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BACKGROUND STUDY

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

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and

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I. The Demand Requirement

One of the most important topics in corporation law is the role and power of the board in derivative actions. The central question within that topic is what standard of judicial review should be applied to a board or committee determination that a derivative action is not in the best interests of the corporation and therefore should be not brought or terminated. To fully understand this question, the issue must be set in the context of law concerning demand.

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) ("Before a stockholder's suit for redress will lie…demand must first be made upon the officers to institute appropriate proceedings, unless such demand would be futile"). The general rule and the excuse exception are codified in Cal. Corp. Code § 800(b)(2), which provides that:

> (b) No action may be instituted or maintained in right of any domestic or foreign corporation by any holder of shares or of voting trust certificates of the corporation unless …
>
> (2) 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.

Two related issues, however, are less well settled.

The first issue is, when is demand excused? The general rule is that demand is excused if it would be futile. See, e.g., Gottesfeld v. Richmaid Ice Cream Company, 115 Cal. App. 2d 854, 860 (1953) ("[I]t is settled corporation law that where a demand upon the directors for corporate action would be useless a stockholder may bring a derivative action without making such demand") (citation omitted); Reed v. Norman, 152 Cal. App. 2d 892, 898 (1957) ("While it is the general rule that in a derivative action the plaintiff must plead a demand upon and refusal by the directors to act, it is equally well settled that such demand and refusal need not be alleged if the facts pleaded demonstrate such a demand would have been futile”) (citation omitted).

Demand is excused under the futility exception if a majority of the directors are implicated in the wrongful conduct, because under those circumstances a demand would in effect be a request to the directors to sue themselves, and it is assumed that such a request would be futile. See Smith v. Dorn, 96 Cal. 73, 30 P. 1024 (1892); James v. P.B. Steifer Mining Co., 35 Cal. App. 778, 787, 171 p. 117, 120 (1918). More generally, demand is excused as futile if a majority of the directors are either interested, not independent, or under a defendant’s control. See, e.g., Smith v. Dorn, supra; James v. P.B. Steifer Mining Co., supra; Wickersham v. Crittenden, 106 Cal. 329, 331 (1895).

The futility exception can create a troublesome issue where the plaintiff essentially alleges that a minority of directors were primary wrongdoers — that is, violated the duty of care or loyalty in a primary way — and the remaining directors violated the duty of care by not preventing the primary wrongdoing (as by failing to monitor) or by conspiring in some way with the primary violators. For example, in Gottesfeld v. Richmaid Ice Cream Co., supra, the plaintiff complained of conduct that allegedly “was the result of a conspiracy among a majority of the directors.” 115 Cal. App. 2d at 860. The opinion suggests that the allegation of conspiracy would have excused demand on the ground of futility, although the court did not squarely decide the issue. In Reed v. Norman, supra, the court said, “Certainly, no demand is necessary when conspiracy, fraud or criminal conduct of the defendants is charged.” 152 Cal. App. 2d at 898, citing *Gottesfeld*.

If *conclusory* allegations of claims such as a conspiracy between the primary wrongdoers and the remaining directors, or a failure by the remaining directors to properly monitor the primary wrongdoers failure or to make proper inquiry, would suffice to establish futility or demand, the exception could eat up the rule, because all plaintiffs would be likely to make such allegations to avoid the requirement of demand. On the other hand, there are cases in which there is real substance to allegations that directors who were not primary wrongdoers failed in their duty of monitoring, did not make proper inquiry, conspired with the primary wrongdoers, or the like.

Generally speaking, the courts address this problem by holding that conclusory allegations of lack of monitoring, conspiracy, or the like will not suffice to excuse demand on the ground of futility, but that particularized allegations of this kind will suffice to excuse demand. Thus ALI, Principles of Corporate Governance: Analysis and Recommendations § 1.23(c)(2) (1994) (hereafter, ALI, Principles of Corporate Governance) provides that:

> [T]he fact a director is named as a defendant does not make the director interested under this section if the complaint against the director:
>
> (A) 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

> (B) 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.

This position seems to be taken by the California courts. Thus in Findley v. Garrett, 109 Cal. App. 2d 166, 240 P.2d 421 (1952), where the board had refused to bring a derivative action, plaintiff claimed that although nine directors — who constituted a majority of the board — were not primary wrongdoers, were interested because they had become directors "with full knowledge of the conspiracy of the [primary wrongdoers] and [had] 'participated' in the acts committed pursuant to the conspiracy, 'became active participants' in the acts of conspiracy, and 'knowingly shielded' and 'actively concealed' said acts of conspiracy by 'affirmative representations' which were 'fraudulent concealments' of material facts." *Id.* at 176. The court held that these conclusory allegations were insufficient to establish that the nine directors were interested, in the absence of allegations of particularized facts:

> Those general allegations are made upon information and belief and are intended to implicate the…additional nine directors in an alleged fraud and conspiracy, which fraud and conspiracy are also alleged upon information and belief. In other words, it appears that plaintiffs have attempted to charge the said additional directors with fraud and conspiracy upon information and belief and have not alleged any fact upon which the charge of fraud or conspiracy is based or upon which the belief is based. In *Dowling v. Spring Valley Water Co.,* 174 Cal. 218, it was said…"[I]t is not sufficient to allege fraud or its elements upon information and belief, unless the facts upon which the belief is founded are stated in the pleading." The general charges of fraud, conspiracy and bad faith are insufficient to overcome the presumption that the…board of directors…acted independently and honestly in declining to prosecute the claims in question against the defendants. Those general statements regarding participation, shielding, concealment, and bad faith by the additional nine directors…are not sufficient to implicate said additional directors in the wrong allegedly committed by the [primary defendants].

Id. at 176-77.

Reed v. Norman, supra, also indicates, without stating, that to excuse demand the complaint must do more than make conclusory allegations of fraud:

> Certainly, no demand is necessary when conspiracy, fraud or criminal conduct of the defendants is charged. (*Gottesfeld v. Richmaid Ice Cream Co.,* 115 Cal. App. 2d 854 [252 P.2d 973].) The facts alleged [in this case] are bristling with inferences that Norman and his associate were bent upon depriving appellant of his corporate rights. They paid moneys to parties not entitled to them; they made claims against the corporation which had no substantial basis. They were enjoined from withdrawing funds of the corporation and in order to circumvent the injunction they assigned claims to an employee and caused default judgments to be entered against the corporation. Also, they attempted to cause themselves to be elected directors without first having the necessary shares legally issued to them. When they appeared at a shareholder's meeting in April, 1950, where appellant challenged Norman's right to vote the 255 shares on the ground that they were

> void because not paid for as required by the stock permit, Norman voted the shares and elected himself and associate as directors. Notwithstanding the Supreme Court's annulment of the shares (*Reed v. Norman*, 41 Cal.2d 17, 22 [256 P.2d 930]) thereafter he manipulated the corporation and its assets in utter disregard of appellant's rights and to his detriment, and that of the corporation.

152 Cal. App. 2d at 898-99.

A more recent case, *Shields v. Singleton*, 15 Cal. App. 4th 1611, 19 Cal. Rptr. 2d 459 (1993), reiterates the distinction between conclusory and particularized allegations in this area:

> Plaintiff's contention that demand on the Company's board of directors would have been futile and was therefore excused is based on the fact that all board members were named as defendants in this suit, are allegedly responsible for the wrongdoing of the employees of Teledyne Electronics who committed crimes on behalf of their employer, and personally benefitted from those criminal acts. Plaintiff cites a number of cases which hold that no demand is necessary when conspiracy, fraud or criminal conduct of the defendants is charged, surely a sound principle. (See, e.g., Reed v. Norman (1957) 152 Cal.App.2d 892, 893 [314 P.2d 204]). Plaintiff fails to distinguish, however, between the criminal conduct of certain defendants…and the vague and general allegations of wrongdoing he has leveled against the demurring defendants. As to each director of the Company, plaintiff alleges, in broad conclusory terms, that he "participated in, conspired in, or aided and abetted the criminal and fraudulent activities at issue.…" However, the complaint does not allege a single fact which would indicate that the directors had any knowledge of, much less participated in, any criminal or fraudulent activities, nor does it allege that they benefitted directly from the wrongdoing or were otherwise disabled from exercising independent business judgment. The Court of Appeal in Findley v. Garrett (1952) 109 Cal.App.2d 166, 174 [240 P.2d 421], held that just such broad, conclusory allegations against all directors of a corporation are insufficient to establish demand futility.…
>
> …[T]he general allegations which plaintiff here indiscriminately levels against all the directors of the Company are insufficient to establish that demand on the board would have been futile. As the court below noted, in order to evaluate the demand futility claim, the court must be apprised of facts specific to each director from which it can conclude that that particular director could or could not be expected to fairly evaluate the claims of the shareholder plaintiff. Such showing was not made in this case.…

Id. at 1621-22.

