Two litigation techniques are available to shareholders to vindicate their interests in the corporation. Shareholders can sue in their own capacity to enforce their rights as shareholders (a direct action, usually brought as a class action), or they can sue on behalf of the corporation to enforce corporate rights that affect them only indirectly (a derivative action). How one characterizes the suit affects a number of things: who pays for litigation expenses, who recovers, what procedures apply to the shareholder-plaintiff, and whether the suit can be dismissed by the corporation. Derivative litigation is the principal means by which shareholders enforce fiduciary duties.

This chapter describes the nature of a derivative suit (§18.1) and how it is distinguished from a direct suit (§18.2), the derivative-suit procedures applicable in state court (§18.3) and the special procedures in federal court (§18.4), and the dismissal of derivative suits, by the board or by a special board committee (§18.5).

§18.1 NATURE OF DERIVATIVE LITIGATION

The derivative suit is nineteenth-century equity jurisdiction’s ingenious solution to the dilemma created by two inconsistent tenets of corporate law: (1) corporate fiduciaries owe their duties to the corporation as a whole, not individual shareholders, and (2) the board of directors manages the corporation’s business, which includes authorizing lawsuits in the corporate name.
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Derivative litigation breaks the stranglehold the board would otherwise have over fiduciary accountability.

In a derivative suit, a shareholder sues on behalf of the corporation. Without this procedure, management’s fiduciary duties to the corporation would be virtually meaningless if the board’s power extended to all litigation decisions. It would be the rare case that managers would choose to sue themselves.

Note on Derivative Litigation in LLCs

Derivative suits are also authorized in LLCs for members who want to vindicate the rights of the LLC, particularly based on claims that managers or other members have breached their fiduciary duties. See ULLCA §1101 (provided “members or managers having authority to do so have refused to commence the action”). Even when the LLC statute is silent, courts have permitted LLC members to bring derivative litigation on behalf of the LLC. See Tzolis v. Wolff, 884 N.E.2d 1005 (N.Y. 2008).

§18.1.1 Two Suits in One

In a derivative suit, shareholders sue on behalf of the corporation to enforce rights of the corporation. It is in effect two suits in one. In theory, the shareholder (1) sues the corporation in equity (2) to bring an action to enforce corporate rights, such as when there is a breach of fiduciary duties by corporate officials. Although the modern derivative suit is treated as one action, the historical notion of two suits survives. The corporation, an indispensable party, is made a nominal defendant. The corporation—that is, the board of directors and management—can compel the derivative suit plaintiff to comply with various procedural requirements (see §18.3 below).

The “two suits in one” notion spawns some procedural effects. For example, federal jury trial rights arise if they would have existed in a suit by the corporation, generally when the suit seeks damages. Ross v. Bernhard, 396 U.S. 531 (1970). (Many states have different jury trial systems; in Delaware, for example, the chancery court hears all corporate law actions, whether direct or derivative, without a jury.) In addition, the court must have personal jurisdiction over the individual defendants. See Shaffer v. Heitner, 433 U.S. 186 (1977) (holding quasi in rem action based on sequestration of defendant directors’ shares in Delaware corporation insufficient to create personal jurisdiction). Many states, including Delaware, now have statutes that treat acceptance of a directorship as consent to jurisdiction in the state. See Armstrong v. Pomerance, 423 A.2d 174 (Del. 1980) (applying 10 Del. Code Ann. §3114).

One consequence of the “two suits in one” notion is that the corporation—in the articles of incorporation—can choose the forum in which derivative litigation must be brought on its behalf. See In re Revlon, Inc.
§18.1 Nature of Derivative Litigation

Shareholders Litigation, 990 A.2d 940 (Del. Ch. 2010) (holding that corporate charter can include forum-selection provision specifying exclusive forum for intracorporate disputes).

§18.1.2 All Recovery to Corporation

Derivative litigation enforces corporate rights. This means any recovery in derivative litigation generally runs to the corporation. The shareholder-plaintiff shares in the recovery only indirectly, to the extent her shares increase in value because of the corporate recovery. The shareholder-plaintiff also benefits indirectly by the deterrent value of an award or when equitable relief forbids or undoes harmful behavior.

Sometimes corporate liability is empty because the corporation is no longer in existence or because it would produce a windfall for new owners. Courts in these circumstances have allowed injured shareholders to recover directly in proportion to their holdings. See Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955) (see §20.2.3); Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975) (see §27.2.2). The ALI Principles of Corporate Governance suggest that when derivative litigation involves a close corporation a court may exercise its discretion to allow direct shareholder recovery, provided the corporation is not exposed unfairly to multiple claims, creditors are not materially prejudiced, and the recovery can be fairly distributed. ALI Principles §7.01(d).

§18.1.3 Reimbursement of Successful Plaintiff’s Expenses

Why would a shareholder, particularly a shareholder in a public corporation, undertake the effort and expense of a derivative suit? The answer is simple and troubling: the corporation reimburses the attorney fees of the successful plaintiff. Contrary to the prevailing American rule that each litigant bears his own litigation expenses, the universal rule in derivative litigation is that the court will order the corporation to pay the successful plaintiff’s litigation expenses, including attorney fees. See MBCA §7.46(1) (“if . . . the proceeding has resulted in a substantial benefit to the corporation”). The theory is that the successful plaintiff (and her attorney) have produced a benefit to the corporation, and thus they should be reimbursed for their effort.

Effect of Rule

The engine driving the derivative suit in public corporations is the plaintiff’s attorney—a “bounty hunter” for the corporation whose fees are contingent on an award by the court or in a settlement. Notice how the attorney
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is the real plaintiff in interest: The attorney often brings the possibility of a lawsuit to the shareholder-plaintiff’s attention; the attorney usually runs the litigation; the attorney typically has the greatest stake in the outcome; and the attorney decides on when and whether to settle the litigation, often depending on the level of attorney fees provided in the settlement offer.

Corporate law deals with this alarming reversal of the client-attorney roles by regulating the bringing and settlement of derivative litigation (see §18.3.4 below).

Method of Fee Calculation

Attorney fees in derivative litigation generally have been calculated using either a percentage-of-recovery or a lodestar method. Under the percentage-of-recovery method, the attorney receives a percentage of the corporation’s recovery, varying between 15 and 35 percent depending on the size of the recovery. Under the lodestar method, fees are based on the number of hours spent on the suit multiplied by the prevailing rate for similar legal work by an attorney of comparable experience and stature; this amount then may be adjusted upward or downward depending on the quality of work, the novelty of the issues, and the original likelihood of success. The lodestar method, unlike the increasingly used percentage-of-recovery method, creates an incentive for protracted litigation and discourages reasonable, prompt settlement.

§18.1.4 Derivative Suit Plaintiff—Self-Appointed Representative

In a derivative suit, the plaintiff-shareholder (with her attorney) chooses herself as a representative for the corporation. The possibility that the plaintiff will conduct the litigation for her own gain without serving the interests of the corporation or the shareholders as a group is evident. A shareholder (and her attorney) may bring a derivative suit solely as a nuisance to extract a settlement that primarily benefits themselves. For this reason, courts and statutes impose on the derivative suit plaintiffs a duty to be a faithful representative of the corporation’s and the other shareholders’ interests. See Fed. R. Civ. P. 23.1 (shareholder-plaintiff must “fairly and adequately represent the interests of the shareholders or members substantially similarly situated in enforcing the right of the corporation”).

Shareholders are not the only parties who can bring a derivative suit. Creditors can bring derivative suits to enforce their claims against an insolvent corporation. North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007) (concluding that creditors cannot assert direct claim against insolvent corporation, but may assert derivative claims).
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In addition, some statutes permit an officer or director to bring a derivative action. See N.Y. Bus. Corp. Law §720(b). But absent express statutory authorization, directors and officers lack standing to sue derivatively in their capacity as a director or officer. See Schoon v. Smith, 953 A.2d 196 (Del. 2008).

§18.1.5 Res Judicata — Preclusion of “Corporate” Relitigation

Because in a derivative suit the shareholder-plaintiff sues on behalf of the corporation, the corporation becomes bound by any judgment or settlement. This means neither the corporation nor a subsequent derivative suit plaintiff can bring a suit based on claims that were raised in the derivative suit. By the same token, if the corporation itself has already litigated or settled in court a claim in good faith, res judicata prevents a shareholder from bringing a derivative suit making the same claim. Given this preclusive effect, shareholders who were not parties in a derivative suit may have a right to appeal any settlement, even though they did not intervene and object in the trial court. See Devlin v. Scardelletti, 536 U.S. 1 (2002) (federal class action).

The res judicata effect of a settlement of shareholder claims can reach beyond the claims before the court. For example, the U.S. Supreme Court has held that a settlement of a class action approved by a Delaware court could preclude ongoing federal claims involving the same corporation brought in a federal court in California. Matushita Elec. Indus. Co. v. Epstein, 516 U.S. 367 (1996). In the case, the Delaware court approved a $2 million settlement that released all claims involving a tender offer in which the bidder had entered into side agreements to acquire shares of the target’s officers. The Supreme Court held that if the Delaware court’s approval of the settlement satisfied due process (particularly, adequacy of representation), the settlement could preclude federal claims (potentially worth $2 billion) even though the Delaware court could not have acquired jurisdiction over them.

