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FASHIONING A COHERENT DEMAND RULE FOR DERIVATIVE LITIGATION IN CALIFORNIA

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This article examines the following question: What test should California adopt to determine whether allegations made pursuant to California Corporations Code section 800(b)(2) by a shareholder seeking to initiate derivative litigation on behalf of a California corporation excuse that shareholder from first making a demand on the board of directors to bring that litigation on behalf of the corporation? This issue is arising with increasing frequency, but California courts lack specific standards for deciding when the demand requirement should be excused in derivative cases involving California corporations.

This article argues that California should adopt its own, clearly defined demand rule, rather than simply adopt Delaware law as many California trial courts have done. Delaware's demand futility rule is costly to apply and counterproductive. This article proposes instead that the California courts adopt a "universal demand" rule, as supported by the Pennsylvania Supreme Court, the American Law Institute ("ALI"), and the American Bar Association's ("ABA") Model Rules. Alternatively, this article argues that if California opts to follow Delaware law, the California appellate courts should at least modify the Delaware rule to make it more simple and cost-efficient to apply. In particular, the article proposes that the Delaware rule, if adopted as California law, be modified to eliminate (1) the exception that allows allegations that a majority of the board committed a breach of the

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duty of care to excuse demand; and (2) the "reasonable doubt" standard embedded in Delaware's demand futility test. Finally, in the event that California ultimately chooses to adopt Delaware's demand rule without modification, the California courts should clearly embrace two other integral aspects of the Delaware rule: (1) the requirement that allegations of demand futility be pleaded with particularity; and (2) Delaware law's distinction between allegations of simple negligence, which do not excuse demand in Delaware, and allegations of gross negligence, which do excuse demand.

I. THE GROWING NEED FOR THE CALIFORNIA COURTS TO ARTICULATE A SPECIFIC TEST FOR EXCUSING DEMAND

A. *The Recurrence of the Legal Issue and the Lack of Governing Precedent with Which to Resolve It*

The question addressed by this article is important, in part because the issue is now arising, and is likely to continue to arise, with considerable frequency considering the increasing number of derivative cases being filed in the California courts.[1] The increase in derivative litigation is a by-product of the enactment by the United States Congress of the Private Securities Litigation Reform Act of 1995 ("Reform Act").[2] After holding hearings in 1995, Congress found "significant evidence of abuse in private securities lawsuits," including:

> (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action . . . (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle.[3]

1. *See, e.g.*, Stuart J. Baskin, *Recent Development in State Securities, Derivative and Corporate Law*, *in* SECURITIES LITIGATION 1996, at 449, 451 (PLI Corporate Law and Practice Course Handbook Series No. 958, 1996) ("[O]ne can already observe a discernible shift in securities and corporate governance actions to state court forums, especially in California.").

2. Private Securities Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 77a *et seq.* (1998)).

3. JOINT EXPLANATORY STATEMENT OF THE CONFERENCE COMMITTEE, H.R. CONF. REP. NO. 104-369, at 31–32 (1995), *reprinted in* 1995 U.S.C.C.A.N.

To eliminate the abusive practices encountered in federal securities class action litigation, Congress passed the Reform Act to provide defendants with procedural and substantive protections against abusive litigation and the enormous costs it imposes.[4] However, the Reform Act has not stopped plaintiffs' attorneys from filing cases against corporations, and their officers and directors, whenever the stock price of a publicly-traded company declines sharply. Instead, to circumvent the protections conferred upon defendants in federal cases by the Reform Act, many plaintiffs' attorneys file those cases in state court. Specifically, California plaintiffs' attorneys bring litigation in state court by employing two vehicles available under California law: (1) securities fraud class actions brought under California Corporations Code sections 25400 and 25500, alleging that officers and directors misrepresented the corporation's performance and prospects;[5] and (2) derivative litigation, alleging that unlawful mismanagement by the officers and directors resulted in a drop in the stock price. In many cases, plaintiffs' attorneys employ both vehicles to avoid the protections of the Reform Act.

The California Supreme Court recognized the need for early appellate review to establish threshold legal rules governing securities fraud cases in California courts. The Court recently granted interlocutory review to address the issue of who may sue under sections 25400 and 25500 in securities fraud class actions.[6]

It is equally important that California's appellate courts address the other category of cases now being filed in the state courts as a result of the Reform Act: derivative litigation. Indeed, there is good reason to believe that the influx of litigation from the federal courts into California courts will,

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679, 730.

4. *See id.*

5. *See, e.g.*, Diamond Multimedia Sys., Inc. v. Superior Court, 968 P.2d 539, 544 n.10 (Cal. 1999) (citing statistics regarding migration of claims to California state courts); *see also* Julia C. Kou, Note, *Closing the Loophole in the Private Securities Litigation Reform Act of 1995*, 73 N.Y.U. L. REV. 253, 256–57 (1998); Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 274, 302 (1998).

6. *See Diamond Multimedia Sys.*, 968 P.2d at 543, 557 (holding persons who bought securities outside California may bring suit under Corporations Code sections 25400 and 25500); *see also* StorMedia, Inc. v. Superior Court, 976 P.2d 214, 222 (Cal. 1999) (holding that offering stock in employee stock purchase plan renders company a "seller" under sections 25400 and 25500).

in the future, be largely comprised of derivative—as opposed to securities class action—litigation. Due to Congress's recent passage of the Securities Litigation Uniform Standards Act of 1998,[7] which preempts most state securities class actions by prohibiting cases involving more than fifty plaintiffs from being brought under state law, securities class action suits in California will decrease.[8] Thus, if a plaintiff-shareholder wishes to avoid the Reform Act by filing a lawsuit in state court, he or she is most likely to file a derivative action.

The first question trial courts must decide in derivative litigation cases is whether the plaintiff-shareholder made a pre-suit demand of the corporation's board of directors to pursue the litigation. If the plaintiff-shareholder failed to make the demand, the case must be dismissed unless demand is excused. While the courts of this state are thus asked with greater frequency to decide whether demand on a company's board should be excused, there is virtually no California law to aid courts in resolving this fundamental issue of corporate governance.[9] There is only one modern case, *Shields v. Sin-*

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7. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified at 15 U.S.C. § 77a–n).

8. *See id.* at 3228 (to be codified at 15 U.S.C. § 77p(b), (f)(2)).

9. One explanation for the dearth of appellate law on the issue of when, if ever, demand will be excused is that the issue is one that inherently evades ordinary appellate review. Because the demand requirement set forth in Corporations Code section 800(b)(2) is a rule of pleading, meaningful judicial review of an order overruling a demurrer on the ground of demand futility can occur only at the pleading stage of a case, before there is a final, appealable judgment. Indeed, the issue raised by a demurrer challenging a plaintiff's failure to make a demand—that is, the question whether the board should have an opportunity to evaluate the claims *before* a shareholder pursues the litigation—is moot long before the time final judgment is entered. Once the trial court overrules the demurrer and excuses demand, the individual shareholder may proceed to litigate on behalf of the corporation. That litigation often lasts for years before judgment is entered, or the case is settled. On the other hand, if the demurrer is sustained, there is an appealable order, but the plaintiff rarely has the incentive to take an appeal because the option of proceeding to make a demand on the board is a much lower cost alternative than prosecuting an appeal. Accordingly, unless an appellate court, upon a petition for a writ of mandate, grants discretionary review of an order overruling a demurrer, it is unlikely that an opportunity will arise for the courts to define the standards in California for applying the demand rule. The appellate courts should grant such extraordinary review when the occasion arises. As one of this country's most important commercial centers, California can no longer afford to have key corporate governance issues resolved by lower courts' application of the law of other states on an ad hoc basis.

gleton,[10] that comments on when demand may be excused in California.[11] The *Shields* case suggests that demand may be excused when a board is not "capable of fairly evaluating" a demand. *Shields* fails to set forth a test to determine whether a board will be deemed incapable of conducting such an evaluation.[12] Thus, California law provides little or no guidance on the standard for excusing demand.[13]

Given the dearth of California case law, the California trial courts frequently look to Delaware law and apply their own interpretation of Delaware case law, even though no California precedent indicates that such borrowing is appro-

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10. Shields v. Singleton, 19 Cal. Rptr. 2d 459 (Ct. App. 1993).

