that a shareholder had to suffer some special injury in order to state a direct claim. The Delaware Supreme Court affirmed the dismissal, but in doing so restated the test for determining whether a suit is to be treated as derivative or direct: "We set forth in this Opinion the law to be applied henceforth in determining whether a stockholder's claim is derivative or direct. That issue must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing shareholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)?" Thus, the Supreme Court removed from the analysis the question of special injury as being the mark of a direct claim.

In *Tooley*, the Supreme Court dismissed the complaint on the grounds that the shareholder plaintiffs had no individual right to have the merger occur at all. From the corporation's perspective as well, there was no wrong alleged. Nevertheless, if there had been a claim stated, it would have been a direct claim, because a shareholder does have a right to bring a direct action for injuries affecting his or her legal rights as a shareholder.

This case shows the limited utility of the special injury concept. Here, while the claim (such as it was) was shared by all shareholders and thus was not "special," it was nevertheless individual (if a legal right had been asserted at all). The restatement in *Tooley* is clarifying, but does not constitute a change in the law.[4]

10.2 Solving a Collective Action Problem: Attorneys' Fees and the Incentive to Sue

As was observed in Chapter 6, the collective action problem is fundamental in the governance of public companies with dispersed share ownership. Where all investors hold small stakes in the enterprise, no single investor has a strong incentive to invest time and money in monitoring management. Nor are derivative or class suits practical if shareholders lack the time and money necessary to prosecute them. Of course, if minority shareholders own large fractions of company shares, as is common in closely held companies, their stakes alone might induce them to bring suit. But if the shareholder suit is to enforce fiduciary duties in widely held corporations, small shareholders must be motivated to prosecute meritorious claims. Incentives for small shareholders — or at least a proxy for them — evolved from the court of equity's practice of awarding attorneys' fees to plaintiffs whose litigation created a common fund that benefited all shareholders. Consequently, a large majority of shareholder suits against the directors and officers of public companies today are initiated by the plaintiffs' bar. The attorneys who bring these suits seek to earn fees from positive outcomes for the "real parties" of interest, the corporation and

4. Recently, the Delaware Supreme Court relied on *Tooley* again in *Citigroup Inc. v. AHW Investment Partnership*, 140 A.3d 1125 (Del. 2016).

its shareholders. Plaintiffs' attorneys are paid — or not — by order of the court or as part of a settlement at the conclusion of the litigation. In form, these attorneys are the economic agents of their shareholder-clients. In substance, they are legal entrepreneurs motivated by the prospect of attorneys' fees.

Whether an attorney for the plaintiff in a shareholder action receives a fee at all turns on whether the suit is dismissed or a judgment is entered in the suit, either through litigation (rare) or settlement (common). The plaintiffs' attorney receives nothing when a derivative suit is dismissed because there is no recovery and no benefit. When a derivative suit succeeds on the merits or settles (the usual outcome), the corporation is said to benefit from any monetary recovery or governance change resulting from the litigation. However, the corporation and its insurer also generally bear the bulk of litigation costs on both sides. The company is likely to have advanced the cost of defense to its managers (e.g., via indemnification agreements), and it must usually pay the plaintiff a sum for "costs" that, in the case of monetary recoveries, range from a couple of percent (where the financial benefit is very large) up to as much as 30 percent in some cases. While the formulas used to calculate attorneys' contingent fees differ by jurisdiction and suit, the percentage of the recovery awarded for legal costs remains surprisingly stable.[5]

FLETCHER v. A.J. INDUSTRIES, INC.

72 Cal. Rptr. 146, 266 Cal. App. 2d 313 (1968)

RATTIGAN, A.J.:

This appeal is from certain orders entered in a stockholders' derivative action against appellant A.J. Industries, Inc. (hereinafter called the "corporation," or "AJ"). . . . The named defendants included the corporation; respondents Ver Halen and Malone . . . [and other members of A.J.'s board of directors].

The complaint alleged generally that . . . Ver Halen had dominated and controlled the board and the management of the corporation . . . and that, in consequence, the corporation had been damaged in the various transactions. . . . The complaint prayed for several forms of relief on behalf of the corporation, including a money judgment against Ver Halen for $134,150 and one against all the individual defendants in the amount of $1,000,000. . . .

During the course of a protracted hearing . . . a settlement of the action was negotiated. . . .

The "executory provisions" of the stipulation included these agreements: Four incumbent directors were to be replaced by persons acceptable to plaintiffs, to Ver Halen, and to the corporation; failing their agreement, the new directors were to be appointed by the trial court. The corporation agreed to employ a new officer who would be in charge of its "operations," and who would be one of the four new directors. In the election of future

5. See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. Econ. & Org. 55 (1991).

directors, Ver Halen's voting powers as a stockholder were to be limited so as to permit him to elect only two of the board's nine members. His employment contract was to be amended to provide that he could be employed as president of the corporation or, at the board's option, as chairman of the board. Malone was to be one of the directors replaced, and he was to resign as the corporation's treasurer.

Several of the specific charges alleged in plaintiffs' complaint related to claimed mismanagement of the corporation due to Ver Halen's "domination" of its affairs; to Malone's allegedly excessive salary; and to Ver Halen's asserted breach of his employment contract. The stipulated agreements summarized above apparently disposed of these matters.

Most of the other charges made in the complaint related to specific transactions in which plaintiffs asserted misconduct on the part of Ver Halen. In other "executory provisions" of the stipulation it was agreed that these would be referred to arbitration. . . .

Whether the corporation was entitled to monetary recovery in any respect was, thus, to be determined in the future. In contrast, the stipulated agreements — providing for the reorganization of the corporation's board of directors and its management, the ouster of Malone, and the amendment of Ver Halen's contract of employment — were to be performed immediately.

The stipulation further provided that the arbitrator could award attorneys' fees, to be paid by the corporation, to any counsel who appeared in the arbitration proceeding, except that plaintiffs' attorneys could be awarded fees only in the event the corporation received a monetary award. The parties acknowledged (1) that plaintiffs' . . . attorneys intended to apply to the trial court — as distinguished from the future arbitrator — for fees and costs to be paid to them by the corporation "in connection with this action," but (2) that the corporation could take "any position in connection with such applications that it may choose." . . .