Thus the California courts seem to be doing a good job of screening out insufficiently particularized allegations of directorial interest.

II. The Standard of Review of a Determination by a Board of Directors or a Committee of the Board that a Derivative Action Is Not in the Corporation's Best Interests

In most of the reported cases concerning demand that arose prior to the 1970s, the corporation moved to dismiss a derivative action on the ground that demand was required and had not been made. The courts in such cases often simply held that demand was or was not required, without getting into what consequences would follow if a demand was made and rejected - although some courts did say or hold that if demand was required and rejected, and the rejection was by disinterested directors who constituted a majority of the board, a derivative action could not proceed unless in rejecting demand the board violated some designated standard of substantive review.

In the 1970s, however, a series of cases held that even when a majority of directors were interested, so that demand was excused, the board could appoint a committee of independent directors to determine whether the derivative action was in the best interests of the corporation. Under these cases, if the committee determined that the action was not in the corporation's best interests, and the committee had engaged in an adequate investigation, the corporation could move to dismiss the action, and the court could grant the motion *even though the action was legally meritorious*, subject to procedural and substantive review of the committee's determination by the court under a designated standard of review. It followed that if a majority of directors was disinterested, independent, and not under the wrongdoer's control, the board itself (rather than a committee) could make such a determination and such a motion.

As these cases emerged, a cluster of problems concerning the consequence of a board rejection of a demand, or of a board or committee determination that a derivative action was not in the corporation's best interest, came into clearer focus. The crucial issue within this cluster is what standard of substantive review should be applied to a board or committee determination that a derivative action is not in the corporation's best interests, where a motion to dismiss the action is made on the basis of such a determination. Broadly speaking, the critical question is whether such a board or committee determination should be reviewed only under the business-judgment rule (assuming the conditions of that rule are satisfied), or should be reviewed under a more exacting standard. Although more exacting standards have been articulated in a variety of ways, for purposes of this Study I will divide the relevant standards of substantive review into two categories: the business-judgment standard (good faith or good faith and rationality) and a reasonability standard. (For discussion of the meaning and applicability of these standards, see my Background Study on Whether the Business Judgment Rule Should be Codified).

If a derivative action is brought against a *third person*, the standard-of-substantive-review issue is relatively easy. A decision whether to bring a lawsuit against a third person is a business decision, and by hypothesis involves no self-interested conduct by any directors or officers. Accordingly, a board or committee (or, for that matter, an executive) determination not to bring such an action implicates only the duty of care. Therefore, if the determination meets the conditions of the business-judgment rule it should be subject to review only under the business-judgment standard.

A much more difficult issue arises where, as is typically the case, a derivative action is brought against directors or officers. In such cases, a recommendation to dismiss the derivative action involves a duty-of-loyalty issue, because the recommendation benefits directors or officers. Because the duty of loyalty is much more demanding than the duty of care, it is far from obvious that business-judgment rule should be applied to such recommendations.

A. Authorities Outside California

The articulations in the case law of the standard of review of a board or committee determination that a derivative action is not in the best interests of the corporation are varied and inconsistent. The state-law authorities outside California tend to fall into three broad categories.[1]

(1) *Cases that accord business-judgment deference to a board or committee determination that a derivative action is not in the corporation's best interests.* The leading case taking this position is Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979). Here the New York Court of Appeals held that a business-judgment standard of substantive review applied to a decision by a special litigation committee to seek dismissal of a derivative action:

> Derivative claims against corporate directors belong to the corporation itself. 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. Necessarily such decision must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calculated to protect and advance the interests of the corporation. This is the essence of the responsibility and role of the board of directors, and courts may not intrude to interfere.
>
> In the present case we confront a special instance of the application of the business judgment rule and inquire whether it applies in its full vigor to shield from judicial scrutiny the decision of a three-person minority committee of the board acting on behalf of the full board not to prosecute a shareholder's derivative action. The record in this case reveals that the board is a 15-member board, and that the derivative suit was brought against four of the directors. Nothing suggests

1. Generally speaking, in this Study I will consider only cases decided by state courts, not federal diversity cases, because the federal courts have not been good predictors of state law in this area. I also will not attempt to survey the state statutes, only a small number of which address the issue considered in this Part.

> that any of the other directors participated in any of the challenged first-tier transactions. Indeed the report of the audit committee on which the complaint is based specifically found that no other directors had any prior knowledge of or were in any way involved in any of these transactions. Other directors had, however, been members of the board in the period during which the transactions occurred. Each of the three director members of the special litigation committee joined the board thereafter.…
>
> We turn then to the action of the special litigation committee itself which comprised two components. First, there was the selection of procedures appropriate to the pursuit of its charge, and second, there was the ultimate substantive decision, predicated on the procedures chosen and the data produced thereby, not to pursue the claims advanced in the shareholders' derivative actions. 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 that substantive decision — "the reasons for the payments, the advantages or disadvantages accruing to the corporation by reason of the transactions, the extent of the participation or profit by the respondent directors and the loss, if any, of public confidence in the corporation which might be incurred"…. Inquiry into such matters would go to the very core of the business judgement 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.

419 N.Y. 2d at 926-28.

New York law is not, however, quite as simple as this passage suggests. *First*, *Auerbach* requires a more intrusive role for the courts in reviewing the *procedural* component of board or committee determination than would be required in ordinary business-judgment rule cases. Continuing the passage quoted above, the court said:

> As to the [procedural] component of the committee's activities, however, the situation is different [than as to the substantive component]…. As to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are well equipped by long and continuing experience and practice to make determinations. *In fact they are better qualified in this regard than are corporate directors in general*. Nor do the determinations to be made in the adoption of procedures partake of the nuances or special perceptions or comprehensions of business judgment or corporate activities or interests. The question is solely how appropriately to set about to gather the pertinent data.

Id. at 929 (emphasis added).

Thus in Davidowitz v. Edelman, 583 N.Y.S.2d. 340 (Sup. Ct. 1992), aff'd, 203 A.D.2d 234, 612 N.Y.S.2d 882 (1994), the court rejected a committee's motion partly on the ground that the committee relied wholly on its counsel, attended only one of the interviews arranged by counsel, and "did not join in their counsel's investigation or review, save in the most perfunctory manner." Id. at 344.

Second, New York law concerning what constitutes lack of director independence is relatively favorable to plaintiffs. Thus Barr v. Wackman, 36 N.Y.2d 371, 329 N.E.2d 180 (1975), held that a failure by otherwise-disinterested directors to investigate a suspicious transaction excused demand. Presumably, the failure would also have been sufficient to demonstrate a lack of independence and impartiality in directors who made a recommendation to dismiss a derivative action. Similarly, the court in *Davidowitz*, supra, found the membership of a special litigation committee to be insufficiently independent and impartial because one committee member was a college president whose institution had received a $1.5 million donation from the defendant, another member was the defendant's tax attorney, and other members were directors of other corporations run by the defendant and had participated in past takeovers as co-investors with the defendant.

In short, the New York rule that board or committee conclusions are substantively reviewable only under the business-judgment rule is somewhat counterbalanced by New York's exacting standards in reviewing committee procedure and determining what constitutes interest. Furthermore, it is widely (although not universally) believed that if a court like New York, which adopts a business-judgment standard of substantive review, believes that a board or committee recommendation is essentially unsound, it will get around the limited standard of substantive review by finding that the board or committee lacked sufficient independence or failed to follow proper procedures.

Outside New York, only Roberts v. Alabama Power Co., 404 So. 2d 629 (Ala. 1981), appears to have followed *Auerbach*, and even *Roberts* states that the committee's decision will be "subject to judicial scrutiny as to whether [the committee's] action was in the best interest of the corporation." Id. at 636. (In 1990, a rule comparable to that of *Auerbach* was adopted in Revised Model Business Corporation Act § 7.44, but this provision of the Model Act appears to have been only sparsely adopted. In addition, the Model Act leaves at least some room for substantive judicial review by providing in the text that the determination of the board or committee must be "based" on reasonable inquiry, and by providing in the Comment that the court may examine the board's determination "to ensure that it has some support in the findings of the inquiry.")

