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Whose Corporation Is It, Anyway - Abolishing the Futility Exception in Derivative Litigation

Victor Arnell DuBose

WHOSE CORPORATION IS IT, ANYWAY? ABOLISHING THE FUTILITY EXCEPTION IN DERIVATIVE LITIGATION

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I. INTRODUCTION

Under the original Revised Model Business Corporation Act (RMBCA) and current Federal Rule of Civil Procedure 23.1, a shareholder seeking to bring a derivative action[1] against a corporation must first make demand on the corporation, or show why such demand would be futile or excused.[2] This demand serves as a formal request to the corporation's board of directors to take over the litigation or otherwise take action. The futility exception allows the shareholder to forego this requirement in various situations, including those in which the board or its members have a special interest in the action complained of, or are the target of the litigation itself.[3]

Two distinct and current "proposals" would require a mandatory demand in all cases, and both would abolish the futility exception. First, amendments to the RMBCA regarding derivative actions were recently approved by the Committee on Corporate Laws of the American Bar Association.[4] Under this amended RMBCA, the futility exception would be abolished, and demand would be required in every case.[5] State legislatures are free to add such a proposal to existing corporate statutes,[6] many of which are based on either the RMBCA or the Model Business Corporation Act (MBCA).[7] Second, the American Law Institute

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1. A derivative action is one brought by a shareholder for the corporation's "benefit," as when a corporation could assert rights against alleged wrongdoers to the corporation, but does not; whether the injury complained of may have been caused by parties outside the corporate structure, or by the corporation's own directors and officers, the plaintiff/shareholder "seeks enforcement of an obligation owed by the corporation to its shareholders . . . ." ROGER J. MAGNUSON, SHAREHOLDER LITIGATION § 8.01 (1984) [hereinafter SHAREHOLDER LITIGATION]; JACK H. FRIEDENTHAL ET AL., CIVIL PROCEDURE § 16.9 (1985) [hereinafter FRIEDENTHAL].

2. The relevant part of the original RMBCA is as follows:

> A complaint in a proceeding brought in the right of a corporation must be verified and allege with particularity the demand made, if any, to obtain action by the board of directors and either that the demand was refused or ignored or why [the person bringing the action] did not make the demand.

REVISED MODEL BUSINESS CORP. ACT § 7.40(b) (1984) [hereinafter RMBCA]. The relevant portion of Federal Rule of Civil Procedure 23.1 reads:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort.

FED. R. CIV. P. 23.1.

3. Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983) ("[d]emand is presumptively futile where the directors are antagonistic, adversely interested, or involved in the transactions attacked."); Lewis v. Curtis, 671 F.2d 779, 787 (3d Cir. 1982), *cert. denied*, 459 U.S. 880 (1982) (entire board of directors approved and participated in a "self-interested transaction," demand was presumed futile).

4. The amended RMBCA sections can be found in Committee on Corporate Laws, *Changes in the Model Business Corporation Act – Amendments Pertaining to Derivative Proceedings*, 45 BUS. LAW. 1241 (1990). For a further discussion see *infra* Westtext accompanying notes 113-43. The RMBCA which reflects these amendments is referred to herein as the "amended RMBCA."

5. Committee on Corporate Laws, *supra* note 4, § 7.42, at 1244.

6. The legislatures of Florida and Georgia have enacted statutes based on an earlier version of the amended RMBCA. *See* FLA. STAT. ANN. § 607.0741 (West Supp. 1991); GA. CODE ANN. § 14- 2-742 (Harrison Supp. 1989). The earlier version of the amended RMBCA is found in Committee on Corporate Laws, *Changes in the Model Business Corporation Act – Amendments Pertaining to Derivative Proceedings*, 44 BUS. LAW. 543 (1989). *See also* Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 500-01 n.218 (1990) [hereinafter Block, *Business Judgment Rule*].

7. *See, e.g.*, MISS. CODE ANN. § 79-4-7.40(b) (1989); CONN. GEN. STAT. §§ 33-282 to -418 (1987).

("ALI") has published tentative draft proposals of its Reporters which address both the demand requirement and additional aspects of derivative proceedings.[8] Though the ALI proposal differs in several respects from the amended RMBCA,[9] it also would require mandatory demand, absent a showing of irreparable harm to the corporation.[10]

The abolition of the futility exception could be cast as a major danger to the rights of minority shareholders seeking to bring derivative actions. A mandatory demand requirement could conceivably extend the deference to board decisions which can be found under the "business judgment rule."[11] Then again, the change could be viewed as one of procedure "only"—an altering of the "hoops" through which one must pass in order to bring such an action. On the other hand, such a change could bring greater judicial review to all derivative actions, in that courts might then give a more extensive examination to refusal of a demand made on the corporation, rather than placing more reliance on the business judgment of the corporation's board and/or that of a special litigation committee. If such review was given, perhaps a corporation would have greater difficulty in dispensing with even the more "frivolous"[12] actions brought against it.

This comment will present an overview of the current status and use of the demand requirement and futility exception, and examine the proposals for the latter's abolition, and the possible effects which the adoption of such could have on derivative litigation.

In addition to these proposals, a third attempt at mandatory demand was recently made and then rebuffed. In *Kamen v. Kemper Financial Services, Inc.*,[13] the Seventh Circuit abolished the futility exception in cases where the derivative action is based on federal substantive law.[14] A unanimous United States Supreme Court reversed, holding that the law of a corporation's state of incorporation should be applied so long as it is not inconsistent with the federal statute in ques-

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8. *See* American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* Tent. Draft No. 8, at 63-64 (1988) [hereinafter ALI, Tent. Draft No. 8]. This reference contains section 7.03, "Exhaustion of Intracorporate Remedies: the Demand Rule." *Id.*; *see also* ALI Tent. Draft No. 8, §§ 7.01-7.02, at 16-63, ALI Tent. Draft No. 8, §§ 7.04-7.15, at 81-233, which contains additional proposals on derivative proceedings; American Law Institute, *Principles of Corporate Governance* Tent. Draft No. 9 §§ 7.10 to 7.15 (1989) [hereinafter ALI, Tent. Draft No. 9].

The ALI demand rule proposal § 7.03 was approved by the ALI membership at its 1988 Annual Meeting. ALI, Tent. Draft No. 9, at 211 (appendix). However, each ALI Tentative Draft (Nos. 8 and 9) is labeled with disclaimers stating that the proposals do not represent the position of the ALI, and are subject to annual membership approval. *Id.* at i. It is assumed here that § 7.03 (the demand rule) is approved as is stated in Tent. Draft No. 9. *Id.* at 211.

9. For a discussion of the ALI Proposal see *infra* notes 144-67 and accompanying text.

10. ALI, Tent. Draft No. 9, *supra* note 8, § 7.03, at 211.

11. *See infra* notes 46-47 and accompanying text.

12. *See* SHAREHOLDER LITIGATION, *supra* note 1, at § 8.01 (derivative actions have "long been stigmatized as the refuge of strike suit artists specializing in corporate extortion"); Lewis v. Curtis, 671 F.2d at 779, 787 (3d Cir. 1982) ("strike suits" are in essence those filed by persons without regard to the accuracy of the charges so as to coerce settlement money from corporate management, which may prefer settling, to make the potential problems go away).

13. 908 F.2d 1338 (7th Cir. 1990), *rev'd*, 111 S. Ct. 1711 (1991).

14. *Kamen*, 908 F.2d at 1344.

tion.[15] While the reasoning and holding of the Seventh Circuit was summarily rejected by the Supreme Court in *Kamen*,[16] that rationale is still available to a state legislature and/or court wishing to reshape its demand requirement. Therefore, a background and analysis of both *Kamen* decisions is also given.[17] It will also be shown that the Supreme Court's holding in *Kamen* would not prevent a state from adopting a mandatory demand requirement.[18]

II. BACKGROUND AND LAW

A. Historical Background

The derivative suit is of longstanding tradition in jurisprudence, dating from the early nineteenth century in England and the latter half of that century in the United States.[19] The action is equitable in nature and origin,[20] and is "in essence nothing more than a suit by a beneficiary [the shareholder] of a fiduciary . . . as such."[21] On the one hand, the equitable ancestry of the action was reflected in a similar construction of the derivative action's requirements, such as particular attention to the facts of each case and the employment of a court's sound discretion in making determinations of whether the requirements were met.[22] However, concerns of corporate self-governance, allowing corporate disputes to be settled within the corporate structure to the extent possible, guarding against the proliferation of strike suits, and "avoiding unnecessary judicial involvement in the internal affairs of business organizations"[23] have also been given considerable weight by courts. A court could thus require a more stringent showing of judicial standing by the derivative plaintiff, and characterize the action as one requesting an "extraordinary remedy."[24] The court could also profess a reluctance to hear matters which, as viewed by the corporation's board, could be more properly handled in the corporate boardroom than in the judicial courtroom.[25]

The requirement that a demand be made on a corporation prior to bringing a derivative action was articulated in the early case of *Hawes v. Oakland*.[26] The plaintiff in *Hawes* was a stockholder in a waterworks company which apparently supplied free water to the City of Oakland in emergency situations, which the plaintiff claimed reduced the value of the stock.[27] The complaint was filed five

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15. Kamen v. Kemper Fin. Serv., Inc., 111 S. Ct. 1711, 1722-23 (1991).

16. *Id.* at 1720-23.

17. *See infra* notes 184-200, 201-22, 243-52 and accompanying text.

18. *See infra* notes 252-55 and accompanying text.

19. SHAREHOLDER LITIGATION, *supra* note 1, at § 8.01.

20. Cohen v. Industrial Fin. Corp., 44 F. Supp. 491, 494 (S.D.N.Y. 1942).

21. Goldstein v. Grossbeck, 142 F.2d 422, 425 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

22. *Cohen*, 44 F. Supp. at 494; Barr v. Wackman, 329 N.E.2d 180, 188 (N.Y. 1975) (whether demand requirement must be met is within sound discretion of first court to which the issue is presented).

23. 7C CHARLES A. WRIGHT AND ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 1831, at 119 (8th ed. 1986) [hereinafter WRIGHT AND MILLER, FEDERAL PRACTICE].

24. SHAREHOLDER LITIGATION, *supra* note 1, at § 8.01.

25. Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979).

26. 104 U.S. 450 (1881).

27. *Id.* at 450-51.

days after the plaintiff had complained in writing to the company's board and requested that the company "desist" from supplying the free water.[28] The Court stated that while a stockholder/plaintiff must allege actionable wrongdoing on the corporation's part as a foundation of the complaint, the stockholder must initially "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."[29] The Court required that a bona fide effort be made "to induce remedial action" by the corporate management, or by the stockholders, or show why such could not be accomplished or should not be required.[30]

The Court later held that such a demand could be excused if the effort would be futile,[31] and codified this holding in former Equity Rule 27 (1912).[32] However, in *Wathen v. Jackson Oil & Refining Co.*,[33] the Court also held that the grounds for foregoing with the demand on the corporation must be stated in the complaint.[34]

B. More to the Present[35]

The demand requirement in federal-based actions is found in Federal Rule of Civil Procedure 23.1, which was adopted in 1966 and made no substantive change to the requirement as expressed in earlier rules.[36] The RMBCA § 7.40, prior to amendment in 1989, required that demand be made on the board of directors or reason(s) alleged for not so doing. The former Model Business Corporation Act (MBCA) did not contain a demand requirement in its derivative section,[37] presumably leaving that matter to be addressed by other state law.[38] Whether the corporate statutes are based on the RMBCA, MBCA, or a variation of either, all

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28. *Id.* at 451, 461.

29. *Id.* at 460-61.

30. *Id.* at 461.

31. Delaware & Hudson Co. v. Albany & Susquehana R.R. Co., 213 U.S. 435, 452 (1909).

32. *See* Daniel R. Fischel, Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 171 n.23 (1976).

