A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation

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The procedural standards for shareholder derivative suits have endured a checkered history. Courts and commentators alike have failed to agree as to a proper set of procedural standards for derivative suits. The Delaware courts and the American Law Institute have each developed an elaborate and comprehensive set of procedural standards that each claims properly balances the competing policies regarding derivative suits. However, this Note argues that both approaches have various weaknesses that detract from their utility and soundness. Each approach alienates certain valid policies regarding the role of shareholder derivative suits and corporate management.

This Note proposes a hybrid procedural approach that integrates the strongest elements of the Delaware and the ALI approaches. This hybrid approach reconciles the seemingly competing policies regarding shareholder derivative suits and produces a set of procedural standards that makes the derivative suit a viable legal mechanism for corporate shareholders, while still respecting the role of corporate management in determining the best interests of the corporation.

I. INTRODUCTION

A shareholder derivative action permits a shareholder to bring suit against wrongdoers on behalf of the corporation, and it forces those wrongdoers to compensate the corporation for the injury they have caused.1 Thus, the cause of

* This Note is dedicated to my parents, Tom and Brenda Ferrell—I am forever grateful for your love and support. In addition, I would like to thank Tara McPherson, who is and always will be my inspiration in life.

1 See Thomas P. Kinney, Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers, 78 MARQ. L. REV. 172, 172 (1994); Carol B. Swanson, Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball, 77 MINN. L. REV. 1339, 1340 (1993).

It should be noted that a derivative action is different than a direct action and carries with it several different procedural requirements. See FED. R. CIV. P. 23.1. The nature of the wrong controls whether the shareholder asserts a derivative or a direct claim. See, e.g., In re General Motors Class E Stock Buyout Sec. Litig., 694 F. Supp. 1119, 1131 (D. Del. 1988) (looking to the nature of the wrong alleged in the complaint and not the label employed by the plaintiffs in determining whether an action was direct or derivative); Lipton v. News Int'l, Plc, 514 A.2d 1075, 1078 (Del. 1986) (“To determine whether a complaint states a derivative or an individual cause of action, we must look to the nature of the wrongs alleged in the body of the complaint . . . .”); Elster v. American Airlines, Inc., 100 A.2d 219, 223 (Del. Ch. 1953) (noting that “the nature of the wrong alleged is what controls” whether a cause of action is direct or derivative); Strasenburgh v. Straubmuller, 683 A.2d 818, 830 (N.J. 1996). “Thus, when the
action actually belongs to the corporation, but a shareholder is permitted to assert the cause of action where the corporation has failed to take action for itself.\(^2\) Although shareholder derivative suits have been in existence for well over a century,\(^3\) the law—particularly the procedural law—governing these suits remains varied and unsettled.\(^4\) Moreover, many of the issues surrounding derivative suits have been, and still are, very controversial.\(^5\)

Injury complained of falls on the corporation or affects all stockholders equally, the cause of action should be brought by the corporation or derivatively by the stockholders if the corporation fails to act." Jesse B. Finkelstein et al., *Derivative Suit Litigation*, in 1 THE 26TH ANNUAL INSTITUTE ON SECURITIES REGULATION 543, 551 (PLI Corp. Law & Practice Course Handbook Series No. B–866, 1994).


In contrast, a direct action by a shareholder involves a claim for some alleged wrong that injured the shareholder in his individual capacity. A direct action is one that exists independently from the corporation or involves a contractual right held by the shareholder. *See In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 330 (Del. 1993); Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1143 (Del. 1989). Examples of direct actions include the following: actions to enforce the shareholder's right to vote, claims that a transaction unfairly affects minority shareholders, and claims that the directors' actions diluted only certain shareholders' proportionate interests in the corporation. *See* Tri-Star Pictures, 634 A.2d at 330; Harnett, 564 A.2d at 1143; Lipton, 514 A.2d at 1079.


\(^3\) *See* Hawes v. City of Oakland, 104 U.S. 450, 450 (1881); Dodge v. Woolsey, 59 U.S. (18 How.) 331, 341 (1855); *DeMott*, *supra* note 2, § 1:03, at 7–8 (citing Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832)).

\(^4\) *See*, e.g., John C. Coffee, Jr., *Derivative Litigation Under Part VII of the ALI Principles of Corporate Governance: A Review of the Positions and Premises, in CURRENT ISSUES IN CORPORATE GOVERNANCE*, at 237, 240 (ALI-ABA Course of Study No. CA53, 1995) (noting that "[t]he derivative action has had a long, convoluted, and controversial history in American law").

\(^5\) *See*, e.g., Glenn G. Morris, *Shareholder Derivative Suits: Louisiana Law*, 56 LA. L. REV. 583, 585 (1996); Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-First Century*, 21 J. CORP. L. 417, 437 (1996) (noting that "shareholder derivative suits have been controversial since their inception").
The major controversy surrounding shareholder derivative litigation stems from the competing policies that underlie the derivative suit. One important policy argument in favor of shareholder derivative suits is that they are an invaluable procedural device in corporate law that allows shareholders to protect the corporation's rights—which in actuality are the shareholders' rights. A minority shareholder, who ordinarily would have no power to challenge or control director malfeasance, can bring an action against corporate directors and officers who have committed wrongful acts that injure the corporation. A minority shareholder can thereby hold directors and officers legally and financially accountable for their wrongdoing. Thus, the shareholder derivative suit serves two important goals: (1) it deters future wrongful conduct on the part of corporate management; and (2) it compensates the corporation for its injuries.

6 See, e.g., Barrett v. Southern Conn. Gas Co., 374 A.2d 1051, 1055 (Conn. 1977) ("If the duties of care and loyalty which the directors owe to their corporations could be enforced only in suits by the corporation, many wrongs done by directors would never be remedied."); Brown v. Tenney, 532 N.E.2d 230, 232 (Ill. 1988) (stating that "[t]he derivative suit is a device to protect shareholders against abuses by the corporation, its officers and directors, and is a vehicle to ensure corporate accountability"); M.D. Bldg. Material Co. v. 910 Constr. Venture, 579 N.E.2d 1059, 1062 (III. App. Ct. 1991) ("In the corporate setting, a derivative suit is a device to protect shareholders against abuses by the corporation, its officers and directors.").

7 The alleged wrongdoers in a shareholder derivative action are not always corporate directors or officers. Third parties that have injured the corporation in some way can also be named as defendants in a derivative action. See, e.g., Ross v. Bernhard, 396 U.S. 531, 538 (1970).

8 See supra note 6.

9 See, e.g., Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (noting that "the derivative suit [is a] potent tool[ ] to redress the conduct of a torpid or unfaithful management"); Kinney, supra note 1, at 172 (stating that "[d]erivative suits are praised for providing a single shareholder with a vehicle for forcing management to compensate the injured corporation"); Swanson, supra note 1, at 1345 ("Absent derivative suits, individual shareholders would have no access to compensation for injuries directly inflicted on their corporation.").

However, this strong policy in support of derivative actions may be tempered somewhat by what has occurred in practice. The assertion that such suits will compensate the corporation and restore it to its financial condition prior to the wrongful conduct has not been entirely accurate. In reality, derivative suits may not provide an injured corporation with much financial gain at all. Furthermore, if the financial injury was relatively small in the first place, a derivative suit may result in overall financial costs to the corporation. Forcing corporations to create special independent committees and to appoint independent legal counsel to assist the committees in reviewing the shareholders allegations creates substantial costs. See 2 ALI PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Reporter's Note, at 12–14 (1994) [hereinafter 2 ALI PRINCIPLES]; George D. Hornstein, The Death Knell of Stockholders' Derivative Suits in New York, 32 CAL. L. REV. 123, 136–37 (1944); Thomas M. Jones, An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits, 60 B.U. L. REV. 542, 545 (1980). For example, Roberta Romano, in her article entitled The Shareholder Suit: Litigation without Foundation?, 7 J.L. ECON. & ORG. 55 (1991), notes that any financial benefits realized by bringing a derivative suit are often marginal at best: 

"W[h]ile most suits settle, the settlements provide minimal compensation... [P]er share
However, courts and commentators have recognized that there are potentially detrimental side effects to a shareholder derivative suit. For instance, the derivative suit can lend itself to abuse by allowing opportunistic shareholders and attorneys to impede the actual best interests of the corporation by filing frivolous and unfounded strike suits.\(^{10}\)

Furthermore, others believe that shareholder derivative suits must be carefully constrained so that minority shareholders and the courts are not permitted to unduly interfere with and second-guess directors' business decisions.\(^{11}\) They argue that a decision regarding whether a corporation should bring a legal action against an alleged wrongdoer is a business decision, and, thus, recoveries are small. In addition, monetary relief is much lower, and more infrequently obtained, in derivative suits compared to class actions. \(\ldots\) The principal beneficiaries of the litigation therefore appear to be attorneys \(\ldots\)" \(\text{Id. at 84.}\)

However, as stated above, financial compensation is not the only goal served by derivative actions. Deterrence is also a justification. Shareholder derivative suits deter corporate officers and directors from practicing wrongful behavior that is injurious to the corporation and its shareholders. Thus, derivative actions can be found to create more responsible management. \(\text{See, e.g., Mills v. Electric Auto-Lite Co., 396 U.S. 375, 396 (1970) (noting that a successful shareholder suit "'accomplishes a result which corrects or prevents abuse'" by the officers or directors (quoting Bosch v. Meeker Coop. Light & Power Ass'n, 101 N.W.2d 423, 426-27 (Minn. 1960)); Neese v. Richer, 428 N.E.2d 36, 42 (Ind. Ct. App. 1981) (noting that shareholders should be able to bring derivative suits "to redress a wrong or prevent a threatened wrong \(\ldots\) even though such action might not result in 'pecuniary benefit'; State ex rel. Weede v. Bechtel, 56 N.W.2d 173, 183 (Iowa 1952) (stating that "stockholders' suits \(\ldots\) have been a most wholesome, though inadequate remedy in deterring these intracorporate transgressions by officers and directors"); Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (noting that the function of a derivative action is not only to compensate the corporation and shareholders, but also to deter officers and directors from wrongdoing). But see Dennis J. Block et al., \textit{Derivative Litigation: Current Law Versus the American Law Institute}, 48 BUS. LAW 1443, 1483 (1993) (noting that derivative actions may also deter risk taking and innovation on the part of directors, which may cause a company to lose its competitive edge in the market).}\)

\(^{10}\) \(\text{See Zapata Corp. v. Maldonado}, 430 A.2d 779, 782, 785 (Del. 1981); ROGER J. MAGNUSON, \textit{SHAREHOLDER LITIGATION § 8.01}, at 3 (1997); Kinney, \textit{supra} note 1, at 172; see also Stuart J. Baskin, \textit{Recent Developments in State Securities, Derivative and Corporate Law, in SECURITIES LITIGATION} 1996, at 449, 452 (PLI Corp. Law & Practice Course Handbook Series No. 958, 1996) (noting that all state jurisdictions closely scrutinize derivative suits and seek to preserve the board's ability independently to decide whether to prosecute legal action on behalf of the corporation'); Swanson, \textit{supra} note 1, at 1340-41 (noting that some commentators feel that "derivative litigation necessarily raises the specter of shareholder strike suits and undue judicial interference with business judgment of management").

\(^{11}\) \(\text{See, e.g., Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) ("[T]he derivative action impinges on the managerial freedom of directors \(\ldots\)"}; Aronson, 473 A.2d at 812 ("[T]he demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations"); Marx v. Akers, 644 N.Y.S.2d 121, 124 (1996) ("By their very nature, shareholder derivative actions infringe upon the managerial discretion of corporate boards"); Swanson, \textit{supra} note 1, at 1340-41 ("The opposing view cautions that corporations, not the courts, should resolve internal conflicts \(\ldots\)").
it should be handled internally by the corporate directors and upper-level management. Moreover, supporters of this position believe that such decisions should be granted judicial deference and protected with a presumption of good faith and reasonableness. In other words, the corporate directors, not the courts, are in the best position to determine what is in the best interest of the corporation. Therefore, the courts should grant tremendous judicial deference to corporate decisions not to pursue litigation against one or more of its own directors or officers.

Yet this policy argument is countered by the proposition that a decision by the directors of a corporation regarding whether to pursue legal action against fellow directors and officers is not a typical business decision. The directors who will make the decisions regarding the propriety of bringing legal action move within the same professional and social circles as the defendant-directors. Thus, a structural bias prevents them from ever voting in favor of the derivative litigation. Thus, this view supports a more intense judicial scrutiny of the merits of the derivative suit and less deference to the corporate directors' decision as to whether a derivative action should go to trial.

