

## Memorandum 96-25

### **Demand and Excuse in Shareholder Derivative Actions: Policy Issues**

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The objective of this memorandum is to advance the study of demand and excuse in shareholder derivative actions, with the objective of preparing a tentative recommendation on the matter that can be circulated for comment.

#### BACKGROUND

##### **Commission Authority**

The Commission in 1993 requested authority, and was granted authority by the Legislature, to study the demand and excuse provisions in shareholder derivative actions. Those provisions preclude a lawsuit by a shareholder on behalf of the corporation against the directors unless, among other requirements, the shareholder “alleges in the complaint with particularity plaintiff’s efforts to secure from the board such action as plaintiff desires, or the reasons for not making such effort”. Corp. Code § 800(b)(2).

The reason the Commission requested authority to study this matter is stated in the Commission’s Annual Report for 1992: “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).

##### **Consultant’s Background Study**

The Commission retained Professor Mel Eisenberg of the University of California, Berkeley, School of Law to prepare a background study on this matter for the Commission. Professor Eisenberg had recently completed an in depth review of this area of law as Reporter for the ALI’s Restatement of Corporate Governance.

At the December 1995 Commission meeting Professor Eisenberg presented the background study. 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).

### **Commission Consideration**

After a preliminary discussion of the matter at the December 1995 meeting the Commission concluded that the issue of the standard applicable to a board action to reject a demand or to dismiss a derivative action was a complex matter that deserved careful scrutiny.

The staff prepared for Commission consideration a memorandum coalescing the material in Professor Eisenberg's study, along with commentary received from the State Bar Corporations Committee and from the law firm of Milberg, Weiss, Bershad & Lerach. The staff expressed concern about the politically sensitive subject of this study.

At the February 1996 meeting the Commission decided to proceed with the study. The Commission directed the staff to prepare for Commission consideration an analysis of the issues, with any recommended draft language and an indication of its impact on existing California law.

### **Synopsis of Memorandum**

This memorandum reviews the policies involved in derivative action demand and excuse issues. It relies heavily on Professor Eisenberg's background study, and recapitulates material in earlier memoranda. The memorandum notes Professor Eisenberg's judgment that the existing California law on demand and excuse is satisfactory and not in need of revision. The memorandum concludes with a staff draft to apply the Delaware rule to judicial review of a board decision that a derivative action is not in the corporation's best interests.

### **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. As a practical matter, for reasons described 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.

#### DEMAND REQUIREMENT

Professor Eisenberg states that, “It has long been the general rule, both inside and outside California, that before bringing a derivative action a shareholder is required to make a demand on the board, unless demand is excused.” See, e.g., *Fornaseri v. Cosmosart Realty & Bldg. Corp.*, 96 Cal. App. 549, 556 (1929). California Corporations Code Section 800(b)(2) provides that no derivative action may be instituted or maintained unless:

The plaintiff alleges in the complaint with particularity plaintiff's efforts to secure from the board such action as plaintiff desires, or the reasons for not making such effort, and alleges further that plaintiff has either informed the corporation or the board in writing of the ultimate facts of each cause of action against each defendant or delivered to the corporation or the board a true copy of the complaint which plaintiff proposes to file.

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. It furthers the policy that judicial interference with corporate decisionmaking 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. The staff has not heard any problems or concerns with it.

#### DEMAND EXCUSED

Existing law recognizes exceptions to the demand requirement — Corporations Code Section 800(b)(2) provides that the shareholder must allege the effort made to obtain the desired board action “or the reasons for not making such effort”.

#### **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.

### **What’s At Stake?**

Why doesn’t the shareholder just make the demand before bringing a derivative action? Why does the shareholder try to avoid doing this and why does the board insist upon it?

On the surface, the shareholder would like to skip the demand for a number of reasons. If the shareholder makes a demand, the shareholder must wait for the board’s response before commencing a derivative action. This 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 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 makes it difficult for the shareholder to proceed further.

In order to avoid these problems, the shareholder ordinarily commences a derivative action without first making a demand; if the failure to make a demand is interposed as a defense, the shareholder alleges that the demand is excused due to futility. The shareholder needs 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 effectively determine the outcome of the case.

### **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. Mr. Lerach concludes:

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 less dramatic. 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

Assuming the existing scheme of demand and excuse is preserved, what standard of review should be applied to the board's action to block a derivative action on the ground that the derivative action is not in the corporation's best interests?

#### Standards 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 may 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 (i.e., the board is in a position to make a disinterested judgment on the merits).