In its order granting plaintiffs' application for attorneys' fees and costs, the trial court found that they had employed their attorneys to prosecute the derivative action, in good faith, on behalf of themselves and the other stockholders of the corporation, and that the corporation was able to pay the fees and costs incurred. The court also found that by reason of the action, and its settlement, "substantial benefits have been conferred" upon the corporation.[2]

2. [I]n the following particulars, to wit:

> a) That by reason of the settlement of said action, and without regard to whether plaintiffs or defendants would have been successful in the ultimate outcome thereof, the defendant A.J. Industries, Inc., a corporation, has been saved substantial expenditures for attorneys' fees, costs, and the loss of valuable time of valued employees by reason of the fact that the settlement and compromise obviates the necessity of a trial of this cause on its merits. Probable expenditures by the corporation, aforesaid, have been estimated by witnesses offered by defendants to be in excess of the sum of $200,000.00.
>
> b) That by reason of said settlement the rights of the defendant corporation, if any, to recover from the defendant C.J. Ver Halen monies . . . has been fully protected and reserved in that a fair and equitable arbitration proceeding is provided for as a part of the terms of said settlement. . . .

Based upon these findings, the court ordered the corporation to pay plaintiffs' attorneys' fees ($64,784) and costs ($2,179.26).

. . . Under the general rule in California and in most American jurisdictions, the party prevailing in an action may not recover attorneys' fees unless a statute expressly permits such recovery. . . .

An exception to the general rule is found, however, in the so-called common-fund doctrine. . . . "It is a well-established doctrine of equity jurisprudence that where a common fund exists to which a number of persons are entitled and in their interest successful litigation is maintained for its preservation and protection, an allowance of counsel fees may properly be made from such fund. By this means *all* of the beneficiaries of the fund pay their share of the expense necessary to make it available to them." . . .

Under the "substantial benefit" rule, a variant of the common-fund doctrine as applied more recently in other jurisdictions, the successful plaintiff in a stockholder's derivative action may be awarded attorneys' fees against the corporation if the latter received "substantial benefits" from the litigation, although the benefits were not "pecuniary" and the action had not produced a fund from which they might be paid. . . .

In the present case, some of the causes of action alleged in plaintiffs' complaint might have produced a "common fund" in the form of a money judgment against appellant corporation. None, however, did: they were referred to an arbitration proceeding which was to be conducted in the future. For the obvious reason that no fund existed, the trial court applied the substantial-benefit rule . . . under which the award of attorneys' fees is charged directly against the corporation. . . .

[W]e conclude, that under the California rule (1) an award of attorneys' fees to a successful plaintiff may properly be measured by, and paid from, a common fund where his derivative action on behalf of a corporation has recovered or protected a fund in fact; but (2) the existence of a fund is not a prerequisite of the award itself. . . .

The stockholder's derivative suit . . . is an effective means of policing corporate management. [It] should not be inhibited by a doctrine which limits the compensation of successful attorneys to cases which produce a monetary recovery: the realization of substantial, if nonpecuniary, benefits by the corporation should [also] be the criterion. . . .

The final question . . . is whether the benefits realized by the corporation were sufficiently "substantial" to warrant the award. To find that they were, . . . [i]t will suffice if the [trial] court finds, upon proper evidence, that the results of the action "maintain the health of the corporation and raise the standards of 'fiduciary relationships and of other economic behavior,'" or "*prevent* an abuse which would be prejudicial to the rights and interests of the corporation or affect the enjoyment or protection of an essential right to the stockholder's interest." [Citation omitted.] . . .

It is not significant that the "benefits" found were achieved by settlement of plaintiffs' action rather than by final judgment. The authorities recognizing the substantial-benefit rule have permitted attorneys' fee awards in settled cases. . . . This is in keeping with the law's general policy favoring settlements . . . and in a stockholder's derivative action the trial court is in a position to scrutinize the fairness of a settlement because the court alone can authorize the action's dismissal. . . .

Some of the "benefits" found by the trial court in the present case related to the comparative economy to be realized by proceeding in arbitration rather than in conventional adversary litigation. Other "benefits," though, were realized in the form of immediate changes in the corporate management. The corporation argues that some of these had been under consideration by its board of directors before plaintiffs sued and settled, and that the real value of others is speculative. But the trial court found that the changes were substantial as benefits to the corporation and, in effect, that plaintiffs' action had brought them about. The finding is supported by ample evidence, and it is decisive on the appeal. We therefore affirm the award of attorneys' fees.

Christian, J. (dissenting in part).

. . . The majority opinion refers to certain considerations of policy which appear to indicate that it would be a good thing to allow attorneys' fees against a corporation when one of its shareholders succeeds in a derivative action and substantial benefit to the corporation results. . . . But countervailing policy arguments are not lacking: for example, if the existence of a "common fund" . . . is not prerequisite to the allowance of fees the officers and directors [of the corporation] may well be faced with a liquidation of assets to pay fees, even though resulting harm to the corporation might be disproportionate to the "substantial benefits" derived from the lawsuit. Considerations of this character can better be appraised in the legislative process than by the [courts]. Moreover, it appears likely that the new enlargement of the "common fund" exception to the rule laid down in the statute may greatly outweigh in practical importance the court-created exception on which it is to be grafted. The variety of shareholders' actions in which "substantial benefit" to the corporation may be found is literally boundless. . . .

QUESTIONS ON FLETCHER v. A.J. INDUSTRIES, INC.

1. What was the "substantial benefit" conferred on the corporation by the derivative suit in this litigation?
2. The rationale for shifting from the traditional common fund doctrine to the substantial benefit test for attorneys' fees is obvious. Is there a counterargument as well? What new risk is introduced by the substantial benefit test? How do you imagine courts deal with that risk?
3. Should the avoidance of litigation costs figure among the "benefits" conferred by the settlement of a derivative suit?

NOTE ON AGENCY COSTS IN SHAREHOLDER LITIGATION

The role of lawyer as bounty hunter creates an obvious agency problem in its own right. Legally, the plaintiffs' lawyers are agents of shareholders, just as the defendants are fiduciaries for the corporation and its shareholders. But both sides have important individual interests at stake: lawyers' fees on one side and the potential liability of corporate officers and directors on the other.

Much of the law of derivative suits is an effort to deal with these crosscutting agency problems. One such problem is that plaintiffs' lawyers may initiate so-called strike suits, or suits without merit, simply to extract settlements by exploiting the nuisance value of litigation and the personal fears of liability — even if unfounded — of officers and directors. A second problem is that defendants may be too eager to settle because they bear at least some of the costs of litigation personally (e.g., the pain of depositions and the risk of personal liability), but they do not bear the cost of settling, which is borne by the corporation or its insurer. Strike suits have long been a concern of the corporate bar and are widely discussed in the literature.[6] One controversial article has even argued that the merits of litigation are unrelated to settlement amounts in the related context of securities class actions.[7]

Agency problems also arise when shareholder litigation is meritorious and corporate managers face a serious prospect of liability. In this case, both plaintiffs' attorneys and defendants — if these defendants control their corporations — have an incentive to settle on mutually advantageous terms that allow the defendants to fully escape personal liability for their conduct.

