

Demand in Derivative Actions: Problems of Interpretation and Function

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This Article, part of a book in progress, explores the question of demand requirements in shareholder derivative litigation. It considers the United States Supreme Court's interpretation of demand requirements under Federal Rule of Civil Procedure 23.1. It then examines states' treatments of demand on directors and demand on other shareholders, explaining that divergent notions of the function of demand understandably affect courts' interpretation of state derivative litigation laws. The Article argues that more consistent approaches to the demand requirements would better enable them to fulfill their purposes.

INTRODUCTION

Many aspects of derivative litigation have been controversial in recent years, producing divergent rules in different jurisdictions.¹ This Article explores the problematic features of demand requirements in derivative litigation. In all jurisdictions, before filing suit the plaintiff must demand that the corporation's directors take the action that plaintiff seeks. In some jurisdictions, plaintiff must make a comparable demand on the corporation's shareholders. Pervasive problems in interpretation and persistent confusion about the function of these demand requirements undercut their efficacy.

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¹ Perhaps the most controversial matter has been the use of special litigation committees as devices to terminate derivative actions. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.08 comment a (Discussion Draft 1985) (discussing variety of rules) [hereafter 1985 DISCUSSION DRAFT].

Jurisdictions vary widely in their treatment of demand on stockholders and answer differently a series of essential questions. First, before a plaintiff files suit, must she first demand that the corporation's stockholders sue or take other steps to redress her grievances on behalf of the company? For example, if the corporation's directors are hostile to the suit, must the plaintiff mount a proxy campaign to persuade the stockholders to replace or remove the directors? Second, if demand is a general precondition to suit, when will a court excuse the plaintiff from making a demand? Third, if the plaintiff makes a demand on stockholders and they decline to authorize the suit, does this bar the action? Likewise, does prior shareholder approval of the transactions involved in the litigation pretermitt the plaintiff's ability to sue alleging that those transactions injured the corporation?

The demand on directors requirement prevails generally: all states, perhaps excepting Florida,² require that plaintiff make demand on directors unless failure to make the demand is excusable. With the qualifications described below, such demand requirements apply as well to much derivative litigation in federal court. Apart from their uniform adherence to this basic principle, however, jurisdictions differ in their resolution of issues related to demand on directors. Varying consequences attach to plaintiff's failure to allege the making of demand or to the directors' refusal to take action in response to the plaintiff's demand. Further, jurisdictions define differently the circumstances under which they will excuse failure to make a demand. Finally, in some jurisdictions demand issues affect corporations' ability to appoint special litigation committees and influence the judicial treatment of recommendations from special litigation committees.

Some of these disparities result from different conceptions of the function served by requiring demand on directors. One view of the demand requirement is that it protects the directors' general power to manage the corporation's business and affairs, thus preserving the corporation's basic internal allocations of power. A competing view of the purpose of the demand requirement is more functional: demand generally is required because of the consequences of that effort, such as aiding the resolution of the parties' dispute without litigation. These divergent conceptions of the nature of demand requirements are revealed in the interpretive difficulties discussed below.

² See *infra* text accompanying notes 26-32.

I. PROBLEMS OF INTERPRETATION

In many jurisdictions, determining the precise nature and content of demand requirements is complicated by interpretive problems in the applicable statute or rule. In addition, some statutes create operational problems. Many states have enacted derivative litigation rules that parallel the requirement in Federal Rule of Civil Procedure 23.1 that the complaint allege "the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort."⁸ Despite the

⁸ FED. R. CIV. P. 23.1. The relevant language in the state statutes and rules requiring demand on stockholders is: ALA. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); ALASKA R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); ARIZ. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action . . . or for not making the effort"); ARK. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); COLO. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); GA. CODE ANN. § 9-11-23(b) (1982) ("and, if necessary, from the shareholders such actions as he desires and the reasons for his failure to obtain such action or the reasons for not making such effort"); HAWAII R. CIV. P. 23.1 ("and from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); IDAHO R. CIV. P. 23(f) ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); IOWA R. CIV. P. 44 ("and allege their efforts to have the directors, trustees or other shareholders bring the action or enforce the right, or a sufficient reason for not making such an effort"); KAN. STAT. ANN. § 60-223(a) (Vernon 1983) ("and, if necessary under the applicable law, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); KY. REV. STAT. ANN. § 271A.245 (Bobbs-Merrill 1985) ("and, if necessary, from the shareholders, and the reasons for his failure to obtain the action or for not making the effort"); LA. CODE CIV. PROC. ANN. art. 596(2) (West 1960) ("and, if necessary, from the shareholders or members, the enforcement of the right; and the reason for his failure to secure such enforcement; or the reason for not making such an effort"); ME. R. CIV. P. 23A ("if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort") & ME. REV. STAT. ANN. tit. 13-A, § 627 (1)(C) ("If the corporation in whose right he is instituting the action is a close corporation, as defined in this Act, the plaintiff alleges in the complaint with particularity his efforts to secure from the shareholders such action as he desires, or alleges with particularity the reason why such efforts would have been futile."); MASS. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); MINN. R. CIV. P. 23.06 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not

straightforward wording of this portion of the rule, courts have inconsistently interpreted its language.

Some courts are unable or reluctant to interpret and apply the rule literally, even when there is no apparent reason to interpret and apply the rule otherwise. For example, the rule's coupling of its reference to demand on shareholders with "if necessary" seems to require courts to examine substantive law external to the rule itself, in order to determine whether plaintiff must make a demand on shareholders and whether an adverse response to the demand should bar the suit.⁴ None-

making the effort"); MO. ANN. STAT. § 507.070(2) (Vernon 1952) ("and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort"); MO. R. CIV. P. 52.09 ("if necessary, from the shareholders or members and his reasons for his failure to obtain the action or for not making the effort"); MONT. R. CIV. P. 23.1 ("if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); NEV. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); N.J. CIV. PRAC. R. 4:32-5 ("and, if necessary, from the shareholders such actions as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort"); N.M. R. CIV. P. 23.1 ("if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); OHIO R. CIV. P. 23.1 ("and, if necessary, from the shareholders and the reasons for his failure to obtain the action or for not making the effort"); OKLA. STAT. ANN. tit. 18, § 1.28(b) (West 1953) ("and, if necessary, from the shareholders, such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort"); PA. R. CIV. P. 1506(2) ("by the corporation or similar entity or the reasons for not making any such efforts"); R.I. R. CIV. P. 23.1(b) ("and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making the effort"); S.D. CODIFIED LAWS ANN. § 15-6-23.1 (1984) ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); TENN. R. CIV. P. 23.06 ("if necessary, from the shareholders, or members, and the reasons for his failure to obtain the action or for not making the effort"); UTAH. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); VT. R. CIV. P. 23.1 ("and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); WASH. CIV. R. for Super. Ct. 23.1, promulgated in 77 Wash. 2d ixiii (1967) ("if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort"); W. VA. R. CIV. P. 23(b) ("if necessary, from the shareholders, such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort"); WYO. R. CIV. P. 23.1 ("and, if necessary from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort").

⁴ See *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 542 (1984) (Stevens, J., concurring). *But cf.* *Clairdale Enters., Inc. v. C.I. Realty Investors*, 423 F. Supp. 257, 261

theless, whether the language of the state counterparts to Rule 23.1 itself imposes a requirement of a demand on stockholders has not received a consistent answer.

This problem is illustrated by the Colorado Supreme Court's 1971 opinion in *Bell v. Arnold*.⁵ *Bell* interpreted a Colorado rule requiring the shareholder's complaint to "set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."⁶ Despite the rule's wording, the court treated the rule as the source of Colorado's demand requirements. After explaining the policy rationales for demand on stockholders, the court referred to "the demand requirements of our previous and present rule pertaining to derivative lawsuits."⁷ To be sure, such infelicities in interpretation do not necessarily affect the outcome of cases, especially if all the "law" potentially applicable to the action comes from the same jurisdiction.

More serious problems surround the interpretation of this rule as applied to derivative litigation in federal courts. Federal courts differ on whether the rule imposes demand requirements — in particular requirements as to demand on directors — or whether it simply regulates pleading, so that any applicable demand requirements originate in law external to the rule. Some federal courts have held that the rule itself requires demand on directors in diversity actions and actions arising under the federal securities laws.⁸ A few courts have even read the rule

(S.D.N.Y. 1976) (granting motion to dismiss derivative claim on the ground that a shareholder demand had not been made as required by FED. R. CIV. P. 23.1).

⁵ *Bell v. Arnold*, 175 Colo. 27, 487 P.2d 545 (1971).

⁶ *Id.* at 28, 487 P.2d at 546 (citing COLO. R. CIV. P. 23(b)).

⁷ *Id.* at 28, 487 P.2d at 547. Contrast the interpretation of the comparable language of former N.Y. BUS. CORP. L. § 626 in *Syracuse Television v. Channel 9*, Syracuse, 51 Misc. 2d 188, 193, 273 N.Y.S.2d 16, 24 (Sup. Ct. 1966), in which the court observed that statutory language referring to demand on shareholders "if necessary" would "presumably [mean] if necessary under the law of the State, i.e., *Continental Securities Co. v. Belmont*," an early case in which the Court of Appeals required demand on shareholders only if the wrongs alleged were within the shareholders' power to remedy or ratify. See 206 N.Y. 7, 19, 99 N.E. 138, 142 (1912).

⁸ See *Galef v. Alexander*, 615 F.2d 51, 59 (2d Cir. 1980) (describing Rule 23.1 as "essentially a requirement that a stockholder exhaust his intracorporate remedies before bringing a derivative action"); *Shlensky v. Dorsey*, 574 F.2d 131, 140 (3d Cir. 1978) (describing Rule 23.1 as the "procedural implementation for the rule laid down in *Hawes v. Oakland*"). The actions in *Galef* and *Shlensky* involved both state law and federal securities laws claims. The opinions do not differentiate between the two in their interpretation of Rule 23.1. See also *Meltzer v. Atlantic Research Corp.*, 330 F.2d 946, 948 (4th Cir.), cert. denied, 379 U.S. 841 (1964) (stating that "[t]he neces-

to require demand on shareholders.⁹ Other federal courts, treating the rule as a pleading regulation, hold that any demand requirements must stem from state corporate law or the federal securities laws rather than Rule 23.1.¹⁰ Some courts have qualified this general principle for claims based on the federal securities laws. These courts refuse to apply the law of the state¹¹ if imposing a demand requirement would conflict with the relevant federal statute's purpose.¹²

sity and sufficiency of the preliminary demand upon the directors, and the circumstance which satisfies omission of such demand under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law.”); *Elfenbein v. Gulf & Western Indus.*, 454 F. Supp. 6, 8 n.4 (S.D.N.Y.), *aff'd*, 590 F.2d 445 (2d Cir. 1978) (stating that Rule 23.1 “does not require or anticipate ratification or approval. Rather, it requires plaintiff to afford the directors an opportunity to control the litigation on behalf of the corporation.”).

⁹ See *Abraham v. Parkins*, 36 F. Supp. 238 (W.D. Pa. 1940); *cf. Clairdale Enters., Inc. v. C.I. Realty Investors*, 423 F. Supp. 257, 258 (S.D.N.Y. 1976) (granting motion to dismiss derivative claim on the ground that a shareholder demand has not been made as required by FED. R. CIV. P. 23.1). One possibility is that the bylaws or charter of the real estate investment trust involved in *Clairdale*, although not described by the court, themselves required that a demand be made on shareholders.

