appeal but focused only upon the power of the board to adopt the preferred rights plan and the applica-

applied the Aronson test and concluded that demand was excused because the plaintiff's allegations indicated that the preferred stock rights plan prevented all takeover bids and thereby entrenched the directors in their offices.¹⁵⁴ This fact was deemed to create a reasonable doubt as to the disinterestedness and independence of the board.¹⁵⁵

In *Pogostin v. Rice*,¹⁵⁶ the stockholder's derivative action charged that the board of directors of City Investing Company wrongfully rejected a tender offer for corporate shares resulting in a substantial loss of value for shareholders.¹⁵⁷ In *Pogostin* it was further alleged that the increase in market price for the corporation's shares, which resulted from the tender offer, provided excessive payments to four officers and directors under compensation plans keyed to market price.¹⁵⁸ The court rejected the contention that the board's ratification of the compensation plan met *Aronson's* standard of demand futility because in *Pogostin* a majority of disinterested directors had adopted the plan, the shareholders had ratified it, and a committee of four disinterested directors had administered it.¹⁵⁹ Absent "actual fraud," directors' judgments concerning the consideration for stock options and compensation plans are conclusive.¹⁶⁰ Furthermore, the board's rejection of the tender offer did not establish demand futility because the plaintiff failed to allege facts indicating that the board members' desire to perpetuate themselves in office had primarily motivated the rejection.¹⁶¹ Nor were facts alleged to indicate that the rejection was the product of gross negligence; the board's decision appeared to be the product of careful, informed consideration.¹⁶²

The divergent conclusions concerning demand futility reached in *Moran* and *Pogostin* are readily distinguishable. The shareholder's allegations in *Moran* that the rights plan deterred all takeover attempts created a reasonable doubt concerning the directors' disinterestedness and independence. In contrast, the mere rejection of a tender offer in *Pogostin* did not as strongly suggest that the desire to retain control had motivated the directors.¹⁶³ The *Moran* and *Pogostin* decisions illustrate the intense factual inquiry accom-

bility of the business judgment rule to the board's actions. *Moran v. Household Int'l, Inc.*, No. 37, 1985 (Del. Nov. 19, 1985).

154. *Moran*, 490 A.2d at 1071.

155. *Id.*

156. 480 A.2d 619 (Del. 1984).

157. *Id.* at 622.

158. *Id.* at 623.

159. *Id.* at 626.

160. *Id.* at 625.

161. *Id.* at 627.

162. *Id.*

163. *See Moran*, 490 A.2d at 1071.

panying decisions of demand futility. The chancery court decisions in *Good* and *Moran* suggest that the implementation of anti-takeover devices by corporate boards will provide factual settings particularly ripe for a conclusion of demand futility.¹⁶⁴

Directors' Approval of Transactions With Management Personnel

Aronson foreshadowed issues of demand futility which have also arisen in the context of derivative suits which challenged various boards' approvals of corporate transactions entered into with present or former corporate officers.¹⁶⁵ In *Kaufman v. Belmont*,¹⁶⁶ for example, a shareholder filed a derivative action charging directors with unlawfully permitting officers of the Phillip A. Hunt Chemical Corporation to make substantial profits through the board's cancellation of the officers' stock options.¹⁶⁷ The complaint alleged that in connection with a tender offer made for fifty-one per cent of the corporation's common stock, the directors cancelled the stock options enabling the officers to receive the difference between the tender price and the option price.¹⁶⁸ Four directors on the board were designees of the tender offeror, Turner & Newell Industries.¹⁶⁹ The plaintiff advanced a number of grounds for demand futility, all but one of which the court systematically rejected. The court initially refused to find that demand futility was established merely because the four directors designated by Turner acquiesced in and refused to attack the stock option cancellations which had occurred before they became directors.¹⁷⁰ The vice chancellor also rejected the conclusion that these four directors were disqualified from acting on the demand merely because Turner nominated them; no facts were pled suggesting that Turner had instructed these directors to reject the demand.¹⁷¹ Similarly dismissed was the argument that one director was rendered incapable of acting on the demand merely because the eight other directors had selected him.¹⁷² While certain personal gains realized from the cancellations clearly disqualified two directors, the court rejected as "pure hyperbole" the charge that a voting

164. In determining whether a reasonable doubt is created concerning the board's disinterestedness in adopting an anti-takeover device or rejecting a tender offer, the court will apply a "primary purpose" test. 480 A.2d at 627. If the board's sole or primary purpose was to perpetuate itself in office, then demand will be deemed futile. *Id.*

165. The *Pogostin* case, as previously noted, included a challenge to the compensation scheme adopted for directors. *Id.* at 623.