(2) *Cases that utilize a more demanding standard of substantive review of a board or committee recommendation that a derivative action is not in the corporation's best interests.* A majority of state cases probably fall into this category. For example, in Alford v. Shaw, 320 N.C. 465, 358 S.E.2d 323 (1987), the North Carolina court held as follows:

> The recent trend among courts…has been to require judicial inquiry on the merits of the special litigation committee's report.…

> … We interpret the trend away from *Auerbach*…as an indication of growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose institutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interest of plaintiffs forced to bring suit on behalf of the corporation. *See generally* Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 Law and Contemporary Problems, Summer 1985 at 83 (1985). Such concerns are legitimate ones and…we find that they must be resolved not by slavish adherence to the business judgment rule, but by careful interpretation of the provisions of our own Business Corporation Act.…
>
> [A] policy of protecting minority shareholders is manifested by [N.C. Bus. Corp. Act] section 55-55(c), which states that a shareholder's derivative action
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>> shall not be discontinued, dismissed, compromised or settled without the approval of the court. If the court shall determine that the interest of the shareholders or any class or classes thereof, or of the creditors of the corporation, will be substantially affected by such discontinuance, dismissal, compromise or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to such shareholders or creditors whose interests it determines will be so affected.…
>
> Although the recommendation of the special litigation committee is not binding on the court, in making this determination the court may choose to rely on such recommendation. To rely blindly on the report of a corporation-appointed committee which assembled such materials on behalf of the corporation is to abdicate the judicial duty to consider the interests of shareholders imposed by the statute.…

338 S.E.2d at 325-27.

In Houle v. Low, 407 Mass. 810, 556 N.E.2d 51 (1990), the Massachusetts court came to a comparable conclusion:

> The majority of courts facing the special litigation committee issue have determined that the use of such committees is permissible.…
>
> Other courts have held that the special litigation committee device cannot be used. In *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 715-718 (Iowa 1983), the Supreme Court of Iowa was concerned with the anomalous situation where a majority of the directors, because they were named as defendants, could not terminate a derivative action, yet could appoint a committee of their choosing which would have that power. The court reasoned that "the potential for structural bias on the part of a litigation committee appointed by directors who are parties to derivative actions is sufficiently great and sufficiently difficult of precise proof in an individual case." *Id.* at 718. Accordingly, the court adopted a prophylactic rule, prohibiting the use of special litigation committees, at least in cases where a majority of directors are named as the defendants in a derivative suit.…
>
> The concern expressed by the *Miller* court…with the "structural bias" of special litigation committees is not unfounded. A number of commentators have recognized the possibility of inherent bias when "independent" directors pass judgment on other directors. In Cox & Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 Law & Contemp. Probs. 83, 84-85 (No. 3, 1985), the authors "examine[d] several

social-psychological mechanisms that can generate bias in the directors' assessment of the suit, including biases established by appointment of members to the board or a special litigation committee, control of pecuniary or nonpecuniary rewards made available to the independent directors by the defendant members of the board of directors, the independent directors' prior associations with the defendants, and their common cultural and social heritages." *Id.* at 84-85.…In another article, the following contention appears: "[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 suiter.'…[A] refusal to protect one's peers once events have transpired is seen as disloyal treachery." Coffee & Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261, 283 (1981). As the Supreme Court of Delaware has noted, even in the case of an independent director, "[t]he question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role." *Zapata Corp. v. Maldonado,* 430 A.2d 779, 787 (Del. 1981).…

[W]e join the majority of courts which hold that the special litigation committee device is permissible. Such a committee can have the ability and expertise to decide whether a given derivative suit is in the corporation's best interest. We turn now to the determination of what standard of judicial review is applicable to decisions of special litigation committees.

The value of a special litigation committee is coextensive with the extent to which that committee truly exercises business judgment. In order to ensure that special litigation committees do act for the corporation's best interest, a good deal of judicial oversight is necessary in each case. At the same time, however, courts must be careful not to usurp the committee's valuable role in exercising business judgment. At a minimum, a special litigation committee must be independent, unbiased, and act in good faith. Moreover, such a committee must conduct a thorough and careful analysis regarding the plaintiff's derivative suit.…The burden of proving that these procedural requirements have been met must rest, in all fairness, on the party capable of making that proof—the corporation.…

Suppose…that the corporate defendant satisfies the judge that the committee was independent.… Massachusetts has always recognized the need for courts to abstain from interfering in business judgments.… At the same time, this court has always "vigorously scrutinize[d] the situation" where a director's loyalty to the corporation is in conflict with his or her own self-interest. *American Discount Corp. v. Kaitz,* 348 Mass. 706, 711, 206 N.E.2d 156 (1965). Both concerns are present in this case, as is the danger of "structural bias" recognized by so many courts and commentators. The balancing of these various concerns requires reviewing judges to go beyond establishing the committee's independence, good faith and the adequacy of its investigation.

The judge must determine, on the basis of the evidence presented, whether the committee reached a reasonable and principled decision. Even in those cases where a committee is independent and conducts a thorough investigation, the judge may conclude that the committee's decision is contrary to the great weight of evidence. In conducting its review, the court should look to factors such as…the likelihood of a judgment in the plaintiff's favor, the expected recovery as compared to out-of-pocket costs, whether the corporation itself took corrective action, whether the balance of corporate interests warrants dismissal, and whether dismissal would allow any defendant who has control of the corporation to retain a significant improper benefit. . .

556 N.W.2d at 54-59.

A similar position was taken in Lewis v. Boyd, 838 S.W.2d 215 (Tenn. Ct. App. 1992). Here the court began by stating the general applicability of the business-judgment rule, but then said:

> We agree with the Supreme Court of North Carolina [in *Alford v. Shaw*] that a special litigation committee's recommendations should be reviewed using a single standard….
>
> …The review should extend to the rationale of the committee's decision.… The court should critically evaluate the committee's findings and recommendations to determine whether they were made in good faith, whether they are supported by the record of the investigation, and whether they are consistent with the corporation's best interests….[2]

The next authorities to be considered also reject the *Auerbach* test, but uses in its place a bifurcated rather than a single standard.

(3) *Cases that apply a bifurcated standard of review to a board or committee determination that a derivative action is not in the corporation's best interests*. The leading cases in this category are Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), and its Delaware progeny. Under Delaware law, if *both* (i) a majority of directors are disinterested and independent *and* (ii) the plaintiff has not alleged with particularity facts that, taken as true, would support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment, the court applies a business-judgment standard of review. If, however, *either* (i) a majority of the corporation's directors are interested or not independent, *or* (ii) the plaintiff alleges with particularity facts that, taken as true, would support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment, then a more demanding, two-step standard of review is applied. Under the first step, the court inquires into whether the committee's conclusions are soundly based — in effect, a reasonability review. Under the second step, which is discretionary, the court determines whether the motion should be granted as a matter of the court's own independent business judgment. (This means that instances can arise when a committee can establish its independence and sound bases for its decisions, but the corporation's motion to dismiss a derivative action may still be denied.)

The second disjunctive test under which Delaware uses a reasonability standard is that the plaintiff has alleged facts that, taken as true, would support *a reasonable doubt* that the transaction was the product of a valid business judgment. This test will often require judicial review under a reasonability standard even when a majority of the directors are disinterested. As reported by Sparks and Mirvis:

2. See also Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 715-18 (Iowa 1983), discussed in Houle v. Low, *supra.*

> A strict reading of *Aronson* and its progeny…might suggest that it has become difficult, if not impossible, to successfully allege demand futility. The reality is to the contrary. Since the decision of the Delaware Supreme Court in *Levine v. Smith* in 1991, there have been a number of decisions where the Delaware Court of Chancery has excused stockholders from making a demand.…
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> For example, in *Abajian v. Kennedy*, C.A. No. 11425 (Del. Ch. Jan. 17, 1992), Chancellor Allen, emphasizing the highly discretionary nature of the "reasonable doubt" determination set forth in *Aronson* and its progeny, denied defendants' motion to dismiss entrenchment claims arising as the result of an issuance of preferred stock and a loan to an ESOP for failure to make demand, concluding that the facts alleged in the amended complaint were "sufficient to create a reasonable doubt concerning the availability of the business judgment protections." *Abajian, supra* slip op. at 2.
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> Continuing the spate of recent cases excusing demand, the most recent pronouncement from the Delaware Supreme Court on the demand requirement came in *Heineman v. Datapoint Corp.*, 611 A.2d 950 (Del. 1992). In *Heineman*, the Court reversed, as an abuse of discretion, the decision of the Court of Chancery dismissing the plaintiff's amended complaint for failure to allege with particularity facts sufficient to excuse demand. While the Supreme Court reaffirmed the principles in *Aronson* and *Levine* with respect to the pertinent legal standards, the Court emphasized that the Court of Chancery's decision under those principles "involves essentially a discretionary ruling on a predominantly factual issue." *Id.* at 952. In reviewing the Court of Chancery's decision, the Supreme Court separately analyzed all four of the transactions challenged in the complaint under the abuse of discretion standard, and rebuked the lower court for giving "conclusory treatment" to the claims in the complaint and for not analyzing the claims separately. The Court went on to find that, with respect to two of the transactions at issue, the plaintiff had "alleged sufficient facts of apparent self-dealing to raise a reasonable doubt concerning director disinterest." With respect to the other two transactions, the Court gave the benefit of the doubt to plaintiff and refused to affirm the dismissal of the claims even though the Court stated that is was "at least arguable" that the factual allegations underlying the claims were inadequate. Instead, the Court gave the plaintiff leave to amend his complaint with respect to those claims.…
>
> These recent Delaware cases suggest that the demand pendulum may have reached its furthest point in *Levine*, and are illustrative of the fact that the demand requirement has not led to a wholesale dismissal of meritorious derivative actions. Instead, the demand requirement, with thoughtful application, appears to be evolving into a sensitive device for sorting out frivolous claims at an early stage in litigation.…

Sparks & Mirvis, *Recent Developments With Respect to the Demand Requirement in Derivative Suits*, in ABA, The New Dynamics of Corporate Governance (1993).