Finally, the legal system itself can generate agency problems by structuring attorneys' fees in dysfunctional ways. For example, awarding plaintiffs' attorneys a percentage of the recovery may encourage premature settlement. The chief alternative fee rule, the so-called lodestar formula sometimes used in federal securities litigation, pays attorneys a base hourly fee for the reasonable time expended on a case, inflated by a multiplier to compensate for unusual difficulty or risk. By decoupling attorneys' fees from the recovery amount, this rule eliminates the incentives of attorneys to settle too soon, but it creates the opposite incentive to spend too much time litigating relative to the likely settlement outcomes.[8] Finally, as a reaction to the evident weaknesses in both techniques for the awarding of attorneys' fees, some courts have experimented with auctioning the rights to represent the corporation (or the class of shareholders) to the law firm that makes the best bid. But even this technique is vulnerable to "gaming" by plaintiffs' attorneys. The

6. See, e.g., Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. Econ. & Org. 55 (1991); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986).

7. Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991). For criticism of this initial study, see, e.g., Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 San Diego L. Rev. 959, 964 (1996). For more recent empirical work on this question, compare Marilyn F. Johnson, Karen K. Nelson & A.C. Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. Econ. & Org. 627 (2007) (finding a "closer relation between factors related to fraud and the filing of securities class actions after the passage of the PSLRA") with Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. Econ. & Org. 598 (2007) (reporting some evidence that meritorious suits were deterred by the PSLRA).

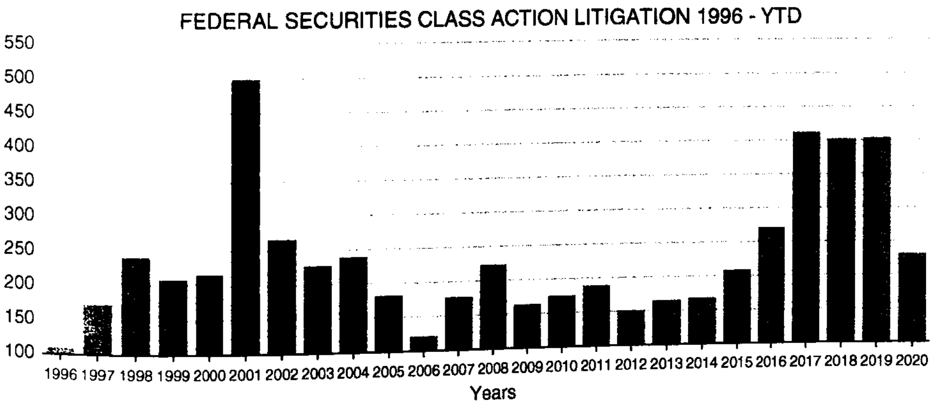
8. See, e.g., John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor of Shareholder Litigation*, 48 Law & Contemp. Probs. 5 (1985).

incentives of bidding firms may, for example, lead to low bids that permit a lawyer to control the case in order to negotiate a settlement.[9]

Thus, while paying bounties to plaintiffs' lawyers mitigates the shareholders' collective action problem in widely held corporations, it also gives rise to new risks and challenges for the legal system. Much of what follows in this chapter — specifically the law of pre-suit demand and the law of dismissal by independent board committees — can be understood as judicially created measures intended to fine-tune the power and incentives of plaintiffs' lawyers to pursue shareholder suits.

In addition to these judicial innovations, there have been several statutory responses to the agency problems of fee-driven litigation. Beginning in the 1940s, a number of states adopted "security for expenses" statutes, which permitted corporations to require plaintiffs (or their attorneys) to post a bond to secure coverage of the company's anticipated expenses in the litigation. See, e.g., NYBCL §627; Cal. Corp. Code §800. The purpose of these statutes was to add a stick to the carrot of attorneys' fees — to engineer a fee rule that would discourage strike suits as well as encourage meritorious litigation. But however attractive this approach seems in theory, it appears to have failed in practice. Savvy plaintiffs' attorneys, reluctant defendants, and sympathetic judges together ensure that plaintiffs are rarely forced to post bonds and are virtually never charged with the litigation costs of defendants.[10]

General dissatisfaction with the growth in the number of securities class actions led to enactment of the federal Private Securities Litigation Reform Act (PSLRA) of 1995.[11] That statute embraces a variety of devices to discourage non-meritorious suits, such as particularized pleading requirements, stays in discovery, and changes in substantive law, and to encourage institutional shareholders to assume control of shareholder litigation under the "most adequate plaintiff" rule considered below. The chart below shows the number of securities class actions filed since 1996.



Source: Stanford Law School Securities Class Action Clearinghouse.

9. See Third Circuit Task Force Report on Selection of Class Counsel, 74 Temple L. Rev. 685 (2001).

10. See Robert Clark, Corporate Law §15.5.

11. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified throughout 15 U.S.C. §§77-78).

Initially, new securities fraud filings decreased after the PSLRA was passed, but only for a year or two. Filings returned to their 1994 (pre-PSLRA) level of approximately 200 new cases per year, then exploded in 2001 with a wave of "IPO Allocation" lawsuits, alleging that underwriters engaged in undisclosed practices in connection with the distribution of IPO (initial public offering) shares. The year 2008 was also a very good year for securities class actions in the wake of the Great Recession against financial institutions. After that, filings stabilized for a few years before increasing dramatically after 2015 to roughly 400 cases annually. These data support the conventional wisdom that the PSLRA was only a minor speed-bump for plaintiffs' lawyers on the way to the courthouse and that the "fundamentals" such as stock market volatility are more important drivers of overall litigation activity.[12] The recent uptick in securities filings during a period of relatively low price volatility reflects a migration of litigation from the Delaware courts to federal courts after an important Chancery Court decision (*In re Trulia*) that we discuss in Section 10.5.2. Visit the Stanford Securities Class Action Clearinghouse on the internet for a trove of data on this topic, including total amount of dollars expended in settlements.

10.3 Standing Requirements

Standing requirements that screen who may bring a derivative suit are established both by statute and by court rule. See, e.g., 10 Del. Code Com. §327; Fed. R. Civ. P. 23.1. They are premised on the assumption that screening for qualified litigants increases the quality of shareholder litigation, that is, that some potential litigants have better incentives to sue than others. (Compare, from this perspective, the various standing requirements for derivative suits in your statutory supplement: Fed. R. Civ. P. 23.1; MBCA §7.41; and ALI Principles of Corporate Governance §7.02.) Federal Rule 23.1, which Delaware also follows, typifies standing rules for derivative actions. First, the plaintiff must be a shareholder for the duration of the action. (Why? What shapes the incentives of a plaintiff who sues on behalf of a company in which she no longer has any financial interest?) Second, the plaintiff must have been a shareholder at the time of the alleged wrongful act or omission (the "contemporaneous ownership rule"). This requirement reflects the traditional bias of courts against plaintiffs who "buy a lawsuit." In public companies, however, this rule is not very important, since shareholders are easy to find. Third, the plaintiff must be able to "fairly and adequately" represent the interests of shareholders, meaning in practice that there are no obvious conflicts of interest.[13] Finally, the complaint

12. See, e.g., Cornerstone Research, Securities Class Action Case Filings: 2005.

13. The requirement that a plaintiff remain a shareholder during the course of litigation, which arises from judicial construction of "fair and adequate" representation under Rule 23.1,

10.4 Balancing the Rights of Boards to Manage the Corporation and Shareholders' Rights to Obtain Judicial Review

An important set of legal doctrines balances the right of boards to manage their companies (including their potential legal claims) against the rights of shareholder-plaintiffs to obtain judicial review of alleged corporate malfeasance. The issue of when a shareholder-plaintiff may pursue a claim on behalf of a corporation without board authorization or despite its opposition arises in several contexts. First, it arises when a company's board considers a shareholder's demand to bring suit, as Rule 23.1 contemplates, but rejects it. Here the court must decide whether or not to defer to the board's business judgment in electing not to prosecute the action. The issue of deference to the board also arises when the shareholder-plaintiff does *not* make demand on the board, on the ground that the board could not exercise disinterested business judgment. Here the court must pass on the validity of the plaintiff's excuse for not making pre-suit demand. In addition, the question of board deference arises when the board seeks to terminate a derivative suit at a later point in the litigation, after the suit has already survived the company's initial motion to dismiss. That is, even if the company's board was disqualified from dismissing the suit as of when the complaint was filed, may be the board subsequently regains competence by delegating authority over the matter to a committee of independent directors who may have been appointed to the board well after litigation began.[16] Finally, the need for courts to balance the rights of management and shareholders in derivative suits also arises in connection with the settlement of shareholder suits. We discuss settlements in Section 10.5.

10.4.1 The Demand Requirement of Rule 23.1

The demand requirement originates in the traditional rule that a derivative complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . or the grounds for not making the effort." Fed. R. Civ. P. 23.1

16. While this may seem like a transparent attempt to defeat and punish derivative plaintiffs, there are circumstances when it is clearly appropriate. Imagine, for example, that a hostile takeover follows the initiation of a derivative suit. Even though the old board may have been implicated in the matter sued on, the new board is not and therefore should be given its rights to manage the company's claim in litigation. The matter becomes far less clear when the company's newfound ability to make a valid business judgment comes, not from a complete turnover of the board, but from the appointment of one or two new directors, who thereafter are appointed to a special committee to review the matter. This is the situation presented in the well-known Delaware case of *Zapata Corp. v. Maldanado*, set forth below.

(Delaware has an identical rule). But under what circumstances may a complaint be dismissed once the plaintiff does — or does not — make a demand on the board? The answer is a matter of common law.

DEMAND EXCUSED: A NOTE ON ARONSON v. LEWIS *AND ITS PROGENY*

Plaintiffs' attorneys prefer not to make demand on the board for the understandable reason that it is likely to be refused, in which case plaintiffs are treated as having waived any objection to the board's independence. See *Spiegel v. Buntrock*, 571 A.2d 767 (Del. 1990).[17] For Delaware corporations at least, plaintiffs' usual strategy is to plead that demand should be excused because it would be futile — the board is too interested or otherwise muddled to exercise unbiased business judgment. But how should Delaware courts decide "demand-futility" claims? More likely than not, the entire corporate board will be defendants in such cases, making it "interested" in a formal sense. On the other hand, if a court were to require proof that a board was interested in the alleged misconduct prior to any discovery, derivative actions would be almost impossible to bring. The Delaware Supreme Court sought a middle way that implicitly gave the Chancery Court a strong screening function.

The controlling Delaware Supreme Court case is *Aronson v. Lewis*, 433 A.2d 805 (1984). The *Aronson* case involved a favorable deal between a company and its 47 percent shareholder/director. The court, per Justice Moore, rejected plaintiff's demand-futility claim, which had stressed the dominant shareholder's power over board appointments. Instead, the *Aronson* court framed the following test:

> . . . "[I]n determining demand-futility the Court of Chancery in a proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." 473 A2d at 814.

The *Aronson* decision naturally gave rise to later case law parsing the meaning of this test.

Among the more instructive (and amusing) of these cases is *Levine v. Smith*, 591 A.2d 194 (Del. 1991), in which the plaintiffs challenged a transaction between General Motors and its best-known outside director of the time, Ross Perot — an acerbic billionaire and later two-time third-party

17. The holding that plaintiffs concede board independence by making demand appears to have been partly qualified by a more recent case, although just how much is difficult to say. See *Scattered Corp. v. Chicago Stock Exchange, Inc.*, 701 A.2d 70 (Del. 1997) ("It is not correct that a demand concedes independence 'conclusively' and in futuro for all purposes relevant to the demand.").

candidate for the U.S. presidency. Perot had sold his company to GM in 1984 and became its largest shareholder and a director, but once on the inside Perot challenged GM's bureaucratic ways and turned to public invective when his suggestions were ignored. One can imagine that GM's management was eager to buy out Perot's stake after its most visible director accused the company of selling "second-rate cars."[18] Whether Perot was simply candid or an astute businessman — or both — we will never know. What is certain is that he received a rich buyout price from GM that almost tripled the value of his holdings in two years. The details of this case are well worth exploring for their own sake, but we restrict ourselves here to *Levine*'s two principal doctrinal contributions.

The first of these was whether the two parts of the *Aronson* test for demand futility were conjunctive or disjunctive. In other words, does establishing demand futility require a reasonable doubt that the board was disinterested *and* that the past transaction at the heart of the complaint was not "the product of a valid exercise of business judgment," or would particularized evidence of either of the propositions suffice? *Levine*'s language indicated that the test was disjunctive, so a reasonable doubt that either today's board is not disinterested *or* that yesterday's challenged transaction was not an exercise of disinterested business judgment might suffice to excuse demand. But how are *Aronson*'s two prongs related? Why should yesterday's board decision affect the ability of today's board to pass on the merits of an action brought by the corporation today? We turn to this second question in the *Rales* case following the note on pre-suit demand.

