Volume 50 | Number 2 Article 4

2016

# Restoring the Promise of the Shareholder Derivative Suit

John Matheson
*University of Minnesota Law School*

# GEORGIA LAW REVIEW

VOLUME 50 WINTER 2016 NUMBER 2

## ARTICLES

# RESTORING THE PROMISE OF THE SHAREHOLDER DERIVATIVE SUIT

*John Matheson**

TABLE OF CONTENTS



* Law Alumni Distinguished Professor of Law and Director, Corporate Institute, University of Minnesota Law School. Of Counsel, Kaplan, Strangis and Kaplan, P.A., Minneapolis, Minnesota. 

## I. INTRODUCTION

The most fundamental and perplexing question in all of corporate law is how to ensure that the board of directors and corporate officers faithfully serve the interests of the corporation and its owners, the shareholders. Over two hundred years ago Adam Smith phrased the problem in terms of handling other people's money: "[t]he directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which . . . [they] watch over their own."[1] Eighty years ago Adolph Berle and Gardiner Means identified the issue as endemic to the publicly-held corporation, that the "separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge."[2] The law and economics movement originating in the 1970s coined the term "agency costs"[3] to identify the same concern: "[i]f both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal."[4] More recently, the American Law Institute's Principles of Corporate Governance summarized the dilemma:

> The challenge for corporate law is to facilitate the development of a corporate structure that allows

---

[1] 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 741 (R.H. Campbell, A.S. Skinner & W.B. Todd eds., Clarendon Press 1976).

[2] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932).

[3] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (using the theory of agency relationships "to develop a theory of the ownership structure of the firm"). From a broader societal policy perspective as opposed to the narrower intra-firm focus, the issue is also part of the discussion of the moral hazard of limited liability. *See, e.g.*, Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 873–74 (1984) (discussing how limited liability provides an "incentive for firm decisionmakers to underprice risk and underinvest in safety").

[4] Jensen & Meckling, *supra* note 3, at 308.

> management the discretion to utilize its expertise on behalf of shareholders, but at the same time establishes safeguards in situations in which management might utilize that discretion to favor itself at the expense of shareholders.[5]

Quite simply, the issue is how best to balance the necessary autonomy of the board of directors to manage the corporation with their accountability to the corporation and its shareholders. A primary means of answering that challenge has been the implication and enforcement of directors' and officers' fiduciary duties to the corporation by means of the shareholder derivative action.[6] "[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.' "[7]

The shareholder derivative claim serves two fundamental functions. First, it tells the board of directors of a company that shareholders consider some action (or inaction) to have harmed the corporation, affording the board the opportunity to respond and

[5] *See* 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 384 (1994) [hereinafter ALI PRINCIPLES].

[6] The derivative suit is not the only means to maintain management accountability. *See* 2 ALI PRINCIPLES, *supra* note 5, at 5–6 (describing alternatives to the derivative suit and assigning a limited role to private enforcement in light of its various problems).

[7] Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) (quoting Cohen v. Beneficial Ind. Loan Corp., 337 U.S. 541, 548 (1949)). Sometimes those efforts are spectacularly successful. *See* Alison Frankel, *Ugly-Duckling Shareholder Derivative Suits are Poised For Swandom*, REUTERS (Jan. 2, 2015), http://blogs.reuters.com/alison-frankel/2015/01/02/ugly-duckling-shareholder-derivative-suits-are-poised-for-swandom/ ("Two of the three biggest-ever derivative settlements [$279 and $130 million] . . . have come in the past two months."); Judy Greenwald, *Multimillion-Dollar Shareholder Derivative Settlements Drive Litigation Boom*, BUS. INS. (Feb. 1, 2015), http://www.businessinsurance.com/article/20150201/NEWS06/302019996/multimillion-dollar-shareholder-derivative-settlements-drive ("Two recent multimillion-dollar settlements of shareholder derivative lawsuits are expected to lead to more litigation and even larger settlements. Experts say derivative actions are a growing problem for companies . . . .").

take corrective or remedial steps.[8] This is the alternative dispute resolution function. Second, if no corrective action is possible or is not taken, it provides a means for pursuing a shareholder-directed suit to remedy conduct believed to be harmful to the corporation.[9] This is the accountability function.

Almost from its inception, however, the derivative suit has been subject to jaundiced treatment by companies, legislatures, and courts. At least twice these negative actions have resulted in the concern that the derivative suit was dead.[10] While these reports were exaggerated,[11] the current state of derivative litigation is encumbered by a series of primarily procedural impediments that make pursuit of the derivative claim unduly litigious and its successful prosecution practically impossible.[12] The latest device to deter derivative claims is the adoption by companies of fee-shifting bylaw provisions which force the derivative claimant to

---

[8] *See* Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) ("First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether.").

[9] *Id.*; *see also* Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 351 (Del. 1988) (describing the derivative suit as "one of the most interesting and ingenious of accountability mechanisms for large formal organizations").

[10] The first such cry came in response to the adoption of security for expenses statutes requiring that derivative plaintiffs file a bond or fee for potential corporate expenses. *See, e.g.*, George D. Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CAL. L. REV. 123, 124–25 (1944) (recognizing the negatives of requiring a bond or fee). The second remonstrance came in response to the rise of special litigation committees. *See, e.g.*, George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 109 (1980) (referring to the creation of the special litigation committee as a "death sentence").

[11] *See* THE UNIVERSITY OF ALABAMA PRESS, *Mark Twain: The Complete Interviews* 317 (Gary Scharnherst ed., 2006) (quoting Mark Twain as saying "[t]he report of my death was an exaggeration" after being notified of the publication of newspaper reports that he had died).

[12] *See* Renee M. Jones & Michelle Welsh, *Toward a Public Enforcement Model for Directors' Duty of Oversight*, 45 VAND. J. TRANSNAT'L L. 343, 344 (2012) ("[T]he disciplinary force of shareholder litigation has been vitiated by procedural rules and doctrines that make it exceedingly difficult for plaintiffs to prevail in derivative litigation."); Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 80 (2011) ("[S]hareholder derivative suits are often strangled by a host of procedural requirements. These requirements are all aimed at preventing frivolous derivative litigation, but their effect is to make it nearly impossible for derivative plaintiffs to present the merits of their claims.").

pay the corporation's attorneys' fees if the suit is not successful.[13] The result is a costly, tortured derivative suit process unrelated to the merits of the underlying claims or any potential remediation. Simply put, the state of the derivative suit process today reflects both bad corporate governance and inefficient public policy.

This Article proposes a transformation of how derivative litigation is handled in the United States today. Part II provides a brief explanation of corporate director and officer fiduciary duties and their relation to the origination of the derivative suit. From this examination, the two main tenets of derivative claims, promotion of alternative dispute resolution and accountability for corporate actors, are identified. The path from that laudable starting point to the dismal state of affairs today is explained in Part III, where the concern for shareholder "strike suits" has led to a series of nearly insurmountable obstacles in the path of the derivative plaintiff shareholder.

Part IV proposes a federal statute as the means of refocusing and revitalizing the derivative claim process to create an efficient accountability and dispute resolution mechanism.[14] This statute posits three fundamental reforms to the derivative claim process and preempts the existing hodge-podge of sundry state impediments and tortured procedures. The first reform is a universal demand requirement to recognize board autonomy and provide a means for alternative dispute resolution of corporate claims. All proposed shareholder litigation must first be presented to the company's board of directors for consideration and potential resolution short of actual litigation.

The second reform is an expansion of the conception of the special litigation committee (SLC), building on the recognition of this device by all fifty states as a reasonable means to address

[13] *See* ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 558 (Del. 2014) (upholding fee-shifting bylaw).

[14] The concept of a federal statute to deal with aspects of shareholder litigation is not unusual today. *See, e.g.*, Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (imposing procedural restrictions on shareholder class action litigation); Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (requiring certain covered shareholder class actions to be brought in federal court).

derivative claims. This reform would allow the subject board of directors to name a committee composed of *independent persons*, not current directors, to investigate the derivative claim and determine how it should be resolved. In this manner, concern over structural bias in the derivative claims process can be mollified. Effective and efficient independent investigation and disposition of derivative claims by non-conflicted actors can proceed outside of the traditional litigation process.

The third reform replaces the various standards of review currently employed by the courts with an explicit delineation of the standards to be used by the courts in reviewing any action by the company to reject, settle or terminate the derivative claim. Application of the proposed tri-partite review standards depends on who makes the determination. If an implicated board itself makes the determination, a strict duty of loyalty and self-dealing standard of entire fairness applies.[15] If an implicated board creates a committee of other directors to determine the fate of the claim, a standard of intermediate scrutiny applies because of the concern for structural bias in that process.[16] Finally, if the decision to dispose of the derivative claim is made by a committee of *independent persons* that are not part of the implicated board, the business judgment rule applies.

The time is ripe for clarity, uniformity and efficiency in the handling of derivative claims. The states' experimentation with the process to date has resulted in a procedural morass where the original purposes of the derivative suit are intentionally obfuscated. The statutory solution proposed here both remedies this dysfunction and also provides a means of effectively meeting

---

[15] *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a)(3) (2011) (stating that a transaction implicating an interested director is not void or voidable so long as it was fair as to the corporation); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (noting that when the duty of loyalty is implicated, "the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction").

[16] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (determining that the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders," may require intermediate or enhanced judicial scrutiny).

the derivative suit's original and still crucial purpose of providing a necessary means for holding corporate boards and officers accountable.

## II. CORPORATE DUTIES AND DEVELOPMENT OF THE DERIVATIVE SUIT

The crux of the derivative suit is that a shareholder seeks to have the corporation enforce supposed rights or claims that the corporation has not yet asserted.[17] While those claims may occasionally be against third parties, the historical focus of the derivative suit has been an attempt by shareholders to hold the corporate board or officers accountable for perceived harm to the corporation caused by a violation of their fiduciary duties.[18] A basic grasp of corporate fiduciary duties aids in understanding both the genesis of the typical derivative suit and the interplay between those duties and the path to shareholder derivative recovery or relief. Therefore, before exploring the development of the derivative suit, a brief description of fiduciary duties is necessary.

### A. AGENCY LAW AND THE ROLE OF FIDUCIARY DUTIES

Investing money in a corporation allows shareholders to participate in the success of that business venture. For many investors, the potential to share in the equity of the corporation and prospective substantial profits is worth the risk of potential loss of their investment. However, when shareholders give their money to a corporation, there is a unique relationship created

---

[17] *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.").

[18] *Compare* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 262–63 (1917) (involving a derivative suit demanding the board of directors sue a third party for antitrust violations), *with* Burks v. Lasker, 441 U.S. 471, 473 (1979) (involving a derivative suit seeking to hold the company's directors personally liable for violation of the Investment Company Act).

between them and the managers of the business. Several aspects of that relationship deserve mention.

A fundamental principle of corporate law in the United States is the division of power between the shareholders, who own the firm, and managers that control its operations.[19] In every state, corporate statutes vest the power to manage the business and affairs of the corporation in the board of directors.[20] That is, while the shareholders own the business, they do not manage it—the board of directors and those acting pursuant to board direction, such as officers and employees, do. These directors, managers and employees serve as agents of the corporation, which is their principal, and thus are indirectly (or derivatively) agents of the shareholders.[21]

The essence of the agency relationship in the corporate context, at least at the director and officer level of management, is the necessity for the agents to have the discretion to be able to make decisions, take risks and make profits for the business.[22] The common law seeks to align this discretion with the interests of the corporation and its shareholders through the implication of

---

[19] *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 105 (2004) ("The chief distinguishing characteristic of the modern public corporation is the separation of ownership and control.").

[20] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2011) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.").

[21] The common law of agency is the foundation of all of business organization law. Whether we have a sole owner hiring a worker to tend the corner shoe repair shop in the evening or a multinational corporation pursuing international operations through its directors, officers and employees, business owners depend on the use of agents to help the business function and grow. Agents allow a principal to accomplish the quintessential Type A Personality goal: to be in two (or millions of) places at one time, taking care of business and getting things done here, there and everywhere. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700 (1981) ("The entire corporate structure is a web of agency relationships.").

[22] Corporate law recognizes that companies must take risks to succeed, and that second-guessing a board's decision using hindsight in a lawsuit will not foster a healthy innovative and entrepreneurial environment. Consequently, decisions of a board are protected by the business judgment rule, which gives deference to a decision of the board of directors if there is some rational basis for that decision and the directors engaged in a process of informed decisionmaking. The leading modern case on the duty of care and the business judgment rule in the decisionmaking context is *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

fiduciary duties.[23] "These duties stem in part from the quasi-trustee and agency relationship directors have to the corporation and stockholders that they serve."[24]

Directors and officers are required to exercise their power to manage the corporation (and the shareholders' money) responsibly.[25] In discharging management functions, "directors owe fiduciary duties of care and loyalty to the corporation and its shareholders."[26]

Traditionally, the duty of loyalty requires directors to make decisions independently.[27] Directors must avoid transactions that involve a financial conflict of interest or otherwise involve self-

---

[23] Easterbrook & Fischel, *supra* note 21, at 700 ("Fiduciary principles govern agency relationships."); *see* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e (2006) ("If the relationship between two persons is one of agency as defined in this section, the agent owes a fiduciary obligation to the principal. The word 'fiduciary' appears in the blackletter definition to characterize or classify the type of legal relationship that results if the elements of the definition are present and to emphasize that an agency relationship creates the agent's fiduciary obligation as a matter of law.").

[24] Schoon v. Smith, 953 A.2d 196, 206 & n.34 (Del. 2008). *See also* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16, at 4-113 (3d ed. 2008) ("Notwithstanding true ownership, most stockholders of today's large corporations are virtually powerless to affect control of corporate operations, so a stockholder must trust the directors to protect his or her investment by their direction of the corporation's management.").

[25] Easterbrook & Fischel, *supra* note 21, at 702 ("Socially optimal fiduciary rules approximate the bargain that investors and agents would strike if they were able to dicker at no cost. Such rules preserve the gains resulting from the delegation of authority and the division of labor while limiting the ability of agents to further their own interests at the expense of investors. The existence of such 'off-the-rack' rules reduces the costs of transacting and of enforcing restrictions on the agent's powers. It also reduces the risk that managers will manipulate the articles of incorporation to their advantage once they assume control.").

[26] *Schoon*, 953 A.2d at 206 (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989)); *accord* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) ("In discharging this function the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders." (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984))).

[27] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) ("We have generally defined a director as being independent only when the director's decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations." (citing *Aronson*, 473 A.2d at 816)).

dealing at the expense of the corporation.[28] Directors are interested if they "will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."[29]

Furthermore, directors cannot usurp a business opportunity for personal gain.[30] In Delaware, the state of incorporation of a majority of publicly-traded corporations,[31] the fountainhead corporate case on the duty of loyalty is *Guth v. Loft, Inc.*[32] There the Court held that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests"[33]:

> While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty[; he does this] affirmatively to protect the interests of the corporation committed to his charge . . . .[34]

When director conduct implicates the duty of loyalty, as in self-dealing or corporate opportunity situations, the concern is that the director is not serving the interests of the company and its shareholders. Where such conflicts of interest exist, strict scrutiny

---

[28] *See, e.g.*, *Guth*, 5 A.2d at 510 ("The one that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.").

[29] Rales v. Balsband, 634 A.2d 927, 936 (Del. 1993) (citing *Aronson*, 473 A.2d at 812; Pagostin v. Rice, 480 A.2d 619, 624 (Del. 1984)).

[30] For an example of a court inquiring into a corporate opportunity claim see, *Miller v. Miller*, 222 N.W.2d 71, 78–82 (Minn. 1974).

[31] Lewis S. Black, Jr., *Why Corporations Choose Delaware*, DEL. DEP'T OF STATE, DIV. OF CORPS., at 1, http://www.corp.delaware.gov/whycorporations_web.pdf ("Of the corporations that make up the Fortune 500, more than one-half are incorporated in Delaware.").

[32] 5 A.2d 503 (Del. 1939).

[33] *Id.* at 510.