166. 479 A.2d 282 (Del. Ch. 1984).

167. *Id.* at 284.

168. *Id.*

169. *Id.* at 287.

170. *Id.*

171. *Id.*

172. *Id.*

conspiracy existed between these two and certain other directors.¹⁷³ No facts were pled to substantiate the conclusion that a conspiracy existed.¹⁷⁴ Following in the wake of *Aronson*, the analysis of *Kaufman* again suggests that Delaware courts will continue to rigorously enforce the "particularized fact" requirement in applying the business judgment test for demand futility. The plaintiff will be frequently unable to meet this burden because of his inability to conduct discovery in connection with the claim of demand futility.

In *Tabas v. Mullane*,¹⁷⁵ shareholders of Bally Manufacturing Corporation filed a derivative action against officers and directors of the corporation alleging that they breached a fiduciary duty and wasted corporate assets through certain agreements entered into with a former corporate president.¹⁷⁶ Specifically, the shareholders challenged the following transactions: (1) Bally's purchase of the former president's stock at a twenty percent premium over market price; (2) a five year extension of the president's employment agreement despite the fact that the New Jersey Casino Control Commission was investigating him; (3) a payment of \$2,112,000 in settlement of claims subsequent to the president's resignation; (4) payment of \$1.9 million to a partnership, in which the president had an interest, for the purchase of premises which had formerly housed the corporate headquarters; and (5) payment of \$292,000 as a lease termination charge on the purchased premises.¹⁷⁷

Predictably, the court rejected the shareholders' contention that demand futility was established merely because the directors would be required to initiate suit against themselves.¹⁷⁸ Furthermore, the particular facts of the land purchase, lease termination, and employment agreement were deemed insufficient to create a reasonable doubt about the board's protection under the business judgment rule.¹⁷⁹ Only the circumstances surrounding the purchase of the former president's shares at a twenty percent premium above the market price were deemed sufficiently suspect to challenge the director's business judgment and thereby excuse demand.¹⁸⁰ The court's analy-

173. *Id.* at 288. These two interested directors received \$123,017 each from the cancellation of their options. *Id.*

174. *Id.*

175. 608 F. Supp. 759 (D. N.J. 1985).

176. *Id.* at 761.

177. *Id.* at 760-61.

178. *Id.* at 766.

179. *Id.* at 769-72.

180. *Id.* at 768-69. The court noted that plaintiff specifically alleged the corporation did not have to buy the stock from O'Donnell, the former president, as he was ordered to divest it by the New Jersey Casino Control Commission. *Id.* at 768. Plaintiff further alleged there was a ready market for Bally stock to accommodate the divestiture. *Id.* Furthermore, the complaint charged that the directors forced the corporation to buy back the shares to circumvent a by-law prohibiting Bally from

sis of the demand futility issue in *Tabas* illustrates the significance of the presumption of propriety attaching to the board's actions under the business judgment rule. Viewed collectively, the decisions in *Aronson*, *Pogostin*, *Kaufman* and *Tabas* suggest that shareholders derivatively challenging the board's approval of compensation agreements entered into with corporate managers will frequently encounter great difficulty in establishing demand futility.¹⁸¹

Miscellaneous

In *Allison on Behalf of G.M.C. v. General Motors Corp.*,¹⁸² a General Motors shareholder filed a derivative action against General Motors and six present and former directors alleging violations of the Racketeer Influence Act and the Corrupt Organizations Act. The plaintiff charged the defendants with knowingly producing and selling cars with defective braking systems, concealing the defects, and filing false disclosures with the National Highway Traffic Safety Administration (NHTSA).¹⁸³ The complaint also stated claims based upon fraud, mismanagement, and breach of fiduciary duties.¹⁸⁴ Although a demand letter was sent prior to initiation of the derivative action, the court was nevertheless required to resolve a claim of demand futility.¹⁸⁵ The shareholder premised demand futility upon the following grounds: (1) failure of the General Motors Board to act after the plaintiff had directed letters to the board demanding that it undertake action, (2) failure of the board to act on behalf of the corporation despite knowledge of the wrongdoing for a period of four years, (3) participation of former and present board members in the alleged wrongs, (4) conclusions that the board members would not file suit against themselves, and (5) charges that individual defendants dominated the board.¹⁸⁶