¹⁰ See *Tabas v. Mullane*, 608 F. Supp. 759, 764-65 (D.N.J. 1985); *Allison ex rel. G.M.C. v. General Motors Corp.*, 604 F. Supp. 1106, 1115-16 (D. Del. 1985); *Reilly Mortgage Group v. Mount Vernon Sav. & Loan Ass'n*, 568 F. Supp. 1067, 1075-76 (E.D. Va. 1983); *Brick v. Dominion Mortgage & Realty Trust*, 442 F. Supp. 283, 296 (W.D.N.Y. 1977); *cf. Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 523-33 & n.8 (1984) (referring to qualifying language added to rule in 1966 requiring allegation of efforts “if any” made to obtain action from directors); *Jacobs v. Adams*, 601 F.2d 176, 179-80 (5th Cir. 1979) (Florida law applies because Florida is both forum state and state of incorporation).

¹¹ See *Brody v. Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973) (complaint alleged violation of § 17(a) of Securities Act of 1933; applicable state law did not require demand on stockholders when plaintiff alleged nonratifiable wrongs); *Brick v. Dominion Mortgage & Realty Trust*, 442 F. Supp. at 297 (dismissing claim based on rule 10b-5 of the Securities Exchange Act because plaintiff failed either to allege demand on stockholders or to allege circumstances excusing demand; applicable state law Massachusetts).

¹² See *Levitt v. Johnson*, 334 F.2d 815, 819 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965) (complaint alleged violations of Investment Company Act of 1940; applicable state law Massachusetts). In *Messinger v. United Canso Oil & Gas Ltd.*, 80 F.R.D. 730, 738 (D. Conn. 1978), the court held that demand on stockholders was not necessary and that plaintiff adequately alleged reasons for not making one. The corporation in question was incorporated in Canada, which defendants argued would require plaintiff to make a demand on shareholders prior to bringing a derivative action. Plaintiff alleged in the complaint that demand was unnecessary because the company's shareholders were widely scattered, so that making the demand would be expensive, and because the wrongs alleged in the complaint were not ratifiable by shareholders. The court's discussion of demand makes no inquiry into Canadian law and whether it

The importance of these interpretive disputes is enhanced, of course, with the presence of restraints on federal courts' ability, through rules of civil procedure, to regulate substantive aspects of corporate governance relationships. The federal Rules Enabling Act¹³ states that federal rules "shall not abridge, enlarge or modify any substantive right." This Act creates doubt about whether a federal rule of procedure could validly impose requirements that concern issues governed by the substantive law of corporations; demand requirements are concededly substantive.¹⁴ Courts can comply with the Rules Enabling Act by recognizing that the language in Rule 23.1 addressing demand relates only to pleading and thus does not impose or define demand requirements; only the substantive law applicable to the action can govern the necessity or conditions for demand on shareholders or directors. Interpreting rule 23.1's treatment of demand in this fashion does not leave that portion of the rule functionless. Rather, it enables the district court to determine, on the basis of pleadings and thus early in the litigation, whether prerequisites for suit have been satisfied.

This reading of Rule 23.1, set forth by Justice Stevens in his concurring opinion in *Daily Income Fund, Inc. v. Fox*,¹⁵ is consistent with most of the rule's wording. It does not accommodate as well Rule 23.1's requirement that stockholder demand be made "if necessary." If this language refers to laws external to Rule 23.1, the interpretation of the rule set forth above makes the words "if necessary" superfluous. This interpretation treats the rule as requiring reference to law external to

would excuse demand under these circumstances. The opinion observes instead that "[t]he sufficiency of the plaintiff's pleading, however, is measured, not by the law of Canada, but by Rule 23.1 of the Federal Rules of Civil Procedure." *Id.* The opinion cites *Levitt v. Johnson*, 334 F.2d 815, 817, for the proposition that demand requirements in Rule 23.1 should be interpreted flexibly and can be excused when they would impose an onerous financial burden on plaintiff. But it omits an essential element in the First Circuit's analysis in *Levitt*: namely, that the Investment Company Act of 1940, upon which the action was based, impliedly forbade the application of Massachusetts demand requirements to the action. *United Canso*, in contrast, was a diversity action arising out of a service contract between an oil and gas production company and another company and a subsequent dispute over the amount of royalties due under the contract when the production company sold its wholly-owned British subsidiary.

¹³ 28 U.S.C. § 2072 (1983).

¹⁴ The United States Supreme Court has, however, given great deference to the Federal Rules of Civil Procedure. *Hanna v. Plumer*, 380 U.S. 460 (1965). The Rules Enabling Act, however, imposes at least some minimal constraints on the scope of federal rules. See generally Ely, *The Irrepressible Myth of Erie*, 87 HARV. L. REV. 673 (1974).

¹⁵ See *Daily Income Fund, Inc. v. Fox*, 464 U.S. at 526 n.2 (Stevens, J., concurring).

the rule to resolve all questions concerning demand, not just those concerning demand on shareholders. This superfluity can be avoided by reading Rule 23.1 itself to impose a requirement of demand on directors, but to require demand on shareholders only if applicable state or federal law, external to Rule 23.1, so provides. But this interpretation treats the rule as the source of substantive regulation of corporate governance relationships, and thus is inconsistent with the Rules Enabling Act. Perhaps the desire not to treat "if necessary" as superfluous explains the position taken in federal procedure treatises that the rule itself imposes a requirement of demand on directors applicable to derivative litigation in federal court.¹⁶

The treatment of demand in Rule 23.1 also contrasts with the rule's treatment of other aspects of derivative litigation that do not raise these interpretive difficulties. For example, the rule requires that the complaint allege "that the plaintiff was a shareholder or member at the time of the transaction of which he complains" Although couched in a prescription relevant to pleading, this language unequivocally requires that a derivative suit plaintiff have been a contemporaneous shareholder. In contrast, the rule's treatment of demand does not on its face embody a comparably unequivocal requirement that the plaintiff have made a demand on directors before filing the action.

Nevertheless, in *Daily Income Fund*, a majority of the Supreme Court expressly declined to decide whether federal Rule 23.1 imposes demand requirements on plaintiffs in derivative suits brought in federal court or whether such requirements originate in the applicable substantive law.¹⁷ The Court declined to decide these questions because it concluded that the action in *Daily Income Fund*, brought as it was under section 36(b) of the Investment Company Act, was not a derivative suit, rendering Rule 23.1 in its entirety inapplicable.¹⁸ Justice Stevens' concurring opinion develops a contrasting thesis: requiring the plaintiff to make a demand on directors would be inconsistent with the applicable substantive law, the Investment Company Act. Moreover, Justice Stevens' opinion argues that Rule 23.1 does not impose demand requirements and regulates only pleading.

¹⁶ See 3B J. MOORE & J. KENNEDY, *MOORE'S FEDERAL PRACTICE* § 23.1.19 (2d ed. 1985); 7A C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE: CIVIL* § 1831 (Supp. 1985).

¹⁷ 464 U.S. at 532 n.8.

¹⁸ As a consequence, the other provisions of Rule 23.1 are also inapplicable to § 36(b) actions, including the safeguards imposed on settlements. See Smith, *Daily Income Fund, Inc. v. Fox — No Demand Requirement for Section 36(b) Advisory Suits Gives Rise to Potential Abuses*, 12 SEC. REG. L.J. 299, 330-31 (1985).

The Court may have been reluctant to address these questions because it initially imposed demand requirements in *Hawes v. City of Oakland*,¹⁹ well prior to its decision in *Erie Railroad v. Tompkins*²⁰ and the subsequent cases delineating the boundaries between federal courts' procedural rules and the applicable substantive law. Thus, for a court to hold that substantive law and not federal Rule 23.1 defines the demand requirements applicable to derivative actions in federal court, it must ascertain the content of the defining law. In actions that involve state law, such as diversity actions, the relevant body of law is that of a state, in some instances one whose jurisprudence on the point may be undeveloped. In actions arising under federal law the statute defining the federal cause of action may be silent on the preconditions for derivative litigation. Thus, to reject the legacy of *Hawes* might appear both cumbersome and unnecessary: cumbersome because of the lacunae in the substantive law that would then define demand requirements, and unnecessary if the outcome on demand questions would be the same regardless of the body of law the court examined.

Although understandable, the Court's reluctance to resolve this question in *Daily Income Fund* is unfortunate. Some lower federal courts interpret Rule 23.1 in a style that is inconsistent with its plain meaning and that purports to regulate matters of internal corporate governance under the aegis of a federal procedural rule. The error in this interpretation is demonstrated by the Court's own characterization of issues raised by derivative legislation. In 1979, the Court held in *Burks v. Lasker*²¹ that questions concerning control of derivative litigation are questions of substantive law governed by the law of the state of incorporation (absent any conflict with the federal securities laws). Surely this principle applies as well to control over the initiation of such litigation, as embodied in demand requirements. This interpretive problem is more than theoretical in significance. As subsequent sections of this Article illustrate, the states differ increasingly on questions of demand. Thus, whether demand requirements are defined by the law of a particular state or by interpretations of Rule 23.1 may well determine the ultimate disposition of the action.

A more mundane question of interpretation arises with some frequency in cases addressing demand issues: What effect should a court give to *omissions* of provisions from rules or statutes, when the drafters give no contemporaneous explanation of the omission's intended signifi-

¹⁹ 104 U.S. 450 (1881).

²⁰ 304 U.S. 64 (1938).

²¹ 441 U.S. 471, 478-80 (1979).

cance? Courts have held that omissions of language dealing with demand on shareholders embody a legislative intention that such demand not be required. For example, one state enacted its statute governing the maintenance of derivative actions well after Rule 23.1 came into force.²² The statute substantially parallels Rule 23.1's language but omits any reference to demand on shareholders. A court held the statute to embody a legislative intention that derivative suits not be preconditioned on demand on shareholders.²³ Likewise, the amendment of such a statute eliminating the language addressing demand on shareholders might manifest a legislative intention no longer to require demand on shareholders.²⁴

Courts should treat omissions as dispositive assertions of legislative intent only after careful scrutiny of the nature of the omission.²⁵ For example, the Florida corporation statute, enacted in 1975, sets forth other regulations of derivative actions but does not mention demand on directors.²⁶ The predecessor statute required complaints in derivative actions to "set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board of directors of such corporation or the reasons for not having made such effort."²⁷ Does the omission of any language dealing with demand in the 1975 statute represent a legislative intention that demand on directors no longer be a precondition to the plaintiff's ability to bring a derivative suit? Indeed,

²² FLA. STAT. ANN. § 607.147 (West 1977 & Supp. 1985).

²³ See *Jacobs v. Adams*, 601 F.2d 176, 180 (5th Cir. 1979) (noting "conspicuous absence" of demand on shareholders from Florida statute).

²⁴ See *Syracuse Television v. Channel 9*, Syracuse, 51 Misc. 2d 188, 193, 273 N.Y.S.2d 16, 24 (Sup. Ct. 1966) (portion of bill amending N.Y. Bus. Corp. Law § 626 to require demand on shareholders "if necessary" not enacted; revised statute omits any language concerning prior demand on stockholders).

²⁵ Another interpretive possibility that omissions occasionally raise is treating the subject of the omission as "too obvious to be mentioned." The legislature should not be understood through the omission to be suggesting that the material omitted in fact be eliminated from the law, if the omitted material's continued inclusion would be self-evident or repetitive of what is evident notwithstanding the statutory language. See, e.g., Fletcher, *The General Common Law and Section 34 of the Judiciary Act of 1789: The Example of Marine Insurance*, 97 HARV. L. REV. 1513, 1517 (1984) (arguing that lack of explicit references to general common law in statute specifying applicability of state law to diversity cases does not establish that general common law was not expected to be applied by inferior federal courts; instead "its applicability was so obvious as to go without saying"). Because rules concerning demand vary so greatly among jurisdictions, this technique of interpretation is useless for the problems discussed in this Article.