NOTE ON PRE-SUIT DEMAND

Aronson v. Lewis and *Levine v. Smith* raise many other issues. The most fundamental of these was taken up by the ALI in its Principles of Corporate Governance project: Is the traditional equity rule of pre-suit demand, with its exception for futility, the best way to adjudicate the board's colorable disability to claim sole right to control the adjudication of corporate claims? The drafters of the ALI's Principles concluded that the answer was "no." Instead, the ALI proposed a rule of universal demand, under which a plaintiff would be required to always make a demand, and if, as is likely, she was not satisfied with the board's response to her demand, she could institute suit. If the defendants thereafter sought dismissal of the suit, the court would review the board's exercise of business judgment in making its response. If the court concluded that the board was in a position to exercise a valid business judgment on the question of whether suit should be brought, then it would dismiss the

18. This is a tame example. According to a Washington Post article "[n]ot only had [Perot] humiliated Smith [GM's CEO] last fall when he suggested to Business Week that trying to change GM was like "teaching an elephant to tap-dance," he had also slammed the company for coddling executives, producing second-rate cars, and losing the race not only to the Japanese, but to Ford as well." David Remnick, *H. Ross Perot to GM I'll Drive*, The Washington Post, April 19, 1987.

MARCHAND v. BARNHILL
212 A.3d 805 (Del. 2019)

STRINE, C.J.:

The defendants moved to dismiss the complaint for failure to plead demand futility. The Court of Chancery . . . held that [a]lthough the complaint alleged facts sufficient to raise a reasonable doubt as to the impartiality of a number of Blue Bell's directors, the plaintiff ultimately came up one short . . . the plaintiff needed [to raise such doubts about the impartiality of] eight directors but only had seven. . . . [W]e reverse. . . .

We . . . hold that the complaint pleads particularized facts sufficient to create a reasonable doubt that an additional director, W.J. Rankin, could act impartially in deciding to sue Paul Kruse, Blue Bell's CEO, . . . due to Rankin's longstanding business affiliation and personal relationship with the Kruse family. . . . Despite the defendants' contentions that Rankin's relationship with the Kruse family was just an ordinary business relationship from which Rankin would derive no strong feelings of loyalty toward the Kruse family, [the plaintiffs'] allegations are "suggestive of the type of very close personal [or professional] relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment."[7] Rankin's . . . ties to the Kruse family raise a reasonable doubt as to whether Rankin could "impartially or objectively assess whether to bring a lawsuit against the sued party."[8] . . .

[T]he Court of Chancery held that the plaintiff "failed to plead particularized facts to raise a reasonable doubt that a majority of the [Blue Bell board] members could have impartially considered a pre-suit demand." Without belaboring the details of the Court of Chancery's thorough analysis, . . . we note that the court essentially ruled that the plaintiff came up one vote short. To survive the Rule 23.1 motion to dismiss, the complaint needed to allege particularized facts raising a reasonable doubt that directors holding eight of the 15 votes could have impartially considered a demand, but the court held that the plaintiff had done so for directors holding only seven votes.

One of the directors who the trial court held could consider demand impartially was Rankin, Blue Bell's recently retired former CFO. Although Rankin worked at Blue Bell for 28 years, the court emphasized that he was no longer employed by Blue Bell, having retired in 2014 [and that other allegations] . . . fell short of Rule 23.1's particularity requirement. Further, the court noted that Rankin voted against rescinding a board initiative to split the CEO and Chairman positions held by Paul Kruse. In the court's view, that act was evidence that Rankin was not beholden to the Kruse family. . . .

A. RANKIN'S INDEPENDENCE

On appeal, both parties agree that the *Rales* standard applies, and we therefore use it to determine whether . . . a majority of the board was

7. *Sandys v. Pincus*, 152 A.3d 124, 130 (Del. 2016).
8. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 942 (Del. Ch. 2003).

independent for pleading stage purposes. "[A] lack of independence turns on 'whether the plaintiffs have pled facts from which the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party."[86] When it comes to life's more intimate relationships concerning friendship and family, our law cannot "ignore the social nature of humans" or that they are motivated by things other than money, such as "love, friendship, and collegiality. . . ."[87]

From the pled facts, there is reason to doubt Rankin's capacity to impartially decide whether to sue members of the Kruse family. For starters, one can reasonably infer that Rankin's successful career as a businessperson was in large measure due to the opportunities and mentoring given to him by Ed Kruse, Paul Kruse's father, and other members of the Kruse family. The complaint alleges that Rankin started as Ed Kruse's administrative assistant and, over the course of a 28-year career with the company, rose to the high managerial position of CFO. Not only that, but Rankin was added to Blue Bell's board in 2004, which one can reasonably infer was due to the support of the Kruse family. Capping things off, the Kruse family spearheaded charitable efforts that led to a $450,000 donation to a key local college, resulting in Rankin being honored by having Blinn College's new agricultural facility named after him. On a cold complaint, these facts support a reasonable inference that there are very warm and thick personal ties of respect, loyalty, and affection between Rankin and the Kruse family, which creates a reasonable doubt that Rankin could have impartially decided whether to sue Paul Kruse and his subordinate Bridges.

Even though Rankin had ties to the Kruse family that were similar to other directors that the Court of Chancery found were sufficient at the pleading stage to support an inference that they could not act impartially in deciding whether to cause Blue Bell to sue Paul Kruse, the Court of Chancery concluded that because Rankin had voted differently from Paul Kruse on a proposal to separate the CEO and Chairman position, these ties did not matter. In doing so, the Court of Chancery ignored that the decision whether to sue someone is materially different and more important than the decision whether to part company with that person on a vote about corporate governance, and our law's precedent recognizes that the nature of the decision at issue must be considered in determining whether a director is independent.[95]

As important, at the pleading stage, the Court of Chancery was bound to accord the plaintiff the benefit of all reasonable inferences, and the pled facts

86. *Sandys v. Pincus*, 152 A.3d 124, 128 (Del. 2016) (quoting *Del. Cty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1024 n.25 (Del. 2015)).

87. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) ("Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement.") . . .

95. *See Sandys v. Pincus*, 152 A.3d 124, 134 (Del. 2016) ("Causing a lawsuit to be brought against another person is no small matter, and is the sort of thing that might plausibly endanger a relationship."); . . . *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 940 (Del. Ch. 2003) (". . . It is, I daresay, easier to say no to a friend, relative, colleague, or boss who seeks assent for an act (e.g., a transaction) that has not yet occurred than it would be to cause a corporation to sue that person [, which may involve finding] . . . that the fellow director has committed serious wrongdoing. . . .")

fairly support the inference that Rankin owes an important debt of gratitude and friendship to the Kruse family for giving him his first job, nurturing his progress from an entry level position to a top manager and director, and honoring him by spearheading a campaign to name a building at an important community institution after him. Although the fact that fellow directors are social acquaintances who occasionally have dinner or go to common events does not, in itself, raise a fair inference of non-independence, our law has recognized that deep and long-standing friendships are meaningful to human beings and that any realistic consideration of the question of independence must give weight to these important relationships and their natural effect on the ability of the parties to act impartially toward each other. As in cases like *Sandys v. Pincus*[97] and *Delaware County Employees Retirement Fund v. Sanchez*,[98] the important personal and business relationship that Rankin and the Kruse family have shared supports a pleading-stage inference that Rankin cannot act independently.