§18.1.6 Time Limitation

Derivative claims typically involve claims of fiduciary breach. What is the applicable statute of limitations for such claims? Some courts view fiduciary breaches as sounding in tort and apply the relatively short two- or three-year limitations period applicable to tort actions. Demoulas v. Demoulas Super Mks., 677 N.E.2d 159 (Mass. 1997) (diversion of corporate opportunities and self-dealing). Other courts view the shareholder-corporation relationship as contractual and subject corporate fiduciary claims to the typically

In some states, claims of fiduciary breach are subject to specific statutes of limitations. See Park City Mines Co. v. Greater Park City Co., 870 P.2d 880 (Utah 1993) (applying Utah statute that requires claims asserting liability against director or shareholder to be brought within three years). In Delaware, a three-year statute of limitations applies to damages actions arising from “an injury unaccompanied with force or resulting indirectly from the act of the defendant.” Del. Code Ann. tit. 10, §8106. Delaware courts have interpreted the statute to apply to derivative actions seeking damages and to be tolled “until such time as a reasonably diligent and attentive stockholder knew or had reason to know of the facts alleged to constitute the wrong.” Kahn v. Seaboard Corp., 625 A.2d 269 (Del. Ch. 1993) (self-dealing). In derivative actions seeking equitable relief (such as a constructive trust or rescission of proxies), the Delaware courts have looked to the statutory period as “a presumptive time period for application of laches to bar a claim.” U.S. Cellular v. Bell Atlantic Mobile Systems, Inc., 677 A.2d 497 (Del. 1996).

§18.2 DISTINGUISHING BETWEEN DERIVATIVE, DIRECT, AND CLASS ACTION SUITS

A shareholder may also sue in her personal capacity to enforce her rights as a shareholder—a direct action. Unlike a derivative suit, a direct action is not brought on behalf of the corporation. To avoid the host of procedural requirements that apply to derivative suits, shareholders will often seek to characterize their suit as direct. For example, if state law requires a demand on the board (see §18.3.3 below), the characterization of the suit as derivative or direct may practically decide its viability.

§18.2.1 Examples of Direct Suits

In many cases, the characterization is straightforward. Direct suits are those in which shareholders seek to enforce rights arising from their share ownership, as opposed to rights of the corporation. Direct suits include suits to

* enjoin ultra vires actions (see §3.3.3)
* compel payment of dividends declared but not distributed (see §4.1.3)
* compel inspection of shareholders’ lists, or corporate books and records (see §7.1.4)
§18.2 Distinguishing between Suits

- require the holding of a shareholders’ meeting, whether the board has violated statutory or fiduciary duties (see §7.2.1)
- challenge fraud on shareholders in connection with their voting, sale, or purchase of securities (see §§10.3, 21.1, 22.5)
- challenge the sale of the corporation in a merger where directors violated their duties to become informed or structure a transaction that was entirely fair (see §§12.3.3, 17.3)
- challenge corporate restrictions on share transferability (see §26.6)
- compel dissolution of the corporation, such as for deadlock or oppression of minority shareholders (see §27.2.1)
- challenge the denial or dilution of voting rights, such as when substantially all the corporation’s assets are sold without shareholder approval (see §36.3)

As you notice, direct suits generally vindicate individual shareholders’ structural, financial, liquidity, and voting rights. See Grimes v. Donald, 673 A.2d 1207 (Del. 1996) (direct action when shareholder claimed directors abdicated statutory control to CEO under terms of employment agreement). Derivative suits, on the other hand, generally enforce fiduciary duties of directors, officers, or controlling shareholders—duties owed to the corporation. A suit claiming that fiduciary wrongdoing caused a loss in share value is usually derivative. For example, suits that ask directors to account for profits from a usurped corporate opportunity or that challenge executive compensation as corporate waste are derivative suits.

Under the Grimes approach, courts make the direct-derivative distinction by focusing on who was injured and who will receive the relief. Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031 (Del. 2004) (characterizing a merger-delay claim as direct because delay of merger only harmed shareholders, not corporation, though dismissing direct claim on ground not yet ripe). In a direct suit, because damages are paid to shareholders and not the corporation, attorney fees are paid from the shareholders’ recovery or in a class action from the common fund.

§18.2.2 Claims with Direct and Derivative Attributes

Some shareholder suits are difficult to characterize. For example, while most courts have characterized a suit to compel the payment of dividends as direct, some have characterized the suit as derivative. See Cowin v. Bresler, 741 F.2d 410 (D.C. Cir. 1984) (direct); Gordon v. Elliman, 119 N.E.2d 331 (N.Y. 1954) (derivative).

Sometimes, the facts suggest both a direct and a derivative claim. In such a case, the shareholder’s pleading choice governs. For example, a wrongful refusal by management to provide a shareholders’ list to a shareholder for a
proxy fight may not only violate the shareholder’s rights to inspection, but also management’s duties of loyalty to the corporation. The shareholder may bring the claim as either a direct action to enforce inspection rights or as a derivative action to enjoin management’s entrenchment, or both. See ALI Principles §7.01(c).

The shareholder’s characterization of the suit, however, is not always controlling. A shareholder cannot escape the procedural restrictions of a derivative suit simply by claiming she was directly injured when the value of her shares fell as a result of a breach of a duty to the corporation. Armstrong v. Frostie Co., 453 F.2d 914 (4th Cir. 1971).

But careful pleading can help. If a shareholder can characterize a transaction as diluting voting power, for example, even though the transaction may also be a fiduciary breach, the suit is direct. In Eisenberg v. Flying Tiger Line, Inc., 451 F.2d 267 (2d Cir. 1971), a shareholder challenged a corporate reorganization in which shareholders of an operating company became, after a merger, shareholders of a holding company. The corporation sought to require the plaintiff to post security for expenses, a derivative suit requirement (see §18.3.2 below). The court, however, held that the action was direct because the reorganization deprived the shareholder of “any voice in the affairs of their previously existing operating company.”

§18.2.3 Close Corporation Exception

Lately many courts permit participants in a close corporation to sidestep the derivative suit procedures and bring direct actions to vindicate their corporate rights, including claims of fiduciary breaches. See Crosby v. Beam, 548 N.E.2d 217 (Ohio 1989). On the theory that close corporation participants owe duties to each other similar to those of partners in a partnership, close corporation shareholder/managers can sue each other directly. See ALI Principles §7.01(d). In a close corporation, compared to a public corporation, there is less risk of multiplicity of suits, preferential recovery, or strike suits brought to coerce a settlement.

One effect of the exception is that recovery in a close corporation suit is to individual shareholder/managers, not the corporation. Direct recovery may disadvantage the corporation’s third-party creditors, whose interests in the corporation’s financial viability are unprotected when a fiduciary breach leads to direct recovery only by shareholder/managers. The ALI Principles address this potential problem by giving the court discretion to treat an action raising derivative claims as a direct action if to do so “will not materially prejudice the interest of creditors of the corporation.” ALI Principles §7.01(d).
§18.2 Distinguishing between Suits

Another effect of the exception is that the complaining shareholder/manager need not make a pre-suit demand on the board (requirement that shareholder in a derivative suit first seek to have the board vindicate the corporate interests, see §18.3.3 below). This reflects the futility of demand in a typical suit involving close corporation participants. For example, when a minority shareholder challenges the majority’s oppression or exclusion, a demand on the majority-controlled board would accomplish little except to delay judicial resolution. See Barth v. Barth, 659 N.E.2d 559 (Ind. 1995) (noting that direct action prevents dismissal by special committee).

§18.2.4 Class Actions — Direct Suits Brought by Representative

When a shareholder sues in his own capacity, as well as on behalf of other shareholders similarly situated, the suit is not a derivative action but a class action. In effect, all of the members of the class have banded together through a representative to bring their individual direct actions in one large direct action. Some of the most important suits enforcing fiduciary duties have been brought as direct class actions. See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (class action challenging director actions and disclosure in squeeze-out merger); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (class action challenging director actions and disclosure in third-party merger).

Some procedural rules applicable to class actions—such as that the class action plaintiff be representative of the other shareholders’ interests and that any settlement be approved by the court—also apply in derivative suits. See Fed. R. Civ. P. 23. They assure that shareholders are well represented and that the judicial process is not abused by nuisance plaintiffs.

A class action, however, does not interfere with the prerogatives of central corporate governance, and many requirements that apply to derivative suits do not apply to class actions. For example, in a class action the plaintiff need not make a demand on the board of directors before bringing suit (see §18.3.3 below). Class actions, however, have their own procedural hoops, such as that plaintiff-representatives bear the expense of providing notice to members of the class.

Examples

1. Ten years ago, Consolidated Engines acquired Digital Engineering in a merger. H. Russell Thoreau, Digital’s principal shareholder, received 2 percent of Consolidated’s common stock, and he was informally assured a seat on Consolidated’s board for as long as he held the stock. Last
year, Thoreau and Consolidated’s chairman had a falling out. The board approved a repurchase of Thoreau’s ten million shares for $90 a share, at a time when the stock was trading on the NYSE at $80—a $100 million premium to Thoreau. Consolidated Engines’ finances were seriously jeopardized by the purchase.

a. Abe Pomerantz, a corporate attorney with broad experience representing shareholders, brought the repurchase to the attention of Pam Walden, a long-time shareholder of Consolidated. Under what procedure can Walden seek to have the repurchase rescinded?

b. Walden (through her lawyer Pomerantz) sues to hold the directors liable for improvidently approving the repurchase of Thoreau’s stock. Walden owns exactly $2,000 (.000004 percent) of Consolidated’s stock. How much can she hope to recover?

c. Consolidated’s directors offer to settle Walden’s derivative suit by promising not to repurchase shares from other major shareholders without shareholder approval. The corporation, however, will recover nothing in cash. Can Pomerantz expect any fees?