[34] *Id.*

of the director's actions under an entire fairness standard is employed:

> [U]nder the traditional operation of the entire fairness standard, the self-dealing director would have breached his duty of loyalty if the transaction was unfair, regardless of whether he acted in subjective good faith. After all, that is the central insight of the entire fairness test, which is that when a fiduciary self-deals he might unfairly advantage himself even if he is subjectively attempting to avoid doing so.[35]

In addition to the duty of loyalty, directors are subject to a duty of care. Generally, a breach of the duty of care occurs when directors fail "to act in an informed and deliberate manner" in making decisions about the corporation.[36] In Delaware, directors and officers are only liable if grossly negligent, and the presumption of regularity embodied in the business judgment rule applies.[37] Therefore, it is uncommon for directors to be held liable for breaching their duty of care.[38]

---

[35] Venhill Ltd. P'ship v. Hillman, C.A., No. 1866-VCS, 2008 WL 2270488, at *22 (Del. Ch. June 3, 2008) (citing *In re* PNB Holding Co. S'holders Litig., No. Civ-A-28-N, 2006 WL 2403999, at *12 (Del. Ch. July 25, 2006)).

[36] Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985), *overruled on other grounds*, Grantler v. Stephens, 965 A.2d 695, 713 & n.54 (Del. 2009); *see also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 369–70 (Del. 1993) (holding that directors violated their duty of care because they were not "adequately informed" about material information before approving a merger agreement).

[37] *In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 749 (Del. Ch. 2005) (referencing the "grossly negligent" standard); Tomczak v. Morton Thiokol, Inc., Civ-A. No. 7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (defining gross negligence as " 'reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason' ").

[38] *See In re* Walt Disney Co. Deriv. Litig., 907 A.2d at 750 ("[D]uty of care violations are rarely found."). Generally, if a board of directors breaches one of its fiduciary duties, the directors will be held personally liable for the extent of the injury to the corporation. However, some states either allow or require indemnification of directors and officers of the corporation for breaches of the duty of care. *See, e.g.*, MINN. STAT. ANN. § 302A.521 (West, Westlaw current through the end of the 2015 First Special Session) (imposing a duty on corporations to indemnify directors and officers of a corporation in certain circumstances).

Modern application of the duty of care in the publicly-traded corporation context involves not only board decisionmaking, but also an oversight responsibility: the duty to monitor.[39] This aspect of the duty of care recognizes that publicly-traded corporations are large, complex organizations whose daily operations cannot be actively managed by boards of directors.[40] Hence, the board monitors the activities of corporate management to ensure that the corporation is being run properly. Indeed, if the board fails to satisfy this duty to monitor in a substantial way, the members of the board may be held personally liable for failing to act in good faith.[41]

The complexities of modern publicly held corporations have also given rise to a third judicial standard of review of directors' actions

---

Many state statutes also allow corporations to exculpate (or eliminate) director liability for breaches of the duty of care. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (West, Westlaw current through 80 Laws 2015, ch. 194) (permitting a corporation to include, in its certificate of incorporation, a clause which exculpates director personal liability for breaches of the duty of care). Such exculpation is not available for breaches of the duty of loyalty or failure to act in good faith. *Id.*

[39] *See, e.g.*, *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967–72 (Del. Ch. 1996) (discussing director liability for directorial decisions and for failure of director duty to monitor corporate activity but finding no liability for failure to monitor).

[40] Pursuant to existing stock exchange requirements, a majority of the board of a listed company must consist of independent directors; that is, directors who are not full-time employees of the company. *See* Order Approving NYSE Proposed Rule Changes Relating to Exchange Listing Standards, 68 Fed. Reg. 64,154, 64,157 (Nov. 12, 2003) (stating that Section 303A(1) of the NYSE Manual will require a majority of the board of directors to be independent). The supposed benefit of having scrutiny from those not beholden to the corporation for their livelihoods comes at the expense of limited attention and ability to actively engage. These directors are often chief executive officers of their own companies and cannot realistically devote substantial time to management and oversight of the company where they sit as outside, independent directors.

[41] *Stone v. Ritter* limited the scope of the duty to monitor, holding that liability results only if "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, [directors] consciously failed to monitor or oversee its operations . . . ." *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). The duty of good faith does not stand on equal footing with the duties of care and loyalty. Failure to act in good faith " 'is a subsidiary element' . . . 'of the fundamental duty of loyalty.' " *Id.* at 369–70 (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)). Good faith is defined in contrast to two categories of bad faith: subjective bad faith that includes an actual intent to harm and intentional dereliction of duty or conscious disregard of one's responsibilities. *In re* Walt Disney Co. Deriv. Litig., 906 A.2d at 64, 66.

which falls between the entire fairness test and the business judgment rule.[42] As the Delaware Supreme Court noted, "our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."[43] In some circumstances, such as when a board of directors acts to adopt anti-takeover measures to thwart a hostile takeover, it is unclear whether the board is acting in the best interests of the corporation or whether the board is merely acting to protect its own position of power and prestige:

> Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.[44]

Therefore, in these situations, the strong deference of the business judgment rule is not justified and the strict scrutiny of the entire fairness standard is not necessary. "The operative standard of review [in these cases], however, is enhanced scrutiny, an intermediate standard that applies in situations where 'there is a basis for concern that directors without a pure self-dealing motive might be influenced by considerations other than the best interests of the corporation and other stockholders.' "[45]

In applying a standard of intermediate scrutiny, "the reviewing court has leeway to examine the reasonableness of the board's actions under a standard that is more stringent than business

---

[42] "Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness." Reis v. Hazelett Strip–Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011).

[43] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985). A similar intermediate standard of enhanced scrutiny was adopted by the Delaware Supreme Court in the sale of control context in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180–82 (Del. 1986).

[44] *Unocal Corp.*, 493 A.2d at 954.

[45] Chen v. Howard-Anderson, 87 A.3d 648, 677 (Del. Ch. 2014) (quoting *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 599 n.181 (Del. Ch. 2010)).

judgment review and yet less severe than the entire fairness standard."[46] The touchstone of intermediate scrutiny is the reasonableness of the board's actions, that is, the "metric of reasonableness employed in the intermediate standard of review enables a reviewing court to 'smoke out mere pretextual justifications for improperly motivated decisions.' "[47]

B. THE DEVELOPMENT OF THE DERIVATIVE SUIT IN THE UNITED STATES

At one time, the only relief a shareholder could seek against directors or officers was through a direct action against such individuals.[48] For a shareholder to bring such an action, the shareholder needed to have a personal, individual claim. The shareholder must have suffered a specific, individual injury from actions of directors or officers to have standing to bring a claim.[49] Judicial recognition of the derivative action expanded shareholders' ability to protect their interests in a corporation, eliminating the need for shareholders to have suffered direct, personal injury in those circumstances where the corporation itself was harmed.

An initial step in this evolutionary process began by analogy to trust law. For example, in 1831, the court in *Taylor v. Miami Exporting Co.*[50] permitted a shareholder to sue directors for injury to the corporation, holding that the directors had to restore corporate assets that were improperly expropriated. The court

---

[46] *In re* Dollar Thrifty S'holder Litig., 14 A.3d at 598.

[47] *Chen*, 87 A.3d at 679 (quoting *In re* Dollar Thrifty S'holder Litig., 14 A.3d at 598–99 n.181).

[48] *See* WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 18-2 (8th ed. 2010).

[49] *See, e.g.*, Kaplan v. First Options of Chi., Inc. (*In re* Kaplan), 143 F.3d 807, 811–12 (3d Cir. 1998) (holding that a stockholder of a closely-held corporation could sue for injuries inflicted upon him distinct from injuries suffered by the corporation).

[50] Taylor v. Miami Exporting Co., 5 Ohio 162 (1831); *see also* Bert S. Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980, 986 (1957) (noting that the Court labeled the relationship between director and shareholder as one of trust in order to allow individual stockholders to "invoke[e] judicial power to curb managerial abuse").

based its legal justification on the law of trusts, labeling the relationship of directors to shareholders, as owners of the corporation, as one of trust:

> Again, if this corporation and directors were trustees and agents of the stockholders, can they not call them to account for the funds placed under their care, and to exhibit the state of the corporate affairs, in order to stay them from totally destroying the whole fund under their charge; or is it true that these extensive trusts and these trustees are peculiarly exempt from responsibility? We think they are not.[51]

The next step was to allow a shareholder to serve as a representative of the other shareholders in a suit against board members for breach of their duties. *Robinson v. Smith* involved directors of a small coal company who used company funds to invest in shares of banks, allegedly for their own personal gain.[52] The court found that a portion of the shareholders could sue on behalf of the corporation in the name of all the shareholders:

> Generally, where there has been a waste or misapplication of the corporate funds, by the officers or agents of the company, a suit to compel them to account for such waste or misapplication should be in the name of the corporation. But as this court never permits a wrong to go unredressed merely for the sake of form, if it appeared that the directors of the corporation refused to prosecute by collusion with those who had made themselves answerable by their negligence or fraud, or if the corporation was still

[51] *Taylor*, 5 Ohio at 168.

[52] Robinson v. Smith, 3 Paige Ch. 222, 223 (N.Y. Ch. 1832); *see also* Ann M. Scarlett, *Shareholder Derivative Litigation's Historical and Normative Foundations*, 61 BUFF. L. REV. 837, 873 (2013) (describing *Robinson* as "the first U.S. lawsuit in which shareholders were allowed to bring a representative action on behalf of themselves and the other shareholders against the corporation's directors").

> under the control of those who must be made the defendants in the suit, the stockholders, who are the real parties in interest, would be permitted to file a bill in their own names, making the corporation a party defendant. And if the stockholders were so numerous as to render it impossible, or very inconvenient to bring them all before the court, a party might file a bill, in behalf of themselves and all others standing in the same situation.[53]

Two fundamental principles arose from these developments. First, directors and officers of corporations, whether viewed as trustees, agents or *sui generis*,[54] have significant fiduciary responsibilities in managing the enterprise and dealing with "other people's money." That is, their corporate authority and discretion is bounded by the accountability of personal liability.[55] Second, the shareholders of the business have a right to seek to hold the officers and directors personally liable for breaches of their duties to the corporation and derivatively to the owners of the corporation.[56]

By 1855, the United States Supreme Court acknowledged the existence and importance of derivative suits to protect shareholder and corporate interests in *Dodge v. Woolsey*:

---

53 *Robinson*, 3 Paige Ch. at 233.

54 
> The scope of appropriate director conduct will vary depending on one's chosen theory of corporate law. For example, under the classic shareholder primacy theory, directors are viewed as agents of the shareholders. From this perspective, directors understandably are thought to owe a duty to maximize shareholder wealth. In contrast, the director primacy view rejects the idea that directors are agents of the shareholders. They are instead in a sui generis category, managing the corporation according to their best judgment. But as developed by its proponents, director primacy is also thought to support a shareholder wealth maximization norm.

Andrew S. Gold, *Dynamic Fiduciary Duties*, 34 CARDOZO L. REV. 491, 501 (2012) (footnotes omitted).

55 *See id.* at 526 (noting how the range of acceptable fiduciary interpretations is bounded).

56 *Robinson*, 3 Paige Ch. at 233.

> It is now no longer doubted, either in England or the United States, that courts of equity, in both, have a jurisdiction over corporations, at the instance of one or more of their members; to apply preventive remedies by injunction, to restrain those who administer them from doing acts which would amount to a violation of charters, or to prevent any misapplication of their capitals or profits, which might result in lessening the dividends of stockholders, or the value of their shares, as either may be protected by the franchises of a corporation, if the acts intended to be done create what is in the law denominated a breach of trust.[57]

This recognition of the derivative suit solidified the concept of holding directors and officers of corporations accountable for their actions. A derivative action allows shareholders to bring a suit against directors or officers in the name of the corporation itself.[58] The shareholders seek to enforce a right of action belonging to the corporation, which it might have asserted, but did not. As a result, shareholders indirectly harmed by actions of corporate officers or directors may bring a claim in the corporation's name, even when they could not bring a claim directly.[59]

The elements of the derivative suit in the United States were further developed by the Supreme Court in the 1881 case of *Hawes v. Oakland*.[60] In *Hawes*, a shareholder of a water works company in California sued the city of Oakland, the water works company, and several directors and officers of the company. The city of Oakland had been requiring the company to provide water for a number of city projects, "including watering the streets, public squares and parks, [and] flushing sewers," without compensating the company in return.[61] The shareholder argued that the city

---

[57] Dodge v. Woolsey, 59 U.S. 331, 341 (1855).

[58] Hawes v. Oakland, 104 U.S. 450, 460 (1881) (describing derivative actions).

[59] *Id.*

[60] *Id.* Hawes sued on behalf of any and all shareholders of the corporation who were willing to contribute financially for the suit.

[61] *Id.* at 451.

could only legally demand water for free in cases of great necessity, such as a fire, rather than for general city functions.[62] The shareholder complained that by complying with the city's demands, the directors of the company allowed the value of the corporate shares to decrease, thus harming the shareholders.[63] The city of Oakland demurred, claiming that the shareholder held no right to sue, as the injury he claimed belonged to the corporation, rather than the shareholders.[64]

Initially, building on the analysis it had undertaken in *Dodge v. Woolsey*, the Court solidified the fundamental nature of the derivative claim, that the suit belongs to the corporation but equity allows the shareholder under certain circumstances to pursue the claim on behalf of the entity: "[w]e understand that doctrine . . . to enable a stockholder in a corporation to sustain in a court of equity in his own name, a suit founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff."[65]

---

[62] *Id.*

[63] *Id.* ("[T]he company compl[ied] with this demand, to the great loss and injury of the company, to the diminution of the dividends which should come to him and other stockholders, and to the decrease in the value of their stock.").

[64] *Id.* at 451–52 ("That appellant has shown no capacity in himself to maintain this suit, the injury, if any exists, being to the interests of the corporation, and the right to sue belonging solely to that body.").

[65] *Id.* at 460. *Accord* Ross v. Bernhard, 396 U.S. 531, 538 (1970) ("[T]he derivative suit has dual aspects: first, the stockholder's right to sue on behalf of the corporation, historically an equitable matter; second, the claim of the corporation against directors or third parties . . . ."); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("The nature of the [derivative] action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it."), *overruled on other grounds*, Brehm v. Eisner, 746 A.2d 244, 253–54 (Del. 2000). The fact that the derivative suit is ultimately a suit by the corporation was recently made clear by the Delaware Supreme Court. Pyott v. Louisiana Mun. Police Emps. Ret. Sys., 74 A.3d 612, 614 (Del. 2013) (holding that a suit filed by shareholders in Delaware must be dismissed after a suit filed by other shareholders in California was dismissed for failure to adequately plead demand futility). The court reasoned that the Full Faith and Credit Clause required this result "because the real plaintiff in a derivative suit is the corporation, 'differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion.'" *Id.* at 616–17 (quoting LeBoyer v. Greenspan, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646, at *3 (C.D. Cal. June 13, 2007)).

Next, the Court imposed two procedural prerequisites to a shareholder pursuing a derivative suit. First, even if a shareholder has a valid foundation for bringing the suit, the shareholder must show that he "was a shareholder at the time of the transactions of which he complains, or that his shares have devolved on him since by operation of law."[66] This prerequisite has become known as the contemporaneous ownership requirement and effectively operates to determine whether a plaintiff shareholder has standing.[67]

Second, the Court recognized that the board of directors ultimately is responsible for the active management of the corporation's business and affairs, including the decision whether to pursue claims on the corporation's behalf.[68] Therefore, before the shareholder can initiate litigation seeking to enforce a right or pursue a remedy belonging to the corporation, the shareholder has a responsibility to pursue other measures to resolve the suit.[69] That is, the shareholder must seek to resolve these potential grievances through a process of alternative dispute resolution:

> [I]t is equally important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial

---

[66] *Hawes*, 104 U.S. at 461.

[67] *See* 2 ALI PRINCIPLES, *supra* note 5, § 7.02 (stating that contemporaneous ownership is a condition shareholder derivative standing).

[68] After all, under all state corporate statutes, "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2011). For a modern statement of this principle, see *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981) ("Directors of Delaware corporations derive their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation, from 8 *Del. C.* § 141(a)." (footnote omitted)).

[69] *Zapata*, 430 A.2d at 782.

> action on their part, and this must be made apparent to the court. If time permits or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body, in the matter of which he complains. And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.[70]

This latter prerequisite survives today as the demand requirement of derivative litigation.[71]

Following the decision in *Hawes v. Oakland*, the Court adopted a rule of procedure to implement its decision.[72] The rule, originally known as Equity Rule 94, then became Equity Rule 27 in 1912.[73] In 1937, Federal Rule of Civil Procedure 23(b) was promulgated, and at the time entitled "Secondary Action by Shareholders."[74] Eventually the Federal Rules of Civil Procedure began to use the term "derivative,"[75] and Federal Rule of Civil Procedure 23.1, adopted in 1966, remains the current federal rule on derivative suits.[76]

Rule 23.1, titled Derivative Actions, states:

> **(a) Prerequisites.** This rule applies when one or more shareholders or members of a corporation or an unincorporated association bring a derivative action to enforce a right that the corporation or association may properly assert but has failed to enforce. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately

---

[70] *Hawes*, 104 U.S. at 460–61.