Because the complaint pleads particularized facts that raise a reasonable doubt as to Rankin's independence, we reverse the Court of Chancery's dismissal of the plaintiff's claims against management for failure to adequately plead demand futility.

NOTE AND QUESTIONS ON ABA AND ALI PROPOSALS FOR REFORM

Both the American Bar Association and the American Law Institute have proposed wholesale — and in some respects similar — revisions of the common law screening doctrines developed by the Delaware courts. Read over MBCA §§7.42-7.44, and compare these provisions to ALI, Principles of Corporate Governance §§7.03, 7.08, and 7.10.

1. How would you contrast the common approach of the ALI and the MBCA to the demand requirement with that of the Delaware courts? Which approach do you prefer?

2. How do the approaches of the ALI and the MBCA differ? Which places more faith in the corporate board?

3. Will either reform proposal significantly improve shareholder litigation incentives?

10.4.2 Special Litigation Committees

In contrast to the demand requirement, which is embedded in Rule 23.1 of the Federal Rules of Civil Procedure, there is no basis in positive law for a

97. 152 A.3d 124, 130 (Del. 2016) (holding that owning an airplane with the interested party "is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment").

98. 124 A.3d 1017, 1020–22 (Del. 2015) (holding that being "close personal friends for more than five decades" with the interested party gives rise to "a pleading stage inference . . . that it is important to the parties" and suggests that the director is not independent).

procedure under which a court, upon the motion of a special committee of disinterested directors, may dismiss a derivative suit that is already underway. Nevertheless, many state courts adopted such a special litigation procedure under the pressure of growing numbers of shareholder suits in the 1970s and 1980s.[19] The special litigation committee (SLC) is now a standard feature of derivative suit doctrine even though it is not triggered in every case (unlike the demand requirement). Different jurisdictions treated the question differently. The chief divide is between those jurisdictions that follow Delaware's lead in the 1981 case of *Zapata Corp. v. Maldonado* (excerpted below) in giving the court a role in judging the appropriateness of an SLC's decision and those jurisdictions, such as New York, that apply a rule that, if the committee is independent and informed, it is entitled to business judgment deference without any further judicial second-guessing. See *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979).

ZAPATA CORP. v. MALDONADO

430 A.2d 779 (Del. 1981)

QUILLEN, J.:

In June, 1975, William Maldonado, a stockholder of Zapata, instituted a derivative action in the Court of Chancery on behalf of Zapata against ten officers and/or directors of Zapata, alleging, essentially, breaches of fiduciary duty. Maldonado did not first demand that the board bring this action, stating instead such demand's futility because all directors were named as defendants and allegedly participated in the acts specified. . . .

By June, 1979, four of the defendant-directors were no longer on the board, and the remaining directors appointed two new outside directors to the board. The board then created an "Independent Investigation Committee" (Committee), composed solely of the two new directors, to investigate Maldonado's actions, as well as a similar derivative action then pending in Texas, and to determine whether the corporation should continue any or all of the litigation. The Committee's determination was stated to be "final . . . not . . . subject to review by the Board of Directors and . . . in all respects . . . binding upon the Corporation."

Following an investigation, the Committee concluded, in September, 1979, that each action should "be dismissed forthwith as their continued maintenance is inimical to the Company's best interests. . . ."* Consequently, Zapata moved for dismissal or summary judgment. . . .

19. See Robert Charles Clark, Corporate Law, at 645-649.

* As reasons for dismissal, the Committee stated: "(1) the asserted claims appeared to be without merit; (2) costs of litigation, exacerbated by likelihood of indemnification; (3) wasted senior management time and talents on pursuing litigation; (4) damage to company from publicity; (5) that no material injury appeared to have been done to company; (6) impairment of current director-defendants' ability to manage; (7) the slight possibility of recurrence of violations; (8) lack of personal benefit to current director-defendants from alleged conduct; (9) that

[W]e turn first to the Court of Chancery's conclusions concerning the right of a plaintiff stockholder in a derivative action. We find that its determination that a stockholder, once demand is made and refused, possesses an independent, individual right to continue a derivative suit for breaches of fiduciary duty over objection by the corporation, . . . is erroneous. . . . *McKee v. Rogers*, Del. Ch., 156 A. 191 (1931), stated "as a general rule" that "a stockholder cannot be permitted . . . to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the managing body refuses. This rule is a well settled one." 156 A. at 193.

The *McKee* rule, of course, should not be read so broadly that the board's refusal will be determinative in every instance. Board members, owing a well-established fiduciary duty to the corporation, will not be allowed to cause a derivative suit to be dismissed when it would be a breach of their fiduciary duty. Generally disputes pertaining to control of the suit arise in two contexts.

Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful.[10] . . . A claim of a wrongful decision not to sue is thus the first exception and the first context of dispute. Absent a wrongful refusal, the stockholder in such a situation simply lacks legal managerial power. . . .

But it cannot be implied that, absent a wrongful board refusal, a stockholder can never have an individual right to initiate an action. For, as is stated in *McKee*, a "well settled" exception exists to the general rule. "[A] stockholder may sue in equity in his derivative right to assert a cause of action in behalf of the corporation, ***without prior demand*** upon the directors to sue, when it is apparent that a demand would be futile, that the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation." . . . A demand, when required and refused (if not wrongful), terminates a stockholder's legal ability to initiate a derivative action. But where demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf.

These conclusions, however, do not determine the question before us. Rather, they merely bring us to the question to be decided . . . : When, if at all, should an authorized board committee be permitted to cause litigation, properly initiated by a derivative stockholder in his own right, to be dismissed? As noted above, a board has the power to choose not to pursue litigation when demand is made upon it, so long as the decision is not wrongful. If the board

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certain alleged practices were continuing business practices, intended to be in company's best interests; (10) legal question whether the complaints stated a cause of action; (11) fear of undermining employee morale; (12) adverse effects on the company's relations with employees and suppliers and customers." *Maldonado v. Flynn*, 485 F. Supp. 274, 284 n.35 (S.D.N.Y. 1980). — Eds.

