Study B-602 January 30, 1996

Memorandum 96-13

Demand and Excuse in Shareholder Derivative Actions: Policy Issues

BACKGROUND

At the December 1995 Commission meeting the Commission's consultant, Professor Mel Eisenberg, presented his background study on demand and excuse in shareholder derivative actions. See Eisenberg, *The Requirement of Making a Demand on the Board Before Bringing a Derivative Action* and *The Standard of Review of a Board or Committee Determination that a Derivative Action Is Not in the Corporation's Best Interests* (Oct. 1995) (referred to in this memorandum as Background Study).

After a preliminary discussion of the matter, the Commission concluded that the issue of the standard applicable to a board action to reject a demand or to dismiss a derivative action is a complex matter that deserves careful scrutiny. The Commission asked the staff to prepare a memorandum that coalesces the material in Professor Eisenberg's study, and to invite additional comment from interested persons, for consideration at a future Commission meeting with Professor Eisenberg.

This memorandum summarizes the Background Study and supplements it with additional material the staff believes will be helpful to the Commission. The memorandum oversimplifies its statement of the governing principles in many instances so that the main concepts do not get lost in the details. The memorandum also presents the staff's proposal for an alternative approach to the demand / excuse dilemma that may offer the parties an attractive resolution of the thorny issues in this area. The memorandum concludes with a caution that this topic is the subject of current political activity, and the Commission may be well-advised to wait for the outcome of the political activity before deciding how to proceed.

The memorandum follows this organization:

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NATURE OF DERIVATIVE ACTION

A derivative action is an action by a shareholder "in the right" of the corporation. That is, the shareholder brings the action on behalf of the corporation to right a wrong to the corporation because the board, which is entrusted with direction of the corporation, has refused to do so.

Since the action is in the right of the corporation, any recovery in the derivative action belongs to the corporation and not the shareholder individually. A motivation for the shareholder to sue in the right of the corporation rather than individually is that a derivative action, which vindicates a right for the benefit of the corporation, entitles the shareholder to recovery of attorney's fees.

The precondition of a derivative action — that the board has refused to act — implies that the shareholder must first have made a demand on the board, and the board has either rejected or ignored the demand. Where the wrong complained of by the shareholder is an act of the board itself, it is likely that the board will not take remedial action on the shareholder's demand, since the shareholder is in effect asking the board to discipline or sue itself. The court may excuse the requirement that the shareholder first have made a demand if it appears the demand would have been futile.

As a practical matter, for the reasons summarized below, it is in the interest of the board to receive a demand and in the interest of the shareholder to bring an action without making a demand.

If the shareholder makes a demand, there is an implication that the shareholder must wait a reasonable period for the board's response before commencing a derivative action. The delay could enable the board to take evasive action to avoid the lawsuit or obtain shareholder approval of the complained of transaction; it could delay the suit beyond the applicable limitations period; or it could deny the shareholder the opportunity to seek intervention before an unfair or unlawful transaction is consummated.

More significantly, the shareholder's demand vests in the board authority to determine in a disinterested manner whether a lawsuit is in the best interests of the corporation. Once the board properly makes a decision that a lawsuit is not in the best interests of the corporation (e.g., through a disinterested special litigation committee of the board), that decision may be protected by the business judgment rule or another protective standard of review. This would make it very difficult for the shareholder to proceed further.

In order to avoid these problems, the shareholder ordinarily will commence a derivative action without first making a demand; if the failure to make a demand is interposed as a defense, the shareholder will allege that the demand is excused due to futility. The shareholder will need to prove that a demand would have been futile, but may not have specific facts that demonstrate futility. Discovery may be available for this purpose. At this point litigation expenses begin to mount and the shareholder may have leverage to pursue the derivative action or force a settlement.

Thus, to a great extent the practicalities of derivative action litigation focus on the preliminaries of demand and excuse; what happens in connection with demand and excuse issues may in effect determine the outcome of the case.

DEMAND REQUIREMENT

Existing California law precludes a shareholder's derivative action unless the shareholder "alleges in the complaint with particularity plaintiff's efforts to secure from the board such action as the plaintiff desires". Corp. Code § 800(b)(2). This has long been the general rule, both inside and outside California.