[71] *See* 2 ALI PRINCIPLES, *supra* note 5, § 7.03 (stating that "[a]ll jurisdictions have a generalized requirement of demand on the board before a derivative action is brought").

[72] Ross v. Bernhard, 396 U.S. 531, 534 n.4 (1970).

[73] *Id.*

[74] Glenn G. Morris, *Shareholder Derivative Suits: Louisiana Law*, 56 LA. L. REV. 583, 584 n.1 (1996) (citing 3B JAMES W. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 23.1.01[2] (2d ed. 1995)).

[75] *Id.*

[76] *Ross*, 396 U.S. at 534 n.4.

represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.

**(b) Pleading Requirements.** The complaint must be verified and must:

- **(1)** allege that the plaintiff was a shareholder or member at the time of the transaction complained of, or that the plaintiff's share or membership later devolved on it by operation of law;
- **(2)** allege that the action is not a collusive one to confer jurisdiction that the court would otherwise lack; and
- **(3)** state with particularity:
  - **(A)** any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and
  - **(B)** the reasons for not obtaining the action or not making the effort.

**(c) Settlement, Dismissal, and Compromise.** A derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval. Notice of a proposed settlement, voluntary dismissal, or compromise must be given to shareholders or members in the manner that the court orders.[77]

---

[77] FED. R. CIV. P. 23.1. Interestingly, Rule 23.1 does not expressly require the individual bringing the suit to be a shareholder at the time the suit is brought, just that the individual be a shareholder at the time the transaction complained of occurred. Despite the lack of clarification, courts consistently require plaintiffs in federal derivative actions to be current shareholders because the rule implies such a requirement in its language mentioning "one or more shareholders." *See, e.g.*, Werfel v. Kramarsky, 61 F.R.D. 674, 679 (S.D.N.Y. 1974) (holding that because the plaintiff was not a shareholder of the corporation at the time he brought suit, he did not have standing to sue on behalf of the corporation).

There are three very important aspects of Rule 23.1 that highlight the three primary policies underlying current recognition and allowance of derivative actions. First, the fundamental policy of accountability of corporate directors and officers that fomented creation of this remedy in the first place[78] is implicitly recognized in the first sentence of the Rule. That is, "[t]his rule applies when one or more shareholders or members of a corporation or an unincorporated association bring a derivative action to enforce a right that the corporation or association may properly assert but has failed to enforce."[79] Allowing the shareholders to bring the claim at all sanctions director and officer accountability while promoting the dual goals of compensation to the corporation for past corporate agent misdeeds and deterrence of similar conduct in the future.[80]

---

[78] *See* Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 745 (1992) ("Shareholder class actions and derivative actions are considered an important means for ensuring managerial accountability.").

[79] *Id.*

[80] *See* John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 305 (1981) ("[T]he great achievement of both class and derivative actions is not that they yield meaningful compensation, but that by aggregating such individual losses, they produce a great enough sanction to create real deterrence."). The first issue to be addressed is whether the claim is direct or derivative, a determination governed by the law of the state of incorporation under the internal affairs doctrine. *See* Fogel v. Zell, 221 F.3d 955, 966 (7th Cir. 2000) (stating that "under standard choice of law rules . . . the law of the state of incorporation determines who can bring a derivative suit"); Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A., 34 A.3d 1074, 1081–82 (Del. 2011) (explaining that derivative standing requirements governed by the state of incorporation under the internal affairs doctrine); *see also* Smith v. Waste Mgmt., Inc., 407 F.3d 381, 384 n.1 (5th Cir. 2005) (stating that under the applicable state law "the determination of whether a plaintiff's claims are direct or derivative depends upon the law of the company's state of incorporation"); Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379, 382 (7th Cir. 1990) ("The choice between derivative and direct litigation is a choice about how (and by whom) the internal affairs of the firm are managed."); Kessler v. Sinclair, 641 N.E.2d 135, 137 (Mass. App. Ct. 1994) ("The issue is one of corporate governance in the sense of locating who is to exercise control of the alleged corporate claim. In these circumstances, the law of Massachusetts and general law as well direct us to apply the law of the State of incorporation."); Fleeger v. Clarkson Co., 86 F.R.D. 388, 395 (N.D. Tex. 1980) (stating that "in a shareholder derivative suit the court must apply the law of the place of incorporation"). Characterization of a claim as derivative, rather than direct, has important consequences. For example, mischaracterization can result in dismissal. *See* Tooley v.

Second, in order to balance the statutory management authority of the board with the necessity for accountability implicit in the derivative suit, subsection (b)(3) of Rule 23.1 requires that a shareholder that seek to obtain resolution of the claim from the company's board of directors.[81] This demand requirement serves two correlated functions, namely to bring the claim to the attention of the members of the board when they may not otherwise be aware of it and also to allow the board to consider and explore means of resolving the claim short of actual litigation. This provides the board of directors with an opportunity to address and potentially remedy the alleged wrongs. The demand requirement also serves the goal of exhaustion of non-litigation remedies by initiating an alternative dispute resolution mechanism to encourage intracorporate handling of derivative claims.[82]

Third, Rule 23.1 explicitly confirms an important third policy component: court supervision. Any resolution of a claim, at least one that ultimately ended up in court, would be subject to judicial oversight.[83] This requirement that the court oversee and approve any settlement, compromise or voluntary dismissal recognizes not only the inherent tensions in the prosecution of a derivative suit between the corporation and its board on the one hand and the shareholder plaintiff on the other, but also that the derivative suit is a representative action where the plaintiff shareholder is acting on behalf of the corporation and all other shareholders. Court oversight mitigates against, among other things, potentially

---

Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1039 (Del. 2004) (holding that the lower court's dismissal was erroneous because the claim was wrongly characterized as a derivative claim).

[81] FED. R. CIV. P. 23.1(b)(3).

[82] *See* Mark D. Seidelson, *Variations on the Theme of Shareholder Derivative Actions: Changing the Tune of Rule 23.1 and the Beat of the Delaware Two-Step*, 57 GEO. WASH. L. REV. 363, 365 (1988) (discussing the purposes of the exhaustion requirement).

[83] FED. R. CIV. P. 23.1(c).

collusive settlements between the company and the named plaintiff.[84]

Concurrent with the evolution of the derivative suit in federal courts, the state courts were traveling a path of their own.[85] As with all matters left to the common law of fifty states, this development was neither always clear nor necessarily consistent.[86] Still, by the time of the middle of the twentieth century, both federal and state courts generally were in accord with the fundamental policies of corporate accountability, deference to alternative dispute resolution and court supervision reflected in Federal Rule 23.1.

## III. THE DIFFICULT ROAD TO DERIVATIVE RECOVERY

Recognition of the derivative suit provided shareholders with a potentially potent weapon to police and remedy corporate malfeasance and self-dealing. Quite simply, it put shareholders in the driver's seat as "the chief regulator of corporate management."[87]

Beyond its recognition as a valid cause of action, no factor favored the development of the derivative suit more than the recognition that successful plaintiffs could recover their attorney's

---

[84] Court supervision also allows the court to determine if the named plaintiff has acted to vigorously represent the interests of the shareholder class in pursuit of the derivative claims.

[85] *See generally* Prunty, *supra* note 50 (discussing the evolution of derivative suits in Federal and State courts); Scarlett, *supra* note 52 (looking at the historical development and normative underpinnings of derivative suits).

[86] John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1411 (1993) ("[T]he law of individual states varies considerably.").

[87] Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949) ("This remedy, born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses."). The derivative suit is not limited to corporations or publicly-held entities. *See* Tzolis v. Wolff, 884 N.E.2d 1005, 1010 (N.Y. 2008) (permitting members of a limited liability company to bring derivative suit on the LLC's behalf).

fees.[88] While any recovery against the defendants in a derivative suit goes to the corporation, the shareholder plaintiff's attorney's fees are recoverable since the plaintiff is obtaining relief in a representative capacity for all shareholders.[89] Under the common fund doctrine, "a litigant or a lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole."[90]

---

[88] *See, e.g.*, Chrysler Corp. v. Dann, 223 A.2d 384, 386 (Del. 1966) ("[W]hen the litigation results in benefit to all members of a class, the successful litigant is entitled to an allowance for counsel fees . . . ." (citing Maurer v. Int'l R-Ins. Corp., 95 A.2d 829 (Del. Ch. 1953))). This result is in derogation of the general common law rule that courts will *not* award attorney's fees to either party, regardless of the outcome. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 245 (1975).

[89] *See, e.g.*, Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1252–53 (Del. 2012) ("Under the common fund doctrine, 'a litigant or a lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole.' The common fund doctrine is a well-established basis for awarding attorneys' fees in the Court of Chancery. It is founded on the equitable principle that those who have profited from litigation should share its costs." (footnotes omitted)); *In re* Cendant Corp., 232 F. Supp. 2d 327, 337 n.1 (D.N.J. 2002) ("Common-fund cases allow a person who maintains a lawsuit that results in the creation, preservation, or increase of a fund in which others have a common interest to be reimbursed from that fund for litigation expenses incurred . . . . It is true that, strictly speaking, a shareholder derivative action is not a typical 'common fund' case, because the award is collected by the derivative plaintiff on behalf of the corporation, the true party in interest . . . . However, [it has been] recognized that plaintiffs in a derivative action may recover attorneys' fees from the award obtained through prosecuting the case as in a more traditional common-fund suit, i.e. a class action." (internal quotation marks omitted) (citations omitted)); Ferko v. Nat'l Ass'n for Stock Car Auto Racing, Inc., 219 F.R.D. 403, 406 (E.D. Tex. 2003) (explaining that the plaintiff and the corporation in a derivative lawsuit had similar interests because, if the plaintiff won, the plaintiff would receive attorneys' fees and the corporation would receive damages); DRW Builders, Inc. v. Richardson, 679 N.E.2d 902, 908–09 (Ind. Ct. App. 1997) (noting that "all relief obtained in a derivative action belongs to the corporation" and that "a shareholder has the right to recover attorneys' fees and expenses of litigation in a shareholder derivative action").

[90] Boeing Co. v. Van Gemert, 444 U.S. 472, 478 (1980) (citations omitted). A derivative suit need not result in a monetary recovery for attorney's fees to be awarded as long as a "valuable benefit" is received by the corporation. Dover Historical Soc'y, Inc. v. City of Dover Planning Comm'n, 902 A.2d 1084, 1090 (Del. 2006). Where there is no fund from which to pay the fees, the court will assess them against the corporation. *See* Chi. Milwaukee Corp. v. Eisenberg, No. 469,1988, 1989 WL 27743, at *1 (Del. Feb. 23, 1989) ("[W]here shareholder litigation confers a substantial benefit upon a corporation and no fund is available to pay for the fees and expenses of plaintiffs' counsel, it is appropriate for the corporation to absorb the costs of plaintiffs' attorneys fees and expenses.").

There has always been a tension surrounding derivative litigation based in significant part on this fact alone. As stated by the United States Supreme Court:

> Unfortunately, the remedy itself provided opportunity for abuse which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as "strike suits." And it was said that these suits were more commonly brought by small and irresponsible than by large stockholders, because the former put less to risk and a small interest was more often within the capacity and readiness of management to compromise than a large one.[91]

These concerns led courts and legislatures to develop a panoply of devices supposedly designed to avoid the dreaded strike suit, with the result that the current path to resolution of derivative claims is not a straight line.[92] Rather, a series of sidebar skirmishes now condemns the derivative claim to a circuitous route of substantive non-resolution. Among the obstacles are: (1)

---

[91] *Cohen*, 337 U.S. at 548. *See also* Paul N. Edwards, *Compelled Termination and Corporate Governance: The Big Picture*, 10 J. CORP. L. 373, 391 (1985) (suggesting that the derivative suit became important because shareholders needed to know that there would be "accountability[,] as management became increasingly divorced from ownership, and its history is the history of the tension between that accountability and strike suit potential").

[92] Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1351 (1993) ("The standards for determining futility vary widely from jurisdiction to jurisdiction; in fact, futility issues have clogged the courts for decades." (internal citation omitted)). Some of this diversity is also due to lags in specific jurisdictions adopting reforms or the adoption by certain jurisdictions of specific procedural impediments.

determining if the claim is direct or derivative;[93] (2) being a "record owner" of shares of the company;[94] (3) having been an owner of the shares at the time of the wrongdoing;[95] (4) maintaining share ownership throughout the litigation;[96] (5) being

---

[93] Generally, the line of demarcation between direct and derivative suits can be discerned. The following are typical examples of situations in which courts have found a direct cause of action: the deprivation of shareholders' voting rights, denial of rights to inspect the corporation's books and records, suits to compel the declaration of dividends, or claims that officers or directors induced a shareholder to sell his stock. Derivative litigation is when shareholders sue on behalf of the corporation in order to redress an injury sustained by a corporation or enforce a duty owed to a corporation. Typical examples of scenarios in which courts have found a derivative cause of action include: breach of directors' fiduciary duties of care and loyalty including grossly negligent mismanagement, waste of corporate assets, excessive compensation, usurpation of corporate opportunity, and general self-dealing. That does not mean that there is consistency within a state or between states. Indeed, at least three main tests have been employed: the special injury test, the direct injury test, and the duty owed test. *See* Elizabeth J. Thompson, *Direct Harm, Special Injury, or Duty Owed: Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigation?*, 35 J. CORP. L. 215, 217–20 (2009).

[94] This is certainly an anachronistic requirement, however, in an age in which the "vast majority of shares in publicly traded corporations are held in nominee, or 'street' (Wall Street) name, rather than the shareholders' names, or 'record ownership.'" ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW § 14.03, at 495 (4th ed. 2013). Yet a number of states maintain this requirement which can only serve to disenfranchise real shareholders from bringing derivative actions. Both the Revised Model Business Corporation Act and the ALI Principles of Corporate Governance jettison this requirement, with the former providing that, for purposes of pursuing a derivative action, a " 'Shareholder' includes a beneficial owner whose shares are held in a voting trust or held by a nominee on the beneficial owner's behalf." MODEL BUS. CORP. ACT ANN. § 7.40(2) (2002). *Accord* 2 ALI PRINCIPLES, *supra* note 5, §§ 1.22, 7.02. Some states that have not adopted the Model Act, such as New York and California, have adopted this approach by statute. *See* CAL. CORP. CODE § 800(b)(1); N.Y.B.C.L. § 626(a). Still others, such as Delaware, have reached the same conclusion by judicial decision. *See, e.g.*, Gamble-Skogmo, Inc. v. Saks, 122 A.2d 120, 121 (Del. 1956).

[95] FED. R. CIV. P. 23.1(b)(1).

[96] That is, "to have standing a derivative plaintiff must satisfy two tests: 1) the contemporaneous ownership test, which requires stockholders to have owned stock at the time of the wrong complained of, and 2) the continuous ownership rule requiring stockholders to maintain their shareholder status throughout the litigation." Parfi Holding AB v. Mirror Image Internet, Inc., 954 A.2d 911, 935 (Del. Ch. 2008) (emphasis omitted) (citing Schoon v. Smith, 953 A.2d 196 (Del. 2008)). *Accord* Lewis v. Anderson, 477 A.2d 1040, 1049 (Del. 1984); BALOTTI & FINKELSTEIN, *supra* note 24, § 13.11 ("Thus, a plaintiff who is not a stockholder, or who ceases to be a stockholder during the pendency of his suit, loses standing to maintain a derivative action."). There are certainly aspects of the contemporaneous ownership requirement that deserve review and potential reform. For

an "adequate representative" as the derivative plaintiff;[97] (6) providing a bond or security for expenses incurred by the company;[98] (7) providing specific verification of the pleadings;[99] (8) swearing that the derivative plaintiff will not accept any compensation for acting as a representative;[100] (9) making a demand on the board of directors;[101] (10) ceding the suit to a SLC formed by the board;[102] and (11) being required to pay for the defendants' litigation and attorneys' fees if the suit is unsuccessful.[103]

This part surveys that path generally as an instructive process on how the potential of the derivative suit has been detoured by a series of roadblocks that prevent the suit from reaching its intended destination. Some of these impediments, such as security for expenses statutes, have fallen out of favor in most jurisdictions.[104]

---

example, then lawyer, now Chancery Judge J. Travis Laster, makes a persuasive argument that the contemporaneous ownership requirement should be jettisoned as a matter of Delaware law. *See* J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673 (2008). His argument is unpersuasive for purposes of federal diversity jurisdiction and Federal Rule 23.1. Since this Article seeks a resolution crossing federal and state lines, his argument is irrelevant for current purposes.