In concluding that none of these asserted grounds were sufficient to establish demand futility, the *Allison* court relied upon federal case law, but noted that application of the *Aronson* test would yield the same result.¹⁸⁷ The plaintiff's allegations were deemed in-

purchasing its shares above market price. *Id.* Also, there were allegations that the directors reached agreement without "meaningful negotiations" in a "hastily called telephone meeting." *Id.*

181. As noted in the *Pogostin* case, directors' decisions concerning the consideration for directors' and officers' stock options are conclusive in the absence of "actual fraud." 480 A.2d at 625.

182. 604 F. Supp. 1106 (D. Del. 1985).

183. *Id.* at 1110.

184. *Id.*

185. *Id.* at 1110-16. The court concluded that while the plaintiff's letter met the requirements for constituting a proper demand, the filing of the suit two and one half months after the demand was premature because the board was not given adequate time to respond to the demand. *Id.* at 1117-19.

186. *Id.* at 1113-16.

sufficient for many of the same reasons highlighted in other cases which applied the *Aronson* demand test. The plaintiff, while asserting that demand futility was established by defendants' participation in the wrongs, failed to allege with particularity the directors' "participation, self-dealing, bias, bad faith, or corrupt motive. . . ." ¹⁸⁸ While claiming individual defendants controlled the board, no factual allegations were presented to substantiate this conclusion. ¹⁸⁹ The *Allison* court rejected the notion that demand futility was established simply because the board knew of a wrong to the corporation and refused to institute suit to redress it. ¹⁹⁰

The *Allison* court reaffirmed the notion that the demand requirement is a substantive right. ¹⁹¹ Thus, it is unlikely that a shareholder can avoid Delaware's stringent demand requirements by initiating the action in a federal forum. ¹⁹² In conclusion, the *Allison* opinion suggests that courts will refuse to readily infer that a director's independence has been forfeited through alleged domination or control. Courts will strictly enforce the requirement that a plaintiff allege particularized facts showing the existence of relationships rendering the board powerless to act.

CONCLUSIONS

It is necessary to reiterate the policies underlying the demand requirement and to consider the effects of derivative litigation upon management and corporate resources when assessing *Aronson's* adoption of the business judgment rule as a guide to demand futility. The demand requirement assures that the board of directors will have the opportunity to review the merits of proposed derivative litigation, to determine whether the claims represent bona fide wrongs against the corporation, and to decide whether those wrongs are best remedied through either the corporation's undertaking of litigation or the corporation's resorting to intracorporate actions. ¹⁹³ By virtue of the demand requirement, the board is granted the first opportunity to sponsor the lawsuit and to thereby use corporate resources to redress a wrong done to the business entity. ¹⁹⁴ In view of the significant benefits to judicial and corporate economy derived from the de-

187. *Id.*

188. *Id.* at 1114.

189. *Id.* at 1115.

190. *Id.* at 1114.

191. *Id.* at 1115.

192. *See id.* at 1115-16. This conclusion was predicted in an early commentary on *Aronson*. Block & Prussin, *Termination of Derivative Actions Against Directors on Business Judgment Grounds: From Zapata to Aronson*, 39 BUS. LAW. 1503, 1512 (1984).

193. *The Demand and Standing Requirement*, *supra* note 7, at 171-72. *See generally* cases cited in note 7 *supra*.

mand requirement, courts should strictly enforce the requirement.¹⁹⁵ The contours of demand futility should encompass situations where the board cannot objectively act on the demand or where the board has previously expressed in clear terms its opposition to the proposed derivative action.¹⁹⁶

Beneficial Aspects of the Aronson Demand Requirement

Initially it is noted that the Delaware Supreme Court's adoption of the business judgment rule as a guide to demand futility is laudable on at least two counts. First, judicial applications of the reasonable doubt standard of proof to the facts of *Aronson*, and in the demand cases following in *Aronson's* wake, generally suggest that the shareholder will not be readily excused from making demand upon the board. The *Aronson* court's apparently rigorous standard for demand could be relaxed through future judicial application and also by subsequent developments in Delaware's business judgment rule.