The demand requirement serves two major functions:

(1) The directors, not the shareholders, are responsible for managing the corporation. The demand requirement enables the board to make an informed decision whether to take action to correct the alleged wrong, either by making a demand on the errant director or by maintaining a lawsuit for that purpose. The demand requirement protects the managerial freedom of those to whom the responsibility of running the business is delegated.

(2) The demand requirement conserves judicial resources. It ensures that a shareholder exhausts internal corporate remedies before resorting to litigation, and provides the corporation with a mechanism to protect itself from strike suits. If furthers the policy that judicial interference with corporate decision-making should be limited.

Professor Eisenberg concludes that the demand requirement is "a sound rule", it is already codified in California, and he recommends no changes in it. Background Study at 19.

DEMAND EXCUSED

Existing law recognizes exceptions to the demand requirement — the shareholder must allege the effort made to obtain the desired board action "or the reasons for not making such effort". Corp. Code § 800(b)(2).

Futility

The basic standard for excuse of the demand requirement is whether the demand would have been futile.

Majority of directors implicated. Where the complaint alleges wrongdoing by a majority of directors, the demand is per se futile and is excused by the courts, since a demand would in effect be a request to the directors to sue themselves. It is assumed that such a request would be futile. By extension, demand is also excused as futile if a majority of the directors are either interested, not independent, or under a defendant's control.

Minority of directors implicated. Where a minority of directors are alleged to be primary wrongdoers, the demand is not excused. However, the remaining directors may be involved because they did nothing to prevent the wrongdoing (e.g., by failing to monitor), or by conspiring in some way with the primary violators. If the remaining directors are involved in this way, demand is excused.

Particularized allegations of involvement. Since demand may be excused even where a minority of directors are implicated if the remaining directors conspired with them, the tendency for the shareholder is to make a conclusory allegation of conspiracy among the directors. Courts deal with this by requiring particularized allegations of directorial involvement before they will excuse demand.

Analysis

One of the reasons the Commission is studying this area is that, "Notwithstanding the statute, the demand requirement is excused routinely. The law should be reviewed with a view toward clarification and codification of standards for excuse under the statute." 22 Cal. L. Revision Comm'n Reports 844 (1992) (fn. omitted). Do the courts in fact enforce the particularized allegation requirement, or do they "routinely" excuse demand on a general allegation of complicity of a majority of the board?

Harold Marsh's analysis supports the perception that courts routinely excuse the demand:

> The great majority of the cases in fact held that, in the circumstances there present, no demand was necessary upon the board; and it appears that only the *Cogswell* case and the *Bacon* case have actually resulted in a decision for the defendant because of the lack of a demand or an insufficient demand upon the board.
> 2 Marsh's California Corporation Law § 15.29 (1994 Supp.)

Professor Eisenberg reaches the contrary conclusion that "the California courts seem to be doing a good job of screening out insufficiently particularized allegations of directorial interest." Background Study at 4.

Professor Eisenberg's conclusion is supported by the letter to the Commission from William S. Lerach of San Diego (December 4, 1995). Mr. Lerach details the court's action on futility allegations in a number of California cases, which show that the courts "regularly do not find that demand is futile, and only find demand futility after discovery and after specific facts are plead detailing why each particular director would not be able to independently and critically assess the validity of the claims at issue." 1st Supp. to Memo. 95-72 at Ex. p. 4.

Alternatives

What are the feasible alternatives concerning excuse of the prerequisite that the shareholder make a demand on the board? Professor Eisenberg reviews three alternatives:

(1) Require a demand in every case without allowing for excuse.

(2) Codify the rules that govern when a demand will be excused.

(3) Leave the matter to case law development.

(1) Universal demand. The theory behind requiring a demand in every case, even if a majority of directors is implicated, is that the board should always have a chance to consider the issue. The ALI Principles of Corporate Governance adopt a universal demand requirement. Professor Eisenberg indicates that codification would be extremely complex, however. He concludes that "as a practical matter a proper treatment of universal demand requires such detail and nuance that it is doubtful whether an attempt should be made to codify the doctrine." Background Study at 20.

Mr. Lerach objects to a universal demand requirement noting that in the ordinary case a demand is in fact futile. This observation is supported by his experience in derivative actions, where the courts initially refuse to excuse the demand but after discovery and particularized pleadings, conclude that the demand would have been futile.