These competing arguments regarding the policies that should be reflected by the derivative suit drive the continuing controversy over the proper procedural

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12 This argument is a more specific version of the age-old doctrine in corporate law that the directors of a corporation—not the shareholders or the courts—should manage the corporation's day to day activities and make the business decisions. See Aronson, 473 A.2d at 811 (noting that it is "[a] cardinal precept of the General Corporation Law of the State of Delaware . . . that directors, rather than shareholders, manage the business and affairs of the corporation").

13 This policy supports application of the "business judgment rule" to decisions of corporate directors. The business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company." Aronson, 473 A.2d at 812; see also Auerbach v. Bennett, 47 N.Y.2d 619, 630-35 (1979).

14 See Auerbach, 47 N.Y.2d at 631–34.

15 "Structural bias is the institutional symbiosis that exists when directors pass judgment upon their fellow directors." Peter E. Kay, Director Conflicts of Interest Under the Model Business Corporation Act, 69 WASH. L. REV. 207, 227 (1994).

16 See, e.g., Hasan v. Clevertrust Realty Investors, 729 F.2d 372, 377 (6th Cir. 1984) ("A derivative action invokes a response of group loyalty so that even a 'maverick' director may feel compelled to close ranks and protect his fellows from the attack of the 'strike suitor.'" (quoting John C. Coffee, Jr. & Donald E. Schwartz, The Survival of the Derivative Suit, 81 COLUM. L. REV. 261, 283 (1981))); Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (stating that, when independent directors participate on executive committees established to evaluate litigation, "[t]he question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role"); Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 717–18 (Iowa 1983) (noting that where defendant-directors appoint the committee of directors that will decide whether to allow the derivative action to continue, the court must be cognizant of the possibility of structural bias).
standards governing derivative litigation. This Note focuses on two of the most important procedural elements of a shareholder derivative suit: (1) the demand requirement; and (2) the standard of judicial review of a corporate committee’s decision that a derivative action should be terminated and dismissed. Both courts and commentators have developed a variety of specific standards and rules that make up both the demand requirement and the standards for judicial review. In particular, the Delaware Supreme Court and the American Law Institute (ALI) have developed two of the most comprehensive sets of procedural rules regarding demand and judicial review.\footnote{In 1994, the ALI enacted its final draft of proposals regarding procedural and substantive rules for derivative actions. These rules are set out in Part VII of the \textit{ALI Principles of Corporate Governance: Analysis and Recommendations} ("ALI Principles"). The \textit{ALI Principles} is an elaborate and exhaustive set of standards and procedures for derivative litigation, and these rules reflect the ALI’s views as to how the various competing policies discussed previously should be balanced in procedural rules governing derivative actions. While these proposals have spawned a substantial amount of law review commentary, courts and legislatures have not yet adopted Part VII of the \textit{ALI Principles} as law. Delaware has also developed a comprehensive set of standards regarding the procedures governing shareholder derivative suits. However, unlike the \textit{ALI Principles}, Delaware has developed its standards primarily through judicial decision.\footnote{The Delaware courts have created rules and standards in the areas of shareholder demand and judicial review of demand-refusal that have proven to be very influential in other jurisdictions. See, e.g., \textit{In re General Tire & Rubber Co. Sec. Litig.}, 726 F.2d 1075, 1083 (6th Cir. 1984) (applying Ohio law); \textit{Joy v. North}, 692 F.2d 880, 891 (2d Cir. 1982) (applying Connecticut law); \textit{Peller v. Southern Co.}, 707 F. Supp. 525, 527 (N.D. Ga. 1988) (applying Georgia law); \textit{Rosengarten v. Buckley}, 613 F. Supp. 1493, 1500 (D. Md. 1985) (applying Maryland law); \textit{Abella v. Universal Leaf Tobacco Co.}, 546 F. Supp. 795, 799–800 (E.D. Va. 1982) (applying Virginia law). However, other jurisdictions have also established approaches to these two procedural issues that differ from the Delaware standards. In addition to the common law in this area, many state legislatures have codified the procedural requirements that govern shareholder derivative litigation.}}

Part II of this Note provides a general explanation of both the demand requirement and the standards of judicial review used by courts to evaluate corporate decisions terminating derivative actions. Part III focuses specifically on the Delaware and the ALI approaches regarding demand and judicial review. Finally, Part IV proposes that a hybrid approach—combining the best aspects of the ALI standards and the Delaware standards—is the best overall procedural approach to derivative litigation.

II. THE DEMAND REQUIREMENT & JUDICIAL REVIEW OF SPECIAL LITIGATION COMMITTEES

A. Demand in General

All jurisdictions have a demand requirement as one of the procedural steps in
bringing a derivative action. Demand is the procedure by which the shareholder formally notifies the corporation of his or her allegations against the wrongdoers and requests that the corporation authorize the shareholder to file a derivative action. The demand requirement stage is the first major hurdle facing a shareholder-plaintiff in his or her quest of carrying a derivative action to a trial on the merits. Some jurisdictions have a demand procedure that requires a shareholder to make demand upon the corporation before filing suit unless such demand would be "futile." Thus, in these jurisdictions, an important issue becomes what standard should be used for determining when demand would be "futile." In contrast, other jurisdictions have a "universal demand rule" that requires demand be made in all situations.

19 See, e.g., Swanson, supra note 1, at 1349 ("All jurisdictions require that shareholders make a demand on the corporation's board of directors before a derivative suit can be brought.").

20 The Supreme Court, in Kamen v. Kemper Financial Services, Inc., 500 U.S. 90, 108-10 (1991), has held that demand is a matter of substantive law, and, thus, the demand rule of the state of incorporation governs in federal court.

21 Delaware excuses demand in situations where it would be futile. See Aronson v. Lewis, 473 A.2d 805, 809-11 (Del. 1984). Regarding the standard for determining "futility," see infra Part III.B.1.b. The "futility" standard is derived from Delaware Chancery Rule 23.1, which states:

In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.

22 See 2 ALI PRINCIPLES, supra note 9, § 7.03, at 57. The American Bar Association in its proposals on corporate law has also adopted a universal demand requirement. Under its proposal, plaintiffs in a derivative action must make a demand upon the corporation in all cases, and the commencement of a derivative action is not permitted until 90 days after demand is made, unless the demand is rejected earlier. See 2 MODEL BUSINESS CORPORATION ACT ANNOTATED § 7.42 (3d ed. 1994 & Supp. 1996) [hereinafter MBCA]. The MBCA demand rule, like the ALI Principles, excuses demand if the shareholder can show irreparable harm. See id.

Twelve states have adopted some form of a universal demand requirement. See ARIZ. REV. STAT. ANN. § 10-742 (West 1996); CONN. GEN. STAT. § 33-722 (1997); FLA. STAT. ANN. § 607.07401(2) (West 1993); GA. CODE ANN. § 14-2-742 (1994); MICH. COMP. LAWS ANN. § 450.1493a (West 1996); MISS. CODE ANN. § 79-4-7.42 (1996); MONT. CODE ANN. § 35-1-543 (1997); NEB. REV. STAT. § 21-2072 (1997); N.H. REV. STAT. ANN. § 293-A:7.42 (Supp. 1997); N.C. GEN. STAT. § 55-7-40(b) (1997); VA. CODE ANN. § 13.1-672.1 (Michie 1993);
There are several justifications for the demand requirement. The most prominent justification is that the cause of action being asserted by the shareholder belongs in reality to the corporation and not to the shareholder. Thus, requiring a shareholder to make demand is necessary because it allows the board of directors, which is empowered as the management body of the corporation, to make the initial review and determination regarding the allegations, their validity, and the proper course of conduct that the corporation should pursue. Another related rationale is that demand provides for potential intracorporate resolution of a dispute before an official derivative action is filed by notifying the corporation of the allegations being asserted. This potentially saves judicial resources by protecting the court from hearing cases that could be resolved through remedies within the corporation. In addition, demand provides


See supra note 2 and accompanying text; see also Auerbach v. Bennett, 47 N.Y.2d 619, 631 (1979) (stating that "[d]erivative claims against corporate directors belong to the corporation itself").

See Del. Code Ann. tit. 8, § 141(a) (1993) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."); see also Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978) (noting that directors are responsible for deciding whether in their business opinion a derivative suit is in the best interests of the corporation); Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993) (noting that directors are "empowered to manage" the corporation under Delaware law); Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) (noting that directors manage the affairs of the corporation); Aronson, 473 A.2d at 811 ("A cardinal precept of . . . General Corporation law . . . is that directors, rather than shareholders, manage the business and affairs of the corporation."); Auerbach, 47 N.Y.2d at 631 ("As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation’s board of directors.").

See, e.g., Starrels v. First Nat'l Bank, 870 F.2d 1168, 1173 (7th Cir. 1989) (describing demand as initiating a "form of alternative dispute resolution"); Lewis v. Graves, 701 F.2d 245, 247 (2d Cir. 1983) (noting that demand may initiate a form of dispute resolution); Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 940-41 (3d Cir. 1982) (noting that demand forces "shareholders to exhaust intracorporate remedies" (quoting Note, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. Chi. L. Rev. 168, 171 (1976))); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (demand requirement "promote[s] intracorporate dispute resolution"); 2 ALI PRINCIPLES, supra note 9, § 7.03 cmt. c, at 55 (suggesting that demand may help the corporation crystallize policies that help to remedy the allegations); Robert K. Payson, Dismissal of Derivative Actions: The Debate, 6 Del. J. Corp. L. 522, 527 (1981); Swanson, supra note 1, at 1350 ("Regardless of whether the corporation rejects or supports the shareholder action, the demand may at least motivate the board to consider difficult issues not previously given serious attention.").

See 2 ALI PRINCIPLES, supra note 9, § 7.03 cmt. c, at 55; see also Dennis J. Block et al., The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade, 45 Bus. Law. 469, 472-73 (1990) (noting that the demand requirement "serves the interest of judicial economy"); Swanson, supra note 1, at 1351 ("[T]he demand requirement promotes intracorporate dispute resolution that avoids unnecessary litigation.").
a corporation with the opportunity to take over the litigation. However, perhaps the most practical rationale for demand is that it “provides the corporation with an opportunity to reject the proposed action or, if it is filed, to seek its early dismissal.”

B. Judicial Review in General

1. The Special Litigation Committee

Judicial review of special litigation committee decisions to terminate derivative actions is another prominent element in derivative actions. If the board of directors fails to get a derivative action dismissed at the demand stage, it will typically appoint a special litigation committee to thoroughly review the shareholder-plaintiff’s allegations. Today, it is a well-settled rule that a board of directors, even when a majority of its members are “interested,” has the power

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27 See Elfenbein v. Gulf & W. Indus., 590 F.2d 445, 450 (2d Cir. 1978); Swanson, supra note 1, at 1350.
28 2 ALI PRINCIPLES, supra note 9, § 7.03 cmt. c, at 55; see also Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) (ensuring that the corporation is provided the opportunity to continue the action or dismiss it depending on the corporation’s best interests).
29 A special litigation committee typically consists of one of the following: (1) acting directors of the corporation who are clearly independent and disinterested in the derivative action, or (2) directors who are elected to the board specifically for the purpose of serving on the special litigation committee.

As soon as a corporation receives demand from a shareholder, or is otherwise notified that a derivative action is to be filed, the board will often quickly appoint a special litigation committee in hopes of expediting the termination of the suit. See Cuker v. Mikalaukas, 692 A.2d 1042, 1044 (Pa. 1997) (appointing a special litigation committee less than one month after demand was made). However, the corporation must be careful about the timing of a special litigation committee’s appointment. For instance, if a shareholder files a derivative action alleging demand is excused, and the board appoints a special litigation committee in response to the complaint, a court might interpret this as a concession by the corporation that demand is excused. See Abbey v. Computer Tech. & Communications Corp., 457 A.2d 368, 374 (Del. Ch. 1983).

Therefore, the most prudent course of conduct for a corporation is to first file a motion to dismiss for failure to make demand before appointing a special litigation committee to investigate the allegations. See Spiegel, 571 A.2d at 776–77 (holding that the appointment of a special litigation committee is not a concession that demand is excused if the motion to dismiss for failure to make demand is filed before a special litigation committee is appointed).