11. The only other California cases that comment on the issue are more than forty years old and involve closely held corporations. *See, e.g.*, Reed v. Norman, 314 P.2d 204 (Cal. Ct. App. 1957); Koshaba v. Koshaba, 132 P.2d 854 (Cal. Ct. App. 1942). In *Reed*, the court noted that "[c]ertainly, no demand is necessary when conspiracy, fraud or criminal conduct of the defendants is charged." *Reed*, 314 P.2d at 208 (citing Gottesfeld v. Richmaid Ice Cream Co., 252 P.2d 973 (Cal. Ct. App. 1953)). That court ultimately found demand to be futile based on the plaintiff's factual allegations that the president and acting director of the corporation committed "high crimes and misdemeanors . . . to the detriment of the corporation" and had "the sole voice in dominating the policy or any particular act of the corporation." *Id.* at 208–09. In *Koshaba*, the court held that demand would have been futile where the plaintiff alleged that the president and managing director of the corporation "was guilty of various fraudulent and dishonest acts" and that he exercised "domination and control" over the other directors, such that the other directors "exercise[d] no functions whatsoever in the conduct of the business of [the] corporation as such directors except to carry out [the president/managing director's] bidding and directions." *Koshaba*, 132 P.2d at 858.

12. *See Shields*, 19 Cal. Rptr. 2d at 466. The *Shields* court noted that the holding in the earlier California cases that "no demand is necessary when conspiracy, fraud or criminal conduct of the defendants is charged" is "surely a sound principle." *Id.* at 465. The court also observed that the complaint at issue did not allege any facts that would indicate that the directors had participated in any criminal or fraudulent activities, nor that the directors "*benefited directly* from the wrongdoing or were otherwise disabled from exercising *independent* business judgment." *Id.* (emphasis added). Ultimately, the court concluded that the complaint provided only "broad, conclusory allegations" against all of the defendant directors and that such "bare allegations of director wrongdoing without factual support" are insufficient in any event to excuse demand. *Id.* at 465–66 (citing Findley v. Garrett, 240 P.2d 421, 425–27 (Cal. Ct. App. 1952)).

13. Piecing together the fragmentary comments from *Koshaba*, *Reed*, and *Shields*, one might summarize California law as follows: demand will be excused as futile only when a plaintiff alleges particularized facts showing that a majority of the directors of a board (1) engaged in fraudulent or criminal conduct, (2) had some self-interest in or derived some direct benefit from the challenged transaction, or (3) lacked independence to evaluate the demand because of domination and control by some other person or persons.

priate. There has been no critical examination by those lower courts to evaluate whether California should apply Delaware law. Further, some trial courts have misapplied Delaware law.[14]

B. *The Importance of the Demand Rule as a Policy Matter*

Whatever demand rule is adopted in California will reduce the number of shareholder derivative actions litigated in the California courts, and therefore substantially affect the California court system's workload.[15] The demand requirement forces a shareholder to seek an "intracorporate resolution" of that shareholder's claim before pursuing litigation on behalf of the corporation.[16] As such, it provides a mechanism for a corporation to resolve shareholder claims without the need for judicial intervention. The demand requirement can fulfill that objective only if the courts establish a clearly defined standard that narrowly limits the circumstances under which demand will be excused.

Moreover, judicial definition of specific standards governing when to excuse demand will affect not only the quantity, but also the quality of the litigation pursued in California courts. The goal of the Reform Act was, in part, to screen non-meritorious cases out of the federal courts, largely at the pleading stage.[17] Because the Reform Act is applicable only in the federal courts, plaintiffs are more likely to file in state court the cases that could not survive the more rigorous threshold scrutiny required by the Reform Act. As a result, a large component of the cases filed in California courts in response to the Reform Act involve the non-meritorious cases that were the target of the Reform Act.

Derivative litigation has historically been notorious as a

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14. *See infra* Part IV.B.

15. In addition, clarification of California's demand rule will have a significant effect on federal courts adjudicating derivative actions brought on behalf of California corporations. To the extent that derivative actions against California corporations continue to be brought in federal courts, California law will control the demand rule analysis in those cases. *See* Kamen v. Kemper Fin. Servs., 500 U.S. 90, 108–09 (1991).

16. *See Shields*, 19 Cal. Rptr. 2d at 463.

17. *See, e.g.*, JOINT EXPLANATORY STATEMENT OF THE CONFERENCE COMMITTEE, H.R. CONF. REP. NO. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 740.

vehicle for bringing strike suits.[18] One purpose of the demand requirement is to enable a corporation's board of directors—*before* litigation arises—to separate the non-meritorious shareholder claims from the meritorious.[19] By performing this "gatekeeper" function, the demand rule empowers a board of directors to protect the corporation from the heavy cost of strike suits, which, by definition, seek to drive up a corporation's costs for the sole purpose of extracting a settlement. The demand requirement can be an effective gatekeeper against strike suits only if the exceptions to the rule are clearly defined and narrowly drawn. The current California law is simply too unclear and underdeveloped to effectuate the purposes of the demand rule.

The standards set by California courts for excusing demand will also impact corporate governance, both from the perspective of California corporations' boards of directors and their shareholders. The fundamental rule of corporate governance in California, as elsewhere, is that the board of directors, not individual shareholders, manages the business of the corporation.[20] The decision whether to pursue litigation on behalf of a corporation is part of the business of the corporation.[21] The demand rule is designed to enforce this scheme of corporate governance by requiring a shareholder to bring any claim brought on the corporation's behalf to the board for evaluation *before* initiating litigation. To leave the exceptions to the demand rule undefined—as California does—or to define them vaguely and expansively, undermines the structure of corporate governance established by Corporations Code

18. *See, e.g.*, Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978) (recognizing that derivative actions may be brought not to remedy wrongs to the corporation, but "to induce settlements beneficial to the named plaintiff or his counsel"), *cert. denied*, 439 U.S. 1129 (1979). A strike suit is a "[s]hareholder derivative action begun with hope of winning large attorney fees or private settlements, and with no intention of benefiting corporation on behalf of which the suit is theoretically brought." Black's Law Dictionary 1423 (6th ed. 1990).

19. *See* Barr v. Wackman, 329 N.E.2d 180, 186 (N.Y. 1975) ("It is clear then that the demand [requirement] is generally designed to weed out unnecessary or illegitimate shareholder derivative suits."); *see also* Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984).

20. *See* CAL. CORP. CODE § 300(a) (West 1990).

21. *See* Findley v. Garrett, 240 P.2d 421, 428 (Cal. Ct. App. 1952) ("Directors have the same discretion with respect to the prosecution of claims on behalf of the corporation as they have in other business matters.").

section 300(a).[22] Undefined or vaguely defined exceptions to the demand rule permit individual shareholders to deprive boards of directors of their authority and right under that statute to manage the affairs of their corporations.

The demand rule and the courts' enforcement of it will also affect corporate governance from the standpoint of the shareholders. The corporate governance structure reflected in the corporations law is modeled on our political system: a representative democracy. A majority of shareholders elects the board of directors to manage the affairs of the corporation.[23] Permitting a single shareholder to wrest control of a corporation's litigation away from the board of directors, which was elected by a majority of the shareholders, disenfranchises the shareholder majority. Leaving the exceptions to the demand requirement undefined, or defining the exceptions too broadly, gives a single shareholder the latitude to nullify the rights of the majority shareholders.

The importance of the legal issues presented in this article is underscored by the fact that the supreme courts of three major commercial states—Delaware, New York, and most recently, Pennsylvania—have all addressed the issue. These three courts promulgated very specific (and different) tests for excusing demand.[24] The following discussion of those tests illustrates the important policy considerations underlying this issue.

II. THE DELAWARE DEMAND FUTILITY RULE AND WHY CALIFORNIA SHOULD NOT ADOPT IT

Because of Delaware's prominence as a commercial jurisdiction, other jurisdictions frequently borrow its decisional law regarding issues of corporate law.[25] However, Delaware's

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22. CAL. CORP. CODE § 300(a) (providing that "the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board.").

23. *See* CAL. CORP. CODE § 301 (West 1990) (annual election of directors); *cf. id.* § 303(a) (removal of directors without cause by simple majority).