²⁶ See FLA. STAT. ANN. § 607.147 (West 1977 & Supp. 1985).

²⁷ See *id.* § 608.131(2) (repealed 1975).

Florida's omission of language dealing with demand on shareholders, in light of Florida's common law requirement that plaintiff make a demand on shareholders, has been interpreted to mean that the legislature did not intend to require demand on shareholders.²⁸

An alternative interpretation of the meaning of the omission from the 1975 statute is at least equally plausible. If the treatment of demand on directors in the predecessor statute was only a regulation of pleading in derivative litigation, then any common law requirement of demand on directors would have survived the 1975 enactment. On its face, the old Florida statute, like the comparable language of federal Rule 23.1, prescribed the content of the plaintiff's complaint. The statute required plaintiff to "set forth with particularity" either her efforts to persuade the directors to initiate the action or her reasons for not making these efforts. This language does not require that the plaintiff make a demand. In addition, it fails to define the grounds that excuse the endeavor. The language only requires that these matters be alleged with particularity in the complaint. Omitting this language from the 1975 statute thus only revised the pleading requirements.

Although no cases address this point directly, one Florida case interpreting the earlier statute is consistent with the second interpretation. In *Belcher v. Schilling*,²⁹ the Florida Court of Appeals held that demand on directors was unnecessary under the circumstances of the case.³⁰ The court referred to the criteria for excuse set forth by the Florida Supreme Court in 1932 in *Orlando Orange Groves Co. v. Hale*.³¹ *Orlando Orange Groves* appears to be the first Florida case articulating a requirement of demand on directors and defining the circumstances under which demand may be excused. Like the United States Supreme Court's opinion in *Hawes v. City of Oakland*, upon which it relies heavily, *Orlando Orange Groves* is a common law statement of demand requirements. Indeed, *Belcher v. Schilling*, decided while the former corporation statute was in effect, explicitly treats *Orlando Orange Groves* as the binding Florida authority on excuse. It further refers to the statutory provision on demand as "reinforc[ing]" the case law. Implicitly, then, *Belcher v. Schilling* viewed the statute as merely the procedural device to implement demand requirements established in the common law and not as the principal authority imposing

²⁸ See *Jacobs v. Adams*, 601 F.2d 176, 180 (5th Cir. 1979).

²⁹ 309 So. 2d 32 (Fla. Ct. App. 1975).

³⁰ *Id.* at 35.

³¹ 107 Fla. 304, 144 So. 674 (1932).

demand requirements.³²

Thus, like the other problems of interpretation discussed above, a court may resolve this one with an appropriately careful reading of the language in question. Underlying all of these interpretive difficulties is courts' all-too-frequent inability or unwillingness to read accurately and interpret accordingly the actual language of the rule or statute. These failures in turn have led to unnecessary ambiguity in the development of the law of demand and, consequently, to unnecessary confusion in the meaning of demand requirements as applied to cases.

II. PROBLEMS OF FUNCTION

Interpretation of demand requirements is complicated by cases' inconsistent view of the purposes behind requiring demand on shareholders or directors. Divergent interpretations of demand requirements in turn dictate different resolutions of questions raised by demand. Although divergent rationales have always existed in the law of demand, the tensions among them have manifested themselves more clearly in recent cases. The Supreme Court opinion first promulgating demand requirements for derivative suits in federal court was *Hawes v. City of*

³² Another portion of the 1975 statute that appears to work a significant change in the prior law has been interpreted to limit its effect drastically. Plaintiff in *Schilling v. Belcher*, 582 F.2d 995 (5th Cir. 1978), obtained a judgment in a derivative action and an award of attorney's fees in his direct favor. He sold his stock while defendants' appeal was pending. Another company acquired all of the shares of the corporation on whose behalf plaintiff had sued derivatively. The Fifth Circuit concluded that plaintiff's sale of his stock destroyed his standing to pursue further the derivative claims (but not the judgment for attorney's fees running directly in his favor). The court compared the treatment of contemporaneous ownership requirements in the former statute with that in § 607.147 of the 1975 statute. The former statute required that the plaintiff be "a stockholder . . . at the time of bringing the action . . ." *Id.* at 1000. In contrast, the 1975 statute omits this language. It does require, however, as did the former statute, that the plaintiff be a stockholder at the time of the contested transaction. The Fifth Circuit nonetheless found numerous vestiges of the more exacting contemporaneous shareholding requirement in § 607.147 of the 1975 statute. The court noted the statute's title ("*Shareholder* derivative actions"), that its security for costs provisions are effective only if the plaintiff owns less than 5% of the outstanding shares, and its initial reference to "*any action commenced or maintained by a shareholder . . .*" *Id.* at 1002 (emphasis in original). Further, the court concluded that only the plaintiff's proprietary interest in the corporation justified derivative standing. *Id.* But see *Di Giovanni v. All-Pro Golf, Inc.*, 332 So. 2d 91, 94 n.5 (Fla. App. Ct. 1976) (court observed in dicta that under § 607.147 of 1975 statute, one need only have been a stockholder at time of contested transaction). Thus, the Fifth Circuit's opinion in *Schilling* discounts the significance of the 1975 statute's omission of the earlier contemporaneous ownership requirement.

Oakland. In *Hawes*, the stockholder, a New York resident, contested a California water corporation's failure to dispute the city of Oakland's practice of using the company's water for all municipal purposes. The plaintiff filed suit five days after requesting that the company's president and directors stop furnishing water free of charge to the city. The Court criticized both the lack of detail in the complaint and the absence of allegations of fraud or ultra vires actions, noting that the complaint revealed nothing other than a dispute over the wisdom of the directors' decision to coexist generously with the city.

The *Hawes* Court focused primarily on the risk of collusive manufacture of federal jurisdiction through the contrived entrance of the plaintiff stockholder. The Court feared this phenomenon would overburden the federal courts with litigation that the true adversaries could have litigated in state court.³³ *Hawes* acknowledged as well the existence of "real contests" between stockholders and corporate fiduciaries, noting however that the case itself "goes beyond" such disputes.³⁴

The Court imposed demand requirements in this context for two reasons. First, requiring that the plaintiff make a demand on directors and stockholders before filing suit may protect the federal court against collusively manufactured federal jurisdiction. Also, requiring the plaintiff to "make it apparent to the court" that the effort has been earnest, not simulated, or futile,³⁵ may reduce the number of cases in which the supposed opposition between plaintiff and the directors proceeds from an artificial and brief ritual of demand and refusal.³⁶ Federal Rule 23.1 reflects this concern by requiring the plaintiff specifically to allege noncollusiveness. Second, *Hawes'* demand requirements reinforce basic norms of corporate governance. The requirements protect directors' ability to judge the corporation's best interests in pursuing litigation against third parties. The requirements also secure the interest of all the corporation's stockholders as the ultimate economic stakeholders in decisions affecting the enterprise.³⁷ *Hawes* requires that plaintiff make "an honest effort to obtain action by the stockholders as a body" or show excuse, if action is not forthcoming from the directors.³⁸ As later cases illustrate, the Court's conception of the demand requirements' primary function determines how it will resolve issues pertinent to

³³ *Hawes v. City of Oakland*, 104 U.S. 450, 453 (1881).

³⁴ *Id.* at 453.

³⁵ *Id.* at 461.

³⁶ *Id.* at 452-53.

³⁷ *Id.* at 462.

³⁸ *Id.* at 461.

demand.

A. Demand on Shareholders

Jurisdictions vary widely in their treatment of the shareholder demand requirements initially established in *Hawes*. Some jurisdictions have eliminated the shareholder demand requirement through amendments to statutes or court rules,³⁹ while other jurisdictions have achieved the same result less explicitly.⁴⁰ Although a number of other

³⁹ CAL. CORP. CODE § 800(b)(2) (West Supp. 1985) (effective Jan. 1, 1977); CONN. GEN. STAT. ANN. § 52-572j (West Supp. 1985) (effective 1977, amended 1982); DEL. CH. R. 23.1 (1981) (adopted Feb. 24, 1968); FLA. STAT. ANN. § 607.147 (West 1977, Supp. 1985) (effective Jan. 1, 1976); ILL. REV. STAT. ch 32 § 7.80 (Smith-Hurd Supp. 1985) (effective July 1, 1984); IND. R. 23.1 (Burns 1983) (effective Jan. 1, 1970); MICH. COMP. LAWS ANN. § 450.149(2)(b) (West 1973) (effective Jan. 1, 1973); MISS. CODE ANN. § 79-3-93 (1972) (effective Jan. 1, 1963); N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963) (effective Sept. 1, 1963); N.C. GEN. STAT. §§ 55-55 (1982) (effective 1973) & 1A-1, R 23(b) (1983) (effective 1967); S.C. CODE ANN. § 33-11-290(b) (Law. Co-op. Supp. 1984) (effective Jan. 1, 1982); TEX. BUS. CORP. ACT ANN. art. 5.14 (Vernon 1980) (effective Aug. 27, 1973) & R.C.P. 42(a) (1984) (effective Apr. 1, 1984); WIS. STAT. ANN. § 180.405 (West 1957) (effective 1953).

See also *Valiquet v. First Fed. Sav. & Loan Ass'n*, 87 Ill. App. 3d 195, 408 N.E.2d 921 (1979) (weight of authority in Illinois establishes that demand must first be made only on directors; plaintiff may proceed with action once demand has been properly made and refused, or when demand is excused for some reason); *Nolen v. Shaw-Walker Co.*, 449 F.2d 506, 508 n.4 (6th Cir. 1971) (in derivative action to which Michigan law is applicable, plaintiff need not have the support of a majority of the stockholders); *Grant v. Gosnell*, 266 S.C. 372, 223 S.E.2d 413 (1976) (excusing failure to make demand on directors and shareholders when one defendant was chairman of board and majority stockholder); *Rose v. Schantz*, 56 Wis. 2d 222, 201 N.W.2d 593 (1972) (statute requires either allegation of efforts to secure action from directors or reason for not making effort).

⁴⁰ The situation in Georgia is problematic. GA. CODE ANN. § 9-11-23b requires the complaint to allege the plaintiff's efforts to seek relief from the directors and "if necessary, from the shareholders such actions as he desires and the reasons for his failure to obtain such action or the reasons for not making such effort." On the other hand, *id.* § 14-2-123c, which requires allegations as to the demand on directors, is accompanied by a comment that, consistent with N.Y. BUS. CORP. LAW § 626(c), the necessity of a demand on shareholders has been omitted.

In Maine, demand on stockholders apparently is required only in close corporations. Compare ME. REV. STAT. ANN. tit. § 13-A, § 627 (1)(c) (requiring demand only when corporation is closely held) with ME. R. CIV. P. 23A (requiring complaint to allege efforts to seek action from directors and "if necessary, from the shareholders or members" or the reason for not making the effort). In Virginia, demand on shareholders is no longer required. The provisions of the 1985 Virginia Stock Corporations Act regulating derivative actions do not mention demand on shareholders. See VA. CODE §§ 13.1-672 (1985). Prior Virginia cases required demand on shareholders but excused the

states require that the plaintiff make a demand on stockholders,⁴¹ these jurisdictions define differently the permissible grounds on which the demand may be excused. To be sure, determining the precise requirements in each state is complicated by a paucity of cases in some states.