The Delaware approach is commonly referred to as the "demand required, demand excused" rule, because the standard of review of a board or committee determination depends on whether demand is required or excused: The business-judgment standard of review is applicable to cases in which Delaware requires demand, while the more demanding two-step standard of review is applicable to cases in which Delaware excuses demand.

A different kind of bifurcated standard is adopted in ALI, Principles of Corporate Governance § 7.10(a). Section 7.10(a) distinguishes between cases in which the underlying transaction or conduct that is the subject of the derivative action would be governed by the business-judgment standard, and cases in which the underlying transaction or conduct would be governed by a more demanding standard, such as reasonability or fairness. Where the underlying transaction or conduct would be reviewed under the business-judgment standard, that standard applies as well to a board or committee determination that a derivative action based on the transaction or conduct is not in the corporation's best interests. Where the underlying transaction or conduct would be reviewed under a more demanding standard, the standard of substantive review of a board or committee determination is that the board or committee reasonably determined that dismissal was in the best interests of the corporation, based on grounds that the court deems to warrant reliance.

B. California Law

California law is not entirely clear on the standard of substantive review of a board or committee determination that a derivative action is not in the corporation's best interests. Many of the California demand cases arose before the 1970s, when the standard-of-review issue had not yet come into sharp focus. Furthermore, the California Supreme Court has not directly addressed this issue. Finally, the cases that do speak to the issue are subject to more than one interpretation.

An important but somewhat delphic early case is Findley v. Garrett, 109 Cal. App. 2d 166, 240 P.2d 421 (1952), in which an independent majority of the board had rejected a shareholder demand. The court said:

> The power to manage the affairs of a corporation is vested in the board of directors.… Where a board of directors, in refusing to commence an action to redress an alleged wrong against a corporation, acts in good faith within the scope of its discretionary power and *reasonably believes* its refusal to commence the action is good business judgment in the best interest of the corporation, a stockholder is not authorized to interfere with such discretion by commencing the action.…
>
> … It appears…under the allegations of the amended complaint, that at all times after 1936 a majority of the board of directors of Douglas was independent and was not under disability or powerless to act with respect to the alleged wrong. There were 13 members of the Douglas board when plaintiff Findley made his demand that legal action be taken, and 11 of them were [not involved in the primary wrongdoing]. The matter was within the discretionary power of the board. An independent majority of the board, in the determination of a discretionary matter, declined to commence an action. *Notwithstanding the insufficiency of the allegations of fraud and bad faith, it was necessary for the court to consider whether, on the facts alleged, the refusal of the directors to prosecute the claims was so clearly against the interests of the corporation that it must be concluded that the decision of the directors did not represent their honest and independent judgment*. The facts alleged would not have justified such a conclusion. It was a question of business whether the transactions over a 12-year period should be investigated and prosecuted. Directors have the same discretion with respect to the

> prosecution of claims on behalf of the corporation as they have in other business matters. In this respect the fact that a claim may be founded in fraud does not differentiate it from other claims.… It appears from the nature of the litigation, the variety and complexity of the issues, the period of time during which the asserted frauds allegedly were committed, the multitude of transactions between the two corporations, the many individuals involved, and the questions of accounting, that the directors were confronted with litigation of formidable proportions. Many directors, other than those named as defendants herein, were also accused in general terms of conspiracy and fraud. A mistake of judgment on the part of a board of directors does not justify taking the control of corporate affairs from the board of directors and placing it with the stockholders. The board of directors may make incorrect decisions, as well as correct ones, so long as it is faithful to the corporation and uses its best business judgment.

Id. at 174, 177-78 (emphasis added).

It is not entirely clear what standard of review was utilized in Findley v. Garrett. Some passages suggest the business-judgment standard, because many phrases in the opinion emphasize good faith and discretion. On the other hand, the court explicitly states that a board must "*reasonably* believe[] [that] its refusal to commence the action is…in the best interest of the corporation." Id. at 174. Similarly, the court explicitly states that "Notwithstanding the insufficiency of the [plaintiff's] allegations of fraud and bad faith, it was necessary for the court to consider whether, on the facts alleged, the refusal of the directors to prosecute the claims was so clearly against the interests of the corporation that it must be concluded that the decision of the directors did not represent their honest and independent judgment," id. at 177, which also seems to involve a reasonability standard of review.

In Beehan v. Lido Isle Community Assn, 70 Cal. App. 3d 858, 137 Cal. Rptr. 528 (1977), the court also appeared to adopt a reasonability standard of review of a board's decision not to sue:

> Neither a court nor minority shareholders can substitute their business judgment for that of a corporation where its board of directors has acted in good faith and with a view to the best interests of the corporation and all its shareholders. (Marsili v. Pacific Gas & Elec. Co., 51 Cal.App.3d 313, 324 [124 Cal.Rptr. 313]; Fairchild v. Bank of America, 192 Cal.App.2d 252, 256-257 [13 Cal.Rptr. 491]; Findley v. Garrett, 109 Cal.App.2d 166, 174-175 [240 P.2d 421].) "The power to manage the affairs of a corporation is vested in the board of directors. [Citation omitted.] Where a board of directors, in refusing to commence an action to redress an alleged wrong against a corporation, acts in good faith within the scope of its discretionary power and reasonably believes its refusal to commence the action is good business judgment in the best interest of the corporation, a stockholder is not authorized to interfere with such discretion by commencing the action…'Every presumption is in favor of the good faith of the directors. Interference with such discretion is not warranted in doubtful cases.'" (Findley v. Garett, supra, 109 Cal.App.2d at p. 174; accord: Fornasert v. Cosmosart Realty & Bldg. Corp., 96 Cal.App. 549, 557 [274 P. 597].) (emphasis added.)

70 Cal. App. 2d at 865-66.

In Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 261 Cal. Rptr. 868 (1989), Ted Will was a 20 percent minority shareholder in Engebretson & Company, a closely held corporation. Lester Engebretson was the majority (80 percent) shareholder. For many years, Will, Lester Engebretson, and Dorothy Engebretson (who was Lester Engebretson's wife), were the directors of the corporation. At the time the action arose, the board consisted of Will, Lester Engebretson, and Dorothy Engebretson's brother, John Quirk.

In October 1986, Will filed a shareholder derivative action against the corporation and the Engebretsons. Will alleged that the Engebretsons had breached their fiduciary duty as directors by receiving excessive and unreasonable amounts from the corporation in the form of salaries, dividends, and deferred compensation in excess of $4 million, and by failing to issue any dividends to minority shareholders.

In January 1987, the board formed a "compensation committee" composed of three directors: Quirk, Harold Brown, and Allen Klosowski, two nominally disinterested directors who had been appointed in December 1986. The committee's task was to review the history of Lester Engebretson's compensation, establish an appropriate compensation package for the president, evaluate the allegations of Will's derivative action, and determine whether the continuation of the lawsuit was in the corporation's best interests. The committee retained the accounting firm Peat, Marwick, Mitchell & Co. to provide an analysis of Engebretson's salary. Counsel for the corporation served as counsel for the committee.

In March 1987, the compensation committee met with corporate counsel by telephone conference call. After reviewing a two-page analysis of Lester Engebretson's salary and compensation, prepared by Peat, Marwick, the committee determined that the continuation of Will's action was not in the best interests of the corporation. The committee's recommendation was adopted by the board of directors.

The corporation then moved for summary judgment against Will, on the ground that a disinterested compensation committee appointed by the board of directors had determined that maintenance of the action was not in the best interests of the corporation, and that under the business-judgment rule the committee's good-faith decision to dismiss the shareholder's derivative action was immune from attack. The corporation argued that as a matter of law the court was required to dismiss the action.