24. *See infra* Part II.B (discussing Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984), Levine v. Smith, 591 A.2d 194, 213 (Del. 1991), and their progeny); Part IV.A. (discussing Marx v. Akers, 666 N.E.2d 1034 (N.Y. 1996)); Part III (discussing Cuker v. Mikalauskas, 692 A.2d 1042 (Pa. 1997)).

25. *See* John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1432 (1993) ("Without doubt, Delaware corporation law has long been followed—sometimes almost reflexively—by other American jurisdictions.").

legal test for determining when pleadings are sufficient to excuse the demand requirement is at odds with the purposes and objectives of California's demand rule. California courts should resist the urge to adopt Delaware law by default.

A. *The Function of and Policies Underlying the Demand Requirement*

In a derivative action, a shareholder seeks to assert, on behalf of a corporation, causes of action that belong to the corporation. The law does not, however, permit any shareholder to take charge of a corporation's litigation whenever he or she pleases. Under California law, the right to conduct litigation on behalf of a corporation resides in that corporation's elected board of directors, not in a dissident shareholder.[26] Accordingly, California law requires that a shareholder, in order to proceed with a derivative action, first tender a demand to the board to have the corporation pursue the litigation.[27] The demand requirement thus implements the basic rule of corporate governance set forth in California Corporations Code section 300(a)—that the board, not the shareholders, holds the power to manage the affairs of a corporation, including its litigation.[28]

Courts recognize that the demand requirement is not merely a "technical pleading hurdle," but rather based on the "fundamental tenet of American corporate law that places the responsibility for making decisions in the hands of the board of directors" rather than on individual shareholders.[29] As the *Shields* court, in California's only modern case regarding presuit demand, explained:

> The purpose of [the requirement] is to encourage intracorporate resolution of disputes and to protect the managerial freedom of those to whom the responsibility of running the business is delegated. This policy is merely an extension of the business judgment rule, which dictates that judicial interference with corporate decision-making

26. *See* CAL. CORP. CODE § 300(a).
27. *See id.* § 800(b)(2) (shareholder must plead that demand has been made or the reasons for not having made demand); *see also* Shields v. Singleton, 19 Cal. Rptr. 2d 459, 462 (Ct. App. 1993).
28. *See Shields*, 19 Cal. Rptr. 2d at 462.
29. Johnson v. Hui, 752 F. Supp. 909, 911 (N.D. Cal. 1990); *accord Aronson*, 473 A.2d at 811–12.

should be limited.[30]

Thus, the demand requirement gives the board an opportunity, *before* a shareholder proceeds with litigation on a corporation's behalf, to exercise its business judgment as to whether that litigation is in the best interest of the corporation.[31]

California law should reject any proposed exception to the demand requirement that would undermine those policy objectives. For example, since a significant objective of the demand requirement is to assure that the board, not individual shareholders, manages the litigation of the corporation, California should not incorporate exceptions to the demand requirement that make it too easy for individual shareholders to wrest control of the litigation from the board. Similarly, since an important purpose of the demand requirement is to create an early opportunity for intracorporate resolution of shareholder claims so as to avoid costly litigation, California law should reject exceptions nullifying that intended benefit. Any test that routinely embroils a corporation in protracted, costly litigation just to determine whether a shareholder must first pursue an intracorporate resolution defeats the purpose of the demand rule. As shown in Part II.B, Delaware law is antithetical to the purposes of the demand requirement because it involves the courts and parties in complex, difficult, and costly threshold litigation regarding excusing demand.

B. *Inconsistencies Between Delaware Law and the Objectives of the Demand Requirement*

1. *The* Aronson *Test and Its Underlying Rationale*

The Delaware test for excusing demand is based on the assumption that in some circumstances making a demand would be futile. In *Aronson v. Lewis*,[32] the Delaware Supreme Court articulated the test for ascertaining the presence of such circumstances. Demand would be futile when "under the particularized facts alleged, a reasonable doubt is created

30. *Shields*, 19 Cal. Rptr. 2d at 463 (quoting 1A BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS § 292.03, at 14–19 (R. Bradbury Clark ed., 4th ed. 1992)).

31. *See* Findley v. Garrett, 240 P.2d 421, 426 (Cal. Ct. App. 1952).

32. *Aronson*, 473 A.2d at 805.

that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[33]

Delaware's futility exception to the demand rule relies on the premise that where a complaint shows that a majority of directors have reason to fear being held personally liable in a derivative lawsuit, it would be futile for a shareholder to ask those directors to pursue the lawsuit.[34] A shareholder cannot, however, establish such fear of personal liability merely by pleading that the directors approved the transaction being challenged or that the directors have been named as defendants in the lawsuit. To permit demand to be excused so easily would nullify the demand requirement.[35]

Instead, Delaware law excuses demand only where the complaint shows that directors would have a realistic—as opposed to a theoretical—fear of liability for having approved the transaction.[36] In effect, the Delaware approach is to make the demand requirement turn on an educated guess as to the likelihood of director liability made by the trial court at the outset of a case. That educated guess is based on the pleadings alone, not on any evidence. If the complaint suggests a reasonable ground for a finding of director liability, then Delaware deems it a waste of time to ask the directors to decide whether the corporation should take action on the shareholder claim.

In most cases, directors need not fear liability for approving corporate transactions because the law furnishes them with a powerful defense: the business judgment rule. The business judgment rule recognizes that courts are ill-equipped to evaluate the wisdom of business decisions made by directors, and, as a result, the judiciary should not second-guess those decisions.[37] Thus, the business judgment rule renders directors immune from liability—even for stupid or careless business decisions—so long as the directors made

33. *Id.* at 814.

34. *See, e.g.*, *id.*

35. *See id.* at 814, 817–18; *see also Shields*, 19 Cal. Rptr. 2d at 465 (rejecting the claim that demand was futile simply because "all board members were named as defendants in this suit").

36. *See Aronson*, 473 A.2d at 818.

37. *See* Brazen v. Bell Atl. Corp., 695 A.2d 43, 49 (Del. 1997); Gaillard v. Natomas Co., 256 Cal. Rptr. 702, 710 (Ct. App. 1989); Eldridge v. Tymshare, Inc., 230 Cal. Rptr. 815, 820 (Ct. App. 1986).

the decisions in good faith, and after a good faith effort to inform themselves of the facts.[38] Accordingly, Delaware courts decide whether directors have reason to fear personal liability, and thus whether to excuse demand, based on the court's best guess as to whether the business judgment rule will be applicable at trial.[39]

Since there are two ways for a director to lose the protection of the business judgment rule—by breaching either the duty of loyalty or the duty of care—the *Aronson* test has two alternative prongs. Under the first prong of *Aronson*, a plaintiff may demonstrate demand futility by alleging particularized facts that create a reasonable doubt that the directors are disinterested and independent.[40] Allegations of this type suggest that the board breached its duty of loyalty. Alternatively, under the second prong, a plaintiff must allege particularized facts that create a reasonable doubt that the challenged transaction was otherwise the product of a valid exercise of business judgment.[41] Satisfying this prong requires particularized allegations of a breach of the duty of care.[42] To satisfy the second prong by means of allegations of inadequate procedural due care, a plaintiff must plead facts alleging gross negligence, rather than simple negligence.[43]

In *Levine v. Smith*,[44] the Delaware Supreme Court articulated the *Aronson* test somewhat differently:

> The trial court is confronted with two related but distinct questions: (1) whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts; and, if not, (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.[45]

This later formulation suggests that the "reasonable doubt"

38. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

39. *See Aronson*, 473 A.2d at 814–15.

40. *See id.* at 814.

41. *See id.*

42. *See* Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988). Notably, no published California decision states that demand may be excused based on allegations of a breach of the duty of care. *See also supra* note 13 (discussing the rules from *Koshaba*, *Reed*, and *Shields*).

43. *See Aronson*, 473 A.2d at 812.

44. Levine v. Smith, 591 A.2d 194 (Del. 1991).

45. *Id.* at 205.

standard applies only to the second prong of the *Aronson* test.