The cases that impose a relatively strong or invariant demand requirement articulate a number of rationales for doing so. Occasionally described as the "business decision" rule,⁴² the strongest conception of the demand requirement mandates that majority stockholders decide all questions of corporate policy. These cases require the stockholders to approve or disapprove the derivative suit by majority vote even when the shareholders could not *ratify* the contested actions or transactions. Shareholder control over litigation in these jurisdictions transcends shareholders' control over the disputed events. These cases protect the value, independent of the possibility of ratification, of informing shareholders of the alleged wrongs and of seeking their participation in available remedies, including the removal of directors involved in the challenged transactions.⁴³ Moreover, these cases attempt to protect the corporation from multiple suits filed by numerous shareholder-plaintiffs.

The second function of a strong demand requirement is the product of a noninterventionist judicial philosophy, one of reluctance "to intervene in internal controversies unless parties are obviously prevented from getting fair treatment at the hands of those with whom they chose to be associated and by whose judgment they once desired to be bound."⁴⁴ Judicial imposition of this requirement reflects skepticism

plaintiff's failure to make a demand when the wrongs alleged were nonratifiable. *See* Meltzer v. Atlantic Research Corp., 330 F.2d 946 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964) (demand on stockholders would be excused under Virginia law); Koch v. Seventh St. Realty, 205 Va. 65, 135 S.E.2d 131 (1964) (complaint dismissed because plaintiff failed to allege that he sought relief within the corporation and because shareholders ratified board action challenged by plaintiff); Liggett v. Roanoke Water Co., 126 Va. 22, 101 S.E. 55 (1919) (holding demand for corporate action would have been useless due to defendant's effective control of corporation).

⁴¹ This category includes Alabama, Arizona, Colorado, Hawaii, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, Oregon, Pennsylvania, Rhode Island, West Virginia, and Wyoming.

⁴² *See* Brick v. Dominion Mortgage & Realty Trust, 442 F. Supp. 283, 296 (W.D.N.Y. 1977) (applying Massachusetts law).

⁴³ *See, e.g.,* Bell v. Arnold, 175 Colo. 277, 283, 487 P.2d 545, 547 (1971); S. Solomont & Sons Trust v. New England Theatres Operating Corp., 326 Mass. 99, 113, 93 N.E.2d 241, 248 (1950).

⁴⁴ Pomerantz v. Clark, 101 F. Supp. 341, 346 (D. Mass. 1951) (applying Massa-

about the effectiveness of derivative litigation and a preference for empowering stockholders as a collective body rather than empowering individual champions of the corporation's interests.⁴⁵

The central difficulty with these arguments is that they ignore the practical realities of shareholder decisionmaking in all but the smallest corporations. In larger corporations, decisions at shareholder meetings are made on the basis of written proxy materials sent to stockholders before the meeting. Most stockholders, represented by proxies, do not attend the meeting in person and thus are unavailable to consider collectively the relative merits of the proposed derivative suit and the other remedial options available to the corporation. Indeed, in many other respects the shareholders' meeting of a large corporation is unsuited to reflective decisionmaking on multifaceted matters like litigation.⁴⁶ The meeting follows a ritual sufficient to satisfy the formal requirements of the company's bylaws and the corporation statutes and otherwise furnishes a forum for questions about sundry matters. Moreover, the remedies available to stockholders that are occasionally presented as alternatives to derivative litigation — such as removal of directors — are available even if a derivative action is filed. However, these alternate remedies, if successful, will not result in a judgment for money damages to compensate the corporation for its losses. Only an action brought by or on behalf of the corporation against the defendants affords this remedy, and requiring the plaintiff to make a demand on the corporation's directors enables the company to institute the litigation itself or take over the derivative action. Thus, the demand on shareholders can be superfluous. Given the functional problems that demand engenders, the rationales for a rigid requirement of demand on shareholders appear little more than result-oriented devices to stymie derivative suits.

Four states — Alabama,⁴⁷ Colorado,⁴⁸ Massachusetts⁴⁹ and New Jersey⁵⁰ — have “strong” requirements that the plaintiff make a demand on stockholders even when stockholders could not have ratified

chusetts law).

⁴⁵ *Id.* at 346-47.

⁴⁶ See 1985 DISCUSSION DRAFT, *supra* note 1, § 7.03(c) comment f (recommending that demand on shareholders not be required).

⁴⁷ See *Kinsaul v. Floral Tel. Co.*, 285 Ala. 16, 228 So. 2d 777 (1969); *American Life Ins. Co. v. Powell*, 262 Ala. 560, 80 So. 2d 487 (1955).

⁴⁸ See *Bell v. Arnold*, 175 Colo. 277, 487 P.2d 545 (1971); *Ireland v. Wynkoop*, 36 Colo. App. 205, 539 P.2d 1349 (1975).

⁴⁹ See *S. Solomont & Sons Trust v. New England Theatres Operation Corp.*, 326 Mass 99, 93 N.E.2d 241 (1950).

⁵⁰ See *Escoett v. Aldecress Country Club*, 16 N.J. 438, 109 A.2d 277 (1954).

the contested action. Pennsylvania and Ohio may also take a comparable approach.⁵¹ In these jurisdictions, demand may be excused if the plaintiff shows that making demand would be futile, typically because the alleged wrongdoers owned or controlled a majority of the stock.⁵² In

⁵¹ The relevant Pennsylvania rule, PA. R. CIV. P. 1506(2), refers only to "efforts made to secure enforcement by the corporation," but does not state specifically what efforts the plaintiff must plead to state a derivative cause of action. See *Burdon v. Erskine*, 264 Pa. Super. 584, 401 A.2d 369 (1979). Case law, however, holds that the plaintiff, prior to filing suit, must make every effort to compel action by the corporation. See *Passmore v. Allentown & Reading Traction Co.*, 267 Pa. 356, 110 A. 240 (1920). Required action includes attempts to secure plaintiff's rights through meetings of the corporation. See *Burdon v. Erskine*, 264 Pa. Super. 584, 401 A.2d 369. In *Abraham v. Parkins*, 36 F. Supp. 238 (W.D. Pa. 1940), the court held that plaintiff's failure to make a demand on stockholders was not excused because the wrongs alleged in the complaint could not be ratified by the shareholders. The usefulness of *Abraham* to a determination of Pennsylvania law is, however, severely undercut by the court's assumption that federal Rule 23.1 itself required that the plaintiff make the demand on stockholders. The court ignored the fact that state law seemed to govern the content of the action, for it involved alleged breaches of fiduciary duties by corporate directors in connection with the terms of a merger. In *Weiss v. Sunasco Inc.*, 316 F. Supp. 1197, 1206-07 (E.D. Pa. 1970), the court assumed *arguendo* that *Abraham* was "still sound in principle" but held that plaintiff was excused from making a demand on shareholders because of (1) the expense and effort necessary to bring the issues raised by the action before the shareholders of a large publicly held corporation (3.6 million shares were outstanding); (2) the difficulties inherent in any attempt to replace an incumbent board; and (3) the unlikelihood of achieving an intra-corporate settlement.

In *Claman v. Robertson*, 164 Ohio St. 61, 128 N.E.2d 429 (1955), the Ohio Supreme Court held that a derivative suit alleging fraudulent transactions by corporate directors was properly dismissed because the plaintiff had not demanded that the shareholders vote to rescind their previous "ratification" of these transactions. To deny shareholders power to ratify would, in the court's reasoning, encourage strike suits. Further, the court held a disinterested majority of stockholders had power to ratify fraud provided there was no actual fraud in inducing or effecting the ratification. *Id.* at 72, 128 N.E.2d at 436. Consistent with the Massachusetts cases, the court also held that shareholders under these circumstances were entitled to decide whether the action would serve the corporation's best interests. *Id.* at 73, 128 N.E.2d at 436. The authority of *Claman* as a statement of Ohio law has been undercut by Ohio's subsequent enactment of Civil Rule 23.1, modeled after federal Rule 23.1. In addition, Ohio courts look to federal law in interpreting federal rule counterparts in Ohio; federal decisions hold that shareholders cannot ratify alleged violations of federal law. See *Leff v. CIP Corp.*, 540 F. Supp. 857, 869 n.8 (S.D. Ohio 1982); cf. Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 757-58 n.70 (1960) (criticizing *Claman* as inconsistent with principle that ratification is a defense on the merits, distinct from the question of preconditions to suit).

⁵² See *Brooks v. Land Drilling Co.*, 564 F. Supp. 1518 (D. Colo. 1983) (demand excused due to coincidence of controlling shareholder and directors); *Kinsaul v. Floral Tel. Co.*, 285 Ala. 16, 19, 228 So. 2d 777, 779 (1969) (requiring demand); *Van*

Massachusetts and New Jersey, demand may also be excused if action in response to the alleged wrong must be taken before a stockholders' meeting can be convened.⁵³ This ground for excuse, however, is less clearly available in the other jurisdictions.⁵⁴ Moreover, all "strong demand" jurisdictions are reluctant to excuse demand when plaintiff asserts that the numerosity of corporate shareholders makes the process unwieldy or very costly.⁵⁵ For example, Massachusetts law requires that the plaintiff make a demand on the policyholders of a mutual insurance company as a precondition to filing a suit challenging the legality of loans made with the company's assets.⁵⁶ In contrast, the law in jurisdictions other than the "strong demand" ones appears much more likely to excuse demand on grounds of expense, difficulty, or

Schaack v. Phipps, 38 Colo. App. 140, 144, 568 P.2d 581, 585 (1976) (controlling shareholders, as directors, either voted in favor of transactions challenged in suit or voted not to pursue action); Pupecki v. James Madison Corp., 376 Mass. 212, 219, 382 N.E.2d 1030, 1034 (1978) (allowing plaintiff to amend complaint to comply with requirements for alleging grounds for excuse); Escoett v. Aldecress Country Club, 16 N.J. 438, 449, 109 A.2d 277, 283 (1954) (demand excused when futile or impracticable).

⁵³ See Heit v. Brown, 47 F.R.D. 33, 34-35 (D. Mass. 1967); accord Escoett v. Aldecress Country Club, 16 N.J. 438, 449, 109 A.2d 277, 283 (1954) (demand may be excused when resort to the stockholders would "jeopardize the cause of action").

⁵⁴ Alabama does not appear to have any cases on point. While a Colorado case, Bell v. Arnold, recognizes that demand may be excused in the presence of "exceptional circumstances," the opinion does not mention the need for speed as an example. See 175 Colo. 282, 285, 487 P.2d 545, 548 (1971).

⁵⁵ See Haffer v. Voit, 219 F.2d 704, 705 (6th Cir.), cert. denied, 350 U.S. 832 (1955) (court applied New Jersey law and refused to excuse demand on "widely scattered" stockholders); Pomerantz v. Clark, 101 F. Supp. 341, 343 (D. Mass. 1951) (refusing to excuse demand on several million policyholders of mutual insurance company); American Life Ins. Co. v. Powell, 262 Ala. 560, 567, 80 So. 2d 487, 492 (1955) (fact that corporation has 700 stockholders does not excuse demand); Bell v. Arnold, 175 Colo. 282, 285, 487 P.2d 545, 548 (1971) (court refused to determine whether fact of corporation's 26,000 stockholders excuses demand because plaintiff did not plead the number of stockholders as an excuse).