2 Settlement negotiations fail and Walden’s suit proceeds. Thoreau offers to repay 10 percent of the premium he received from Consolidated. The Consolidated board seizes the opportunity: It authorizes a suit against Thoreau, who then settles under the terms of his offer. The settlement is approved by the court.

a. Can Walden continue her suit?

b. Is there another course open to Walden?

c. When Pomerantz hears of Consolidated’s settlement, he is outraged. He has spent a significant amount of time preparing Walden’s derivative suit for trial. Can Pomerantz seek attorney fees?

3 Consolidated’s senior executives propose a management buyout (see §34.2). Under the terms of the buyout merger, Walden and all other shareholders would receive $80 for their shares.

a. Walden thinks $80 is inadequate. The proxy materials seeking shareholder approval of the going-private transaction fail to disclose that Consolidated’s board considered the company was worth at least $100 per share. Walden wants to enjoin the merger. What kind of suit would you advise?

b. Walden brings both direct and derivative claims. The board agrees to settle by amending its proxy materials and paying Walden $500,000 on the condition that she dismiss all her claims. Are there any problems if Walden accepts?

c. The shareholders approve the merger. Walden amends her complaint to claim damages. The court holds the directors liable for gross negligence in approving the merger at $80 per share. What is the appropriate remedy?
§18.2 Distinguishing between Suits

Explanations

1. a. Walden can model her suit to be derivative or direct:
   • **Derivative action.** Walden can sue on behalf of the corporation (derivative) alleging that Consolidated’s directors breached their fiduciary duties to the corporation. The theory might be that the repurchase wasted corporate assets (see §12.3.2), lacked a reasonable relation to the threat of Thoreau launching a proxy fight or other takeover attempt (see §39.2.3), or constituted self-serving entrenchment (see §39.2.1). The suit would be subject to derivative suit requirements: demand on the board, possible shifting of fees, dismissal by the corporation.
   • **Direct action.** Walden might sue on her own behalf (direct) claiming the repurchases were an illegal distribution under an insolvency or balance sheet test (see §31.2). Otherwise, the transaction did not dilute Walden’s voting rights (to the contrary, it concentrated them) or otherwise affect her financial or liquidity rights as a shareholder. Just because the corporation’s assets are depleted, the indirect injury to Walden’s interest does not allow her to sue in her own capacity.
   b. Nothing. This is a derivative suit because the allegation is that the directors violated their fiduciary duties to the corporation by approving the repurchase of Thoreau’s stock and any recovery would go to the corporation. See *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004) (§18.2.1). Walden can only hope to increase the value of her shares to the extent corporate recovery increases general share value. There are a few exceptions to this approach. Shareholders can recover directly if the corporation is closely held or no longer in existence, or recovery would not redound to the benefit of contemporaneous shareholders indirectly injured. None of these, however, applies to Consolidated.
   c. Yes. Pomerantz can expect attorney fees either as part of the settlement or as ordered by the court in its approval of the settlement even though the corporation recovered nothing. Studies show that attorneys in settlement of shareholder suits involving public companies receive fees 90 percent of the time even though only 55 percent of the settlements involve monetary recovery.

   Under a lodestar method for computing his fees, Pomerantz’s billable hours would be multiplied by a reasonable hourly rate, which because of Pomerantz’s stature would likely be at the upper end of the range. This amount then might be adjusted upward given Pomerantz’s success in the face of the business judgment rule’s teaching that courts normally defer to valuations by the board. The percentage-of-recovery method would not apply.
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2. a. Probably not. Walden’s derivative suit is brought on behalf of the corporation. If the corporation settles the subject matter of her claim, the corporate settlement is binding (res judicata) on Walden in her suit. The corporate suit resolves any corporate claims involving the Thoreau repurchase. Unless she can show fraud or a fiduciary breach that would justify vacating the judgment, she cannot continue her suit.

b. A fiduciary challenge. Walden might be able to challenge the directors’ decision to enter into the settlement as a breach of their duty of care or loyalty. This derivative claim may be difficult because of the business judgment rule. Unless Walden can show that the board was interested (because of an entrenchment motive) or failed to become informed about the settlement’s terms, the board has discretion to make rational litigation decisions.

c. Perhaps. Pomerantz might argue Walden’s suit goaded the Consolidated board to act. In derivative litigation, shareholder-intervenors often recover their expenses and attorney fees if their efforts contributed to the recovery or settlement. Pomerantz could argue that Walden’s suit brought the excessiveness of the repurchase price to the board’s attention, and the board’s out-of-court settlement (like a successful derivative suit settlement) should be seen as resulting from her suit and his efforts.

3. a. Walden can choose between a direct suit, a derivative suit, or a suit with both direct and derivative claims. She has a direct claim under the federal proxy rules and under the state “duty of disclosure” doctrine that the corporation failed to adequately disclose the terms of the merger. Rule 14a–9, Securities Exchange Act of 1934 (see §10.2); Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981) (see §10.3).

Walden also has a derivative claim that the board’s approval of this self-dealing, going-private merger and its deception about the merger price violate the executives’ and the board’s fiduciary duties (see §13.3.3). Walden maximizes her leverage by bringing both claims in one suit. If she brings a federal proxy fraud claim, she must sue in federal district court, which has exclusive jurisdiction over these claims. She could bring her state fiduciary claims as pendent claims.

b. Yes. It is unclear why Consolidated is offering $500,000 to Walden. The payment does not seem to relate to her direct claim because the merger has not been approved and Walden has suffered no loss. Nor can the payment be tied to the derivative suit because any recovery in such a suit is to the corporation. Rather, the payment appears to be a bribe for her to dismiss the derivative claims. Although such a payment is perfectly acceptable in an individual direct action, it is not in a derivative suit. The court is unlikely to approve a settlement of the derivative claim in these circumstances (see §18.3.4 below).
c. Recovery by the shareholders, whether the claim is seen as derivative or direct. If the claim is direct, as was the case in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (see §12.3.4), the shareholder class members would recover in proportion to their shareholdings. The claim can be characterized as direct because the directors’ approval of the merger led to the conversion of the shareholders’ ownership interest to a cash payment right. To the extent the suit challenged the board’s disclosure, it would also be direct. If the claim is seen as derivative, the normal rule is that defendant directors (or their insurers) would pay the corporation. In this case, this would result in payment to New Consolidated, the surviving corporation after the merger that acquired all the rights of Consolidated (see §36.2.1). But New Consolidated is controlled by new owners (the management team), and any corporate recovery would not remedy the injury to the body of shareholders who received an inadequate price for their shares. An exception to the rule of corporate recovery in derivative litigation is appropriate. Pro rata recovery by former Consolidated shareholders would produce a correct result.

§18.3 PROCEDURAL RESTRICTIONS ON DERivative LITIGATION

The derivative suit is an essential tool to enforce management accountability. It is also subject to abuse. To address the risk that the derivative suit plaintiffs may not represent corporate interests, various procedural requirements seek to filter out abusive or spurious derivative litigation.

§18.3.1 Distorted Incentives in Derivative Litigation

Derivative litigation allows self-appointed shareholders to become champions of corporate rights. But the incentives of the derivative suit parties may produce results at odds with corporate interests:

- The plaintiff may be indifferent to the outcome of the litigation. Any recovery will be to the corporation, and the plaintiff’s financial interest in the corporation will often be insignificant.
- The plaintiff’s attorney, whose fees are usually contingent on a settlement or court award, may be indifferent to the substantive outcome—so long as there are attorney fees.
- The individual defendants (typically directors or officers of the corporation) usually will prefer settlement rather than trial. Settlement
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increases the chances their expenses, as well as amounts paid in settlement, will be indemnified by the corporation or covered by insurance (see §§15.1.2, 15.2.1).

- The corporation (the board of directors) often will be influenced by the interests of the individual defendants.

These realities of derivative litigation invite weak-willed and even evil-hearted plaintiffs. Some shareholders may be tempted to bring suit to coerce a settlement based on the suit’s nuisance value—the infamous strike suit. The history of corporate law is spiced with colorful stories of “strike suit artists” with long and lucrative careers as gadfly plaintiffs. Derivative litigation also creates a potential for well-meaning but faint-hearted plaintiffs, unwilling to pursue a meritorious claim because of the incentives to settle.

Derivative litigation also threatens the integrity of the judicial process. By using the courts to bring vexatious litigation, strike suit plaintiffs waste and abuse judicial resources. Nonetheless, derivative litigation provides the means for enforcing fiduciary duties, and corporate statutes attempt to distinguish between the meritorious claim and the strike suit.

§18.3.2 Litigation Procedural Requirements

A variety of procedural requirements in litigation attempt to weed out strike suits.