Will submitted evidence that the nominally disinterested directors were relatives of the Engebretsons and that the compensation committee failed to make an independent review of the matter. He asserted that none of the committee members reviewed the complaint or the corporation's financial records, and that the committee did nothing more than ratify the advice of Engebretson's attorney to recommend to the board that the action be terminated.

The trial court found that the compensation committee acted with disinterested independence and that its decision was made in good faith. Based on these findings, the court dismissed the Will's complaint. The Court of Appeal reversed. The opinion began by giving lip service to *Auerbach* and the business-judgment rule:

> [C]ourts which have considered the issue have concluded that judicial review of the independence, good faith, and investigative techniques of a special litigation committee is governed by traditional summary judgment standards. In the leading case of Auerbach v. Bennett (1979) 47 N.Y.2d 619 [419 N.Y.S.2d 920, 393 N.E.2d 994],… [a]fter noting that the courts are "better qualified" by "long and continuing experience and practice" to determine the adequacy of the committee's formation and investigative techniques, [the court] held that the plaintiff who opposes a summary judgment motion on these issues must show "facts sufficient to require a trial of any material issue of fact."…Finding nothing in the record raising a triable issue of fact, it held the motion should have been granted.

213 Cal. App. 3d at 1041.

After this passage, however, the court strongly suggested that a reasonability review was required, because unreasonability would be evidence that the committee was structurally biased:

> [T]here are three reasons why Will is entitled to a trial on the merits as opposed to a "limited review" of the merits regarding the issue of the good faith and independence of the committee. First, the motion was made pursuant to the summary judgment statute. (Code Civ. Proc., § 437c.) That section clearly provides that the sole function of the trial court is to determine if there is a triable issue of fact. Having chosen that procedural avenue, [the corporation] and the Engebretsons are bound to follow it in all its particulars. If that procedure is inadequate for the termination motion made here, it is up to the Legislature, not the courts, to fashion a better rule.
>
> Second, the court is uniquely equipped to judge the independence and fact-gathering techniques of the special litigation committee.… By conducting only a limited review of the merits on the theory the court should give deference to the business judgment of the committee, the court, in effect, lets the committee determine its own independence and good faith. But the business judgment rule was not designed to insulate actions of the committee committed in bad faith, and thus the committee should not receive the benefit of the presumption when the court seeks to judge the committee's independence and good faith.
>
> Third, a limited review of the merits will tend to hide the structural bias of the special litigation committee. It has been well documented that 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 suiter." As a result, an outside director independent enough to oppose a chief executive officer with respect to a proposed transaction he thinks is unfair or unwise may still be unable to tell the same officer that he thinks the suit against him has sufficient merit to proceed….'" (*Hasan v. CleveTrust Realty Investors*,… 729 F.2d at p. 377; see also *Joy v. North* (2d Cir. 1982) 692 F.2d 880, 888.) This inherent structural bias requires the court to be "mindful of the need to scrutinize carefully the mechanism by which directors delegate to a minority committee the business judgment authority to terminate derivative litigation, particularly when the lawsuit is directed against some or a majority of the directors." (*Gaines v. Haughton*,…645 F.2d at p. 772….) Absent a full hearing or trial on these issues,

> the derivative plaintiff may lose the one opportunity to contest the decision of the board.[3]

213 Cal. App. 3d at 1043-44.

Two provisions of the California Corporations Code also bear on the standard of substantive review in California. To begin with, a major rationale of allowing the board or a committee to move to dismiss a derivative action is that such a motion acts as a mechanism to screen out frivolous derivative actions. In California, however, a screening mechanism is already provided by Cal. Corp. Code § 800(c) and (d), which allow a court to make just such a screening when the defendant moves for security for expenses, as a defendant would normally do if the plaintiff's case is weak. That section provides:

> § 800. Conditions; security; motion for order; determination
>
> …
>
> (c) In any [derivative] action…the corporation or the defendant may move the court for an order, upon notice and hearing, requiring the plaintiff to furnish a bond as hereinafter provided. The motion shall be based upon one or both of the following grounds:
>
> (1) That there is no reasonable possibility that the prosecution of the cause of action alleged in the complaint against the moving party will benefit the corporation or its shareholders.
>
> (2) That the moving party, if other than the corporation, did not participate in the transaction complained of in any capacity.…
>
> (d) At the hearing upon any motion pursuant to subdivision (c), the court shall consider such evidence, written or oral, by witnesses or affidavit, as may be material (1) to the ground or grounds upon which the motion is based, or (2) to a determination of the probable reasonable expenses, including attorneys' fees, of the corporation and the moving party which will be incurred in the defense of the action. If the court determines, after hearing the evidence adduced by the parties, that the moving party has established a probability in support of any of the grounds upon which the motion is based, the court shall fix the amount of the bond, not to exceed fifty thousand dollars ($50,000), to be furnished by the plaintiff for reasonable expenses, including attorneys' fees, which may be incurred by the moving party and the corporation in connection with the action, including expenses for which the corporation may become liable pursuant to section 317.

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3. In addition to the California cases discussed in the text of this Study, in Lewis v. Anderson, 615 F.2d. 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); and Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982), the Ninth Circuit concluded that the standard of review under California law would be the business-judgment rule. These conclusions are entitled to relatively little weight. *Lewis* relied in significant part on Findley v. Garrett, which it misinterpreted, and on Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980), which wrongly predicted Delaware law in this area. *Gaines* essentially followed *Lewis*, and wrongly predicted that "the developing trend in corporate law we discerned in *Lewis* has become unmistakably clear." Furthermore, at least one important California case (Will v. Engebretson, supra) was decided after *Lewis* and *Gaines*, and does not in fact apply the business-judgment standard. Finally, both *Lewis* and *Gaines* failed to understand the significance of Cal. Corp. Code § 310 (see infra).

An even more important reason under California law for applying a reasonability standard of review to board or committee determinations concerning duty-of-loyalty cases is Cal. Corp. Code § 310(a). That section provides:

> (a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm or association in which one or more of its directors has a material financial interest, is either void or voidable because such director or directors or such other corporation, firm or association are parties or because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies the contract or transaction, if
>
> (1) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the shareholders and such contract or transaction is approved by the shareholders…in good faith, with the shares owned by the interested director or directors not being entitled to vote thereon, or
>
> (2) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the board or committee, and the board or committee authorizes, approves or ratifies the contract or transaction in good faith by a vote sufficient without counting the vote of the interested director or directors *and the contract or transaction is just and reasonable* as to the corporation at the time it is authorized, approved or ratified, or
>
> (3) As to contracts or transactions not approved as provided in paragraph (1) or (2) of this subdivision, the person asserting the validity of the contract or transaction sustains the burden of proving that the contract or transaction was just and reasonable as to the corporation at the time it was authorized, approved or ratified.

(emphasis added)

Section 310(a) carefully distinguishes between the standard of review that governs a transaction that has been approved by the shareholders (the approval must be good faith), and the standard of review that governs a transaction that has been authorized, approved, or ratified by disinterested directors (the transaction must be just and reasonable). The obvious reason for this distinction is the same as the rationale for the cases that require a more demanding standard of substantive review of board or committee recommendations to terminate a derivative action than the business judgment rule: even nominally disinterested directors are bound by various ties to their colleagues and are normally reluctant to authorize a suit against their colleagues.

In short, under Cal. Corp. Code § 310(a) even if a self-interested transaction has been authorized, approved or ratified by disinterested directors acting in good faith, the transaction is still subject to substantive judicial review to determine whether the transaction was just and reasonable. It would be anomalous if (i) a determination by disinterested directors to authorize, approve, or ratify a self-interested transaction *will not* insulate the transaction from substantive review to determine whether the transaction was just and reasonable, but (ii) a vote of disinterested directors that a suit based on a self-interested transaction was not in the corporation's best interests *would* insulate the transaction from substantive review to determine whether the transaction was just and reasonable. Although some slight distinctions can be made between a decision by the board to authorize, approve, or ratify a self-interested transaction by a colleague and a decision by the board not to allow suit on the transaction, the distinctions are technical and non-meritorious. Accordingly, Cal. Corp. Code § 310(a) leaves little room in California for application of the business-judgment standard of review to a board or committee determination that a derivative action based on the duty of loyalty would not be in the corporation's best interests. Giving proper weight to § 310(a), therefore, in my view California law requires a reasonability standard of review for well-pleaded cases founded on the duty of loyalty or on other duties that implicate standards that are stricter than the business-judgment rule. Although the California case-law is somewhat ambiguous, it is consistent with this view.

III. Recommendations

Three issues have been discussed in Parts I and II: the requirement of demand; the parameters of the excuse exception; and the substantive standard of review that should be applied to a board or committee determination that a derivative action is not in a corporation's best interests and, therefore, should be not brought or, if brought, should be terminated. In Part III, I will make recommendations concerning the codification of rules dealing with these issues.