Pennsylvania may excuse demand more readily on these grounds than do the other jurisdictions with "strong" demand requirements. Cf. Weiss v. Sunasco, Inc. 316 F. Supp. 1197, 1206-07 (E.D. Pa. 1970) (demand excused due to expense and difficulty of making demand in large publicly held corporation; court appeared, however, to treat demand on shareholders as a question controlled by federal Rule 23.1 itself).

⁵⁶ Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951). Contra Levitt v. Johnson, 334 F.2d 815, 818 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965) (explaining that requiring demand on 48,000 stockholders of mutual fund imposes an "enormous burden" on plaintiff and that no disclosure plaintiff might make would succeed in persuading stockholders to take over action or permit an informed decision not to bring action).

burdensomeness.⁵⁷

The "strong demand" jurisdictions, however, appear to differ on the effect of the stockholders' refusal to sue once the plaintiff makes a demand. An Alabama case holds that the majority's decision not to pursue the suit does not necessarily bind the derivative plaintiff. In *Smith v. Dunlap*, in which the plaintiff alleged the corporation had made excessive payments to its officers, the court held that the directors' and majority stockholders' refusal to pursue recovery for the corporation did not preclude a minority stockholder from bringing suit in equity.⁵⁸ Supporting this outcome, in the court's view, is the doctrine of substantive law treating as nonratifiable actions that constitute waste of corporate assets.⁵⁹ New Jersey law, as interpreted by the Third Circuit in *Rogers v. American Can Co.*,⁶⁰ is consistent with the Alabama position, at least when the plaintiff's complaint alleges that the corporation violated positive law at the behest of the individual defendants.⁶¹

In contrast, Massachusetts authorities separate entirely the question of ratification from the stockholders' assessment of the benefits of bringing suit. Thus, they may view the function of requiring a demand on shareholders differently than do these jurisdictions associating demand with ratifiability. In *S. Solomont & Sons Trust v. New England Thea-*

⁵⁷ See, e.g., *Levitt v. Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Meltzer v. Atlantic Research Corp.*, 330 F.2d 946 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964); *Gottesman v. General Motors Corp.*, 268 F.2d 194 (2d Cir. 1959).

⁵⁸ *Smith v. Dunlap*, 269 Ala. 97, 111 So. 2d 1 (1959).

⁵⁹ *Id.* at 101-02, 111 So. 2d at 5-6.

⁶⁰ 305 F.2d 297 (3d Cir. 1962).

⁶¹ See *id.* at 317. Colorado does not appear to have any cases directly on point. Of some relevance, however, is *Mountain States Packing Co. v. Curtis*, 86 Colo. 355, 281 P. 737 (1929), in which the plaintiff challenged a number of transactions between the corporation and other interrelated corporations. One challenged transaction was the sale of the corporation's business to one of its major stockholders and the sale to the same individual of stock in another company owned by the corporation. The Colorado Supreme Court assumed the latter sale was voidable even though a majority of the directors who authorized the sale were disinterested. The court held that the sale was expressly ratified by a majority of the corporation's stockholders in a vote excluding shares owned or controlled by interested persons. Because the court's opinion emphasizes the power of the corporation's majority stockholders over voidable contracts, 86 Colo. at 360, 281 P. at 739, one may well wonder whether the power extends to the preclusion of litigation concerning void contracts. Only the strict separation of concepts of ratification from notions of control over stockholder litigation could yield such a result, and only Massachusetts, as described in text *supra*, appears to draw this distinction with utmost rigor.

tres Operating Corp.,⁶² the plaintiff challenged terms of the corporate managers' compensation and transactions made on the corporation's behalf with film and theatre companies. The Supreme Judicial Court held that a prior vote by a majority of the corporation's stockholders opposing the suit barred a suit raising these claims. The court noted that the defendants did not own or control a majority of the stock, that an opportunity to discuss plaintiff's claims preceded the vote, and that the stockholders voted in good faith.⁶³ The First Circuit in a later case declined to extend *Solomont* when a majority of the stockholders, although not expressly authorizing the suit, did not unequivocally refuse to approve it.⁶⁴ By rigorously separating demand issues from substantive questions of ratifiability, *Solomont* narrowly focuses the purposes of the demand requirement on derivative litigation itself. The case requires a shareholder assessment of the desirability of the suit independent of any shareholder vote on the underlying transaction.

An important limitation on the significance of the shareholder vote in response to the plaintiff's demand is the requirement implicit in these cases that the shareholders vote in good faith, based on adequate disclosure about the proposed derivative action and the transactions upon which it is based. Even in the jurisdictions with "strong" demand requirements, if the plaintiff makes a demand and the stockholders decline to take the requested action, the plaintiff may successfully contest the circumstances surrounding the refusal, such as the adequacy of disclosure made to the stockholders.⁶⁵

⁶² *S. Solomont & Sons Trust v. New England Theatres Operating Corp.*, 326 Mass. 99, 93 N.E.2d 241 (1950).

⁶³ *Id.* at 114, 93 N.E.2d at 249.

⁶⁴ *See Halprin v. Babbitt*, 303 F.2d 138 (1st Cir. 1962). Although the facts stated in the *Halprin* court's opinion do not disclose whether the plaintiff made a demand on the corporation's stockholders, they reveal a curious set of circumstances. Plaintiff filed an affidavit stating that, after bringing his action, the corporation's directors (who were not alleged to have been involved in the transaction to which plaintiff objected) through its president told plaintiff that they and the majority stockholders did not oppose the action. Subsequently, however, they moved for dismissal alleging plaintiff's failure to satisfy the preconditions of demands on directors and shareholders. The First Circuit treated the directors' communications with plaintiff as an effective acquiescence in the derivative action, observing that the directors and the corporation's majority stockholders, whom the district court described as standing silent and smiling like a Cheshire cat, were free to "permit someone else to be the cats-paw." *Id.* at 141. As a general proposition, apart from these unusual circumstances, the court stated it was unwilling to permit a corporation's directors to authorize the plaintiff to short circuit the rights of majority stockholders.

⁶⁵ *See* 1985 DISCUSSION DRAFT, *supra* note 1, § 7:03(e) comment f; *see also* *Leff v. CIP Corp.*, 540 F. Supp. 857 (S.D. Ohio 1982) (excusing demand on shareholders

Demand on shareholders is not an invariable requirement; the plaintiff need not make the demand if an appropriate excuse is available. In general, the trial court has discretion as to whether the alleged circumstances constitute a valid excuse.⁶⁶ As stated above, all jurisdictions excuse demand when making the demand would be futile, although jurisdictions differ on the relevant definition of futility. In Massachusetts, for example, futility was held to mean that the alleged wrongdoers own or control a majority of the corporation's stock.⁶⁷ Other jurisdictions, in contrast, define futility less rigorously to include the burdens or costs of making the demand, or the unlikelihood that the shareholders would agree to authorize the derivative suit.⁶⁸

In a number of states, the requirement of demand on stockholders turns on whether a majority of the stockholders could ratify the wrongs alleged in the complaint. These jurisdictions excuse demand when the alleged wrongs are nonratifiable, actions alleged to be ultra vires, fraudulent or illegal. The bellwether among these states was Delaware, until 1968, when it amended its chancery rules. The new rules eliminated the requirement that plaintiff's complaint allege either efforts to make a demand on shareholders or reasons for not making a demand.⁶⁹ Delaware cases, under the regime of the earlier rule, excused demand when the wrongs alleged were nonratifiable.⁷⁰ The states that still follow this approach are Maryland,⁷¹ Minnesota,⁷² Missouri,⁷³ Mon-

when plaintiff alleges violations of § 14(a) arising out of proxy fight). Indeed, if the parties have solicited proxies in connection with the plaintiff's demand, the plaintiff may subsequently be able to allege violations of § 14(a) of the Securities Exchange Act in the defendant's proxy solicitation. Demand on shareholders has been held unnecessary when violations of § 14(a) have been alleged because these allegations suggest the shareholders cannot make an informed decision. *See id.* at 869.

⁶⁶ *See* *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

⁶⁷ *See* *Pupecki v. James Madison Corp.*, 376 Mass. 212, 216, 382 N.E.2d 1030, 1034 (1978).

⁶⁸ *See supra* note 55.

⁶⁹ *See* DEL. CODE ANN. tit. 8 § 327 (1983) & DEL. CT. C.P.R.23.1 (adopted Feb. 24, 1968).

⁷⁰ The leading case articulating this position is *Mayer v. Adams*, 37 Del. Ch. 298, 141 A.2d 458 (1958). The complaint alleged a series of improper dealings between the defendant Phillips Petroleum and codefendant Ada Oil Co. The transactions enriched Ada and the president of Phillips. Federal cases applying Delaware law to excuse demand in cases alleging nonratifiable wrongs are *Brody v. Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973); *Steinberg v. Hardy*, 90 F. Supp. 167 (D. Conn. 1950).

⁷¹ *See* *Parish v. Maryland & Va. Milk Producers*, 250 Md. 24, 84, 242 A.2d 512, 545-46 (1968), *cert. denied*, 404 U.S. 940 (1971); *cf.* *Rosengarten v. Buckley*, 565 F. Supp. 193 (D. Md. 1983) (plaintiff required to make more detailed statement of basis

tana,⁷⁴ Nebraska,⁷⁵ and New Hampshire.⁷⁶

In contrast, while a number of states also require by rule or statute

for action); *Eisler v. Eastern States Corp.*, 182 Md. 329, 35 A.2d 118 (1943) (complaint properly dismissed when futility of demand on stockholders and directors not shown by complaint).

Whether the shareholder can achieve redress through corporate channels controlled by stockholder vote is relevant to demand issues in Maryland. In *Wall & Beaver St. Corp. v. Munson Line*, 58 F. Supp. 109, 119-20 (D. Md. 1944), the district court held that Maryland law as stated in *Eisler* required the plaintiff to make a demand on shareholders before bringing suit as part of exhausting internal corporate remedies. The court pointed out that the plaintiffs held sufficient shares to call a special shareholders' meeting and elect a majority of directors. The court interpreted their failure to do so as an occasion for not interfering in the corporation's internal management. *Id.* at 120. Nonetheless, in a later case in which the complaint alleged nonratifiable wrongs, the court held that the shareholders' ability under a declaration of trust to remove or refuse to reelect incumbent trustees did not mandate that the plaintiff make a demand on stockholders. Such shareholder decisions were a possibility in all derivative litigation and did not prevent the demand from being futile. *See Oldfield v. Alston*, 77 F.R.D. 735, 742 (N.D. Ga. 1978); *accord Zimmerman v. Bell*, 585 F. Supp. 512, 516 (D. Md. 1984).

⁷³ *See Winter v. Farmers Educ. & Coop. Union of Am.*, 259 Minn. 257, 264, 107 N.W.2d 226, 233 (1961) (demand required unless shareholders are powerless to ratify the alleged wrong or a majority of shareholders is interested; in this case demand unrealistic due to character of corporation).

⁷⁴ *See Wolgin v. Simon*, 722 F.2d 389, 392 (8th Cir. 1983) (requiring demand prior to suit when challenged acts may be subject to ratification by a majority of shareholders); *Heit v. Bixby*, 276 F. Supp. 217 (E.D. Mo. 1967) (demand on directors and stockholders excused when plaintiff alleges willful and negligent breaches of directors' fiduciary duties; stockholders had reelected directors after secret side commissions came to light); *Saigh v. Busch*, 396 S.W.2d 9, 18-19 (Mo. Ct. App. 1965), *cert. denied*, 384 U.S. 942 (1966); *cf. Quirke v. St. Louis-San Francisco Ry.*, 277 F.2d 705 (8th Cir.), *cert. denied*, 363 U.S. 845 (1960) (demand not excused simply because stockholders are numerous and widely scattered); *Broski v. Jones*, 614 S.W.2d 300 (Mo. Ct. App. 1981) (stockholders' ratification of payments to officer-directors foreclosed action contesting payments).