2. *The Flaws of the* Aronson *Rule as a Test for Whether Demand is Required*

The Delaware test has been criticized,[46] and should not be adopted in California, for at least four reasons. First, the collateral litigation engendered by the *Aronson* test makes it costly and inefficient to administer. Second, the *Aronson* test forces the trial court to make an uninformed prediction, based only on the pleadings, as to how the merits of the case might fare. Third, the potentially expansive second prong of the *Aronson* test opens the door for individual shareholders to eviscerate section 300(a). Finally, the "reasonable doubt" standard embedded in the *Aronson* test is confusing, inconsistent with the objectives of the demand rule, and injects an excessive degree of subjectivity into the court's determination of whether demand should be excused.

a. *Cost and Inefficiency*

The *Aronson* test and its rationale are exceedingly complicated, and those complexities generate substantial amounts of unnecessary litigation.[47] Applying the *Aronson*

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46. *See* Starrels v. First Nat'l Bank, 870 F.2d 1168 (7th Cir. 1989); Coffee, *supra* note 25, at 1413 ("[T]he *Aronson* test ultimately is an empty one that seldom dictates the result in a specific case."); Glenn G. Morris, *Shareholder Derivative Suits: Louisiana Law*, 56 LA. L. REV. 583, 613 (1996) ("[T]he *Aronson* court introduced a considerable degree of unnecessary technical complexity into the law, for which the court has received some well-reasoned criticism.") (citing Kaplan v. Wyatt, 484 A.2d 501, 509–12 (Del. Ch. 1984), *aff'd*, 499 A.2d 1186 (Del. 1985)); Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1353 (1993) ("Commentators have almost universally criticized the judicial confusion surrounding the various applications of the futility exception."). Professor Coffee argues that the "universal demand rule" promulgated in the ALI's *Principles of Corporate Governance* is far preferable to the Delaware rule. Professor Swanson's article, as suggested by its title, criticizes certain aspects of the universal demand rule on policy grounds. However, as discussed below in Part III, even the ALI's critics, including Professor Swanson, appear unanimously to endorse the modern trend towards some form of universal demand. *See infra* note 68 and accompanying text.

47. *See, e.g.*, Coffee, *supra* note 25 at 1414 ("Delaware's demand rule . . . results in a substantial amount of collateral litigation and sometimes can be a trap for the unwary."); *see also* 2 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.03 (1992) [hereinafter ALI PRINCIPLES] ("The Delaware law on demand and its excuse seems in particular to invite collateral litigation.").

test, and particularly its second prong, necessarily collapses litigation about the threshold issue of whether a demand on the board is required into litigation about the merits of the case. For example, to determine whether to excuse demand under the second prong of *Aronson*, a court must assess the sufficiency of the cause of action alleging a breach of the duty of care.[48] This undertaking requires a court (1) to examine the substantial case law defining breach of the duty of care, and (2) to decide whether the factual allegations suggest that the board committed gross negligence or merely simple negligence.[49] Not surprisingly, particularly given the liberal standard for granting leave to amend, such litigation can cost a corporation and its shareholders hundreds of thousands of dollars.[50]

The purpose of the demand requirement, however, is to eliminate strike suits and *avoid* litigation where non-judicial resolution is possible, not to engender collateral litigation regarding this threshold issue.[51] The objective of the demand requirement is to afford the board of directors an opportunity to exercise its authority and responsibility under section 300(a), not to subject the corporation to the costs of further litigation when the board believes in good faith that the litigation would not be in the best interests of the shareholders. That objective is defeated by a rule that forces a corporation to spend perhaps hundreds of thousands of dollars just to obtain the opportunity to make that determination. In addition, the demand rule in California is intended to provide an opportunity for "intracorporate resolution" of claims so that they may be resolved outside the courtroom, *before* substantial litigation costs are incurred.[52] A rule that imposes a substan-

48. *See supra* notes 40–42 and accompanying text.

49. *See supra* note 43 and accompanying text.

50. The author has been involved in cases in the California Superior Courts in which litigation about demand futility alone has lasted two years.

51. *See supra* text accompanying notes 18–19 and 26–31.

52. *See* Shields v. Singleton, 19 Cal. Rptr. 2d 459, 463 (Ct. App. 1993). As one commentator summarized:

> The reason for the demand requirement is that directors, not shareholders, are supposed to make major corporate decisions. Another purpose of demand is to give corporate management a chance to take corrective measures or persuade the wrongdoers to make right. Judicial economy is achieved by ending the need for a lawsuit. Likewise, the board may accept the demand, bring suit against the wrongdoer, and try

tial litigation cost on corporations and their shareholders before attempting an "intracorporate resolution" eliminates this opportunity.[53]

b. *Courts' Inability to Predict the Cases in Which Demand Would Make Practical Sense*

The *Aronson* rule for demand futility is irrational because it makes the demand requirement turn on the court's uninformed prediction of how the case will turn out on the merits, rather than on whether the purposes of the demand rule could be achieved in a particular case. As the ALI stated, "the demand rule, if used as a rule of substantive law, inherently asks the court to make a premature prediction both about the basic merits of the action at the outset, before discovery has occurred, and about the board's objectivity."[54]

The Delaware approach of excusing demand based on what is at most a preliminary hypothetical guess as to whether directors would prevail on a business judgment rule defense makes little sense for at least two reasons. First, the guess is entirely uninformed: it is based purely on what is alleged in the pleadings, not on any facts. Thus, much of the time, the court's guess will be wrong. Each time the court's

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> to persuade the shareholder to step aside. The board might be concerned that, if allowed to bring suit, the shareholder might settle for an inadequate amount from the wrongdoers. Conversely, the board may find the lawsuit to be unmeritorious and reject the demand—perhaps aware that the suit's legal fees would be more costly than the possible recovery from the defendants.

Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 176 (1994) (citations omitted).

53. The demand rule, in encouraging the "intracorporate resolution" of claims, is comparable in function to any court rule that requires early submission of claims to mediation. *See, e.g.*, CAL. CIV. PROC. CODE § 1141.10–.11 (West 1982 & Supp. 1999) (governing referral of cases involving an amount in controversy of less than $50,000 to mandatory judicial arbitration). No court would adopt a rule that forces a party seeking to enforce its right to mediation to litigate for years at enormous expense just to determine whether mediation should at least be tried. *See id.* § 1141.11(a) (making non-appealable the trial court's determination that the amount in controversy in a case meets the relevant maximum for referral to arbitration).

54. ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. d, at 56; *see also* Starrels v. First Nat'l Bank, 870 F.2d 1168, 1173–74 (7th Cir. 1989) (Easterbrook, J., concurring) (criticizing *Aronson* test because "it requires courts to adjudicate the merits on the pleadings").

uninformed guess is contrary to the facts, enforcement of the demand requirement would have served its intended purpose. There is perhaps no other place in the law where statutory rights—both the board's right to manage the corporation's litigation and the majority shareholders' rights to have the corporation's affairs managed by their elected board members—can be divested prior to discovery and without *any* factual showing.

Second, why excuse demand simply because directors may not have a business judgment rule defense to an alleged claim? Since the purpose of the demand rule is to encourage the pre-litigation, intracorporate resolution of shareholder claims, the demand requirement can serve a useful function both with respect to meritorious and non-meritorious claims.[55] Indeed, the more meritorious a claim, the more beneficial it may be to have the board evaluate it *before* the parties commit themselves to extended litigation.[56]

The analysis might be different if making a pre-suit demand were particularly costly to a shareholder. Were that the case, a court's prediction that a board might be predisposed not to pursue a derivative claim because of its merit might provide some justification for excusing the shareholder from incurring the cost of that pre-suit demand. But in nearly all cases, requiring a demand imposes virtually *no* cost on a shareholder.[57] At most, the shareholder experiences a minimal delay in filing the derivative claim while the board investigates and decides on a course of action. If the board does not adequately investigate and respond to the claim in good faith, the shareholder may proceed with the derivative lawsuit.[58] The demand rule simply puts into play a require-

55. *See, e.g.*, Kinney, *supra* note 52, at 176 (summarizing the actions a board might undertake as to meritorious and non-meritorious claims).