30 The following is a good explanation of the general standard for determining whether a director is “interested”:

A director is interested if he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the stockholders. The “mere threat” of personal liability in the derivative action does not render a director interested; however, a “substantial likelihood” of personal liability prevents a director from
to appoint a special litigation committee. The committee will perform a factual investigation of the shareholder-plaintiff’s allegations and will conclude its investigation by reaching a decision as to whether the derivative action should be continued or terminated. The committee will also draft a report that details the methods it used in investigating the allegations, its conclusions, and the facts relied upon in reaching those conclusions. If the committee’s final conclusion is that the action should be terminated, the corporation will petition the court to have the case dismissed based on the committee’s conclusions. The court will then review the committee’s investigative methods—and possibly its factual findings and conclusions—to determine whether the case should be dismissed.

impartially considering a demand.

Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1995) (citations omitted); see also Pogostin, 480 A.2d at 624 (“Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.”).

31 See Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981); Spiegel, 571 A.2d at 767–77. However, the Iowa Supreme Court in Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709 (Iowa 1983), held that a board may not empower a special litigation committee with the authority to recommend termination of a derivative suit where a majority of that original board are defendants in the derivative action. See id. at 715–16.

32 See, e.g., 2 ALI PRINCIPLES, supra note 9, § 7.04, at 69–71; Baskin, supra note 10, at 477; Finkelstein et al., supra note 1, at 588 (“[A] special litigation committee of disinterested directors has the ability, in its business judgment, to determine whether the action should be continued. Such ability derives from the duty of the board of directors to govern the affairs and manage the assets of the corporation.”).

More specifically, section 7.08 of the ALI Principles requires the board to decide whether allowing the derivative action to continue would be “contrary to the best interests of the corporation.” 2 ALI PRINCIPLES, supra note 9, § 7.08, at 112; see also Finkelstein et al., supra note 1, at 586 (“[T]he board will in some instances opt to appoint a special litigation committee to investigate the shareholder’s allegations, to determine whether the litigation is in the best interests of the corporation and, if appropriate, to seek the termination of the derivative suit.”).

Theoretically, the special litigation committee could conclude that the litigation is in the best interests of the corporation and should be supported. In reality, however, the special litigation committee almost always decides that the derivative suit should be terminated. See, e.g., Lewis v. Boyd, 838 S.W.2d 215, 223 (Tenn. Ct App. 1992); see also Demott, supra note 2, at § 5.04.

33 See 2 ALI PRINCIPLES, supra note 9, § 7.09, at 116–17; see also Kaplan v. Wyatt, 484 A.2d 501, 519–20 (Del. Ch. 1984) (discussing the comprehensiveness of the special committee’s report).

34 See, e.g., Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 1040–41 (1989) (stating that if the special committee decides to dismiss, then the corporation will move to dismiss based on this decision); Lewis v. Fuqua, 502 A.2d 962, 964–65 (Del. Ch. 1985); 2 ALI PRINCIPLES, supra note 9, § 7.09, at 116–17.

35 A court may or may not be permitted to inquire into the factual findings and conclusions of the special litigation committee depending on the standard of judicial review followed in that jurisdiction. The court may only be permitted to review the procedures used by
The court's review of a special litigation committee's report and decision to terminate a derivative action is a very important, and highly controversial, issue. The controversy surrounds the question of what level of judicial scrutiny the court should apply when reviewing a special committee's decision to move for dismissal of a derivative action. Some jurisdictions advocate a high level of scrutiny by the court in which the court makes its own evaluation of the merits of the derivative action. Other jurisdictions follow a very deferential approach in which the court only reviews the procedures the special litigation committee followed in reaching its decision. If those procedures indicate good faith and reasonable investigation, then the court will defer to the committee's decision.

There are at least five different standards presently being applied by various jurisdictions across the country. See infra notes 37-40 and accompanying text; see also Charles W. Murdock, Corporate Governance—The Role of Special Litigation Committees, 68 WASH. L. REV. 79, 89 (1993) (“During the 1980s, a split of authority arose over what weight the recommendation of a special litigation committee should be accorded and what the standard for judicial review of the committee’s decision should be.”).

See Alford v. Shaw, 358 S.E.2d 323, 326-28 (N.C. 1987) (rejecting application of the business judgment rule to the decision of the special litigation committee and instead adopting a standard whereby the court must review the substantive decision reached by the special committee to determine if it was reasonable and proper). This standard applies in all cases regardless of whether demand was required or not.

See Auerbach v. Bennett, 47 N.Y.2d 619, 623-24 (1979). In other words, these courts will apply the business judgment rule to the special litigation committee's decision. The Auerbach court explained its standard of review of the special committee's decision to terminate the derivative action as follows:

The latter, substantive decision falls squarely within the embrace of the business judgment doctrine, involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. To this extent the conclusion reached by the special litigation committee is outside the scope of our review. Thus, the courts cannot inquire as to which factors were considered by that committee or the relative weight accorded them in reaching [ ] substantive decisions . . . . Inquiry into such matters would go to the very core of the business judgment made by the committee. To permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee. Its substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach.

Yet other jurisdictions steer a middle course by allowing some judicial review of the reasonableness of the committee's decision but not permitting the court to completely substitute its own judgment for that of the committee. Finally, other jurisdictions apply different standards of judicial review depending on the type of case or the underlying theories of liability being asserted by the shareholder-plaintiff.

III. THE ALI APPROACH V. THE DELAWARE APPROACH

A. The ALI Approach

The ALI approach requires universal demand and sets up a bifurcated standard of judicial review for when a corporation rejects demand and moves to dismiss the derivative action. In addition, it sets forth the specific criteria that a special litigation committee must meet in order to be permitted to review a shareholder-plaintiff's allegations and to recommend what action the corporation should take with respect to those allegations. Furthermore, the ALI has created elaborate standards for judicial review of a special litigation committee's recommendation that a derivative action should be terminated. These standards draw a distinction between cases where the plaintiff is alleging violations of the duty of loyalty and cases where he or she is alleging violations of the duty of care.

1. Universal Demand

Section 7.03 of the ALI Principles sets forth a "universal demand rule,"

39 See Houle v. Low, 556 N.E.2d 51, 59 (Mass. 1990) (holding that, in addition to inquiring into the procedural due care of the special litigation committee in deciding that the derivative action should be terminated, the court must also "determine, on the basis of the evidence presented, whether the committee reached a reasonable and principled decision").

40 For instance, Delaware provides different standards of review for cases where demand is "excused" and cases where demand is "required." See Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981). The ALI standard is bifurcated with the specific standard of review depending on whether the plaintiff is alleging a breach of the duty of care or the duty of loyalty. See 2 ALI PRINCIPLES, supra note 9, §§ 7.08-7.10, at 116-31. Both the Delaware and the ALI approaches will be discussed at length below. See infra Part III.

41 The ALI Principles is a comprehensive set of standards and rules to be applied in all areas of corporate law. However, this Note only focuses on the procedures mentioned above.

42 See 2 ALI PRINCIPLES, supra note 9, § 7.03, at 53. Specifically, section 7.03(a) states:

Before commencing a derivative action, a [share]holder ... should be required to make a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective measures, unless demand is excused under § 7.03(b).

The demand should give notice to the board, with reasonable specificity, of the essential
which provides that a shareholder must make a written demand upon a corporation's board of directors before he or she commences a derivative action. This demand must be made in every case, unless the shareholder can show that the corporation would suffer irreparable injury if filing of the action were delayed. Furthermore, the demand should provide the board with notice of the allegations being asserted by the shareholder and the specific facts being relied upon in support of those allegations. The court should dismiss a derivative action that is filed before the board of directors has made a response to the demand.

Once this demand is made upon the corporation, the board of directors will decide whether the litigation should be permitted to continue or whether demand should be rejected. Typically the board will reject demand. Once the corporate board of directors formally rejects the shareholder's demand, the shareholder may immediately file the derivative action with the court. In addition, once the action is filed, the board will typically move to dismiss the action based on its prior facts relied upon to support each of the claims made therein.

Id.

43 This demand would consist of a request to the board that it take "suitable corrective measures," such as taking over the litigation, authorizing the derivative action, or perhaps resolving the dispute internally.

44 See Coffee, supra note 4, at 253.

45 See 2 ALI PRINCIPLES, supra note 9, § 7.03(a), at 53.

46 See id. § 7.03(d), at 53. However, a shareholder may be able to file a suit before a response if the board fails to respond within a "reasonable time." Id.

47 However, a board could decide that the litigation should continue, and then it could authorize the plaintiff-shareholder to continue the litigation on the corporation's behalf or could even take over the litigation itself. Also, the corporation could respond to the shareholder allegations through intracorporate resolution and thus eliminate the need for the derivative action. See id. § 7.08 cmt. c, at 113.

48 See id. § 7.03 cmt. f, at 59–61.

49 In a derivative action, the corporation is considered a nominal defendant along with the defendants facing actual liability. Thus, the board of directors—as the managers of the corporation—will file the motion to dismiss. See ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL § 16.3 (4th ed. 1996); see also Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) ("The nature of the derivative action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.")(quoting Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984))); Kramer v. Western Pac. Indus., Inc., 546 A.2d 348, 351 (Del. 1988) (noting that a derivative action consists of two suits: (1) one against the corporation seeking an order compelling the corporation to bring suit against the wrongdoers, and (2) a second by the shareholders, on behalf of the corporation, against the wrongdoers); Abramson v. Blakeley, 202 N.Y.S.2d 586, 591 (1960) ("While it is true that the corporation is a necessary defendant, its role is nominal, and in actuality it is the plaintiff.").
rejection of the plaintiff's demand.\textsuperscript{50} At this point, the court must decide whether the board's demand rejection should be honored and the case dismissed, or whether the action should continue.

\textbf{a. Demand Rejection in Duty of Loyalty Cases}

The ALI has created a complex set of standards for courts to apply in determining whether to honor the board's rejection.\textsuperscript{51} First, the shareholder, in his or her complaint, must plead with particularity the facts that constitute the basis for the shareholder's theories of liability.\textsuperscript{52} These facts must raise a "significant prospect" that the defendant-directors violated some legal duty that they owed to the corporation.\textsuperscript{53} Thus, if the shareholder is alleging that the defendant-directors violated their duty of care to the corporation, then the complaint must plead particularized facts that, if true, establish a violation of the business judgment rule.\textsuperscript{54} Furthermore, if the shareholder is alleging that the directors violated their...
duty of loyalty, then the complaint must contain facts that raise a “significant prospect” that the directors’ conduct did not meet the legal standards for the duty of loyalty.\textsuperscript{55}

55 Along with the duty of care, the duty of loyalty is part of the overall fiduciary duty that directors owe to the corporation. The duty of loyalty requires the directors and officers to remain loyal to the corporation and to act in the corporation’s best interests at all times. In other words, the duty of loyalty requires directors and officers to place the interests of the corporation above any personal financial interests they may have in a corporate transaction. See 18B AM. JUR. 2d Corporations § 1711 (1985). However, not all transactions in which directors have a personal interest or stand to make a personal financial gain will violate the duty of loyalty, but directors will have to meet a stricter standard. Directors must show that the transaction was overall reasonable and fair to the corporation. See id.; see also DEL. CODE ANN. tit. 8, § 144 (1996) (explaining similar test under Delaware law); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) (finding that the burden of proof shifts in a duty of loyalty case to the director when a “prima facie showing is made that directors have a self-interest in a particular . . . transaction”); In re Santa Fe Pac. Corp. Shareholder Litig., 669 A.2d 59, 66–68 (Del. 1995) (finding that directors did not breach the standards for the duty of loyalty); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1148 (Del. Ch. 1994) (applying standard under Delaware law); Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc., 430 N.W.2d 447, 453 (Iowa 1988) (noting that, in duty of loyalty actions, the director carries the burden of proof on the issue of whether the action was “fair and reasonable” to the corporation).