Plaintiff’s Verification of Complaint

Some statutes require that the plaintiff verify the complaint. See Fed. R. Civ. P. 23.1. The requirement provides a basis for applying sanctions for perjury against those who fabricate charges in a strike suit. It is not necessary, however, that the plaintiff have personal knowledge or comprehend the specific factual allegation in the complaint so long as the plaintiff reasonably relied on her lawyer’s investigation and advice. Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966).

Equity Shareholder Standing

Most statutes give equity (common and preferred) shareholders standing to bring a derivative suit to protect their residual ownership interests in the corporation against management abuse. Some cases have also allowed holders of stock options or convertible securities and creditors of an insolvent corporation to protect their ownership interests and assert derivative claims. The MBCA limits derivative suit standing to equity shareholders and
§18.3 Procedural Restrictions on Derivative Litigation

beneficial owners and excludes option holders and convertible debtholders. MBCA §7.40(2). Some statutes, however, require that the plaintiff be a record (not merely beneficial) owner. See Del. GCL §327.

Dismissal of Multiple Suits

Often multiple shareholder-plaintiffs (and lawyers) will bring more than one derivative suit concerning the same transaction. If each suit makes essentially the same claims, allowing all to proceed would produce a wasteful and potentially confusing overlap. Courts will want to choose which shareholder should be the leading representative. Toward this end, courts have broad discretion to dismiss redundant derivative suits, to consolidate derivative suits brought in the same court, to stay proceedings in one suit to await a board investigation or the outcome in another suit, and to transfer proceedings (in federal cases) to other courts. See ALI Principles §7.06 (stay pending board review or resolution of “related action”).

Continuous and Continuing Ownership

Most statutes require the plaintiff to have been a shareholder when the wrong occurred—the contemporaneous ownership requirement. MBCA §7.41(1). The requirement is meant to assure that the shareholder did not buy shares to buy a lawsuit. The ALI Principles provide an exception to the requirement when an undisclosed wrong (such as a pattern of waste) was continuing when the plaintiff acquired her shares. See ALI Principles §7.02(a)(1).

A logical extension of the contemporaneous ownership rule is that the corporation itself cannot sue for wrongdoing that occurred before a change in ownership—the vicarious incapacity or corporate incapacity rule. If ownership changes, the corporation’s new owners should not be able to cause the corporation to sue former managers (or shareholders) for wrongs committed before control changed hands. To allow the corporation to recover would produce a windfall for the new owners whose purchase price presumably took into account any losses caused by the earlier wrongs. See Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co., 417 U.S. 703 (1974). The theory does not work as neatly when the recovery would benefit others besides the new owners—such as when the new owners hold less than 100 percent of the stock or when a corporate recovery would benefit creditors. Some jurisdictions, including Delaware, reject the vicarious incapacity rule and allow recovery by the surviving corporation. See Lewis v. Anderson, 477 A.2d 1040 (Del. 1983).

Another exception to the contemporaneous ownership rule arises when shareholders of a parent corporation complain about wrongdoing in a subsidiary. See Brown v. Tenney, 532 N.W.2d 230 (Ill. 1988) (finding “double
derivative action” to be a longstanding doctrine of equity jurisprudence). In effect, a double derivative action permits the parent shareholders to claim that the parent has failed to take action against corporate wrongs occurring in the subsidiary.

In addition to the contemporaneous ownership rule, some statutes require that the plaintiff continue to be a shareholder when suit is brought and then through trial—the continuing interest requirement. Cf. MBCA §7.41 (no continuing ownership requirement, but plaintiff must “fairly and adequately” represent corporate interests). The continuing interest requirement tests the genuineness of the plaintiff’s intentions. Delaware courts recognize a narrow exception when the plaintiff ceases to be a shareholder after a fraudulent or illegal merger. Lewis v. Anderson, 477 A.2d 1040 (Del. 1983). The ALI Principles broaden the exception to allow a plaintiff to continue her derivative action after a merger if the action was pending at the time of the merger or if the plaintiff is best able to vindicate the shareholders’ interests. ALI Principles §7.02(a)(2).

**Shifting Expenses to Plaintiff**

Many statutes provide for shifting the defendants’ litigation expenses, including attorney fees, to the plaintiff. This discourages unfounded derivative claims and compensates defendants who must defend strike suits. Under the MBCA, the court may order fee-shifting if the plaintiff commenced or maintained the suit “without reasonable cause or for an improper purpose.” MBCA §7.46(2). This standard forces derivative suit plaintiffs to tread cautiously; the normal standard for recouping expenses based on a claim of frivolous prosecution is more demanding and requires a showing of malicious intent or fraud. Cf. MBCA §13.31 (in appraisal proceeding, expenses may be shifted to shareholder-dissenter who acted “arbitrarily, vexatiously, or not in good faith”).

A once-common requirement in many states—though now very few—allowed the court to require the plaintiff to post security (pay a bond) for the defendants’ litigation expenses as a condition of maintaining the action. The court would act on a motion of the corporation or the defendants. A security-for-expense requirement often had a lethal effect on derivative litigation. The cost of posting security and the risk of having to pay the amount that the bond secured usually outweighed any gain a shareholder-plaintiff might hope for in the suit. Most modern statutes reject this requirement as going too far in limiting fiduciary accountability. See ALI Principles §7.04(c).

Many of the security-for-expense statutes exempted shareholders with a specified percentage of ownership (such as 3 percent or 5 percent) or a minimum dollar amount ($25,000 or $50,000). The exemptions assumed that most strike suits are brought by shareholders with small holdings and
presumably little real concern for the corporation’s interests. Shareholder-plaintiffs would try to avoid the security-for-expense requirement by bringing direct actions (see §18.2) or actions under federal law, such as Rule 10b-5 (see §9.1).

§18.3.3 Demand Requirement — Exhaustion of Internal Remedies

Many statutes require that the derivative plaintiff’s complaint state with particularity her efforts to make a demand on the board to resolve the dispute or the reasons she did not make demand. Del. Ch. Ct. R. 23.1; Fed. R. Civ. P. 23.1. By their terms, these statutes neither require the plaintiff to make a pre-suit demand on the board nor specify the effect that should be given the board’s response. Nonetheless, many courts (including Delaware) have interpreted the statutes to make demand mandatory unless demand would be futile (see §18.5.3). The demand-pleading requirement allows the court to ascertain whether the board could have acted on the demand. Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

A demand requirement has some advantages. It serves as a kind of alternative dispute mechanism that requires a challenging shareholder to first exhaust intracorporate remedies. If litigation is beneficial, it allows the corporation to control the proceedings.

But demand has a number of untoward effects. A pre-suit demand forewarns defendants of an impending suit, giving them an opportunity to take evasive actions. It delays litigation while the shareholder waits for the board to act on her demand. Making demand might be understood as the challenger’s concession that the board is capable of addressing the problem. And if the shareholder brings suit without making demand, the court must resolve whether demand was excused — litigation within litigation.

Many recent statutes explicitly impose a demand requirement in all cases, thus forcing a shareholder contemplating a derivative suit to first make a demand on the board. Under the MBCA, the shareholder must wait for 90 days before filing suit unless the board rejects the demand or the corporation would be irreparably injured by waiting. MBCA §7.42. The demand requirement gives the board (even if the directors would be named defendants) a chance to take corrective action and avoids the difficult question whether demand is excused. See also ALI Principles §7.03(b) (recommending a universal demand requirement unless it would irreparably injure the corporation).

These different approaches do not answer what substantive effect should be given to the board’s rejection of a demand or its refusal to bring a suit. Also unanswered is whether the board (or a committee of the board) can act on behalf of the corporation to dismiss the litigation. The demand-pleading
requirement is inextricably linked to the question of who can decide the fate of derivative litigation. We discuss these issues and the dismissal of derivative litigation below. See §18.5.

§18.3.4 Court Approval of Settlement–A Clean Solution

The principal danger of derivative litigation is the potential for abusive settlements. Unlike normal litigation in which an arm’s-length compromise agreed to by plaintiff and defendant provides the best measure of the suit’s worth, derivative litigation provides no such assurance. In a derivative suit none of the parties may represent the interests of the corporation-on whose behalf suit is presumably brought.

Most statutes face this problem and require judicial approval before a derivative suit can be settled, discontinued, or dismissed. MBCA §7.45; Fed. R. Civ. P. 23.1. Proponents of the settlement have the burden to show it is fair and reasonable to the corporation. To decide whether to approve the settlement, the court has broad discretion to consider

- the terms of the settlement, including recovery by the corporation (or other relief) and any reimbursement of expenses (including attorney fees) to the shareholder-plaintiff and to the individual defendants; and
- the outcome that might have resulted from a trial, discounted by the inherent uncertainty of litigation, the costs caused by the delay of trial, additional litigation expenses that the corporation might be required to pay the plaintiff, additional indemnification payments to the defendants if they are successful or if indemnification is determined to be appropriate, disruption of business and possible negative publicity because of trial, and increased insurance premiums if recovery at trial is higher than in settlement.

Because the proponents’ reasons for supporting the settlement may diverge from general corporate and shareholder interests, many statutes require the court to notify nonparty shareholders and solicit their comments. MBCA §7.45; Fed. R. Civ. P. 23.1. In a public corporation, where such a notice-and-comment procedure would be tantamount to an expensive proxy solicitation, the court may request comments from a sampling of shareholders or solicit comments through published notice.