A. Demand

The general rule that a shareholder must make a demand before bringing a derivative action is a sound rule. The rule is already codified in Cal. Corp. Code § 800(b)(2), and I recommend no changes.

B. Excuse

The rules concerning excuse present more difficult problems. At present, the excuse exception is codified in a very general way in Cal. Corp. Code § 800(b)(2). That section provides, in effect, that a shareholder does not have to make demand if he alleges "reasons" for not making demand. The clear implication is that the courts are given authority to develop the rules concerning what reasons will be legally sufficient to excuse demand. Given the existence of § 800(b)(2), there are three ways to approach the issue of excuse from a codification perspective:

(i) The excuse exception could be abolished, so that demand was required in all cases — even when a majority of the board is interested. (This is sometimes referred to as "universal demand.")

(ii) The rules that govern the excuse exception could be codified.

(iii) The development and application of the excuse exception could continue to be left to the courts.

(i) *Universal demand*. A rule of universal demand is adopted in ALI, *Principles of Corporate Governance* § 7.02 and Model Act § 7.42. The theory of requiring demand in all cases is that the board should always be given a chance to consider the subject-matter of a prospective derivative action, even if the board is interested. A corollary of universal demand is that whether demand is required or excused has no impact on what substantive standard of review governs a board's determination whether a derivative action should be terminated.

The problem with codifying a rule of universal demand is that the codification would have to be extremely complex, as illustrated by ALI, *Principles of Corporate Governance* § 7.04(a) and the Comment thereto, excerpts from which are set out in Appendix A. The complexity and subtlety of section 7.04(a) and the Comment illustrate that although universal demand may be desirable in principle, 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.

(ii), (iii). *Codification of the rules that govern the excuse exception*. Assuming that a rule of universal demand was not adopted, then as between the second and third options — codifying the rules that govern the excuse exception or continuing to leave development and application of that exception to the courts — the latter seems preferable. The California courts have on the whole done a good job in developing and administering the excuse exception. In particular, they have been properly sensitive to the need for particularized pleading. I would therefore recommend that no change be made in Cal. Corp. Code § 800(b)(2).

C. The standard of substantive review of a board or committee determination that a derivative action is not in the corporation's best interests and therefore should not be brought or should be terminated

This issue raises two questions:

(i) What is the proper standard of substantive review?

(ii) Should a substantive standard of review be codified?

(i) *What is the proper standard of substantive review?* For the reasons stated in Houle v. Low, *supra* and Alford v. Shaw, *supra*, an across-the-board business-judgment standard of review is unjustified — especially in California, where it would effectively conflict with Cal. Corp. Code § 310(a). 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 corpore 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.

Both Delaware law and the ALI provisions satisfy this criterion. The Delaware test turns on whether a majority of directors were interested, or alternatively whether (in effect) the plaintiff has filed a particularized pleading that makes out a strong case. The ALI test, although also requiring particularized pleading, emphasizes the nature of the underlying claim on which the underlying action is brought, and, in particular, whether substantive review of that claim would be governed by the business-judgment rule or a more demanding standard. If a substantive review of the claim would be based on the business-judgment rule, so should a substantive review of a board or committee determination concerning a derivative suit based on that claim. If a substantive review or underlying claim would be based on a more demanding standard, the substantive review of a board or committee determination should be based on reasonability.

The ALI test is in my view preferable to the Delaware test, because it is anomalous to apply a business-judgment standard of review to a determination by directors concerning a transaction to which the law applies a more demanding standard of review, as may occur in theory under the Delaware test. In practice, however, the Delaware and ALI tests would probably produce the same result in most cases, because if the plaintiff alleges with particularity a violation of the duty of loyalty, the Delaware courts are likely to treat the case as one in which the plaintiff had alleged facts that, taken as true, would support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment, so that the board or committee determination will be subject to Delaware's higher, two-step standard of review.

(ii) *Should a standard of substantive review be codified*? This is a very difficult question. In favor of codification is that California law is not as clear as it could be. Against codification is that a complete codification of the rules that should govern this issue is no easy matter, as illustrated by Appendix B, which reproduces the relevant sections from the ALI's *Principles of Corporate Governance*.

On the other hand, Appendix B may somewhat overstate the problem. Many of the ALI provisions are procedural rather than substantive, and it would be possible to codify the substantive standard of review while allowing the courts to determine, on a case-by-case basis, whether proper procedures have been followed. On balance, I would favor codification, provided that a simple and appropriate codification was adopted.

IV. Suggested Codifications

If it is determined that the legislature should codify the substantive standard of review of a board or committee determination that an action against a director or officer is not in the corporation's best interests, I recommend adoption of one of the following two alternative formulations, listed in descending order of preference based on the considerations discussed above. The first alternative is a modified and highly simplified version of the ALI rule. The second is a modified version of the Delaware rule. Either could be added to section 800 as a new subsection (c).

Alternative I

> In a proceeding in which a corporation moves to dismiss a derivative action on the ground that the board, acting through disinterested and independent directors or a committee of disinterested and independent directors, has determined, either in response to a writing or proposed complaint under subdivision (b)(2) or after the action has been instituted, that the action would not be or is not in the corporation's best interests, the following standard of judicial review shall be applied to the board or committee determination:
>
> > (1) If in the absence of such a determination the transaction or conduct that would be or is the subject of the action would be judicially reviewed under the business-judgment rule, the board or committee determination should be accepted by the court 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 claims made in the writing or proposed complaint submitted to the board under subdivision (b)(2), or particularized allegations in an actual complaint where such a submission is not required, the transaction or conduct that would be or is the subject of the action would be judicially reviewed under a standard of reasonability, fairness, or justice, the board or committee determination should be accepted by the court if in making the determination the board or committee followed procedures that were appropriate under the circumstances and the determination is reasonable.

Alternative II

> In a proceeding in which a corporation moves to dismiss a derivative action on the ground that the board, acting through disinterested and independent directors or a committee of disinterested and independent directors, has determined, either in response to a writing or proposed complaint under subdivision (b)(2) or after the action was instituted, that the action would not be or is not in the corporation's best interests, the following standard of judicial review shall be applied to the board or committee determination:
>
> > (1) If the writing or proposed complaint submitted to the board under subdivision (b)(2) or, if such a submission is excused, the actual complaint, has not stated or alleged with particularity facts that taken as true 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 board or committee determination should be accepted by the court 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 the writing or proposed complaint submitted to the board under subdivision (b)(2) or, if such a submission is excused, the actual complaint, has stated or alleged with particularity facts that, taken as true,

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 determination should be accepted by the court if in making the determination the board or committee followed procedures that were appropriate under the circumstances and the determination is reasonable.

V. A.B. 920

The issues addressed in this background study are presently the subject of an Assembly Bill, A.B. 920, introduced by Assembly Member Cunneen on February 22, 1995. The Legislative Counsel's Digest accurately summarizes A.B. 920 as follows:

> Under existing law, a holder of shares or voting trust certificates may bring an action on behalf of a corporation against the board of the corporation if certain requirements are met. One requirement is that the plaintiff allege in his or her complaint the efforts to secure from the board the action that the plaintiff desires. If there has been no effort, the plaintiff must allege the reasons for not making the efforts.
>
> This bill would instead require that the plaintiff allege a demand to the board and the board's unjustifiable rejection of the demand. If the plaintiff does not make a demand, the plaintiff must allege facts from which the court can conclude that a majority of directors could not be expected to fairly evaluate themselves. The bill would provide that certain allegations, including that a majority of the directors would have to sue themselves, are not sufficient to meet this burden.
>
> The bill would also provide that in order to be considered an unjustifiable rejection of a demand, the board must have failed to exercise its business judgement either in considering or in rejecting the demand.

In detail, A.B. 920 would amend Cal. Corp. Code § 800 principally by revising subsection (b)(2), and adding a new subsection (c), as follows:

> (b) No action may be instituted or maintained in right of any domestic or foreign corporation by any holder of shares or of voting trust certificates of…the corporation unless …
>
> (2) The plaintiff alleges in the complaint with particularity plaintiff's efforts to secure from the board ~~such~~ *the* action ~~as~~ *that* plaintiff desires (the "*demand*") *and the board's unjustifiable rejection of the demand*, or the reasons for not making ~~such effort, and alleges further~~ *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.

(3) The plaintiff alleges in the complaint 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~~, *that* plaintiff proposes to file.