The ALI’s standards for the duty of loyalty are contained in section 5.02 of the \textit{ALI PRINCIPLES}}
Additionally, section 7.04(a)(2) sets out the standards that the board of
directors must meet in making its decision to reject demand. If these standards are
not met, the board’s rejection will not be given any weight by the court, and the
court will not grant the board’s motion to dismiss.\textsuperscript{56} First, rejection of demand
must be in the form of a written statement.\textsuperscript{57} Second, the board’s rejection of
demand will only be given “legal effect” if a majority of the directors are (1) not
“interested”\textsuperscript{58} in the underlying transaction, and (2) capable of “objective

\textit{Principles.} It states in pertinent part:

(a) \textit{General Rule.} A director [§ 1.13] or senior executive [§ 1.33] who enters into a
transaction with the corporation (other than a transaction involving the payment of
compensation) fulfills the duty of fair dealing with respect to the transaction if:

1. Disclosure concerning the conflict of interest [§ 1.14(a)] and the transaction
[§ 1.14(b)] is made to the corporate decisionmaker [§ 1.11] who authorizes in advance or
ratifies the transaction; and

2. Either:
   (A) The transaction is fair to the corporation when entered into;
   (B) The transaction is authorized in advance, following disclosure concerning the
conflict of interest and the transaction, by disinterested directors [§ 1.15], or in the
case of a senior executive who is not a director by a disinterested superior, who could
reasonably have concluded that the transaction was fair to the corporation at the time
of such authorization;
   (C) The transaction is ratified, following such disclosure, by disinterested directors
who could reasonably have concluded that the transaction was fair to the corporation
at the time it was entered into, provided (i) a corporate decisionmaker who is not
interested [§ 1.23] in the transaction acted for the corporation in the transaction and
could reasonably have concluded that the transaction was fair to the corporation; (ii)
the interested director or senior executive made disclosure to such decisionmaker
pursuant to Subsection (a)(1) to the extent he or she then knew of the material facts;
(iii) the interested director or senior executive did not act unreasonably in failing to
seek advance authorization of the transaction by disinterested directors or a
disinterested superior; and (iv) the failure to obtain advance authorization of the
transaction by disinterested directors or a disinterested superior did not adversely
affect the interests of the corporation in a significant way; or
   (D) The transaction is authorized in advance or ratified, following such disclosure, by
disinterested shareholders [§ 1.16], and does not constitute a waste of corporate assets
[§ 1.42] at the time of the shareholder action.

(b) \textit{Burden of Proof.} A party who challenges a transaction between a director or
senior executive and the corporation has the burden of proof, except that if such party
establishes that none of Subsections (a)(2)(B), (a)(2)(C), or (a)(2)(D) is satisfied, the
director or senior executive has the burden of proving that the transaction was fair to the
corporation.

\textsuperscript{1} ALI PRINCIPLES, supra note 54, § 5.02, at 209–10.

\textsuperscript{56} Like section 7.04(a)(1), section 7.04(a)(2) requires the shareholder to \textit{plead with
particularity} that the board’s decision to reject does not meet the standards set out in section
7.04(a)(2). See 2 ALI PRINCIPLES, supra note 9, § 7.04(a)(2), at 70.

\textsuperscript{57} See id.

\textsuperscript{58} See supra note 30. Section 1.23 of the ALI Principles contains its definition of director
If these preliminary requirements are met, then 
the court will review the board’s demand rejection by applying one of the 
standards set out in section 7.04(a)(2). The standard differs depending on the type 
of case. If the shareholder is alleging that the underlying conduct or transaction 
was a violation of the duty of fair-dealing or some other form of self-dealing, 
then the board’s decision to reject demand must satisfy an objective standard of 
fairness under section 7.04(a)(2)(C). Under this standard, the court asks: Could 
the directors “reasonably have determined that rejection of the demand was in the 
best interests of the corporation”? Furthermore, under this standard, 

“interest.” Basically, under this section a director will be deemed “interested” when: (1) the 
director is a party to the underlying transaction or conduct; (2) the director has a pecuniary 
interest in the transaction or conduct that would reasonably be expected to affect the director’s 
judgment in a manner adverse to the corporation; or (3) the director is subject to a controlling 
influence by a party that is “interested” in the underlying transaction, and that controlling 
influence could reasonably be expected to adversely affect the director’s judgment. See 1 ALI PRINCIPLES, supra note 54, § 1.23, at 25–26. However, the mere fact that a director approved of 
or acquiesced in the underlying transaction or conduct, without more, does not make that 
director “interested” under the ALI Principles. See id. § 1.23(c), at 25.

Coffee, supra note 4, at 255 (quoting 2 ALI PRINCIPLES, supra note 9, § 7.04(a)(2), at 70); see also infra note 83 and accompanying text (discussing the meaning of “objective 
judgment in the circumstances”).

As section 7.04(a)(2) implies, the option to reject the demand and then have the action 
dismissed based upon this rejection is not available to a board of directors when a disinterested 
majority does not exist, or when disinterested directors are too personally involved in the 
conduct or transaction under review to be capable, as a group, of objective judgment in the 
circumstances. See 2 ALI PRINCIPLES, supra note 9, § 7.03 cmt. f, at 59–61. In this situation, the 
board will likely proceed under section 7.08, which sets forth the standard for appointing 
a committee of disinterested directors who will then conduct a review and investigation of the 
plaintiff’s allegations pursuant to the standards contained in sections 7.09 and 7.10. See id. 
§ 7.08, at 112. These sections are explained in Part III of this Note.

Furthermore, when the corporation cannot utilize the demand-rejection standard under 
section 7.04(a)(2), its initial response to the demand need only consist of a statement that the 
board has appointed a special litigation committee and has transferred the matter to the special 
 litigation committee for study and evaluation. See id. § 7.04(a)(2), at 70. When the board 
follows this course of action, it must also inform the plaintiff that it will make its determination 
within a reasonable time.

The ALI Principles define the standards for the duty of loyalty, the duty of care, and 
other duties that the directors of a corporation must comply with when making corporate 
decisions and transactions. See supra notes 54–55. Section 7.04 draws upon these standards in 
creating the standards of judicial review of a board’s demand rejection. In other words, the 
standard of review that will apply under section 7.04(a)(2) is determined by the legal standards 
to which the underlying conduct is subject.

The ALI Principles, throughout its provisions, uses the phrase “fair-dealing.” This refers 
to the duty of loyalty. For a discussion of the duty of loyalty under the ALI Principles, see supra 
ote note 55.

See Coffee, supra note 4, at 256.

2 ALI PRINCIPLES, supra note 9, § 7.04(a)(2)(C), at 70 (emphasis added); see also
disinterested directors must also satisfy the business judgment rule by adequately informing themselves before making a decision to reject. The court will review the procedures that the board followed in making its decision to reject demand to make sure they meet the standards of the business judgment rule, and the court will also review the substance of the board's decision to make sure that it is "reasonable."

The ALI has stated that this "reasonableness" standard is really a balancing test. The court should balance the board's reasons and justifications for rejecting demand against the legal merits of the case as pleaded with particularity in the plaintiff's complaint. The commentary to section 7.04(a)(2) provides a good explanation of the "trade-off" that occurs under this "reasonableness" standard:

In applying § 7.04(a), a court should balance the strength and seriousness of the case set out by the particularized pleading of the plaintiff, as tested under § 7.04(a)(1), with that required under § 7.04(a)(2). The stronger and more serious the case set out by the plaintiff's particularized pleading as tested under § 7.04(a)(1), the less the complaint must allege with particularity to establish under § 7.04(a)(2) that there is a significant prospect the directors could not have determined that rejection of the demand was in the best interests of the corporation under § 7.04(a)(2)(C). See Coffee, supra note 4, at 256.

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64 See 2 ALI PRINCIPLES, supra note 9, § 7.04(a)(2)(C), at 70.
65 See id. § 7.04 cmt. d, at 72; see also Swanson, supra note 1, at 1363 (noting that "the business judgment rule shields the substantive bases for the committee's recommendation from any judicial inquiry").
66 See Coffee, supra note 4, at 256–57.
67 Id. (quoting 2 ALI PRINCIPLES, supra note 9, § 7.04 cmt. d, at 72). Professor Coffee has elaborated further on the implications of this reasonableness standard:

What this balancing test implies is that where an action is strong on its merits, less must be shown by the plaintiff in response to the board's rejection of demand in order to raise a "significant prospect" that the rejection was unreasonable (in a duty of fair dealing case). In such a case, a reply to demand that is only conclusory or that "does not state the reasons for the disinterested directors' rejection should be given only limited weight as against a particularized allegation that strongly raises a significant prospect of a violation under the standard of § 7.04(a)(1)." Stated more simply, the "stronger and more serious the showing under § 7.04(a)(1), the more difficult it will be to dismiss the action in the absence of a statement of equivalently credible reasons for the rejection of the reply."

Id. at 257 (citations omitted); see also Kinney, supra note 1, at 184 ("The [balancing] test requires that the more serious the wrongdoing, the less particularized the allegations need be that the rejection was unreasonable. Also, the more conclusory the corporation's reply, the less weight it is given.").
b. Demand Rejection in Duty of Care Cases

A different standard for judicial review applies in duty of care cases. If the underlying transaction involves an alleged violation of the duty of care, then the board's decision to reject demand will conclusively terminate the case unless the plaintiff can prove, through his or her complaint, that the board's decision to reject demand fails to meet the standards of the business judgment rule. This standard is very deferential to a board's decision to reject demand.

The ALI standard that applies to duty of loyalty cases provides the court with more discretion to review the merits of the case than the business judgment rule standard the ALI proposes to be applied in duty of care cases. Thus, the plaintiff has a much better chance of getting past the demand stage in duty of loyalty cases than in duty of care cases.

2. Judicial Review of a Special Litigation Committee

a. General Overview

As previously stated, there are various ways that a shareholder can get past the demand stage of a derivative action under the ALI Principles: (1) the board's rejection of demand may not be given any legal weight by the court under section 7.04(a)(2) because a majority of the entire board was not "disinterested" or because the board members making the decision to reject were not "capable as a

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68 See 2 ALI PRINCIPLES, supra note 9, § 7.04(a)(2)(B), at 70; see also supra note 54 (discussing the duty of care under the ALI Principles).
69 See Coffee, supra note 4, at 256; see also supra note 54 (discussing the business judgment rule).

Section 4.01(c) contains the ALI's business judgment rule. Generally, in order to get the protections of the business judgment rule under section 4.01(c), directors (1) must be disinterested, (2) must reasonably inform themselves about the subject matter of the underlying transaction, and (3) must have made the business decision in good faith. See 1 ALI PRINCIPLES, supra note 54, § 4.01(c), at 139.

70 At the demand-rejection stage, the court does not actually review the merits of the underlying allegations through the traditional sources of evidence such as sworn testimony, affidavits, depositions, and interrogatories. Rather, the court must assume that all of the facts alleged in the shareholder's complaint are true and, based upon that, must decide whether the board's rejection of demand was "reasonable." See 2 ALI PRINCIPLES, supra note 9, § 7.04(a) cmt. c, at 72.

71 However, this standard by no means permits intensive judicial review.

72 It must be remembered that under the ALI Principles, if the court finds that one of the preliminary requirements of section 7.04(a)(2) is not met, such as a majority of the board is not "disinterested" in the underlying allegations, then the court does not even have to review the board's decision to reject. Instead, the board's motion to dismiss will be denied and the case will continue.
group of objective judgment in the circumstances"; or (2) the court may decline the motion to dismiss because it finds that the plaintiff pleaded with particularity facts sufficient enough to raise a "significant prospect" that the board's decision to reject did not satisfy the standards of section 7.04(a)(2).

Once a shareholder has successfully guided a derivative action past the demand stage, the board of directors will appoint a special litigation committee to review the allegations being asserted by the shareholder. The committee will conduct an extensive investigation of the allegations and will eventually reach a conclusion as to whether continuing the derivative action would be in the best interests of the corporation. If it decides that the derivative suit should be terminated, the committee will petition the court to dismiss the case. The court will then review the committee's report and will decide whether to dismiss the action. The key issue here is what level of judicial review should be applied.