By their terms, these settlement procedures apply only to derivative litigation. An argument can be made, however, that they should apply whenever
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the corporation on its own (without a lawsuit being filed) settles claims out of court that might have been brought in a derivative suit. Such an out-of-court settlement by the corporation raises doubts about the parties’ incentives much as an in-court settlement does. In Wolf v. Barkes, 348 F.2d 994 (2d Cir. 1965), the Second Circuit rejected this argument even though the corporation’s out-of-court settlement purported to resolve fiduciary claims involving management stock options pending in a derivative suit. Judge Friendly explained that management flexibility should not be impeded in settling corporate claims and that the out-of-court settlement would not necessarily preclude the shareholder’s continuing her derivative claims. The shareholder could still attack the settlement as unfair self-dealing, fraudulent, or wasteful. But under this analysis, a corporation’s out-of-court settlement is subject to less stringent review than when the same claims are settled as part of a derivative suit.

§18.4 DERIVATIVE LITIGATION IN FEDERAL COURTS

§18.4.1 Diversity Jurisdiction

In federal diversity action, there are two principal issues: (1) Is the corporation a plaintiff or a defendant for assessing the parties’ diversity of citizenship? (2) What procedural rules govern the action—state or federal?

Corporation Is a Defendant

The Supreme Court has held that even though shareholders technically bring derivative suits on behalf of the corporation, the corporation should be treated as a defendant for purposes of federal diversity jurisdiction if it (or, more precisely, its management) is antagonistic to the claim. Smith v. Sperling, 354 U.S. 91 (1957). (Recall from Civil Procedure that a corporation is considered both a citizen of its state of incorporation and its principal place of business. See 28 U.S.C. § 1332(c)(1).)

A further requirement under Fed. R. Civ. P. 23.1 is that the suit not be brought collusively to avoid “complete diversity” requirements. For example, if a North Carolina corporation wished to sue a North Carolina supplier for breach of contract (no diversity of citizenship), a Virginia shareholder of the corporation could not collude with management to bring a derivative action on behalf of the corporation based on diversity by naming the corporation as nominal defendant and the North Carolina supplier as real defendant.
State Derivative Suit Requirements Are “Substantive”

Courts have held that certain state procedural requirements (those that relate to the allocation of power between shareholders and management) are “substantive” under the Erie doctrine. This means that, even though not imposed by federal Rule 23.1, some state conditions such as the security-for-expense requirement apply in derivative actions brought under federal diversity jurisdiction actions. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949).

§18.4.2 Federal Actions

Actions brought in federal court on behalf of the corporation claiming violations of federal law are subject to federal, not state, procedures. The Supreme Court has held that derivative suits may be brought for alleged violations of Rule 10b-5 (the general securities trading antifraud rule) and Rule 14a-9 (the proxy antifraud rule) of the Securities Exchange Act of 1934 if the fraud was perpetrated on the corporation. Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) (Rule 10b-5); J. I. Case Co. v. Borak, 377 U.S. 426 (1964) (Rule 14a-9). In such derivative cases, the procedural requirements of Rule 23.1 apply, but state procedural requirements—such as state security-for-expense requirements—do not.

Even in a derivative suit brought under federal diversity jurisdiction, which generally adopts the substantive law of the state in which the federal court sits, federal procedural rules apply, such as the continuous ownership requirement of federal Rule 23.1. Kona Enters. v. Estate of Bishop, 179 F.3d 767 (9th Cir. 1999).

Nonetheless, the Supreme Court has said that when there are gaps in federal substantive law on the question of allocation of power in the corporation, federal law should refer to the law of the state of incorporation. Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991). Thus, in a derivative suit brought under the federal Investment Company Act for the breach of fiduciary duties by a mutual fund’s investment advisor, the Court held that demand on the board was to be determined by reference to state law, absent contrary federal policies. This is because the demand requirement serves to allocate corporate governance between the board and shareholders—traditionally a matter of state law. The Court rejected the lower court’s conclusion that a universal demand requirement makes good policy sense and should be adopted as a matter of federal common law.

Examples

1. Protox Corporation, a public company incorporated in Delaware, issues options on 400,000 shares of its common stock to Paula, the outgoing
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CEO and chair of the board. The options entitle Paula to buy Protox shares at $30 (the current market price) at any time for the next five years.

a. Lois, a longtime Protox shareholder, is outraged. She brings a derivative suit in federal district court in the State of New Columbia, claiming that the directors breached their fiduciary duties. Delaware does not have a security-for-expense requirement, but New Columbia does. Is Lois subject to New Columbia’s procedures?

b. Believing the security-for-expense requirement applies, Lois looks for other shareholders to join her so their aggregate shareholdings will exceed the New Columbia threshold of $50,000. Lois finds three such shareholders, but none owned their shares when the board granted Paula’s stock options. New Columbia does not have a contemporaneous ownership requirement. Can Lois bring her federal diversity action?

c. Is there any way for Lois to avoid this tangle of derivative suit requirements?

2. After discovery, Paula agrees to settle Lois’s claims and to return half the stock options granted her.

a. Lois’s complaint had sought a return of all the options. Can the court approve the settlement?

b. Under the terms of the settlement, the corporation agrees to pay Lois’s attorney $500,000 for his representation. Is the court bound by the parties’ agreement on attorney fees?

3. While the federal court in New Columbia is reviewing the settlement, shareholders file two more derivative actions challenging the stock options, one in state court in Virginia and the other in federal district court in California.

a. What becomes of these later actions?

b. What will be the effect on them of a court-approved settlement of Lois’s claim?

c. The plaintiff in the Virginia case filed his suit hoping that a successful resolution of the New Columbia suit would automatically allow him to claim attorney fees in his suit. Will this scheme work?

4. Protox has become the subject of takeover speculation, and the board approves contracts for top executives that promise three years’ worth of compensation if forced to leave the company after a change in ownership (commonly known as “golden parachutes”). One year later, Protox is bought in a leveraged buyout by RKK Partners, which after a cash-out reverse subsidiary merger (see §36.2.5) becomes Protox’s 100 percent parent.

a. The new Protox board fires many Protox executives, but RKK chafes at paying their golden parachutes. Can RKK bring a derivative suit on behalf of new Protox challenging the contracts?
b. RKK has the new Protox board initiate a suit against the old directors for awarding the golden parachutes. Can Protox assert these fiduciary claims?

c. Lois, who owned Protox shares when the board approved the golden parachutes, believes RKK paid less because of the contingent golden parachute liability. Can she bring a derivative suit challenging the golden parachutes?

Explanations

1. a. Perhaps not. Lois’s action in New Columbia federal court is based on diversity jurisdiction. Erie requires that the district court apply the substantive rules of New Columbia, including its choice-of-law rules. In a case involving substantially the same facts, the Supreme Court has held that a security-for-expense requirement is substantive and must be applied in diversity actions. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949).

Although this analysis would seem to require the court to impose New Columbia’s security-for-expense requirement, closer analysis leads to the opposite conclusion. Remember the security-for-expense requirement (like other derivative suit requirements) has dual purposes, to protect corporate interests and prevent abuse of the judicial process. In this case, New Columbia has no reason to be concerned about either. Protox is a Delaware corporation, and to the extent the security-for-expense requirement assures that corporate interests are well represented in derivative litigation, this is a concern of Delaware corporate law, which does not impose such a requirement on its shareholder-litigants. Moreover, suit is brought in federal court, and to the extent the security-for-expense requirement protects courts from abuse of their process, that is a concern of the federal district court, whose rules (specifically Rule 23.1) do not impose a security-for-expense requirement. Cohen may have been wrongly decided.

b. No. The three new shareholders, although their combined holdings exempt the plaintiffs from the security-for-expense requirement, are not contemporaneous owners. Rule 23.1 protects against abuse of judicial process in federal derivative suits and imposes this procedural requirement even though the state of incorporation, New Columbia, does not. Thus, Lois avoids the New Columbia obstacle but is now caught by the federal obstacle—a patchwork of federal and state rules.

Also notice that in this diversity suit the plaintiff-shareholders must be from states completely different from that of the corporation (nominal defendant) and those of the other defendants (Paula and any named directors). The suit must also seek more than $75,000 in
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damages to the corporation, an amount unrelated to the shareholdings of the plaintiff-shareholders.

c. Perhaps, though she needs more facts. Lois can avoid the security-for-expense requirement by bringing a direct action against the corporation under state law. Direct claims are not subject to derivative suit procedural requirements (see §18.2 above). For example, she could make a direct claim if the options were not properly authorized or if they required shareholder approval.

    In addition, Lois can avoid state derivative suit requirements by bringing a federal securities claim—whether direct or derivative. For example, she might bring a federal derivative suit claiming that Paula had violated her Rule 10b-5 duties of full disclosure to the corporation if she failed to disclose the options were without consideration (see §22.3).

2. a. Yes, if the court determines the settlement is fair and reasonable to the corporation. In making this determination, the court will weigh the terms of the settlement against the probable outcome of the case had it gone to trial, offset by the delay, expense, and inherent uncertainty of a trial, particularly when the board’s grant may be protected by the business judgment rule.

    b. No. Again the issue is whether this aspect of the settlement is “fair and reasonable.” Whether the attorney fees are related to the outcome and represent a fair valuation of services is largely within the discretion of the court.

3. a. It depends on how the courts exercise their procedural discretion. Because derivative suit plaintiffs sue on behalf of the corporation, subsequent derivative suits may be dismissed, consolidated with the original suit, transferred to another court, or stayed pending the outcome of the original suit. Although the Virginia state court cannot consolidate or transfer the new case, it can dismiss or stay it. The federal court in California can dismiss or stay the case, or transfer it to the federal court in New Columbia for that court to decide its disposition.

    b. The settlement would have a res judicata effect and bar the continuation of any other suit based on the same claims, provided the settlement satisfied due process (see §18.1.5). An important question would be whether the settlement advanced corporate/shareholder interests or merely benefited Lois’s lawyers.

    c. No. Many statutes permit the court to shift fees against derivative suit plaintiffs. Even if the New Columbia suit succeeds, the defendants in the Virginia suit could argue that the “me too” plaintiff brought it for an “improper purpose.” See MBCA §7.46(2). Fee-shifting deters suits brought for their nuisance value.
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4. a. Perhaps not. If RKK was not a shareholder when the directors awarded the golden parachutes, the contemporaneous ownership requirement would bar RKK from pursuing a derivative claim. Although RKK might argue the payments constitute a “continuing wrong” to the corporation, RKK in all likelihood discounted its purchase price to account for the contingent golden parachute obligations. If so, any recovery by RKK would be a windfall.

Even if RKK owned some shares before the buyout and was a contemporaneous owner, a court might apply the same theory to deny a recovery to RKK or might decide the recovery should be shared pro rata with other pre-buyout shareholders. See ALI Principles §7.01(d) (applying this analysis in context of closely held corporation). It would be an important factual question whether RKK figured its potential golden parachute obligations in its buyout price.

b. Perhaps not. Protox may be barred by the vicarious incapacity rule from bringing a suit that RKK, its only shareholder, could not bring derivatively. (See the previous answer.) Any recovery by Protox would produce a windfall for RKK if it had already discounted Protox’s value to take into account the contingent golden parachute obligations. Nonetheless, some jurisdictions allow the surviving corporation (at the behest of new owners) to pursue existing fiduciary claims, and this contingent benefit is sometimes taken into account in deciding the purchase price.

c. Perhaps, depending on the jurisdiction. If the jurisdiction does not have a continuing interest requirement, a former shareholder who was a contemporaneous owner would have standing if she fairly and adequately represented the corporation—or, here, all former shareholders after the merger. MBCA §7.41.

If the jurisdiction has a continuing interest requirement, Lois could argue an exception to the requirement. Unless cashed-out shareholders could sue the former directors for premerger wrongdoing, their overreaching would go undetected and the shareholders’ loss uncompensated. See ALI Principles §7.02(a)(2) (allowing former shareholder to bring a postmerger derivative suit seeking pro rata recovery). The only question is whether Lois is best suited to represent the other former shareholders.

Under Delaware’s strict “continuing interest” rule, Lois could not maintain a derivative suit after the cash-out merger. At most, she could bring a direct action if the merger was illegal or accomplished by fraud. See Lewis v. Anderson, 477 A.2d 1040 (Del. 1983). The strict Delaware approach assumes the buyer has paid the former shareholders for the right to sue for management abuse. If RKK chooses not to pursue this claim, the claim would be lost.
§18.5 DISMISSAL OF DERIVATIVE LITIGATION — FINDING A CORPORATE VOICE

In theory, a shareholder’s derivative suit is brought on behalf of the corporation, and the “corporation” should have a voice in deciding whether the suit is brought, maintained, or settled. But who speaks for the corporation—

• the individual shareholder-plaintiff?
• the shareholders as a group?
• the board of directors?
• a committee of the board?
• the court?

As you review the variety of approaches to identifying a trustworthy corporate voice, consider the incentives of each speaker.

§18.5.1 Self-Appointed Derivative Suit Plaintiff

A derivative suit plaintiff, though purporting to step into the corporation’s shoes and to represent general corporate interests, may in fact be representing his own inconsistent interests. To prevent abuse of the judicial process and protect the integrity of centralized corporate governance, derivative suit plaintiffs are subject to a variety of procedural rules (see §18.3 above). In addition, corporate law increasingly instructs judges to listen to other voices in deciding the fate of a shareholder’s derivative suit.

§18.5.2 Unwieldy Body of Shareholders

In theory, allowing the body of shareholders to decide the fate of derivative litigation would overcome the problems of entrusting fiduciary litigation to individual shareholder-plaintiffs. But requiring a demand on all shareholders and permitting a shareholder majority to decide whether the suit should proceed would create its own problems:

• **Proxy contest.** In public corporations, a demand requirement would entail the shareholder-plaintiff initiating an expensive and burdensome proxy contest before suit could commence. It would effectively kill derivative litigation against all but the clearest and most costly fiduciary breaches.
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- **Shareholder passivity.** Shareholders, particularly in a public corporation, might lack the incentives to evaluate the relative costs and benefits of derivative litigation. Shareholders might approve suits that are not in the corporation’s best interests and disapprove others that are.

- **Illegitimate.** Allowing a shareholder majority to refuse to litigate would permit ratification of fraud, self-dealing, or waste. In a public corporation, management’s control of the proxy machinery might make majority refusal of doubtful legitimacy. In a close corporation, majority refusal would predictably gut fiduciary protection for the minority.

Most statutes do not require a demand on shareholders. MBCA §7.42; ALI Principles §7.03(c); cf. Fed. R. Civ. P. 23.1 (pleading requirement). Moreover, in those states where shareholder demand is required, courts have excused it when the derivative plaintiff alleges a wrong (such as waste) that cannot be ratified by a majority of shareholders or when demand would be burdensome because of the number of shareholders. See *Mayer v. Adams*, 141 A.2d 458 (Del. 1958).

§18.5.3 Board of Directors — Voice of Centralized Corporate Governance

The board’s power to speak for the corporation in a derivative suit is linked to whether shareholders must make a demand on the board.

**Dilemma**

Before we consider the various judicial and statutory approaches, consider the mixed signals from corporate law. On the one hand, the business judgment rule assumes the board has wide discretion to make business decisions, including litigation decisions. The directors, more than shareholders or judges, are better positioned to evaluate whether a claim has merit, whether it is consistent with corporate interests, and whether corporate resources (money and personnel) should be used to pursue it. If there is no conflict of interest, the board’s incentives will predictably be closely aligned with general corporate interests.

On the other hand, if the claim involves charges of a fiduciary breach, corporate law doubts the board’s impartiality. Even directors not involved in the alleged wrongdoing or not themselves named defendants may be solicitous of fellow directors (or other members of the control group) who are sued. Structural bias on the board because of personal, professional, and
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social ties may create pressures for directors to act in ways inconsistent with
general corporate interests.

Despite this tension between board discretion and answerability, courts
and statutes increasingly assume that disinterested directors may be a better
voice for the corporation than self-appointed shareholder-plaintiffs.

Demand-Required (Futility Exception)

Under the prevailing judicial approach, the board of directors can decide the
fate of derivative litigation if a pre-suit demand on the board is required.
If the board receives a demand and refuses to act or settle the charges, its
response (or nonresponse) receives deferential review under the business
judgment rule. A shareholder-plaintiff must show the board’s response to
the demand was self-interested, dishonest, illegal, or insufficiently informed.
Usually a demand-required claim is a lost claim.

But demand is excused if it would be futile to bring the matter to the
board. When demand is excused, the directors cannot block a derivative
suit. Their voice is silenced. The assumption in a demand-excused case is
that the board is unlikely to be objective in considering the merits of the
suit. Allowing a tainted board to make litigation decisions would be tanta-
mount to allowing an accused to decide whether to prosecute himself.

The demand-excused approach produces the following results:

| Demand required | Board decides fate of claim, subject to review under business judgment rule |
| Demand excused  | Claim goes forward; board cannot dismiss |

When is demand excused? The Delaware Supreme Court has adopted two
is excused if the shareholder-plaintiff can allege with particularity facts that create
a reasonable doubt on either of two scores—

- doubt that a majority of the current directors on whom demand
  would have been made are disinterested and independent, or
- doubt that the challenged transaction was protected by the business
  judgment rule—by showing a conflict of interest, bad faith, grossly
  uninformed decision making, or a significant failure of oversight.

To make this showing, the plaintiff must point to specific facts (before dis-
covery) that tend to show either that the board is now untrustworthy to
respond to the demand or that the underlying transaction was improper.
(The Aronson decision states the trial court is to make both inquiries—a
seeming conjunctive standard—but later cases make clear either showing
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is sufficient to establish demand futility.) See Marx v. Akers, 666 N.E.2d 1034 (N.Y. 1996) (adopting Aronson approach and excusing demand when (1) current board is “interested” in challenged transaction, or (2) board decision not appropriately informed, or (3) challenged transaction so egregious that it could not be product of sound business judgment).

As applied, the Aronson test places a heavy burden on derivative plaintiffs seeking review of board operational decisions. See Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (refusing to excuse demand despite findings of “lavish” pay and “sloppy” review by board of directors) (see §14.2.4). In Aronson, for example, the plaintiff challenged a compensation package the board approved for the company’s retiring chair and 47 percent shareholder. The court said that just because the defendant owned a controlling block of the company’s stock and had selected all of the directors did not create a “reasonable doubt” concerning the directors’ independence. Further, the court held the alleged facts failed to make out a claim of waste, even though the allegations included that the defendant performed “little or no service” and would be compensated whether or not he was able to perform.

In Delaware, once a shareholder makes a demand, she cannot bring a derivative suit unless she can show the board’s rejection was wrongful—that is, it was not made in good faith after a reasonable investigation. Spiegel v. Buntrock, 571 A.2d 767 (Del. 1990). A shareholder who makes a demand cannot later assert that demand should have been excused. Levine v. Smith, 591 A.2d 194 (Del. 1991). Making a demand in Delaware effectively places the fate of the derivative suit in the hands of the board.

Universal Demand

The MBCA avoids the demand-required/demand-excused question (thus avoiding litigation within litigation) by making demand a universal precondition to derivative litigation. MBCA §7.42. A shareholder wishing to file suit must make a demand and then wait 90 days — unless the board rejects the demand or waiting would result in irreparable injury to the corporation. See also ALI Principles §7.03 (requiring demand in every case, except when “irreparable injury” would result).

After the 90-day waiting period, the shareholder may bring a derivative suit. If the board rejected the demand, the plaintiff must plead with particularity that either the board’s rejection of the demand was not disinterested or the rejection was not in good faith or not informed. (This is similar to the Delaware Aronson approach.) After suit is brought, the board can move for dismissal if independent directors constitute a quorum (a majority of the board) and a majority of independent directors determine in “good faith” and after a “reasonable inquiry” that maintaining the suit is not in the corporation’s best interests. MBCA §7.44(a), (b)(1). The statute defines
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independence much as have the courts. A director is not disqualified merely because he is named as a defendant, was nominated or elected to the board by defendants, or approved the challenged transaction. MBCA §7.44(c).

Demand and Dismissal in Federal Court

If a derivative claim is brought under federal law, the demand and dismissal rules are governed by the law of the incorporating state unless its application would be inconsistent with federal policy. Burks v. Lasker, 441 U.S. 471 (1984). The Supreme Court has rejected a federal universal demand standard in federal securities derivative litigation because the demand requirement bears on the allocation of power in the corporation, a matter federal law normally leaves to the law of the state of incorporation. Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991).

State rules governing shareholder litigation, however, must also be consistent with federal policy. In Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984), the Supreme Court concluded no pre-suit demand is required in a shareholder suit against a mutual fund’s investment advisor under §36(b) of the Investment Company Act of 1940. The Court characterized the suit as not derivative, thus making Fed. R. Civ. P. 23.1 inapplicable. The Court pointed out that §36(b) is a remedial provision that allows mutual fund investors to challenge unfair compensation in investment advisory contracts, which are rife with conflicts of interest.

§18.5.4 Special Litigation Committee

During the 1970s, boards of directors responded to a spate of derivative litigation with an ingenious device. The board, whose members were usually named as defendants for various infractions, appointed a special litigation committee (SLC) of disinterested and often recently appointed directors with the exclusive power to decide whether the suit should go forward. The committee, often assisted by outside counsel, investigated the charges and prepared a (usually voluminous) report. The committee invariably recommended that the suit not be pursued further and then sought its dismissal.

During the 1980s, SLCs gained popularity. Typically, the board would give the committee full power to make litigation decisions for the corporation. See §30.1.3. The committee usually was comprised of directors who had not participated in the challenged transaction and hence could not be named as defendants. SLCs have shown a remarkable disposition for director defendants. In the vast majority of cases, SLCs refuse to continue the suit against a colleague.

Academic commentators doubted the trustworthiness of the SLC ruse and pointed to research on group dynamics suggesting committee
members face unspoken pressure to dismiss charges against fellow directors—so-called structural bias. See Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985) (holding committee member not to be independent because he was director when the challenged actions took place, was named as defendant, had political and financial dealings with company’s dominating CEO, and was president of university that had received significant contributions from the CEO and company).

Courts have responded to SLCs in a variety of ways.

**Business Judgment Review**

The first cases during the 1970s uniformly held that an SLC’s recommendation to dismiss litigation was like any other corporate business decision, despite the self-interested taint of the board that had appointed the committee. Unless the plaintiff could show the committee’s members were themselves interested or had not acted on an informed basis, the committee’s recommendations were entitled to full judicial deference under the business judgment doctrine. Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979).

Under this approach, after a committee investigates the claims made by the plaintiff, it can recommend dismissal of the litigation on many grounds: The suit would undermine employee morale and waste employee time; litigation expenses would exceed any possible gain; the suit would create bad publicity for the company; the underlying claim lacks merit; the corporation might be required to indemnify a successful defendant; and so on. Some commentators criticized this business judgment deference as sounding the death knell for derivative litigation, and the approach has eroded. See In re PSE&G Shareholder Litigation, 801 A.2d 295 (N.J. 2002) (applying modified business judgment rule to require corporation to show SLC’s independence, good faith, and reasonable decision).

**Heightened Scrutiny (Demand-Excused Cases)**

In Delaware, when demand on the board is excused as futile, the courts listen to the SLC—but with suspicion. In Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), the Delaware Supreme Court agreed there might be “subconscious abuse” by members of the committee asked to pass judgment on fellow directors. The court established a two-part inquiry into whether an SLC’s recommendation to dismiss would be respected—

- **Procedural inquiry.** The defendants must carry the burden of showing the committee members’ independence from the defendants, their good faith, reasonable investigation, and the legal and factual
bases for the committee’s conclusions. If there is a genuine issue of material fact as to any of these counts, the derivative litigation proceeds. See In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003) (finding lack of SLC independence, despite being composed of unnamed board members and its use of reputable outside law firm, because SLC members had long-standing professional/academic relationships with principal defendants through Stanford University).

- **Substantive inquiry.** Even if the SLC’s recommendation passes this first stage of inquiry, the trial judge may apply his own “independent business judgment” as to whether the suit should be dismissed. This second inquiry—which focuses on such matters as the strength of the fiduciary claims and the likelihood of recovery—is far more intrusive than even the fairness test applicable to self-dealing transactions. It recognizes that judges are particularly adept (in fact it is generally their job) to evaluate the merits of litigation and that judicial incentives to further the interests of the corporation are perhaps stronger than those of an SLC.

At first blush, the two-step Zapata inquiry seems to be a remarkable departure from cases that apply the business judgment presumption to SLC recommendations. But in Delaware, the Zapata test applies to SLC recommendations only in demand-excused cases. Three years after Zapata, the Delaware Supreme Court significantly limited the decision’s importance by making demand a requirement in a large number of cases. Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (see §18.5.3 above).

### Heightened Scrutiny (Regardless of Demand)

Some courts have subjected SLC dismissal recommendations to heightened scrutiny whether demand is required or excused. Under this approach, the trial court independently evaluates the suit’s merits, giving some (but not presumptive) weight to the SLC’s recommendation. Joy v. North, 692 F.2d 880 (2d Cir. 1982); see also ALI Principles §7.08.

For example, in Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987), the North Carolina Supreme Court focused on the court’s supervisory function in derivative litigation under the state’s demand-pleading statute. See §18.3.3. The court refused to read the statutory requirement that the plaintiff plead his demand efforts as requiring different levels of judicial scrutiny depending on whether demand was required or excused. Just as settlement of derivative litigation is subject to court review, so is dismissal. Under the statute, the court concluded, the trial judge could not disregard shareholder interests by relying blindly on the SLC’s recommendations.
18. Shareholder Litigation

Measured Scrutiny (Universal Demand)

Under the MBCA, an SLC (of at least two independent directors) may seek dismissal of derivative litigation after a shareholder has made the obligatory pre-suit demand. If the committee was appointed by a majority of independent directors, the MBCA requires the court to dismiss the action under the same standards as board dismissal — namely that the SLC determines in “good faith” and after a “reasonable inquiry” that maintaining the suit is not in the corporation’s best interests. MBCA §7.44(a), (b)(2). The same definition of independence applies for dismissal by the board. See Einhorn v. Culea, 612 N.W.2d 78 (Wis. 2000) (independence depends on whether committee member can decide “on merits of the issue rather than on extraneous considerations or influences”). A director is not disqualified merely because he is named as a defendant, was nominated or elected to the board by defendants, or approved the challenged transaction. MBCA §7.44(c).

Whether an SLC satisfies these standards requires a factual inquiry into the committee members’ disinterestedness, assistance by outside advisors, preparation of a written report, adequacy of their investigation, and reasonable belief in their decision. See Cuker v. Mikalsuska, 692 A.2d 1042 (Pa. 1997) (adopting the procedures and deferential review standards of the ALI Principles, which the court noted is “a comprehensive, cohesive work more than a decade in preparation”).