(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 (i.e., the board is not in a position to make a disinterested judgment on the merits). 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 Analysis**

The staff believes that, if we are going to codify the business judgment rule, we must say something about its application to a board decision to block a derivative action as not in the best interests of the corporation. However, this is an extremely complex matter, and any radical changes risk upsetting the balance that has developed.

The staff agrees with Professor Eisenberg's analysis that an across-the-board business judgment standard of review is unjustified.

Although such a standard of review may be appropriate in a straightforward duty-of-care case, the application of such a standard would be wholly inappropriate in a well-pleaded and particularized duty-of-loyalty case, given the close collegial relationships that normally prevail among directors, the empirical fact that directors historically have been highly averse to bringing suit against their colleagues, and the critical role of the duty of loyalty in maintaining the integrity of, and confidence in, the corporate system. Accordingly, the substantive standard of review applied to board or committee determinations concerning a derivative action should allow the courts to treat different cases

differently, according to the nature and gravity of the claims that underlie the derivative action.  
Background Study at pp. 20-21.

The staff also agrees with Professor Eisenberg that the bifurcated schemes of both the ALI Principles of Corporate Governance and of Delaware law offer the possibility of clarifying and rationalizing California law in a way that will be workable and acceptable.

The staff prefers the Delaware approach because it is a known quantity. It is consistent with the law on demand and excuse (and is sometimes referred to as the demand required/demand excused rule). It is more likely to be generally acceptable as a basis for codification because there is less risk of an unintended shift in the balance of power. The staff believes it offers the best possibility for codifying and clarifying the law in this area, and we recommend that the Commission develop this approach.

#### **Staff Draft**

The staff suggests Commission consideration of the following draft, based on the Delaware approach.

#### **§ 801 (added). Board determination that derivative action is not in corporation's best interests**

SECTION 1. Section 801 is added to the Corporations Code, to read:

801. (a) This section prescribes the standard for judicial review of a determination by the board that an action under Section 800 is not in the best interests of the corporation. This section applies only if both of the following conditions are satisfied:

(1) The determination is made by the board acting through disinterested and independent directors or a committee of disinterested and independent directors.

(2) In making the determination the board or committee follows procedures that are appropriate under the circumstances.

(b) Except as provided in subdivision (c), the standard for judicial review of the determination is whether the determination satisfies the business judgment rule (Section 320).

(c) If the complaint in the action 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 in the transaction or conduct that is the subject of the action, or (ii) the transaction or conduct that is the subject of the action was the product of a valid exercise of business judgment, the standard for judicial review of the determination is whether the determination is reasonable.

(d) A director is interested within the meaning of subdivision (a) if the director is interested in the transaction or conduct that is the subject of the action or if the director is a defendant in the action. However, the fact that a director is named as a defendant does not make the director interested if the complaint against the director (i) is 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 (ii) does not otherwise allege with particularity facts that, if true, raise a significant prospect that the director would be adjudged liable to the corporation or its shareholders.

**Comment.** Section 801 adopts a bifurcated standard for judicial review of a board or committee determination that a derivative action is not in the corporation's best interests. The leading cases that apply such a standard are *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) and its Delaware progeny. Existing California law on this issue is not entirely clear, but appears to be consistent with this approach. See discussion in 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* 13-19 (Oct. 1995).

This section applies to a board action to reject or dismiss a derivative action, in response to a writing or proposed complaint under Section 800(b)(2) or after an action is instituted. If the conditions set out in subdivision (a) are not satisfied, general law, and not this section, governs judicial review of a board determination that a derivative action is not in the corporation's best interests.

Subdivision (a)(1) requires action by disinterested directors. Elaboration of this concept may be found in subdivision (d).

Subdivision (a)(2) does not attempt to elaborate the procedures that may be appropriate in varying circumstances. Guidance

concerning appropriate procedural standards may be found in ALI Principles of Corporate Governance § 7.09 (1992).

Subdivision (b) refers to the proposed codification of the business judgment rule in California Law Revision Commission, *Business Judgment Rule* (Tent. Rec. 1996).

Subdivision (d) is drawn from the ALI Principles of Corporate Governance § 1.23(c) (1992). The application of subdivision (d) is based on the facts alleged in the complaint. Those facts should normally be accepted as hypothetically true, and all doubts should be resolved in the plaintiff's favor. However, if the gravamen of a complaint against a director is based only on the fact that the director approved of or acquiesced in the transaction or conduct that is the subject of the action, the court should disregard the plaintiff's different labeling of the claim or other pleading devices. Similarly, an alleged fact need not be accepted as even hypothetically true if it is patently false. An alleged fact is patently false for these purposes if, for example, it is patently false on the basis of public knowledge or documents of which the court may take judicial notice.

Respectfully submitted,

Nathaniel Sterling  
Executive Secretary