⁷⁵ *See Noble v. Farmers Union Trading Co.*, 123 Mont. 518, 526, 216 P.2d 925, 933 (1950); *cf. S-W Co. v. John Wight, Inc.*, 179 Mont. 392, 587 P.2d 348 (1978) (plaintiff not required to obtain unanimous support of minority stockholders to qualify as an adequate representative in derivative litigation; demand requirements waived by defendant directors' de facto control of majority of shares).

⁷⁶ *See Fisher v. Nat'l Mortgage Loan Co.*, 132 Neb. 185, 271 N.W. 433, *modified*, 133 Neb. 280, 274 N.W. 568 (1937); *cf. Kowalski v. Nebraska-Iowa Packing Co.*, 160 Neb. 609, 71 N.W.2d 147 (1955) (demand excused only if making it would have been useless or unavailing).

⁷⁶ *See Bowker v. Nashua Textile Co.*, 103 N.H. 242, 169 A.2d 630 (1961) (approval of liquidation plan by majority of stockholders does not bar suit when ratification secured with votes by persons accused of wrongdoing; plaintiff himself disqualified for other reasons).

that the plaintiff "if necessary" allege the efforts made to seek relief from the stockholders, case law in these states is not as well developed, leaving unanswered many of the questions addressed above. Cases in Arizona,⁷⁷ Hawaii,⁷⁸ Kentucky,⁷⁹ Louisiana,⁸⁰ New Mexico,⁸¹ Rhode Island,⁸² West Virginia,⁸³ and Wyoming⁸⁴ recognize a demand on shareholders requirement and, in some instances, acknowledge the possibility of circumstances excusing demand. Tennessee may also require a demand on shareholders in some circumstances.⁸⁵ No case law, how-

⁷⁷ See *Callanan v. Sun Lakes Homeowners' Ass'n No. 1*, 134 Ariz. 332, 337, 656 P.2d 621, 625 (Ct. App. 1982) (amended complaint dismissed due to failure to allege demand on shareholders; court described Rule 23.1 preconditions as more than mere "technical" requirements).

⁷⁸ See *Yap v. Wah Yen Ki Tuk Tsen Nin Hue*, 43 Hawaii 37 (1958) (complaint alleged that plaintiff had demanded withdrawal of loan at meeting of members of charitable corporation).

⁷⁹ See *Security Trust Co. v. Dabney*, 372 S.W.2d 401 (Ky. Ct. App. 1963) (excusing demand when shareholders, despite litigation pending in another jurisdiction, had voted to approve consolidation challenged by plaintiff); *Harris v. Tri-Union Oil & Gas Co.*, 283 Ky. 241, 140 S.W.2d 1056 (Ct. App. 1940) (excusing demand on other two stockholders in suit brought by third stockholder in closely held corporation); cf. *Levitan v. Stout*, 97 F. Supp. 105, 114 (W.D. Ky. 1951) (despite plaintiff's allegation that two director-shareholders had effective control of corporation, court refused to excuse demand on directors and stockholders because the two director-shareholders owned less than 50% of corporation's stock).

⁸⁰ Cf. *Orlando v. Nix*, 171 La. 176, 179, 129 So. 810, 811 (1930) (court in dicta referred to necessity of demand on "the corporation" as a precondition to derivative action).

⁸¹ See *Prager v. Prager*, 80 N.M. 773, 461 P.2d 906 (1969) (interpreting rule to require demand on management of shareholders or excuse for not making demand); *Porter v. Mesilla Valley Cotton Prods.*, 42 N.M. 217, 76 P.2d 937 (1937) (following *Hawes* as to preconditions to suit, court found failure in complaint to plead properly plaintiff's exhaustion of remedies).

⁸² Cf. *Gallogey v. Stender*, 51 R.I. 303, 154 A. 280 (1931) (excusing demand on "the corporation" as futile).

⁸³ See *Moore v. Lewisburg & Ronceverte Elec. Ry.*, 8 W. Va. 653, 93 S.E. 762 (1917) (demand must be made on directors and shareholders but may be excused when wrongdoers are directors or are in control of stock; suit dismissed due to insufficient pleading).

⁸⁴ See *Gunn v. Voss*, 154 F. Supp. 345 (D. Wyo. 1957) (Wyoming law requires plaintiff request that stockholders, as a body, sue directors before bringing an action in the interest of the corporation, unless the request would be useless and unavailing).

⁸⁵ Cf. *Hannewald v. Fairfield Communities, Inc.*, 651 S.W.2d 222 (Tenn. Ct. App. 1983) (court broadly interpreted rule governing derivative suits in context not directly involving demand on shareholders). Complicating the situation in Tennessee is a rule requiring allegation of efforts to seek relief from the shareholders, "if necessary," see TENN. R. CIV. P. 23.06, and a statute addressing only demand on directors, see TENN. CODE ANN. § 48-1-718 (1984). Cases preceding the 1968 enactment of this statute

ever, directly interprets the equivalent statutes and rules of Alaska,⁸⁶ Arkansas,⁸⁷ Idaho,⁸⁸ Iowa,⁸⁹ Kansas,⁹⁰ Nevada,⁹¹ Oklahoma,⁹² South Dakota,⁹³ Utah,⁹⁴ Vermont,⁹⁵ and Washington⁹⁶ as they apply to demand on stockholders. Oregon,⁹⁷ which does not have a comparable statute or rule, appears to require demand on shareholders but also excuses demand on grounds of futility. Thus, the law remains in flux on the issue of shareholder demand. Among the states requiring shareholder demand, there is relatively little uniformity as to proper excuses of the demand requirement and as to the effect of shareholder rejection of the action. Further, a substantial number of states have case law that is unclear as to whether shareholder demand is required at all.

B. Demand on Directors

Like demand on shareholders, demand on directors serves a number of potentially inconsistent functions. Some courts, like the Supreme Court in *Hawes*, treat the requirement as an embodiment of the direc-

recognized a requirement of demand on shareholders. *See Akin v. Mackie*, 203 Tenn. 113, 310 S.W.2d 164 (1958) (excusing demand as futile when corporation and its operations control alleged wrongdoers); *cf. Lockhart v. Moore*, 25 Tenn. App. 456, 159 S.W.2d 438 (1941) (sole shareholder should have requested that corporation bring suit or should have called shareholders meeting to elect new officers).

⁸⁶ ALASKA R. CIV. P. 23.1.

⁸⁷ ARK. R. CIV. P. 23.1. *But cf. Morgan v. Robertson*, 271 Ark. 461, 609 S.W.2d 662 (Ct. App. 1980) (recognizing that demand on directors may be excused on grounds of futility).

⁸⁸ IDAHO R. CIV. P. 23f; *cf. Kerner v. Johnson*, 99 Idaho 433, 583 P.2d 360 (1978) (pleadings did not allege compliance with rule).

⁸⁹ IOWA R. CIV. P. 44; *cf. Holi-Rest, Inc. v. Treloar*, 217 N.W.2d 517 (Iowa 1974) (excusing demand on directors when vain or useless).

⁹⁰ KAN. STAT. ANN. § 60-223a (Vernon 1983); *cf. Newton v. Hornblower, Inc.*, 224 Kan. 506, 582 P.2d 1136 (1978) (excusing demand when futile).

⁹¹ NEV. R. CIV. P. 23.1; *cf. Nelson v. Sierra Constr. Corp.*, 77 Nev. 334, 364 P.2d 402 (1961) (recognizing necessity of allegations required by rule).

⁹² OKLA. STAT. tit. 18, § 1.28(b) (1953).

⁹³ S.D. CODIFIED LAWS ANN. § 15-6-23.1 (1984).

⁹⁴ UTAH CODE ANN. § 23.1 (1953).

⁹⁵ VT. R. CIV. P. 23.1; *cf. Lash v. Lash Furniture Co.*, 130 Vt. 517, 296 A.2d 207 (1972) (plaintiff not barred from instituting suit; stockholder had no other effective action available within corporation, which was closely held by three brothers).

⁹⁶ WASH. CIV. R. FOR SUPER. CT. 23.1, promulgated in 77 Wash. 2d ixiii (1967).

⁹⁷ *See Browning v. C & C Plywood Corp.*, 248 Or. 574, 434 P.2d 339 (1967) (excusing absence of efforts to obtain intracorporate relief on grounds of obvious futility); *North v. Union Sav. & Loan Ass'n*, 59 Or. 483, 117 P. 822 (1911) (demand excused when alleged wrongdoers controlled majority of stock).

tors' prerogative to control the corporation's business and affairs, enabling them to determine dispositively whether the litigation the plaintiff proposes will further the company's best interests. Other rationales for the demand requirement have also emerged, however, in cases that treat it as a device to encourage the parties to resolve their disputes without litigation. If the plaintiff presents a demand to the corporation's directors, they may respond to her grievance directly. For example, the corporation could discharge employees or cease objectionable practices. The directors might, of course, decide to take these actions even in the absence of a demand, but the demand formally establishes their opportunity to do so. Although demand thus furthers the potential for a rapid and straightforward solution to the plaintiff's grievance, this understanding of its function is not tied to substantive allocations of power within the corporation. Likewise, demand also raises formally the possibility that the directors may take over the litigation, casting it as a direct action on behalf of the company rather than a derivative suit.⁹⁸ This section of the Article explores the tensions between these conceptions of demand's functions, focusing principally on recent Delaware cases.

The dominant purpose attributed to demand inevitably dictates the answer to questions raised by the requirement. If demand principally embodies basic governance relationships within the corporation and honors directors' prerogative over corporate affairs, then demand requirements reinforce allocations of substantive power over transactions within the corporation. Thus, if the plaintiff makes a demand and the directors refuse it, absent extreme circumstances the refusal should bar the plaintiff's derivative action. Under the same conception of the purpose of demand, the plaintiff should be excused from making a demand on directors only when the directors appear to lack authority to make dispositive decisions about the challenged transactions.

Under the competing view that demand on directors may enable the parties to resolve their dispute without litigation, the requirement reflects a desire to conserve resources rather than fundamental assumptions about allocation of managerial power. Demand, under this view, is principally a device "to promote intracorporate dispute resolution,"⁹⁹ but it is not a mechanism to answer the substantive questions raised by the suit. Under this conception, the directors' refusal to take action should not inevitably be dispositive of the derivative suit brought by the

⁹⁸ See *Elfenbein v. Gulf & Western Indus.*, 454 F. Supp. 6 (S.D.N.Y.), *aff'd*, 590 F.2d 445 (2d Cir. 1978).

⁹⁹ *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984).

plaintiff, and demand should be excused when the directors appear unlikely to favor the litigation proposed by the plaintiff for some reason other than its merits.

The current significance of these questions is heightened by the plaintiff's predicament once a demand is made: while the directors may ultimately refuse the demand, by making a demand the plaintiff may have foregone the chance of testing the availability of excuse. In *Stotland v. GAF Corp.*,¹⁰⁰ a 1983 decision by the Delaware Supreme Court, plaintiff's original complaint did not allege that a demand had been made on the corporation's directors. The lower court denied plaintiff's motion to amend the complaint to add further allegations and instead dismissed the complaint on grounds of failure either to make a demand or properly to demonstrate its futility. The plaintiff then made a demand on the board and appealed from the dismissal on grounds of futility. Next, the directors appointed a special litigation committee to review the demand, an effort that was in progress at the time of plaintiff's appeal. The Delaware Supreme Court held that, by making the demand, plaintiff mooted his appeal on the futility point. In the court's view, once the demand was made, the corporation's directors received control over the litigation and, absent a wrongful refusal by them, plaintiff was no longer able to initiate a derivative suit.¹⁰¹ Indeed, any statement from the court on the issues involved in the appeal would, in its view, constitute an advisory opinion.¹⁰²

Stotland thus treats the demand requirement as an aspect of the allocation of powers within the corporation. The case also creates a substantial practical dilemma for the plaintiff: if she makes no demand, the court may and probably will dismiss the suit; but once she makes the demand, the plaintiff can no longer maintain that demand should be excused. Earlier cases in Delaware and other jurisdictions permitted the plaintiff to preserve the issue of futility for appeal,¹⁰³ a possibility

¹⁰⁰ *Stotland v. GAF Corp.*, 469 A.2d 421 (Del. 1983).

¹⁰¹ *See id.* at 422-23. *Stotland* seems at odds with an earlier chancery court opinion holding that once the directors appoint a special litigation committee, they concede that the circumstances alleged in the complaint justified the plaintiff's initiation of the derivative suit, and thereby concede that demand should be excused. *See Abbey v. Computer & Communications Technology Corp.*, 457 A.2d 368 (Del. Ch. 1983).

¹⁰² *See* 469 A.2d at 423.

¹⁰³ *See, e.g.,* *Sohland v. Baker*, 141 A. 277 (Del. 1927); *Mackay v. Pierce*, 86 A.D.2d 655, 446 N.Y.S.2d 403 (1982); *cf. Winter v. Farmers Educ. & Coop. Union*, 259 Minn. 257, 107 N.W.2d 226 (1961) (after defendant raised for first time on appeal question of derivative nature of suit, court held that although dispute at issue in suit was put before board and no action was taken, demand would be excused due to enter-

undercut significantly by *Stotland*. For example, in *Sohland v. Baker*,¹⁰⁴ the Delaware Supreme Court upheld the Chancellor's cancellation of stock issued to a corporation's dominant stockholder in the face of defendant's challenge to plaintiff's right to maintain a derivative suit. Although the corporation's directors had declined to institute litigation to seek cancellation, a majority of the directors had participated in the challenged transaction. Thus, the court questioned whether they would bring such a suit and whether their management of the litigation would be proper.¹⁰⁵

Once the plaintiff makes a demand on the corporation's directors, various possibilities arise. The directors may do nothing, neither instituting litigation nor taking other actions to remedy the difficulties described in the demand. If the plaintiff files a derivative suit at this point, the defendants may challenge it as premature and persuade the court to dismiss the action¹⁰⁶ or stay it pending a response to the demand from the directors.¹⁰⁷ Another possibility, albeit one that occurs infrequently, is that the directors themselves will bring litigation on behalf of the corporation against the alleged wrongdoers.¹⁰⁸ Unless the plaintiff can challenge the directors' fitness to manage the litigation, the directors' decision to litigate on behalf of the company seems well within their discretion. The directors' response to the demand may also be unequivocally negative. If the plaintiff then files a derivative suit, defendants may seek dismissal on the ground that the directors' refusal bars the suit.

Cases addressing the question of whether directors' refusal to sue bars a derivative suit generally hold that the directors' refusal is binding unless it is "wrongful." Many courts, however, have not clearly defined "wrongful refusal." Indeed, some cases dismiss the derivative action due to the plaintiff's failure to allege a "wrongful refusal" with-

prise's nature and inactivity).

¹⁰⁴ 141 A. 277 (Del. 1927).

¹⁰⁵ *Id.* at 282-83.

¹⁰⁶ *See, e.g.,* Findley v. Garrett, 109 Cal. App. 2d 166, 240 P.2d 421 (1952).

¹⁰⁷ *See, e.g.,* Dawson v. Dawson, 645 S.W.2d 120 (Mo. Ct. App. 1982).

¹⁰⁸ In *Elfenbein v. Gulf & Western Indus.*, 454 F. Supp. 6 (S.D.N.Y.), *aff'd*, 590 F.2d 445 (2d Cir. 1978), the court dismissed without prejudice plaintiff's derivative complaint on behalf of Bulova Watch Co. The suit challenged Gulf & Western's sale of Bulova stock to a competing watch manufacturer because plaintiff made no effort to obtain action from Bulova's directors. The court held that "[i]t is by no means inevitable that the directors of Bulova will decline to bring a suit against" the other corporations. Although employees of Bulova, they cannot, in the court's view, be assumed to be unwilling to take an action antagonistic to the other watch company, which as a result of the stock sale owned 27% of Bulova's stock. *Id.* at 8-9.

out explaining the meaning of the term.¹⁰⁹ In *Zapata Corp. v. Maldonado*,¹¹⁰ the Delaware Supreme Court stated that directors' response to plaintiff's demand falls "under the 'business judgment' rule and will be respected if the requirements of the rule are met."¹¹¹ In this context, courts have held the "business judgment rule" to require judicial deference to the directors' decision if they acted independently and in good faith in rejecting the demand.¹¹² The Second Circuit in *Abramowitz v. Posner*¹¹³ interpreted this standard to mandate dismissal of a derivative action unless plaintiff showed that the directors actually voting on the demand were controlled by the defendants or profited from the transactions challenged in the suit.¹¹⁴ Effectively, this approach imposes the burden of proof on the plaintiff to establish that the refusal was wrongful. *Abramowitz* also suggests that naming all directors as defendants in the suit excuses the demand requirements.¹¹⁵ However, in a subsequent case the Second Circuit rejected this suggestion,¹¹⁶ as do subsequent Delaware cases.¹¹⁷ *Abramowitz* implicitly recognizes that although the demand requirements focus the court's attention on the parties' pleadings, the standards governing wrongful refusal involve factual questions on which the plaintiff may seek discovery.¹¹⁸ The directors' refusal to sue also calls into question whether the refusal represents the corporation's position if fewer than a majority of the directors consider the demand. *Abramowitz* treated as sufficient the action of the corporation's two disinterested directors, even though they were a minority of the board.¹¹⁹

Cases in other jurisdictions articulate tests for "wrongful refusal" that, although likely to result in the same outcome as the *Abramowitz* test in most instances, define more broadly the circumstances under

¹⁰⁹ See, e.g., *James Talcott, Inc. v. McDowell*, 148 So. 2d 36 (Fla. Dist. Ct. App. 1962); *Cooper v. Central Alloy Steel Corp.*, 43 Ohio App. 455, 183 N.E. 439 (1931).

¹¹⁰ 430 A.2d 779 (Del. 1981).

¹¹¹ *Id.* at 784 n.10.

¹¹² See *Abramowitz v. Posner*, 672 F.2d 1025, 1032 (2d Cir. 1982).

¹¹³ *Id.*

¹¹⁴ See *id.* at 1034.

¹¹⁵ See *id.* at 1033 (noting designation of all directors as defendants in *Zapata* as instance of presumptive futility).

¹¹⁶ See *Lewis v. Graves*, 701 F.2d 245, 248-49 (2d Cir. 1983).

¹¹⁷ See *Aronson v. Lewis*, 473 A.2d 805, 817 (Del. 1984).

¹¹⁸ *Abramowitz* referred to the fact that plaintiff did not seek discovery regarding the good faith and independence of the directors who acted on her demand. Her subsequent allegations that those directors were pawns controlled by defendants lacked evidentiary support. See 672 F.2d at 1034.

¹¹⁹ See *id.* at 1034 n.11.

which a refusal will not bar the derivative action. In *Syracuse Television v. Channel 9, Syracuse*,¹²⁰ the New York supreme court held that for plaintiff to sue derivatively after the corporation's directors refuse the demand, "[t]he failure to sue must be the result of a breach of duty on the part of the Board of Directors, not merely an error of judgment."¹²¹ Applying this standard to the facts of the case, the court held that the directors wrongfully refused plaintiff's demand in light of the gravity of the charges. Each director represented a party interested in the operation of a commercial television station. Plaintiff complained that excessive and improper salaries and perquisites were paid to corporate employees, that valuable advertising time was exchanged for much less valuable merchandise and services, and that officers and employees had acquired these items for their personal benefit.¹²² Although the plaintiff named three members of the board's executive committee as defendants, the court did not find that the defendants "legally controlled" the corporation. Nor did the court find that *all* directors who declined to act on plaintiff's demand received personal benefits from the transactions that plaintiff challenged. The court pointed out, however, that plaintiff criticized the transactions for over a year but faced the directors' "total indisposition" to act. Thus, "[i]t can hardly be argued that the Board members exercised their sound business judgment by refusing to even consider the motion."¹²³

In contrast to the Delaware standard for wrongful refusal articulated in *Abramowitz, Syracuse Television* sets forth a broader definition of wrongful refusal. Directors act wrongfully under the *Syracuse Television* standard when they appear to have neglected to act upon plaintiff's presentation of apparently grave charges. Thus, the business judgment rule does not protect their failure to act under those circumstances, even though the plaintiff fails to establish that the defendants controlled them or that they benefited personally from the suspect transactions. The court's refusal to bar the derivative suit in *Syracuse Television* on the basis of the directors' inaction is consistent with the more general tendency to limit application of the business judgment rule to instances of directors' action rather than their inaction.¹²⁴ None-

¹²⁰ *Syracuse Television v. Channel 9, Syracuse*, 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966).

¹²¹ *Id.* at 194, 273 N.Y.S.2d at 25.

¹²² *Id.* at 194-95, 273 N.Y.S.2d at 22, 25-26.

¹²³ *Id.* at 195, 273 N.Y.S.2d at 26.

¹²⁴ *See* *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) (contrasting "conscious decision to refrain from acting" with mere failure to act).

theless, a court applying the *Syracuse Television* standard is less likely than a court following *Abramowitz* to bar a derivative action because the showing plaintiff must make is less exacting.

Many recent cases examine the circumstances in which courts will excuse the plaintiff's failure to make a demand. Since a derivative suit will likely not last long if plaintiff files it after she makes a demand, it is unsurprising that many plaintiffs instead claim that the demand should be excused.¹²⁵ The cases defining permissible grounds for excuse are inconsistent. Many cases describing valid excuses for failure to make a demand on directors use a test of "futility." This test excuses demand when a substantial number of directors are connected with the challenged transactions or are believed to be antagonistic to the derivative action. This test also allows excuse when the plaintiff alleges that the wrongdoers control a majority or sizable minority of the directors or when the plaintiff names all or a majority of directors as defendants.¹²⁶ In contrast, a number of cases excuse demand only when the plaintiff alleges that the directors themselves had personal economic interests in the challenged transaction.¹²⁷ Recent Delaware cases excuse demand only when the plaintiff makes particularized allegations showing the directors' bias or self interest. Delaware does not excuse demand when directors are named as defendants or approved the contested transactions.¹²⁸ Other jurisdictions continue even in recent cases to excuse demand more readily.¹²⁹

A leading illustration of the judicial tendency to define narrowly the grounds for excuse is the Delaware Supreme Court's 1984 opinion in *Aronson v. Lewis*.¹³⁰ While emphasizing that assessing the adequacy of the excuse is within the trial court's sound discretion,¹³¹ the supreme court held that demand can be excused only when the plaintiff alleges with particularity facts that "create a reasonable doubt that the direc-

¹²⁵ See 1985 DISCUSSION DRAFT, *supra* note 1, § 7.03 comment e.