97 *See, e.g.*, FED. R. CIV. P. 23.1(a) ("The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.").

98 *See, e.g.*, N.Y.B.C.L. § 627 (McKinney 2003) ("Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor.").

99 *See, e.g.*, FED. R. CIV. P. 23.1(b) ("The complaint must be verified. . . .").

100 DEL. CH. CT. R. 23.1.

101 *See, e.g.*, FED. R. CIV. P. 23.1(b)(3)(A) (explaining that the complaint "shall state with particularity . . . any effort by the plaintiff to obtain the desired action from the directors").

102 *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981) (mentioning the board created Committee); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (discussing the created SLC). *See* PINTO & BRANSON, *supra* note 94, § 14.01, at 454.

103 *See, e.g.*, ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 555 (Del. 2014) (upholding fee-shifting bylaw); Kevin M. LaCroix, *Oklahoma Legislature Adopts Derivative Litigation Fee-Shifting Provision*, D&O DIARY (Sept. 25, 2014), http://www.dandodiary.com/2014/09/articles/corporate-governance/oklahoma-legislature-adopts-derivative-litigation-fee-shifting-provision/.

104 For example, the Model Business Corporation Act included a security for expenses provision in its 1949 promulgation, but that provision was eliminated in 1984. *See* MODEL BUS. CORP. ACT § 49 (1969) (repealed 1984). Today only a few jurisdictions have security for

Others, such as complaint verification, contemporaneous ownership and being an adequate representative, maintain their fundamental validity but provide no more than momentary pause in the derivative claim process.

The focus here will be on the two most fundamental of these procedures: the demand requirement and the use of the SLC. The demand requirement is the primary obstacle to derivative litigation substantive success. This is so, not because of the requirement that demand must be made, but rather that the process of navigating this requirement has been loaded by the courts against derivative plaintiffs. As a result, the demand inquiry process has developed into an unnecessary, expensive and often fatal detour for the derivative lawsuit. The use of SLCs has also become an area of unnecessary debate and division. While a positive device in concept, its applicability has been hampered by jurisdictional variations and substantive corporate law limitations.

### A. THE DEMAND REQUIREMENT DETOUR

A shareholder brings a derivative suit to remedy some perceived harm to the corporation and potentially to obtain a monetary recovery on the corporation's behalf. As previously noted, however, Federal Rule of Civil Procedure 23.1, as well as state rules governing derivative suits, requires that a demand be made on the board of directors.[105]

---

expenses statutes. *See* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS § 3:2, at 283 (2014–2015 ed.) ("Nine states have security for expense statutes that are applicable only to derivative actions.").

[105] *See* FED. R. CIV. P. 23.1(b)(3)(A); Ross v. Bernhard, 396 U.S. 531, 534 (1970) (explaining that the stockholder must demonstrate "that the corporation itself ha[s] refused to proceed after suitable demand, unless excused [under] extraordinary conditions" as a precondition and to prevent abuse, of the derivative suit); Delaware & Hudson Co. v. Albany & Susquehannna R.R. Co., 213 U.S. 435, 446 (1909) ("[The demand requirement] recognizes the right of the corporate directory to corporate control; in other words, to make the corporation paramount, even when its rights are to be protected or sought through litigation."); *see also* Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (noting that demand is principally a device "to promote intracorporate dispute resolution"). The primary source of law for this discussion will be taken from Delaware case law. There are several reasons for this choice. First, although Federal Rule of Civil Procedure 23.1 applies in certain

The demand requirement is supported by both theoretical and practical justifications. Since a derivative suit is a claim on behalf of the corporation, it is a corporate asset and should be subject to the control and management of the board of directors.[106] Thus, before asserting the claims of the corporation, the shareholder, theoretically, should give the board of directors an opportunity to do so. As a practical matter, the demand requirement allows shareholders and corporate management a chance to work out their differences internally before involving the courts.[107]

*1. The Initial Fork in the Road: To Make a Demand or Not.* The act of making a demand places the litigation in the hands of the board of directors.[108] Once demand is made, the board of

circumstances, derivative claims are fundamentally state law-based claims for breach of fiduciary duty. Second, even where Rule 23.1 applies, the Supreme Court has declared that state law governs the substance of the requirements even under that rule. *See* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 104 (1991) (holding that the demand futility exception as defined by law of state of incorporation applies to a derivative action brought under the Investment Company Act); *see also* DIV. OF CORPS., DEL. DEP'T OF STATE, ABOUT AGENCY, https://corp.delaware.gov/aboutagency.shtml (last visited Oct. 28, 2015) ("More than 50% of all publicly-traded companies in the United States . . . have chosen Delaware as their legal home."). Third, most publicly-held corporations are incorporated under Delaware law. Fourth, Delaware has the most developed case law on the subject, providing a debilitatingly nuanced analysis of the impediments facing derivative plaintiffs. Brian Buckley, *So You Think Washington Is a Delaware State? Debunking the Myth That Washington Follows Delaware on Issues of Corporate Law*, CORP. & SEC NEWSLETTER (Feinwick & West LLP) ("Delaware has developed a large body of case law interpreting and implementing [the 'demand futility' concept].").

[106] James F. Hogg & Kyle R. Triggs, *Finessing Well-Plead Derivative Lawsuits: The Implications of the Minnesota Supreme Court's Selection of* Auerbach *Over* Zapata, 36 WM. MITCHELL L. REV. 70, 80 (2009).

[107] *See* Joseph C. Barsalona II, Commentary, *Litigation Supply Should Not Exceed Shareholder ADR Demand: How Proper Use of the Demand Requirement in Derivative Suits Can Decrease Corporate Litigation*, 90 OR. L. REV. 773, 781 (2012) ("The [demand] requirement is thus designed to promote intracorporate dispute resolution and to fix the corporation as a whole." (footnote omitted)). There is no specific form a demand must take, but it must inform the board of the underlying circumstances leading to the perceived wrong and of the issue the shareholder wishes the board to remedy. *Id. See also* Stoner v. Walsh, 772 F. Supp. 790, 796 (S.D.N.Y. 1991) (reiterating that the demand does not need to "assume a particular form . . . [or] be made in any special language").

[108] Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) ("[P]re-suit demand . . . affords the corporation the opportunity to address the alleged wrong without litigation, to decide whether to invest the resources of the corporation in litigation, and to control any litigation which does occur.").

directors can decide whether litigation is or is not in the best interests of the corporation. If presented with a demand, the board may not remain neutral or courts will find a tacit approval of the derivative litigation.[109] If the board rejects a shareholder's demand, the shareholder may only proceed through proof that the rejection of demand was wrongful.[110] To demonstrate wrongful rejection, the shareholder must overcome the strong presumption of the business judgment rule, which insulates board decisions.[111] Unless a court finds that the directors acted in bad faith, or with lack of due care or inadequate information, the board's rejection of demand will be upheld.[112]

In most derivative cases, the shareholder is seeking to hold some or all of the current board members liable for breach of their fiduciary duties. Since it is these very same people upon whom the shareholder is supposed to make a demand, shareholders understandably can be reluctant to ask the directors to sue themselves.[113] Once demand is made, the shareholder not only

---

[109] *See* Grimes v. Donald, 673 A.2d 1207, 1218–19 (Del. 1996) (stating that in no event may a corporate board assume a position of actuality, and if there is a reason to doubt that the board acted with due care in responding to the demand then the shareholder has the right to bring an underlying action). Occasionally, the board will accept the demand, which places the board in control of the litigation. Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 533 (1984) ("[I]f, in the view of the directors, litigation is appropriate, acceptance of the demand places the resources of the corporation, including its information, personnel, funds, and counsel, behind the suit.").

[110] *Grimes*, 673 A.2d at 1219.

[111] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[The business judgment rule gives rise to] a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption." (internal citations omitted)), *overruled on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[112] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981) ("A board's decision to cause a derivative suit to be dismissed . . . after demand has been made and refused, will be respected until it was wrongful.").

[113] *See* Barsalona, *supra* note 107, at 782 ("Most plaintiffs, however, do not trust the board to remedy their demands."); Jamie L. Kastler, Note, *The Problem with Waste: Delaware's Lenient Treatment of Waste Claims at the Demand Stage of Derivative Litigation*, 95 MINN. L. REV. 1899, 1909 (2011) ("[The demand requirement] is problematic, in that the board is not likely to sue its own members.").

loses control of the case but, if the board rejects the demand, as is the most likely scenario, the shareholder is left with challenging the board's action as wrongful, which is a nearly impossible burden.[114]

Fundamentally, then, if the shareholder makes a demand on the board of directors, the shareholder concedes that the board is capable of determining whether to pursue the derivative claim.[115] Practically, this is an acknowledgment that the demand is not futile. This concession acts as a waiver of the shareholder's ability to challenge the board's independence.[116] Therefore, making a demand, although required by the applicable procedural rule, is rarely the course taken by derivative plaintiffs.[117] To avoid the demand requirement, a shareholder will seek to have demand excused based on futility.

*2. The Demand Futility Pothole.* When the derivative shareholder sues without making a demand, as is the presumptive route, the company will seek to have the complaint dismissed for failure to make a demand.[118] The shareholder then must prove that demand would have been futile. That is, if demand futility

---

[114] Courts use the business judgment rule to evaluate the board's refusal. *Zapata*, 430 A.2d at 784 n.10 ("[W]hen stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met."). Without wrongful refusal, a stockholder lacks standing to maintain a suit on behalf of the corporation. *Id.* at 784.

[115] Spiegel v. Buntrock, 571 A.2d 767, 775 (Del. 1990); *see also* Kamen v. Kemper Fin. Servs. Inc., 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991) ("Except in extraordinary cases . . . tendering a demand to the board puts the plaintiff out of court under Delaware law."); *Grimes*, 673 A.2d at 1220 (holding any other standard would create a risk of harassment).

[116] *Spiegel*, 571 A.2d at 774–75; Coffee, *supra* note 86, at 1413 ("Doctrinally, the real bite in the Delaware formula is its waiver rule, which faces the plaintiff with a 'Catch 22'-like dilemma: If the plaintiff does not make demand on the board, the plaintiff must overcome the *Aronson* test; but if the plaintiff does make demand, the plaintiff thereby concedes the disinterestedness of the board.").

[117] Coffee, *supra* note 86, at 1414 ("Plaintiffs today seldom make demand in Delaware, but instead litigate the issue of whether demand was excused.").

[118] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984) ("Defendants moved to dismiss for plaintiff's failure to make demand on the [corporation's] board prior to suit . . . ."), *overruled on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

can be proven, then the demand requirement will be excused and the shareholder can proceed with the derivative lawsuit.[119]

In Delaware, the test for demand utility comes from *Aronson v. Lewis*.[120] The *Aronson* test requires that a shareholder prove "whether, under the particularized facts alleged, 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."[121]

With respect to the first prong of the *Aronson* test, board disinterestedness and independence, logic would dictate that demand futility should easily be demonstrated in most derivative suits. Because the shareholder is typically seeking to hold all or at least a majority of the current board of directors liable for some breach of fiduciary duty, the directors upon whom demand would be made are defendants in the lawsuit and face potential personal liability.[122] Therefore, making a demand on those very directors

[119] If a plaintiff-shareholder brings a derivative action without making demand and demand is not excused, the suit will be dismissed for failure to make demand. *See* Kastler, *supra* note 113, at 1909–10 (noting that if a shareholder-plaintiff's claim is brought without making demand, the claim can only avoid dismissal by meeting the *Aronson* test, thus excusing the requirement of demand). Demand futility must be pled with particularity. *See, e.g.*, DEL. CH. CT. R. 23.1 (requiring demand futility to be particularly pled); FED. R. CIV. P. 23.1 (imposing the particularity requirement as well); Shields v. Singleton, 19 Cal. Rptr. 2d 459, 465 (Cal. App. Dep't Super. Ct. 1993) ("[B]road, conclusory allegations against all directors of a corporation are insufficient to establish demand futility.").

[120] 473 A.2d at 814. In *Aronson*, a shareholder asserted a derivative claim based on the compensation and certain loans given to a director who also owned 47% of the stock of the corporation, and asserted demand futility because all of the current directors were named defendants in the suit, they all approved of the challenged transaction and the corporation was effectively controlled by the subject director. *Id.* at 808–09. The Delaware Supreme Court held that the shareholder failed to prove that demand was futile. *Id.* at 817–18.

[121] *Id.* at 814. The two prongs of the *Aronson* test are disjunctive. *See* Levine v. Smith, 591 A.2d 194, 205 (Del. 1991) (recognizing that the two questions are distinctive).

[122] However, many states either allow or require indemnification of directors and officers of the corporation for breaches of the duty of care, effectively limiting any personal liability for such breaches. *See, e.g.*, MINN. STAT. § 302A.521 (2010) (imposing a duty on corporations to indemnify directors and officers of a corporation in certain circumstances). Some state statutes allow corporations to exculpate (or eliminate) director liability for breaches of the duty of care. *See, e.g.*, MINN. STAT. § 302A.251 subdiv. 4 (2010) (allowing a corporation to elect, in its Articles of Incorporation, to eliminate or limit a director's personal liability for a breach of a fiduciary duty, with certain exceptions, such as a breach of a duty of loyalty); DEL.

would appear to be facially futile. After all, the directors are not going to sue themselves.

Well, common sense does not always equate to common law. Consider the facts of *Aronson v. Lewis* itself. The suit challenged certain self-dealing transactions between Meyers Parking System, Inc. and one of its directors, Leo Fink, who owned 47% of the company's outstanding stock.[123] Plaintiff-shareholder alleged that demand would be futile for three separate reasons:

> (a) All of the directors in office are named as defendants herein and they have participated in, expressly approved and/or acquiesced in, and are personally liable for, the wrongs complained of herein.
> (b) Defendant Fink, having selected each director, controls and dominates every member of the Board and every officer of Meyers.
> (c) Institution of this action by present directors would require the defendant-directors to sue themselves, thereby placing the conduct of this action in hostile hands and preventing its effective prosecution.[124]

The Delaware Supreme Court rejected all three claims and denied that demand would be futile under these circumstances.[125] The Court held that the complaint must be dismissed for failure to make a demand on the board of directors.[126]

As to the second allegation, that court rejected the claim that selection and election of the defendant board members by Fink was sufficient to taint independence.[127] Rather, the plaintiff must

CODE ANN. tit. 8, § 102(b)(7) (Supp. 2010) (permitting a corporation to include, in its certificate of incorporation, a clause which exculpates or limits director personal liability for breaches of the duty of care).

[123] *Aronson*, 473 A.2d at 808.

[124] *Id.* at 809.

[125] *Id.* at 819.

[126] *Id.*

[127] *Id.* at 815.

allege particularized facts showing that defendant Fink controlled these other directors:

> Thus, it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. . . . We conclude that in the demand-futile context a plaintiff charging domination and control of one or more directors 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.'[128]

More fundamentally, the court also rejected the first and third allegations, that the very directors upon whom demand would be made approved the challenged transactions and that acceptance of the demand would require the directors to sue themselves.[129] As posited by the plaintiff, "the directors' interest in avoiding personal liability automatically and absolutely disqualifies them from passing on a shareholder's demand."[130] Rather than focus on this fundamental fact, the court challenged the plaintiff's allegations about the validity of the underlying transaction: "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."[131]

---

[128] *Id.* at 816.

[129] *Id.* at 817.

[130] *Id.*

[131] *Id.*; *see also* Dennis J. Block & H. Adams Prussin, *Termination of Derivative Suits Against Directors on Business Judgment Grounds: From* Zapata *to* Aronson, 39 BUS. LAW. 1503, 1506 (1984) ("Self-interest, for these purposes, is defined in terms of direct financial interest in the challenged transaction; the fact that a majority of directors voted to approve the transaction—and are therefore named as defendants in the action—does *not* constitute the requisite self-interest and will not excuse demand.").