56. *See Starrels*, 870 F.2d at 1174–75 (Easterbrook, J., concurring). Many derivative cases are settled without the payment of damages by the directors. Instead, boards often agree to adopt certain procedural reforms or "therapeutic measures" to prevent recurrences of the situation or actions alleged. *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 972 (Del. Ch. 1996) (requiring demand even in a meritorious case alleging a breach of the duty of care could facilitate the achievement of such a resolution at an early stage).

57. *See, e.g.*, Swanson, *supra* note 46, at 1387 ("[D]emand is undisputedly easy to make."); ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. e, at 57 (stating that a demand is a "relatively costless step").

58. *See* Levine v. Smith, 591 A.2d 194, 213 (Del. 1991); *see also* Findley v. Garrett, 240 P.2d 421, 426 (Cal. Ct. App. 1952).

ment of exhausting "intracorporate" remedies that are cost-free, both to the shareholder and to the courts. Since that system will result in the early disposition of at least some meritorious claims outside of court, why excuse demand just because the pleading suggests that the claim may be meritorious?

c. *Evisceration of Section 300(a)*

The second prong of *Aronson* opens the door to excessive usurpation by individual shareholders of the authority granted to the board by Corporations Code section 300(a). Although the Delaware Supreme Court intended that it be difficult for a plaintiff to avoid the demand requirement based on allegations of a breach of the duty of care,[59] the amorphous nature of the second prong of *Aronson* makes it relatively easy for any plaintiff to avoid the demand requirement. This vagueness arises because many courts view gross negligence and simple negligence as merely two overlapping parts of a spectrum, with no clear dividing point between the two.[60] A shareholder who, with the benefit of hindsight, can plead enough facts to place his complaint in the "gray area" between simple and gross negligence has an outstanding opportunity to avoid the demand requirement. The Delaware Supreme Court exacerbated that problem by suggesting that the demand futility issue under *Aronson* is a factual question, the resolution of which may involve some discretion by the lower court.[61]

In short, unless California rejects the second prong of *Aronson*, in nearly every case where hindsight provides room to second-guess the decision-making of the board in the under-

59. *See* Grobow v. Perot, 539 A.2d 180, 190 (Del. 1988) (placing a "heavy burden" on a plaintiff who attempts to avoid the demand requirement by alleging a lack of due care).

60. A leading torts treatise, after surveying numerous jurisdictions' attempts to define "gross negligence," notes that "most courts consider that 'gross negligence' . . . differs from ordinary negligence only in degree, and not in kind," and concludes that "[t]here is, in short, no generally accepted meaning." W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS § 34, at 211–12 (5th ed. 1984); *accord* Pacific Bell v. Colich, 244 Cal. Rptr. 714, 722 (Ct. App. 1988) (same language); *see also* 46 CAL. JUR. 3D *Negligence* § 88 (Gene A. Noland et al. eds., 1978) (listing five distinct definitions of gross negligence used by California courts and citing numerous cases representing each different formulation).

61. *See e.g.*, *Grobow*, 539 A.2d at 186.

lying transaction, the board risks being forced to cede control of the corporation's litigation to minority shareholders.

d. *The Reasonable Doubt Standard*

The "reasonable doubt" standard in *Aronson* has been criticized on several grounds. For example, the standard is difficult to apply outside the criminal context (particularly at the pleading stage). Further, reasonable doubt is inconsistent with the demand rule's objective of granting the board, rather than individual shareholders, the power to decide initially whether the corporation should bring litigation.

Regarding the difficulty of applying the reasonable doubt standard, Judge Easterbrook stated:

> If "reasonable doubt" in the *Aronson* formula means the same thing as "reasonable doubt" in criminal law, then demand is excused whenever there is a [ten-percent] chance that the original transaction is not protected by the business judgment rule. Why should demand be excused on such a slight showing? . . . If "reasonable doubt" in corporate law means something different from "reasonable doubt" in criminal law, however, what is the difference?, [sic] and why use the same term for two different things?[62]

The reasonable doubt test thus contradicts the rationale of *Aronson* itself, in that it permits demand to be excused in even those cases where, based on the pleadings, it is more likely than not that the directors have a meritorious business judgment rule defense. For example, even where a complaint itself suggests a sixty-percent chance that the board exercised business judgment and would prevail on such a defense, the reasonable doubt standard would allow—or indeed require—the court to excuse demand.

Others criticize the reasonable doubt test for injecting "a substantial measure of subjective judicial discretion into the decision whether to excuse demand."[63] The ALI notes that this subjectivity permits wide variance in the application of

62. Starrels v. First Nat'l Bank, 870 F.2d 1168, 1175 (7th Cir. 1989) (Easterbrook, J., concurring).

63. ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. d, at 57 & reporter's note 5, at 67; *see* Coffee, *supra* note 25, at 1413 ("A strong judge can usually manipulate a 'reasonable doubt' standard to reach the outcome that he or she desires."); *see also* Swanson, *supra* note 46, at 1352 ("[T]he reasonable doubt test . . . invites a certain amount of judicial subjectivity in determining futility [of demand].") (citations omitted).

Delaware law to similar facts, and "may result in demand being excused too frequently, thereby unduly diminishing the role of the board."[64]

At a minimum, the "reasonable doubt" standard connotes to most judges that the plaintiff has a relatively minimal pleading burden. Consequently, if California were to adopt the "reasonable doubt" aspect of Delaware's demand rule, the demand requirement is likely to be excused so often that the demand rule would become virtually meaningless.

III. A PROPOSED SOLUTION: THE ALI/ABA RULE AND WHY CALIFORNIA SHOULD ADOPT IT

For many of the reasons described above, there is an increasing trend in the law to reject the *Aronson* rule in favor of a bright line test that provides simplicity and excuses demand in fewer cases. In 1992, following fourteen years of deliberations, the American Law Institute's Corporate Governance Project adopted its *Principles of Corporate Governance* (*"Principles"*). Section 7.03 of the *Principles* provides that demand on the board in derivative actions "should be excused only if the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result."[65] Section 7.03 thereby simplifies the demand rule by deleting the futility exception and substituting a narrower "irreparable injury" exception.[66] The revised Model Business Corporations Act, promulgated by the Business Law Section of the American Bar Association, advocates a similar rule.[67]

The ALI/ABA rule eliminates much of the threshold litigation, collateral to the merits of the action, that slows the pace and increases the cost of derivative actions under the Delaware approach.[68] The ALI/ABA rule achieves this result

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64. ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. d, at 57 & reporter's note 5, at 67.

65. *Id.* § 7.03.

66. *See id.* § 7.03 cmt. e, at 57.

67. *See* 2 MODEL BUS. CORP. ACT § 7.42 (3d ed. Supp. 1997) [hereinafter MODEL ACT]. The ABA's model act would require a shareholder to wait for 90 days after serving a demand, before filing a derivative suit, unless (1) the demand is rejected earlier, or (2) "irreparable injury to the corporation would result by waiting for the expiration of the 90-day period." *Id.* In light of the narrowness of this exception to the demand requirement, both the ABA and ALI approaches have been referred to as a "universal demand" rule. *See, e.g.*, Swanson, *supra* note 46, at 1353–54.