Perhaps the most significant aspect of the *Aronson* decision is the limitation it imposes on the power of courts to independently determine whether a shareholder can maintain a derivative action. To the extent that *Aronson* is interpreted as mandating a rigorous demand requirement, it is to be hailed as a fortunate sequel to *Zapata*. *Zapata* was significant in its recognition of the power of a board committee, composed of one or more independent directors, to dismiss a derivative action directed against a majority of the board members.¹⁹⁷ The *Zapata* court sought to remedy perceived directorial bias by proclaiming that when demand futility is present a court, subsequently reviewing the committee's motion for dismissal of a derivative action against board members, should independently determine whether the derivative lawsuit should be continued.¹⁹⁸ *Zapata*, therefore, resulted in an inextricable linking of the demand

194. See *Abrams v. Mayflower Investors, Inc.*, 62 F.R.D. 361, 369 (N.D. Ill. 1974).

195. Two standards for demand futility seem to capture the spirit and purposes of the demand requirement. First, demand can be required whenever there is a possibility that it could result in the board's remedial action. *The Demand and Standing Requirement*, *supra* note 7, at 173. See also *Lewis v. Curtis*, 671 F.2d 779, 786 (1982) (demand should be required if "it would be likely to prod them [directors] to correct a wrong."). Alternatively demand could be required whenever "there is a reasonable possibility that it would positively affect the board's behavior." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.03 comment e (Discussion Draft No. 1, 1985). The comments accompanying the American Law Institute's recent draft on rules of corporate governance suggest that the demand standard proposed in *Lewis* is inadequate because it "assumes that there is a wrong to be corrected." *Id.* at comment d. The draft continues: "The director's antagonism to an action may well be justified and flow from a sound judgment that the action is either not meritorious or would otherwise subject the corporation to serious injury." *Id.*

196. See Comment, *supra* note 7, at 173-82.

197. See *Zapata Corp.*, 430 A.2d at 786.

requirement with the power of the board to terminate a derivative action under the business judgment rule.¹⁹⁹ In situations when the shareholder is required to make a demand, the business judgment rule shelters from judicial review the board's subsequent decision to recommend dismissal.²⁰⁰ Under *Zapata's* demand futility-strict scrutiny approach, expansion of the concept of demand futility reduces the frequency with which board motions for termination of derivative litigation will be insulated from judicial review.²⁰¹

The *Zapata* court's linking of the demand requirement with the level of judicial scrutiny applicable to a board's decision to terminate a derivative action is unfortunate. An important purpose underlying the demand requirement is to grant the corporation an initial opportunity to undertake litigation proposed by the shareholder.²⁰² *Zapata's* demand futility-strict scrutiny procedure incorrectly assumes that whenever demand futility is present, a board's decision to forego the derivative litigation is suspect.²⁰³ While demand futility will generally be premised upon allegations that directors have engaged in injurious acts to the corporation, or that a wrongdoer controls the director,²⁰⁴ demand could also be deemed futile when the board has in good faith previously expressed its opposition to the shareholder's lawsuit which it views as inimical to the corporation's best interest.²⁰⁵ If the shareholder was excused from making demand in such a setting, *Zapata* would nevertheless subject the board's good faith motion for termination of the lawsuit

198. *Id.* at 779-80. See generally *supra* note 44.

199. By virtue of *Zapata*, business judgment rule protection for the board's decision to terminate a derivative suit is only afforded when demand has been required. 430 A.2d at 784 n.10.

200. *Id.* In explaining the premise underlying *Zapata's* demand futility-strict scrutiny approach, one author has noted: "The court in *Zapata* may have assumed that the directors can be expected to rise above the pressures of structural bias when a demand is required because the majority is not affiliated with the cause of action." Cox, *supra* note 10, at 1009.

201. See 473 A.2d at 813.

202. See *Reilly Mort. Group v. Mt. Vernon Sav. & Loan Ass'n*, 568 F. Supp. 1067, 1075 (E.D. Va. 1983); see *The Demand and Standing Requirement*, *supra* note 7, at 172.

203. A shareholder may nevertheless file a derivative law suit after the board has refused a demand and assert his standing to bring the action suit by demonstrating the wrongfulness of the directors' decision. 430 A.2d at 784 n.12. Although the requirement that a shareholder first demand action from the board does not prevent the shareholder from initiating litigation after a refusal by the board, *Aronson* nevertheless insures that the directors' motion for dismissal will frequently be successful because of business judgment protection. See *infra* notes 207-09 and accompanying text.

204. See generally *supra* notes 107-39 and accompanying text. The court in *McKee v. Rogers*, 18 Del. Ch. 81, 156 A. 191, 195 (1931), may suggest that demand futility is only established when it is demonstrated that the board is incapable of acting in "good faith."

to its second tier judicial scrutiny.²⁰⁶

The *Aronson* decision curtails the potential expansion of *Zapata's* second tier scrutiny by formulating a rigorous approach to the demand requirement.²⁰⁷ The *Aronson* test for demand futility does not inquire about whether the board might act on the demand, but merely determines whether a reasonable doubt is created about the applicability of the business rule to a majority of the directors.²⁰⁸ By virtue of this rigid standard for demand futility, *Aronson* assures that judicial review of the board's termination of a derivative action will only occur when it appears that a majority of the directors have been participating in wrongdoing and, therefore, they were not acting in good faith on the demand.²⁰⁹

Defects in the Aronson Demand Standard

While *Aronson* reflects a positive development in Delaware corporate law by adopting an ostensibly expansive interpretation of the demand requirement, its erroneous linking of the demand requirement with the business judgment rule produces a series of potentially unfortunate consequences. As a precursor to examining these defective aspects of the *Aronson* test, it is valuable to reiterate the essential components of the demand futility test articulated in the decision.

In determining whether or not the derivative litigant has established demand futility, *Aronson* concludes that the focal point of concern is the board's approval of the challenged transaction. Specifically, the court must determine whether the plaintiff has alleged particularized facts which create a reasonable doubt concerning the applicability of the business judgment rule to a majority of the board members in their approval of the challenged transactions.²¹⁰ This requires initially an inquiry into the independence and disin-

205. See *The Demand and Standing Requirement*, *supra* note 7, at 180-81. *Aronson's* apparent requirement that a demand be made in settings where the board has previously expressed hostility to the lawsuit may be inconsequential for two reasons. First, in the vast majority of cases, the shareholder's assertion of demand futility is not premised on previous expressions of the board's opposition to the lawsuit, but is premised instead upon charges that the board is engaged in wrongdoing or controlled by a wrongdoer. Secondly, the demand requirement can easily be fulfilled by the shareholder. See *The Demand and Standing Requirement*, *supra* note 7 at 172.

206. See *Zapata Corp.*, 430 A.2d at 787.

207. See *Aronson*, 473 A.2d at 808.

208. *Id.*

209. *Aronson's* application of the business judgment rule to demand futility resembles the First Circuit's approach set forth in the case of *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). The court in *Kauffman* concluded that in order to properly claim demand futility, the shareholder must "demonstrate why the directors are incapable of doing their duty." *Id.* at 263.

terestedness of the directors in approving the transaction.²¹¹ Secondly, the court must ascertain whether or not a reasonable doubt has been raised concerning the directors' exercise of business judgment in approving the transaction.²¹²

Three criticisms can be leveled at *Aronson's* adoption of business judgment as an analytical framework for resolutions of demand futility. The first defect in the *Aronson* test arises from its second prong inquiry concerning business judgment.²¹³ As previously suggested in this article, demand undoubtedly should be deemed futile when directors are engaged in transactions in which their loyalty to the corporation has been compromised. Directors are rendered incapable of acting on the demand when they are engaged in self-dealing, are knowing participants in fraud, or are controlled by a wrongdoer.²¹⁴ Similarly, directors are incapable of acting on demand when apparent conflicts of interest are present as in the *Good* or *Moran* settings.

A director should not, however, be denied an opportunity to rectify an injury that arose not from his attempt at self-aggrandizement or knowing participation in fraud, but from his failure to exercise due care.²¹⁵ Directors can still be expected to respond with remedial action in such a setting.²¹⁶ Unfortunately, the second prong of the *Aronson* test suggests that demand could alternatively be excused because a reasonable doubt has been established concerning the directors' exercise of due care in approving the transaction. *Van Gorkom's* pronouncements concerning informed and deliberate judgments indicated that demand futility might be premised upon allegations that the directors who approved a major corporate transaction failed to consult with experts or deliberated for an inordinately short period of time. The *Tabas* case illustrates such a result. In concluding that the plaintiff established a reasonable doubt concerning the directors' independence and business judgment in approving the stock purchase, the court in part relied upon allegations "that the directors did not act on an informed basis and approved a transaction 'partly absent any meaningful negotiations' at a hastily called telephone meeting."²¹⁷ Also, the court observed that the directors did not have advance notice of the meeting.²¹⁸

One limiting factor on this deficiency in the *Aronson* test is that

210. 473 A.2d at 814.

211. *Id.*

212. *Id.*

213. *Id.*

214. See *The Demand and Standing Requirement*, *supra* note 7, at 174, 179-80.

215. *Id.* at 178.

216. *Id.* at 178-79.

217. 608 F. Supp. at 768.

218. *Id.* at 769.

a shareholder, at the time of filing a derivative action, generally will not have detailed information concerning a board's deliberations and directors' procedures in approving a challenged transaction.²¹⁹ Thus, the plaintiff would frequently be incapable of alleging particularized facts indicating that a majority of the board had failed to use requisite care. One setting in which the plaintiff would have such access to detailed information concerning the board's deliberations is when the shareholder bringing the derivative action is also a member of the board of directors. The *Moran* case illustrated such a scenario because the plaintiff served on the Household board and was also the Chairman of the Dyson-Kissner-Moran Corporation, the largest single shareholder in Household.²²⁰ The inadequacy of the business judgment rule as a guide to demand futility is manifest. Even though a director may not be able to claim protection under the business judgment rule because of a failure to exercise requisite care in approving a challenged transaction, the underlying purposes of the demand requirement suggest that demand should nevertheless be required.²²¹

A second criticism of the *Aronson* test is that it could require demand in settings where it would constitute a formalistic and meaningless act. When the board has clearly manifested its hostility to the proposed derivative action, requiring demand does not further the underlying purposes of the demand requirement.²²² Unfortunately, if demand was regarded as futile in such a setting, *Zapata* would dictate that a board's subsequent motion to terminate the derivative action would not be subject to the protection of the business judgment rule.²²³

A third deficiency in the *Aronson* test is perceived in the light of recent developments in the jurisprudence of the Delaware business judgment rule. The *Van Gorkom*, *Unocal*, and *Moran* decisions indicate that the contours of the Delaware business judgment rule may be in a state of flux. The conclusions of the Delaware Supreme Court in *Van Gorkom* suggest that changes can be wrought in business judgment protection through stringent judicial interpretations of the essential elements of the business judgment rule. In particular, the rule is always subject to more rigorous interpretation based upon the judiciary's evolving views concerning the levels of directo-

219. Plaintiffs are not afforded the opportunity to conduct discovery for purposes of substantiating allegations of demand futility. *Kauffman v. Belmont*, 479 A.2d 282, 289 (Del. Ch. 1983).

220. *Moran v. Household Int'l*, slip. op. No. 37, 1985 (Del. Nov. 19, 1985) (available on lexis).

221. See *The Demand and Standing Requirement*, *supra* note 7, at 178-79.

222. *Id.* at 178. For a discussion of the reason why this aspect of the test may constitute an insignificant defect, see the discussion in note 205 *supra*.

223. See 473 A.2d at 787.

rial activity deemed necessary to support a conclusion that a board's decision was both informed and diligent.²²⁴ In contrast, the *Moran* and *Unocal* decisions indicate that the parameters of the business judgment rule are subject to refinement through decisions addressing the rule's applicability to new and unique board transactions. As the court noted in another context in the *Unocal* decision: "However, our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."²²⁵ The holdings of *Moran* and *Unocal* are encouraging because they affirmed that board adoptions of anti-takeover devices are subject to the protection of the business judgment rule.²²⁶ Nevertheless, the decisions, when viewed in conjunction with *Van Gorkom*, suggest that while the concept of the business judgment rule may be a fixed star in the constellation of Delaware corporate law, its applicational scope is subject to change.

In view of the potential evolution in Delaware's business judgment rule, serious questions are raised concerning the suitability of the *Aronson* business judgment test for demand futility. The linking of the demand requirement with the business judgment rule indicates that subsequent judicial limitations on business judgment protection could broaden the scope of demand futility.²²⁷ The benefits forthcoming from the demand requirement would be more readily secured by simply requiring demand to be made whenever the board is capable of acting on demand and has not previously expressed its hostility to the proposed action.²²⁸ Subjecting the demand requirement to fluctuations in the Delaware business judgment rule could result in demand being deemed futile where a demand could serve a useful purpose.²²⁹

Review of the most recent cases applying the *Aronson* demand

224. See generally Emerson, *The Director as Corporate Legal Monitor: Environmental Legislation and Pandora's Box*, 15 SETON HALL L. REV. 593, 601, 610-11 (1985).

225. 493 A.2d at 957.

226. The applicability of the business judgment rule to the board's implementation of defensive devices to frustrate hostile takeover attempts has engendered significant disagreement among commentators. Compare Easterbrook and Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1984) (rejecting the notion that anti-takeover measures should be protected by the business judgment rule) with Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 131 (business judgment rule is applicable to takeovers).

227. The suggestion of this article that *Van Gorkom* reflects a departure from the Delaware jurisprudence of business judgment is certainly subject to debate. Compare Fischel, *supra* note 78, at 1454-55 (noting Delaware's "rich and stable body of precedents" but concluding that *Van Gorkom* is "one of the worst decisions in the history of corporate law") with *Practical Tips on Life in the Boardroom*, *supra* note 79, at 4 ("*Van Gorkom* . . . can be fitted [and I predict later will be fitted] into the mainstream of business judgment rule jurisprudence.")

228. See *The Demand and Standing Requirement*, *supra* note 7, at 181.

229. See text accompanying notes 215-16 *supra*.

test suggests that the potential problems herein discussed are yet to be realized. The decisions in *Kaufman*, *Allison*, and *Pogostin* indicate that *Aronson* has placed a difficult burden on the shareholder seeking to establish demand futility. The conclusions of demand futility in *Good* and *Moran* comport with the general guidelines for applications of the demand requirement articulated herein. Each of these two cases involved a factual setting in which a strong possibility existed that a conflict of interests impaired the directors' abilities to objectively assess the merits of the demand. The outcome in *Tabas* is somewhat troubling because of the court's apparent premising of demand futility on grounds that the board may have failed to exercise requisite care in approving the transaction.²³⁰ The factual setting portrayed by the complaint suggested, however, the board's approval of the buy out agreement was not merely the product of gross negligence, but reflected a conscious decision to aid the former president in a self-serving transaction at corporate expense.²³¹

The issue of demand futility, as addressed by the court in *Aronson*, represents one small aspect of the much greater issue of the degree of independence that the major corporation should enjoy as an economic and social force in our society.²³² The decision may disturb those who perceive corporate management as a group wielding inordinate power without sufficient accountability to shareholders or to society, but *Aronson* should reflect a mixed blessing in the development of Delaware's substantive law governing derivative actions. *Zapata* erroneously concluded that reference to whether demand was required initially determines the level of judicial scrutiny that should be applied to a board's decision to seek termination of a derivative action. In *Aronson* the court has incorrectly perceived the relationship of the demand requirement and business judgment protection for the transaction challenged in a derivative action. *Aronson*, however, is a welcome development to the extent that, through rigorous application of the demand requirement, it curtails the impact of *Zapata's* second tier strict scrutiny of board decisions to terminate.

230. 608 F. Supp. at 768-69.

231. See *id.* at 768.

232. The *Aronson* court recognized this point. 473 A.2d at 811 n.6. For examples of the general debate over corporate autonomy and the issue of whether there is a need for reform in corporate governance compare Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982) (defending sufficiency of present corporate structure) with Eisenberg, *Legal Models of Management Structure in the Modern Corporations: Officers, Directors, and Accountants* 63 CALIF. L. REV. 375 (1975) (proposing reforms in corporate law).