33. 235 U.S. 635 (1915).

34. *Id.* at 640-41.

35. It is noted that this comment is not intended as an extensive presentation of all the various nuances of the demand requirement, but focuses on the abolition of the futility exception to that requirement, and the policy considerations which accompany this proposed abolition. It is necessary to present material on the current status of demand-excused litigation and related topics, and information follows to that end. For more information on the demand requirement, *see, e.g.*, Fischel, *supra* note 32; Mark D. Seidelson, Note, *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 (1988); Deborah A. DeMott, *Demand in Derivative Actions: Problems of Interpretation and Function*, 19 U.C. DAVIS L. REV. 461 (1986); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746 (1960).

36. CHARLES A. WRIGHT, THE LAW OF FEDERAL COURTS § 73, at 488 (4th ed. 1983) ("pre-1966 decisions remain completely authoritative") [hereinafter WRIGHT, FEDERAL COURTS]. *But see Kamen*, 111 S. Ct. at 1716 ("although Rule 23.1 clearly *contemplates* both the demand requirement and the possibility that demand may be excused, it does not *create* a demand requirement of any particular dimension. On its face, Rule 23.1 speaks only to the adequacy of the shareholder representative's pleadings."). Therefore, under this latest holding of the Court, while Rule 23.1 may "contain" a demand requirement, the rule is not the source of it. *Kamen*, 111 S. Ct. at 1716.

37. *See supra* note 2; MODEL BUSINESS CORP. ACT § 49 (1978) [hereinafter MBCA].

38. *E.g.*, COLO. R. CIV. P. 23.1.

states require that demand be made on the board of directors, absent futility or excuse.[39]

Rule 23.1 allows for the necessity of demand on the shareholders of the corporation by the complainant, if required by state law.[40] The states take varying paths as to whether this demand is required, "although the growing trend appears to reject a shareholder demand requirement."[41] The reasons for having a shareholder demand are similar to that of demand on directors, including enhancing the possibility that the shareholders themselves might take any needed remedial measures at a shareholders meeting, or decide no action was warranted after all.[42] Among the jurisdictions requiring shareholder demand, several require that the shareholders "ratify," or approve, the action challenged by the derivative plaintiff, unless the shareholders are powerless to do so.[43]

Demand on a board of directors may be excused under the "futility" exception for a variety of reasons. Justifications for excusal may include the antagonism or hostility of the directors toward the complaint, the self-interest of the directors in the action complained of, that the board is under the influence of a controlling shareholder named as the alleged wrongdoer, and that the board approved the transaction complained of, or denies that it occurred.[44] These reasons may not, however, be deemed sufficient to excuse demand in a given case, especially if the plaintiff failed to allege a justification for futility with "particularity," i.e., with the basis for excuse appearing "in the pleading itself."[45] If the demand is made and refused, that refusal may be viewed as dispositive by a court as an extension of the "business judgment" rule.[46] Judicial deference may be given to that rule even if no demand is made due to futility if an "independent" or "special litigation commit-

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39. WRIGHT, FEDERAL COURTS, *supra* note 36, at 488.

40. FED. R. CIV. P. 23.1.

41. WRIGHT AND MILLER, FEDERAL PRACTICE, *supra* note 23, § 1832, at 123-24. Mississippi, whose Business Corporation Act is based on the RMBCA, does not require shareholder demand. MISS. CODE ANN. § 79-4-7.40(b) (1989). Likewise, neither (former) RMBCA § 7.40 nor the current amended version § 7.42, require shareholder demand. RMBCA § 7.42 (amended 1989). The Official Comment to § 7.42 notes that demand is to be made on the "corporation," which it says will usually be the board of directors, but could be an officer of the corporation. Committee on Corporate Laws, *supra* note 4, at 1245; *see also* DeMott, *supra* note 35, at 462, 474-84.

42. WRIGHT AND MILLER, FEDERAL PRACTICE, *supra* note 23, § 1832, at 121-22.

43. *Id.* at 124; *see, e.g.*, RICHARD W. JENNINGS & HAROLD MARSH, SECURITIES REGULATION 1083 (6th ed. 1987) (where derivative action was based on Rule 10b-5 of the Securities Exchange Act of 1934 no shareholder demand was required, since shareholders "could not ratify a violation of the Federal Securities laws," (citing Dopp v. American Elec. Lab., Inc., 55 F.R.D. 151, 155 (S.D.N.Y. 1972))). The practitioner involved in a derivative action must be aware, of course, of the particular shareholder demand requirements, if any, of the state in which the action may be brought. This comment, however, is primarily concerned with demand on the directors or corporation.

44. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 365, at 1069 (3d ed. 1983).

45. *In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 263 (1st Cir. 1973), *cert. denied*, 414 U.S. 857 (1973) (plaintiff cannot plead in general terms, hoping to later make a case through discovery or otherwise).

46. HENN & ALEXANDER, *supra* note 44, at 1070. The business judgment rule "is 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." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citing Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. 1971)).

tee" of the board recommends that the suit is not in the corporation's best interests.[47]

1. Treatment of the Futility Exception in Federal Courts

Derivative actions are brought in federal courts either on the basis of federal substantive law or diversity of citizenship. Federal courts vary in their determinations regarding the futility exception, as between circuits, on the basis of whether the underlying law applied is federal or state (or some of both),[48] and due to differing interpretations given to the reasons for futility named above.[49]

One situation in which the futility exception has been granted involves cases in which either a significant number of or a majority of the board either acquiesced in the conduct complained of, or were allegedly under the influence of controlling shareholders who were the named defendants. "The question is whether, given the composition and structure of the board, it would be futile to expect it to respond to the shareholder's concerns."[50] In *Clark v. Lomas & Nettleton Financial Corp.*,[51] the Fifth Circuit held that because the controlling shareholders were named defendants, and those shareholders picked the board which would have entertained any demand request made, the futility of the demand was presumed.[52] The First Circuit recently excused demand in a case in which the two defendants constituted the entire board of directors of a small corporation, were the majority shareholders of both that corporation and others named as defendants, and who personally profited from the wrongdoing charged.[53] In *Lewis v. Curtis*,[54] the Third Circuit held that since the complaint alleged that all the directors approved of and took part in the challenged activity, and that activity was an interested transaction for the directors, demand would be excused.[55] "When a complaint alleges . . . that all the directors participated in and approved of a self-interested transaction, and sets

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47. HENN & ALEXANDER, *supra* note 44, at 1070, 1074. The "independent" committee, which may be aided by "independent" counsel or other experts, may investigate the alleged wrongdoing, and if done with independence in fact and in good faith, its recommendation may receive deference from the court through the business judgment rule. *Id.* at 1074. The operation and reach of such committees goes beyond the scope of this comment, but general information is presented along with cases pertinent to the futility exception.

48. *See, e.g., Kamen*, 908 F.2d at 1341-42; Johnson v. Hui, 752 F. Supp. 909, 912 (N.D. Cal. 1990).

49. *See supra* text accompanying notes 44-47.

50. WRIGHT AND MILLER, FEDERAL PRACTICE, *supra* note 23, at 115.

51. 625 F.2d 49 (5th Cir. 1980).

52. *Clark*, 625 F.2d at 53 (citing Abbe v. Goss, 411 F. Supp. 923, 924-25 (S.D.N.Y. 1975) (demand excused where 44% of outstanding shares were owned by three defendants); *In re* Penn Cent. Secs. Litig., 367 F. Supp. 1158, 1164-65 (E.D. Pa. 1973) (80% of shares owned by one defendant, demand excused)).

53. Marquis Theatre Corp. v. Condado Mini Cinema, 846 F.2d 86, 90-91 (1st Cir. 1988) (noting that it reached the same conclusion in a case in which half of a corporation's board were interested parties (citing Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22 (1st Cir. 1978))).

54. 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).

55. *Curtis*, 671 F.2d at 787.

forth in detail facts showing [the self-interest of the directors], any demand must be presumed futile."[56]

Contrary to the *Lomas & Nettleton* decision, the Second Circuit held that demand was not excused although one defendant was president and chairman of the board of the corporation in question, had chosen all but one of the directors, and owned 71% of the company's voting shares.[57] The court stated that "[t]he complaint must further indicate that the majority shareholder controls the votes of the board."[58] Ownership of the majority of the corporation's shares, and, apparently, choosing most all of the board's directors, did not "automatically" make demand futile.[59] This circuit had already held in *Lewis v. Graves*[60] that mere acquiescence and approval by the board of the challenged action, without specific allegations of bias or self-dealing by a majority of that board, was not sufficient to establish demand futility.[61] To most courts, the mere naming of the directors of the derivative corporation as defendants also does not excuse demand solely on the premise that the directors "would have to decide whether to sue themselves."[62] Absent bias such as where the directors have wrongly taken part in a self-interested transaction or one "completely undirected to a corporate purpose,"[63] which would make demand futile, the suit should usually be dismissed.[64]

The cases involving the futility exception illustrate that the plaintiff must make specific allegations having some basis other than mere accusation in order to have demand excused. The decisions may vary within or among circuits on grounds of factual differences, with the cases stating many of the same presumptions and requirements, such as that of self-interested transactions and the need for particular-

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56. *Id.* (citing Vernars v. Young, 539 F.2d 966, 968 (3d Cir. 1976)) (demand required "where the allegations do not make charges against a majority of a Board"); *see also* deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1228 (10th Cir. 1970) (in accord with district court's conclusion that demand was excused in merger context, in which survivor corporation was so dominated by defendants that demand would have been futile).

57. Kaster v. Modification Sys., Inc., 731 F.2d 1014, 1015-16, 1019 (2d Cir. 1984).

58. *Id.* at 1019.

59. *Id.* at 1020. However, the court also held that the district court erred in not allowing the plaintiffs to amend their complaint. *Id.* at 1015.

60. 701 F.2d 245 (2d Cir. 1983).

61. *Id.* at 248 (while stating that demand is presumptively futile if the directors are "antagonistic, adversely interested, or involved in the transactions attacked").

62. Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 943 (3d. Cir. 1982), *vacated*, 465 U.S. 1001 (1984); *accord*, Lewis v. Sporck, 612 F. Supp. 1316, 1323 (N.D. Cal. 1985); Kaufman v. Safeguard Scientifics, Inc., 587 F. Supp. 486, 489 (E.D. Pa. 1984).

63. Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1210 (9th Cir. 1980) (quoting *In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 265 (1st Cir. 1973)); *see also* Gaubert v. Federal Home Loan Bank Bd., 863 F.2d 59, 65, 67-68, 70 (D.C. Cir. 1988) (mere acquiescence of board did not excuse demand even though the savings and loan association had been placed in federal receivership; plaintiff must make particularized showing that board members would not give impartial hearing to his claim for demand to be futile); Landy v. FDIC, 486 F.2d 139, 147-48 (3d Cir. 1973) ("When a corporation is in receivership, any demand to bring suit in its behalf must be made upon the receiver rather than the directors," general allegation of demand futility was "merely a vague, conclusory statement.").