68. *See* ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. e, at 67; 2 MODEL ACT,

first by concerning itself solely with the comparative costs of requiring or excusing demand, and second by abandoning any attempt to guess at the pleading stage, as required by *Aronson*, whether directors would ultimately have a valid business

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supra note 67, § 7.42 cmt., at 7-335; *accord, e.g.*, Coffee, *supra* note 25, at 1415; *see also* Kamen v. Kemper Fin. Servs. Inc., 500 U.S. 90, 106 (1991) (acknowledging, in dicta, judicial economies associated with universal demand); Swanson, *supra* note 46, at 1354. The Supreme Court in *Kamen* ultimately decided that any advantages to be gained by applying a universal demand rule to federal derivative actions were not sufficient to overcome the federal courts' obligation to incorporate analogous state law (in that case, Delaware law) into federal common law unless inconsistent with the policies underlying the federal statute being interpreted. *See Kamen*, 500 U.S. at 106–07. The Court based its opinion in part on its conclusion that the costs to be saved by avoiding collateral litigation regarding demand would be "marginal[]," because a "universal-demand rule will merely shift the focus of threshold litigation from the question whether demand is excused to the question whether the directors' decision to terminate the suit is entitled to deference." *Id.* at 106. California courts need not be swayed by this reasoning, for at least three reasons. First, the conclusion that the cost savings would be "marginal" is erroneous. In nearly all derivative litigation in California where the board has refused a demand, there are two major components of expensive motion practice: litigation on the pleadings about demand futility and litigation challenging the board's subsequent substantive decision, if any, not to pursue the lawsuit. The rule proposed here would, notwithstanding the observation in *Kamen*, eliminate the first component and could thereby save litigants hundreds of thousands of dollars per case. Moreover, in those cases where the board heeds the shareholder demand and takes action satisfactory to the shareholder, *both* components of the motion practice would be eliminated if the rule proposed here were adopted. Second, shifting the focus of the litigation to the issue of whether the board properly refused a demand has the distinct advantage of enabling the litigation to be decided based on the facts, rather than based on the guesswork now employed in Delaware demand futility litigation. Rather than speculating based upon the pleadings alone as to whether a board would be capable of fairly evaluating a demand—as a court must do under *Aronson*—courts are called upon in the demand-refused stage to evaluate the actual decision-making process used by the board in deciding to reject the demand. The discovery necessary to develop those facts ought to be minimal. *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) (stating that because the business judgment rule applies to a board's decision to reject a demand, only discovery regarding the board's process in reaching the decision is relevant); *see also* Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc., No. CIV. A 18950, 1997 WL 38130, at *3 (Del. Ch. Jan. 29, 1997). Third, there is no reason that a California court adjudicating a case involving a California corporation need follow *Kamen*. The *Kamen* Court was bound to borrow from state law unless it conflicted with the policies underlying the federal statute at issue. *See Kamen*, 500 U.S. at 98. Because a Delaware corporation was involved, the Court had to examine whether the policies underlying the federal statute, the Investment Company Act of 1940, 15 U.S.C. § 80a-1(a) (1998), should override the presumption that Delaware law should be borrowed. *See Kamen*, 500 U.S. at 98. California's courts face no such constraint because, far from there being a presumption in favor of borrowing from Delaware law, no California case indicates that such borrowing would be proper.

judgment rule defense. A primary rationale behind the ALI/ABA rule is that it places little, if any, burden on the plaintiff, because making demand on the board is a "relatively costless step."[69] Since requiring a shareholder to postpone derivative litigation until the board can assess the claim ordinarily imposes no cost on the shareholder or the company, the ALI/ABA demand rule excuses demand only where a complaint pleads that such a brief delay will cause irreparable injury. For example, if a proposed merger could be concluded while the board is evaluating a demand for an action seeking to enjoin the merger, the demand may be excused under the "irreparable injury" exception.

The ALI/ABA proposed rule is also based in part on the view that the Delaware test is founded on a fallacy: that the corporation is powerless to act on a demand when a majority of its members participated in the alleged wrongdoing. In fact, the board is not "powerless" in such a situation. Among other possible options, the board can still delegate its authority to assess and manage the litigation to disinterested directors or can expand its size and delegate that function to a "special litigation committee" composed of the newly appointed directors.[70] Thus, "demand is still an appropriate starting point" even when a majority of the board is accused of wrongdoing.[71]

In 1997, the Supreme Court of Pennsylvania explicitly adopted the universal demand rule set forth in the ALI's *Principles*.[72] In doing so, the court noted, among other things,

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69. ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. e, at 57.

70. Use of special litigation committees in such situations has been approved under California law. *See* Gaines v. Haughton, 645 F.2d 761, 770–71 (9th Cir. 1981); *see also* Lewis v. Anderson, 615 F.2d 778, 782–83 (9th Cir. 1979); Will v. Engebretson & Co., 261 Cal. Rptr. 868, 872 (Ct. App. 1989).

71. ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. e, at 57; *accord* 2 MODEL ACT, *supra* note 67, § 7.42 cmt., at 7-335 ("[E]ven though no director may be independent, the demand will give the board of directors the opportunity to reexamine the act complained of in light of a potential lawsuit and take corrective action.").

72. *See* Cuker v. Mikalauskas, 692 A.2d 1042, 1049 (Pa. 1997). The Pennsylvania Supreme Court adopted, in total, ten sections of the ALI's *Principles*, including § 7.04, which governs judicial review of an allegedly improper response by a board to a shareholder demand. With respect to the scope of review of a decision by a board to reject a demand, the ALI's approach differs from that of the ABA. *Compare* ALI PRINCIPLES, *supra* note 47, § 7.04, *with* 2 MODEL ACT, *supra* note 67, § 7.43. Various commentators have endorsed each approach. *Compare* Dennis J. Block et al., *Derivative Litigation: Current Law*

the consistently reliable scholarship reflected in the work of the ALI.[73] The court observed that the ALI's *Principles* furthered the policies inherent in the business judgment rule and provided an appropriate degree of specificity to guide trial courts.[74]

The Pennsylvania Supreme Court adopted the ALI demand rule under its authority to adopt rules governing the filing of litigation, including derivative litigation, in Pennsylvania courts.[75] California courts similarly have the inherent authority to adopt the ALI's proposed demand rule as the law of California, just as they have the authority to adopt a proposed rule set forth in, for example, the ALI's *Restatement of Torts*. The ALI commentary indicates that Section 7.03 "is intended to express a preferred rule of state law" and that it "can be implemented by judicial decision."[76] Because California law currently fails to define specific standards for when to excuse demand,[77] the courts must fill that gap.

The "clear trend of recent decisions has been toward re-

Versus the American Law Institute, 48 BUS. LAW. 1443, 1482 (1993) (criticizing the ALI's approach as engendering excessive judicial scrutiny of post-demand business judgments, and approving the ABA rules), *with* Douglas M. Branson, *Recent Changes to the Model Business Corporations Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258, 276–77 (1993) (criticizing the ABA's approach as overly deferential to the board's response to a demand, and endorsing the ALI's rules). The issue of what is the appropriate scope of review of a board's decision to refuse a demand is beyond the scope of this article.

73. *See Cuker*, 692 A.2d at 1049.

74. *See id.* at 1048–49.

75. The language of the Pennsylvania statute describing the demand requirement, which provides the statutory context in which the *Cuker* court announced its adoption of the ALI's universal demand rule, is virtually identical to California's statute. *Compare* PA. R. CIV. P. 1506(a) (1998) ("[A derivative complaint] shall set forth . . . the efforts made to secure enforcement by the corporation or similar entity [of its rights] *or the reason for not making any such efforts*.") (emphasis added), *with* CAL. CORP. CODE § 800(b) (West 1990) ("[N]o [derivative] action may be instituted . . . unless . . . 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*.") (emphasis added). Neither statute specifies what "reasons" will be sufficient to excuse demand. The decisional backdrop to the *Cuker* opinion was also similar to current California case law. Before Pennsylvania adopted the ALI approach, at least one case decided under Pennsylvania law excused demand where the transaction was alleged to have been fraudulent or infected by self-dealing. *See* Garber v. Lego, 11 F.3d 1197, 1203 & n.8 (3d Cir. 1993); *cf. supra* note 13 (discussing *Koshaba*, *Reed*, and *Shields*).

76. ALI PRINCIPLES, *supra* note 47, § 7.03 cmt. b, at 54.

77. *See supra* Part I.A.

quiring pre-suit demand, even when earlier precedents might have excused it."[78] Commentators, even those critical of some aspects of the derivative litigation rules proposed by the ALI and the ABA, acknowledge the advantages of a universal demand approach.[79] Since 1988, at least thirteen states have statutorily adopted some form of a universal demand rule.[80] California should similarly follow the modern trend by adopting the universal demand rule and reject Delaware's cumbersome and costly test for excusing demand and.