¹²⁶ See, e.g., *Brooks v. Land Drilling Co.*, 564 F. Supp. 1518, 1522 (D. Colo. 1983) (applying Colorado law; demand excused because all directors would be defendants in suit); *Valiquet v. First Fed. Sav. & Loan*, 87 Ill. App. 3d 195, 408 N.E.2d 921, 926 (1979) (demand excused as futile when directors approved the challenged transaction); *Johnson v. Steel, Inc.*, 678 P.2d 676, 678-79 (Nev. 1984) (all directors approved suspect transaction and were named as defendants).

¹²⁷ See, e.g., *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1210 (9th Cir. 1980); *In re Kauffmann Mut. Fund Actions*, 479 F.2d 257, 265 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

¹²⁸ See *infra* text accompanying notes 141-42.

¹²⁹ See *Lewis v. Curtis*, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).

¹³⁰ *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

¹³¹ *Id.* at 814.

tors' action was entitled to the protections of the business judgment rule."¹³² That is, whether the plaintiff must make a demand on directors to bring suit attacking the transactions challenged by the plaintiff turns on whether the directors' own relationship to those transactions is within the protective ambit of the business judgment rule. In *Aronson* the supreme court held that the centrality of business judgment issues to demand requires the trial court to make two inquiries to determine whether to excuse the demand. The first inquiry is into the directors' independence and disinterestedness, to assess whether the threshold requisites for the business judgment rule's protection are met. The second inquiry is into "the substantive nature of the challenged transaction and the board's approval thereof," to review the alleged wrong against the factual background alleged in the complaint.¹³³

Of equal interest is the court's application of these standards to the facts in *Aronson*. Plaintiff challenged the company's terms of employment and loan agreements with one of its directors. The director owned forty-seven percent of the corporation's shares. Plaintiff argued that a demand on directors would be futile because all of the directors, whom plaintiff named as defendants, approved the transactions and because the forty-seven percent shareholder had selected each director and controlled all of them. These allegations were insufficient, in the court's view. Simply because the directors approved a transaction, the court would not excuse demand without particularized facts showing the directors wasted corporate assets or otherwise breached their fiduciary duties.¹³⁴ Naming the directors as defendants was also insufficient to excuse demand. The plaintiff must allege particular facts to overcome the presumptions that the directors are disinterested and will properly exercise their business judgment.¹³⁵ Finally, the fact that a controlling stockholder may¹³⁶ have selected the directors did not establish to the court that they lack independence and did not overcome the presumption of board independence. Instead, the court required the plaintiff to allege particular circumstances of control and domination.¹³⁷

In a number of respects *Aronson* and similar cases impose more ex-

¹³² *Id.* at 808.

¹³³ *Id.* at 814.

¹³⁴ *Id.* at 817.

¹³⁵ *Id.* at 818.

¹³⁶ *Aronson* states that the "personal-selection-of-directors allegation stands alone, unsupported. At best it is a conclusion devoid of factual support." *Id.* at 816. On the other hand, if the allegedly controlling stockholder owned a majority of the shares rather than only 47%, some presumption about selection of directors is hard to resist.

¹³⁷ *Id.* at 816-17.

acting requirements for excusing the demand than do more lenient cases. To begin with, *Aronson* and cases adopting its approach enforce the requirement of pleading "with particularity" with greater care and scrutiny through a searching examination of the plaintiff's allegations than do some other cases to which the requirement of particularized pleading is also applicable.¹³⁸ Although the supreme court in *Aronson* remanded the action with leave to amend,¹³⁹ the decision requires the allegation of specific facts rather than generalized or conclusory assertions pertinent to the assessment of director independence and good faith. *Aronson's* greatest significance may be as a bellwether of change in judicial method rather than as an articulation of changes in specific legal doctrine. That is, the court's shift to an exacting analysis of pleadings may do more to limit the availability of excuse than the court's articulation of somewhat narrower grounds for excuse. *Aronson* also refused to recognize as grounds for excuse a number of circumstances that were so regarded in other cases, including the directors' approval of the challenged transactions¹⁴⁰ and the plaintiff's designation of all directors as defendants.¹⁴¹ Consistent with its approach in *Aronson*, the Delaware Supreme Court in *Pogostin v. Rice* limited the circumstances under which it would excuse a demand. A plaintiff challenging transactions undertaken to defend against a tender offer must show through particularized allegations that the directors' primary motive was the improper retention of control.¹⁴²

Under the present Delaware cases, a court's decision to require or excuse demand affects other aspects of the litigation. Much turns under the present Delaware cases on whether demand is required or excused, including the level of judicial scrutiny applicable to the recommendation of a special litigation committee (composed of the corporation's directors) that the derivative litigation be terminated. The court in

¹³⁸ In a later case, the chancery court acknowledged that *Aronson* "imposes a higher burden on a plaintiff who seeks to be excused from making a demand by showing its futility." *Kaufman v. Belmont*, 479 A.2d 282, 286 (Del. Ch. 1984). Under *Aronson*, as interpreted by the chancery court, plaintiff must allege with particularity facts "that show that a reasonable doubt exists that the directors were not sufficiently disinterested or independent to have entertained a presuit demand or that the transaction, for other reasons, cannot be the product of business judgment." *Id.* at 286-87. Prior to *Aronson*, the chancery court had excused demand when it determined, after a review of facts alleged in the complaint, that there was a "reasonable inference" that the business judgment rule was not applicable to at least part of the claim. *Id.* at 286.

¹³⁹ 473 A.2d at 808.

¹⁴⁰ See *supra* note 126.

¹⁴¹ See *id.*

¹⁴² *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984).

Zapata Corp. v. Maldonado held that the committee's decision fell within the business judgment rule once the court had determined that demand was required. On the other hand, when demand is excused, and the special litigation committee subsequently recommends terminating the derivative action, the court must examine the committee's independence and good faith and the bases supporting its conclusions.¹⁴³ The corporation has the burden of establishing these matters, in contrast to the plaintiff's burden of establishing that demand should be excused or that the directors' response to the demand was wrongful.¹⁴⁴ Further, *Zapata* states that the court may order "limited discovery,"¹⁴⁵ whereas discovery is not available to the plaintiff alleging that demand would be futile. *Zapata* also permits the court to apply "its own independent business judgment" in considering whether to grant the committee's motion to dismiss even if the court acknowledges the independence, good faith, and sound bases of the committee and its recommendations.¹⁴⁶ First, however, the court must decide whether to excuse demand; that, in turn, depends on the plaintiff's ability to make the particularized allegations required by *Aronson*.

A further problem with the current Delaware approach is that it requires the court to resolve dispositive substantive questions about the merits of the litigation when it determines whether the plaintiff has met demand "prerequisites." Factual issues have not been developed at that point. The court's attention is focused on the pleadings, and the plaintiff is not entitled to conduct discovery to supplement her allegation that making a demand would be futile.¹⁴⁷ Thus, the court must adjudicate factual issues determinative of substantive liability in the context of a dispute over pleading.

These concerns appear to have prompted the Third Circuit to state a different test for excuse in *Lewis v. Curtis*.¹⁴⁸ Rather than determining whether under any circumstances the transaction could be justified as a product of business judgment, the court should instead consider "whether a demand on the directors would be likely to prod them to correct a wrong."¹⁴⁹ While this test may presuppose that "a wrong" has occurred,¹⁵⁰ it also shifts the focus of the court's concern with de-

¹⁴³ See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 n.10, 788 (Del. 1981).

¹⁴⁴ *Id.* at 788.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 789.

¹⁴⁷ See *Kaufman v. Belmont*, 479 A.2d 282, 289 (Del. Ch. 1984).

¹⁴⁸ *Lewis v. Curtis*, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).

¹⁴⁹ *Id.* at 786.

¹⁵⁰ See 1985 DISCUSSION DRAFT, *supra* note 1, at 56 (criticizing *Lewis*).

mand to the directors' capacity to respond to it and away from their personal stake (if any) in the challenged transaction itself.

The standard for excuse formulated by the New York Court of Appeals also differs from the *Aronson* test. In *Barr v. Wackman*,¹⁵¹ the court of appeals held that the plaintiff's derivative complaint could withstand a motion to dismiss for failure to allege that a demand had been made on the board, even if the complaint did not allege that a majority of the directors had engaged in fraud or self-dealing.¹⁵² Rather, in the court's discretion, demand could be excused if the plaintiff made "[p]articular allegations of formal board participation in and approval of wrongdoing."¹⁵³ In contrast, under *Aronson* the allegation that directors approved of a challenged transaction but did not personally benefit from it, does not excuse demand, at least in the absence of an allegation that the transaction itself constituted waste of corporate assets.

Thus, jurisdictions differ widely in defining the circumstances under which demand on directors will be excused. Rules defining excuse diverge for the same reasons as do other rules concerning the ramifications of the demand requirements. The principal purpose, nature, or function of the requirements can be conceived differently. If demand parallels in microcosm the directors' power to act on the corporation's behalf, demand should be excused only when the transactions at issue appear not to be within the ambit of the directors' power. The inevitable consequence of this approach is that the court will resolve dispositive substantive issues in the etiolated context of pleading. On the other hand, if demand is principally a device to call prominent attention to disputes so that they may be resolved outside litigation, the likelihood of that resolution should be the focus of the court's concern with excuse. In consequence, some derivative suits that will ultimately be unsuccessful will survive preliminary challenges to the pleadings. In most instances, however, the cases will survive, only to be dismissed at the behest of the corporation's special litigation committee. Thus, the inevitable may only be postponed in many cases, but in some a substantive review of the merits will precede dismissal of the litigation.

¹⁵¹ *Barr v. Wackman*, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 479 (1975).

¹⁵² *Id.*

¹⁵³ *Id.* at 381, 329 N.E.2d at 188, 368 N.Y.S.2d at 507-08.

CONCLUSION

Inevitably, rules about these aspects of derivative litigation reflect courts' appraisal of the merits of the particular suit and the general social utility of derivative actions. Some courts believe that derivative actions are useful deterrents to managerial misconduct and effective devices to achieve compensation for injuries to the corporation. Other courts believe these actions are strike suits brought on inadequate bases by rapacious attorneys on behalf of underinformed clients. A court's position affects its interpretation and treatment of the prerequisites to such actions. Indeed, the fact that a number of the cases discussed in this Article involve the same plaintiff¹⁵⁴ may go far to explain why, in some eyes and perhaps for the wrong reasons, derivative litigation is a problematic enterprise.

¹⁵⁴ Harry Lewis appears in *Aronson v. Lewis*, *Lewis v. Curtis*, and *Lewis v. Graves* (discussed *supra* in text accompanying note 116). One might well wonder about Mr. Lewis's technique for portfolio selection. *See also* *Lewis v. Anderson*, 453 A.2d 474, 475 n.1 (Del. Ch. 1982), *aff'd*, 477 A.2d 1040 (Del. 1984) (confirming continued corporeal existence of habitual plaintiff; disproving thesis that "Harry Lewis" was a "street name" employed by various counsel). Harry B. Lewis successfully resisted a motion to dismiss a derivative action pursuant to a recommendation of a special litigation committee, on the grounds that the sole committee member's past associations with the individual defendants raised questions of fact as to his independence, and that the committee had not discharged its burden of establishing the reasonableness of the bases for its conclusions. *See Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985).