64. *Greenspun*, 634 F.2d at 1210.

ized allegations.[65] However, in *Smith v. Gordon*,[66] the court characterized the circuit "majority position" as the approach taken in cases such as *In re Kauffman Mutual Fund Actions*,[67] requiring the specificities of bias or self-dealing.[68] The "minority position" would be represented by the Fifth Circuit's *Clark v. Lomas & Nettleton Financial Corp.*[69] and the Tenth Circuit case of *deHaas v. Empire Petroleum Co.*,[70] holding for a broader possibility of demand excusal.[71] While the issue of demand futility can be a matter of factual dispute, the issue is one for the trial court to decide in its "sound discretion."[72] That decision is reviewed by the appeals court on an abuse of discretion standard.[73]

Another issue in cases brought in a federal venue is the application of state and federal law to the demand requirement and futility exception. The issue involves a question of which law, state or federal, is to apply—first, as to whether demand should be required or excused, and also whether the plaintiff's complaint has met the particularity requirement of Rule 23.1 of the Federal Rules of Civil Procedure.[74] The answer regarding the particularity requirement would seem settled, in that whether a complaint met the requirements of a federal rule of procedure would be decided by federal law.[75] However, whether the source of the demand requirement is from state or federal law and whether the requirements for pleading demand or futility are to be considered under state or federal law are matters which have attracted differing views.[76] "Many federal courts have apparently assumed that the federal procedural rule [23.1] establishes both the pleading guidelines as well as the substantive contours of the underlying demand requirement."[77]

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65. *See, e.g.*, Johnson v. Hui, 752 F. Supp. 909, 912-13 (N.D. Cal. 1990) (alleging that directors would have to sue themselves is insufficient to excuse demand; however, held futile where six of the eight directors were accused of "profiting from insider trading"); Burt on Behalf of McDonnell Douglas v. Danforth, 742 F. Supp. 1043, 1047-48 (E.D. Mo. 1990) (merely naming directors as defendants fails to excuse demand; however, where plaintiff alleges that "*entire* board has been engaged in a conspiracy to violate federal laws," and board "would have to sue itself for engaging in illegal activity," the demand should be excused); First Am. Bank & Trust by Levitt v. Frogel, 726 F. Supp. 1292, 1298 (S.D. Fla. 1989) (plaintiff alleged directors' and officers' liability insurance policy prohibited board from instituting suit on corporation's behalf against any director or officer; inside directors had 40% of voting power; demand held futile).

66. 668 F. Supp. 520 (E.D. Va. 1987).

67. 479 F.2d 257, 265 (1st Cir. 1973); *see also* Lewis v. Graves, 701 F.2d 245, 248-49 (2d Cir. 1983); Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1209-10 (9th Cir. 1980).

68. *Smith*, 668 F. Supp. at 522-23; *see also In re Kauffman*, 479 F.2d at 264-65 (mere participation or approval by directors not enough to excuse demand, otherwise, FED. R. CIV. P. 23.1 would be rendered "virtually meaningless").

69. 625 F.2d 49 (5th Cir. 1980).

70. 435 F.2d 1223 (10th Cir. 1970).

71. *See supra* text accompanying notes 51-52, 56.

72. *deHaas*, 435 F.2d at 1228.

73. Peller v. Southern Co., 911 F.2d 1532, 1536 (11th Cir. 1990) (so reviewing denial of motion to dismiss under FED. R. CIV. P. 23.1); Starrels v. First Nat'l Bank of Chicago, 870 F.2d 1168, 1170 (7th Cir. 1989) (if no error of law was made, review demand requirement under abuse of discretion standard).

74. *In re* Bank Am. Secs. Litig., 636 F. Supp. 419, 421 (C.D. Cal. 1986).

75. *Id.* at 421 (federal law should determine whether sufficient particularity has been shown).

76. *Id.* (citations omitted).

77. *Gaubert*, 863 F.2d at 63 (citing Greenspun v. Del E. Webb Corp., 634 F.2d 1204, 1208-10 (9th Cir. 1980); *In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 263 (1st Cir. 1973)).

Some courts, however, have considered whether "*state* corporate law must provide the source of" the substantive requirement, rather than using Rule 23.1 for that purpose.[78] In *Daily Income Fund, Inc. v. Fox*,[79] the United States Supreme Court did not reach this issue in holding that Rule 23.1 did not apply to an action brought under section 36(b) of the Investment Company Act of 1940,[80] meaning no demand was required.[81] In his concurrence, Justice Stevens stated that Rule 23.1 did not *require* a demand, but only that the complaint meet the particularity requirement as to whether a demand had been made or not.[82] He added that "the Rule concerns itself solely with the adequacy of the pleadings; it creates no substantive rights."[83]

The Supreme Court's holding in *Kamen*[84] reflects the view expressed by Justice Stevens in *Daily Income*.[85] In *Kamen*, the Court stated that Rule 23.1 does not "abridge, enlarge or modify any substantive right."[86] The Court also stated that the function of the demand requirement was clearly a matter of "substance" rather than "procedure,"[87] and that Rule 23.1 does not itself "create" a demand requirement.[88] The Court in *Kamen* held that in a derivative action founded on federal law, a court should apply the demand/futility doctrine of the state of incorporation, unless federal law clearly indicated otherwise, or the application of such state law would be "inconsistent with the policies underlying the federal statute."[89]

In the actual decision of a given case, the federal/state choice-of-law matter may amount only to "a distinction without a difference."[90] Under a "federal" standard or state substantive law, the requirement of a demand or provision for excuse may be basically the same, meaning the result in a given case would be the same under either application.[91]

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78. *Id.* at 63-64 (citations omitted).

79. 464 U.S. 523 (1984).

80. 15 U.S.C. § 80a-35(b) (1982).

81. *Daily Income*, 464 U.S. at 542.

82. *Id.* at 543 (Stevens, J., concurring).

83. *Id.* at 543-44 (Stevens, J., concurring). Justice Stevens also stated that the demand requirement itself, rather than Rule 23.1, being "designed to improve corporate governance," was "one of substantive law." *Id.* at 544 n.2. *But see In re Kauffman*, 479 F.2d at 263 (quoting Barlett v. New York, N.H. & H.R.R., 109 N.E. 452, 456 (Mass. 1915)) ("[Rule 23.1] is not a technical rule of pleading, but one of substantive right.").

84. 111 S. Ct. 1711 (1991).

85. 464 U.S. at 542-43 (Stevens, J., concurring).

86. 111 S. Ct. at 1716 (quoting 28 U.S.C. § 2072(b) (1990)).

87. *Id.*

88. *Id.*

89. *Id.* at 1717-18, 1722.

90. Smith v. Gordon, 668 F. Supp. 520, 522 (E.D. Va. 1987).

91. *Gaubert*, 863 F.2d at 64 (court found "no meaningful differences between the prevailing 'federal' standard" and that of Texas law); *Smith*, 668 F. Supp. at 522 ("For all practical purposes, there is no difference between the demand requirements of federal and Virginia law"); *In re BankAmerica*, 636 F. Supp. at 421 (state law applied, though court noted parenthetically that the decision of the case would not differ under federal analysis).

2. State Law Under the Delaware Approach

The evaluation of demand futility is interrelated with both the weight given to the business judgment rule,[92] and the status of the corporation's board, in terms of having "interested" directors or "disinterested" directors to transactions allegedly involving self-dealing or conflicts of interest.[93] Also crucial to this area are the use and role of special litigation committees in the process of handling either a demand for action from a shareholder, or the latter's effort to establish sufficient excuse for not making such a demand.[94] The significance which is given to the business judgment rule, and/or the recommendation of a board's special litigation committee, and the burden on the plaintiff in attempting to establish demand futility have been heavily litigated and the subject of much judicial review.[95] The Delaware approach to these issues is presented due to the influence of Delaware corporate law throughout the nation, and the high level of corporate activity within that state.[96]

The historic case of *Zapata Corp. v. Maldonado*[97] set out a two-step process to be followed in derivative actions in which a majority of the board was "interested" in the transaction or wrong complained of: First, the court was to examine the independence and good faith of the special litigation committee appointed by the board to make recommendations on the complaint, and the burden was on the corporation to show reasonable investigation of the wrongful action alleged.[98] If the committee indeed lacked independence or did not show a reasonable basis for findings made in good faith, then the action could not be dismissed on the basis of the special litigation committee's recommendation.[99] If, however, independence and a good faith, reasonable basis were shown, the court "may proceed, in its discretion,"[100] to the second step: The court would determine whether the suit should be dismissed, applying "its own independent business judgment,"[101] amounting to a review of the complaint on the merits.

In *Aronson v. Lewis*[102] the Delaware Supreme Court answered a question that it stated was left unanswered in *Zapata:* When would a demand be excused as futile when a shareholder sought to bring a derivative suit.[103] The court addressed the question as being "inextricably bound" to issues of the business judgment rule,

92. *See supra* note 46; *see also infra* notes 104-07 and accompanying text.

93. *See infra* notes 104-07 and accompanying text.

94. Spiegel v. Buntrock, 571 A.2d 767, 773-74 (Del. 1990).

95. *See, e.g., Kamen*, 908 F.2d at 1344.

96. Michael P. Dooley and E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503 (1989) (noting that over half of the Fortune 500 companies are incorporated in Delaware).

97. 430 A.2d 779 (Del. 1981).

98. *Id.* at 788.

99. *Id.* at 789.

100. *Id.*

101. *Id.*

102. 473 A.2d 805 (Del. 1984).

103. *Id.* at 807.

which it defined as "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."[104] As this presumption can serve to protect a board from protracted inquiry by a court into the validity of that judgment, the court added that this protection could be claimed only by "disinterested directors whose conduct otherwise meets the tests of business judgment," in terms of a lack of self-dealing and personal profit from a transaction, other than one shared by the corporation or stockholders in a general sense.[105] If a majority of the board was not disinterested, and thus unable to approve the questioned transaction, then the business judgment rule was inapplicable. The court stated the standard to be followed as: "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."[106] Mere approval by directors of the challenged transaction, standing alone, would not suffice to show reasonable doubt, nor would a contention that the directors would have to sue themselves in order to take the proper action.[107] In a later case the court declined to formulate criteria for what would constitute "reasonable doubt," preferring a fact-based, case-by-case analysis at the trial court level.[108]

If the plaintiff falls short of meeting this burden through sufficiently particularized allegations, then demand is not excused and must be made on the directors. Once the demand is required, the board may choose to investigate the complaint itself or appoint a special litigation committee ("SLC") for that purpose. The conclusion of the SLC in that instance is not to be reviewed judicially. "Judicial review of the merits of a special litigation committee's decision to refuse a demand is limited to those cases where demand upon the board of directors is excused and the board has decided to retain control of litigation through the use of an independent special litigation committee."[109] Therefore, the only issues in the Delaware demand-required context are the reasonableness of the SLC's investigation and its good faith. "By electing to make a demand, a shareholder/plaintiff tacitly concedes the independence of a majority of the board to respond."[110] Therefore, while not going as far as the highly deferential approach of New York in *Auerback v. Ben-*

104. *Id.* at 812.

105. *Id.*

106. *Id.* at 814.

107. *Id.* at 817-18 (the latter being the so-called "bootstrap" argument).

108. Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988).

109. *Spiegel*, 571 A.2d at 778.

110. *Id.* at 777; *see also* Donald E. Pease, *Aronson v. Lewis: When Demand is Excused and Delaware's Business Judgment Rule*, 9 DEL. J. CORP. L. 39 (1984); Dooley & Veasey, *supra* note 96, at 504-12.

nett,[111] the weight given by the Delaware court to the determinations of an SLC is considerable, particularly if the plaintiff cannot show that the refusal was "wrongful."[112]

III. Abolition of the Futility Exception

A. The Amended RMBCA

Subchapter D, an amendment to the Revised Model Business Corporation Act, was adopted in December of 1989 by the Committee on Corporate Laws ("the Committee") of the American Bar Association Section of Business Law.[113] The amendment replaces section 7.40 of the RMBCA, and contains substantive changes for both the demand requirement issue[114] and the stay of proceedings in derivative suits.[115] The amendment also provides for dismissal of such actions,[116] a matter not previously addressed by the RMBCA.[117]

1. The Demand Requirement of Amended RMBCA Section 7.42

This section states that written demand on a corporation will be a prerequisite in *all* derivative actions; there is no provision for a showing of excuse or futility.[118] According to the Official Comment, this mandatory demand and the ninety-day waiting period between its submission and the commencement of a suit will give the directors, independent or not, the chance to reexamine the allegedly wrongful action and take any corrective action necessary.[119] In addition, the delay and expense spent litigating whether demand is excused or required is eliminated. The ninety-day period is proposed as a reasonable wait, and one which can be shortened on a showing of threat of irreparable injury to the corporation.[120] The Committee characterized the granting of demand excusal as a rarity anyway, and stated

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111. 393 N.E.2d 994, 1000 (N.Y. 1979). The approach of *Auerbach* is apparently alive and well in New York, *see, e.g.*, Levandusky v. One Fifth Ave. Apartment Corp., 553 N.E.2d 1317, 1321 (N.Y. 1990) (business judgment rule of *Auerbach* applied as standard of judicial review to actions of condominium governing board; applied by analogy); Rosen v. Bernard, 485 N.Y.S.2d 791, 793 (N.Y. App. Div. 1985) (in a derivative setting, the independence of the SLC and its methods of investigation, being possibly dispositive, warrant granting a limited hearing solely for those issues).