Therefore, even when all directors of a corporation are sued for breach of fiduciary duty for allegedly having approved a self-interested transaction involving another director, the directors who were not directly involved in the transaction are presumed to be independent and demand is not excused, even if the involved director selected them for their current positions. "[T]he mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors . . . ."[132] As clarified in subsequent cases, a director is only interested under the first *Aronson* prong if the transaction is self-dealing (the director is on both sides of the transaction), if the director will receive a personal financial benefit which is not received by the shareholders of the corporation in general or if the director was dominated by a shareholder or director who is a defendant.[133]

The second prong of the *Aronson* test requires that the shareholder's complaint "support[s] a reasonable doubt of business judgment protection, not whether the [complaint] support[s] a judicial finding that the directors' actions are not protected by the business judgment rule."[134] Therefore, a shareholder

---

[132] *Aronson*, 473 A.2d at 815.

[133] *See* Del. Cnty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1023 (Del. 2015) ("But rather certainly, there arises a pleading stage inference that Jackson's economic positions derive in large measure from his 50–year close friendship with Chairman Sanchez, and that he is in these positions because Sanchez trusts, cares for, and respects him."); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. In order to show lack of independence, the complaint of a stockholder-plaintiff must create a reasonable doubt that a director is not so 'beholden' to an interested director (in this case Stewart) that his or her 'discretion would be sterilized.'" (internal citations omitted)); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) ("Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.").

[134] Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988). In certain circumstances, Delaware courts have found the second prong of the *Aronson* test to be inapplicable. If the board of directors takes no action, then no business judgment has been made. Rales v. Blasband, 634 A.2d 927, 933–34 (Del. 1993) ("Where there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application."). Similarly, if a

presumptively must demonstrate that the challenged transaction would not be shielded by the business judgment rule.[135] This prong of the *Aronson* test was further defined in *In re Walt Disney Co. Derivative Litigation*.[136] In order to raise a reasonable doubt that the application of the business judgment rule applies, the shareholder must "raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision."[137]

New York law on demand futility is similar to Delaware law. Under *Marx v. Akers*,[138] which established the New York test for demand futility: a shareholder must show with particularity that either a majority of directors was interested in the transaction, the board of directors was not adequately and reasonably informed, or that the transaction had no rational basis such that it could be supported by sound business judgment.[139] These three elements essentially reflect the inquiries under Delaware's *Aronson* test. The major difference between Delaware and New York is the

---

majority of the board of directors has been replaced or there has been a merger or sale of the corporation (creating a situation where the board now controlling the corporation was not the board that made the challenged decision), the second prong of the *Aronson* test will not apply. *Id.* (recognizing that the *Aronson* test should not apply "where a business decision has was made by the board of directors of a company, but a majority of the directors making the decision have been replaced"). In these situations, Delaware courts will determine solely if the current board of directors could have exercised "independent and disinterested business judgment in responding to a demand." *Id.* at 934.

[135] Levine v. Smith, 591 A.2d 194, 205 (Del. 1991).

[136] 825 A.2d 275 (Del. Ch. 2003).

[137] *Id.* at 286. It is important to note that the *Disney Litigation* test is disjunctive as well. Therefore, the second prong of the *Aronson* test can be satisfied by a showing that the directors did not act in good faith or that the directors failed to engage in an adequate decisionmaking process. *Id.* When a breach of the business judgment rule is based on the alleged failure of the board of directors to oversee or monitor the corporation, the failure must be sustained and systemic to rise to the level that a court will find a lack of good faith. *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996) ("[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exi[s]ts—will establish the lack of good faith that is a necessary condition to liability.").

[138] 666 N.E.2d 1034 (N.Y. 1996). In this case, a shareholder sued IBM based on excessive board and executive compensation. The claim was dismissed because the shareholder was not excused from making demand. *Id.* at 1036.

[139] *Id.* at 1039.

degree of certainty needed. Although both states require that demand futility must be pled with particularity, New York has rejected the "reasonable doubt" standard applied by Delaware courts[140] and requires a shareholder to show with greater certainty that the board lacked independence or care or failed to exercise sound business judgment.[141]

It is clear that the derivative plaintiff faces substantial difficulty in satisfying this aspect of the judicial demand-futility standard. First, the standard appears inherently subjective and malleable: "The ambiguities . . . have been noted and criticized by others, but the relevant point here is that this standard is susceptible to highly variant interpretation and application."[142] Second, the futility standard effectively forces a shareholder to prove its case on the merits at the pleading stage. That is, the judicially-created futility requirement appears to involve, in significant part, proof of the ultimate question of liability:

> Delaware practice require[s] the court to determine at the pleading stage whether demand was necessary. This requires courts to adjudicate the merits on the pleadings, for a decision that the business judgment rule shelters the challenged conduct *is* 'the merits' in derivative litigation, and under *Aronson* also shows

[140] *Id.* at 1040.

[141] *Id.* at 1038 ("The reasonable doubt threshold of Delaware's two-fold approach to demand futility has been criticized. The use of a standard of proof which is the heart of a jury's determination in a criminal case has raised questions concerning its applicability in the corporate context. The reasonable doubt standard has also been criticized as overly subjective, thereby permitting a wide variance in the application of Delaware law to similar facts." (citations omitted)).

[142] Coffee, *supra* note 86, at 1412–13 ("Thus, even if the judges of the Delaware Court of Chancery understand *Aronson* and interpret it consistently, federal district courts applying Delaware law in diversity cases demonstrably do not—as recent cases have indicated. In particular, the meaning of the term *reasonable doubt* and the quantum of particularization necessary to rebut the presumption in favor of the board are undefined and invite inherently subjective responses from other courts.").

> that demand was necessary. It is a bobtailed adjudication, without evidence.[143]

Finally, the derivative plaintiff is intentionally handicapped in its effort to make the requisite showing. Discovery is not available when the complaint is filed.[144] Stockholder-plaintiffs must rely on "tools at hand," including SEC filings, media reports, and possible books and records request results.[145] This places an "almost impossible burden" on the shareholder because relevant, sufficiently particularized facts are not public knowledge.[146] Therefore, although derivative plaintiffs will regularly fail to make a demand and seek to allege demand futility, it is "clear that demand will almost always be required."[147]

### B. THE SPECIAL LITIGATION COMMITTEE VEHICLE

If a shareholder is able to demonstrate that demand would be futile, the shareholder is free to initiate and pursue a derivative suit on behalf of the corporation.[148] "[W]here demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf."[149] In this context, however, the device of the SLC provides a further fundamental roadblock to the shareholder's ability to pursue the derivative litigation. A SLC is an ad hoc committee of directors appointed by a board of directors of a company to determine whether to pursue litigation in the

---

[143] Starrels v. First Nat'l Bank, 870 F.2d 1168, 1175–76 (7th Cir. 1989) (Easterbrook, J., concurring).

[144] Scattered Corp. v. Chi. Stock Exch., Inc., 701 A.2d 70, 79 (Del. 1997); Levine v. Smith, 591 A.2d 194, 208–09 (Del. 1991).

[145] DEL. CODE ANN. tit. 8, § 220 (2010); Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996); Rales v. Baslband, 634 A.2d 927, 934–35 n.10 (Del. 1993).

[146] Brehm v. Eisner, 746 A.2d 244, 268 (Del. 2000) (Hartnett, J., concurring).

[147] Block & Prussin, *supra* note 131, at 1505.

[148] "Ordinarily, it is only when demand is excused that the shareholder enjoys the right to initiate 'suit on behalf of his corporation in disregard of the directors' wishes.'" Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 96 (1991) (quoting R. CLARK, CORPORATE LAW § 15.2, at 640 (1986)).

[149] Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).

name of the company.[150] As it has developed, the SLC serves as a vehicle by which almost any derivative claim can be wrestled from the hands of the shareholder derivative plaintiff.[151]

*1. Development of the SLC Model.* Since the beginning of the corporate governance movement in the mid-1970s, enhancing the independence of corporate boards has been at the centerpiece of corporate governance reform.[152] To a large extent, the reform was in response to the rise in executive compensation, the takeover movement, the market for corporate control and insider trading.[153] As a result of the interest and concern about corporate governance at that time, the use of committees consisting of independent directors expanded substantially. At the instigation of the Securities and Exchange Commission, stock exchanges today require their members to have a majority of independent directors on the board as well as nominating, compensation and audit committees composed solely of independent directors.[154]

In addition to these standing committees, other ad hoc committees have also been used. For example, in conflict of interest situations, Delaware General Corporation Law provides that transactions involving an interested director are not voidable solely for that reason if the transactions were approved by a

---

[150] *See* Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1310 (2009) ("A special litigation committee (SLC) is a subcommittee of a corporation's board of directors that has the power to intercede in shareholder derivative claims brought against other members of the board.").

[151] *See, e.g.*, Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 409 (2005) ("[W]hether demand is made or excused, the board of directors, as an entire body or through a committee, generally determines that suits against directors should not proceed."); Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 179 (1994) ("After an exhaustive study, the committee will likely recommend the suit's dismissal.").

[152] *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 86–94 (2005) (discussing SEC efforts to regulate corporate governance).

[153] *See* Charles W. Murdock, *Corporate Governance – The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 81–82 (1993) (discussing the development of the Special Committee's Structure).

[154] *Id.* at 86–87. *See also* Order, *supra* note 40, at 64,157 (discussing the independence of directors).

committee comprised of disinterested directors.[155] Building upon the general statutory authorization for committees, another ad hoc committee—the SLC—developed in the 1970s and became widely used in the 1980s.[156]

The origin of SLCs appears to have been in the ancillary relief that the Securities and Exchange Commission (SEC) sought in its enforcement litigation in *SEC v. Mattel, Inc.*[157] There, the SEC alleged that the financial statements submitted by Mattel in certain filings and statements made by Mattel in various press releases overstated its profits and understated its costs.[158] Upon the SEC's request, the court ordered Mattel to establish and maintain a Litigation and Claims Committee of its Board of Directors.[159] The committee consisted of three members and had the duty and responsibilities to (1) review litigation and claims against officers, directors, employees or controlling persons; (2) review other matters involving conflict of interest questions regarding officers, directors, employees and controlling persons; and (3) approve any settlement or disposition of any claims or actions against officers, directors, employees or controlling persons.[160]

The real growth of SLCs came out of the "improper foreign payments" cases in the 1970s.[161] Litigation in these cases usually started when a shareholder filed a derivative suit against the

---

[155] DEL. CODE ANN. tit. 8, § 144 (2011).

[156] *See* Murdock, *supra* note 153, at 88 (discussing the evolution of the SLC).

[157] SEC v. Mattel, Inc., 1974 U.S. Dist. LEXIS 6489, at *2 (D.D.C. 1974).

[158] *See id.* at *1 (discussing that preliminary information given to the SEC by Mattel indicated that Mattel's financial statements substantially overstated its sales, net income, and accounts receivable).

[159] *Id.* at *17. The SEC demanded that Mattel "add a sufficient number of new independent directors to constitute a majority of its board, create three new independent board committees, and appoint a special counsel to file an investigatory report with both the SEC and the court." Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 394 (2008).

[160] *Mattel*, 1974 U.S. Dist. LEXIS 6489, at *17.

[161] *See, e.g.*, Gall v. Exxon Corp., 418 F. Supp. 508, 510 (S.D.N.Y. 1976) (noting that Exxon's creation of the Special Committee on Litigation came in response to Exxon's alleged financial contributions to Italian political campaigns); SEC v. American Ship Bldg. Co., 1974 WL 390409 (C.C.H.) (D.D.C. Apr. 15, 1974) (discussing the SEC's decision to charge the defendant with making improper payment towards political campaigns).

directors who had authorized the questionable payments to foreign officials, seeking on behalf of the corporation to recover the amount of the payments from the challenged directors.[162] The corporation would respond by appointing a committee of supposedly disinterested directors who would investigate the merits of the litigation, and almost invariably, recommend dismissal of the suits.[163]

For example, in *Gall v. Exxon Corp.*, the plaintiff sued derivatively on behalf of Exxon to recover from certain directors alleged payment of $59 million in corporate funds as bribes improperly contributed to Italian political parties and others.[164] The facts were "clear that several of the Exxon directors named as defendants in this suit were aware of the existence of the political payments."[165]

In response, Exxon's board unanimously resolved to establish a Special Committee on Litigation pursuant to its bylaws.[166] The committee was composed of directors who had joined the board after the alleged wrongful payments.[167] After investigation, the Special Committee issued a report summarizing the Committee's findings and recommendations and determined that it would be contrary to the interests of Exxon and its shareholders to institute or maintain a legal action against any present or former Exxon director or officer.[168] The court held that since the interests of the corporation were at stake, it was the responsibility of the directors to determine, in the first instance, whether an action should be brought on the corporation's behalf.[169] It followed that the decision

---

[162] *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994, 997 (N.Y. 1979) (discussing the shareholders derivative action filed against defendant corporation's directors for allegedly authorizing improper payments to foreign entities).

[163] *See* Myers, *supra* note 150, at 1310 (discussing the role of special litigation committees in investigating the merits of shareholder derivative claims and these committees' of such claims in an "overwhelming number of cases").

[164] *Gall*, 418 F. Supp. at 509.

[165] *Id.* at 512.

[166] *Id.* at 510.

[167] *Id.*

[168] *Id.* at 511, 514.

[169] *Id.* at 515–16.

of corporate directors of whether or not to assert a cause of action held by the corporation rested within the sound business judgment of the SLC pursuant to the business judgment rule.[170]

For those concerned with derivative strike suits, the magic of the SLC is twofold. First, it takes the case away from the derivative plaintiff and places it in the hands of members of the board of directors.[171] As a result, even though demand may be excused as being futile, the very directors who are defendants in the derivative lawsuit can set up a committee of other directors who decide whether the litigation should be pursued.[172] As declared by the Delaware Supreme Court:

> Rule 23.1, by excusing demand in certain instances, does not strip the board of its corporate power. It merely saves the plaintiff the expense and delay of making a futile demand resulting in a probable tainted exercise of that authority in a refusal by the board or in giving control of litigation to the opposing side. But the board entity remains empowered under §141(a) to make decisions regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.

---

[170] *Id.* at 517–18. The SLC process was given a big boost when it was upheld in *Burks v. Lasker*, 441 U.S. 471 (1979). In that case, the Supreme Court agreed that if a disinterested group of corporate directors decided to terminate pending derivative litigation, then it would be given business judgment rule deference. *See id.* at 474–75 (reversing the Second Circuit's reversal of the District Court's holding that the business judgment rule gave disinterested and independent directors authority to terminate a derivative suit). The Court concluded that the law of the state controlled the issues of use of a SLC even in a federal question suit governed by Federal Rule of Civil Procedure 23.1. *See id.* at 486 n.10 (holding FED. R. CIV. P. 23.1 does not apply where plaintiff's action is involuntary dismissed).

[171] *See Gall*, 418 F. Supp. at 486 n.1 ("To the extent provided by such resolution each such committee shall have and may exercise all the authority of the board.").

[172] Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981) ("Even when demand is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests. . . . Even though demand was not made in this case and the initial decision of whether to litigate was not placed before the board, Zapata's board, it seems to us, retained all of its corporate power concerning litigation decisions.").

> The corporate power inquiry then focuses on whether the board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors. We find our statute clearly requires an affirmative answer to this question.[173]

Second, the SLC process decisively changes the derivative litigation calculus. When a shareholder brings a derivative suit, the shareholder is alleging that some fundamental harm has taken place as a result of a breach of fiduciary duties.[174] In that underlying lawsuit, the corporation, acting through the shareholder, might have a valid claim. The SLC's role is different. The SLC does not solely explore the validity of the underlying claims, but rather, "if a 'committee, composed of independent and disinterested directors, conducted a proper review of the matters before it, considered a variety of factors and reached, in good faith, a business judgment that [the] action was not in the best interest of [the corporation]', the action must be dismissed."[175] That is, the issue morphs from whether there is a valid claim to whether a lawsuit is a desirable action for the corporation to pursue. Many of us have at one time or another thought that we might have a valid legal claim but decided not to pursue that claim based on the time, expense, disruption and other factors that might be involved in pursuing the claim through litigation. The SLC makes a similar multi-faceted determination.

In making the determination of what is in the best interests of the company, the SLC reviews a variety of considerations, including the validity of the underlying claim, the cost of the litigation, effect on other litigation, the company's reputation, relationships with customers, suppliers and employees, as well as

---

[173] *Id.* at 786.