The ALI has developed a complex set of standards that govern this entire process.

b. The Special Litigation Committee under the ALI Principles

i. Section 7.08—Dismissal of a Derivative Action Based on a Motion By a Committee

Section 7.08 basically states that the court should dismiss a derivative action against a corporate director or executive if the following three criteria are met: (1) a special litigation committee appointed by the original board determines that the derivative action is "contrary to the best interests of the corporation and... request[s] dismissal of the action"; (2) the procedures set forth in section 7.09 are substantially complied with by the committee; and (3) the committee's

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73 2 ALI PRINCIPLES, supra note 9, § 7.08 cmt. c, at 72.
74 See id.
75 See Coffee, supra note 4, at 258 (noting that "if the complaint survives the § 7.04(a) hurdle, the plaintiff still does not proceed automatically to discovery and trial"). It should be noted that the ALI Principles does not require a corporation to wait until the court has denied the board's rejection of demand and accompanying motion to dismiss before it may appoint a committee. Rather, the corporation may perform an initial screening of its original board members in order to see if a majority of its directors are disinterested and capable of an objective evaluation as required under section 7.04(a)(2). If it finds that it does not meet these requirements, the board may choose to forego an attempt to dismiss the action based on demand rejection and may immediately appoint a committee to begin investigating the shareholder's allegations.
76 See supra notes 37–40 and accompanying text.
77 These standards are contained in sections 7.08 through 7.10.
78 2 ALI PRINCIPLES, supra note 9, § 7.08(a), at 112.
79 See id. § 7.08(b), at 112.
determination satisfies the applicable standard of judicial review set forth in section 7.10(a). 80

Section 7.08 sets up a two-step test that must be satisfied before a court will dismiss a derivative action. The first step is a procedural test contained in section 7.09. If the committee complies with section 7.09, the court will then proceed to the second step. 81 The second step, which is contained in section 7.10, requires that the committee’s decision to terminate be subjected to some standard of substantive judicial review.

ii. Section 7.09—Procedures for Requesting Dismissal of a Derivative Action

In order for a court to give any legal weight to the committee’s decision to terminate a derivative action, four procedural requirements must be satisfied: (1) the committee should be composed of two or more persons who are not interested in the underlying derivative action and are “capable of objective judgment in the circumstances”; 82 (2) the committee must acquire the assistance of counsel or other agents as may be necessary to assist the committee in

80 See id. § 7.08(c), at 112.
81 See id. § 7.09 cmt. c, at 118.
82 The ALI Principles defines “interest,” for purposes of derivative actions, in section 1.23(c). Section 1.23(c) states that a director is not interested if both the director is named as a defendant in the derivative action “based only on the fact that the director approved of or acquiesced in the transaction or conduct that is the subject of the action” and the complaint does not otherwise allege “facts that...raise a significant prospect that the director would be adjudged liable to the corporation or its shareholders.” 1 ALI PRINCIPLES, supra note 54, § 1.23(c), at 25; see also supra note 58. This definition thus permits “nominal defendants”—directors who are named as defendants in the complaint because they approved of or voted for the alleged transaction but who were not the major players in the transaction—to serve on a committee that will investigate the shareholder’s allegations and determine whether the derivative action should be terminated. See 2 ALI PRINCIPLES, supra note 9, § 7.09 cmt. g, at 122–23.

83 See 2 ALI PRINCIPLES, supra note 9, § 7.09(a), at 116. A committee must satisfy two requirements to be considered “capable of objective judgment in the circumstances.” First, the committee must “be able to understand and evaluate the transaction at issue.” Id. § 7.09 cmt. g, at 122–23. Second, there should not be any “relationships” between any of the committee members and the defendant-directors that could bias the committee’s investigation. See id. “For example, a director who was the close personal friend and next-door neighbor of the defendant would probably lack this capacity and should not serve on the committee.” Id. This standard is similar to the standard used by Delaware courts in determining if a director is “independent.”

84 See id. § 7.09 cmt. a, at 117. The ALI Principles, unlike Delaware and other jurisdictions, does not require that the counsel who assists the special litigation committee be “independent” of the corporation. See id. § 7.09 cmt. h & Reporter’s Note 4, at 123, 127. Therefore, the corporation’s in-house counsel is permitted to serve, provided that certain requirements are met. For instance, the appointed counsel must be capable of exercising
reaching an informed judgment;85 (3) the committee’s determinations should be 
based upon a review and evaluation that is sufficient to satisfy the standard of 
review applicable under section 7.10; and (4) the committee must prepare a 
“report or other written submission setting forth the...committee’s 
determinations in a manner sufficient to enable meaningful judicial review.”86 If 
these four criteria are met, the court should proceed to review the committee’s 
conclusions pursuant to the applicable standard under section 7.10.

iii. Section 7.10—Standards of Judicial Review of a Committee’s 
Decision to Recommend Dismissal of a Derivative Action

Section 7.10 sets forth the applicable standards for judicial review of a special 
litigation committee’s decision to terminate a derivative action. It provides a 
“bifurcated standard of judicial review.”87 Section 7.10(a)(2) provides that if the 
“gravamen” of the underlying derivative action alleges a violation of the duty of 
loyalty,88 or if the action alleges a “knowing and culpable violation of law”89 (or 
other violations of the duty of care to which the business judgment rule is not 
applicable), then the court must apply the following standard in determining 
whether to dismiss the action based on the committee’s report: “[T]he court 
should dismiss the action if the court finds... that the board or committee was 
adequately informed under the circumstances and reasonably 
determined that 
dismissal was in the best interests of the corporation, based on grounds that the 
court deems to warrant reliance.”90

85 The counsel or other agents must be “capable of exercising professional judgment 
under the circumstances.” Coffee, supra note 4, at 258.
86 2 ALI PRINCIPLES, § 7.09 cmt. a, at 117.
87 Coffee, supra note 4, at 258.
88 The duty of loyalty is referred to as the duty of fair dealing throughout the ALI 
Principles. See supra note 55 and accompanying text.
89 2 ALI PRINCIPLES, supra note 9, § 7.10(a)(2), at 130.
90 Id. (emphasis added). This standard calls for the court to first evaluate the committee’s 
methods of investigation to determine whether they were adequate. Then, it requires the court to 
review the committee’s conclusion to determine whether the decision was “reasonable.” This 
standard permits some subjective evaluation by the court of the merits of the plaintiff’s 
allegations because the rule contains the language: “on grounds that the court deems to warrant 
reliance.” Id.
However, the *ALI Principles* provides a different standard of review if the “gravamen of the [underlying] claim” is that the defendant(s) violated a duty of care or some other duty that is protected by the business judgment rule. In that case “the court should dismiss the [plaintiff’s] claim unless it finds that the board’s or committee’s determinations fail to satisfy the requirements of the business judgment rule.”

In general, the standard of review that will apply under the *ALI Principles* is dictated by whether the underlying claim alleges violations of the duty of loyalty or the duty of care. Committee decisions in duty of loyalty cases will receive more searching judicial scrutiny, while decisions to terminate in duty of care cases will be given the deference that is customary of the business judgment rule. The duty of loyalty standard does allow the court, to some extent, to review the committee’s substantive conclusions in order to evaluate their reasonableness, but it does not permit the court completely to apply its own judgment and evaluation of the merits of the case.

**B. The Delaware Approach**

1. Delaware’s Demand Rule: Demand-Required v. Demand-Excused

Delaware does not have a universal demand requirement. Under Delaware

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91 *Id.* § 7.10(a)(1), at 129–30.

92 *Id.* Section 4.01(c) of the *ALI Principles* articulates its version of the business judgment rule. See *supra* note 54.

93 For a discussion of the rationales behind the ALI’s distinction between the duty of loyalty and the duty of care, see *infra* Part IV.C.

Section 7.10(b) provides an additional requirement to the standard of review. It provides that the court should not dismiss the plaintiff’s action if dismissal of the case would allow a defendant (or an associate) to retain a “significant improper benefit.” 2 *ALI PRINCIPLES, supra* note 9, § 7.10(b), at 130.

94 This bifurcated standard of judicial review is similar to the standards of review of demand-rejection under section 7.04(a)(2). Under both section 7.04(a)(2) and section 7.10, the standard of review is directly linked to the legal standard that applies to the underlying transaction (duty of loyalty or duty of care). However, there are some significant differences. The *ALI Principles* provides:

[T]here should usually be a fuller evaluation by the... committee when a motion is made under § 7.08 [and § 7.10] than when a motion on the pleadings is made under § 7.04(a)(2). ... In general, § 7.04(a) envisions a preliminary screening of the... “significant prospect” tests of § 7.04(a)(1)–(2). In contrast, although the depth and scope of the inquiry under §§ 7.10 will depend upon the gravity and plausibility of the plaintiff’s allegations, the review and evaluation contemplated by §§ 7.10 is likely to be more extensive than that required simply to reject demand under § 7.04(a)(2).

2 *ALI PRINCIPLES, supra* note 9, § 7.08 cmt. c, at 113–14.
law, the rule is that a demand must always be made upon the corporation before filing a derivative suit unless making the demand would be "futile." 95 When making demand would be futile, the shareholder can file the derivative action without making demand on the corporation. 96 These are known as "demand-excused" cases, while cases where demand must be made are called "demand-required" cases. 97

a. Demand-Required Cases—When Demand is Made and Refused

When demand is required to be made and it is subsequently rejected by the board of directors, the board's decision to dismiss the derivative suit will be respected unless it was "wrongful (i.e., unless it was not the product of a valid exercise of business judgment)." 98 In this situation, plaintiffs may not merely make a conclusory statement in their complaint that the refusal was "wrongful." 99 Rather, the plaintiff must allege with particularity facts sufficient to rebut the presumption that the board's decision is protected by the business judgment rule. 100 Therefore, when a board refuses demand, the only issues to be examined are the board's good faith, the reasonableness of its investigation, 101 and whether the board members making the decision were "independent" and "disinterested" 102 in the underlying transaction. 103 Furthermore, in demand-

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97 See Swanson, supra note 1, at 1365–66.

98 Finkelstein et al., supra note 1, at 562; see also Abramowitz v. Posner, 672 F.2d 1025, 1030 (2d Cir. 1982); Aronson, 473 A.2d at 813; Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).


102 See supra note 30 for a discussion of the definition of "interested." Director "independence" is a concept very closely related to director "interest":
required cases in which the board has refused demand, the plaintiff is not entitled to any discovery in trying to prove that demand was wrongfully refused. Thus, "whether the business judgment rule protects the board's rejection of a demand from judicial scrutiny must be decided solely from the well-pleaded allegations of the complaint." 

b. Demand-Excused Cases—Proving "Futility"

Because of the difficulty of successfully pleading that refusal of demand was wrongful, shareholders will often choose to file a derivative action without making demand at all. Demand is only excused in cases where making demand would be a "futile" act. Delaware has developed a two-prong test for determining demand "futility" and, thus, for determining when demand is

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Even if a director has no personal interest in a decision, his discretion must also be free from the influence of other interested persons. . . . A director is independent if he can base his decision "on the corporate merits of the subject before the board rather than extraneous considerations or influences."

Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1995) (quoting Aronson, 473 A.2d at 816); see also Scattered Corp. v. Chicago Stock Exch., Inc., 701 A.2d 70, 73 (Del. 1997) (using the terms "independent" and "disinterested" interchangeably).

See Ash v. IBM, Inc., 353 F.2d 491, 493 (3d Cir. 1965); Allison, 604 F. Supp. at 1122; Scattered Corp., 701 A.2d at 73; Spiegel, 571 A.2d at 777 ("Whenever any action or inaction by a board of directors is subject to review according to the traditional business judgment rule, the issues before the Court are independence, the reasonableness of its investigation and good faith . . . ").

Furthermore, by electing to make demand, the plaintiff-shareholder is conceding the board's independence. Thus, only reasonableness of investigation and good faith need to be examined in determining whether the board's decision meets the business judgment rule. See Scattered, 701 A.2d at 73; Rales v. Blasband, 634 A.2d 927, 935 n.12 (Del. 1993); Levine, 591 A.2d at 212; Spiegel, 571 A.2d at 777; Charal Inv. Co. v. Rockefeller, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,979, at 93,761–62 (Del. Ch. Nov. 7, 1995), available in 1995 WL 684869; Thorpe, 611 A.2d at 10.


Finkelstein et al., supra note 1, at 565; see also Levine, 591 A.2d at 210 (stating that the lower court properly considered the "reasonable doubt" standard of Aronson as ultimately controlling its determination of the sufficiency of the plaintiff's complaint).

See, e.g., Levine, 591 A.2d at 212; Finkelstein et al., supra note 1, at 565 ("Because of the relative difficulty of successfully alleging the wrongful refusal of a demand, shareholders wishing to prosecute a derivative action on behalf of a corporation will often opt to commence litigation without making a demand at all."); Kinney, supra note 1, at 175 (noting that because shareholders are "[a]ware of this deferential treatment to demand refusal, many plaintiffs now avoid demand by filing suit and pleading to the court that demand would have been futile").

excused. This test was first articulated in *Aronson v. Lewis*, in which the court stated:

In determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a *reasonable doubt* is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board’s approval thereof.  