> What this means is that plaintiffs *are* generally correct that pre-litigation demand would be futile, but because of the strict scrutiny which courts undertake in analyzing the demand futility issue, such a finding is generally not made until after the case has been advanced. To rely upon the Board of Directors in *every* circumstance to determine whether the litigation should proceed would ultimately undermine the very reason for shareholder derivative actions, as it would be very difficult to determine those situations where the Board was in fact biased and not in a position to authorize litigation and act in the best interests of the corporation.
> 1st Supp. to Memo. 95-72 at Ex. p. 5.

(2) Codify the standards for a determination of futility. Professor Eisenberg sees no need to codify the rules that govern the excuse exception.

He also addresses AB 920 (Cunneen), which failed passage in the 1995 legislative session. That measure is part of the Governor's legislative program and its substance has been incorporated into SB 994 (Haynes), which is pending in the 1996 legislative session. It would codify standards for excusing the demand:

> If the plaintiff has not made a demand, the plaintiff shall allege facts specific to each director from which the court can conclude that a majority of the directors could not be expected to fairly evaluate the demand of the shareholder plaintiff. The following allegations standing alone shall not be deemed sufficient to conclude that the directors could not fairly evaluate the demand of the shareholder plaintiff:
>
> (A) That the majority of the directors would have to sue themselves.
>
> (B) That the directors received fees and benefits in payment for their services.
>
> (C) That the corporation's liability insurance might not cover an action brought by the company against its officers or directors.
>
> (D) That the wrongdoing alleged is incapable of ratification.
>
> (E) That the director in question approved the transaction in issue.

According to the Assembly Judiciary Committee analysis of this measure, the Consumer Attorneys of California oppose it — each of the specific allegations eliminated by the bill goes to the heart of director resistance to shareholder demands; in effect, the proposal would abolish demand futility, vesting full discretion regarding whether the corporation should litigate in the hands of the very persons who wronged it.

Professor Eisenberg's analysis of the proposal is not so dire. He finds the provisions substantively unobjectionable but probably unnecessary. There is "no evidence that California courts would deem that any of the factors listed [above], standing alone, sufficed to excuse demand. Moreover, because there are so many factors that standing alone are either relevant or irrelevant to excusing demand, the selection of just these factors one way or the other seems questionable." Background Study at 24.

Preserve existing law. After reviewing the existing statute and cases governing demand and excuse, Professor Eisenberg, concludes that the California courts seem to be doing a good job of screening out insufficiently particularized allegations of directorial interest. He recommends that no change be made in the existing California statutes on this point.

BOARD ACTION TO BLOCK DERIVATIVE ACTION

If a demand is made, the board must decide whether to accede to the demanded action or to reject it as not in the corporation's best interests. If a derivative action is commenced without a demand having been made, the board must decide whether to seek to have the action dismissed as not in the corporation's best interests. The standard of review of both types of board decision should be the same, although the law governing the standard of review has developed largely in the context of a decision to seek dismissal of a derivative action since the shareholder rarely makes a demand before commencing an action.

Standard of Review

Where the purpose of the derivative action is to obtain corporate redress against an outsider, there is not a problem of determining the standard of review. The board's decision is a typical business judgment and is reviewed under the business judgment rule.

But where the derivative action is against the members of the board, business judgment principles may be inapplicable, since the board's decision will be an interested one. Often the board will attempt to achieve a disinterested decision by delegating the matter to a special litigation committee composed of disinterested directors.

Professor Eisenberg identifies three competing standards of review where the derivative action involves directors and a decision on the derivative action is made by the board or a special litigation committee:

Business judgment rule. New York, under the *Auerbach* case, applies a modified form of the business judgment rule to the board or committee decision, scrutinizing carefully the composition and procedures of the committee before giving its decision business judgment rule treatment. Few jurisdictions besides New York take this approach.

Substantive review. A majority of states require substantive review of the special litigation committee's decision. They reason that, though the committee is "independent" from the board, it is likely to have a structural bias in favor of the board. Therefore the courts must scrutinize the decision for reasonableness.

Bifurcated standard. Delaware uses different standards depending on whether a demand is required or excused for the type of case alleged. Under the "demand required, demand excused" approach:

(1) The business judgment rule is applied to a board or committee decision to seek dismissal of a derivative action if a demand is required (minority of directors implicated).