112. *See* Dooley & Veasey, *supra* note 96, at 509 (wrongful refusal must be pleaded with same particularity as is required for demand excusal).

113. *See* Committee on Corporate Laws, *supra* note 4, at 1241 (the amendment is reprinted in full along with the Committee's Official Comment).

114. *Id.* at 1244 § 7.42.

115. *Id.* at 1246 § 7.43.

116. *Id.* at § 7.44.

117. *Id.* at 1241.

118. *Id.* at 1244. Section 7.42 reads in full:

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

RMBCA § 7.42.

119. Committee on Corporate Laws, *supra* note 4, at 1244.

120. *Id.* at 1244-45.

that "[m]any plaintiffs' counsel as a matter of practice make a demand in all cases rather than litigate the issue whether demand is excused."[121]

While section 7.42 is a marked departure from former section 7.40(b), which by implication allowed a futility exception to making demand,[122] the new section also *allows* the derivative shareholder to still bring the action even if demand is refused.[123] If the corporation refuses the demand or does not respond, the plaintiff can commence a derivative action at the end of the ninety-day period. However, if the corporation accepted the demand and filed suit, or after the shareholder brought suit decided to assume control, the shareholder's involvement as a principal to the litigation ends, absent a showing that the company would not sufficiently handle the matter.[124] If the corporation does not assume control, but instead begins an "inquiry" into the allegations, a stay of proceedings can be obtained from the court, before or after the action has commenced.[125]

It should be noted that the demand under section 7.42 is to be made on "the corporation" rather than the directors or shareholders. Although the directors or their designee are usually the appropriate body to receive and review a demand, the amendment allows for the possibility that an officer of the corporation would be the proper person to examine the demand request.[126]

2. Dismissal of Derivative Actions – Amended RMBCA Section 7.44

Neither the prior RMBCA nor the MBCA specifically provided for the dismissal of derivative actions in cases where demand was properly refused, and did not address the effect of a determination by an independent special litigation committee (SLC) to move for dismissal of such suits.[127] The amended RMBCA provides for dismissal "if there is a proper determination that the maintenance of the proceeding is not in the best interests of the corporation."[128] Such a determination can be made in response to the demand, prior to suit, or after the suit begins on the basis of the complaint's allegations.[129] Section 7.44 provides several mechanisms

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121. *Id.* at 1244; *see also* Dooley & Veasey, *supra* note 96, at 509.

122. The relevant portion of section 7.40(b) of the former RMBCA read as follows:

> (b) A complaint in a proceeding brought in the right of a corporation must be verified and allege with particularity the demand made, if any, to obtain action by the board of directors and either that the demand was refused or ignored or why he did not make the demand.

RMBCA § 7.40(b) (1984).

123. Committee on Corporate Laws, *supra* note 4, § 7.42, at 1244.

124. *Id.* at 1245-46. The irreparable injury exception to the ninety-day period would require a showing similar to that required for the granting of a preliminary injunction. Time of expiration of any applicable statute of limitations might also be grounds for reducing the ninety days. Only a single demand is necessary to put the board on notice for the alleged need for corrective measures, and the person making the demand and the shareholder bringing the suit do not necessarily have to be the same. *Id.*

125. *Id.* at 1246. "If the corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for such a period as the court deems appropriate." *Id.* at § 7.43 ("Stay of Proceedings").

126. *Id.* at 1245.

127. *Id.* at 1247-48; *see also* former RMBCA § 7.40 (1984); MBCA § 49.

128. Committee on Corporate Laws, *supra* note 4, at 1248.

129. *Id.*

through which the inquiry and determination can be made, including by a majority of independent directors if such constitutes a quorum, or a majority of an SLC composed of at least two independent directors, quorum or not, or by one or more court-appointed independent persons selected to conduct the inquiry.[130]

The Official Comment states that the term "independent" director necessarily includes "disinterested," in that the director should have "no interest" in the questioned transaction.[131] However, the category is not limited to "outside" directors not employed by the corporation.[132] In addition, the amendment expressly rejects case holdings of the "minority" view[133] which would allow the "interest" of a director to be shown on the basis of naming directors as defendants of the derivative action, or due to mere "approval" of the act in question, if done without personal benefit to that director, or by a showing that a director was elected by others named as defendants in the suit.[134]

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130. *Id.* at 1246-47; RMBCA § 7.44 reads in full:

(a) A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsections (b) or (f) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation. (b) Unless a panel is appointed pursuant to subsection (f), the determination in subsection (a) shall be made by:

(1) a majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum; or

(2) a majority vote of a committee consisting of two or more independent directors appointed by majority vote of independent directors present at a meeting of the board of directors, whether or not such independent directors constitute a quorum.

(c) None of the following shall by itself cause a director to be considered not independent for purposes of this section:

(1) the nomination or election of a director by persons who are defendants in the derivative proceeding or against whom action is demanded;

(2) the naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded; or

(3) the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

(d) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of independent directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met.

(e) If a majority of the board of directors does not consist of independent directors at the time the determination is made, the corporation shall have the burden of proving that the requirements of subsection (a) have been met. If a majority of the board of directors consists of independent directors at the time the determination is made, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

(f) The court may appoint a panel of one or more independent persons upon motion by the corporation to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

RMBCA § 7.44 (amended 1989).

131. Committee on Corporate Laws, *supra* note 4, at 1248 (the "no interest" means a lack of personal benefit from the challenged transaction, other than "one which devolves upon the corporation or the shareholders generally").

132. *Id.*

133. *See supra* text and cases accompanying notes 50-56.

134. Committee on Corporate Laws, *supra* note 4, § 7.44(c)(1)-(3), at 1247. Subsection (f) of section 7.44 provides for a court-appointed independent panel which could conduct the inquiry, upon the motion of the corporation. This provision could be useful to a corporation which does not have any independent directors, or does not wish to appoint new directors merely for the purpose of "creating" disinterested slots. *Id.* at 1247, 1249.

The term "inquiry" is used in section 7.44(a), rather than "investigation," to provide a more flexible framework for the corporation's consideration of the demand and/or suit. The group conducting the inquiry may need only make a limited examination of certain complaints, while a more intensive effort may be required regarding others, depending on the facts and allegations.[135] The focus is to be on the "good faith" in which both the inquiry and determination were made, and "the inquiry intended by this phrase goes to the spirit and sincerity with which the investigation was conducted, rather than the reasonableness of its procedures or basis for conclusions."[136]

If a demand is rejected prior to suit being brought, the plaintiff must then establish by alleging particular facts that either the majority of the board was not independent at the time of the section 7.44(a) "determination," or that the subsection's requirements have not been met.[137] The burden of proof regarding those requirements is on the plaintiff in the case of an independent board majority, and on the corporation if the majority is not independent—in each instance, "independence" relates to the time of the determination, not the alleged wrongful transaction.[138] The Committee states that these subsections as to board independence and the resultant burden of proof follow the first prong of the *Aronson* test.[139] Significantly, the amendment does not allow for the second inquiry of *Aronson*, that of whether the transaction was the product of a "valid exercise of business judgment."[140] "The Committee believes the only appropriate concern in the context of derivative litigation is whether the board considering the demand has a disabling conflict."[141] The word "reasonable" in section 7.44(a) modifies "inquiry," not the ultimate determination of that inquiry, and this section does not authorize courts to review whether the determination itself was reasonable.[142]

The amended RMBCA as set out above represents a definite change from the present "demand excused-demand refused" dichotomy.[143] The plaintiff must always make demand under this proposal, though a derivative action can theoretically still be brought on refusal, albeit through the strictures of judicial deference to the corporation's refusal, absent an "interested" majority or a lack of good faith.

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135. *Id.* at 1246, 1249-50.

136. *Id.* at 1250 (Official Comment) (quoting Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795, 800 (E.D. Va. 1982)).

137. Committee on Corporate Laws, *supra* note 4, § 7.44(d), at 1247, 1251 ("[t]he board's response to the shareholder's demand is presumptively protected by the traditional business judgment rule . . . . The plaintiff must allege with particularity a lack of good faith, care, independence or disinterestedness by the directors in responding to the demand.") *Id.* at 1251.

138. *Id.* at 1247, 1250 (section 7.44(e)).

139. *Id.* at 1251; Aronson v. Lewis, 473 A.2d 805 (Del. 1984); *see supra* text accompanying notes 105-06.

140. Committee on Corporate Laws, *supra* note 4, at 1247; *Aronson*, 473 A.2d at 814; *see also supra* note 94.

141. Committee on Corporate Laws, *supra* note 4, at 1252 (amended RMBCA) (citing Starrels v. First Nat'l Bank of Chicago, 870 F.2d 1168, 1172-76 (7th Cir. 1989) (Easterbrook, J., concurring)).

142. *Id.*

143. *See* Dooley & Veasey, *supra* note 96, at 507-09.

B. ALI Proposal

The American Law Institute has also put forth proposals regarding the demand requirement and dismissal of derivative proceedings. These proposals are part of the ALI's corporate governance project, and are referred to herein as "the ALI proposal."

1. The Demand Requirement of the ALI Proposal

Consistent with the amended RMBCA in this respect, the ALI proposal requires a written demand in all cases, unless the plaintiff has made a satisfactory showing that irreparable injury would result to the corporation.[144] This demand is to be presented specifically to the board of directors, rather than the "corporation" as under section 7.42 of the amended RMBCA. The ALI demand rule, section 7.03, also states that demand on shareholders should not be required.[145]

The comment to section 7.03 states that a universal demand rule should be adopted for three main reasons. First, a mandatory demand rule "would eliminate much of the collateral litigation that . . . slows the pace and increases the cost of litigation."[146] Foregoing with any dispute over demand futility would allow the merit of the action, if any, to be reached sooner and more efficiently.[147] Second, the cost to the plaintiff in making the demand is minimal, and the demand provides the board an opportunity to take corrective action,[148] which may serve as "a form of alternative dispute resolution."[149] Third, the ALI proposal rejects the deferential standard of judicial review employed by Delaware in demand-required situations.[150] This proposal provides instead for a "variable standard of judicial scrutiny,"[151] which can extend to the merits of the action, rather than the more deferential review standard of section 7.44 of the amended RMBCA.[152] Therefore, although the futility exception is eliminated, the plaintiff does not necessarily face

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144. The ALI demand rule reads as follows:

> [Section] 7.03 Exhaustion of Intracorporate Remedies: the Demand Rule (a) Before commencing a derivative action, a holder . . . should make a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective action, unless demand is excused under [§] 7.03(b). The demand should give notice to the board with reasonable specificity of the essential facts relied upon by the holder to support the allegations made therein.
>
> (b) Demand on the board should be excused only when the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result. A plaintiff who is excused from making demand prior to the filing of the action should make demand on the board as provided in [§] 7.03(a) promptly thereafter.
>
> (c) Demand on shareholders should not be required.

ALI, Tent. Draft No. 9, *supra* note 8, at 211 (appendix). This section was approved by the ALI membership at its 1988 annual meeting. *Id.*

145. *Id.*

146. ALI, Tent. Draft No. 8, *supra* note 8, § 7.03 cmt., at 64 (1988).

147. *Id.* at 64-65.