IV. TWO LESSER ALTERNATIVES: MODIFYING *ARONSON* AND ASSURING THAT IT IS APPLIED PROPERLY

If the California courts fail to follow the modern trend towards a universal demand model, they ought to at least reduce some of the undesirable effects of the *Aronson* rule. One approach would be to modify the *Aronson* test by eliminating its second prong (which permits allegations of breach of the duty of care to excuse demand) and its reasonable doubt standard.[81] A second approach, if California courts are determined to adopt Delaware law part and parcel, would be to make clear that California is adopting not only the *Aronson*

78. ALI PRINCIPLES, *supra* note 47, § 7.03 reporter's note 1, at 63.

79. Commentators representing a wide variety of perspectives have both criticized and defended various aspects of both the ALI's and ABA's proposed rules governing derivative litigation. These commentators have been almost unanimous in their support of the element common to both proposals, the universal demand rule. *See, e.g.*, Block et al., *supra* note 72 (approving the ABA's universal demand approach, in light of the model act provisions on demand-refused analysis, and criticizing the ALI's post-demand approach as failing to accord sufficient deference to business judgments regarding how to respond to a demand); Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW., 469, 485 (1990) ("We agree with the drafters of the Model Business Corporation Act and [Tentative Drafts 8 & 9 of the] Principles of Corporate Governance that there is much to be said in favor of requiring a prelitigation demand on a universal basis . . . ."); *see also* Branson, *supra* note 72, at 275 (approving the ALI's universal demand proposal, in light of its provisions for substantive judicial review of the board's response to demand, and criticizing the ABA's post-demand rules as overly deferential to a board's refusal of a demand); Kinney, *supra* note 52, at 182–87 (criticizing the ALI approach as overly litigation-oriented and the ABA approach as biased in favor of board decisions, but proposing universal demand requirement for cases alleging a breach of the duty of care); Swanson, *supra* note 46, at 1386–87 (offering criticism of the balances struck by the ALI and ABA approaches, but strongly endorsing the universal demand rule).

80. *See* Marx v. Akers, 666 N.E.2d 1034, 1038–39 (N.Y. 1996) (describing the rules in those thirteen states).

81. *See supra* Part II.B.2.

rule *in toto*, but also the Delaware case law that forms the backdrop of the *Aronson* decision. That case law requires that demand futility be pleaded "with particularity" and distinguishes gross negligence, which excuses demand, from simple negligence, which does not. Although both alternatives offer fewer advantages than adopting the ALI/ABA rule, they are presented as potential compromise positions that would make California's demand rule more clear, simpler in application, and more consistent with the functions and policy underpinnings of the rule.

A. *Modifying the* Aronson *Rule: Eliminating the Second Prong and Eliminating the Reasonable Doubt Standard*

If California courts are inclined to look to Delaware law for a model, they should adopt only the first prong of the *Aronson* test. The first prong is more consistent with the modern trend in that it establishes a relatively bright line test (at least when compared to the potentially expansive second prong) that will diminish collateral litigation and provide less opportunity for avoidance of the demand requirement.

To apply the first prong, a court need only determine whether a complaint contains particularized allegations showing that a majority of the directors had a personal financial interest in the underlying transaction, or were controlled by someone who did.[82] Either the complaint identifies a financial interest for each director or it does not. There is no need to litigate the merits of the causes of action asserted in the complaint, as required under the second prong, in order to assess whether to excuse demand. There is also no need for complex litigation in each case to determine where to draw the line between simple and gross negligence.[83] Thus, declining to import the second prong of *Aronson* into California law will make the test for excusing demand less costly and easier to administer.

Moreover, the first prong approximates much more closely than the second what little law there is in California

82. *See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

83. The rule proposed here is the formulation of the first prong of the *Aronson* test as set forth more recently by the Delaware Supreme Court in Levine v. Smith, 591 A.2d 194, 205 (Del. 1991), which appears to have eliminated the problematic "reasonable doubt" standard from the first prong of the *Aronson* test. *See supra* text accompanying note 45.

on excusing demand.[84] The *Shields* case, in refusing to excuse demand, observed that the plaintiff failed to plead with particularity that the board engaged in a fraud or conspiracy, benefited from the transaction, or was unable to exercise independent judgment.[85] The common thread among those missing allegations is actual or implied intentional wrongdoing—that is, bad faith conduct on the part of the board. Similarly, the first prong of *Aronson* identifies the cases that demonstrate a likelihood of such intentional wrongdoing.

Alternatively, if California adopts both prongs of the *Aronson* test, the "reasonable doubt" standard should be eliminated. As described earlier, the "reasonable doubt" standard contained in the second prong of the *Aronson* test (as modified by *Levine v. Smith*[86]) is excessively confusing, subjective, and permissive.[87] The standard unnecessarily diminishes the role of the board in managing the litigation affairs of the corporation. Thus, if California courts adopt both prongs of *Aronson* as the law of California, eliminating the problematic "reasonable doubt" standard from that test would add at least a degree of administrability and predictability to the demand futility determination. New York's high court recently adopted this approach. In *Marx v. Akers*,[88] the New York Court of Appeals, after reviewing the criticism of the reasonable doubt standard, expressly refused to adopt that portion of the Delaware test.[89] California courts should follow New York's lead and reject the unwieldy and inherently subjective reasonable doubt standard.

B. *Clarifying How the* Aronson *Rule Should Be Applied*

1. *The Particularity Standard*

If California adopts Delaware law *in toto*, then the lower courts must be given guidance as to how the *Aronson* rule should be applied. In addition to guidance on how to address the problematic "reasonable doubt" standard, the trial courts need clear standards in two important areas. First, the

84. *See supra* note 13 (discussing *Koshaba*, *Reed*, and *Shields*).
85. *See* Shields v. Singleton, 19 Cal. Rptr. 2d 459, 465 (Ct. App. 1993).
86. *Levine*, 591 A.2d at 205. *See supra* text accompanying note 45.
87. *See supra* Part II.B.2.d.
88. Marx v. Akers, 666 N.E.2d 1034 (N.Y. 1996).
89. *See id.* at 1039.

courts must articulate the standard for pleading facts "with particularity." Under Delaware case law, conclusory allegations cannot excuse demand: a plaintiff must plead "*particularized* facts" showing demand futility.[90] The particularity requirement is an integral part of the *Aronson* test, as it seeks to prevent the authority of the board to manage the affairs of the corporation from being too easily nullified by individual shareholders. Thus, if California adopts the *Aronson* test, the courts must take note of, and strictly enforce, the specificity requirement dictated by *Aronson* and its progeny.[91]

2. *Differentiating Simple from Gross Negligence*

Similarly, to apply *Aronson*'s second prong properly, California courts must also incorporate the surrounding Delaware case law regarding what is and what is not gross negligence. The Delaware courts recognized that *Aronson*'s second prong was intended to excuse demand only in very rare cases.[92] Thus, an expansive view of what allegations constitute gross negligence can seriously undermine the balance that the Delaware courts intended to strike. In order to preserve the

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90. *See* Aronson v. Lewis, 473 A.2d 805, 814, 816–817 (Del. 1984) (where plaintiff's allegation of control is "at best . . . a conclusion devoid of factual support," the court "cannot conclude that the complaint factually particularizes any circumstances of control"); *see also* Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988) ("[C]onclusionary allegations of fact or law not supported by allegations of specific fact may not be taken as true."). California law similarly refuses to permit conclusory allegations to excuse demand. CAL. CORP. CODE § 800(b)(2) (West 1990); *see also Shields*, 19 Cal. Rptr. 2d at 466 ("[B]are allegations of director wrongdoing without factual support cannot excuse demand."); Fairchild v. Bank of Am., 13 Cal. Rptr. 491, 494 (Ct. App. 1961) (where "[n]o sufficient facts are alleged with particularity," a "conclusionary allegation" of demand futility does not meet the statutory pleading requirement).

91. *See, e.g., Aronson*, 473 A.2d at 817 (the "shorthand shibboleth" that the directors were "dominated and controlled" is insufficient to excuse demand); *see also* Cottle v. Hilton Hotels Corp., 635 F. Supp. 1094, 1100 (N.D. Ill. 1986) (applying Delaware law) (holding that a "conclusional" charge that directors "completed a transaction as an improper entrenchment device to ward off a takeover attempt" is insufficient to excuse demand). To the extent the case law has not sufficiently defined the quantum of particularity required to excuse demand, *see* Coffee, *supra* note 25, at 1413, that fact only argues more forcefully in favor of rejecting the *Aronson* test altogether. Assuming, though, that California courts choose to adopt *Aronson*, they should adopt the surrounding Delaware case law regarding particularity of pleadings to minimize the variances in results that might otherwise be produced by application of the *Aronson* rule. *See id.* at 1412–13 & nn. 22–26.