(2) A board or committee decision to seek dismissal will receive more careful court scrutiny if the case is a type for which the demand is excused (majority of directors implicated). In this case, the court will review the reasonability of the board or committee decision.

(3) Regardless whether demand is required or excused, if it appears that the transaction being challenged was not the product of a valid exercise of business judgment, the board or committee decision to seek dismissal of the action is subject to a reasonability standard.

The ALI Principles of Corporate Governance also use a bifurcated standard, but this is not based on whether a demand is required, since the ALI Principles adopt a universal demand requirement. Under the ALI approach, if the transaction that is the subject of the derivative action will be reviewed under the business judgment rule, the board or committee decision to seek dismissal will be reviewed under the business judgment rule; if the transaction will be reviewed under a more demanding standard, the board or committee decision will be reviewed under a reasonability standard.

California Law

The California case law on the standard to be applied to a board or committee decision to seek dismissal of a derivative action is sparse, inconsistent, and confused. Reading the cases and statutes together, Professor Eisenberg concludes that where the transaction complained of in the derivative action would be subject to a more demanding standard than the business judgment rule, California law probably would apply a reasonability standard of review to a board or committee decision to seek dismissal.

Possible Codification

Balancing the lack of clarity in California law against the complexity involved in codifying an appropriate standard of review of board or committee action to block a derivative action, Professor Eisenberg concludes that codification would be beneficial, provided a simple and appropriate provision can be developed.

The Governor's reform proposal — formerly found in AB 920 (Cunneen) and now found in SB 994 (Haynes) — would in effect codify a business judgment standard of review in California. It requires the plaintiff to demonstrate the board's failure "to exercise its business judgment" either in considering or in rejecting plaintiff's demand. Professor Eisenberg observes that this proposal would go beyond Delaware law and relegate all decisions in all cases — even well-pleaded duty-of-loyalty cases — to the business judgment rule, "contrary to sound policy" and to the reasons that underlie present statutes governing interested directors. Background Study at 24.

Professor Eisenberg believes a bifurcated standard, preferably the ALI approach but alternatively the Delaware approach, would be appropriate and suggests possible drafts of both alternatives (which have been further simplified here by the staff, for purposes of discussion).

Simplified ALI Rule

> The following standard of judicial review applies to a determination of the board, acting through disinterested and independent directors or a committee of disinterested and independent directors, that a derivative action is not in the corporation's best interests:
>
> (1) If the transaction or conduct that is the subject of the derivative action would be judicially reviewed under the business judgment rule, the court shall accept the determination if in making the determination the board or committee followed procedures that were appropriate under the circumstances and the determination satisfies the business judgment rule.
>
> (2) If, based on particularized allegations, the transaction or conduct that is the subject of the derivative action would be judicially reviewed under a standard of reasonability, fairness, or justice, the court shall accept the determination if in making the determination the board or committee followed procedures that were appropriate under the circumstances and the determination is reasonable.

Modified Delaware Rule

> The following standard of judicial review applies to a determination of the board, acting through disinterested and independent directors or a committee of disinterested and

> independent directors, that a derivative action is not in the corporation's best interests:
>
> (1) If the complaint alleges with particularity facts that would support a reasonable doubt that either (i) a majority of the members of the board were disinterested and independent, or (ii) the transaction or conduct that is the subject of the action was the product of a valid exercise of business judgment, the court shall accept the determination if in making the determination the board or committee followed procedures that were appropriate under the circumstances and the determination is reasonable.
>
> (2) If the complaint does not satisfy paragraph (1), the court shall accept the determination if in making the determination the board or committee followed procedures that were appropriate under the circumstances and the determination satisfies the business judgment rule.

STAFF ALTERNATIVE

The Commission undertook the present study of demand and excuse in derivative actions because of a concern that the standards for excusing a demand are unclear. Further investigation reveals that, for reasons relating to the dynamics of derivative action litigation, the key issue in the lawsuit is whether a demand would have been futile. Futility or lack of it is determined by interestedness of the board or lack of it, and that in turn determines whether the business judgment rule or a more stringent standard of judicial review is applied to the board's action to dismiss the derivative action.