(c) *To constitute an "unjustifiable rejection" under paragraph (2) of subdivision (b), the board must fail to exercise its business judgment either in considering or in rejecting plaintiff's demand within a reasonable period of time after the plaintiff has informed the corporation of the ultimate facts of each cause of action pursuant to paragraph (3) of subdivision (b).*

The proposed revisions of subdivision (b)(2) are substantively unobjectionable. However, these revisions are probably unnecessary, because there is no evidence that California courts would deem that any of the factors listed in subdivision (b)(2)(A)-(E), 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.

On the surface, proposed new subdivision (c) may look like a codification of Delaware law, because subdivision (c) in effect differentiates between cases in which demand is required (where the standard of review is the business-judgement rule) and cases in which demand is excused (where the standard of review is unspecified, and indeed it is not clear that the board has the power to make any determination). In fact, however, proposed subdivision (c) differs radically from Delaware law. Delaware law applies a higher standard of review not only in cases where demand is excused because a majority of directors are interested, but also in cases where demand is excused because the plaintiff has alleged facts that, taken as true, would support a reasonable doubt that the transaction was the product of a valid business judgement. As shown above, the practical meaning of this alternative test is that in a strong, well-pleaded case, Delaware applies a higher, two-step standard of review, not the business-judgment rule. By omitting this alternative test, proposed subdivision (c) would take out the heart of the Delaware approach. Thus proposed subdivision (c) would relegate all decisions in all cases — even well-pleaded duty-of-loyalty cases — to the business judgement rule, contrary to sound policy and to the reasons that underlie present Cal. Corp. Code § 310.

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Appendix A

ALI § 704(a)

(a) Particularity; Demand Rejection.

(1) In General. The complaint shall plead with particularity facts that, if true, raise a significant prospect that the transaction or conduct complained of did not meet the applicable requirements of [the duty of care, the duty of loyalty, or the duty of directors in takeover cases] in light of any approvals of the transaction or conduct communicated to the plaintiff by the corporation.

(2) Demand Rejection. If the corporation rejects the demand…and if, at or following the rejection, the corporation delivers to the plaintiff a written reply to the demand which states that the demand was rejected by directors who were not interested…in the transaction or conduct described in and forming the basis for the demand and that those directors constituted a majority of the entire board and were capable as a group of objective judgment in the circumstances, and which provides specific reasons for those statements, then the complaint shall also plead with particularity facts that, if true, raise a significant prospect that either:

(A) The statements in the reply are not correct;

(B) If…the underlying transaction or conduct would be reviewed under the standard of the business judgment rule, that the rejection did not satisfy the requirements of the business judgment rule …; or

(C) If…the underlying transaction or conduct would be reviewed under a standard other than the business judgment rule, either (i) that the disinterested directors who rejected the demand did not satisfy the good faith and informational requirements…of the business judgment rule or (ii) that disinterested directors could not reasonably have determined that rejection of the demand was in the best interests of the corporation.…

This provision is accompanied by extensive and indispensable commentary. For example, the Comment to Principles of Corporate Governance § 7.04 provides in pertinent part that:

> As in all motions on the pleadings, the complaint should be interpreted in such a manner that doubts concerning well-pleaded facts are resolved in favor of the nonmoving party (here, the plaintiff).…The ultimate question in a motion to dismiss under §7.04(a)(2) is whether the plaintiff has alleged with particularity facts sufficient, if true, to raise a significant prospect, under the circumstances, that the standard of either Subsection (a)(2)(A), (B), or (C) is met.
>
> Section 7.04(a) does not attempt to quantify the standard of "significant prospect" in percentage terms, in part because of a belief that any such attempt would prove illusory in practice. The inquiry should be whether the complaint shows sufficient indications of legal merit and factual substance to justify the expenditure of the court's and the corporation's limited time and resources in permitting the action to proceed.
>
> Section 7.04(a)(1) and § 7.04(a)(2) state separate tests, so both are required to be met. There is nevertheless an interrelationship between the two tests. 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 satisfied the business judgment rule under § 7.04(a)(2)(B), or could not reasonably have determined that rejection of the demand was in the best interests of the corporation under §7.04(a)(2)(C).

Of course, the degree to which the particularized showing of a meritorious legal claim under § 7.04(a)(1) should carry over to influence the court's evaluation of the board's rejection of demand under § 7.04(a)(2) can depend on other factors as well. For example, although the "reasonable specificity" requirement for a demand in § 7.03(a) is a lesser standard than the "particularity" standard for the complaint under §7.04(a), the demand has to be sufficiently specific to warrant a reply to the demand that has the specificity contemplated in § 7.04(a)(2). The adequacy of the reply to the demand should therefore be weighed by the court in light of the specificity of the demand itself.

Similarly, when the plaintiff's particularized pleading sets out a strong and serious case, as tested under § 7.04(a)(1), particularly a case involving the duty of fair dealing or a knowing and culpable violation of law, the court should take into account, in considering a motion under § 7.04(a)(2), the fact that discovery will not have been available to the plaintiff at the time of pleading. For that reason, the processes the disinterested directors employed to inform themselves and the disinterested directors' reasons for rejection of the demand will be difficult or impracticable for the plaintiff to determine unless those processes and reasons are described in the reply to the demand or information concerning them is available without undue burden. In such cases, the court should consider, among other elements, any reasons provided in the reply for rejecting the demand, or the fact that no such reasons were provided, and any description in the reply of the processes by which the disinterested directors arrived at their decision, or the fact that those processes were not described. Although § 7.04(a)(2) does not require the corporation to state in the reply the reasons for rejection of the demand, a reply that does not state the reasons for the disinterested directors' rejection should be given only limited weight as against a particularized pleading that sets out a strong and serious case, as tested under § 7.04(a)(1).

The judicial balancing approach of § 7.04(a) should only be applied in situations in which the case set out by the plaintiff's particularized pleading, as tested under § 7.04(a)(1), is sufficiently strong and serious that the rejection of the demand, standing alone, would be difficult to understand. Accordingly, while the disinterested directors must inform themselves to the extent required under § 4.01(c)(2), a more substantial inquiry — possibly involving a costly and time-consuming review and evaluation by the board —need not be made except in situations when such a case is set out. For example, a duty of care case involving only a poor business decision would not evoke (absent some unique circumstance) this balancing approach or require a more substantial inquiry. Balancing will be more likely to be used in cases involving the duty of fair dealing or knowing and culpable violations of law, where the standard of review is stricter than the business judgment rule. In general, the depth and scope of the inquiry necessary to satisfy § 7.04(a)(2) will be less than that required by § 7.09 and should depend on the gravity and plausibility of the particularized allegations made by the plaintiff. On this basis, ordinary due care actions alleging poor business decisions, as well as other cases in which such a sufficiently strong and serious case has not been set out by the plaintiff's particularized pleading, as tested under § 7.04(a)(1), can normally be dealt with by the board in relatively summary fashion.

Appendix B

Provisions of the ALI's Principles of Corporate Governance, Concerning the Review of Determinations by a Board that a Derivative Action Is Not in the Corporation's Best Interests

§ 7.07 Dismissal of a Derivative Action Based on a Motion Requesting Dismissal by the Board or a Committee: General Statement

(a) The court having jurisdiction over a derivative action should dismiss the action as against one or more of the defendants based on a motion by the board or a properly delegated committee requesting dismissal of the action as in the best interests of the corporation, if:

(1) In the case of an action against a person [§ 1.28] other than a director [§ 1.13], senior executive [§ 1.33], or person in control [§ 1.08] of the corporation, or an associate [§ 1.03] of any such person, the determinations of the board or committee underlying the motion satisfy the requirements of the business judgment rule as specified in § 4.01;

(2) In the case of an action against a director, senior executive, or person in control of the corporation, or an associate of any such person, the conditions specified in § 7.08 (Dismissal of a Derivative Action Against Directors, Senior Executives, Controlling Persons, or Associates Based on a Motion Requesting Dismissal by the Board or a Committee) are satisfied; or

(3) In any case, the shareholders approve a resolution requesting dismissal of the action in the manner provided in § 7.11 (Dismissal of a Derivative Action Based Upon Action by the Shareholders).

(b) Regardless of whether a corporation chooses to proceed under § 7.08 or § 7.11, it is free to make any other motion available to it under the law, including a motion to dismiss the complaint or for summary judgment.