148. *Id.* at 65.

149. *Id.* (quoting Lewis v. Graves, 701 F.2d 245, 247 (2d Cir. 1983)).

150. ALI, Tent. Draft No. 8, *supra* note 8, at 65; *see supra* notes 109-12 and accompanying text.

151. ALI, Tent. Draft No. 8, *supra* note 8, at 119. The subject of judicial review is addressed *infra* notes 163-67 and accompanying text.

152. *See supra* notes 135-36, 140-42 and accompanying text.

a higher possibility of dismissal simply by making the required demand. The comment of the ALI proposal states that continuance of the futility exception is not justified, even in a case in which the entire board is interested in the alleged wrongdoing, because even in that situation the board is not "powerless to act."[153] The board could add new disinterested directors and appoint them to consider the demand request,[154] or could request the court to appoint an independent panel.[155] "[H]ence demand is still an appropriate starting point."[156]

2. Termination of Derivative Proceedings – The ALI Proposal

Section 7.08 of the ALI proposal addresses termination of derivative actions.[157] After a demand has been made, the board must first determine which body will respond to the request: (1) the board itself, minus any interested directors, (2) a committee of disinterested directors, who may be appointed by an inter-

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153. ALI, Tent. Draft No. 8, *supra* note 8, at 70-71.

154. *Id.*

155. *Id.* Provision for appointment of this panel is found at section 7.12. *See* ALI, Tent. Draft No. 9, *supra* note 8, at 63 (1989).

156. ALI, Tent. Draft No. 8, *supra* note 8, at 71.

157. Section 7.08 is as follows:

> Termination of Actions Against Directors, Senior Executives, Controlling Persons, or Associates Based on Action Taken by the Board or a Committee:
>
> The court should dismiss a derivative action against a defendant who is a director . . . a senior executive . . . a person having control . . . over the corporation, or an associate . . . of any such person, if the court determines in response to a motion made on behalf of the corporation by its board of directors, or a properly delegated committee thereof, that the conditions set forth below in paragraphs (a), (b) and (d) have been satisfied:
>
> (a) The procedures specified in [§] 7.10 for the conduct of an internal evaluation of the action were substantially complied with (either in response to a demand or following commencement of the action), or any material departures therefrom were justified under the circumstances.
>
> (b) Based on adequately supported determinations that the court deems to warrant reliance, the board of directors or committee reasonably concluded (either in response to a demand or following commencement of the action) that dismissal is in the best interest of the corporation.
>
> (c) In evaluating whether the board's or committee's determinations warrant reliance and the reasonableness of the board's or committee's conclusions, the court (i) may consider any relevant information as to material developments occurring subsequent to the time of demand or the board's or committee's report; (ii) should independently review any conclusions of law upon which the determinations of the board or the committee were based and any related legal matters; and (iii) where the conduct of the defendant is alleged to have violated a duty set forth in Part IV (Duty of Care), but did not involve a knowing and culpable violation of law by the defendant, should accept any determinations and conclusions as to business matters, unless the plaintiff establishes that such determinations and conclusions are so clearly unreasonable as to fall outside the bounds of the directors' discretion.
>
> (d) Dismissal of the action would not permit a defendant, or an associate [§ 1.02] thereof, to retain a significant improper benefit where:
>
> (1) the defendant, either alone or collectively with others who are also found to have received a significant improper benefit arising out of the same transaction, possesses control of the corporation; or
>
> (2) such benefit was obtained:
>
> (A) as the result of a knowing and material misrepresentation or omission or other fraudulent act; or
>
> (B) without authorization of such benefit by disinterested directors or authorization or ratification by disinterested shareholders, in breach of § 5.02 ("Transactions with the Corporation") or § 5.04 ("Use of Corporate Information, Non-Public Information Concerning the Corporation, or Corporate Property").

ALI, Tent. Draft No. 9, *supra* note 8, at 212-14. This section was approved by the ALI membership at its 1988 annual meeting. *Id.* at 211.

ested board, or (3) a panel appointed by the court upon the board's request, as per section 7.12.[158] The responding body then essentially has five alternatives from which to choose in handling the demand: (1) it may reject the demand in whole or in part, or (2) attempt to reach a settlement with the "potential defendants," or (3) take corrective action in response to the allegations of the demand, and later request dismissal of any suit which may be filed, or (4) take over the suit itself, or (5) permit the party making demand to file suit.[159] Regarding the first three options, a written report complying with section 7.10[160] must be filed with the court. The depth required of both the evaluation made for (or by) the board regarding the demand, and the accompanying report will depend on the "gravity and plausibility" of the demand's allegations.[161] The submission of this evaluation and report to the court are prerequisites to a request by the board for a dismissal of a suit, under the first three alternatives noted above.[162]

Under section 7.08(c) the judicial review given to a derivative action filed after the demand will *differ* according to whether the action is based on a breach of the defendant's duty of care, or a breach of the duty of loyalty.[163] In a duty of care case, "the court should accept adequately supported findings [of the board or its evaluating body] as to business matters, even if the court itself [would not so conclude], unless the findings are so clearly unreasonable as to fall outside the bounds of the directors' discretion."[164] Therefore, in duty of care cases a court would give deferential review to the judgment of a properly constituted board or committee, absent compelling factors to the contrary.[165] This same deference, however, would not extend to duty of loyalty cases, which typically involve knowing violations of the law or willful misconduct. The ALI proposal states that such cases merit "a closer judi-

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158. ALI, Tent. Draft No. 8, *supra* note 8, at 126.

159. *Id.*

160. Section 7.10 is as follows:

> [Section] 7.10 Board Procedures for Termination of Derivative Actions. (a) In deciding whether an action should be dismissed under [§ 7.08] the court should require that:
>
> (1) The determinations and conclusions of the board or committee were based upon an evaluation that was adequately informed under the circumstances, conducted by the board or a committee of two or more directors, none of whose members was interested . . . in the transaction or the alleged wrong that is the subject of the demand or the action, and who as a group were capable of objective judgment under the circumstances;
>
> (2) The board or committee was assisted by a counsel of its choice . . . and such other agents as it reasonably deemed necessary; and
>
> (3) The board or committee prepared and submitted to the court a written report or other written submission meeting the standards specified in § 7.08(b).

ALI, Tent. Draft No. 9, *supra* note 8, § 7.10, at 33-34. This is the version which was approved by the ALI membership at its 1989 annual meeting. *See* Block, The Business Judgment Rule, *supra* note 6, at 502-03 n.220.

161. ALI, Tent. Draft No. 8, *supra* note 8, § 7.10 cmt., at 126-27; *see also* ALI, Tent. Draft No. 9, at 37, 42-43.

162. ALI, Tent. Draft No. 8, *supra* note 8, at 126.

163. *Id.* at 120.

164. *Id.* at 122. The burden of showing this unreasonableness is on the plaintiff. ALI, Tent. Draft No. 9, *supra* note 8, § 7.08(c), at 214.

165. A duty of care case could be based, for example, on an alleged lack of proper business judgment where a major corporate investment proved to be unsuccessful. If the action was protected under the business judgment rule, then the court would defer to the board or committee's judgment, if substantial compliance with section 7.10 procedures is shown. ALI, Tent. Draft No. 8, *supra* note 8, at 133.

cial scrutiny," and that the deference, if any, given to the board should be less.[166] How "close" this judicial review would be would apparently depend on the gravity of the alleged wrongdoing, and whether a majority of the board was involved in the claimed misconduct.[167]

While a form of deferential review is part of the ALI proposal, this proposal generally contemplates a higher amount of involvement by the judiciary. That involvement could include review of the merits of a complaint to a greater degree than that provided in the amended RMBCA, particularly in duty of loyalty cases.

C. The Kamen *Cases*

A recent federal case provided a third avenue in which a mandatory demand rule was promulgated. In *Kamen v. Kemper Financial Services, Inc.*,[168] the Seventh Circuit held that where a "claim for relief is based on federal substantive law,"[169] and the demand requirement comes from "federal common law,"[170] demand is required in all such cases,[171] and the futility exception to demand is abolished.[172] In a unanimous decision authored by Justice Marshall, the United States Supreme Court reversed,[173] holding that the demand/futility doctrine of the state of incorporation should be applied in this context,[174] and that the Court of Appeals had erred in pronouncing a "uniform federal common law rule" in this situation.[175] The facts of this case and the Seventh Circuit's opinion will be addressed first, and the Supreme Court's decision will follow.

1. Background of the Case

The defendant in this case was an investment adviser for a money market fund subject to federal regulation[176] under section 36(b) of the Investment Company Act of 1940.[177] The Act provides that such advisers have a fiduciary duty, requiring honest dealing, regarding their compensation for services rendered.[178] Kamen, the plaintiff and an investor in the fund, filed suit under section 36(b) of the Act claiming that the defendant had charged excessive fees in its management of the fund.[179] Kamen also claimed that the fund's solicitation of investor approval of the

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166. *Id.* at 134-35.

167. *Id.* at 135 (disavowing a uniform standard of review for all duty of loyalty cases, and choosing not to word the review in terms of the court's "independent business judgment," as was used in *Zapata*, 430 A.2d at 789).

168. 908 F.2d 1338 (7th Cir. 1990), *rev'd*, 111 S. Ct. 1711 (1991).

169. *Kamen*, 908 F.2d at 1342.

170. *Id.* at 1344.

171. *Id.*

172. *Id.* at 1344, 1347.

173. Kamen v. Kemper Fin. Serv., Inc., 111 S. Ct. 1711, 1723 (1991).

174. *Id.* at 1722-23 (meaning the state of incorporation of the corporation on whose behalf the derivative action has been brought).

175. *Id.* at 1718, 1723.

176. *Kamen*, 111 S. Ct. at 1715; *Kamen*, 908 F.2d at 1339.

177. 15 U.S.C. § 80a-35(b) (1982).

178. *Id.*

179. *Kamen*, 111 S. Ct. at 1714-15; *Kamen*, 908 F.2d at 1339; 15 U.S.C. § 80a-35(b) (1982).

adviser's fee structure was done through the use of a proxy statement which was materially misleading,[180] in violation of section 20(a) of the Investment Act.[181] The claim was eventually dismissed on class action grounds pertinent to the section 36(b) claim,[182] but the Seventh Circuit stated that the appeal presented questions in addition to the class action issue, only one of which is relevant here: whether the section 20(a) claim, regarding the allegedly misleading proxy solicitation, should be dismissed for failure to make a demand on the fund's directors, in light of the requirements of Rule 23.1 of the Federal Rules of Civil Procedure.[183]

2. The Seventh Circuit's Holding and Rationale

In an opinion by Judge Easterbrook, the Seventh Circuit interpreted Rule 23.1 of the Federal Rules of Civil Procedure as not creating a demand requirement, but only governing the pleading requirements of a demand or why such was not made.[184] As the plaintiff's section 20(a) claim was one grounded in federal substantive law, the court stated that federal law should also govern the demand requirement.[185] The court did consider the possibility of importing a state law demand requirement, since the fund was a Maryland corporation, but instead used "federal common law."[186] The court held that no federal precedent required the court to adhere to an acknowledgement of the futility exception, and that none of the usual grounds for excusal justified its continued existence.[187] The exception had produced "gobs of litigation," and "sapped the potential role of the demand requirement as an alternative dispute resolution mechanism."[188] The possibilities of interested directors who would not sue themselves should demand be made, a board determined not to sue on a claim it would view as undesirable, or directors whose judgment could be impaired by self-dealing or corporate intimidation were all held to be inadequate reasons for allowing lack of demand due to futility.[189] "The time has come to do away with it. If demand is useful, then let the investor make one; if indeed futile, the board's response will establish that soon enough."[190] The court cited with approval the American Law Institute's effort to do away with the futility exception,[191] and also apparently concluded that a plain-

180. *Kamen*, 111 S. Ct. at 1715; *Kamen*, 908 F.2d at 1340.