10. In other words, when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the "business judgment" rule and will be respected if the requirements of the rule are met. . . . That situation should be distinguished from the instant case, where demand was not made, and the *power* of the board to seek a dismissal, due to disqualification, presents a threshold issue. . . . We recognize that the two contexts can overlap in practice.

determines that a suit would be detrimental to the company, the board's determination prevails. Even when demand is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests. Our inquiry is whether, under such circumstances, there is a permissible procedure under §141(a) by which a corporation can rid itself of detrimental litigation. If there is not, a single stockholder in an extreme case might control the destiny of the entire corporation. . . .

Section 141(c) allows a board to delegate all of its authority to a committee. Accordingly, a committee with properly delegated authority would have the power to move for dismissal or summary judgment if the entire board did.

Even though demand was not made in this case and the initial decision of whether to litigate was not placed before the board, Zapata's board, it seems to us, retained all of its corporate power concerning litigation decisions. If Maldonado had made demand on the board in this case, it could have refused to bring suit. Maldonado could then have asserted that the decision not to sue was wrongful and, if correct, would have been allowed to maintain the suit. The board, however, never would have lost its statutory managerial authority. . . . Similarly, Rule 23.1, by excusing demand in certain instances, does not strip the board of its corporate power. It merely saves the plaintiff the expense and delay of making a futile demand resulting in a probable tainted exercise of that authority in a refusal by the board or in giving control of litigation to the opposing side. But the board entity remains empowered under §141(a) to make decisions regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.

The corporate power inquiry then focuses on whether the board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors. We find our statute clearly requires an affirmative answer to this question. As has been noted, under an express provision of the statute, §141(c), a committee can exercise all of the authority of the board to the extent provided in the resolution of the board. . . .

We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest.

Our focus now switches to the Court of Chancery which is faced with a stockholder assertion that a derivative suit, properly instituted, should continue for the benefit of the corporation and a corporate assertion, properly made by a board committee acting with board authority, that the same derivative suit should be dismissed as inimical to the best interests of the corporation.

At the risk of stating the obvious, the problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. . . . If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result. . . . It thus appears desirable to us to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.

[T]he question has been treated by other courts as one of the "business judgment" of the board committee. If a "committee, composed of independent and disinterested directors, conducted a proper review of the matters before it, considered a variety of factors and reached, in good faith, a business judgment that [the] action was not in the best interest of [the corporation]," the action must be dismissed. . . . The issues become solely independence, good faith, and reasonable investigation. The ultimate conclusion of the committee, under that view, is not subject to judicial review.[11] . . .

We are not satisfied, however, that acceptance of the "business judgment" rationale at this stage of derivative litigation is a proper balancing point. While we admit an analogy with a normal case respecting board judgment, it seems to us that there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the theory of business judgment.

The context here is a suit against directors where demand on the board is excused. We think some tribute must be paid to the fact that the lawsuit was properly initiated. It is not a board refusal case. Moreover, this complaint was filed in June of 1975 and, while the parties undoubtedly would take differing views on the degree of litigation activity, we have to be concerned about the creation of an "Independent Investigation Committee" four years later, after the election of two new outside directors. Situations could develop where such motions could be filed after years of vigorous litigation for reasons unconnected with the merits of the lawsuit.

Moreover, notwithstanding our conviction that Delaware law entrusts the corporate power to a properly authorized committee, we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

. . . There is some analogy to a settlement in that there is a request to terminate litigation without a judicial determination of the merits. . . . "In determining whether or not to approve a proposed settlement of a derivative stockholders' action [when directors are on both sides of the transaction], the Court of Chancery is called upon to exercise its own business judgment." *Neponsit Investment Co. v. Abramson*, Del. Supr., 405 A.2d 97, 100 (1979) and cases therein cited. In this case, the litigating stockholder plaintiff facing

11. The leading case is *Auerbach v. Bennett*, . . . 393 N.E.2d 994 . . . (1979).

dismissal of a lawsuit properly commenced ought, in our judgment, to have sufficient status for strict Court review. . . .

Whether the Court of Chancery will be persuaded by the exercise of a committee power resulting in a summary motion for dismissal of a derivative action, where a demand has not been initially made, should rest, in our judgment, in the independent discretion of the Court of Chancery. We thus steer a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to unbridled plaintiff stockholder control. In pursuit of the course, we recognize that "[t]he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal." *Maldonado v. Flynn, supra*, 485 F. Supp. at 285. But we are content that such factors are not "beyond the judicial reach" of the Court of Chancery which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems. We recognize the danger of judicial overreaching but the alternatives seem to us to be outweighed by the fresh view of a judicial outsider. Moreover, if we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits. At this point, we are not convinced that is necessary or desirable.

After an objective and thorough investigation of a derivative suit, an independent committee may cause its corporation to file a pretrial motion to dismiss in the Court of Chancery. The basis of the motion is the best interests of the corporation, as determined by the committee. The motion should include a thorough written record of the investigation and its findings and recommendations. Under appropriate Court supervision, akin to proceedings on summary judgment, each side should have an opportunity to make a record on the motion. As to the limited issues presented by the motion noted below, the moving party should be prepared to meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law. The Court should apply a two-step test to the motion.

First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.[17] If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under . . . [summary judgment] standards that the committee was independent and showed reasonable bases for good faith

17. Compare *Auerbach v. Bennett*, 393 N.E.2d 994 (1979). Our approach here is analogous to and consistent with the Delaware approach to "interested director" transactions, where the directors, once the transaction is attacked, have the burden of establishing its "intrinsic fairness" to a court's careful scrutiny. . . .

findings and recommendations, the Court may proceed, in its discretion, to the next step.

The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted.[18] This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.

If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms or conditions the Court finds necessary or desirable.

. . . [Reversed and remanded.]

NOTES AND QUESTIONS ON ZAPATA v. MALDONADO

1. If, as *Zapata* holds, a court may second-guess the board's evaluation of a derivative action when demand is excused, why shouldn't a court be able to do the same in cases in which demand was required but the board rejected suit? Academic commentary has generally criticized the "demand required/demand excused" distinction,[20] arguing that courts should be able to exercise their own judgment in both classes of cases. As one might expect, corporate counsel have criticized this distinction in the name of *Auerbach v. Bennett* and have urged that the board's business judgment should prevail in both classes of cases.

2. What elements should be included in an appraisal of the corporation's "best interests" in the second step of the *Zapata* test? In particular, what "matters of law and public policy" — if any — should a court consider in addition to the corporation's economic best interests? Would a court's decision to weigh matters other than the company's economic interests be consistent with viewing the derivative suit as an asset "belonging to" the corporation? (One former Delaware Chancery Court judge was heard to confide about

18. This step shares some of the same spirit and philosophy of the statement by the Vice Chancellor: "Under our system of law, courts and not litigants should decide the merits of litigation." 413 A.2d at 1263.

20. E.g., Reporters Notes to ALI, Principles of Corporate Governance §7.03 (1994).

the second level of *Zapata* inquiry, "I have no business judgment. If I had I wouldn't be a judge.")

3. In a later case, *Kaplan v. Wyatt*, 499 A.2d 1184 (Del. 1988), the Delaware Supreme Court held that whether to proceed to the second step of the *Zapata* test, and how much discovery to accord derivative plaintiffs, lies entirely within the discretion of the Delaware Chancery Court.

NOTE ON JUDICIAL INQUIRY INTO THE INDEPENDENCE OF A SPECIAL LITIGATION COMMITTEE

As you know from earlier chapters, independence is a key concept in corporate law. Ordinarily, independence means that a person has no *financial* ties to the firm, its executives, directors, and controllers.[21] Sometimes, however, Delaware courts expand the inquiry beyond financial ties to include other considerations for assessing independence, such as social connections. The focus is no longer financial disinterest alone but rather whether the person can act impartially, more generally, as in *Zapata* and the *Marchand* decisions (excerpted above).

Prior to *Marchand*, Chief Justice Strine (when he was Vice Chancellor) had addressed the issue of independence in an earlier SLC case, *In re Oracle Corp. Derivative Litigation*, 824 A. 2d 917 (Del. Ch. 2003). This decision involved allegations that some members of Oracle's top management (including its wealthy founder and controller, Larry Ellison) had engaged in insider trading and that other defendant directors violated *Caremark*. Oracle set up an SLC which, after extensive investigation and consultation, produced a 1,100-plus page tome finding that the suits should be dismissed. Plaintiffs challenged the SLC's recommendation and the independence of two of its members — two well-known and highly regarded professors at Stanford University (one of whom, Professor Joseph Grundfest, was a former SEC Commissioner). The court held that the SLC bore the burden of proving independence and had failed. The court noted that although the SLC members did not have the financial ties that traditionally raised concerns about independence, that did not end the inquiry.

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. . . . To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. . . . Some things are "just not done," or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution.

21. See, e.g., *Rales* at 396 noting that "[a] director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."

The court noted that social and other ties between Stanford, Oracle, and the primary defendants were quite "thick." For example, Oracle, Ellison, and other executives and directors had funded various initiatives at Stanford and were part of the social milieu in the Silicon Valley area. *Oracle* concluded by reiterating that there was no evidence that the two Stanford professors had been biased in favor of their fellow board members, but held that the burden was on Oracle to demonstrate their independence from social as well as economic constraints:

> Nothing in this record leads me to conclude that either of the SLC members acted out of any conscious desire to favor the Trading Defendants or to do anything other than discharge their duties with fidelity. But that is not the purpose of the independence inquiry.
>
> *Zapata* requires independence to ensure that stockholders do not have to rely upon special litigation committee members who must put aside personal considerations that are ordinarily influential in daily behavior in making the already difficult decision to accuse fellow directors of serious wrongdoing.

Following the court's rejection of the SLC's motion for dismissal, the case proceeded a bit further. However, in the end, the plaintiffs dropped their claims against some defendants and the court granted summary judgment in favor of the remaining defendants[22]—reaching the same outcomes that the SLC members had suggested earlier.

NOTES AND QUESTIONS ON IN RE ORACLE

1. The court's rationale for declining to grant the special committee's motion to dismiss is arguably less intrusive than the second step of the inquiry offered by Justice Quillen in *Zapata*. Recall that *Zapata*'s (optional) second step envisions a substantive exercise of judicial business judgment, an exercise without explicit parallels elsewhere in corporate law (although one imagines that, to some degree, courts are always cognizant of the value of shareholder litigation). As a result, *Zapata*'s second step is rarely used by Delaware courts.

2. Initially, the Delaware Supreme Court limited *In re Oracle*'s holding to the SLC context and applied an exclusively financial test of independence for other contexts, such as demand-futility assessments. See *Beam v. Martha Stewart*, 845 A.2d 1040, 1055 (Del. 2004). In the last few years, however, the Delaware Supreme Court has applied *In re Oracle*'s expanded version of independence in demand-futility cases where the firm had a controlling shareholder.[23] Although the cases don't explicitly state so, we speculate that these decisions reflect judicial concerns in assessing independence in a controlled firm rather than a desire to create a uniform independence standard across all contexts. Indeed, one could argue that boards appear more suspect in the

22. *In re Oracle Corp. Derivative Litigation*, C.A. No. 18751 (Nov. 24, 2004).
23. See, e.g., *Marchand* excerpted above; *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016); *Del. Cty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015).

SLC context (because the predicate is that the board appointing the SLC is not independent) and in controlled firms (because the controller appoints the board) than in other contexts, thereby warranting greater judicial scrutiny before dismissing a suit. This appears consistent with *Zapata*'s basic rationale. In light of this, might it make sense to assess independence or disinterestedness differently in different settings?

3. Consider the problem that a board now faces in the aftermath of *In re Oracle*. *Zapata* makes clear that the power to appoint an SLC comes from DGCL §141(c), which means that the SLC must consist entirely of directors. But wouldn't the independence of any current director be questioned given the "'thickness' of the social and institutional connections" between themselves and the defendant directors? And if so, would a board be forced to add new directors whenever it wished to establish an SLC? How would you advise a board that wanted to establish an SLC without changing its size, but also staying within the constraints imposed by *In re Oracle*?

4. At a conceptual level, the broader vision of independence in *In re Oracle* and *Marchand* may be in some tension with the notion of competence. Consider the following: Most people who display the competence and skills necessary to be effective as SLC members or board members are likely to be, as the *Oracle* court notes, "deeply enmeshed in social institutions." If this leads to them not being considered independent, then are we sacrificing competence for the *Oracle* vision of independence? Of course, this tension might not be crippling—for example, if the SLC members came from universities not so closely associated with Oracle—but this suggests that some further guidance may be desirable on what level of social ties are too close.

HOW DOES THE COURT EXERCISE ITS BUSINESS JUDGMENT?

What does it mean to exercise business judgment about whether litigation should go forward? Is litigation "like" an investment in a factory? And does the business judgment of a court resemble the business judgment of a corporate manager, or may the court weigh matters of public interest as well as the private interest of the firm? Consider the following excerpt from a well-known case.

JOY v. NORTH
692 F.2d 880 (2d Cir. 1982)

[In a diversity case, the court predicted that Connecticut would adopt the *Zapata* approach to derivative suits and, exercising its business judgment, rejected a special litigation committee's motion to dismiss.]

WINTER, J.:

[The dissent] is correct in anticipating difficulties in judicial review of the recommendations of special litigation committees. These difficulties are not new, however, but have confronted every court which has scrutinized the fairness of corporate transactions involving a conflict of interest.