92. *See* Grobow v. Perot, 539 A.2d 180, 190 (Del. 1988); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

authority and right of a board to manage the corporation's litigation, California trial courts must understand the distinction between gross and simple negligence drawn under Delaware law. Failure to recognize this important distinction would convert the Delaware demand futility rule into an extraordinarily permissive threshold, something that it was never intended to be.

For example, in virtually every derivative case, a plaintiff pleading with the advantage of hindsight will be able to allege that a board overlooked a particular fact in approving a transaction. After all, derivative litigation results only when a transaction has in some way gone sour. In such cases, particularly where a large or high-profile company is involved, the media and securities analysts often publish post-mortems on those transactions. Those post-mortems, in assessing what went wrong with a transaction, identify, in retrospect, "red flags" that indicate the transaction was imprudent. Thus, whenever a transaction goes bad, a shareholder can meet a simple negligence standard by copying those post-mortems into a complaint and alleging that the board "overlooked" one or more "red flags."

But under Delaware precedents, it is clear that merely overlooking certain facts, even material ones, constitutes only simple negligence. What turns negligence into gross negligence is the absence of a meaningful investigative process. The existence of even a minimal good faith investigative process precludes a finding of gross negligence.[93] Indeed, a Delaware Chancery Court recently found that even a board overlooking a "smoking gun" is irrelevant to the gross negligence analysis.[94] As summarized by one commentator:

93. *See* Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc., No. Civ. A. 13950, 1997 WL 38130, at *5 (Del. Ch. Jan. 29, 1997) (noting, with respect to reasonableness of investigation, that "[w]hat is important . . . is what the [board members] knew and did during the investigation" and not the existence of other information); *accord Caremark Int'l*, 698 A.2d at 967 ("[C]ompliance with a director's duty of care . . . [is] determined by . . . the good faith or rationality of the *process* employed.") (emphasis added); *see* Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("[N]o risk [of liability] if they act in good faith and meet minimal procedural standards of attention."); *cf.* Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (directors were "grossly negligent in approving the 'sale' of the company upon two hours' consideration, without prior notice").

94. *See Carlton Invs.*, No. Civ. A. 13950, Tr. of Scheduling Conf. at 56 (Del.Ch. Nov. 27, 1996) [hereinafter Carlton Invs. Tr.].

> The court noted that "to be reasonable in getting informed doesn't mean to be perfectly informed. There is always something more you could do to get better informed." Accordingly, the court held that it would only evaluate "what the directors did based upon the reasonableness of their own efforts to become informed, and then the rationality of the judgment that they reached." The court went so far as to state that, even if "there is a smoking gun out there," but, based upon the information reasonably gathered by the committee, its judgment was still sound, the "smoking gun" would be irrelevant to a determination of whether the investigation was reasonable and whether the [board members] reached reasonable conclusions.[95]

The Delaware decisions clarify that the focus of the inquiry should be on the existence of a good faith *process*, not on whether the board overlooked one or more particular facts during that process.[96]

Delaware's high threshold for showing gross negligence reflects the Delaware courts' policy that rules regarding the duty of care should not unduly inhibit directors in making difficult or risky business decisions on behalf of the shareholders.[97] For that reason, directors should rarely be found in breach of the duty of care under Delaware law, and accordingly, demand should rarely be excused on that basis. As the Delaware Supreme Court stated in *Grobow v. Perot*:

> Approval of a transaction by a majority of independent, disinterested directors *almost always* bolsters a presumption that the business judgment rule attaches to transactions approved by a board of directors that are later attacked on grounds of lack of due care. In such cases, a

95. Gregory V. Varallo, et al., *From* Kahn *to* Carlton*: Recent Developments in Special Committee Practice*, 53 BUS. LAW. 397, 417 (1998) (citing *Carlton Invs. Tr.*, No. Civ. A. 13950, at 56).

96. *See, e.g.*, Levine v. Smith, 591 A.2d 194, 214 (Del. 1991) ("[A] determination of what matters will (and will not) be considered must necessarily fall within the board's discretion."); *see also* Ryan v. Aetna Life Ins., 765 F. Supp. 133, 139 (S.D.N.Y. 1991) (applying Delaware law) (holding that allegations that the board's investment banker failed to investigate "the higher value that might have been realized by alternative types of transactions" insufficient to plead gross negligence); *In re* RJR Nabisco, Inc. Shareholders Litig., No. Civ. A. 10389, 1989 WL 7036, at *19 (Del. Ch. Jan. 31, 1989) ("[T]he amount of information that it is prudent to have before a decision is made is itself a business judgment of the very type that courts are institutionally poorly equipped to make.").

97. *See Caremark Int'l*, 698 A.2d at 967.

heavy burden falls on a plaintiff to avoid presuit demand.[98]

Excusing demand based on allegations that a board overlooked certain material facts would collapse the gross negligence standard into the simple negligence standard. Further, such an expansive rule would render meaningless the "heavy burden" that the Delaware Supreme Court intended to impose in duty of care cases. If a plaintiff's attorney need only plead allegations based on a few published, hindsight analyses of a transaction that performed poorly, demand will be excused in every case. Accordingly, if California adopts Delaware's demand rule, California courts should strictly adhere to and articulate the Delaware case law's distinction between gross negligence and simple negligence. Failure to do so will nullify the balance that *Aronson* and subsequent Delaware decisions intended to strike.

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98. *Grobow*, 539 A.2d at 190 (emphasis added). The *Grobow* decision does, however, contain additional language that at least on its face appears inconsistent with the Delaware case law on gross negligence discussed above. This fact is likely to generate some confusion in the California courts unless those courts clearly articulate the distinction between simple and gross negligence under Delaware law. The *Grobow* opinion states at one point that gross negligence means "being uninformed in critical respects." *Id.* at 190. This language should not be read to mean that overlooking one or more facts constitutes gross negligence in Delaware. In making that statement, *Grobow* cites *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), as its example, a case where there was a complete absence of a good faith investigative *process*. *See id.* at 874 (summarizing lack of investigative process and concluding that directors "were grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice"). Moreover, interpreting *Grobow* as defining gross negligence as something less than the absence of a good faith process would be inconsistent with the language in *Grobow* imposing a "heavy burden" on any shareholder who seeks to have demand excused based on allegations of breach of the duty of care. *See Grobow*, 539 A.2d at 190; *see also Caremark Int'l*, 698 A.2d at 967 ("The theory here advanced [the breach of the duty of care or attention] is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."). It would also be inconsistent with the manner in which gross negligence has been defined by the Delaware Chancery courts in the last decade and with the absence of any case in Delaware where demand has been excused because a board, in approving a transaction, had simply overlooked one or more facts. Finally, it would be inconsistent with the language in "*Grobow II*," where the Delaware Supreme Court described a breach of the duty of care as "acting in an uninformed *manner*," thus placing the focus on the *process* employed by the board. Levine v. Smith, 591 A.2d 194, 207 (Del. 1991) (emphasis added) (arising out of the amended complaint filed in *Grobow* after the Delaware Supreme Court's 1988 *Grobow* decision).

V. CONCLUSION

As derivative actions are brought with increasing frequency in California courts against California corporations, California must adopt a clear rule specifying the circumstances under which a shareholder-plaintiff will be excused from making a demand on the board to pursue litigation on behalf of the corporation. California's rule should be consistent with the important policies the demand requirement intended to achieve. The Delaware rule of demand futility is inconsistent with those policies. This article proposes three alternatives from which California courts may choose. Primarily, this article advocates that the California courts should adopt the proposed ALI/ABA rule, which will eliminate substantial litigation costs and better effectuate corporate governance policies underlying the demand requirement. Alternatively, the California courts should modify the Delaware test to eliminate its reasonable doubt standard and to render allegations of a breach of the duty of care by a board insufficient to excuse demand. Finally, at the very least, if the California courts choose to adopt the Delaware demand rule, they should also adopt Delaware's requirement that demand futility be pleaded with particularity, and Delaware's distinction between gross negligence and simple negligence.