181. 15 U.S.C. § 80a-20(a) (1982).

182. *Kamen*, 908 F.2d at 1340. The first district judge to hear the case dismissed the section 20(a) claim for lack of a demand on the fund's board of directors; following this dismissal, the Seventh Circuit refused to grant a mandamus order, and certiorari was denied by the United States Supreme Court. *Id.* The second district judge to hear the case (on the section 36(b) claim) then dismissed the action on the grounds that the plaintiff was an inadequate representative for a class action. *Id.* at 1340.

183. *Id.*

184. *Id.* at 1341.

185. *Id.* at 1342.

186. *Id.* The court ruled that Kamen's "suggestion" that Maryland law be applied "came too late," as this point was not raised until in her reply brief. *Id.*

187. *Id.* at 1344-47.

188. *Id.* at 1344.

189. *Id.* at 1344-45.

190. *Id.* at 1344.

191. *Id.* (citing ALI, Proposal, Tent. Draft No. 8 (1988)).

tiff could still proceed with a derivative action once demand was made and refused.[192]

Also significant in the Seventh Circuit's opinion was the rejection of Delaware's "demand-refused"/"demand-excused" dichotomy as applied to the standard of judicial review, which Judge Easterbrook termed "[the] link between the making of a demand and special deference to the board's decision not to sue."[193] In a Delaware demand-refused situation, the burden of *Aronson v. Lewis*[194] can be insurmountable for a plaintiff shareholder. "Except in extraordinary cases . . . tendering a demand to the board puts the plaintiff out of court under Delaware law. No wonder plaintiffs stoutly resist making demands."[195] However, the court also stated that a board's decision to refuse demand should be reviewed in light of state corporate law,[196] which would seem to make its review distinction more apparent than real, particularly since the business judgment standard the court would apply is that which "ordinarily applies to corporate decisions."[197]

Abolition of the futility exception, according to the court, would bring any real controversy, rather than hypothetical scenarios of such, to the forefront,[198] and would reduce the possibility of the demand requirement becoming "the centerpiece of the litigation."[199] Judge Easterbrook's opinion was foreshadowed by his concurrence a year earlier in *Starrels v. First National Bank of Chicago*.[200]

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192. *Id.* at 1345 (the plaintiff can argue wrongful refusal of demand, while "the board will stand on the business judgment rule. The court will resolve the question on the merits rather than trying to treat it as a procedural hurdle.").

193. *Id.* at 1343 ("In Delaware, the Mother Court of corporate law, any shareholder who makes a demand is deemed to concede that demand was required." (citing Spiegel v. Buntrock, 571 A.2d 767, 775 (Del. 1990); Stotland v. GAF Corp., 469 A.2d 421 (Del. 1983))).

194. 473 A.2d 805, 813 (Del. 1984); *see also supra* notes 102-07 and accompanying text.

195. *Kamen*, 908 F.2d at 1343.

196. *Id.* at 1347.

197. *Id.*

> If the directors run the show, then they must control litigation (versus other remedies) to the same extent as they make [other] business decision[s] . . . . If principles such as the 'business judgment rule' preserve room for managers to err in making an operational decision, so too they preserve room to err in deciding what remedies to pursue.

Id. at 1343.

198. *Id.* at 1344 ("futility is the usual sticking point" in the demand requirement context). "Courts predictably have great difficulty in deciding who is right when, as is usual, it must decide such questions on the pleadings." *Id.*

199. *Id.* at 1342. "Demand then becomes a threshold issue in every derivative suit, one that must be resolved in advance of discovery and on the basis of a good deal of speculation about what the board might do." *Id.* at 1343-44.

200. 870 F.2d 1168, 1172-76 (7th Cir. 1989) (Easterbrook, J., concurring). The *Starrels* court, applying Delaware law, held that the plaintiff's complaint did not state with particularity facts entitling her to excusal from demand. *Id.* at 1172. Judge Easterbrook concurred in the opinion, and offered a lengthy critique of the demand requirement and futility exception. That this was a "foreshadowing" of his opinion in *Kamen* is perhaps an understatement. Several sections of the two opinions read either word for word or with close similarity. *Compare Starrels*, 870 F.2d at 1173-74 (Easterbrook, J., concurring) with *Kamen*, 908 F.2d at 1342-43.

3. The Supreme Court's decision in *Kamen*

The United States Supreme Court unanimously reversed the Seventh Circuit's decision to create a mandatory federal demand rule.[201] The Court rejected both the source and the content of the Seventh Circuit's demand rule, and held that proper weight had not been given to state law regarding the demand requirement.[202]

The Court stated that Rule 23.1 of the Federal Rules of Civil Procedure was not the source of a demand requirement, although it also stated that the rule "clearly *contemplates* both the demand requirement and the possibility that the demand may be excused."[203] The Court also stated that the demand doctrine was a matter of substance rather than procedure, given its role in and effect on derivative actions.[204] As this was a suit under the Investment Company Act of 1940, a federal statute, the paramount issue was identifying "the source and content of the substantive law that defines the demand requirement in such a suit."[205]

While the applicable demand requirement in a suit based on federal law is to be governed by federal law, the Court also stated that the content of that rule was not necessarily to be "wholly the product of a federal court's own devising."[206] Throughout *Kamen*, the Court relied heavily on its prior decision in *Burks v. Lasker*.[207] The question in *Burks* was whether independent directors could terminate a nonfrivolous suit brought under the Investment Company Act.[208] The *Burks* Court held that federal courts should apply state law to this question so long as that law was not inconsistent with the policies of the federal statute.[209] In *Kamen* the Court used this principle in ruling on the universal demand requirement, holding that a federal court which formulates "federal common law" to close the gap in a federal statute, should use *state* law unless that conflicts with the policies of the statute in question.[210] In applying the *Burks* principle, the Court ruled that the Seventh Circuit drew its universal demand rule from an inappropriate source—namely, the ALI proposal.[211] The Court also stated that the universal demand rule would increase the power of directors to dismiss corporate litigation, contrary to the laws of many states which provide for a futility exception.[212]

The Seventh Circuit had attempted to separate the requirement for demand from the deferential review standard given to directors in demand-required situa-

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201. Kamen v. Kemper Fin. Serv., Inc., 111 S. Ct. 1711, 1723 (1991).

202. *Id.* at 1720-23.

203. *Id.* at 1716.

204. *Id.*

205. *Id.* at 1716-17.

206. *Id.* at 1717.

207. 441 U.S. 471 (1979).

208. *Id.* at 484-86.

209. *Id.* at 485-86. "Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute." *Id.* at 478.

210. *Kamen*, 111 S. Ct. at 1722.

211. *Id.* at 1719-20.

212. *Id.* at 1720.

tions under the law of Delaware and other states.[213] The Supreme Court also rejected that attempt at "legal reform," stating that such a measure "would impose upon federal courts the very duty 'to fashion an entire body of federal corporate law' that *Burks* sought to avoid."[214] The Court also noted the uncertainty which could accompany such a federal review standard, particularly in cases in which federal and state law claims were joined in the same derivative action.[215] The shareholder could be faced with the possibility of having demand required for federal law claims but not for state claims based on the same transaction.[216]

The Seventh Circuit had touted the mandatory demand rule as a time-saver and a measure of reducing "needless" litigation, as a required demand would eliminate having to decide whether such demand would be futile.[217] The Supreme Court, however, held that such supposed "judicial economies" were simply overstated. A universal demand rule would "merely shift the focus of the threshold litigation from the question whether demand is excused to the question of whether the directors' decision to terminate the suit is entitled to deference under federal standards."[218] The Court again held that such a displacement of state law would not justify the alleged advantages of a mandatory demand requirement, in light of *Burks*.[219]

Finally, the Court rejected the possibility that a futility exception would be inconsistent with the policies underlying the Investment Company Act. The imposition of mandatory demand in this context would actually give directors of these investment companies "*greater* power to block shareholder derivative litigation than these actors possess under the law of the State of incorporation."[220] The Court concluded that there was no such policy in the federal statute which could justify such a rule. Therefore, the Court reversed the Seventh Circuit's decision and remanded the case because the lower court had never considered whether the shareholder's complaint sufficiently met the futility exception under Maryland state

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213. *See supra* notes 195-99 and accompanying text.

214. *Kamen*, 111 S. Ct. at 1721 (quoting Burks v. Lasker, 441 U.S. 471, 480 (1979)).

215. *Id.*

216. *Id.* (noting that the board of directors would face a dilemma of their own in not knowing the level of deference they would be afforded given the differing review standards). A Second Circuit opinion which came after the Seventh Circuit's decision in *Kamen*, but before the Supreme Court's review of *Kamen* is RCM Securities Fund, Inc. v. Stanton, 928 F.2d 1318 (2d Cir. 1991). In *RCM*, the Second Circuit considered and rejected the attempted "reform" of the Seventh Circuit in *Kamen*. The Second Circuit used a *Burks* reasoning similar to the Supreme Court's in applying state law to questions of the demand requirement in a derivative action based on both federal securities law and Delaware corporate law. *RCM*, 928 F.2d at 1324, 1326-27.

> If a state demand requirement were to apply to state claims and a federal demand requirement were to apply to federal claims, a plaintiff bringing a derivative suit based on a single transaction might well be subject to a demand requirement as to one legal theory while excused from making a demand as to another legal theory.

Id. at 1327.

217. *See supra* notes 190-92 and accompanying text.

218. *Kamen*, 111 S. Ct. at 1721.

219. *Id.* at 1721-22.

220. *Id.* at 1722. The Court had stated that even given the principles of *Burks* it would be "constrained to displace state law" if it had concluded that a futility exception would be inconsistent with policies of the Investment Company Act. *Id.*

law.[221] Ironically, on remand the Seventh Circuit ruled that the directors' opposition to the suit did not excuse demand, and that the plaintiff/shareholder had not adequately pleaded futility.[222]

IV. ANALYSIS

A. The Proposals On the Table

The amended RMBCA and the ALI proposal both contain departures from current law regarding the demand requirement and exceptions to demand. Most basically, each abolishes the futility exception and requires demand to be made to the corporation in every instance. In addition, each addresses the type and standard of judicial review to be employed in derivative actions.