Federal Derivative Claims

When a derivative suit involves federal claims — such as under the federal securities laws — the Supreme Court has accepted as a matter of federal law that an SLC can dismiss the litigation provided dismissal is consistent with federal policy. In Burks v. Lasker, 441 U.S. 471 (1979), a shareholder brought a derivative action against several directors of a mutual fund and its investment advisor claiming violations of the Investment Company Act of 1940. The fund had purchased commercial paper of Penn Central Railroad just before it became insolvent. An SLC investigated the allegations that the directors and investment advisor had breached their duty of care. The SLC decided litigation was not in the fund’s best interests and sought dismissal. The Supreme Court upheld the dismissal on the theory the suit on behalf of the fund was governed by the law of the state of the fund’s incorporation, provided state law is not inconsistent with federal policy. In the case, the Court held that the 1940 Act did not forbid termination of nonfrivolous claims, and thus dismissal was not inconsistent with federal policy.
§18.5 Derivative Litigation in Federal Courts

Examples

1. Owing-Indiana (O-I), a public company incorporated in an MBCA jurisdiction, manufactures glass containers. Last year O-I’s board unanimously approved a $5 million loan to Glass Advocates Committee (GAC), a political action committee set up to stop a state referendum to ban disposable soda bottles. GAC was organized by Frank Jr., the son of O-I’s CEO, Frank Sr. There were reports that GAC spent most of its funds paying its organizers. The GAC loan is now delinquent, and O-I has done nothing. Dottie, a long-time O-I shareholder, wants O-I to collect the loan. She asks you for litigation advice.
   a. Must Dottie first make a demand on the shareholders?
   b. Must Dottie first make a demand on the board?

2. Kerning International is a holding company incorporated in Delaware. Among its subsidiaries is wholly owned Kerning Glass, a glass container manufacturer, incorporated in Delaware. The Kerning Glass board also approved a loan to GAC, which is now delinquent. Phil, a long-time Kerning International shareholder, wants Kerning Glass to collect. He asks you for litigation advice.
   a. Must Phil first make a demand on shareholders?
   b. Must Phil first make a demand on the Kerning International or Kerning Glass board?
   c. What litigation strategy do you recommend to Phil?

3. Dottie and Phil do not make demands on the relevant boards, and each files a derivative suit naming the board’s directors. In response, each board considers whether to request dismissal. After a cursory presentation by the company’s inside attorney who says the suit is “no more than the machinations of another gadfly shareholder,” each board moves the court to have the suit dismissed.
   a. Under the MBCA, how will the court respond to the O-I board’s request?
   b. Under Delaware law, how will the court respond to the Kerning Glass board’s request?

4. After Dottie files her complaint, the O-I board considers appointing an SLC to investigate the claims of the complaint. This will avoid any questions about the role of Frank Sr.
   a. What should the board do to maximize the effect of the committee recommendations?
   b. What should the committee do to maximize the chances that its recommendations will be listened to?
   c. The SLC issues a report recommending that Dottie’s complaint be dismissed. Is the recommendation binding on the court?
18. Shareholder Litigation

Explanations

1. a. No. The MBCA has no requirement of a demand on shareholders.
   b. Probably. The MBCA requires a complaining shareholder to exhaust internal remedies by making a pre-suit demand on the board. MBCA §7.42. Dottie can avoid making demand if there would be irreparable injury by waiting for the board to act during the 90-day waiting period. Dottie might argue that the ongoing dissipation of funds by GAC makes time of the essence. Unless the suit proceeds immediately, the corporation may be unable to recover from GAC or its organizers.

   Demand on the board is required even though the GAC loans might be characterized as a director’s conflicting-interest transaction. See MBCA Subchapter F (§13.4.1). The universal demand requirement gives even nonindependent directors an opportunity to reconsider their position and saves the time and expense of litigating the demand issue.

2. a. Probably not. Although the Delaware statute requires the plaintiff plead her efforts to make a demand on the shareholders or the reasons she did not, courts have largely read this demand requirement out of the statute in public corporations. If the shareholder can show such demand would be expensive or delay the action, or if the wrong is nonratifiable, courts have excused demand on shareholders. Making a demand on Kerning International’s public shareholders would be burdensome; a demand on Kerning Glass’s shareholder (the holding company) would be essentially a demand on the parent board.
   b. Not necessarily. Delaware case law permits a shareholder to bring a derivative suit and argue that demand was excused as futile. In a double derivative suit, such as this one, in which the shareholder seeks to have the parent exercise the subsidiary’s litigation rights, the Delaware courts have focused their demand analysis on the subsidiary’s board. See Rules v. Blushand, 634 A.2d 927 (Del. 1993) (look to subsidiary board because its decision is being challenged). Under Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (see §18.5.3), Phil would have to plead particular facts that created reasonable doubts about either the lack of independence of the subsidiary’s current directors, or the validity of the loan and its forgiveness. Although the sketchy pleadings are insufficient under Delaware case law to create doubts about the subsidiary directors’ disinterestedness or independence, the subsidiary’s forgiveness of a political loan may be illegal (see §12.3.1) and thus unprotected by the business judgment rule. Demand would be excused.
   c. Phil should file suit and not make demand. In Delaware, a shareholder who makes a demand concedes that a majority of the board has the requisite disinterest and independence to respond to the demand and decide the fate of the shareholder’s claim. That is, a demand on the board shifts
§18.5 Derivative Litigation in Federal Courts

the corporate voice to the board. If Phil makes a demand, he can continue his claim only if he shows the board’s response to the demand—whether inaction or settlement of the claim—was not protected by the business judgment rule. That is, he would have to show the board was grossly uninformed or lacked any rational basis for its response. If Phil files suit and argues demand was excused, he must plead particular facts to create the doubts of Aronson v. Lewis (see previous answer).

3. a. Under the MBCA, assuming demand was excused because otherwise there would be irrevocable harm, the court must dismiss the suit if a majority of the board is independent and sought dismissal in good faith after a reasonable inquiry. MBCA §7.44. Under the doctrine of res judicata, the GAC loan controversy would then be precluded from further judicial review in any court. If the court determines a majority of the board was independent, judicial review approximates that under the business judgment rule. That the O-I directors were named by Frank Sr. or have been named as defendants does not necessarily cause them to not be independent. The burden will be on the shareholder to show the board acted insincerely or without sufficient information. The official comment clarifies that the board need not engage outside counsel or advisors if it has knowledge of the pertinent facts or reasonably relies on others. The board could dismiss if it honestly and reasonably believed Dottie was “another gadfly shareholder.”

b. If demand was required, the court will dismiss the action unless Phil can show that the board’s decision to dismiss was grossly uninformed or irrational, thus not protected by the business judgment rule. If demand was excused, the board’s dismissal request will have no effect. Demand excusal carries with it the assumption the board lacks the independence to make a dismissal request or the allegations are sufficiently serious that the board could not request dismissal in good faith.

In Delaware, the board’s capacity to entertain the demand depends on a lack of interest among a majority of current directors and their independence of interested directors. See Rales v. Blasband, 634 A.2d 927 (Del. 1993). A director is considered interested if he will receive a personal financial benefit from nonprosecution of the suit that is not equally shared with the shareholders. For example, a director facing a significant potential for personal liability is disqualified. A director lacks independence if he is “beholden” to interested persons. For example, an executive whose substantial salary depends on the favor of an interested person lacks independence.

4. a. The committee should be composed of directors who have no connection to the loan approval—either because they did not participate in the decision or were elected afterward. The committee should be given full power to hire outside advisors and to bind the
corporation. Its recommendations should not be subject to review or approval by the board.

b. The committee must create the appearance that it has fully investigated the charges of the plaintiff’s complaint. It should conduct a discovery-like investigation: hire a prestigious unaffiliated special counsel (such as a retired judge or law professor), interview relevant people, review documents, and seek other knowledgeable and expert advice. The committee should carefully document its investigation and the basis for its recommendations.

c. Probably. If a majority of the whole board was independent when the SLC made its recommendation, Dottie would have the burden to overcome a business judgment presumption and show the SLC members acted insincerely or without adequate information. Even if a majority of the whole was not independent, but the committee members were, the SLC has the power to seek dismissal, but it would have the burden to show its recommendation is protected by the business judgment rule. See Carlton Investments v. TLC Beatrice Int’l Holdings, Inc., No. 13,950 (Del. Ch. May 30, 1997) (approving settlement negotiated by SLC, intended to stop spiraling litigation costs and end distraction of lawsuit). The SLC need not achieve perfection so long as it demonstrates independence, good faith, and a studied process.

The MBCA’s approach largely disregards the problems of structural bias on the board. Nonetheless, it is possible judges will review dismissal requests with greater scrutiny than under the normal business judgment rule. Just as a court has authority to consider the merits of the derivative suit when it approves a settlement, judges may feel inclined to delve into the SLC’s “no sue” decision. See Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987) (see §18.5.4). Judicial scrutiny of the SLC’s independence or its deliberations would recognize the self-interested motives of the possible voices in a derivative suit. This would be consistent with the logic in demand-required cases of the two-step Zapata test (see §18.5.4) and the general judicial rejection of the Auerbach v. Bennett business judgment rule approach (see §18.5.4).

Judicial scrutiny of the SLC recommendations assumes, as does the second step of the Zapata test, that inevitably judges will exercise their own “business judgment” concerning the litigation’s merits to the corporation. Although some have argued that such decisions are not significantly different from ordinary business decisions and should not be left to judges, a strong argument can be made that judges are particularly capable of making judgments about the expected value of litigation—a task at which they are expert. In any event, judges are often called on to make business judgments when considering the substantive fairness of self-dealing transactions.