§ 7.08 Dismissal of a Derivative Action Against Directors, Senior Executives, Controlling Persons, or Associates Based on a Motion Requesting Dismissal by the Board or a Committee

The court should, subject to the provisions of §7.10(b) (retention of significant improper benefit), dismiss a derivative action against a defendant who is a director [§ 1.13], a senior executive [§ 1.33], or a person [§ 1.28] in control [§ 1.08] of the corporation, or an associate [§ 1.03] of any such person, if:

(a) The board of directors or a properly delegated committee thereof (either in response to a demand or following commencement of the action) has determined that the action is contrary to the best interests of the corporation and has requested dismissal of the action;

(b) The procedures specified in § 7.09 (Procedures for Requesting Dismissal of a Derivative Action) for the conduct of a review and evaluation of the action were substantially complied with (either in response to a demand or following commencement of the action), or any material departures therefrom were justified under the circumstances; and

(c) The determinations of the board or committee satisfy the applicable standard of review set forth in § 7.10(a) (Standard of Judicial Review with Regard to a Board or Committee Motion Requesting Dismissal of a Derivative Action Under § 7.08).

§ 7.09 Procedures for Requesting Dismissal of a Derivative Action

(a) The following procedural standards should apply to the review and evaluation of a derivative action by the board or committee under § 7.08 (Dismissal of a Derivative Action Against Directors, Senior Executives, Controlling Persons, or Associates Based on a Motion Requesting Dismissal by the Board or a Committee) or § 7.11 (Dismissal of a Derivative Actio Based Upon Action by the Shareholders):

(1) The board or committee should be composed of two or more persons, no participating member of which was interested [1.23] in the action, and should as a group be capable of objective judgment in the circumstances;

(2) The board or committee should be assisted by counsel of its choice and such other agents as it reasonably considers necessary;

(3) The determinations of the board or committee should be based upon a review and evaluation that was sufficiently informed to satisfy the standards applicable under § 7.10(a); and

(4) If the board or committee determines to request dismissal of the derivative action, it shall prepare and file with the court a report or other written submission setting forth its determinations in a manner sufficient to enable the court to conduct the review required under §7.10 (Standard of Judicial Review with Regard to a Board or Committee Motion Requesting Dismissal of a Derivative Action Under § 7.08).

(b) If the court is unwilling to grant a motion to dismiss under § 7.08 or § 7.11 because the procedures followed by the board or committee departed materially from the standards specified in § 7.09(a), the court should permit the board or committee to supplement its procedures, and make such further reports or other written submissions, as will satisfy the standards specified in § 7.09(a), unless the court decides that (i) the board or committee did not act on the basis of a good faith belief that its procedures an report were justified in the circumstances; (ii) unreasonable delay or prejudice would result; or (iii) there is no reasonable prospect that such further steps would support dismissal of the action.

§ 7.10 Standard of Judicial Review with Regard to a Board or Committee Motion Requesting Dismissal of a Derivative Action Under §7.08

(a) *Standard of Review*. In deciding whether an action should be dismissed under § 7.08 (Dismissal of a Derivative Action Against Directors, Senior Executives, Controlling Persons, or Associates Based on a Motion Requesting Dismissal by the Board or a Committee), the court should apply the following standards of review:

(1) If the gravamen of the claim is that the defendant violated a duty set forth in Part IV (Duty of Care and the Business Judgment Rule), other than by committing a knowing and culpable violation of law that is alleged with particularity, or if the underlying transaction or conduct would be reviewed under the business judgment rule under § 5.03, § 5.04, § 5.05, §5.06, § 5.08, or § 6.02, the court should dismiss the claim unless it finds

that the board's or committee's determinations fail to satisfy the requirements of the business judgment rule as specified in § 4.01(c).

(2) In other cases governed by Part V (Duty of Fair Dealing) or Part VI (Role of Directors and Shareholders in Transactions in Control and Tender Offers), or to which the business judgment rule is not applicable, including cases in which the gravamen of the claim is that defendant committed a knowing and culpable violation of law in breach of Part IV, the court should dismiss the action if the court finds, in light of the applicable standards under Part IV, V, or VI 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.

(3) In cases arising under either Subsection (a)(1) or (a)(2), the court may substantively review and determine any issue of law.

(b) *Retention of Significant Improper Benefit*. The court shall not dismiss an action if the plaintiff establishes that dismissal would permit a defendant, or an associate [§ 1.03], to retain a significant improper benefit where:

(1) The defendant, either alone or collectively with others who are also found to have received a significant improper benefit arising out of the same transaction, possesses control [§ 1.08] of the corporation; or

(2) Such benefit was obtained:

(A) As the result of a knowing and material misrepresentation or omission or other fraudulent act; or

(B) Without advance authorization or the requisite ratification of such benefit by disinterested directors [§ 1.15] (or, in the case of a non-director senior executive, advance authorization by a disinterested superior), or authorization or ratification by disinterested shareholders [§ 1.16], and in breach of § 5.02 (Transactions with the Corporation) or § 5.04 (Use by a Director or Senior Executive of Corporate Property, Material Non-Public Corporate Information, or Corporate Position);

unless the court determines, in light of specific reasons advanced by the board or committee, that the likely injury to the corporation from continuation of the action convincingly outweighs any adverse impact on the public interest from dismissal of the action.

(c) *Subsequent Developments*. In determining whether the standards of § 7.10(a) are satisfied or whether § 7.10(b) or any of the exceptions set forth therein are applicable, the court may take into account considerations set forth by the board or committee (or otherwise brought to the court's attention) that reflect material developments subsequent to the time of the underlying transaction or conduct or to the time of the motion by the board or committee requesting dismissal.

§ 7.13 Judicial Procedures on Motions to dismiss a Derivative Action Under § 7.08 or § 7.11

(a) *Filing of Report or Other Written Submission*. Upon a motion to dismiss an action under § 7.08 (Dismissal of a Derivative Action Against Directors, Senior Executives, Controlling Persons, or Associates Based on a Motion Requesting Dismissal by the Board or a Committee) or § 7.11 (Dismissal of a Derivative Action Based Upon Action by the Shareholders), the corporation shall file with the court a report or other written submission setting forth the procedures and determinations of the board or committee, or the resolution of the shareholders. A copy of the report or other written submission, including any supporting documentation filed by the corporation, shall be given to the plaintiff's counsel.

(b) *Protective Order*. The court may issue a protective order concerning such materials, where appropriate.

(c) *Discovery.* Subject to § 7.06 (Authority of Court to Stay a Derivative Action), if the plaintiff has demonstrated that a substantial issue exists whether the applicable standards of §7.08, § 7.09, § 7.10, § 7.11, or § 7.12 have been satisfied and if the plaintiff is unable without undue hardship to obtain the information by other means, the court may order such limited discovery or limited evidentiary hearing, as to issues specified by the court, as the court finds to be (i) necessary to enable it to render a decision on the motion under the applicable standards of § 7.08, § 7.09, § 7.10, § 7.11, or § 7.12, and (ii) consistent with an expedited resolution of the motion. In the absence of special circumstances, the court should limit on a similar basis any discovery that is sought by the plaintiff in response to a motion for summary judgment by the corporation or any defendant to those facts likely to be in dispute. The results of any such discovery may be made subject to a protective order on the same basis as under § 7.13(b).

(d) *Burdens of Proof.* The plaintiff has the burden of proof in the case of a motion (1) under § 7.08 where the standard of judicial review is determined under § 7.10(a)(1) because the basis of the claim involves a breach of a duty set forth in Part IV (Duty of Care and the Business Judgment Rule) or because the underlying transaction would be reviewed under the business judgment rule, or (2) under § 7.07(a)(1) (suits against third parties and lesser corporate officials). The corporation has the burden of proof in the case of a motion under § 7.08 where the standard of judicial review is determined under § 7.10(a)(2) because the underlying transaction would be reviewed under a standard other than the business judgment rule, except that the plaintiff retains the burden of proof in all cases to show (i) that a defendant's conduct involved a knowing and culpable violation of law, (ii) that the board or committee as a group was not capable of objective judgment in the circumstances as required by § 7.09(a)(1), and (iii) that dismissal of the action would permit a defendant or an associate [§ 1.03] thereof to retain a significant improper benefit under § 7.10(b). The corporation shall also have the burden of proving under § 7.10(b) that the likely injury to the corporation from continuation of the action convincingly outweighs any adverse impact on the public interest from dismissal of the action. In the case of a motion under § 7.11 (Dismissal of a Derivative Action Based Upon Action by the Shareholders), the plaintiff has the burden of proof with respect to § 7.11(b), (c), and (d), and the corporation has the burden of proof with respect to § 7.11(a).

(e) *Privilege.* The plaintiff's counsel should be furnished a copy of related legal opinions received by the board or committee if any opinion is tendered to the court under § 7.13(a). Subject to that requirement, communications, both oral and written, between the board or committee and its counsel with respect to the subject matter of the action do not forfeit their privileged character, and documents, memoranda, or other material qualifying as attorney's work product do not become subject to discovery, on the grounds that the action is derivative or that the privilege was waived by the production to the plaintiff or the filing with the court of a report, other written submission, or supporting documents pursuant to § 7.13.