### i. The First Aronson Prong

Under the first prong of the Delaware approach, a plaintiff must allege particularized facts creating a *reasonable doubt* that the directors who made the decision to reject demand were independent and disinterested. Moreover, the Delaware Supreme Court has held that it must be shown that a *majority* of the board members are interested or not independent in order to satisfy the standard. The *Aronson* court stated that a director’s “interest” can be established by showing either that the directors appear on both sides of the underlying transaction or that they derived some personal benefit from the transaction in the sense of self-dealing, as opposed to a benefit which devolves upon the stockholders generally. In addition, the director’s self-interest must be material.

The *Aronson* court also articulated the meaning of director independence: “Independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.” The most typical manner in which a plaintiff will try to establish

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108 473 A.2d at 814 (emphasis added).
109 See *id.*
110 See *id.* at 815 n.8.
111 See *id.* at 812; see also *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). Finkelstein notes:

> [D]irectors may be interested, however, even if their interest in a particular transaction is not, strictly speaking, a financial one. Such forms of self-interest as actions to perpetuate one’s self in office, and acquisition by a board of the right to vote a significant amount of stock if pleaded with particularity, may be sufficient to create a reasonable doubt that the directors were disinterested.

Finkelstein *et al.*, *supra* note 1, at 569–70.
113 473 A.2d at 816; see also *Cede & Co.*, 634 A.2d at 362; *Pogostin*, 480 A.2d at 624.
lack of independence is by alleging that a majority of the board members are "controlled" by one of the interested defendants.\textsuperscript{114} To prove control, "[t]here must be coupled with the allegation of control such facts as would demonstrate that through personal or other relationships the directors are \textit{beholden} to the controlling person."\textsuperscript{115}

\section*{ii. The Second Aronson Prong}

If a plaintiff is unable to establish demand futility under the first prong by pleading interest or lack of independence on the part of the board members, then the plaintiff must try to satisfy the second prong of \textit{Aronson} by alleging particularized facts that create a reasonable doubt that "the challenged transaction was otherwise the product of a valid exercise of business judgment."\textsuperscript{116} The business judgment rule requires both substantive due care and procedural due care.\textsuperscript{117} Under Delaware law, to establish a breach of the business judgment rule, the \textit{Aronson} court further elaborated upon why the business judgment rule will not apply when "independence" is lacking: "The requirement of director independence inheres [sic] in the conception and rationale of the business judgment rule. The presumption of propriety that flows from an exercise of business judgment is based in part on this unyielding precept." \textit{Aronson}, 473 A.2d at 816.

\textsuperscript{114} See, e.g., Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988); \textit{Aronson}, 473 A.2d at 815-16. This alleged controlling person will be one of the defendants alleged to have committed the wrongdoing that is the subject of the derivative action. However, it is not an easy task to show that the directors rejecting demand are "controlled" by an interested director. Mere conclusory or speculative allegations of control will not suffice.\textsuperscript{115} \textit{Aronson}, 473 A.2d at 815 (citing Mayer v. Adams, 167 A.2d 729, 732 (Del. Ch. 1961)) (emphasis added). The \textit{Aronson} court further stated:

\begin{quote}
[E]ven proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation. . . .

We conclude that in the demand-futile context a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting "a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling."
\end{quote}

\textit{Id.} at 815-16 (quoting Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971)).

\textsuperscript{116} \textit{Id.} at 814.

\textsuperscript{117} See, e.g., Grobow, 539 A.2d at 189. Procedural due care means that the board followed careful procedures and informed itself properly before making the business decision. Substantive due care means that the actual decision that was made by the directors was reasonable. \textit{See id.} at 189-90; Abrams v. Koether, 766 F. Supp. 237, 251 (D.N.J. 1991) (discussing the standards of procedural due care and substantive due care); Decker v. Clausen, 15 \textit{DEL. J. CORP. L.} 1022, 1028-29 (1990), \textit{available in} Civ.A. Nos. 10,684, 10,685, 1989 WL 133617 (Del. Ch. Nov. 6, 1989) (stating that the business judgment "analysis includes the question of whether the directors fulfilled their duty of procedural due care, by becoming fully
the plaintiff must establish either substantive or procedural gross negligence on the part of the directors making the decision or conducting the transaction.\textsuperscript{118}

Regarding substantive due care, in order for plaintiffs to establish demand futility under the second prong of \textit{Aronson}, they must allege particularized facts that support a claim that the underlying transaction which is the subject of the derivative action amounted to corporate waste.\textsuperscript{119} The standard for establishing that a transaction is a waste of corporate assets is whether, "what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid."\textsuperscript{120}

Procedural due care under the business judgment rule pertains to the methods and procedures the directors instituted and followed in investigating the subject matter about which they made a business decision. Therefore, to have demand excused on procedural grounds, plaintiffs must allege particular facts that show that the directors were grossly negligent in failing to adequately investigate and inform themselves about the subject matter of the challenged transaction before entering into that transaction.\textsuperscript{121}

If the plaintiff can satisfy either of the two prongs of \textit{Aronson}, the


\textsuperscript{121} See Starrels v. First Nat’l Bank, 870 F.2d 1168, 1172 (7th Cir. 1989) (stating that plaintiffs must plead "specific facts describing what steps the directors did not take in informing themselves or how they could have better informed themselves before entering into the challenged transactions"); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364, 366 (Del. 1993); Levine v. Smith, 591 A.2d 194, 207 (Del. 1991); \textit{Citron}, 569 A.2d at 66 (noting that to violate the business judgment rule, the director must be grossly negligent in failing to inform himself); \textit{Van Gorkom}, 488 A.2d at 873 (stating that gross negligence is the "proper standard for determining whether a business judgment reached by a board of directors was an informed one"); \textit{In re Sea-Land Corp. Shareholders Litig.}, 642 A.2d 792, 807 (Del. Ch. 1993) ("The standard for determining whether a board decision was sufficiently informed is gross negligence."); Finkelstein et al., \textit{supra} note 1, at 575–76.
corporation's motion to dismiss will be denied and the action will continue. However, if the plaintiff cannot establish demand futility, then the action will be dismissed.\footnote{122}

2. Judicial Review of a Special Litigation Committee

After a shareholder establishes demand futility and, thus, the derivative action is not dismissed, the corporation will typically appoint a special litigation committee.\footnote{123} Delaware has developed a standard of judicial review that is linked directly to whether the case is a demand-excused case or a demand-required case.\footnote{124} If the case requires demand to be made upon the corporation, then the standard of review is the business judgment rule standard.\footnote{125} Thus, the motion to dismiss will be granted unless the plaintiff can plead with particularity facts showing that the demand rejection was "wrongful."\footnote{126} However, if the plaintiff is able to establish that demand would have been futile, then the standard of review is different.

For demand-excused cases, the Delaware Supreme Court, in Zapata Corp. v. Maldonado,\footnote{127} articulated a two-step test to determine whether to dismiss a derivative action pursuant to a special litigation committee’s decision that the action should be terminated. The court stated:

\footnote{122} Typically, it will be dismissed without prejudice so that plaintiffs can either amend their complaint to make a more particularized factual pleading or so that they can make demand upon the corporation. However, in reality, if the court finds that failure to make a demand was not excused, this will likely mark the end of the derivative litigation because any demand that is made will be rejected by the corporation, and this rejection will be protected by the business judgment rule. See Aronson, 473 A.2d at 813.

\footnote{123} See supra note 29 and accompanying text. This committee will thoroughly investigate the shareholder’s allegations in order to make a determination of whether the litigation is in the best interest of the corporation. Typically, the special litigation committee will determine that the derivative action is not in the best interests of the corporation and will seek termination of the derivative action. The committee’s decision will then be subject to judicial review. Some of the most common reasons given by special litigation committees for recommending termination of derivative actions are “that the action’s continuation would (1) undermine employee morale, (2) create an adversarial relationship between the board and management, (3) result in public stigmatization and loss of goodwill, and (4) subject the corporation to liability for indemnification and related expenses.” 2 ALI PRINCIPLES, supra note 9, § 7.10 Reporter’s Note 8, at 160.

\footnote{124} See Swanson, supra note 1, at 1365.

\footnote{125} See Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n.10 (Del. 1981); 2 ALI PRINCIPLES, supra note 9, § 7.10 cmt. a(3), at 132; Swanson, supra note 1, at 1365 (recognizing that the Delaware approach “applies the deferential business judgment rule in cases requiring demand”).

\footnote{126} See supra Part III.B.1.b.ii.

\footnote{127} 430 A.2d at 779.
First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions . . . If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation’s motion.\textsuperscript{128}

Under this first step, the \textit{corporation} has the burden of proving independence, good faith, and reasonable investigation.\textsuperscript{129} If the corporation can show “that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.”\textsuperscript{130} The second step instructs that the court “should determine, applying its own independent business judgment, whether the motion should be granted.”\textsuperscript{131}

This standard of judicial review for demand-excused cases allows for much more judicial scrutiny of the special litigation committee’s decision to terminate the litigation.\textsuperscript{132} It not only directs the court to evaluate the procedures used by the special litigation committee in making its decision, but it also allows the court to review the reasonableness of the special litigation committee’s conclusions. More importantly, the court is also permitted to apply its own business judgment and may review the substance of the special litigation committee’s decision as well as the merits of the underlying transaction. Therefore, the court may overrule the committee’s decision about whether the derivative action should proceed to trial.

\section*{IV. Policy Analysis and Proposed Hybrid Standard}

Although the Delaware and ALI approaches have several similarities, careful analysis reveals a plethora of differences. Each commentator who has developed standards for derivative actions, including the ALI, claims to have created a more reasonable and logical set of standards than all of the other presently existing procedural approaches. Furthermore, each commentator aspires to develop a new angle to separate his or her approach from all of the competing approaches. However, perhaps the more prudent approach to this entire issue lies not so much in developing a completely new set of standards, but in drawing upon the best aspects of the existing standards and integrating them.

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{128}] \textit{Id.} at 788-89.
\item[\textsuperscript{129}] See \textit{id.} This is the opposite of the burden of proof under the traditional business judgment rule, which creates a presumption of independence, good faith, and reasonable investigation, and forces the plaintiff to rebut the presumption.
\item[\textsuperscript{130}] \textit{Id.} at 789.
\item[\textsuperscript{131}] \textit{Id.} (emphasis added).
\item[\textsuperscript{132}] See, e.g., Swanson, \textit{supra} note 1, at 1365 (noting that the Zapata standard “permits broader scrutiny if demand is excused”).
\end{itemize}
\end{footnotesize}
The ALI and Delaware Supreme Court have spent enormous amounts of time developing what they believe to be the proper standards for derivative actions. Moreover, both the ALI Corporate Governance Project and the Delaware Supreme Court are comprised of very experienced and bright corporate-legal analysts. This Note proposes taking the best of what these two entities have to offer regarding standards for derivative actions and integrating them into a hybrid approach.

In general, this section proposes an overall approach that is a hybrid of the Delaware standards and the ALI Principles. This hybrid approach consists of the following:

1. The ALI’s universal demand rule, but with a unitary standard of judicial review of demand rejection, rather than the ALI’s present bifurcated standard that is linked to the nature of the underlying transaction;

2. The ALI’s bifurcated standard of judicial review of special litigation committees’ motions to dismiss:
   a. For duty of care cases, the standard of review should be the business judgment rule standard proposed by the ALI.
   b. For duty of loyalty cases, Delaware’s standard of review, which requires the court to review a special litigation committee’s decision under the business judgment rule and, in addition, permits the court to apply its own business judgment to the allegations, is the proper standard to apply.

This hybrid approach views the procedural standards governing derivative suits as a continuum with several gates that plaintiff-shareholders must successfully pass through in order to bring a successful derivative suit. Universal demand serves the initial gate-keeping role. It provides a fairly strict standard to sift out the frivolous strike suits that are filed, but not a standard that is so strict that even plaintiff-shareholders with valid claims have no chance of surviving a corporation’s rejection of demand.

The second gate consists of the motion to dismiss by a special litigation committee based on its investigation of the shareholder’s allegations. At this stage, two distinct policies exist. First, the second gate attempts to filter out any meritless claims that have managed to escape dismissal at the demand stage. Thus, a special litigation committee’s conclusions about the matter should be given some respect at this stage. Second, one can also assume that claims that have survived demand rejection must have some merit. Therefore, the standard of judicial review at this stage should not be too deferential to the special committee’s decision. The standards of review at this stage must balance these competing policies of (1) giving more respect and deference to a committee’s
decisions, and (2) not being too deferential so as to prohibit valid claims from getting to a trial on the merits.

If a plaintiff survives these first two hurdles, the third gate is a trial on the merits. A trial should sift out any meritless actions that have managed to survive, and presumably justice will be served because only the truly valid claims will win at trial. This hybrid approach reflects this view of the derivative action and its procedures.

A. Universal Demand is Best

1. Universal Demand Allows the Court to Focus on the "Appropriate" Issues

There are several good policy justifications for the ALI's universal demand rule, some of which are essentially criticisms of the Delaware approach. One valid justification is that universal demand reduces a substantial amount of "collateral litigation" that arises in determining when demand is excused due to futility. The Delaware approach to demand-futility focuses mainly on whether a majority of the board is independent and disinterested rather than waiting for the

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133 See Coffee, supra note 4, at 254. This "collateral litigation" primarily surrounds the issue of whether the plaintiff is excused from making demand upon the corporation because it would be "futile." In addition, this issue of whether demand is excused under Delaware law spawns several other issues that create litigation and consume judicial resources, such as "whether a demand need be made, what demand concedes, what issues the demand did or did not relate to, [and] whether shareholders who did not make demand can attack the board's independence when other shareholders did make demand, etc." Id. Professor Coffee has also made the following statements regarding this issue:

Delaware's demand rule also results in a substantial amount of collateral litigation and sometimes can be a trap for the unwary. For example, issues arise as to whether (1) a skeptical or protesting letter from a shareholder constitutes a demand (thereby waiving the issue of board independence) or only a request for information, (2) whether a non-specific letter from a shareholder is too indefinite to constitute a demand (and thus requires no board response), (3) how long after demand the plaintiff must wait for a response before filing its action, (4) how broadly a demand letter relates when there are multiple issues, and (5) what effect does demand have when there is a subsequent change in the composition of the board. All in all, the shareholder plaintiff faces an unattractive choice: either (1) to not make demand and thereby accept the burden of convincing the court that seemingly respectable directors should be deemed by the court too biased even to deserve an opportunity to respond to demand, or (2) to make demand and thereby acknowledge the applicability of the business judgment rule (and, for most practical purposes, concede the outcome of the case). Neither option is attractive.

Coffee, supra note 4, at 245. In addition, the Supreme Court, in Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991), acknowledged that there are "high collateral litigation costs associated with the demand futility doctrine." Id. at 106.
board to respond to the demand and then evaluating its response.\textsuperscript{134} Thus, under the Delaware approach, the court is forced to hear arguments on peripheral issues such as board independence and disinterestedness instead of focusing on the validity of the plaintiff’s claims and the reasonableness of the board’s rejection of demand. In other words, universal demand shifts the focus of the litigation to the most important issue in shareholder derivative litigation—“the central question of the board’s or committee’s justifications for dismissal of the action.”\textsuperscript{135} Universal demand focuses on the board’s or committee’s justifications for rejecting demand and balances the merits of the plaintiff’s case against the justifications provided by the board of directors. This is where the courts’ focus should be in a derivative action.

2. The Benefits of Universal Demand Outweigh the Costs

Demand is a relatively low-cost procedure for shareholders.\textsuperscript{136} Therefore, the benefits that demand creates, such as providing the corporation with notice of the allegations and potentially allowing it to conduct intracorporate dispute resolution that will save substantial judicial resources,\textsuperscript{137} clearly outweigh any slight financial burden that demand places on the shareholder. Moreover, the slight costs of making demand are much less than the substantial costs and waste of judicial resources that are caused by the vast amount of collateral litigation that arises under the Delaware approach. In addition, the ALI procedures for universal

\textsuperscript{134} See Aronson v. Lewis, 473 A.2d 805, 811–15 (Del. 1984). However, in practice this distinction may sometimes be illusory because, under the ALI approach, the board is only permitted to have its rejection of demand be dispositive if a majority of the board members are disinterested. If they are disinterested, they will likely reject the action and there stands a good chance the court will dismiss the action (unless it is a duty of loyalty case in which the standard is tougher). The same result would occur in Delaware because, if a majority of the board members are disinterested, the case will likely fall within the demand-required category. Thus, demand will have to be made and it will be rejected, and that decision is protected by the business judgment rule.

Furthermore, if a majority of the board is interested, the ALI approach will not dismiss a derivative action pursuant to the board’s rejection, and that will force the board to appoint a special litigation committee and the action will continue. Again, this is the same result as would occur under the Delaware approach because, if a majority of the board are interested, demand is excused and the action proceeds to the next stage at which the board will appoint a special litigation committee. So in the end, the real difference between the two approaches is in the standards of review, when such standards apply, and the fact that the ALI has a universal demand rule.

\textsuperscript{135} Coffee, supra note 4, at 254.


\textsuperscript{137} See supra notes 25–26 and accompanying text.
demand are set up to operate quickly and efficiently so that the shareholders will find out soon after making demand whether it has been rejected (or at least they will be notified that the matter has been turned over to a special Litigation committee so that they can commence the derivative action).\footnote{See 2 ALI PRINCIPLES, supra note 9, § 7.03 cmt. f, at 59–61.}

3. The ALI's Universal Demand Incorporates the Strengths of the Delaware Approach Without Incorporating Its Weaknesses

The Delaware approach of excusing demand when a majority of the board members are interested or lack independence is based upon the rationale that requiring a shareholder to make demand upon a board whose members are directly interested in the derivative action is truly a practice in futility. Requiring demand under these circumstances forces a plaintiff to waste financial resources in making a demand that is guaranteed to be rejected. Moreover, allowing an interested board to reject demand and to have the protections of the business judgment rule in making that decision would tip the scales too far in the corporation’s and the defendant’s favor.

This justification for excusing demand for futility is very sound. However, the ALI’s universal demand rule also has this requirement of board disinterestedness and independence built into its standard. Instead of excusing demand where a majority of the board is interested, the ALI standard requires demand, but gives the board’s response to that demand no legal weight.

The ALI’s universal demand rule is the better standard. It still requires demand and thus retains many of the benefits that demand provides, such as giving notice to the corporation of the shareholder’s allegations and enabling the corporation to conduct intracorporate dispute resolution that could eliminate the need for litigation. Yet, it also incorporates the policy behind the Delaware approach that a demand-rejection by an interested board should be given no legal deference because defendant-directors will rarely authorize litigation against themselves. In other words, the ALI standard incorporates the valid policies underlying the Delaware approach and, by requiring the shareholder to make demand, also retains some of the benefits demand provides.

4. The Delaware Approach Is Too Costly and Inefficient

The costs of the Delaware demand-excused/demand-required approach outweigh any potential benefits. The ALI’s argument that this standard creates too much “collateral litigation” rings true. Excusing demand when a majority of the board members are interested or lack independence appears to be supported by valid justifications. In practice, however, nearly all plaintiffs will attempt to forgo demand by alleging futility even if the situation appears to require demand. This
is because Delaware applies the business judgment rule to a board’s decision to reject demand in cases in which demand is required. This nearly always marks the end of a derivative action. Thus, a plaintiff’s only chance lies in pleading that demand would be “futile.” Hence, even cases whose facts require demand will be pleaded in terms of futility. This increases the amount of litigation regarding demand futility and drains judicial resources.

To summarize, universal demand, as established by the ALI Principles, is the wiser approach. It is a low-cost step for the plaintiff, and it is based on sound policy rationales.

B. A Unitary Standard for Reviewing a Board’s Rejection of Demand

While the ALI’s universal demand rule reflects sound policy judgments, its standards of review of a board’s rejection of demand and motion to dismiss at the demand stage are too complicated and too strict for the purposes that demand should serve. As stated above, the purpose of demand should be to serve an initial gate-keeping role in a derivative action, sifting out the most frivolous claims before they have the opportunity to waste judicial resources and force corporations into unfounded settlements. However, judicial review of demand rejection should not be fashioned in such a manner as to make it impossible for even valid shareholder claims to make it past demand.

Yet, this is what at least one of the ALI standards does. As discussed in Part III.A, the ALI has a bifurcated approach to judicial review of a board’s rejection of demand. Under section 7.04, if the underlying claim by the shareholder alleges a violation of the duty of care, then the court must review the board’s rejection of demand (if a majority of the board is disinterested) under the standards of the business judgment rule. If, on the other hand, the underlying claim alleges a violation of the duty of loyalty, then the court must determine whether the directors could “reasonably have determined that rejection of the demand was in the best interests of the corporation,” in addition to applying the procedural requirements of the business judgment rule.

This standard for duty of loyalty cases should be applied as a unitary standard when the court is reviewing motions to dismiss based on demand rejection. The ALI’s standard for duty of care cases is much too strict for the demand stage. At the demand stage, the plaintiffs are not even entitled to discovery, yet they are forced to plead facts with particularity in an attempt to avoid having the case dismissed. This is burdensome enough on plaintiffs without also forcing them to overcome a standard of review that is often insurmountable even with months of discovery. This “business judgment rule” standard swings the balance too far in

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139 See supra Part III.A.1.b.
140 2 ALI PRINCIPLES, supra note 9, § 7.04(a)(2)(C), at 70.
the corporation's favor.\textsuperscript{141}

The demand stage should be a preliminary screening device. The special litigation committee and its accompanying procedures are intended to be the stage where all but the most valid shareholder claims get dismissed. Demand should not become a sword to be wielded by the corporation, enabling it to strike down all potential derivative actions, whether valid or frivolous. Therefore, the ALI's standard for duty of loyalty cases should be applied to all motions to dismiss based on rejection of demand. It allows the court to balance the strength of the plaintiff's allegations against the reasonableness of the board's justifications for rejecting demand.\textsuperscript{142} Thus, it forces the board to provide at least some detailed justifications for why it chose to reject demand. This is appropriate considering the fact that the corporation is the party with all of the information pertaining to the underlying allegations.

C. The Proper Standard of Judicial Review of Special Litigation Committees

The ALI's approach to judicial review of special litigation committees' decisions to terminate derivative litigation provides a bifurcated standard. It is much like the standards of judicial review at the demand stage. This bifurcated standard draws a sharp distinction between duty of loyalty cases and duty of care cases. Section 7.10 provides for application of the business judgment rule to duty of care cases, but, in duty of loyalty cases, it allows the court to evaluate the reasonableness of a special litigation committee's justifications for seeking termination of the derivative suit.\textsuperscript{143}

While at the demand stage this bifurcated standard is an unnecessary procedure that complicates the process of making demand and places too heavy a burden on the plaintiff for that stage of a derivative action,\textsuperscript{144} a bifurcated standard at the special litigation committee stage is the proper approach. It is based on strong policy rationales, many of which the ALI has articulated.

First, judicial competence is less in duty of care cases.\textsuperscript{145} This argument provides that when a business decision turns out to be erroneous, there are "multiple explanations" for it.\textsuperscript{146} Thus, a judge—who is not likely experienced in

\textsuperscript{141} While there are several valid justifications for having different standards of review for duty of care and duty of loyalty cases at the special litigation committee stage, those justifications do not apply to the demand stage, which should only serve a preliminary gatekeeping role. See infra Part IV.C.

\textsuperscript{142} See supra Part III.A.2.b.iii.

\textsuperscript{143} See supra Part III.A.2.

\textsuperscript{144} See supra Part IV.B.

\textsuperscript{145} See Coffee, supra note 4, at 262.

\textsuperscript{146} See id. As Professor Coffee states:

It could be that the decision-maker was negligent, but, conversely, the truth may instead be
the day-to-day business decisions made by corporate directors and officers—may mistakenly find negligence where none exists. Therefore, the standard of judicial review in these cases should be more deferential to the corporate committee because the committee is much better suited to evaluate the allegations in these cases.

In contrast, with duty of loyalty cases, "the possibility of non-culpable error is much smaller." When directors allegedly exploit their positions in the corporation for their personal financial gain, the likelihood of a legitimate business explanation for the directors' conduct is slim. Thus, the standard of judicial review should be more searching to ensure that self-dealing breaches of fiduciary duties do not escape liability.

Furthermore, the ALI standard draws a very logical analogy to the traditional approach that most courts have taken in reviewing duty of care cases, as compared with duty of loyalty cases. Traditionally, where a case has involved alleged violations of the duty of care, courts have applied the business judgment rule. This application is based on the rationale that "courts should be reluctant to review the acts of directors in situations where the expertise of the directors is likely to be greater than that of the courts."149

that a risk that was knowingly and prudently accepted simply came to unfortunate fruition. Or, it could be that a new and unforeseeable risk arose and matured after the time the business decision was irrevocably made.