1. The Amended RMBCA

The amended RMBCA, Subchapter D,[223] could be viewed as the opening of one door and the closing of another in derivative litigation. The plaintiff may still bring suit even after a demand refusal, which is a broader approach than the deference given in Delaware to a board refusal of demand.[224] However, what section 7.42 of the amended RMBCA gives in this regard is taken away in section 7.44 concerning dismissal of the action: Unless the plaintiff can establish a claim within the only two allowable "windows of opportunity," then the suit is dismissed. One of the possible challenges to the demand refusal is the lack of an independent board majority at the time of the refusal. The other is a claim that the board or committee's determination lacked good faith or reasonable inquiry.[225] Since the court is not to inquire as to the reasonableness of the actual determination made by the board or committee regarding the suit, this deference may leave the "independence" of the determining body as the only attainable ground on which the suit could proceed.[226] The review standard also explicitly rejects the *Zapata* reasoning which would allow a court to apply its "own business judgment,"[227] and the more strict second prong of *Aronson*, which would examine the merits of the transaction in light of the business judgment rule.[228] While *Aronson* calls for a "reasonable doubt" burden regarding the directors' independence,[229] the amended RMBCA provides for a "no doubts considered" standard as to the merits of a challenged transaction.[230] The new subchapter also repudiates the so-called "minority view" line of federal cases which have held that the naming of directors as defendants, or

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221. *Id.* at 1723 n.10.
222. Kamen v. Kemper Fin. Serv., Inc., 939 F.2d 458, 462 (1991), *cert. denied*, 112 S. Ct. 454 (1991).
223. *See* Committee on Corporate Laws, *supra* note 4, at 1241.
224. *See supra* notes 109-12 and accompanying text.
225. Committee on Corporate Laws, *supra* note 4, at 1247.
226. *Id.* at 1250-52. Perhaps instead of two windows, there is but one window and a porthole.
227. *Zapata*, 430 A.2d at 789; *see supra* text accompanying note 101.
228. *Aronson*, 473 A.2d at 814; *see supra* text accompanying note 106.
229. *Aronson*, 473 A.2d at 814.
230. Committee on Corporate Laws, *supra* note 4, at 1252.

controlling shareholders who control the board as defendants could suffice to meet an excusal for demand.[231] Regarding whether such persons are "independent" for purposes of evaluating the demand, section 7.44 requires a higher showing of self-interest or lack of independence.[232]

Provision for a court-appointed, independent person or persons as the demand evaluator does offer hope for objectivity and fairness. However, this mechanism is available only on the motion of the corporation, not the plaintiff shareholder, although the Official Comment adds that the court is free to appoint a special master to consider the matter, subject to the state's rules of civil procedure.[233]

The new RMBCA subchapter on demand and dismissal of derivative actions represents an express effort to curtail the amount of such litigation, as well as the type, given the restrictions noted above. Whether this model act would be so applied in practice remains to be seen. The practitioner should be aware of the current status of his or her state's business corporation statute, and the changes the amended RMBCA could entail for that statute. In addition, the possibility that only part of the revised act's amendment would be adopted by a legislature could lead to a mixed situation in terms of mandatory demand and a review standard either less deferential or more so than that of the amended act.[234]

2. The ALI Proposal

The ALI proposal, like the amended RMBCA, makes demand mandatory, and also allows for the filing of a derivative suit if demand was refused. It is markedly different from the amended RMBCA and the Delaware approach in several respects. The ALI proposal encompasses a higher level of judicial involvement, a broader scope of judicial review, and less deference to justifications advanced by the board under the business judgment rule.[235] Depending on one's perspective, these aspects could be viewed as an effort to "level the playing field" of derivative litigation – the futility exception is discarded, but a "closer judicial scrutiny" of the substance of the plaintiff's allegations takes its place. To the corporate observer, however, the field is probably level enough as it is, and the ALI proposal would mean increased "judicial meddling" in areas a board would rather have cloaked in the business judgment rule, and afforded great deference by a court. On the other hand, if a minority stockholder seeking to bring a derivative claim had to choose between a Delaware demand-required situation, the amended RMBCA, or the ALI proposal, he or she would most probably choose the latter.

What the ALI proposal and the amended RMBCA have in common is that regarding even a derivative action which would clearly meet the futility exception

231. *See supra* text accompanying notes 50-56.

232. Committee on Corporate Laws, *supra* note 4, § 7.44(c)(1)-(3), at 1247.

233. *Id.* at 1249.

234. *See also* Block, *Business Judgment Rule*, *supra* note 6, at 499, 501.

235. *See supra* notes 163-67 and accompanying text.

under Delaware or other existing law, demand must still be made.[236] While the ALI proposal offers the best chance to the derivative plaintiff for merit review of her claim,[237] it is fair to ask why demand should be required in a case where it would almost certainly be futile—particularly when the demand requirement carries with it a process advantageous to the status quo which may be charged with the wrongdoing in the first place. However, if futility is not to be an option, the ALI proposal increases the derivative stockholder/plaintiff's opportunity for positive action.

The ALI proposal has been roundly criticized by some commentators for going too far in its departure from Delaware law[238] and the confines of the business judgment rule.[239] One criticism concerns the heightened judicial review afforded to duty of loyalty cases under the ALI proposal.[240] Another is that the ALI proposal grossly underestimates the added cost to derivative proceedings which this process could entail.[241] Finally, these commentators charge that the ALI's proposal is based on a theory of structural bias—that regardless of the actual "independence" of a board or committee, the ALI presents a process of heavier judicial review, due to an alleged inherent bias in the board setting.[242]

3. The *Kamen* Decisions

The Seventh Circuit in Kamen stated that it "follow[ed] the tradition of *Hawes* and use[d] federal common law" in its approach to the issue of demand futility.[243] The court acknowledged the Supreme Court cases which followed *Hawes* and "arguably" adopted a futility exception prior to *Erie Railroad Co. v. Tompkins*,[244] but

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236. ALI, Tent. Draft No. 9, *supra* note 8, § 7.03, at 211; Committee on Corporate Laws, *supra* note 4, § 7.42, at 1244-45 (amended RMBCA); *Kamen*, 908 F.2d at 1344, 1347.

237. ALI, Tent. Draft No. 8, *supra* note 8, at 120-21.

238. *See* Dooley & Veasey, *supra* note 96. The authors compare existing Delaware law with the ALI proposal, and offer a searing critique of the latter. As Professor Dooley and Mr. Veasey point out, both are members of an ABA ad hoc committee designated to examine that proposal; the Committee on Corporate laws, which formulated the amended RMBCA, is also a committee of the ABA. *Id.* at 503 n.1. In addition, the authors noted that Mr. Veasey is counsel of record for General Motors' outside directors in several derivative cases. *Id.* at 508 n.26.

239. *See* Block, *Business Judgment Rule*, *supra* note 6, at 503, 505-07 (citing Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current Act Proposals Compared*, 44 BUS. LAW. 503, 534-35, 537-40 (1989)).

240. Dooley & Veasey, *supra* note 96, at 537 (duty of care versus duty of loyalty distinction does not affect the judgment of those "assessing the conduct of someone else after the fact. To advance this argument in favor of closer judicial review of board decisions on loyalty matters is to assert that independent directors are more likely to risk their reputations to excuse cheating than to excuse carelessness.").

241. *Id.* at 524-29, 531-32. Interestingly, both the ALI proposal and the Amended RMBCA contain provisions for awarding costs against a party pleading in bad faith, or pursuing a claim without reasonable cause. ALI Tent. Draft No. 8, *supra* note 8, § 7.05, at 93-94; Committee on Corporate Laws, *supra* note 4, § 7.46, at 1253-54 (amended RMBCA).

242. I.e., that the "independent" litigation committee named by the board cannot help but be slanted in favor of the board. *See* Dooley & Veasey, *supra* note 96, at 534-37; Block, *Business Judgment Rule*, *supra* note 6, at 504-07. *But see* ALI, Tent. Draft No. 8, *supra* note 8, at 124-25 (the termination proceedings and review of Section 7.08 "does not depend on the view one takes on the issue of 'structural bias' ").

243. *Kamen*, 908 F.2d at 1342. *Hawes* is the landmark case which stated a demand requirement. Hawes v. Oakland, 104 U.S. 450, 460-61 (1881); *see also supra* text accompanying notes 26-30.

244. Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938). "There is no federal general common law." *Id.* at 72.

stated that the cases did not prevent "the evolution of the federal common law."[245] The court also stated that these cases were interpreting former equity rules no longer of consequence today, despite the fact that these rules were more than "arguably" consistent precursors of present Rule 23.1 of the Federal Rules of Civil Procedure.[246] The court also concluded that Rule 23.1 does not "create" a federal demand requirement, but governs only what the complaint says in addressing the demand matter.[247] While the Supreme Court also stated that Rule 23.1 does not itself "create" such a requirement,[248] the Rule's express language acknowledges both the demand requirement *and* an exception to the making of that demand: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort."[249] To conclude that no futility exception exists would seem to make the above language of Rule 23.1 at least superfluous, if not meaningless.[250] Nevertheless, the Seventh Circuit stated that the trend of the 1970s, and continuing today, that of the development and use of "independent" litigation committees (SLCs) in handling demand matters, "washed away" any assumption of the early cases as to the incompetence of interested directors to act on demands. That those directors may have taken part in the alleged wrongdoing, and/or formed that "independent" committee themselves, was of no real consequence to the court. The court continued down this winding path to create some "federal common law" of its own – the abolition of the futility exception.[251]

The Supreme Court squarely rejected both the Seventh Circuit's universal demand rule and the process through which the lower court had formulated the rule. The Court also held that, independent of any state law concerns under *Burks*, the futility exception to the demand requirement did not frustrate the policies of the Investment Company Act.[252] The Court had noted in its opinion that only a handful of states require a mandatory demand.[253] If the law of one of these mandatory demand states had been the underlying state law, one can speculate as to whether the Supreme Court would have held as it did. In other words, if the amended RMBCA or the ALI proposal were enacted in a state whose law provided the basis for defining the demand requirement, would the Supreme Court stay with the

245. *Kamen*, 908 F.2d at 1346.

246. *See* WRIGHT, FEDERAL COURTS, *supra* note 36, at 488 (Rule 23.1 made no substantive change of previous rules pertinent to derivative actions, and was intended to not alter the procedural balance already established; "pre-1966 decisions remain completely authoritative"); Fischel, *supra* note 32, at 171 n.23 (tracing the evolution of former Equity Rule 94 to the present Rule 23.1).

247. *Kamen*, 908 F.2d at 1341.

248. *Kamen*, 111 S. Ct. at 1716.

249. FED. R. CIV. P. 23.1; *see also Kamen*, 111 S. Ct. at 1716.

250. Under the Seventh Circuit's interpretation of Rule 23.1 in *Kamen*, there could be no viable "reasons" for not making a demand. *Kamen*, 908 F.2d at 1344.

251. *Id.* at 1346-47.

252. *Kamen*, 111 S. Ct. at 1718, 1720, 1722.

253. *Id.* at 1719 n.7 (Maryland, whose law was to apply as the state of incorporation, is not among those states).

Burks reasoning and allow that law to define the federal demand requirement? It appears possible under the reasoning of the Supreme Court in *Kamen* to take a federally based derivative claim, mix it with a state-law based mandatory demand requirement, and end up with a mandatory demand requirement at the federal level. However, a plaintiff bringing a federal derivative claim subject to another state's law, i.e., one *not* requiring a mandatory demand, could have an entirely different result.

The Supreme Court held in *Kamen* that the futility exception was not inconsistent with the policies of the Investment Company Act.[254] If the Court were presented with a state-based mandatory demand rule in the future, it would seem inconsistent for the Court to hold that such a rule also did not conflict with the policies of that Act. The Court placed strong emphasis on state corporate law and the use of that law in formulating federal law as it applied to the demand requirement.[255] In no way did the Court hold that states were not free to adopt mandatory demand rules, and it did not speculate as to how it would view such rules in derivative actions based on federal substantive law.

B. Assumptions and Realities

1. Independence "vanished in the haze" . . .[256]

One commentator briefly described the operation of a special litigation committee this way: "The 'independent' litigation committee . . . investigates the shareholder derivative action, usually with the aid of 'independent' special counsel, accountants, and other experts . . . . The very appointment of the committee may involve an inherent conflict of interest."[257] The amended RMBCA, the ALI proposal, and the Seventh Circuit's *Kamen* rationale all reject the possibility that a truly "independent" special litigation committee simply may not be forthcoming from the same group which both selects and compensates the SLC, and to which the SLC is to give its "independent" inquiry and/or investigation.[258] If such an inherent conflict is present in the creation and operation of SLCs, it is not given significance under any of those scenarios.

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254. *Id.* at 1722.

255. *Id.* at 1718-21.

256. Adapted from the musical composition "Help!", written by John Lennon & Paul McCartney. THE BEATLES, *Help!* on THE BEATLES/1962-1966 *(Capitol/EMI 1973)*.

257. HENN & ALEXANDER, *supra* note 44, § 367, at 1074, 1077. In an earlier case, speaking to the appointment of directors by a controlling shareholder after a wrong had been alleged, the district judge stated:

> The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority. Where we know that puppet directors would at best only go though the motions, are we barred from considering who would be manipulating the wires?