[174] *See, e.g.*, *id.* at 780 (noting that a stockholder instituted a derivative action alleging a breach of fiduciary duty by Zapata officers and directors).

[175] *Id.* at 787 (citing Maldonado v. Flynn, 485 F. Supp. 274, 282, 286 (S.D.N.Y. 1980), *aff'd in part, rev'd in part*, 671 F.2d 729 (2d Cir. 1982)).

ethical, commercial, fiscal and promotional factors.[176] The strength of the original claim is often lost in the translation. Even a clear claim of illegality and breach of fiduciary duty may not be pursued. As the court in *Gall v. Exxon Corp.* put it bluntly:

> Thus, even assuming that the political payments in Italy were illegal where made, the business judgment rule is nonetheless applicable. The decision not to bring suit with regard to past conduct which may have been illegal is not itself a violation of law and does not result in the continuation of the alleged violation of law. Rather, it is a decision by the directors of the corporation that pursuit of a cause of action based on acts already consummated is not in the best interest of the corporation. Such a determination, like any other business decision, must be made by the corporate directors in the exercise of their sound business judgment. The conclusive effect of such a judgment cannot be affected by the allegedly illegal nature of the initial action which purportedly gives rise to the cause of action.[177]

---

[176] La. Mun. Police Emps. Ret. Sys. v. Pyott, 46 A.3d 313, 339 (Del. Ch. 2012), *rev'd on other grounds*, 74 A.3d 612 (Del. 2013) (noting that "[t]he magnitude and merits of the claims; [t]he size and likelihood of a recovery of damages or other relief; [t]he possible detriment to the company from the assertion of any claims, as well as the indirect costs, such as the effect upon other potential litigation to which the company is a party, and relationships with customers or suppliers; and [t]he remedial steps already taken and that, in the future, could be taken by the corporation to prevent a reoccurrence of the challenged actions" (alterations in original)). The SLC may properly consider the adverse effects of pending, parallel securities class actions in deciding whether derivative litigation is in the best interests of the corporation. *Zapata*, 430 A.2d at 788 (citing *Maldonado*, 485 F. Supp. at 285) (explaining that SLCs may consider facts beyond the merits, including ethical, commercial, promotional, employee relations, reputational, and fiscal factors).

[177] Gall v. Exxon Corp., 418 F. Supp. 508, 518 (S.D.N.Y. 1976) (footnote omitted). *See also* Seidl v. Am. Century Cos., 799 F.3d 983, 989 (8th Cir. 2015) ("This was a permissible business judgment: a special litigation committee may reasonably determine that it is not in the best interests of the corporation to pursue a legal remedy, even where a proposed defendant has violated the law.").

And so it goes. First of all, the original derivative plaintiff is forced to fight the demand required/demand excused litigation battle, having to effectively prove the substance of its case on a motion to dismiss. Then, even if the shareholder wins that battle, the company can form a SLC to take over the litigation.

*2. The Design Defect of Structural Bias.* How is an implicated board of directors able to create an arguably sufficiently disinterested SLC? That is, as a properly constituted committee of the board of directors, the SLC must be made up of current board members.[178] The difficulty comes in finding directors to serve on the committee who may be seen as sufficiently independent to deserve the respect of the courts when the committee recommends settling or dismissing the derivative litigation on behalf of the company.

Under current case law, a common approach to forming a SLC is to appoint any directors not implicated in the derivative suit to the SLC, even if they were on the board at the time of some or all of the challenged transactions. This approach is illustrated in the Second Circuit case, *Joy v. North*.[179] In *Joy*, a shareholder filed a derivative action against the board of directors for losses sustained as a result of allegedly improper loans that the company had made to a real estate developer.[180] The board then appointed two outside board members who were not implicated in the suit to a SLC.[181] This approach was also followed in the Delaware case, *Lewis v. Fuqua*.[182] Following a shareholder suit alleging interested stock purchases, the board of directors in *Lewis* created

---

[178] DEL. CODE ANN. tit. 8, § 141(c)(2) ("The board of directors may designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation."); MODEL BUS. CORP. ACT ANN., *supra* note 94, § 8.25(a) ("[A] board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee.").

[179] 692 F.2d 880 (2d Cir. 1982).

[180] *Id.* at 883–84.

[181] *Id.*

[182] 502 A.2d 962 (Del. Ch. 1985). *See also* Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980) (finding that summary judgment for the defendant corporation was appropriate where the special litigation committee comprised of outside directors investigated the plaintiffs' claims in good faith and recommended dismissal).

a single member SLC, comprised of the single board member who had not been involved in the challenged stock purchases.[183]

Even in cases where the entire board is implicated in a derivative action, certain directors still may be deemed disinterested enough by the courts to serve on a SLC. The mere fact that a director is a named defendant in a particular suit may not be enough, without additional facts, to establish that he or she is not disinterested.[184] This positon has been adopted in a number of jurisdictions.[185] As explained in *Mills v. Esmark*, this policy is to prevent plaintiff gamesmanship.[186] If plaintiffs were allowed to disqualify the entire board by simply naming all of the board members as defendants, then plaintiffs could easily avoid the potential for SLCs, and usurp the board's normal power to pursue or reject claims on behalf of the corporation.[187]

Another common practice in choosing SLC members is to appoint directors who were not on the board at time of the suit, or, if the company's bylaws allow, to add board members in order for them initially to serve on the SLC. An early example of this approach was *Gall v. Exxon Corp.*, in which the SLC consisted of three board members who were appointed to the board after illegal payments and bribes were allegedly made.[188] The same approach was used in the landmark New York case, *Auerbach v. Bennett*,[189] in which the company appointed three independent directors to

---

[183] *Lewis*, 502 A.2d at 965.

[184] MODEL BUS. CORP. ACT ANN., *supra* note 94, § 7.44(c).

[185] *See, e.g.*, O.C.G.A. § 14-2-744(c) (explaining that the naming of a director as a defendant in the derivative proceeding will not by itself cause a director to be considered not independent); IND. CODE § 23-1-32-4(d)(1) (stating that a director or other person is disinterested if that person "has been made a party but only on the basis or a frivolous or insubstantial claim or for the sole purpose of seeking to disqualify the director or other person from serving on the committee").

[186] Mills v. Esmark, Inc., 544 F. Supp. 1275, 1284–85 (N.D. Ill. 1982).

[187] *See* Grimes v. Donald, 673 A.2d 1207, 1215 (Del. 1996). This is by no means a universal rule, and some courts may find even nominally named board members to be not sufficiently disinterested. *See, e.g.*, *Lewis*, 502 A.2d at 966–67 (finding that a special litigation committee member who was on the board at time of challenged transaction and was a nominally named defendant was not sufficiently independent).

[188] Gall v. Exxon Corp., 418 F. Supp. 508, 509–10 (S.D.N.Y. 1976).

[189] Auerbach v. Bennett, 47 N.E.2d 994, 997 (N.Y. 1979).

the SLC who had joined the board after illegal payments were allegedly made. The defendant in *In re Oracle* also used this strategy, appointing two members of the Stanford faculty to their board a year and a half after the shareholder-challenged conduct took place.[190]

The effectiveness of this approach can depend on a board's unilateral ability to increase the size of the board by appointing new members. Many corporate statutes provide that the "number of directors shall be fixed by, or in the manner provided in, the bylaws."[191] It is typical for the bylaws of publicly held companies to give the board unilateral authority to set the number of directors.[192] Where corporate articles or bylaws grant the current board discretion to expand the board, then simply expanding the board and appointing new members is an easy way to create a SLC that is superficially untainted. Even boards without such wide discretion can find ways to appoint new board members following challenged actions.[193] For instance, in *Zapata Corp. v. Maldonado* four of the defendant directors resigned from the board following a

---

[190] *In re* Oracle Corp. Deriv. Litig., 824 A.2d 917, 923 (Del. Ch. 2003). *See also* Seidl v. Am. Century Cos., 799 F.3d 983, 989 (8th Cir. 2015) ("Olson and Whitten were members of the Board when the demand was made, but were not members when the investments in PartyGaming were made or sold.").

[191] DEL. CODE ANN. tit. 8, § 141(b) (2011); *accord* MODEL BUS. CORP. ACT § 8.03(a) (2004) ("A board of directors must consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws.").

[192] *See, e.g.*, BYLAWS OF GOOGLE § 3.2 (2012) ("[T]he authorized number of directors shall be determined from time to time by resolution of the Board . . . ."), http://www.sec.gov/Archives/edgar/data/1288776/000119312512312575/d357361dex302.htm.

[193] As noted in *Mills v. Esmark Inc.*, in some situations there are no possible people to serve on a special litigation committee. *See* Mills v. Esmark, Inc., 544 F. Supp. 1275, 1284 n.6 (N.D. Ill. 1982) (disapproving of the SLC's members and prohibiting it from dismissing the claim even though it was disinterested and independent under Delaware law). This could occur in a case where the entire board is interested, a company cannot appoint new directors under its articles or bylaws and the jurisdiction in question does not have a statute that allows non-board members to serve on a special litigation committee. It could also occur in a jurisdiction which does not accord special litigation committee recommendations any weight under any circumstances. In either case, a plaintiff could potentially maintain control of the derivative suit, as plaintiffs generally did before the advent of special litigation committees in the 1970s. *See supra* Part II.B.

shareholder's derivative suit, thus allowing the board to appoint two new directors to serve on a SLC.[194]

The problem with any of these approaches to appointment of the SLC is the potential for structural bias. The term "structural bias" may be loosely defined as a type of inherent or intrinsic prejudice embedded in the composition and character of the board that results in opposition to a derivative action.[195] "The central theme of these concerns has been focused on the 'structural bias' approach, which suggests that it is unrealistic to assume that the members of independent committees are free from personal, financial or moral influences, which flow from the directors who appoint them."[196] The primary concern arises from the fact that the defendant directors effectively are picking their own judges. "The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role."[197]

Even if the potential bias which flows from concern for future personal liability is not a factor that challenges the credulity of independence, the SLC members are being called upon to judge the conduct and determine the potential liability of board members who are fellow directors.[198] The role of the SLC members does not end when they file their report and make their recommendation as to disposition of the derivative claims. Rather, those same individuals are and will continue to be part of the same board of directors that is the subject of the litigation. They will sit in the same room, represent the same company and make decisions together on business matters for that company potentially for many years to come. "[W]e must be mindful that directors are

---

[194] Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981). By contrast, in *Bluth v. Bellow*, a proxy contest following a derivative suit resulted in the appointment of new board members, who then proceeded to prosecute the derivative claim. Bluth v. Bellow, No. CIV. A. 6823, 1987 WL 9369, at *1 (Del. Ch. Apr. 9, 1987). *Bluth v. Bellow* is one of the few cases in which a company actually chose to pursue a pending derivative suit, likely due to the fact that a proxy contest completely altered the composition of the board of directors.

[195] Mark A. Underberg, Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 601 n.14 (1980).

[196] Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 716 (Iowa 1983).

[197] *Zapata*, 430 A.2d at 787.

[198] *See supra* note 178 and accompanying text.

passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members."[199] It may seem that this is a very uncomfortable context in which to expect impartial judgment by SLC members appointed by defendant board members.[200]

*3. Structural Bias and Standards of Review.* After an SLC does its investigation and drafts its report, it makes a recommendation as to disposition of the derivative claims. The issue then becomes what deference a court should accord to the recommendation of the SLC. Because the concept of structural bias carries negative connotations about boardroom and committee behavior, courts and commentators frequently use its potential presence as an argument for significant judicial scrutiny of SLC decisions.[201] Indeed, whether due to structural bias or otherwise, the courts have adopted a variety of approaches to govern that

---

[199] *See Zapata*, 430 A.2d at 787.

[200] While the theory of structural bias has strong supporters, it is not without criticism. As one commentator articulated:

> The structural bias argument asks us to believe that outside directors generally are more willing to risk reputation and future income than they are to risk the social embarrassment of calling a colleague to account. There is no more reason to believe this than there is to believe that independent accountants are easily suborned because they are indifferent to the loss of income from other professional engagements thereby put at risk.

Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 535 (1989).

[201] *See, e.g.*, Alford v. Shaw, 358 S.E.2d 323, 326 (N.C. 1987) ("We interpret the trend away from *Auerbach* among other jurisdictions as an indication of growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose institutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interest of plaintiffs forced to bring suit on behalf of the corporation."); *Miller*, 336 N.W.2d at 716 ("The central theme of [commentators'] concerns has been focused on the 'structural bias' approach, which suggests that it is unrealistic to assume that the members of independent committees are free from personal, financial or moral influences which flow from the directors who appoint them."); James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 1008 ("The most effective remedy for structural bias is to require the courts to take a more active role in their review of the directors' recommendation than *Zapata* advocates.").

review process. As discussed below, however, none of them adequately addresses the nuances presented in this context.

Iowa, at one extreme, has held that an SLC's determination to terminate a derivative, demand-excused suit should never be accorded any weight.[202] That approach was premised on the theory that a board cannot delegate authority that it does not have, and a board does not have any authority over a derivative suit when the majority of the board is implicated.[203] The court adopted this preventative measure to avoid director bias.[204] This "prophylactic rule" has been interpreted "as a means of circumventing the 'structural bias' inherent in the committee appointment process."[205]

The Iowa approach is clearly wrong. A board does have authority to bind the corporation, even if all of the board members are directly and personally interested in the transaction under consideration. It is not that the board (or an SLC) does not have authority to approve the transaction. Rather, if a conflicted board approves a self-dealing transaction, the action of the board is subject to strict scrutiny under the entire fairness standard. This is the law in Iowa[206] and, significantly, Delaware,[207] among other states with respect to director conflict of interest transactions generally.

This standard should be no less applicable in the derivative litigation context. Therefore, if a determination whether to reject a shareholder demand or dismiss derivative litigation is proffered by a conflicted board or SLC, that action should be sustained only

---

[202] *Miller*, 336 N.W.2d at 718. This was a demand-excused situation where a majority of the board was implicated in the lawsuit.

[203] *Id.* at 716.

[204] *Id.* at 718. *See also* Boland v. Boland, 31 A.3d 529, 533 n.29 (Md. 2011) (citing *Miller*, 336 N.W.2d at 79) ("[T]he Iowa Supreme Court adopted a prophylactic rule as a means of circumventing the 'structural bias' inherent in the committee appointment process. Under *Miller*, directors charged with misconduct are prohibited from selecting SLCs.").

[205] *Alford*, 358 S.E.2d at 325.

[206] IOWA CODE ANN. § 490.861(2)(c) (West 2004) (stating that director conflict of interest transaction is not subject to judicial invalidation if "the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation").

[207] *See supra* notes 15, 27–34 and accompanying text.

if the conflicted directors can demonstrate that the proposed action satisfies the exacting scrutiny of the entire fairness standard.

Most other courts accord at least some deference to an SLC's decision, and thus the question becomes what level of deference is appropriate. In answering this question, courts must find a balance between the business judgment presumption that normally attaches to corporate board actions and the implicit structural bias that arises when an SLC composed of other board members is allowed to make a decision on behalf of an interested board. New York and Delaware have addressed this tension with disparate standards of review.

New York is at the other end of the spectrum from Iowa. In the case *Auerbach v. Bennett*, New York adopted the deferential business judgment test in examining decisions of SLCs.[208] Emphasizing the fact that derivative claims against corporate directors belong to the corporation itself, the court held that New York courts will defer to a committee's determination absent fraud or bad faith.[209] Under this test, a court can examine the independence of the committee and the adequacy of procedures used, but cannot look at the actual substance of the ultimate decision reached, even as an indicator of bad faith or insufficient process.[210] Further, a determination of inadequate procedures requires proof that "investigation has been so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or a sham."[211] Under this rule, the plaintiff has the burden to create a reasonable doubt regarding the

---

[208] Auerbach v. Bennett, 393 N.E.2d 994, 996 (N.Y. 1979).

[209] *Id.* at 1000–02.

[210] *Id.* at 1002. *See also* Murdock, *supra* note 153, at 95 (arguing that the New York rule is inherently contradictory since judicial scrutiny of the ultimate conclusion is necessary to demonstrate a sham process).

[211] *Auerbach*, 393 N.E.2d at 1002–03 ("As to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are well equipped by long and continuing experience and practice to make determinations. In fact they are better qualified in this regard than are corporate directors in general. Nor do the determinations to be made in the adoption of procedures partake of the nuances or special perceptions or comprehensions of business judgment or corporate activities or interests. The question is solely how appropriately to set about to gather the pertinent data.").

independence of the committee or the reasonableness of the procedures the committee used.[212]

A number of additional jurisdictions have adopted New York's deferential approach to SLCs, including Alabama,[213] California,[214] Colorado,[215] Michigan[216] and Minnesota.[217] Courts have noted the trend to apply the business judgment rule to SLC decisions.[218]

The *Auerbach* approach requires, *inter alia*, a court to defer to the substantive decision of the SLC.[219] One of the primary

---

[212] *Id.* The New York rule is often criticized for giving too much deference to SLCs, failing to distinguish between demand excused and demand required cases, and its failure to allow courts to look at the substance or ultimate decision as indicators of bad faith. *See, e.g.*, Swanson, *supra* note 92, at 1364; Murdock, *supra* note 153, at 95 (discussing how the court can discover a sham process only if they are allowed to look at the final decision).

[213] *See* Roberts v. Alabama Power Co., 404 So. 2d 629, 636 (Ala. 1981) ("There would be no purpose served by allowing a shareholder to bring a derivative suit after a thorough and good faith determination that such a suit would not be in the best interest of the corporation.").

[214] *See* Will v. Engebretson & Co., 13 Cal. App. 3d 1033, 1041 (Cal. Ct. App. 1989) ("[C]ourts which have considered the issue have concluded that judicial review of the independence, good faith, and investigative techniques of a special litigation committee is governed by traditional summary judgment standards.").

[215] *See* Curtis v. Nevens, 31 P.3d 146, 153 (Colo. 2001) ("The business judgment doctrine precludes the trial court from inquiring into the factors considered and balanced by an SLC.").

[216] *See* Genzer v. Cunningham, 498 F. Supp. 682, 686–89 (E.D. Mich. 1980) ("[T]his court . . . would follow the lead of the New York courts in allowing a business judgment dismissal of litigation determined by a disinterested committee to be contrary to the corporation's best interests.").

[217] *In re* UnitedHealth Group Inc. S'holder Derivative Litig., 754 N.W.2d 544, 556–58 (Minn. 2008). Sometimes the test is adopted with slight variations. For example, Minnesota allocates the burden differently than New York does, leaving the initial burden of proving that the special litigation committee was independent and acted in good faith with the corporation. *Id.*

[218] *See* Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979) (quoting Auerbach v. Bennett, 393 N.E.2d 944, 996 (N.Y. 1978)) ("*Auerbach* . . . reflect[s] a clear trend in corporate law, and we are confident that a California court would follow this trend . . . . [T]he *Auerbach* court recognized [that] a court may 'inquire as to the disinterested independence of the members of that [special litigation] committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee'. . . . Our decision here, like that in *Auerbach*, is 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.").

[219] *See* Auerbach v. Bennett, 393 N.E.2d 994, 1002 (N.Y. 1979) ("[The Special litigation committee's] substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach.").

arguments for a deferential review standard is that the corporation, not the shareholder, is the true owner of the action.[220] As the true owner of the action, the corporation should decide how to pursue potential wrongdoings, and should control the litigation.[221]

In addition, the corporation's management is the best body for decisionmaking.[222] Boards or committees, not judges, are in a better position to make business decisions regarding litigation matters. As noted by one court, "courts are not qualified to evaluate the business judgment of an SLC."[223]

*Auerbach*, however, goes too far in deferring to the activities of an SLC. The specter of structural bias looms large when directors are judging the potential liability of their fellow directors. As with other situations where "there is a basis for concern that directors without a pure self-dealing motive might be influenced by considerations other than the best interests of the corporation and other stockholders,"[224] a standard of intermediate scrutiny is appropriate. In this context, as in others where there is a concern for lack of objectivity, the SLC should have the burden to demonstrate the reasonableness of its recommendations.[225]

---

[220] *See id.* at 1000 ("Derivative claims against corporate directors belong to the corporation itself.").

[221] *See* Gall v. Exxon Corp., 418 F. Supp. 508, 515 (S.D.N.Y. 1976) ("Since it is the interests of the corporation which are at stake, it is the responsibility of the directors of the corporation to determine, in the first instance, whether an action should be brought on the corporation's behalf. . . . It follows 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.").

[222] *See* Kinney, *supra* note 151, at 180 ("Some believe that giving deference to a court's independent business judgment to deny the corporation's motion, allows the court to usurp a role that is more appropriately performed by directors and officers.").

[223] *In re* UnitedHealth Group Ins. S'holder Derivative Litig., 754 N.W.2d 544, 556 (Minn. 2008). *See also* Bradley T. Ferrell, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation*, 60 OHIO ST. L.J. 241, 277 (1999) (stating that for duty of care cases, "the standard of judicial review . . . should be more deferential to the corporate committee because the committee is much better suited to evaluate the allegations in these cases").

[224] Chen v. Howard-Anderson, 87 A.3d 648, 677 (Del. Ch. 2014) (citation omitted).

[225] *See supra* notes 42–47 and accompanying text.

Surprisingly, Delaware takes a less deferential approach. In *Zapata Corp. v. Maldonado*,[226] the Delaware Supreme Court heard a derivative action involving allegations of breach of fiduciary duty (self-dealing) brought against ten officers and/or directors.[227] The shareholder bringing the action, William Maldonado (Maldonado), argued that demand on the board was futile "because all directors were named as defendants and allegedly participated in the acts specified."[228] Zapata Corporation's (Zapata) board of directors created an SLC to review and investigate Maldonado's actions and granted the committee complete decisionmaking authority regarding continuance or termination of the litigation.[229] The SLC concluded the corporation should not pursue the actions, and consequently, Zapata moved to dismiss the derivative action.[230]

The court found demand was excused[231] but adopted a two-step test for judicial review of the SLC's determination.[232] The first step is very similar to the *Auerbach* test:

> [T]he Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. . . . The corporation should have the burden of proving independence, good faith and a reasonable investigation . . . If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied . . . that the committee was independent and

---

[226] 430 A.2d 779 (Del. 1981).
[227] *Id.* at 780.
[228] *Id.* (footnote omitted).
[229] *Id.* at 781.
[230] *Id.*
[231] *Id.* at 787. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) for the detailed Delaware test for proving demand futility.
[232] *Zapata*, 430 A.2d at 788–89.

> showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.[233]

The *Zapata* Court, however, went on to say that a court reviewing SLC recommendations should insert itself into the substantive business decisionmaking process. Therefore, the Court imposed a second step of analysis:

> The Court should determine, applying its own independent business judgment, whether the motion should be granted. This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to

[233] *Id.* Two Delaware cases have highlighted judicial findings of compromised committees and conflicts of interest due to close relationships and inappropriate appointments. *See* Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973, 1003–04 (2007) (citing and quoting Biodi v. Scrushy, 820 A.2d 1148, 1156–57 (Del. Ch. 2003) ("In *Biondi v. Scrushy*, the court found that the SLC was 'fatally compromised' because of the members' strong friendship with a key defendant, inadequate delegation of authority to the SLC, and a premature statement by its chair that one key defendant would be exonerated.")); *id.* (citing *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917, 947–48 (Del. Ch. 2003) ("Similarly, in In re Oracle Corp. Derivative Litigation, the court found an impermissible conflict in judgment because two SLC members were professors at Stanford, a university where all of the defendants had important ties.")).

> matters of law and public policy in addition to the corporation's best interests. If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms or conditions the Court finds necessary or desirable.[234]

The *Zapata* two-step test provides flexibility in the judicial review of an SLC's determination and requires less deference than the law in other states following the *Auerbach* standard.

Unlike the case it was hearing in *Zapata*, the Delaware Supreme Court noted that "[c]onsistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful."[235] This is considered a "demand-refused" scenario.[236] Therefore, in demand-refused cases under Delaware law, the board's decision is generally protected by the business judgment rule[237] and a court only reviews the issues of "independence, the reasonableness of its investigation and good faith."[238]

In sum, the Delaware approach is considered a demand-dependent bifurcated standard.[239] On the one hand, in demand-refused cases, Delaware courts apply a deferential standard that shields directors by the business judgment rule.[240] On the other hand, in demand-excused cases, Delaware courts have greater

---

[234] *Zapata*, 430 A.2d at 789.

[235] *Id.* at 784.

[236] As opposed to the "demand-excused" scenario dealt with in *Zapata*. *Id.* at 787.

[237] Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals*, 60 FLA. L. REV. 589, 599 (2008) ("At its most basic, the business judgment rule supplies a defense in shareholder derivative actions that challenge a decision by a corporation's board of directors." (citing Brehm v. Eisner, 906 A.2d 27, 52 (Del. 2006))).

[238] Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990). This is consistent with the standard applied in all circumstances under the test employed in *Auerbach v. Bennett*, 393 N.E.2d 994, 999–1000 (N.Y. 1979).

[239] Swanson, *supra* note 92, at 1365.

[240] *Id.*

scrutiny and afford less deference as seen through the *Zapata* two-step test.[241]

This Delaware approach has been criticized for giving courts too much discretion under the second *Zapata* prong, and therefore ignoring the important policies behind the business judgment rule.[242] Despite these criticisms, the approach has been adopted in a number of other jurisdictions, sometimes with some modification. For example, the Second Circuit in *Joy v. North* adopted the Delaware test, but modified the controversial second prong by limiting the court's discretion.[243] The Court in *Joy* said that courts should focus their inquiry in the second step on the potential costs and rewards to the corporation of pursuing the suit.[244] North Carolina and New Jersey have also adopted modified versions of the Delaware test, extending the two-part inquiry to demand-required cases as well as demand-excused cases.[245]

The *Zapata* approach requires a court to utilize its own "independent business judgment" to determine whether the substantive decision of an SLC was proper.[246] This higher-scrutiny standard arguably is justified by concerns over structural bias.[247]

---

241 *Id.*

242 *See, e.g.*, Kriston D. Qualls, Zapata Corp. v. Maldonado: *Delaware's Judicial Business Judgment Rule—A Ship Without a Rudder?*, 19 CAL. W. L. REV. 189, 210 (1982) (arguing that courts do not have the institutional competence to review the decisions of special litigation committees under such heightened scrutiny). On the other hand, commentators have noted that one of the underlying purposes of the *Zapata* test is to avoid the "structural bias" that may be present in an SLC. *See* Cox, *supra* note 201, at 975 (arguing that the *Zapata* court demonstrated sensitivity to potential abuse "of structural bias"). The fact that the board often recommends, appoints, or approves the members of an SLC only exacerbates the potential for bias. *See* Murdock, *supra* note 153, at 102 ("Often the defendant directors will have been responsible for the committee members' initial appointment or election to the board and also for their appointment to the special litigation committee.").

243 Joy v. North, 692 F.2d 880, 891 (2d Cir. 1982).

244 *Id.* at 892.

245 Alford v. Shaw, 358 S.E.2d 323, 327 (N.C. 1987); *In re* PSE & G S'holder Litig., 801 A.2d 295, 310–11 (N.J. 2002).

246 Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981).

247 *See, e.g.*, Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 716 (Iowa 1983) ("The central theme of these concerns has been focused on the 'structural bias' approach,

One of the underlying purposes of the *Zapata* test is to avoid the "structural bias" that may be present in an SLC.[248] The fact that the board often recommends, appoints, or approves the members of an SLC arguably only exacerbates the potential for bias.[249]

The *Zapata* approach, however, is fundamentally at odds with basic corporate law. There is nothing wrong with a court imposing a significant burden on directors or others to justify their conduct. As previously discussed, in appropriate circumstances, courts impose an entire fairness standard on directors to justify certain activities.[250] In other circumstances, courts apply intermediate scrutiny or an enhanced scrutiny standard.[251] Making directors justify their conduct is one thing but having courts impose their own business judgment is quite another. Indeed, the concept of a court having business judgment is an oxymoron in corporate jurisprudence: "[t]o employ a different rule—one that permitted an

---

which suggests that it is unrealistic to assume that the members of independent committees are free from personal, financial or moral influences which flow from the directors who appoint them."); Alford v. Shaw, 358 S.E.2d 323, 326 (N.C. 1987) ("We interpret the trend away from *Auerbach* among other jurisdictions as an indication of growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose institutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interest of plaintiffs forced to bring suit on behalf of the corporation."); Cox, *supra* note 201, at 1008 ("The most effective remedy for structural bias is to require the courts to take a more active role in their review of the directors' recommendation than *Zapata* advocates.").

[248] *See* Cox, *supra* note 201, at 975 ("By seeking a middle course, the court demonstrated a sensitivity to the abusive potential of structural bios rarely seen in SLC cases."). *But see In re* UnitedHealth Group Inc. S'holder Derivative Litig., 754 N.W.2d 544, 558 (Minn. 2008) ("We also reject the argument of *Auerbach's* critics that structural bias is a phenomenon that requires an extraordinary level of judicial intervention.").

[249] Murdock, *supra* note 153, at 102 ("Often the defendant directors will have been responsible for the committee members' initial appointment or election to the board and also for their appointment to the special litigation committee."). Some commentators recognize the *Zapata* approach is appropriate for transactions that implicate the duty of care, but advocate for even stricter standards of scrutiny in a duty of loyalty context. *Id.* at 100. It is argued that courts recognize the limitations of their expertise in business decisions, but directors "have no particular expertise with duty of loyalty issues" and "because of structural bias, are ill-equipped to pass judgment on their fellow directors." *Id.*

[250] *See supra* note 35 and accompanying text.

[251] *See supra* note 16 and accompanying text.

'objective' evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges."[252]

Regardless of whether structural bias plays a significant role in the determinations of a SLC, or whether it exists at all, commentators have routinely noted that the overwhelming majority of SLC recommendations dictate a dismissal of derivative actions.[253] Conversely, one empirical study indicates that SLCs choose to settle or pursue derivative litigation about forty percent of the time.[254] Nevertheless, it appears that derivative litigation is not going to disappear.[255] The clarion call is to find a process that allows the derivative claim to proceed down a more efficient and effective road, rather than being taken off-road by preliminary procedural potholes.

---

[252] *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 122 (Del. Ch. 2009); *see also* Gantler v. Stephens, 965 A.2d 695, 706 (Del. 2009) (refusing to substitute the court's judgment for that of the board if the board's decision can be ascribed to any rational business purpose); Seinfeld v. Slager, C.V. No. 64620VCG, 2012 WL 2501105, at *16 (Del. Ch. June 29, 2012) (refusing to substitute the court's judgment for that of the board's).

[253] *See* Murdock, *supra* note 153, at 84 ("Invariably the committee moves to dismiss the litigation."); Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1791 n.147 (2004) ("The limited data that has been collected on this question supports the view that the appointment of a special litigation committee almost always leads to dismissal of the case."); Morrissey, *supra* note 233, at 1003 (stating that an SLC will "investigate the allegations of a derivative suit filed against its company and almost always recommend its dismissal, finding that its maintenance was not in the firm's best interest").

[254] *See* Myers, *supra* note 150, at 1332 ("Contrary to the predominant view in legal scholarship, SLCs do not invariably move to dismiss litigation. Instead, approximately forty percent of the time SLCs either settled claims or pursued them against one or more defendants. These decisions to pursue or settle claims resulted in substantial financial recoveries for the corporation, indicating that SLCs are not taking it easy on defendants. In view of the speed with which claims subject to SLC authority are resolved, the SLC appears to function as a form of alternative dispute resolution.").

[255] Thomas E. McCurnin, *Measures for Avoiding or Lessening the Sting of Derivative Lawsuits*, 36 L.A. LAW. 14 (Feb. 2014) ("In the last five years, derivative suit filings have increased threefold.").

## IV. A FEDERAL STATUTORY SOLUTION TO REFORM THE DERIVATIVE CLAIM PROCESS

The preceding discussion demonstrates the disarray of the existing derivative claim process. Far from serving the goals of alternative dispute resolution and accountability in modern corporations, the process seems designed to exhaust the willpower and resources of the derivative plaintiff with procedural impediments and uncertainty. This result serves no one well, not even the defendants in the suits whose companies must pay significant litigation fees as part of a battle where the ultimate resolution is tainted by concerns over its validity in serving corporate and shareholder interests. What is needed is a new approach to derivative claims that both streamlines the process and enhances its ultimate credibility as a means to secure corporate accountability.

The proposal here is for a federal statute to make uniform the federal and state standards with respect to derivative litigation (the Proposal). The Proposal would preempt existing state law to the extent that state law is inconsistent with the Proposal.[256] It would apply to all derivative claims, whether they would be brought in federal or state court. The Proposal embodies three essential and interconnected reforms: (1) the requirement of universal demand; (2) the expansion of the SLC concept to include appointment of independent persons who are not current directors; and (3) the adoption of a tri-partite standard of review of derivative dispositions that is consistent with the standards adopted for other director decisions. The Proposal reads:

---

[256] Although it is possible that the proposed statute could be adopted by states individually, the argument for a uniform process under a federal statute flows from the fact that many of the disputes involve companies engaging in activities across state borders, that many of the suits involve claims under federal securities and other laws and that efficiency will be enhanced by the uniform resolution of these matters. In any event, any state could adopt the proposed statute as a matter of state law or it could be adopted as part of the Model Business Corporation Act. In addition, there are aspects of derivative suits not addressed by the Proposal, such as attorneys' fees for successful derivative claims. These are left to individual state determination.

## *DERIVATIVE ACTION STATUTE*

**Section 1: Demand Required**. Before initiating a derivative action, a shareholder must make demand on the board of directors of the corporation. The demand must be in writing, and shall state plainly any and all claims the shareholder wishes the board of directors to consider. The demand shall also specify which individuals the shareholder would propose to make as defendants in the derivative action and the basis for naming each of those individuals.

**Section 2: Demand Response**. Once demand has been properly made, the board of directors shall respond in writing to the shareholder within ninety (90) days. The board of directors may:

(A) Allow the shareholder to proceed with the derivative claims;

(B) Accept the demand and pursue the claims presented in the demand;

(C) Reject the demand;

(D) Refer the demand to a special litigation committee of disinterested directors to consider the claims; or

(E) Refer the demand to a special litigation committee of independent persons to consider the claims.

**Section 3: Special Litigation Committee of Independent Persons**.

(A) The board may establish a special litigation committee consisting of one or more independent persons to consider the legal rights and remedies of the corporation and whether those rights and remedies should be pursued. Committee members cannot be past or current directors, officers or employees of the subject company, cannot have represented the company in any other capacity, and cannot have past or present material financial dealings with the company or with any potential defendant named in the demand. The committee shall have complete authority to take any action necessary, including retention of independent legal and financial advisors, and shall have full authority to pursue, settle, dismiss or otherwise dispose of the derivative litigation. Once formed, the committee shall not be subject to the direction or control of the board.

(B) A person is "independent" if that person does not have a material interest in the outcome of the proceeding, or a material relationship with a person who has such an interest, including any potential defendant specified in the demand. A "material interest" means an actual or potential benefit or detriment (other than one which would devolve on the corporation or the shareholders generally) that would reasonably be expected to impair the objectivity of the person's judgment when participating as a member of the special litigation committee. A "material relationship" means a familial, financial, professional, employment or other relationship that would reasonably be expected to impair the objectivity of the person's judgment when participating as a member of the special litigation committee.[257]

[257] This definition of independence relies substantially on the concept of independence under the Model Business Corporation Act. MODEL BUS. CORP. ACT § 1.43 (2010).

**Section 4: Interestedness of Directors, Officers or Others in the Derivative Claim**. For purpose of this statute, a person is interested in any derivative claim if that person is named in good faith in the demand as a potential defendant as a result of having participated in, voted on, failed to act on, or obtained a personal benefit from the transaction, activities or conduct that form the basis of the demand.

**Section 5: Standard of Review**. Once the board or a committee takes action on the demand, a court shall review that determination in accordance with the following standards.

(A) If a majority of the board is not interested in the claim or claims that are the subject of the demand, then the court shall review any board or committee recommendation pursuant to the business judgment rule.

(B) If a majority of the board is interested in the claim or claims that are the subject of the demand, then the court shall review any recommendation:

(1) by the board under Section 2(c) pursuant to the entire fairness standard, with the burden being on the board;

(2) by a committee under Section 2(d) pursuant to the intermediate scrutiny standard to determine the reasonableness of the recommendations, with the burden being on the committee; and

(3) by a committee under Section 2(e) pursuant to the business judgment rule to determine if:

(a) the members of the special litigation committee possessed a disinterested independence, and

(b) the special litigation committee's investigative procedures and methodologies were adequate, appropriate, and pursued in good faith, with the burden being on the committee to demonstrate satisfaction of (a) and (b).

A. THE REQUIREMENT OF UNIVERSAL DEMAND

Section 1 of the Proposal imposes a universal demand requirement. Demand on the board of directors is required for all derivative claims as a prerequisite to bringing a derivative suit. In a universal demand regime, a shareholder may not commence a derivative action without first making demand on the board of directors.[258]

Importantly, the universal demand approach shifts the focus of the inquiry from the ability of the board of directors to consider demand to the actual response of the board.[259] A universal

---

[258] The concept of universal demand is not necessarily new—it just has never been effectively employed. The American Law Institute and the Revised Model Business Corporations Act both propose a universal demand requirement. *See* ALI PRINCIPLES, *supra* note 5, § 7.03 (requiring demand); MODEL BUS. CORP. ACT ANN. § 7.42 (2002) (requiring a demand but setting a ninety day response deadline for the board). A number of states have also imposed a uniform demand requirement, which supplants the common law doctrine of demand and futility. *See, e.g.*, N.C. GEN. STAT. § 55-7-42 (1995) (requiring demand). This provision is modeled off the RMBCA approach, and has been held to require a shareholder to make demand on the board as a prerequisite to derivative litigation, thereby statutorily eliminating the futility exception to the demand requirement. *See* Norman v. Nash Johnson & Sons' Farms, Inc., 537 S.E.2d 248, 262 (N.C. Ct. App. 2000) (holding that N.C. GEN. STAT. § 5-7-42 eliminates the futility exception). Approximately nineteen states have adopted a form of universal demand requirement. *See* Kurt A. Goehre, *Is the Demand Requirement Obsolete? How the United Kingdom Modernized Its Shareholder Derivative Procedure and What the United States Can Learn From It*, 28 WIS. INT'L L.J. 140, 147 n.52 (2010).

[259] *See* John C. Coffee, Jr., *Derivative Litigation Under Part VII of the ALI Principles of Corporate Governance: A Review of the Positions and Premises*, CA53 ALA-ABA 237, 254 (1995). Coffee argues that this approach provides for more accurate judicial review, particularly because "nothing proves [the board's] capacity [to respond to demand] better than actual performance. . . ." *Id.*

demand requirement will eliminate the need for the demand futility doctrine.[260] This will avoid most of the preliminary battles that currently consume derivative litigation today.

With the requirement of universal demand, the primacy of the board will be affirmed and the board will have to decide what to do. Only if the board chooses to allow the shareholder to proceed would the shareholder then be able to pursue the claims in court. In this manner, the Proposal will also allow the dispute between the board and the shareholder to be settled internally, if possible, and will promote alternative dispute resolution through cooperative corporate governance. By rendering meaningless the concept of demand futility, the Proposal streamlines the process for starting a derivative action and removes the uncertainty and inevitable expense that can come with protracted litigation centering on whether demand must be made or can be considered futile.

### B. THE COMMITTEE OF INDEPENDENT PERSONS

If, as proposed here, demand is universally required, the concern over structural bias then potentially undermines the credibility of the derivative dispute resolution process. The problem with the existing SLC model is the inability of a current board of directors to compose a committee of members that appear to be truly disinterested and able to determine objectively whether the derivative action should be pursued.[261] This limitation is due to the corporate law of the individual states. As written, board committees, including the SLC, can only "consist of 1 or more directors of the corporation."[262]

This limitation must be dealt with directly and decisively. The only way to overcome the angst over the concern for structural bias

---

[260] *See* ALI PRINCIPLES, *supra* note 5, § 7.03 cmt. a (explaining that § 7.93 drops the futility exception).

[261] *See supra* Part III.B.2 (discussing the design defect of structural bias).

[262] DEL. CODE ANN. tit. 8, § 141(c)(2) (2011); *see also* MODEL BUS. CORP. ACT § 8.25(a) (2011) ("[A] board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee.").

is to have the ultimate decision to pursue the litigation be made by individuals completely divorced from the defendant board members. Therefore, Section 3 of the Proposal provides for a new device for implicated boards to deal with a demand, namely, to appoint a committee of *independent persons* empowered to determine whether to pursue the derivative litigation. Patterned after the laws of only a few states,[263] the Proposal gives a board the power to create "a special litigation committee consisting of one or more independent persons to consider the legal rights and remedies of the corporation and whether those rights and remedies should be pursued."[264] These "independent persons" would be non-directors selected by the board solely for the purpose of investigating and determining how to handle the derivative litigation.[265]

A committee of independent persons appointed by the board with full authority to determine the fate of the derivative claims sidesteps concerns over structural bias. The independent committee members cannot be past board members and will not be board members after their work is done. These will be individuals who have no past or current affiliation with the company or the defendant board members.[266] They are an ad hoc committee solely for the purpose of the derivative litigation. In the few circumstances where this type of process has been employed and reviewed, committee members often have been former judges or

---

[263] *See, e.g.*, MINN. STAT. § 302A.241 (2014) ("Committees may include a special litigation committee consisting of one or more independent directors or other independent persons to consider legal rights or remedies of the corporation and whether those rights and remedies should be pursued.").

[264] *See supra* Proposal § 3.

[265] A superficially similar model is proposed in the ALI Principles, but there the court creates and appoints the independent members of the committee. The ALI proposal divests the board of its rightful authority to appoint the committee. ALI PRINCIPLES, *supra* note 5, § 7.12.

[266] *See supra* Proposal § 3(A) ("Committee members cannot be past or current directors, officers or employees of the subject company, cannot have represented the company in any other capacity, and cannot have past or present material financial dealings with the company. . . .").

business attorneys.[267] The use of a committee of independent persons provides an elevated level of credibility, enabling confidence that there will be an efficient and effective resolution of the derivative claims process.

C. THE APPROPRIATE STANDARD OF REVIEW

Finally, the standard of judicial review must be addressed. Here, the tripartite standards of entire fairness, intermediate (or enhanced) scrutiny and business judgment that have been used by the courts in other contexts come directly into play. Initially, there needs to be a determination if the current board is disabled from acting objectively. For these purposes, Section 4 of the Proposal posits that a director who is named as a potential defendant in the litigation cannot be viewed as disinterested in the outcome of that litigation.[268] A director might be a potential defendant for participating in or voting on the activities or transactions that are the subject of the claim.[269] In addition, in this modern era of monitoring or oversight liability under the duty of care, the director may be implicated due to a failure to act, that is, a failure to respond to red flags or otherwise supervise activities that are alleged to have harmed the corporation.[270]

---

267 *See, e.g., In re* UnitedHealth Group Inc. S'holder Derivative Litig., 754 N.W.2d 544, 548 (Minn. 2008) (discussing a special litigation committee composed of two former state supreme court judges).

268 In order to avoid gamesmanship by a shareholder simply naming all directors as potential defendants in the demand letter and thereby arguably preventing those directors from being disinterested, Section 4 of the Proposal provides that the allegations and naming of defendants must be in good faith. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (explaining the purpose of the good faith requirement).

269 Today many companies have adopted exculpation provisions that insulate directors from breach of the duty of care. Adoption of such a provision does not mean that a director is not interested in a claim in which he or she is alleged to have breached that duty. Extreme failures to exercise due care can be found to be a failure to act in good faith and thereby a breach of the duty of loyalty. *See, e.g., supra* note 41 and accompanying text.

270 *See* Stone v. Ritter, 911 A.2d 362, 373 (Del. 2006) ("In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions to assure a reasonable information and reporting system exists, and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome." (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996))).

If a majority of directors is disinterested with respect to the derivative claim, traditional principles allow the board to act with the standard of review being the familiar business judgment rule.[271] Section 5(A) of the Proposal reflects this circumstance.

On the other end of the spectrum, if a majority of the board of directors is interested, as defined in Section 4, there is a direct conflict of interest between the board and the shareholder making the demand. Any decision of the board to act on the demand, other than allowing the shareholder to proceed or proceeding itself, is classic self-dealing.

In this context, Section 5(B)(1) of the Proposal provides that the board's determination is subject to strict scrutiny under the exacting duty of loyalty entire fairness standard. This is appropriate because the board is in a direct conflict of interest position, acting on both sides of the issue. It is both defendant and judge. While even a direct conflict of interest is not absolutely prohibited under state corporate law generally, even in regular corporate transactions, it is judged by the entire fairness standard in those circumstances,[272] and should be here as well.

On the other hand, if the majority-implicated board acts to form an SLC of purportedly independent fellow board members, structural bias is still a concern.[273] As with other situations where it is unclear whether directors are acting in their own self-interest as opposed to that of the corporation, there is an "omnipresent specter" that the committee of co-directors will be influenced by their continuing positions on the board and relationships with their fellow defendant directors.[274] Moreover, there is still the "but

---

[271] Grimes v. Donald, 673 A.2d 1207, 1220 (Del. 1996) ("In this case, the Board of DSC considered and rejected the demand. After investing the time and resources to consider and decide whether or not to take action in response to the demand, the Board is entitled to have its decision analyzed under the business judgment rule unless the presumption of that rule can be rebutted.").

[272] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (stating that the entire fairness standard applies when the plaintiff rebuts the presumption of reasonableness).

[273] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[274] *Id.*

for the grace of God go I" inclination.[275] In this context, an intermediate or enhanced scrutiny standard of review is appropriate.[276] The determination of a board appointed committee of co-directors should only have their recommendations confirmed if those recommendations are demonstrated by the committee to be reasonable.[277] Section 5(B)(2) of the Proposal adopts this standard for these circumstances.

Finally, if the majority of the board is implicated but chooses to create a "committee of independent persons" pursuant to Section 3 of the Proposal, then concerns over committee structural bias, past and continuing relationships and potential future liabilities disappear. These individuals appointed to the SLC can do their job, act in the best interests of the company and its shareholders, and then walk away. This is the cleanest and most efficient way to handle disposition of derivative claims.

As with other unconflicted determinations by a board or committee, the recommendation of a committee of independent persons should be entitled deference.[278] And so Section 5(B)(3) provides. In these circumstances the full deference of the business judgment rule (effectively the standard of *Auerbach v. Bennett*) should apply. If the committee members are independent and engaged in a good faith investigation, their recommendation should be binding on the court. "[A] court should defer to an SLC's decision to settle a shareholder derivative action if (1) the members of the SLC possessed a disinterested independence and (2) the SLC's investigative procedures and methodologies were adequate, appropriate, and pursued in good faith."[279]

[275] Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

[276] *In re* Dollar Thrifty S'holders Litig., 14 A.3d 573, 598 (Del. Ch. 2010).

[277] *See supra* notes 42–47 and accompanying text.

[278] Auerbach v. Bennett, 393 N.E.2d 994, 1002 (N.Y. 1979).

[279] *In re* UnitedHealth Group Inc. S'holder Derivative Litig., 754 N.W.2d 544, 559 (Minn. 2008).

## V. CONCLUSION

The derivative claim serves a valid role in the jurisprudence of corporate law. It seeks to hold the managers of the corporation responsible for activities which may have harmed the corporation and indirectly its shareholders. Over the decades, concern for strike suits has resulted in a panoply of procedural devices obstructing the path of the derivative suit. The result today is costly litigation over preliminary issues unrelated to the merits of the claims, primarily over the issue of demand futility.

In addition, companies have employed the SLC as a means to terminate derivative actions. The problem with this method is the concern for structural bias in the process since the committees are composed of co-directors. Their past and expected continuing relationships with the defendant board members cause concern about their objectivity in acting on behalf of the corporation and its shareholders.

The Proposal addresses both of these issues directly. Recognizing the presumptive authority of the board to control corporate litigation, demand is required. Conceding, however, the concern over the credibility of the existing SLC process, the Proposal creates a new mechanism by which a board can address the derivative demand, formation of a SLC composed of independent persons unaffiliated with the company or any of the defendants in the litigation. Use of this independent committee can effectively deal with derivative claims in a manner that preserves the integrity of the process.

Finally, in place of the varying standards currently applied to review board or committee determinations in the derivative demand response context, the Proposal draws on the fundamental tri-partite standard of review employed by the courts in regular corporate matters. Depending on the level of conflict presented by the particular decision maker, the business judgment rule, the intermediate scrutiny standard of reasonableness or the duty of loyalty, strict scrutiny of entire fairness applies. Overall, the Proposal brings much needed clarity and credibility to a process currently subject to malleability and mistrust.