Id.

147 Id.


"[T]he business judgment doctrine [is] a rule of law that insulates business decisions from most forms of review...." The business judgment rule "expresses a sensible policy of judicial noninterference with business decisions made in circumstances free from serious conflicts of interest between management, which makes the decisions, and the corporation's shareholders. Not only do businessmen know more about business than judges do, but competition in the product and labor markets and in the market for corporate control provides sufficient punishment for businessmen who commit more than their share of business mistakes." "[T]he fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business
However, where the allegations in the case have consisted of duty of loyalty violations, the courts have not hesitated to apply a more intense judicial review. This is based on the justification that where the directors have conflicts of interest, their relative expertise in business transactions is not relevant because personal financial interest, not business expertise, guides the directors' actions in these circumstances. Judicial scrutiny is necessary in these situations to protect the corporation and its shareholders.¹⁵⁰

The ALI has, by analogy, applied this traditional judicial distinction between duty of care and duty of loyalty cases to its standards of review of special litigation committees. This is highly sensible. During a trial on the merits in a duty of care case, the business judgment rule is applicable because a director is deemed to have more expertise than the courts in deciding what is a legitimate business decision. That rationale applies with equal strength to the situation where a corporate committee is making an investigation and determination as to whether

For efficiency reasons, corporate decision makers should be permitted to act decisively and with relative freedom from a judge's or jury's subsequent second questioning. It is desirable to encourage directors and officers to enter new markets, develop new products, innovate, and take other business risks.

Id. (citations omitted); see also Frances v. Village Green Owners Ass'n, 723 P.2d 573, 582 n.14 (Cal. 1986) (noting that one justification for the business judgment rule is "that directors should be given wide latitude in their handling of corporate affairs because the hindsight of the judicial process is an imperfect device for evaluating business decisions"); In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996) (stating that judges are "ill-equipped" to "second-guess" directors' business decisions within the context of the duty of care); Alford v. Shaw, 349 S.E.2d 41, 47 n.5 (N.C. 1986) (stating that the rationales behind the business judgment rule include the recognition that "management decisions are more properly the province of directors selected by shareholders rather than of a judge; and as a matter of judicial economy, the rule relieves the courts from involvement in complicated business questions"); Cuker v. Mikalauskas, 692 A.2d 1042, 1046 (Pa. 1997) (stating that the business judgment rule reflects the policy that corporate management knows what is best for the corporation, and, thus, judges should not second-guess directors in most situations); Dennis Honabach & Roger Dennis, The Seventh Circuit and the Market for Corporate Control, 65 CHI.-KENT L. REV. 681, 686 (1991) ("Courts frequently announce that they are reluctant to review the acts of directors because they lack the expertise to evaluate the wisdom of business decisions.").

¹⁵⁰ Judge Cudahy provided a good explanation of this issue in Panter v. Marshall Field & Co.:

But, where the directors are afflicted with a conflict of interest, relative expertise is no longer crucial. Instead, the great danger becomes the channeling of the directors' expertise along the lines of their personal advantage—sometimes at the expense of the corporation and its stockholders. Here courts have no rational choice but to subject challenged conduct of directors and questioned corporate transactions to their own disinterested scrutiny. Of course, the self-protective bias of interested directors may be entirely devoid of corrupt motivation, but it may nonetheless constitute a serious threat to stockholder welfare.

646 F.2d at 300 (Cudahy, J., concurring in part & dissenting in part).
a derivative action alleging violations of the duty of care is in the best interests of the corporation. The directors on the committee are better equipped than the court to make the decision because they have more expertise than the judge to determine whether a director made a negligent business decision. Furthermore, the decision whether the derivative action is in the best interests of the corporation is essentially a business decision. In a practical sense, then, it should be given the same traditional deference that business decisions involving the duty of care have always been given.

Likewise, in duty of loyalty cases, the ALI permits more judicial review of a special committee’s investigation and conclusion. Courts have long exercised more judicial review of allegations of duty of loyalty violations. Hence, they should be permitted to exercise that increased scrutiny when a committee has determined that a shareholder’s duty of loyalty allegations against the corporation’s directors should be dismissed. Also, from a practical standpoint, judges have traditionally been much more active in reviewing duty of loyalty allegations. Thus, regardless of any policy justifications, they will be more experienced at judicial review in this area and should make fewer mistakes.

Another justification for the ALI standard is that the duty of care is “self-policing.” If corporate directors act negligently in making business decisions, the market will flush out these directors and dismiss them in favor of more responsible directors. The negligence will be borne out because the corporation will become less competitive in the market. In other words, the competitive corporate market will force directors to act as responsibly as possible because no corporation is going to retain a director or officer who continuously makes poor business decisions.


153 Coffee, supra note 4, at 262.

In contrast, with duty of loyalty violations, the incentive to commit self-dealing is much higher and the potential for detection is less. As Professor Coffee, the reporter for the ALI Principles, notes, self-dealing tends to perpetuate itself. Thus, judicial scrutiny must be more searching in order to detect and deter this harmful conduct.

The ALI's justifications for distinguishing between duty of care cases and duty of loyalty cases are very compelling. Furthermore, it is more logical to tailor the standards of judicial review to the nature of the allegations of the underlying transaction than it is to tailor the standards to whether a majority of the board is independent and disinterested—as Delaware does. While independence and disinterestedness should play a role in what standards apply—especially at the demand stage—they should not be the key elements that trigger the applicable standard at the special litigation committee stage. Thus, the ALI bifurcated standard of judicial review, which is keyed to the nature of the underlying transaction, is based on stronger policies and rationales than the Delaware approach.

D. Delaware's "Independent Business Judgment" Standard Should Be Applied in Duty of Loyalty Cases

There is one significant flaw in the ALI's bifurcated approach. Its standard of review in duty of loyalty cases—while providing for more judicial scrutiny than in duty of care cases—does not permit enough judicial scrutiny of special litigation committee termination decisions. Even though the court is permitted to review the reasonableness of the special litigation committee's conclusions, the ALI does not permit the court to apply its own business judgment to the allegations. This is where the Delaware standard for demand-excused cases is the superior rule.

The Delaware standard provides for substantial judicial scrutiny in demand-

("The press of market forces . . . will more effectively serve the interests of all participants than will an error-prone judicial process.").

155^ For instance, suppose a corporate director highly recommends to the rest of the board that the corporation enter into a transaction with company X. The director's secret motivation is that he is also a controlling shareholder and director of company X, and, thus, he stands to make a considerable profit from the transaction. In addition, assume that the director recommends this transaction with company X rather than a similar transaction with company Y. Although the transaction with company X will be profitable for the corporation, the transaction with company Y would have allowed the corporation to realize a much higher profit. If the board of directors authorizes the transaction with company X, the director may very well have violated his duty of loyalty to the corporation by zealously recommending the less profitable transaction with company X over company Y. Yet, because the transaction with company X was still profitable for the corporation, the market may not flesh out this duty of loyalty violation, and, thus, traditional market forces will not constrain the director's conduct.

156^ See Coffee, supra note 4, at 262.
excused cases. It requires the court to review the special litigation committee’s decision to see if the committee was independent, acted in good faith, and made reasonable conclusions.\textsuperscript{157} Furthermore, the corporation has the burden of proving that the committee met these requirements.\textsuperscript{158} More importantly, it also permits the court to apply its own business judgment to the facts of the underlying transaction.

This standard that Delaware has adopted for its demand-excused cases should be applied with the ALI approach where the underlying transaction is alleged to be a violation of the duty of loyalty. Violations of the duty of loyalty are likely to consist of egregious self-dealing, and the courts should be able to thoroughly scrutinize any decision by a special litigation committee that recommends dismissal of an action alleging such conduct. Furthermore, as discussed above, courts have been performing a more intense judicial review of alleged duty of loyalty violations for decades and are well-equipped to perform the type of scrutiny that the Delaware demand-excused standard entails.\textsuperscript{159}

Moreover, a defendant-director who is accused of self-dealing may be more inclined to take advantage of any structural bias that may exist among corporate directors in order to avoid liability. It cannot be ignored that some structural bias exists among directors—regardless of whether they are outside and independent. These directors are all part of the same social class. They often attended the same universities, they mingle within the same social circles, and they have the same general economic interests and positions in society. When one of these directors is facing liability, the others will tend to close ranks, if for no other reason than the “there, but for the grace of God go I”\textsuperscript{160} rationale.

Once certain types of director conduct are held by the courts to be violations of the duty of loyalty, the floodgates may open, and other directors may face liability through a derivative action. Thus, even if these “independent” directors who serve on special litigation committees take the task very seriously and intend to make a good faith effort—as most of them probably do—these psychological influences of bias may still make them reluctant to reach a decision that clears the way for their fellow directors to get hit for millions of dollars in liability.

While this presence of structural bias is not problematic enough to overcome the well-founded justifications for application of the business judgment rule in duty of care cases, there are no such compelling justifications in duty of loyalty cases.

\textsuperscript{157} See supra Part III.B.1.b.

\textsuperscript{158} Typically, the business judgment rule acts as a presumption; therefore, the plaintiff-shareholder has the burden of proving that the standards of the business judgment rule were not met. See Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1374 (Del. 1995); Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990). Under the Delaware standard, however, the defendant-corporation has the burden of proof.

\textsuperscript{159} See supra note 152 and accompanying text.

\textsuperscript{160} Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).
Thus, the Delaware standard, which allows for full independent judicial review by the court, rather than the present ALI standard, is the better standard to apply in duty of loyalty cases. The Delaware standard allows the court to evaluate fully the merits of the plaintiff's allegations as well as the special litigation committee's justifications for its decisions, whereas the present ALI standard for duty of loyalty cases only allows the court to scratch the surface by checking if the committee's justifications are "reasonable."

The Delaware standard goes much further by allowing the court to draw its own conclusions and even second-guess the committee if it believes such action is warranted. Thus, the Delaware standard fully protects against the danger of special litigation committees displaying structural bias by blindly concluding that a derivative action is not in the best interests of the corporation and hiding this arbitrary decision under the guise of thorough investigation and impeccable procedures. In other words, the Delaware standard prevents committees from being able to present justifications for termination that look good on their face, but are, in reality, completely arbitrary.

V. CONCLUSION

The ALI Principles and the Delaware courts have been two of the major developers of procedural standards for shareholder derivative suits. By drawing on the best aspects of each of their various standards, one is able to create a set of standards that best satisfies the variety of competing policy justifications underlying the derivative suit. The hybrid approach proposed by this Note does this by combining certain aspects of the ALI Principles and the Delaware approach. In particular, the hybrid proposal adopts the ALI's universal demand rule with one significant change. Instead of a bifurcated standard of review, there should be a unitary standard at the demand stage in which the court evaluates the reasonableness of the board's rejection of demand. Next, at the special litigation committee stage, the ALI's bifurcated approach, which draws a sharp distinction

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161 As discussed above, determining violations of the duty of care can be a very complex and uncertain task. Any number of things can cause a business decision to turn sour. What initially was an unforeseen risk may, in hindsight, look like director or officer negligence. This concern, plus the fact that fellow corporate directors will likely have more expertise than a court at sifting through the possible causes of a poor business transaction, outweighs any potential structural bias that may exist. Thus, application of the business judgment rule is warranted.

Furthermore, in duty of care cases, there is an additional check on negligent director conduct. Even if it is not caught by a derivative action, the competitive market forces at work in the corporate community will likely dispose of negligent and inefficient directors. However, these rationales are not present in duty of loyalty cases, and, thus, the balance tips in favor of increased judicial scrutiny in such cases.

162 It has been shown that the overwhelming majority of special litigation committees conclude that maintaining the derivative suit is not in the best interests of the corporation. See MAGNUSON, supra note 10, § 8.17, at 58 & n.13.
between duty of loyalty and duty of care cases, should be applied. It is based on more compelling policies than the Delaware demand-excused/demand-required approach.

However, the ALI's standard of judicial review for duty of loyalty cases still falls short of the amount of judicial review that is necessary to prevent special litigation committees from arbitrarily terminating valid derivative suits. Thus, the superior standard is Delaware's demand-excused approach, which permits the court—at its discretion—to exercise its independent judgment of the merits of the action and the validity of the special litigation committee's conclusions. This combination of the ALI Principles and the Delaware standard of judicial review strikes the best balance between the interests of shareholders in bringing derivative actions and the interests of the corporation and its directors—who are the true "managers" of the corporation—in handling corporate affairs.