Cohen v. Industrial Fin. Corp., 44 F. Supp. 491, 494 (S.D.N.Y. 1942)

258. Committee on Corporate Laws, *supra* note 4, at 1246-49 (amended RMBCA); ALI, Tent. Draft No. 8, *supra* note 8, at 70-71, 173-74; *Kamen*, 908 F.2d at 1344-45.

The Seventh Circuit observed that the demand requirement and the futility exception are all too often the center of litigation, rather than the actual merits of a given case.[259] The court also stated that questions raised by plaintiffs as to the independence of those handling the demand matter detracted from "the real issues."[260] However, if self-interest and possible lack of independence by directors or others considering demand requests (or claims of futility) are not relevant questions, one must ask just what "the real issues" are of which the court spoke. That this whole process will go more smoothly and produce less litigation should not justify a demand process which may bury merited claims, particularly those which may be "inextricably intertwined" with a bias of the board.

Possibly the real conclusion to be made here is that if the interest of the directors and/or a lack of independence on their part is not a real cause for concern, and a high level of deference to those directors' business judgment is to be given to their original conduct and their consideration of the requested derivative claim—a deference which may exclude any real merit review, then the survival of an effective derivative claim, even a meritorious one, is in extreme doubt under the "new wave" of mandatory demand. The point may be to indeed foreclose such claims, unless the board happens to agree with the premises of the complaint and will take it forward. While the Seventh Circuit did stress the need to get to "the merits" of a complaint, whether it would be possible to do just that under that court's interpretation of the business judgment rule is doubtful. In addition, the same concern is raised by the process of the amended RMBCA. While the Seventh Circuit endorsed the ALI proposal, the court's methodology and deferential view of board independence is more akin to that of the amended RMBCA. Although both the Seventh Circuit's result and method of reaching it in *Kamen* were solidly renounced by the Supreme Court in its opinion,[261] that rationale is available for adoption by either a state legislature formulating a demand requirement or a state court interpreting such.[262] In fact, the Official Comment of the amended RMBCA borrowed from a similar Easterbrook rationale.[263]

It well may be unworkable to answer "it can't be done" to the question of how can a corporation form an independent-in-fact SLC. However, there is a strong analogy to be made between an "independent" SLC, sworn to objective inquiry of the corporation which both formed it and pays its fees, and the use of expert wit-

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259. *Kamen*, 908 F.2d at 1342.

260. *See id.* at 1345 ("Framing questions about the independence of the directors as exceptions to the demand requirement diverts attention from the real issues.").

261. *Kamen*, 111 S. Ct. at 1718-23.

262. *See Kamen*, 908 F.2d at 1346 ("Although none of these [prior circuit] opinions dispenses with the exception altogether, the day is at hand—unless decisions of the Supreme Court bar the way."). The Court's decision in *Kamen* did just that, although applying state law adopted from the amended RMBCA or the ALI proposal could yield the same result the Seventh Circuit sought.

263. *See supra* notes 141, 200 and accompanying text. The Official Comment cited with approval the same portion of Judge Easterbrook's concurrence in *Starrels*, 870 F.2d at 1173-74, which reads quite similarly to his rationale in *Kamen*, 908 F.2d at 1342-43. Committee on Corporate Laws, *supra* note 4, at 1252 (amended RMBCA).

nesses in the trial setting: Yes, the experts testifying at trial are "experts," but everyone at the trial knows or learns for whom the expert is testifying, and that he or she is being compensated for the appearance. And, to be sure, the party presenting the expert would not have him or her on the stand unless the party knew the testimony would be favorable to the party's case. While the expert may be presented at trial as an "independent" expert, surely the inherent bias is obvious. At trial, both sides can present the opinions of such experts, giving an element of fair play. However, in the derivative demand setting, only one side, the corporation/board, gets the benefit of the use of such "independent" persons, some of whom may be "experts." Under either the ALI proposal, the amended RMBCA, or the Seventh Circuit's rationale in *Kamen*, the determination of a nominally autonomous SLC could survive a challenge by the shareholder or the limited review of a court. When this type of "independence" is combined with the business judgment rule's deferential protection of board and SLC actions, then the burden on the derivative stockholder/plaintiff becomes insurmountable. Perhaps the "independence," real or apparent, of the SLC would indeed "vanish in the haze"[264]of the business judgement rule.

2. "Much Ado About Nothing,"[265] or Much More?

One could take the view that the above proposals do not really represent substantive changes in derivative litigation, but are instead an altering of the procedural "hoops" through which one must pass in order to effectively commence a derivative suit; that the burden on the plaintiff of carrying forward a claim is heavy under any procedural scenario, and that that is as it should be. For a corporation to be successful, managers must be allowed to manage. If directors and officers do not have the requisite freedom to formulate and implement policy, and steer the corporation in a course of its best interests, then the progress of the company's efforts is stymied, and the value of the shareholders' investment decreased.[266] Included in this need for "directional freedom" is the capacity for efficiently dealing with actions based on harassment and strike suits. An unwillingness to meet the derivative plaintiff halfway may be based in some instances on a decision not to pursue "silly or frivolous claims."[267] "Why should the plaintiffs be authorized to sue, and without so much as a request to the board, just because the complaint is all heat and no light?"[268]

Balanced against this concern are those of investors who may think their only viable option for avoiding severe damages to their investments is through a derivative suit. While these actions may be voluminous in number, and even feature a

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264. *See supra* note 259.

265. WILLIAM SHAKESPEARE, MUCH ADO ABOUT NOTHING (1598).

266. *See, e.g., Kamen*, 908 F.2d at 1342-43.

267. *Id.* at 1345.

268. *Id.*

familiar cast of parties,[269] the need for relief may be genuine. The amended RMBCA and the Seventh Circuit's Kamen rationale represent a lessening of the chance that the truly meritorious claims will "rise to the top" for appropriate remedial action. If this proves to be so, then the changes brought under those respective approaches will be much more than "just" procedural. Whether the ALI proposal's trade-off, that of the futility exception for increased judicial scrutiny, would actually preserve merited derivative claims could only be known if adopted.

3. Whose Corporation is it, Anyway?

Derivative litigation, by definition, involves a shareholder bringing an action on behalf of the corporation, rather than as an action brought on a personal right.[270] Implicit in the litigation process is that the corporation has the opportunity to bring the action on its own behalf, and hence the demand requirement. Also fundamental to the corporate structure is that the *shareholders* own the corporation, while the board manages it.[271] The board must have the requisite level of "control" in order to act in the corporation's best interests, including an effective handling of impending litigation, be it "legitimate" actions or strike suits.[272] That level of control must be high enough to act quickly and efficiently in addressing problems and capitalizing on opportunities.

However, the shareholders still own the show, even if it is the directors' and officers' show to run. Notwithstanding the directors' need for validation of board actions and liability protection under the business judgment rule, the ownership interest of the shareholder as expressed through the corporation's actions (or inaction) should be paramount. The *minority* shareholder, in particular, needs a means through which he or she can assert, as an owner, a legitimate interest of the corpo-

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269. Regarding the recurring pattern of the same parties, in the following shareholder derivative cases the named plaintiff is "Harry Lewis": Lewis v. Chiles, 719 F.2d 1044 (9th Cir. 1983) (summary judgment for defendant affirmed); Lewis v. Graves, 701 F.2d 245 (2d Cir. 1983) (demand not excused); Lewis v. Knutson, 699 F.2d 230 (5th Cir. 1983) (affirming summary judgement for defendant); Lewis v. Curtis, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982) (excusal possible, remanded); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980) (dismissal affirmed); Lewis v. Hilton, 648 F. Supp. 725 (N.D. Ill. 1986) (complaint dismissed); Lewis v. Sporck, 646 F. Supp. 574 (N.D. Cal. 1986) (dismissed with leave to amend); Lewis v. Anselmi, 564 F. Supp. 768 (D.C.N.Y. 1983) (dismissed); Lewis v. Valley, 476 F. Supp. 62 (S.D.N.Y. 1979) (dismissed); Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (remanded with leave to amend); Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985) (motion to dismiss denied). This list is illustrative only, and not intended to be exhaustive. *See also* DeMott, *supra* note 35, at 495 n.154 (citing Lewis v. Anderson, 453 A.2d 474, 475 n.1 (Del. Ch. 1982), *aff'd*, 477 A.2d 1040 (Del. 1984) ("confirming continued corporeal existence of habitual plaintiff; disproving thesis that 'Harry Lewis' was a 'street name' employed by various counsel.")).

270. *See supra* note 1.

271. HENN & ALEXANDER, *supra note* 44, § 188, at 491.

272. *See supra* note 12.

ration which the latter, through its management, resists or would otherwise refuse.[273]

A particular instance in which mandatory demand could frustrate this opportunity is that of closely-held corporations, in which the number of shareholders is relatively low. These corporations may be composed of mostly members of the same family and a few additional investors. If one family or group controls the board, or *is* the board, then the minority shareholder with a merited claim faces an unfair disadvantage in a mandatory demand setting. The better course would allow that shareholder to plead futility and go on with her claim, and not be straddled with potential delay tactics of the board, and the possibility of not even surviving the demand stage.[274]

While strike suits may always be present in the corporate arena, the legitimate claims of minority and other shareholders must have accessibility to bona fide adjudication and remedy, or perhaps the actual significance of that ownership interest will be inconsequential when the time comes to act on a threat to the entity in which that interest lies.[275] The disposition of meritless claims, harassment actions, and strike suits in an efficient manner which legitimizes the board's role is a worthy objective. However, if the bona fide derivative claim of the shareholder is caught in this same mechanism of "efficiency," then the owner will have little real access to that which he or she owns.[276]

V. CONCLUSION

The longstanding tradition of the demand requirement in derivative litigation dates from the late 19th century.[277] Of almost as lengthy a tradition is the futility exception to that demand requirement. The amended Revised Model Business Corporation Act, and a recent proposal of the American Law Institute, and the Seventh Circuit's rationale in *Kamen v. Kemper Financial Services, Inc.*[278] would abolish this exception, and also heighten the burden of the shareholder seeking to

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273. An alternate dispute resolution mechanism which could be given consideration in the derivative context is *arbitration*. The typical advantages of arbitration over litigation in terms of a faster process at a possibly lesser expense could be attractive features for both the shareholder and the corporation. If the scope of review available to the arbitrator was not "buried" by deference to the business judgment rule, then perhaps in this venue the plaintiff would have a better opportunity to make his or her case and do so in an objective setting. The corporation might find this mechanism effective in disposing of strike suits more quickly than under the various situations of demand-refused, demand-excused, or mandatory demand with special litigation committee involvement.

274. *See, e.g., Marquis Theatre*, 846 F.2d at 87-88, 90-91 (plaintiff owned 22.5% of corporation, defendant and his family owned the remainder, defendant and his wife composed entire board of directors, and he was chief executive officer; demand held futile).

275. The shareholder cannot simply bring a direct action to protect that interest, if the interest is actually derivative. *See* Sax v. World Wide Press, Inc., 809 F.2d 610, 614-15 (9th Cir. 1987).

276. This comment is not intended to be "pro-plaintiff" or "anti-corporation." However, one can acknowledge the corporation's need for increased efficiency and effectiveness in dealing with the proliferation of derivative litigation, and even endorse in principle efforts to bring that about, and still express a legitimate concern for the rights of the shareholder, especially the minority shareholder. The "plaintiff" in a derivative action could be another company which is a minority shareholder, and one which traditionally uses defense-oriented firms for representation.

277. *See supra* text accompanying notes 19-34.

278. 908 F.2d 1338 (7th Cir. 1990), *rev'd*, 111 S. Ct. 1711 (1991).

bring a derivative suit. The amended RMBCA and the ALI proposal are available for adoption by state legislatures, and the Seventh Circuit's *Kamen* rationale could be borrowed by the states as well. What was already a tough road may also become more narrow.