The reason for the demand requirement is to enable the board to block unmeritorious actions before litigation expenses start to mount. But by refusing to make demand and alleging futility, the shareholder may be able avoid being blocked by the board action, or at least get past the initial hurdle.

The crux of the matter is not whether the shareholder has made a demand, but whether the board's action to block the derivative action is properly made by truly disinterested directors.

To the staff's mind, there is probably some legitimacy to the claims of both sides in this debate. Corporations are probably right that many lawsuits are filed unmeritoriously without any real basis, and many times the corporation is forced to settle these lawsuits simply to avoid the exceedingly high cost of defending them. On the other hand, plaintiffs are probably right that "disinterested" boards or special litigation committees routinely act to dismiss the complaints as a result of their structural bias even though the complaints may have some legitimacy.

Is there any way to cut through all this and simplify the process in a way that is fair to both sides? Probably not, but the staff would like to give it a try.

Suppose demand is required in every case ("universal demand"), but a higher standard of review than the business judgment rule is imposed on a board decision that the derivative action would not be in the corporation's best interests. The philosophy behind this approach is that a demand should always be required since the proposed action is really the corporation's, and the board should have the opportunity to act on it. But the board action should never be upheld on the basis of the business judgment rule because it is inherently suspect for structural bias; the board action would be upheld only if reasonable.

Under this approach, both the demand and the board's response would be verified and include particularized allegations, declarations, and affidavits. The court would resolve the issue in the same manner as a summary judgment, but based on the pleadings and supporting information without discovery. The demand would toll the statute of limitations until the board's response, and failure of the board to respond within a specified period (e.g., 30 days) would preclude a later motion to dismiss on the basis that the derivative action is not in the corporation's best interests.

One problem with this approach is the possible complexity of a universal demand requirement. Professor Eisenberg concludes that although a universal demand requirement may be desirable in principle, the complexity of it makes codification problematic. Background Study at 20. However, a large part of the complexity is due to requirements of detailed allegations from both sides in the effort to determine whether the business judgment rule should be applied to the board's decision to reject the demand. Since under the approach we are examining now the test in every case will be whether the board's rejection of the demand is reasonable, much of the complexity will fall away.

Another problem is the possibility that a 30-day delay between the time a demand is made and the time a derivative action may be brought could render improper board action irremediable. There are a number of devices to address this problem, such as a shorter response time or interim judicial relief based on a clear and convincing showing. The problem is solvable, if we have a mind to pursue this approach.

The more significant question, however, is whether the interested parties would see this approach as a fair trade-off for what each has now. Are corporate interests willing to give up business judgment rule protection at the preliminary phase in exchange for a limitation on discovery concerning disinterestedness of directors? Are shareholder advocates willing to give up discovery at the preliminary phase concerning disinterestedness of directors in exchange for a stricter standard of review than the business judgment rule?

The staff thinks this proposal could help rationalize the law and procedure in this area, and offers a reasonable balance of interests. We need to hear from affected parties whether they agree with this assessment.

POLITICAL CONSIDERATIONS

When the Commission first decided to seek legislative authority to study this matter, it was not the highly politicized issue it has now become. The Governor is pushing his derivative action proposals as part of his tort reform package. AB 920 (Cunneen) failed passage last year in the Assembly Judiciary Committee on a partisan vote, all seven Republican committee members voting for it and all seven Democratic committee members voting against it. The substance of the proposal has been amended into SB 994 (Haynes), and the measure is again pending before the Assembly Judiciary Committee, with a different composition, this session.

Moreover, derivative action lawsuits are the subject of an initiative measure — Proposition 201 — that will come before the voters in the March 26 primary election. That measure, known as the Shareholder Litigation Reform Act, is sponsored by a coalition of business interests. It would require the losing party in a shareholder action (including a derivative action) to pay the prevailing party’s litigation costs, including attorney fees, and provides for a litigation bond as security for costs. It would eliminate the $50,000 limitation in existing law on recovery of litigation expenses in a derivative action. Obviously, enactment of this measure could have a significant impact on the frequency of derivative actions.

The Commission must ask itself whether it makes sense to push this study until the dust has settled on the pending measures. One capitol insider has cautioned the staff that this is a highly charged political issue and the

Commission would be well-advised to tread carefully here. It is not the type of environment in which the Commission functions particularly well.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary