Shareholder Derivative Suits: Louisiana Law

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I. INTRODUCTION

A derivative action\(^1\) is a procedural device that permits a corporate shareholder to overcome the normal rule that corporate rights of action must be filed and managed by a corporate officer or agent who is subject to the control of the corporation's board of directors. The derivative nature of such a suit does not change the actual ownership of the claim—the claim continues to be owned by the corporation rather than the shareholder\(^2\)—but it does change the identity of the person who is placed in charge of the suit; if the special requirements of a derivative suit are satisfied, the plaintiff shareholder, not the usual board-authorized agent, is treated as the corporation's representative in the suit.

Although, in theory, a derivative suit could be filed to enforce any type of corporate claim, in practice these suits are used almost exclusively as a means of suing corporate officers and directors for alleged breaches of the fiduciary duties that are owed by the officers and directors themselves to the corporation.\(^3\) Efforts by shareholders to take over other types of legal disputes on behalf of the corporation are usually rejected on grounds that management, not individual shareholders, should make all ordinary litigation decisions for the corporation.

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1. The Louisiana Code of Civil Procedure calls a derivative action a "secondary" action. La. Code Civ. P. art. 593. This distinctive terminology is simply an accident of history, and has no substantive importance. "Secondary" was the term used in the federal rules at the time that the Louisiana Code of Civil Procedure was adopted in 1960. In 1960, the pertinent federal rule was Fed. R. Civ. P. 23(b), which was promulgated in 1937 and entitled "Secondary Action by Shareholders." 3B James W. Moore et al., Moore's Federal Practice ¶ 23.1.01 [2] (2d ed. 1995). The Federal Rules of Civil Procedure did not begin to use the "derivative" terminology until 1966. Id. at ¶ 23.101 [5]. Louisiana copied the then-current term, and did not bother to update it after the federal terminology was changed. Despite the older Code language, Louisiana courts generally use the more widely-accepted term "derivative," rather than "secondary," in discussing suits filed by shareholders on behalf of their corporations. See, e.g., Robinson v. Snell's Limbs & Braces, Inc., 538 So. 2d 1045 (La. App. 4th Cir. 1989); Bordelon v. Cochrane, 533 So. 2d 82 (La. App. 3d Cir. 1988), writ denied, 536 So. 2d 1255 (1989); Smith v. Wembley Indus., Inc., 490 So. 2d 1107 (La. App. 4th Cir. 1986). The same practice will be followed in this article.


3. See Maestri v. Destrehan Veterinary Hosp., 653 So. 2d 1241 (La. App. 5th Cir.), writ denied, 660 So. 2d 879 (1995); Robert C. Clark, Corporate Law § 15.2, at 644 (1986); Harry G. Henn & John R. Alexander, Laws of Corporations § 358, at 1037 (3d ed. 1983). The Maestri court's suggestion that derivative suits may be filed only by minority shareholders, and not by 50% or majority shareholders, is incorrect. Maestri, 653 So. 2d at 1243-44. Ordinarily, a majority shareholder faces no practical need to file a derivative action, as he is already in control of all of the corporation's litigation decisions anyway through his power to elect and to remove most or all of the members of the corporation's board of directors. Still, the law does not require that the plaintiff in a derivative action be a minority shareholder. As was true in Maestri, a non-minority shareholder (particularly a deadlocked 50% shareholder) might sometimes find it necessary as a result of his lack of managerial power to pursue the corporation's remedies derivatively, rather than directly though an exercise of managerial power over the subject corporation itself. In that case, regardless of the reasons for the complaining shareholder's lack of managerial power, the derivative suit is just as appropriate—and just as necessary—as in the more typical minority shareholder suit.
under the normal protections of the business judgment rule. But when management itself is the target of the suit, the resulting conflicts of interest may be serious enough to disqualify management from making the controlling decisions.

In the context of large, publicly-traded corporations, derivative suits are controversial. Critics of such suits argue that the suits do little good for investors; they merely foster a form of legalized extortion in which the corporation and its insurers are forced to pay huge fees to plaintiff lawyers to settle expensive but meritless cases. Proponents of the suits contend that derivative actions are vital to the enforcement of management's legal duties of care and fidelity and that the benefits of these suits, especially when their deterrent value is included, do exceed their costs.

At least for public corporations, the critics appear to be winning the debate. Managerial control over derivative suits is considered to be a question of substantive state law, and Delaware, the dominant corporation law state, has devised some jurisprudential rules on derivatives suits that make it extraordinarily difficult for the plaintiff to survive a management-sponsored motion to dismiss. Most of Delaware's pro-management policy choices, though not all its procedural quirks, have now been incorporated into the ABA's Revised Model Business Corporation Act and into the American Law Institute's Principles of Corporate Governance. For most publicly-traded corporations, therefore, the law seems reasonably well-settled in management's favor.

But not all states agree with these leading, pro-management authorities. Many states simply have not addressed the critical issues, while others have explicitly rejected the pro-management stance of the Delaware cases and the model provisions. Not surprisingly, most of the "anti-Delaware" positions on this subject have been taken in states that, like Louisiana, deal in their courts more with smaller, closely-held corporations than with major, publicly-traded

5. See infra notes 69-71.
6. See infra notes 72-73.
7. Questions about the control of corporate claims in a derivative suit have been held by the United States Supreme Court to be governed by substantive state law, even if the claim being enforced has arisen under federal law. Kamen v. Kemper Fin. Sec. Servs., Inc., 500 U.S. 90, 111 S. Ct. 1711 (1991); Burks v. Lasker, 441 U.S. 471, 99 S. Ct. 1831 (1979). Nevertheless, much of the law in the field has arisen from federal decisions predicting the state law on the subject. Relatively few states have adopted statutes or rendered judicial decisions on the critical questions. See A.L.I., supra note 4, § 7.08, at Reporter's Note 2.
8. See infra part V.B.2, Delaware Changes Its Mind.
10. See A.L.I., supra note 4, § 7.08, at Reporter's Note 2.
companies. It may be that the states in the opposition camp do not so much disagree with Delaware on the dangers of derivative suits in the context of public corporations as they do with the out-of-context application of public corporation reforms to smaller, closely-held corporations. Indeed, the American Law Institute, even while adopting pro-management positions on derivative suits generally, has also adopted a provision that makes the normal derivative suit rules inapplicable to closely-held corporations.12

It is difficult to say just where Louisiana fits into this disagreement. Louisiana's law on derivative suits is, on most noncontroversial points, similar to that in other states. But on the more controversial point of managerial powers in the derivative suit—the focus of the national debate for the last twenty years or so—Louisiana courts seem simply to have missed the point. Despite the extensive national debate, and despite the clear pro-management trend in the law, the leading Louisiana decisions not only employ a contrary, anti-management form of reasoning, they actually reject the idea that anyone, anywhere has ever done anything else.13 Yet when limited to their facts all of the Louisiana decisions reported so far still could be reconciled with Delaware's pro-management views. Moreover, no Louisiana court has yet articulated, much less rejected, the Delaware view explicitly. One decision has even seemed, unknowingly, to endorse Delaware's basic policy choices.14 Thus, depending on how the Louisiana cases are interpreted, they might be placed either in the Delaware camp based on their facts or in the anti-Delaware camp based on their reasoning—reasoning that does not so much reject the Delaware view as refuses to believe it exists.

The purpose of this article is twofold, first to provide a primer on the Louisiana law of derivative suits, and second to place into a national context the Louisiana decisions about managerial control of such suits. The basic, noncontroversial aspects of derivative suits will be discussed first. The article will then turn to the debate about managerial control over these suits. This second, main part of the article will begin with a summary of the conflicting empirical evidence on the subject. It will then discuss the three seminal cases on the subject, cases which have produced not only the current doctrine in Delaware, but also the basic policy choices that are now reflected in the Revised Model Business Corporation Act and in the American Law Institute's Principles of Corporate Governance. Finally, the Louisiana law on the issue of managerial control, and of potential ethical conflicts in the legal representation of both management and the corporation in derivative suits will be discussed. The article will conclude that the incredulity of Louisiana courts toward the leading national rules is not only understandable from their close corporation perspective, but has

12. A.L.I., supra note 4, § 7.01(d).
13. See infra part VI, Louisiana Decisions—Wembley.
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also produced sound results so far. However, the article will suggest that the Louisiana courts' views would inspire greater confidence if the competing views were stated accurately, and then rejected in a more deliberate way.

II. DISTINGUISHING DIRECT FROM DERIVATIVE SUITS

Ordinarily, a corporate shareholder owns no direct, personal right of action to enforce a corporate claim. Only the corporation itself may enforce corporate claims.15 If a disagreement exists among the various participants in the corporation about the wisdom of pursuing a particular lawsuit, that disagreement is ordinarily resolved in the same way as most other internal corporate disagreements. The board of directors, or a person authorized by the board, makes the controlling decision.16 If a shareholder disagrees with that decision, he is entitled to act on his displeasure at the next election of directors, but he is not entitled to take his own position in the litigation separately from the corporation. The corporation is treated as a separate and unitary person for litigation purposes. Either the entire corporation sues or none of the corporation sues, based on management's decision in the matter. Similarly, once a suit is brought, the suit is pursued, dismissed or settled in accordance with the same unitary rule. Management is entitled to control corporate litigation just as it is entitled to control virtually all other aspects of corporate operations.17

Of course, not all rights held by shareholders are derivative in nature. Some rights are held directly by shareholders personally, and so may be enforced without compliance with the law on derivative suits. Distinguishing direct from derivative claims can sometimes be difficult, and can sometimes pose dangers of circular reasoning,18 but the basic contours of the classification scheme are

15. E.g., Department of Transp. & Dev. v. Clark, 548 So. 2d 365 (La. App. 2d Cir. 1989), writ denied, 552 So. 2d 395 (1990); Hinchman v. Oubre, 445 So. 2d 1313 (La. App. 5th Cir. 1984); Mahfouz v. Ogden, 380 So. 2d 646 (La. App. 1st Cir. 1979); Afeman v. Insurance Co. of N. Am., 307 So. 2d 399 (La. App. 4th Cir. 1975). But cf. Coury v. Coury Moss, Inc., 510 So. 2d 1316 (La. App. 3d Cir. 1987) (veil pierced to allow shareholder to bring suit personally for wrongs suffered by corporation as result of alleged managerial misconduct), disagreed with by Bordelon, 533 So. 2d at 85-86.
17. See id.
18. See Moore et al., supra note 1, ¶ 23.1.16 [1]. In the context of mergers and acquisitions, for example, an action for damages arising out of a management decision to forego a profitable buyout transaction may be treated as derivative, as if the corporation as a whole rather than the shareholders lost the profits that would have accrued from their sale of stock, while a decision to proceed with a sale at less than an optimum price, or an action to enjoin or rescind defensive maneuvering, may be treated as direct, as a loss by the shareholders personally of either of money or of prospective opportunities. Compare Pogostin v. Rice, 480 A.2d 619 (Del. 1984) (derivative—opposition to profitable buyout proposal) with Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (direct action—inadequate price in merger) and Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (direct—action to set aside defensive poison pill device) and Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990) (direct—action to enjoin defensive maneuvering).
fairly well established. Suits brought by shareholders to recover for damage or loss to corporation-owned property or interests or to recover for losses caused to the corporation as a result of the self-dealing or negligence of a corporate officer or director are considered to be derivative in nature. But suits brought to vindicate some right held by a shareholder personally, such as a right to vote or to protect against dilution of voting or financial rights, to inspect books or records, to enjoin ultra vires acts, to receive a dividend, or to recover for fraud in connection with the purchase or sale of his stock, are considered direct suits. The American Law Institute has suggested this test for distinguishing direct from derivative claims: if a shareholder can recover in a suit only by showing that the corporation was injured, then the suit is derivative in nature, even if the corporate injury does cause indirect harm to the shareholder. On the other hand, if a recovery can be granted to the shareholder without proof of a corporate loss, then the suit is direct.

19. Clark, 548 So. 2d at 365; Fouchi v. Lazzara, 508 So. 2d 853 (La. App. 5th Cir. 1987); Hinchman, 445 So. 2d at 1313; Richard v. Morgan, 433 So. 2d 263 (La. App. 1st Cir.), writ denied, 438 So. 2d 1108 (1983); Mahfouz, 380 So. 2d at 646; Afeman, 307 So. 2d at 399. But cf. Coury, 510 So. 2d at 1316 (veil pierced to allow shareholder to bring suit personally for wrongs suffered by corporation as result of alleged managerial misconduct), disagreed with by Bordelon, 533 So. 2d at 85-86.


21. Cf. Reiss v. Superior Indus., Inc., 466 So. 2d 542 (La. App. 5th Cir. 1985) (suit challenging issuance of stock that diluted plaintiff's percentage of ownership permitted as direct action, without apparent challenge by defendants to plaintiff's direct right of action).

22. See La. R.S. 12:103(D) (1994). These inspection rights are subject to certain conditions and limitations, but to the extent that the rights exist substantively, they are held and may be enforced directly by shareholders.


26. A.L.I., supra note 4, § 7.01 cmt. c; Clark, supra note 3, § 15.9, at 662-63; Henn & Alexander, supra note 3, § 360, at 1048-49.


28. See A.L.I., supra note 4, § 7.01(b). Official Comment (c) to § 7.01, supra, lists the following actions as direct:
Although Louisiana's corporation statute now states that officers and directors owe fiduciary duties to shareholders as well as to the corporation itself,29 Louisiana courts have rejected the argument that this language, adopted in 1968, made any changes in the traditional rules concerning the distinctions between direct and derivative lawsuits.30 Despite the personal duty language in the statute, only those duties thought to be owed to shareholders directly (e.g., to make disclosures in stock transactions)31 may be enforced in direct actions. Duties owed to the corporation, even though owed indirectly for the protection of shareholders, must still be enforced by the corporation itself, either in a direct action brought in the usual way by management or in a derivative suit brought by a shareholder.32

From a functional standpoint, characterizing a suit as derivative rather than as direct in nature has four important effects: (1) any monetary recovery

(1) To enforce voting rights, to prevent improper voting, to protect against dilution, or to protect preemptive rights;
(2) To compel the payment of dividend or to protect dividend arrearages;
(3) To challenge the improper use of managerial power to perpetuate management or to frustrate voting by shareholders;
(4) To prevent ultra vires or unauthorized acts;
(5) To prevent oppression of, or fraud against, minority shareholders;
(6) To compel dissolution or the appointment of a receiver;
(7) To challenge the unlawful expulsion of shareholders through mergers, redemptions, or other means;
(8) To inspect corporate books and records;
(9) To require the holding of a shareholders' meeting or the sending of notice of such a meeting; and
(10) To hold controlling shareholders liable for actions taken in their individual capacities that reduce the value of minority shares.

29. La. R.S. 12:91 (1994). It is not clear whether this shareholder duty language changed the earlier substantive law, or merely codified it. See Wilson, 430 So. 2d at 1227 (La. R.S. 12:91 duty owed by director to shareholder in connection with allegedly fraudulent stock transaction between director and shareholder personally); Junker, 650 F.2d at 1349 (interpreting La. R.S. 12:91 as imposing on directors a fiduciary duty in dealing with shareholders in the purchase and sale of corporate stock, including a duty "to disclose facts within their [the directors'] knowledge to shareholders and to deal with them in an atmosphere of trust and confidence." Id. at 1356.). But see Markey v. Hibernia Homestead Ass'n, 186 So. 757 (La. App. 3d Cir. 1939) (pre-1968 decision imposing duties of disclosure in stock transaction); Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317 (5th Cir.), cert. denied, 361 U.S. 885, 80 S. Ct. 156 (1959) (pre-1968 decision imposing disclosure duties in stock transaction).

30. The argument was explicitly rejected in Beyer v. F. & R. Oilfield Contractors, Inc., 407 So. 2d 15 (La. App. 3d Cir. 1981), and later cases have followed Beyer's lead in continuing to draw the traditional distinctions between suits that are direct and those that are derivative in nature. Palowsky, 597 So. 2d at 543; Bordelon v. Cochrane, 533 So. 2d 82 (La. App. 3d Cir. 1988), writ denied, 536 So. 2d 1255 (1989).

31. Wilson, 430 So. 2d at 1227; Markey, 186 So. at 757; Junker, 650 F.2d at 1349; Mansfield Hardwood Lumber Co., 268 F.2d at 317.

32. Maestri v. Destrehan Veterinary Hosp., Inc., 653 So. 2d 1241 (La. App. 5th Cir.), writ denied, 660 So. 2d 879 (1995); Palowsky, 597 So. 2d at 543; Bordelon, 533 So. 2d at 82; Beyer, 407 So. 2d at 15.
obtained in the suit is paid to the corporation, and not to the representative
plaintiff personally, so that the recovery must used, retained, or paid out in the
same way and under the same managerial and creditor-protection rules as apply
to the use or distribution of all other corporate assets; (2) the derivative suit
plaintiff, if successful, will be entitled to an award of attorney's fees from the
corporation (as the theoretical plaintiff/beneficiary of the litigation pursued on its
behalf); (3) the corporation, rather than individual corporate participants, is
treated as the owner of the claim, so that a judgment or settlement of just one
suit, the corporation's suit, will conclude the matter—thus avoiding multiple
suits; and (4) the suit will be subjected to whatever managerial controls and
special procedural rules as the jurisdiction in question chooses to impose on
derivative suits.33

These effects are generally considered desirable in large, publicly-traded
corporations because they fit the collective and representative character of the
corporate claim being asserted. But in a small, closely-held corporation, the
fiction that the corporation owns the claim may do more harm than good, as it
may help obscure the truth that individual, rather than collective, interests are
really at stake.34 In a close corporation, the chief impact of a derivative
characterization of a minority shareholder's breach-of-fiduciary-duty suit is to
make it impossible for the shareholder to obtain any direct form of relief, even
if he proves his case. Recognizing these problems, the American Law Institute
has suggested that courts be granted the discretion to treat suits brought by
the shareholders of closely-held corporations as direct suits unless the derivative
characterization is needed to avoid injury to corporate creditors, to prevent a
multiplicity of litigation, or to provide a fair distribution of the recovery in the
case.35 This article will suggest later that Louisiana courts, practically speaking,

33. See A.L.I., supra note 4, § 7.01 cmt. (d).
34. See Barth v. Barth, 659 N.E.2d 559 (Ind. 1995) (adopting A.L.I. rule permitting minority
shareholder to maintain direct, personal action alleging freezeout by majority stockholder); Richards
(Ohio 1989) (rejecting traditional classification scheme in context of closely held corporations;
permitting direct action by minority shareholder against majority shareholders where alleged breaches
damaged minority shareholders); Balvik v. Sylvester, 411 N.W.2d 383 (N.D. 1987) (permitting direct
action by minority shareholder against majority shareholder for freezeout); Steelman v. Mallory, 716
P.2d 1282 (Idaho 1986) (permitting direct suit by minority shareholder based on allegations that
majority, through their control of corporation, were freezing him out); Johnson v. Gilbert, 621 P.2d
916 (Ariz. App. 1980) (treating suit between two 50% shareholders as direct, and applying
partnership dissolution principles to determine relative rights); Donahue v. Rodd Electrotype Co., 328
N.E.2d 505 (Mass. 1975) (permitting direct suit by minority against majority shareholders to require
equal treatment in corporate share repurchase); Watson v. Button, 235 F.2d 235 (9th Cir. 1956)
(permitting direct suit by former shareholder for misappropriation from corporation by other
shareholder). But see John W. Welch, Shareholder Individual and Derivative Actions: Underlying
Rationales and the Closely Held Corporation, 9 J. Corp. L. 147 (1984) (questioning analogy between
partnerships and closely-held corporations and arguing for only limited relaxations of traditional
rules).
35. A.L.I., supra note 4, § 7.01(d).
have moved at least a bit in this direction, and that even further movement would be desirable.

III. CLASS ACTION OR JOINDER-BASED

The Louisiana rules on derivative actions are set forth in the class action provisions of the Code of Civil Procedure, articles 591 through 611, as if all derivative actions were also class actions. Nevertheless, Louisiana actually recognizes both a class-action, and a non-class-action form of derivative suit.\(^{36}\) Whether a derivative suit may be filed as a class action rather than as a multi-party action under Louisiana law depends, as it does with all other types of suits, on the difficulties of joining all members of the purported class as parties to the suit.\(^{37}\) If it is impracticable to join all shareholders of the corporation as parties, then the class action form of derivative suit is available.\(^{38}\) If not, then under Article 611 the class action form of derivative suit is not available;\(^{39}\) actual joinder of all the shareholders is required. If a shareholder refuses to join in the suit as a plaintiff, then Article 611 requires that he be joined as a defendant.\(^{40}\)

The differences between class action and multi-party forms of derivative suits arise principally out of the representational role of the plaintiff in a class action suit.\(^{41}\) Subject to the rights of members to opt out of the class (or to intervene

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36. See La. Code Civ. P. art. 611 cmt. b (rejecting view that all derivative actions must be class actions); La. Code Civ. P. art. 591 cmt. a (recognizing past recognition of secondary, i.e., derivative, actions and stating that “[a] few of these cases have been secondary class actions”).

37. Numerosity is required for all class action suits, but numerosity is not sufficient by itself to justify a nonderivative class action. A nonderivative class action is based on a combination of numerosity and common questions of law or fact, while a derivative class action is based on a combination of numerosity and the secondary nature of the claims being asserted. La. Code Civ. P. art. 591; McCastle v. Rollins Envtl. Servs., Inc., 456 So. 2d 612, 616 (La. 1984) (listing numerosity, common question and adequacy of representation requirements in nonderivative class actions). Cf. Palowsky v. Premier Bancorp, Inc., 397 So. 2d 543 (La. App. 1st Cir. 1984) (recognizing class action form of derivative action). In effect, the secondary quality of the claim in a derivative suit automatically provides the required commonality, as the cause of action being asserted is unitary—it is owned by the corporation as a separate, solitary person. Although different shareholders might have different interests and wishes concerning the corporation’s assertion of the corporation’s theoretically unitary claim, these potential differences are handled through rules on adequacy of representation, and management’s power to terminate the suit, not through the treatment of the unitary corporate claim as a collection of claims by the corporation’s shareholders. Regardless of how the claim is handled, whether by management or by the derivative suit plaintiff, the claim remains just one claim, and thus necessarily poses questions of law and fact that are entirely common.


40. Id. The corporation must be joined as a defendant in any form of derivative suit, whether class-action or joinder-based. La. Code Civ. P. arts. 596(3) (joinder of corporation required in derivative suits); 611 (joinder-based derivative suit governed by same rules as class action form, except for Articles 591, 592 and 597).

41. Louisiana law recognizes the possibility of both plaintiff and defendant class actions. See La. Code Civ. P. arts. 591 (referring to rights to be enforced “for or against” the class); 592
personally as parties), if a suit is treated as a class action then members of the class will participate in the litigation strictly through the actions of the representative plaintiff. Judgments rendered in the litigation will bind the entire class, even though most members were not named as parties, as long as the plaintiff “fairly insure[s] the adequate representation of all members” of that class. Accordingly, to qualify his suit as a class action to begin with, the plaintiff must establish not only that a class action is appropriate, but also that he will serve as an adequate representative of all class members. The representative plaintiff may negotiate a settlement of the case, but the settlement must be approved by the court, to avoid the danger that the representative will settle on terms favorable to him (or his lawyer) personally, but not to other members of the class. And if the representative plaintiff obtains some recovery or benefit for the members of the class, then the court may award the representative party his reasonable expenses of litigation, including reasonable attorney’s fees.

In contrast, a plaintiff who initiates a joinder-based derivative action is representing only himself. All other parties will be joined either as plaintiffs or defendants, and will be in a position to protect their own interests in the suit. Logically, none of the normal class action rules should apply to such an action, but in fact, Article 611 lifts only certain of the class action rules—those concerning numerosity, adequate representation, and the class-wide effect of the judgment. In all other respects, the normal class action rules continue to apply.

Two of the articles that continue to apply in an Article 611 derivative suit, those concerning venue and derivative lawsuits generally, do seem appropriate regardless of whether the suit is based on actual joinder or on class action theories.

(Representatives who may “sue or be sued”). But in the case of a shareholder derivative suit, the pertinent class is the plaintiff class, consisting of the shareholders of the corporation.

42. La. Code Civ. P. art. 597.
45. Moore et al., supra note 1, ¶ 23.1.24 [1], [2]. Cf. Verdin v. Thomas, 191 So. 2d 646 (La. App. 1st Cir. 1966) (trial court’s approval of settlement affirmed where evidence showed no advantage to representative plaintiffs over that gained by class of plaintiffs as a whole).
46. La. Code Civ. P. art. 595. Note that Article 595 does not authorize fee shifting from the prevailing to the losing party in the suit, i.e., to award fees to the prevailing plaintiff to be paid by the defendant. Article 595 simply authorizes an award of fees to the representative party out of the recovery obtained by him in the suit or, in the case of derivative suits, out of corporate funds. See La. Code Civ. P. art. 595 cmts. a & c.
47. La. Code Civ. P. art. 611 (lifting application of Articles 591, 592 and 597).
48. Article 611 of the Louisiana Code of Civil Procedure provides that a joinder-based derivative action is governed by the provisions of Articles 593 through 596. Article 611 thus excludes application of Article 591, on the prerequisites of a class action, Article 592, on adequacy of representation, and Article 597, on the effects of a judgment in a class action suit. However, Article 611 fails to exclude the application of several other provisions, which would appear to be inappropriate in a nonderivative class action.
But the other three—concerning class action certification, settlement, and the awarding of expenses—do not.⁴⁹ Thus, if ill-advised results are to be avoided, some means must be found to avoid the application of the inappropriate articles in an Article 611 suit, while not excluding application of the articles that still should apply.

Arguably, despite the language of Article 611, the inappropriate articles render themselves inapplicable by their own references strictly to “class actions.” But the same thing could be said about the language of one of the appropriate provisions, Article 596 (concerning the general requirements imposed on derivative suits), so that is not a good solution. Article 596 should apply to all derivative suits, whether or not they are class actions.

A more selective exclusion of the effects of the class action articles could be achieved by “applying” all of the articles left in place by Article 611, but only to the extent that an application of the articles was possible under the circumstances. Under this approach, Article 596 could be applied both in theory and in practice, as it would be possible to comply with its terms—concerning such things as demand on directors and verification of the complaint—whether or not the suit was filed in the form of a class action. In contrast, Article 595, on the awarding of litigation expenses to class representatives, would apply only in theory. In practice, it would not be possible to award expenses to a representative party when no such party existed. This selective application approach would still leave open questions about the need for court approval of settlements under Article 594, and the furnishing of security for costs under Article 595. But in both of those cases, the court’s actions under the rules would be discretionary. If, as usual in a joinder-based suit, the rules seemed inappropriate, a court could simply exercise its discretion in a way that did not scuttle the affected settlement or order security for costs or attorney’s fees in a suit in which none of the class-action-based justifications for such devices were present.

IV. REQUIREMENTS FOR DERIVATIVE SUITS GENERALLY

In any type of shareholder derivative suit, whether class-action or joinder-based,⁵⁰ Article 596 of the Code of Civil Procedure requires that the complaint in the action comply with the following five requirements:

⁴⁹. It makes no sense to certify a class under Article 593.1 if no class action is being pursued, nor to require court approval of settlements under Article 594 if all shareholders are themselves parties (and thus are facing no possibility of an adverse settlement being imposed on them by a class representative), nor to allow for recovery of expenses by the class representative when no representative exists. The failure to exclude Article 593.1 from application in an Article 611 suit appears to have arisen inadvertently when Article 593.1 was added to the Code of Civil Procedure in 1984, without making the appropriate conforming amendments to Article 611. See 1984 La. Acts No. 55, § 1. Article 611 had been adopted some twenty-four years earlier in the context of the rules that existed at the time.

⁵⁰. See supra part III—Class Action or Joinder-Based.
1. **Contemporaneous Shareholder:** The complaint must allege that the plaintiff was a shareholder of the corporation at the time or the occurrence or transaction of which he complains or that his shares devolved on him by operation of law.

2. **Management and Shareholder Demand or Demand Futility:** The complaint must allege “with particularity” either:
   (a) the plaintiff’s efforts to secure from management, and “if necessary” from the shareholders, enforcement of the right being asserted in the suit and the reasons for failing to secure such enforcement; or
   (b) the reason that the plaintiff did not make any such efforts to secure enforcement.

3. **Corporation as Defendant:** The complaint must join the corporation as a defendant in the suit.

4. **Corporation as Plaintiff:** The complaint must include a prayer for judgment in favor of the corporation.

5. **Verification:** The complaint must be verified by the affidavit of the plaintiff or his counsel.

Some of these items are fairly straightforward while others, although seemingly simple, have generated enormous controversy. Items 3 through 5 seldom pose interpretational problems, and item 1 is fairly simple to understand after some background explanation. But item 2 contains the language that has become the focal point for the national debate about the purposes and effects of shareholder derivative suits. Item 2 and its related concerns will be discussed in the next several sections, first from a national viewpoint, and then as applied in Louisiana. The other four items will be covered in this section, in a reverse numerical order that puts the easiest questions first.

Item 5 requires simply that the truth of the factual allegations in a derivative suit complaint, unlike those in most other pleadings,\(^{51}\) be verified by affidavit.

Items 3 and 4 in Article 596 may seem at first to be contradictory, one treating the corporation as defendant and the other as plaintiff. But the explanation for this apparent contradiction is actually rather simple. The corporation must be made a party to the derivative action so that judgments rendered in the action will be binding on it. And because the derivative suit is being filed for the very reason that corporate management is refusing to cause the corporation to act as a plaintiff in the suit, the corporation is made a party by having the complaining shareholder join the corporation as a defendant. Nevertheless, the joinder of the corporation as defendant, for purposes of forcing it to become a party to the litigation, does not change the fact that the rights being enforced in the suit still belong to this corporate defendant. From this standpoint, the corporation is really the plaintiff in the case. So, to protect the corporation’s rights in the claim being enforced, Article 596

\(^{51}\) La. Code Civ. P. art. 863(B).
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requires the complaint in the suit to include a prayer for judgment in favor of the corporation.

The dual role for the corporation in a derivative suit, although confusing, is well-established. Historically, the derivative suit was actually considered a dual suit, a main suit in which the corporation was the plaintiff seeking a recovery, and a second action in equity, in which the corporation, as defendant, was being forced to bring the first, main, suit. The derivative suit is now considered a single unified action, but the corporation’s dual role in the action continues. The corporation acts as both a nominal defendant, capable in most states of objecting to the bringing of the suit in its name, and the party in whose name the relief sought in the suit is to be granted.

Item 1, the contemporaneous shareholder requirement, receives a bit more attention than the more routine verification and corporation-as-party rules, and requires some amplification to be understood correctly. Read literally, the language of the Code article refers only to the shareholder status of the plaintiff at the time of the wrong about which the plaintiff is complaining. The article does not say explicitly that the plaintiff must also be a shareholder at the time that he files his complaint, or that he must maintain his status as shareholder until judgment is rendered in the suit. Instead, the Code article appears to assume that the plaintiff in a derivative action will be and remain a shareholder in the corporation, as if those points were too obvious to mention, and to address itself strictly to the more difficult question whether the plaintiff must also have been a shareholder sometime before the suit was filed, at the time of the alleged wrong.

The reason for this quirk in the language of the Code article is historical. The language that is used in Louisiana to express the contemporaneous shareholder requirement is virtually identical to that used for similar purposes not only in the Federal Rules of Civil Procedure but also in the rules of procedure in most other states. These rules did not create derivative suits, but merely regulated a form of action that had been recognized as an equitable remedy in English and American law.

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52. Clark, supra note 3, § 15.1, at 639-40.
53. Id. In Louisiana, the nominal character of the corporation’s role as defendant has been interpreted by one court as precluding any active role by the corporation in the suit, as if nominal meant “passive.” See Robinson v. Snell’s Limbs & Braces, Inc., 538 So. 2d 1045, 1048 (La. App. 4th Cir. 1989). The leading corporation law authorities outside Louisiana reject the purely passive role contemplated by this case. They insist that the corporation does possess the power to file objections to the continuation of the suit, as long as the corporation takes these actions through directors who are adequately disinterested in the outcome of the suit. Sometimes, this active role for the corporation is described as part of its power as a defendant in the suit. See Clark, supra note 3. Nevertheless, the underlying justification of the exercise of this corporate, or directorial, power is not the corporation’s role as defendant, but its role as plaintiff. As plaintiff, the theory goes, the corporation should be able to make a business decision to dismiss its own suit, even if the suit does have legal merit. Under this theory, a self-appointed shareholder representative of the corporation is not permitted to pursue the suit unless he can show that the corporation’s normal management would be incapable of making a lawful decision on this question, or if a decision has indeed been made, that the decision is not entitled to be respected by the courts. See infra part V—Demand Requirements.
54. The same thing is true under federal law. Moore et al., supra note 1, ¶ 23.1.17.
Derivative suits were conceived as analogues to the equitable action for an accounting that could be brought against trustees by trust beneficiaries. Directors were analogous to the trustees and shareholders were analogous to the beneficiaries. In both cases, substantive law imposed the fiduciary duties enforced; the derivative suit was simply a procedural device that permitted the substantive rights of the beneficiaries or shareholders to be enforced.

When rules of civil procedure were later adopted to regulate derivative suits, they were indeed drafted against this background of assumed, seemingly obvious, principles of law. Only those who were the intended beneficiaries of a fiduciary duty as a matter of substantive law, i.e., the owners of the corporation, were entitled to bring an action to enforce such duties. Thus, the language of the typical derivative suit provision describes a derivative suit as one "brought by a shareholder . . . of a corporation," even though the rule explicitly imposes the holding requirement only as of the time of the alleged wrongdoing that is the subject of the suit.

Nevertheless, as a general principle of American law, the rule is well-established that the plaintiff in a derivative action must be a beneficial owner of stock not only at the time of the wrongdoing, but also at the time of the filing of the suit, and throughout the continuance of the suit. Called the "continuous shareholder" rule, this requirement has received explicit recognition in Louisiana.

55. Id. at ¶ 23.1.01; Bert S. Prunty, Jr., The Shareholders' Derivative Suit: Notes on its Derivation, 32 N.Y.U. L. Rev. 980 (1957).
57. Id.
58. Moore et al., supra note 1, ¶ 23.1.01.
59. La. Code Civ. P. art. 596. See Fed. R. Civ. P. 23(b). Other participants in the corporation, such as creditors and employees enjoy no such standing. E.g., Darrow v. Southdown, Inc., 574 F.2d 1333 (5th Cir. 1978); Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974), affirmed on lack of creditor standing, rev. on other grounds, 347 A.2d 133 (Del. 1975); A.L.I., supra note 4, § 7.02(a) (recognizing general rule against creditor standing, but treating holder of certain convertible debt as a holder of equity security entitled to maintain derivative suit if an adequate representative of shareholder interests). For a criticism of the traditional rule against creditor standing, see Morey W. McDaniel, Bondholders and Corporate Governance, 41 Bus. Law. 413 (1986); Creditors' Derivative Suits on Behalf of Solvent Corporations, 88 Yale L.J. 1299 (1979).
60. La. Code Civ. P. art. 596 (derivative action by "shareholder"; no reference to creditor suits). Although courts in Louisiana have yet to address the issue, the general rule in other jurisdictions is that beneficial or equitable ownership, not record ownership, is the kind of stock ownership that the derivative lawsuit rules require. Henn & Alexander, supra note 3, § 361, at 1055-56. Similarly, shareholders of a parent corporation are generally permitted to maintain derivative suits on behalf of direct or indirect subsidiaries of the corporation in which the plaintiff shareholder actually owns stock. Id. at 1056. Louisiana courts have yet to address this question.
62. Clark, supra note 3, § 15.4, at 652.
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only recently, but it seems likely to be followed in future cases, at least where the loss of stockholder status is voluntary. Where the loss is involuntary, as in a cash-out merger, the authorities are split. According to some courts, including one in Louisiana, the shareholder's standing is lost even though his relinquishment of stock was involuntary, but at least one court, backed by the American Law Institute, has rejected this view.

Article 596, and similar provisions in federal law and the law of most other states, devotes special attention to the shareholder's status at the time of the wrongdoing, not because that is the only time that matters, but because an argument might otherwise be made that an outsider could see a corporate wrong, and then become a shareholder, after the fact, to obtain standing to file the suit. This type of tactic is viewed as a form of champerty, and so is precluded by the "contemporaneous shareholder" rule, i.e., the rule that the plaintiff shareholder allege that he was a shareholder contemporaneously with the wrongdoing that is the subject of his complaint. Notice, however, that only the named shareholder plaintiff must meet the contemporaneous shareholder requirement. Other shareholders may come and go after the time of the wrongdoing, and even after the filing of the suit. Those shareholders who happen to own the corporation at the time that judgment is rendered in the suit will be affected by the judgment in the same way (i.e., indirectly by their stake in the corporation that is bound by the judgment) regardless of when they acquired their stock.

V. DEMAND REQUIREMENTS—INTRODUCTION

Out of all five of the Article 596 requirements, the second one, concerning demand, is the most controversial. As with the contemporaneous shareholder

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63. Christopher v. Liberty Oil & Gas Corp., 665 So. 2d 410 (La. App. 1st Cir. 1995). See Armand, 570 So. 2d at 158 (dismissing derivative suit filed after shareholders lost shares in an involuntary cash-out merger).

64. Lewis v. Anderson, 477 A.2d 1040 (Del. 1984) (standing lost in existing suit); