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NEW RULINGS THREATEN THE
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DANIEL J. MORRISSEY*

I. INTRODUCTION

In both legal form and economic reality, shareholders of
publicly-held corporations have for some time lacked any real
control over the entities which, in theory, they own. As a con-
sequence, these shareholders have needed a device to enforce the

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1. Under a traditional concept of corporate law, holders of common stock own the
basic entrepreneurial interests in a corporation. They may vote to elect directors, are
entitled proportionately to such dividends as are distributed, and receive proportionately
the net assets after payment of all creditors' claims in the event of liquidation. H. HENN
& J. ALEXANDER, LAW OF CORPORATIONS § 160 (3d ed. 1983); 11 W. FLETCHER, CYCyclopedia
of the Law of Private Corporations § 5086 (rev. perm. ed. 1980). These rights are
typically set forth in the corporation's certificate of incorporation. See, e.g., Del. Code
Ann. tit. 8, § 151 (1983). In large, publicly-held corporations, however, where no one
shareholder owns a significant portion of the company's stock, it has long been recog-
nized that management is an endocratic body. As was aptly observed over 50 years ago:
"Under such conditions control may be held by the directors or titular managers who can
employ the proxy machinery to become a self-perpetuating body, even though as a group
they own but a small fraction of the stock outstanding." A. BERLE & G. MEANS, THE
Modern Corporation and Private Property 5 (1933).

A leading text on corporate finance explains the position of shareholders in the cor-
porate structure:

As receivers of residual income, holders of common stock are frequently
referred to as the ultimate entrepreneurs in the firm. They are the ultimate
owners, and they have the ultimate control. Presumably, the firm is managed
on behalf of the holders of common stock, but there has been much dispute
about the actual situation.

discussion of how the separation of corporate ownership from corporate control pro-
moted the emergence of the profession of management in America, see R. REICH, THE
Next American Frontier 60-82 (1983).
rights of their corporations when confronted with unfaithful stewardship by their putative managing representatives, the directors.\(^2\) To afford stockholders such a tool, courts in equity created a legal oddity, the derivative suit, which actually consists of two separate causes of action.\(^3\) First, shareholders must sue the corporation for refusing to pursue its rights. They may then assert the corporation’s claim on its behalf against the wrongdoer.\(^4\)

\(^2\) Management of a corporation is legally vested in the board of directors. See, e.g., Del. Code Ann. tit. 8, \(\S\) 141(a)(1983). For a troubling report on techniques now in use by management to enrich themselves at the expense of the corporation, see Crittenden, *The Age of “Me-First” Management*, N.Y. Times, Aug. 19, 1984, \(\S\) 3, at 1, col. 1. Crittenden describes such current abuses of corporate power as payments of disproportionate salaries and bonuses, buy-outs of potential tender-offerors (so-called “greenmail”), and lucrative severance arrangements known colloquially as “golden parachutes.” One former top corporate official has recently asserted that the contemporary structure and operating practice of boards of directors make it virtually impossible for directors to exercise any meaningful supervisory authority over company officers. Geneen, *Why Directors Can’t Protect the Shareholders*, FORTUNE, Sept. 17, 1984, at 28. However, another commentator has argued that the problem of effective corporate oversight is an organizational one, inherent in the structure of all large associations in modern society. Kristol, *Dilemma of the Outside Director*, Wall St. J., Sept. 11, 1984, \(\S\) 1, at 36, col. 3.

\(^3\) See Prunty, *The Shareholders’ Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. Rev. 980 (1957) for a discussion of the 19th century English and American origins of this action. Although several early American cases recognize the rights of shareholders to redress wrongs to their corporations, Prunty argues that the derivative suit originated in an English case, Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (Ch. 1843).

Three other remedies available to shareholders seeking to hold management accountable for its actions are summarized in Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Colum. L. Rev. 261, 264-65 (1981). For that purpose, the authors find that direct shareholder suits, the proxy mechanism, and tender offers are relatively ineffective and inferior to derivative actions.

\(^4\) Ross v. Bernhard, 396 U.S. 531 (1970). In *Ross* the Supreme Court extended the right of trial by jury to shareholders in a derivative suit when the underlying claim, had it been asserted by the corporation, would have been tried by a jury. *Id.* at 542. Shareholders who suffer direct injuries may sue the wrongdoer to enforce their own rights. A decline in stock value resulting from an injury to the corporation, however, can not form the basis of an individual shareholder action. See Note, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110 U. Pa. L. Rev. 1147 (1962) for a discussion of the difference between the two actions. Any recovery from a derivative suit is put into the corporate treasury for the benefit of the whole community of corporate interests. H. Henn & J. Alexander, *supra* note 1, \(\S\) 358. The Supreme Court recently re-emphasized that rules governing derivative suits apply only to actions which the corporation itself could bring. In *Daily Income Fund, Inc. v. Fox*, 104 S. Ct. 831 (1984), the Court considered an action brought by an investment company shareholder for breach of a fiduciary duty owed to the company under the Investment Company Act. Because the Act did not provide for such a corporate cause of action, the Court held that the shareholder was not required to make a demand on the company’s directors to institute a suit before com-
Not surprisingly, many derivative suits are brought against directors\textsuperscript{5} or controlling shareholders\textsuperscript{6} who have allegedly injured their corporations and who, out of self-interest, fail to bring the resulting corporate claims.\textsuperscript{7} The derivative suit has thus rightly been called a "needed policeman"\textsuperscript{8} and hailed as the most efficient mechanism to hold officers and directors to proper standards of corporate governance.\textsuperscript{9}

A potential for misuse is, however, inherent in the derivative suit mechanism. Plaintiff-shareholders or their attorneys may seek to enrich themselves rather than to redress corporate wrongs.\textsuperscript{10} To guard against such "strike suits," lawmakers have

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7. One authority states that, "The need for the derivative remedy is best illustrated when those in control of the corporation are the alleged wrongdoers, for they can compound their wrong by preventing an action by the corporation against themselves." H. HENN & J. ALEXANDER, supra note 1, § 358.


"Despite the numerous abuses which have developed in connection with such [derivative] suits, they have accomplished much in policing the corporate system especially in protecting corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty. They have encouraged faith in the wisdom of full disclosure to stockholders. They have discouraged membership on boards by persons not truly interested in the corporation. . . . The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to managements and outsiders. Corporate attorneys now have an arsenal of authorities to support their cautioning advice to clients who may be disposed to risk evasion of the high standard the courts have imposed upon directors.

Id. at 525-26.

Judge Wyzanski expressed similar ideas in Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951): "[I]t is recognized that while minority corporate members are often activated by selfish interests, they are sometimes useful gadflies which become the most effective instruments for ferreting out wrongdoing, for pursuing it publicly and for giving point to the only sanctions actual and potential wrongdoers fear." Id. at 346.


10. Franklin S. Wood conducted the most detailed and critical study of these abuses for the Special Committee on Corporate Litigation of the Chamber of Commerce of the State of New York. In 1944 that special committee published the study under the title
imposed preliminary requirements such as security-for-expense statutes\(^{11}\) and the contemporaneous ownership rule.\(^{12}\) Neither of these requirements, however, has proven to be an insurmountable barrier to derivative actions.\(^{13}\) A more persistent threat to the derivative action is the so-called "demand requirement," which is typically accompanied by the companion issue of shareholder standing to sue.

Management, as one would expect, does not favor derivative suits and maintains that derivative suits are both a nuisance to efficient business operations\(^ {14}\) and an usurpation of the directors' rightful authority to run the affairs of the corporation, specifically its litigation.\(^ {15}\) As early as 1881, the United States Supreme Court, in Hawes v. City of Oakland,\(^ {16}\) bowed to management's formal corporate authority by preconditioning shareholders' rights to sue upon the exhaustion of internal corporate remedies.\(^ {17}\)

In Hawes, the Court required the shareholders to allege in

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11. The first such statute was enacted by New York in 1944 in reaction to the Wood Report. This statute provides that a corporation upon whose behalf a derivative suit is brought may require a plaintiff who owns less than five percent of any class of its outstanding shares, and whose shares are valued at less than $50,000, "to give security for reasonable expenses including attorney's fees." N.Y. Bus. Corp. Law § 627 (McKinney 1983). Similar enactments of other states are aptly summarized in Dykstra, supra note 8, at 88-94.

12. See, e.g., Fed. R. Civ. P. 23.1 (requiring that plaintiffs in a derivative suit must allege, in a verified complaint, that they were shareholders at the time of the transaction of which they complain or that their shares thereafter devolved to them by operation of law). See H. Henn & J. Alexander, supra note 1, § 362 for a more elaborate discussion of this requirement.

13. See Dykstra, supra note 8, at 88-97; Coffee & Schwartz, supra note 3, at 261 nn. 3-4 (security-for-expense statutes); H. Henn & J. Alexander, supra note 1, § 362 (contemporaneous ownership rule), § 372 (security-for-expense statutes).

14. See Byers v. Baxter, 69 A.D.2d 343, 419 N.Y.S.2d 497 (1979). In Byers the court agreed with the board of directors that disruption of the corporation's business and large expenses are justifiable reasons for deciding not to press claims against officers and directors. Id. at 347, 419 N.Y.S.2d at 500.

15. See, e.g., Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976). Gall is an early case approving the use of special litigation committees to dismiss derivative actions. In Gall, the court commented that "the decision of corporate directors whether or not to assert a cause of action held by the corporation rests within the sound business judgment of the management." Id. at 515.


17. Id. at 460-61.
their complaint either that they had made a demand upon the board to sue which had been refused or that such a demand would have been futile.\textsuperscript{18} The court discussed the theoretical underpinnings of corporate power and charged that a plaintiff must demonstrate, "if he fails with the directors, that he has made an honest effort to obtain action by the shareholders . . . and he must show a case, if this is not done, . . . [that] it was not reasonable to require it."\textsuperscript{19}

Shareholder demand, however, is not an absolute prerequisite to bringing a derivative suit, as the Court in \textit{Hawes} acknowledged by the almost advisory tone of its language.\textsuperscript{20} Courts which apply state law on the question of shareholder demand have further eroded that requirement when federal jurisdiction is predicated on diversity of citizenship.\textsuperscript{21} Certain states have no such requirement\textsuperscript{22} and many others require it only when the alleged wrong is ratifiable by the shareholders,\textsuperscript{23} which is not the case with two of the most common claims in derivative actions,

\begin{itemize}
  \item \textit{Id.} at 461.
  \item \textit{Id.}
  \item In line with that interpretation, demand on shareholders has often been excused, especially when it is found to be unreasonable. One commentator noted that:
\begin{quote}
At one time or another, all of the following facts have been said to provide an excuse [for demand on shareholders]: that there would be delay involved in making a demand and awaiting a response to it; that a majority of the shareholders are, or are controlled by, the alleged wrongdoers; that the stock is diversely held; that the alleged wrong is not ratifiable; that there has already been a purported ratification; and that the demand is prohibitively expensive.
\end{quote}
\textit{Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746, 754 (1960). But see Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951), where the court stated that,}
\begin{quote}
The mere fact that a corporation is a large one with scattered members to whom it would be expensive to send proxies and whose support it would be difficult to command even in a just cause has not been recognized in Massachusetts as a ground for not resorting to the body of the members.
\end{quote}
\textit{Id. at 344.}
  \item \textit{See Cal. Corp. Code § 800 (West Supp. 1984); N.Y. Bus. Corp. Law § 626(c)(McKinney 1963).}
  \item \textit{See, e.g., Mayer v. Adams, 37 Del. Ch. 298, 141 A.2d 458 (1958); Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912). One commentator stated that the reason for the demand requirement in this situation is that "a demand presumes that shareholders are able to take remedial measures: Where shareholders have no power to ratify actions, no purpose is served by requiring demand." Note, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. Chi. L. Rev. 168, 183 (1976).}
\end{itemize}
fraud and illegality. Shareholders in those two types of actions therefore are not required to make a prior demand on the other shareholders.

Because other commentators have thoroughly explored the requirement of shareholder demand, this Article focuses on the more troublesome questions presented by recent rulings which flow from the holding in Hawes that a shareholder must initially present a derivative claim to the board. As a predicate to that discussion, this Article first examines the requirement of director demand itself and then discusses several cases dealing with special litigation committees, a tactic directors have employed recently to rid themselves of derivative suits. These decisions preceded and strongly influenced a recent line of cases dealing with the requirement of director demand.

II. THE REQUIREMENT OF DIRECTOR DEMAND

The Supreme Court in Hawes followed accepted maxims of corporate governance by holding that shareholders ordinarily must afford directors the initial opportunity to institute litigation on behalf of the corporation. As a collegial body, the directors of a corporation are its statutory managers. Accordingly,


the board of directors, and not the shareholders, should control its litigation.\textsuperscript{30} Because of their unique position of authority, directors are in the best position to evaluate whether the prosecution of a specific claim would serve the corporation's best interests.\textsuperscript{31} Directors are able to employ the ample resources of the business to litigate the claim and are in the best position to decide whether to settle the matter without suit, thus promoting judicial economy.\textsuperscript{32} One commentator notes that,

This removal of the suit from the would-be plaintiff's exclusive control has the additional effect of eliminating the danger of a secret settlement between him and the alleged wrongdoers. Moreover, the mere possibility of such removal discourages one of the major abuses in the use of the derivative suit, namely, its employment as a device to enable plaintiff's counsel to earn substantial fees.\textsuperscript{33}

Proffering demand is a relatively simple procedure if a plaintiff makes "an earnest and sincere and not a feigned or simulated effort to induce the managing officers of the corporation to take remedial action in its name."\textsuperscript{34} Mailing a copy of the complaint to the board and demanding that it commence the

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\textsuperscript{note 1, § 203.}
\textsuperscript{30} Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981); Note, \textit{supra} note 23, at 171. The Second Circuit remarked that demand on directors is intended "to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975)(per curiam).
\textsuperscript{31} See Brooks v. American Export Indus., Inc., 68 F.R.D. 506, 510 (S.D.N.Y. 1975); Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361, 369 (N.D. Ill. 1974); Note, \textit{supra} note 23, at 171-72. Using a related approach, the Third Circuit reasoned that "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." Lewis v. Curtis, 671 F.2d 779, 786 (3d Cir. 1982).
\textsuperscript{32} Lewis v. Graves, 701 F.2d 245, 247-48 (2d Cir. 1983).
\textsuperscript{33} Note, \textit{supra} note 20, at 749. In theory, secret settlements of derivative suits are no longer possible because Rule 23.1 of the Federal Rules of Civil Procedure now requires court approval of all such agreements. The requirement of director demand protects against a similar potential for abuse, namely, "strike suits." The Second Circuit recently noted that "deference to directors' judgments may also result in the termination of meritless actions brought solely for their settlement or harassment value." Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983). \textit{See also} H. HENN & J. ALEXANDER, \textit{supra} note 1, § 358.
action will likely satisfy the requirement; the directors' failure to respond within a reasonable time may be construed as a refusal to sue.\(^{35}\) However, because "equity will not require . . . a useless thing,"\(^{36}\) the demand requirement has never been absolute and courts have excused it when demand would have been futile. For example, when a majority of the board is either accused of active misconduct\(^ {37} \) or under the obvious control of allegedly wrongdoing defendants,\(^ {38} \) some courts have permitted plaintiffs to dispense with the demand requirement.

A determination of futility, however, is not always easily made. One commentator argues that a narrow standard should be adopted which requires a demand unless the directors' interests are clearly antagonistic to the shareholders' claim.\(^ {39} \) He questions the inclination of courts to excuse demand when directors, although elected by an alleged wrongdoer, show some propensity to act independently.\(^ {40} \) This commentator argues that

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39. Note, supra note 23, at 173-75. Two other commentators have proposed a standard which would excuse demand if a court determines that the directors are substantially implicated as defendants. "The extent to which the directors are 'substantially implicated' may depend on the severity of the derivative claim and the extent to which the directors are the principal defendants involved in the alleged wrongdoing." Frankel & Barsky, The Power Struggle Between Shareholders and Directors: The Demand Requirement in Derivative Suits, 12 Hofstra L. Rev. 39, 41 (1983).
40. Note, supra note 23, at 173-74. The author criticizes deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968) (a leading case which excuses demand in such a situation), aff'd, 435 F.2d 1223 (10th Cir. 1970). In deHaas, three members of a five person board stated that they were not controlled by the alleged wrongdoer even though they were elected by him, and professed that they would independently investigate the shareholders' complaint and take appropriate action. 286 F. Supp. at 814. The Tenth Circuit affirmed the District Court's ruling that demand was not required and noted that "courts have generally been lenient in excusing demand." 435 F.2d at 1228.
shareholders should be required to establish with specificity any allegations that the directors have a conflict of interest before demand is excused.\textsuperscript{41}

When directors have not received profits from the questioned transaction, but have only passively approved it, the majority of courts have required demand.\textsuperscript{42} In these situations, it may be appropriate to call the alleged mistakes of the directors to their attention so that they may have an opportunity to correct them without litigation.\textsuperscript{43} Excusing demand automatically when all the directors are named as defendants could encourage sham pleadings that charge all directors with a breach of fiduciary duty for approving the questioned transaction.\textsuperscript{44} Demand

\textsuperscript{41} Note, supra note 23, at 179-80. The psychological, economic, and sociological ties, however, which typically bind independent directors to one another and the controlling corporate figure should be kept in mind in judging that situation. Eisenberg emphasizes that a substantial number of directorships are held by corporate executives and a large number of the "outside" seats are filled by lawyers, investment bankers, or others who are dependent on the corporation for business. Many, if not most, of the remaining seats are held by individuals connected to the chief executive by friendship or former colleagueship and even the directors not so bound to the chief executive officer tend to be his nominees. M. EISENBERG, THE STRUCTURE OF THE CORPORATION 145-48 (1976). Another commentator, however, expresses hope that the movement toward more independent boards will ameliorate such "groupthink" tendencies and promote higher quality corporate decisions. Haft, Business Decisions by the New Board: Behavioral Science and Corporate Law, 80 Mich. L. Rev. 1, 5 (1981).

\textsuperscript{42} See, e.g., Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); Grossman v. Johnson, 674 F.2d 115, 124 (1st Cir. 1982), cert. denied, 459 U.S. 838 (1982), reh'g denied, 459 U.S. 1138 (1983); Lewis v. Curtis, 671 F.2d 779, 785 (3d Cir.), cert. denied, 459 U.S. 880 (1982); Heit v. Baird, 567 F.2d 1187, 1182 (1st Cir. 1977). Contra Zilker v. Klein, 510 F. Supp. 1070, 1073 (N.D. Ill. 1981) (the court excused demand when, over the course of many decisions, the board had acquiesced in objectionable corporate behavior). Other cases excusing demand upon a showing that the board had merely approved the questioned transaction are: Papilsky v. Berndt, 59 F.R.D. 95, 97 (S.D.N.Y. 1973), appeal dismissed, 503 F.2d 554 (2d Cir. 1974), cert. denied, 419 U.S. 1048 (1974); Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (per curiam). Professor Buxbaum proposed a novel approach to these situations in which directors are accused of only "actionable impropriety." To determine if demand would be futile, and thus excused, he would bring to bear the standards developed to judge self-dealing between corporations and their directors. Buxbaum, Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions, 68 Calif. L. Rev. 1122 (1980).

\textsuperscript{43} Note, supra note 23, at 178-79. See also Note, supra note 20, at 753-54; Kim, The Demand on Directors Requirement and the Business Judgment Rule in the Shareholder Derivative Suit: An Alternative Framework, 6 J. Corp. L. 511, 518-19 (1981) (the author argues for strict application of the demand requirement, but would automatically grant shareholders standing to sue regardless of the reasons for a board's refusal to bring such a suit).

\textsuperscript{44} See Lewis v. Graves, 701 F.2d 245, 249 (2d Cir. 1983); Note, supra note 23, at
may be excused, however, when it may be logically inferred that the directors would oppose the suit, but one commentator has argued that such allegations should be demonstrated by uncontroverted factual assertions.

If director demand is not excused, it must of course be made. If the board accepts the demand and effectively prosecutes the action, the wrongdoer is pursued and the corporation's rights are enforced. This, however, is rarely the case. Usually the directors refuse the demand and the shareholder, in the face of the board's opposition, must establish his standing to proceed with the action.

A board of directors typically premises its argument against shareholder standing on the business judgment rule, the supposition that a court should not interfere with the board's prerogative to run the affairs of a corporation. The business judgment

179-80.

46. Nussbacher v. Continental Ill. Nat'l Bank & Trust Co., 518 F.2d 873 (7th Cir. 1975), cert. denied, 424 U.S. 928 (1976). In Nussbacher, the court excused demand because of the directors' prior opposition to a nearly identical suit. 518 F.2d at 878.

46. Note, supra note 23, at 180-81. The court in Mills v. Esmark, Inc., 91 F.R.D. 70 (N.D. Ill. 1981) echoed similar sentiments in a factual situation which it distinguished from Nussbacher: "[E]xcept when demand obviously would be futile dissident shareholders are required to make a sincere effort to obtain relief from the corporation prior to petitioning the court." Id. at 73.

47. Hawes v. City of Oakland, 104 U.S. 450, 460-61 (1881); Fed. R. Civ. P. 23.1. Most states also have this requirement. See, e.g., Cal. Corp. Code § 800 (West 1977); N.Y. Bus. Corp. Law § 626(c)(McKinney 1963). In Daily Income Fund, Inc. v. Fox, 104 S. Ct. 831 (1984), the Supreme Court left open the question whether Rule 23.1 of the Federal Rules of Civil Procedure "itself, as a matter of federal procedure, makes demand on directors the predicate to a proper derivative suit in federal court or whether any such obligation must instead be found in applicable substantive law." 104 S. Ct. at 837 n.8.

48. See H. HENN & J. ALEXANDER, supra note 1, § 365.

49. In Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957), the court reasoned, "It is obvious that the requirement that a stockholder . . . must first demand of the board of directors that it cause such an action to be instituted, does not mean that the board's refusal on demand to act, ipso facto, clears the way for a suit by the . . . stockholder. . . ." Id. at 858.

50. See Ash v. International Business Machines, Inc., 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966). The court in Ash ruled that a derivative suit may be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way. 363 F.2d at 493.
rule, however, arose as a defense to claims charging directors with violations of their duty of care.\textsuperscript{51} As one commentator cogently points out, "Technically, the rule would seem irrelevant as to the effect that a refusal to sue has on a derivative suit, since the derivative suit seeks neither to hold the directors liable for their refusal to sue nor to compel the corporation to sue.\textsuperscript{52}"

Additionally, in the three seminal cases\textsuperscript{53} often cited by those who would deny standing to shareholders after demand refusal, the alleged malefactors were not corporate insiders.\textsuperscript{54} When shareholders allege self-dealing, however, courts have traditionally been more inclined to let the cases proceed, especially when the board of directors acquiesced in some fashion in the transaction.\textsuperscript{55}

III. THE SPECIAL LITIGATION COMMITTEE

In the mid-1970s certain directors named as defendants in existing derivative actions artfully began moving for dismissal by invoking their managerial authority over corporate affairs.\textsuperscript{56}

\begin{itemize}
\item \textsuperscript{51} See Joy v. North, 692 F.2d 880, 885-86 (2d Cir. 1982), cert. denied sub nom., Citytrust v. Joy, 460 U.S. 1051 (1983); H. Henn & J. Alexander, supra note 1, § 242. See also infra notes 88-95 and accompanying text. The Delaware Supreme Court has recently held that the business judgment rule will not protect from liability directors who act to approve a merger without pertinent information. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
\item \textsuperscript{52} Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit, 75 Nw. U. L. Rev. 96, 101-02 (1980).
\item \textsuperscript{53} Hawes v. City of Oakland, 104 U.S. 450 (1881); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903); United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917).
\item \textsuperscript{54} See, e.g., Gall v. Exxon Corp., 418 F. Supp. 508, 515 (S.D.N.Y. 1976). Coffee and Schwartz argue that in each of the three seminal cases, "The plaintiff shareholder wished the corporation to sue an entirely separate and unaffiliated entity, and the board of directors was not subject to even a colorable conflict of interest in any of the cases." Coffee & Schwartz, supra note 3, at 266.
\item \textsuperscript{55} Coffee & Schwartz, supra note 3, at 270-71 (citing Fleishhacker v. Blum, 109 F.2d 543 (9th Cir. 1940) and other cases to support that observation). In Fleishhacker, the court held that the refusal by the board of directors of a bank to bring suit against its president for receiving an improper bonus would not impair a derivative action by the shareholders. 109 F.2d at 547-48. A commentator similarly argues that "if the alleged wrongdoer is a director, officer, or other agent of the corporation it seems that a suit against him should be permitted, since the high standards of fiduciary responsibility require that he be held directly accountable for his malfeasance even when the board would protect him." Note, supra note 20, at 760.
\item \textsuperscript{56} See Lasker v. Burks, 404 F. Supp. 1172 (S.D.N.Y. 1975), rev'd, 567 F.2d 1208 (2d
The defendants would first set up a committee of their "disinterested" colleagues, other directors not named in the suit, to determine whether maintenance of the action was advantageous to the corporation. The committee would engage counsel of impeccable repute, usually a retired judge. He would investigate the allegations and report that the action should be terminated, citing such factors as the suit's lack of merit and its cost to the corporation in legal fees, adverse publicity, and the disruption of business. The committee would then concur and present its recommendation to the full board, which would use the committee's report as grounds for a dismissal motion. After several lower courts approved this approach as a valid and unprejudiced exercise of the board's management authority, the United States Supreme Court implicitly condoned it in Burks v. Lasker.

In Burks, shareholders of a registered investment company charged that some of their directors failed to adequately investigate the quality and safety of certain investments made on behalf of the company. The plaintiffs sued derivatively in federal court alleging causes of action under two federal statutes, the Investment Company Act and the Investment Advisors Act, and under the common law. Independent directors on the investment company's special litigation committee concluded that the litigation was not in the corporation's best interest and made a motion for dismissal. The Supreme Court refused to hold that the federal statutes foreclosed that motion. State corporate law, the Court stated, determines when a board's business judgment gives it authority to terminate a derivative suit unless the

57. The court in Lasker v. Burks, 404 F. Supp. 1172, 1179-80 (S.D.N.Y. 1975), held that the special litigation committee could constitute a minority of the board. 404 F. Supp. at 1179-80. In Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), the committee consisted of only two directors and the court held that Del. Code Ann. tit. 8, § 141(c)(1983) empowered the committee of disinterested directors to act on behalf of the full board. 430 A.2d at 786.
board's decision is inconsistent with federal acts. The Court emphasized that state law is the source of corporate rights and of directors' powers, and that the federal government plays only a limiting, secondary role.

Shortly after the Court in *Burks* accorded federal deference to state laws which shape the powers of special litigation committees, an important state court addressed the issue and indicated that derivative suits exist only at the sufferance of a corporation's purportedly independent directors. In *Auerbach v. Bennett*, a special report of the Securities and Exchange Commission disclosed a widespread program of illegal payments made by certain directors of a large, publicly-held corporation. The plaintiff alleged that the director defendants breached certain fiduciary duties to the corporation, and demanded an accounting for those transactions.

Following the customary pattern, the corporation's board of directors set up a special litigation committee composed of three directors who joined the board after the challenged payments occurred. The board then granted the committee authority to determine its position on the suit. When the committee found that the suit was not in the corporation's best interest, it informed counsel, who moved for dismissal. The New York Court of Appeals held that the committee's business judgment to terminate the suit should be respected unless the plaintiff could demonstrate that the decision was not an honest exercise of independent discernment. Absent such a showing, the New York Courts would not review the board's decision. That substantive determination, the court reasoned, involved weighing and balancing numerous business considerations best left to directors.

63. 441 U.S. at 486.
64. Id. at 478.
68. 47 N.Y.2d at 631, 393 N.E.2d at 1000, 419 N.Y.S.2d at 927.
not judges. 69

The thrust of Auerbach met with some favor. Following that decision, the Ninth Circuit Court of Appeals questioned the wisdom of giving one shareholder the right to overrule the views of a disinterested committee of directors charged with promoting the long range interests of a corporation. 70 Thus, some commentators noted that Auerbach would deter nonmeritorious derivative actions brought by “strike suit lawyers” hoping to extort unfair settlements from innocent directors. 71 In such situations the corporations ultimately bear the cost of any recovery because corporations usually indemnify their directors. 72 It was also noted that the burden of even a nonfrivolous law suit may outweigh its benefits considering the resulting adverse publicity and disruptive effects on a corporation’s activities. 73

Many commentators, however, perceived dangers in the apparent unbridled discretion which the court in Auerbach granted special litigation committees. 74 The business judgment rule was developed by courts as a protection for corporate managers charged with negligently carrying out the corporation’s business. In those situations, judges were understandably reluctant to second-guess commercial or industrial plans, made in good faith, which later turned out to have unfavorable conse-

69. 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court held that factors involving “the weighing and balancing of legal, ethical, commercial, promotional, public relations, [and] fiscal” matters fall within the business judgment rule. Id.

70. Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979)(applying California law), cert. denied, 449 U.S. 869 (1980). The court in Lewis agreed with the reasoning in Auerbach that

the good faith exercise of business judgment by a special litigation committee of disinterested directors is immune to attack by shareholders or the courts. . . . To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders. There is no reason to believe that a minority shareholder is more likely to act in the best interest of the corporation than are directors who are elected by a majority of the stockholders.


71. Comment, supra note 28, at 654 (citing Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978)).


73. Comment, supra note 28, at 654.

74. See generally Steinberg, supra note 28; Note, supra note 28.
quences for the corporation. The court in Auerbach, however, employed the business judgment rule, not as a defense to liability, but as an offensive weapon to override a shareholder's standing to sue, on the specious grounds that decisions about corporate litigation should be made only by the board.

Critics of the special litigation committee process also view it as a transparent device manipulated by management to escape liability. One lower court aptly identified the structural bias inherent in the procedure and reasoned that "aggrieved shareholders, when suing their directors for breach of fiduciary duty, are entitled to receive judgment from an impartial tribunal rather than from a committee appointed by the alleged wrongdoers."

Two important courts did not share Auerbach's uncritical acceptance of special litigation committees. In Zapata Corp. v. Maldonado, the Delaware Supreme Court forthrightly acknowledged the danger of a subtle bias in the process and sought to cure it by authorizing substantive judicial review of the committee's decisions. Zapata involved a derivative action against a number of corporate officers and directors for breach of fiduciary duties. The defendants formed an "Independent Investigation Committee," composed of two new outside directors, to review the pending action. After following the typical investigative scenario, the committee concluded that the suit was immaterial to the corporation's best interest and moved for dismis-

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75. One New York court stated that, "The law will not interfere with the internal affairs of a corporation so long as it is managed by directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than the welfare of the corporation." Bayer v. Beran, 49 N.Y.S.2d 2, 6 (1944). See also N. LATTIN, LATTIN ON CORPORATIONS § 78 (2d ed. 1971)(discussing liability of directors for failure to use due care); 3A W. FLETCHER, supra note 1, § 1039.

76. 47 N.Y.2d at 632, 393 N.E.2d at 1000-01, 419 N.Y.S.2d at 927-28. The court thus permitted use of the business judgment rule as much more than a defense to liability.

77. One article pointed out that, "As a practical consequence of this extension of the business judgment rule, a veto power over derivative actions may now rest with a corporation's often only nominally independent directors." Coffee & Schwartz, supra note 3, at 262.


80. 430 A.2d at 781.
The Delaware Supreme Court framed the issue squarely: "When, if at all, should an authorized board committee be permitted to cause litigation, properly initiated by the derivative stockholder in his own right, to be dismissed?" The court in Zapata acknowledged the right of a properly constituted committee of the board to superintend such corporate matters as litigation, but recognized that the unchecked exercise of such power could destroy the effectiveness of derivative suits in policing corporate governance. The Zapata court therefore found it desirable "to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation."

The Zapata court found that an Auerbach review, limited to determining the committee's honesty and independence, would not strike the correct balance because of a natural "'there but for the grace of God go I' empathy" between the committee members and their codirectors, the defendants. The Zapata court therefore authorized a second aspect of judicial review over the committee's actions by permitting the Chancellor to resort to his own independent business judgment in determining whether to grant the committee's dismissal motion. Analogizing its decision to the judicial approval of the fairness of a settlement, the Delaware Supreme Court disagreed with the reasoning in Auerbach and held that a judge was competent to make such a determination and could effectively evaluate the "'ethical, commercial, promotional, public relations, employee relations, fiscal [and] . . . legal' " factors involved.

In establishing this substantive review process, the court in Zapata also implicitly acknowledged that more than monetary benefit was at stake. It authorized the Chancellor to "give special consideration to matters of law and public policy in addition to the corporation's best interests." In addition, the court in Zapata went further than the court in Auerbach in the first step...
of its review process by putting the burden on the committee to establish its independence and good faith and allowing the Chancellor to order limited discovery to probe those matters.\textsuperscript{87}

In an important subsequent case, \textit{Joy v. North},\textsuperscript{88} the United States Court of Appeals for the Second Circuit\textsuperscript{89} found that Connecticut, which had no statute or precedent on point,\textsuperscript{90} would follow \textit{Zapata} rather than \textit{Auerbach}.\textsuperscript{91} In a lucid description of the business judgment rule, the court in \textit{Joy}, out of both a sincere reluctance to reverse commercial decisions and a fear of fostering overly cautious business planning, found merit in judicial deference to the mercantile decisions of corporate management. Only when corporate action obviously lacked justification would the court find the decision-makers liable for failing to use due care.\textsuperscript{92} On the other hand, the Second Circuit viewed the business judgment employed by special litigation committees differently because

special litigation committees created to evaluate the merits of certain litigation are appointed by defendants to that litigation. It is not cynical to expect that such committees will tend to view derivative actions against other directors with skepticism. Indeed, if the involved directors expected any result other than a recommendation of termination at least as to them, they would probably never establish the committee.\textsuperscript{93}

The Second Circuit therefore rejected the pure application of the business judgment rule to special litigation committees and adopted Delaware's two-step review process. The Second Circuit disagreed with the court in \textit{Auerbach} concerning the ability of

\textsuperscript{87} 430 A.2d at 788.
\textsuperscript{89} Federal jurisdiction in \textit{Joy} was based on diversity of citizenship as provided by 28 U.S.C. \textsection{} 1332 (1982).
\textsuperscript{90} The court in \textit{Joy}, having jurisdiction because of diversity of citizenship of the parties, anticipated and applied the substantive law of the state in which it sat. See Erie R.R. v. Tompkins, 304 U.S. 64, 78, 80 (1938).
\textsuperscript{91} \textit{Joy}, 692 F.2d at 888-89. Also following \textit{Zapata} was Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982)(applying Virginia law). See also Hasan v. Clevertrust Realty Investors, 729 F.2d 372 (6th Cir. 1984), which looked to both \textit{Auerbach} and \textit{Zapata} in holding that a special litigation committee recommending dismissal did not establish the good faith and thoroughness of its investigation.
\textsuperscript{92} Id. at 885.
\textsuperscript{93} Id. at 888.
judges to discern corporate benefit from particular litigation and analogized such court review to "a lawyer's determining what a case is 'worth' for purposes of settlement." Interestingly, the Second Circuit's settlement calculus expressly excludes consideration of certain potential indirect costs of derivative lawsuits. The court's analysis omits consideration of the "negative impact on morale and upon the corporate image" because such effects are quite often related to the degree of wrongdoing, "a spectacular fraud being generally more newsworthy and damaging to morale than a mistake in judgment as to the strength of consumer demand."^{95}

In 1983, the Iowa Supreme Court went beyond Zapata and Joy and rejected entirely the power of director-defendants to delegate litigation authority in derivative lawsuits to special litigation committees.^{96} The court suggested as an alternative that directors could apply to the court for the appointment of a "special panel," which would be empowered to make such decisions.^{97} Although these judicial rulings have curbed management's power to terminate derivative suits by use of special litigation committees, more stringent constructions of the demand requirement now pose an even graver threat to the ability of shareholders to champion those actions.

IV. RECENT CASES ON DIRECTOR DEMAND

Several recent cases indicate that courts may be reluctant to excuse demand in all but the most obviously futile situations and may uncritically respect the refusals of boards to bring the actions by denying the shareholders standing to sue. If such a trend prevails, the derivative suit, so recently saved from the machinations of special litigation committees, will fall prey to another artful triumph of legal form over sociological reality.

In Abramowitz v. Posner,^{98} one of the important post-Zapata cases from the Second Circuit, the plaintiff shareholder

94. Id. at 892.
95. Id.
97. 336 N.W.2d at 718.
98. 672 F.2d 1025 (2d Cir. 1982).
commenced a derivative action against five of seventeen directors for fraud and misappropriation of corporate assets. The plaintiff alleged violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 promulgated thereunder, and the common law. By the time the plaintiff brought suit, the defendants had repaid substantial amounts of the allegedly converted corporate funds pursuant to both an SEC consent decree and the report of a special audit committee established through the SEC proceeding.

The plaintiff originally made no demand on the board, alleging in her complaint that it would have been futile. The trial court disagreed and dismissed the action with leave to replead. The plaintiff then made demand, and when the board refused, pursued her claim nonetheless. The trial court again dismissed the suit and ruled that, absent a showing of bad faith, a derivative action could not be maintained in opposition to the board’s decision that the suit was not in the best interest of the corporation.

Applying Delaware law, the Second Circuit recognized that the reasoning in Zapata provided for substantive judicial review of a special litigation committee’s determination not to continue a derivative action. It declined, however, to apply such a standard in examining a board’s refusal to sue in response to a shareholder’s demand. The court emphasized that, in such a situation, only the independence and good faith of the directors would be scrutinized, not the merits of their decision. The Second Circuit also reasoned that the federal securities laws did not require a Zapata-like review of a board of directors’ refusal to bring suit because “the policies underlying Section 10(b) are not offended by [adhering to] the business judgment rule . . . when a corporation’s disinterested directors, independently and in good faith, determine that the action is not in the company’s best interest.”

100. 672 F.2d at 1028.
101. Id.
102. Id. at 1029.
103. Id. at 1030-31.
104. Id. at 1031.
105. Id.
106. Id. at 1032.
The court in Abramowitz also declined to treat the plaintiff's situation as the functional equivalent of demand futility, which would have arguably necessitated a Zapata review.\textsuperscript{107} Because only five of the corporation's seventeen directors were defendants, and the board had cooperated in the SEC's action, the Second Circuit found "it far from 'inevitable' that [the plaintiff's] demand would [have been] refused."\textsuperscript{108}

One year later, in \textit{Lewis v. Graves},\textsuperscript{109} the Second Circuit again enunciated strict guidelines for when demand would be excused. In \textit{Lewis}, the plaintiff challenged a highly publicized merger and the issuance of stock to certain officers and directors. All the directors named in the complaint approved both corporate actions, and the plaintiff claimed that the approval was sufficient involvement to make a demand futile and therefore excused.\textsuperscript{110}

The court in \textit{Lewis}, however, rejected the plaintiff's claim, and held that neither naming all the directors as defendants nor questioning transactions which the directors approved was sufficient to render demand futile.\textsuperscript{111} Instead, the court held that a plaintiff must plead particularized allegations of bias or self-dealing by the defendant directors to demonstrate their inability to fairly consider a demand for suit.\textsuperscript{112} Despite their earlier approval, directors might still bring suit when their consent was obtained by fraud or when the dealings in question later turned out to be unprofitable for the corporation.\textsuperscript{113} The court reasoned that to excuse demand merely because all directors were named as defendants would condone an easy ploy to eviscerate the demand requirement.\textsuperscript{114}

In \textit{Lewis}, the plaintiff alleged that only five of the eleven directors on the board at the time of the complaint received tainted stock. A majority of directors was therefore free, the court stated, to rule on the proposed suit although the board

\textsuperscript{107} Id. at 1033.
\textsuperscript{108} Id.
\textsuperscript{109} 701 F.2d 245 (2d Cir. 1983).
\textsuperscript{110} Id. at 247.
\textsuperscript{111} Id. at 248-49.
\textsuperscript{112} Id.
\textsuperscript{113} Id. at 248.
\textsuperscript{114} Id.
had authorized the stock issuance in question. With respect to the challenged merger, the court found no facts alleged which indicated that the defendant directors arranged the merger to entrench their own positions. The court therefore held that the plaintiff’s showing of bias was not sufficient to disqualify the directors from examining the proposed action before its filing.

In 1984, the Delaware Supreme Court decided two important director demand cases. In Aronson v. Lewis, a shareholder brought a derivative action alleging that the board authorized payment of unearned fees and benefits to a director who owned 47% of the corporation’s outstanding stock. The plaintiff named all of the corporation’s directors as defendants and did not make demand because the board approved the consulting agreement which generated the fees and benefits, and because the shareholder who profited from the agreement allegedly selected the board. The defendants moved to dismiss the complaint for failure to make demand or “to allege with factual particularity why demand [should have been] excused.”

The issue confronting the court in Aronson was whether the allegations of the complaint indicated that the board could not have impartially considered and acted upon the proposed suit, thus making demand futile. In the lower court, the Vice-Chancellor found that the underlying transactions supported a “reasonable inference” that the directors who had approved the transaction might be liable for a breach of fiduciary duty and thus could not fairly consider the demand. The court therefore denied the motion to dismiss and granted the shareholder standing to sue. The Delaware Supreme Court reversed, focusing its analysis more sharply on the business judgment rule. When

115. Id. at 249-50.
116. Id. Judge Friendly commented that the court in Lewis might have reached the opposite conclusion had the plaintiff alleged facts sufficient to demonstrate that the defendant-directors were opposing a hostile tender offer. Kaster v. Modification Systems, Inc., 731 F.2d 1014, 1023 (2d Cir. 1984)(Friendly, J., concurring in part and dissenting in part).
118. Id. at 809.
119. Id.
120. Id. at 807. The Delaware Supreme Court framed the issue as follows: “[W]hen is a stockholder’s demand upon a board of directors, to redress an alleged wrong to the corporation, excused as futile prior to the filing of a derivative suit?” Id.
121. Id. at 808.
directors are disinterested and fully informed on a question of business policy, the court reasoned that judicial deference to acts of corporate management is warranted.\textsuperscript{122} The court acknowledged that in Zapata, a factually similar case, it had restricted its interpretation of the business judgment rule,\textsuperscript{123} but emphasized that the decision in Zapata addressed special litigation committees and the continuation of litigation, not the excusing of demand.\textsuperscript{124}

The court in Aronson then established a two-pronged test to determine when demand would be excused.\textsuperscript{125} The threshold question is whether the defendants are "interested" in the transaction; if the directors are found to be "interested," they cannot be expected to scrutinize the transaction with independence.\textsuperscript{126} In such a situation, the court found that demand should be excused. Showing that the directors have merely approved a transaction, however, will not make out such a case unless the transaction is so egregious on its face that the approval cannot meet any test of business judgment.\textsuperscript{127} If directors pass this initial test of independence, the substantive nature of the challenged transaction must then be examined, in light of the allegations in the complaint, to see if the board is protected by the business judgment rule:\textsuperscript{128}

In sum the entire review is factual in nature. The Court of Chancery in the exercise of its sound discretion must be satisfied that a plaintiff has alleged facts with particularity which, taken as true, support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment. Only in that context is demand excused.\textsuperscript{129}

Applying this standard to the facts, the court in Aronson found that the board's business judgment was not so obviously tainted that demand would have been futile.\textsuperscript{130} The court rea-

\begin{itemize}
\item \textsuperscript{122} Id. at 814-15.
\item \textsuperscript{123} Id. at 813.
\item \textsuperscript{124} The court noted that the issue in Aronson, quoted supra note 120, was left unanswered in Zapata. 473 A.2d at 807, 814.
\item \textsuperscript{125} 473 A.2d at 814.
\item \textsuperscript{126} Id.
\item \textsuperscript{127} Id. at 815.
\item \textsuperscript{128} Id.
\item \textsuperscript{129} Id.
\item \textsuperscript{130} Id. at 816.
\end{itemize}
soned that neither the amount of voting stock owned by the director who benefited from the challenged consulting agreement nor the mere allegation that he nominated or selected all the other directors sufficiently demonstrated that he controlled the board.\textsuperscript{131} Particularized facts demonstrating such dominance were needed to qualify those charges as a basis for excusing demand.\textsuperscript{132}

The court in \textit{Aronson} also held that the employment agreement did not appear on its face so obviously valueless to the corporation that the court should question the directors' business judgment.\textsuperscript{133} Although the plaintiff charged that the controlling shareholder performed "no or little services"\textsuperscript{134} for his large compensation package, the court found the charges to be only "bare allegation[s]."\textsuperscript{135} The court distinguished the facts at bar from an earlier case of established corporate waste in which an elderly stroke victim received large benefits pursuant to a consulting agreement which required nothing from him.\textsuperscript{136}

Within four months of its decision in \textit{Aronson}, the Delaware Supreme Court reapplied its rule to bar another derivative action because the plaintiffs failed to make a demand on the directors and could not demonstrate why it would have been futile. In \textit{Pogostin v. Rice},\textsuperscript{137} plaintiff-shareholders named all fourteen directors of their corporation as defendants and charged them with wrongfully rejecting a tender offer. The plaintiffs also claimed that the temporary increase in the market price of the corporation's shares resulting from the tender offer caused excessive payments to four of the directors under an executive compensation plan tied to the stock's market price.\textsuperscript{138}

The plaintiffs did not make a demand on the directors to pursue those actions on behalf of the corporation, alleging that such a request would have been ineffective because "[e]ach of the directors participated in the wrongs alleged, and each is lia-

\textsuperscript{131} \textit{Id.}
\textsuperscript{132} \textit{Id.}
\textsuperscript{133} \textit{Id.} at 817.
\textsuperscript{134} \textit{Id.} at 809.
\textsuperscript{135} \textit{Id.} at 817.
\textsuperscript{136} \textit{Id.} at 817-18 (distinguishing \textit{Fidanque v. American Maracaibo Co.}, 33 Del. Ch. 262, 92 A.2d 311 (1952)).
\textsuperscript{137} 480 A.2d 619 (Del. 1984).
\textsuperscript{138} \textit{Id.} at 622.
ble therefor’ and ‘the directors could not and would not sue themselves.’” The court noted, however, that a special committee composed of outside directors, none of whom had a personal interest in the tender offer, made the initial recommendation to reject the bid upon the advice of disinterested financial experts. The court also observed that a majority of disinterested directors had approved the challenged compensation arrangement and the shareholders had ratified it many years before the questioned payments. The court, in addition, found that tying executive remuneration to the “vagaries of the [stock] market” was not unreasonable.

The Delaware Supreme Court then applied its two-step Aronson inquiry that a plaintiff, seeking to have demand excused, must allege facts sufficient to create a reasonable doubt that “(1) the directors are disinterested and independent and (2) the challenged transaction otherwise was the product of a valid exercise of business judgment.” The court in Pogostin agreed with the court in Aronson that questions of business judgment and the standards used to substantively review director action are intricably mixed with the preliminary issue of demand futility. This statement was perhaps a candid admission that the court would use the threshold demand issue to prejudge sub silentio the merits of a plaintiff’s contentions.

The court in Pogostin also held that the plaintiff had not asserted facts which, if proven, would reasonably call into question either the directors’ independence or their business judgment. The court therefore ruled with an air of finality that “the plaintiffs’ bootstrap allegations of futility, based on claims of directorial participation in and liability for the wrongs alleged, coupled with a reluctance by directors to sue themselves, were laid to rest in Aronson.”

The court in Aronson and Pogostin thus gave a narrow re-
sponse to Zapata’s unanswered question concerning when the court will excuse shareholder demand on directors as futile. The anomaly which results from the rulings is that when demand is excused, Zapata requires the court to substantively scrutinize a board of director’s control over litigation through purportedly independent special committees.147 When, however, shareholders cannot show that demand would be futile, they may have little chance of successfully challenging a board’s refusal to sue and gaining standing to litigate the matter themselves. According to the reasoning of Abramowitz, in “demand-refused” situations, the court will grant shareholders standing to sue only when they can impugn the honesty or independence of the board.148 A deferential application of the business judgment rule will thus truncate the judicial review of the merits of the plaintiffs’ suit. Professor Dent notes, however, that plaintiffs faced with a demand refusal have rarely challenged the board’s action as unreasonable and courts have therefore seldom ruled on such claims.149 From that observation, Dent concludes that the implication and scope of the business judgment rule remain unsettled in the context of refusals to sue.150

Both a board’s refusal to sue and a special litigation committee’s motion to dismiss present similar potential for structural bias. A board in a situation similar to the one confronting the court in Aronson is certainly no more independent than a special litigation committee like the one in Zapata. The “there but for the grace of God go I’ empathy”161 is as much present

147. Zapata, 430 A.2d at 785-89.
148. 672 F.2d at 1031-33.
149. Dent, supra note 52, at 103.
150. Id. In Zapata, 430 A.2d at 784 n.10, the Delaware Supreme Court commented, in dicta, that it would apply the business judgment rule to review demand refusals. One commentary, therefore, sees Delaware, like New York, giving uncritical acceptance to the decisions of boards to terminate derivative suits unless the directors are financially interested in the questioned transaction. Block & Prussin, Termination of Derivative Suits Against Directors on Business Judgment Grounds: From Zapata to Aronson, 39 Bus. Law. 1503, 1509 (1984). In Zapata, however, the Delaware Supreme Court described its substantive review of the special litigation committee’s motion to dismiss as an application of the business judgment rule, 430 A.2d at 784, and in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), it has recently held that the business judgment rule will not protect directors from liability who act to approve a merger without pertinent information. The degree of latitude, therefore, that the Delaware Supreme Court will accord directors in “demand refused” situations remains an open question.
151. Zapata, 430 A.2d at 787. Professor Cox puts the matter forcefully: “Structural
with full boards in the "demand refused" scenarios as with the special litigation committees in the "demand excused" cases. In fact, the directors on the special litigation committees in Zapata and Joy, appointed after the questioned transactions, were arguably more independent than the directors in Aronson and Pogostin who had actually approved the challenged employment agreement and compensation plan.

V. CONCLUSION

The holdings in Aronson and Pogostin, standing alone, may not trouble partisans of the derivative suit. Even though demand may appear to be a meaningless step, because directors rarely champion suits proposed by shareholders, practical reasons may exist for requiring it in all but the most obviously futile situations. The demand requirement frustrates legitimate causes of action only when courts use a demand refusal to foreclose the shareholder's ability to bring a suit.

The decisions in Aronson and Pogostin indicate an inclination by the Delaware Supreme Court to require demand when it appears, at the threshold, that derivative suits will not be successful. In setting forth its two-pronged standard, the court believed it was "strik[ing] the essential balance between avoiding abuse of the derivative action and forcing a plaintiff to plead evidence without the benefit of discovery." Those rulings, however, should not be allowed to chill plaintiffs with meritorious actions from seeking standing to sue in their own right if their demands are refused.

A review of the directors' decision not to sue under the business judgment rule must mean something more than only passing on the bona fides of the board. If the Delaware Supreme Court in Zapata thought it necessary to subject the dismissal

bias may be easier to discern in the recommendation of a special litigation committee, but is equally present, and equally problematic, when the directors refuse a demand for suit or approve an out-of-court settlement.” Cox, Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, 1982 Duke L.J. 959, 1011.


153. Pogostin, 480 A.2d at 625.
decisions of independent special litigation committees to a judge's business judgment, there is even more reason for the court not to give uncritical deference to the refusals by boards themselves to bring such suits in the first place. A similar substantive review is warranted in both situations. Condoning the approach taken by the Second Circuit in *Abramowitz* would revive the superficial review standards of *Auerbach* and permit derivative suits to be "snuffed out" even earlier than they would be by special litigation committees. A few short years after surviving that endangerment, the derivative suit will again face extinction if such a judicial attitude prevails.  

154. The descriptive metaphor is carried from *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982).

155. As this Article was being set in print, the American Law Institute published the initial discussion draft of its *Principles of Corporate Governance: Analysis and Recommendations* concerning the derivative action. In a position quite similar to the one advocated in this Article, the ALI draft rejected the "demand required/demand excused" distinction as "an overly crude instrument" to measure the quality of judicial scrutiny needed over the decisions of directors to terminate derivative suits. In all such instances, the ALI would have the court employ a *Zapata*-like review of the action's probable merit and its likely impact on the corporation. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, Part VII, ch. 1, § 7.08 (discussion draft no. 1, June 3, 1985).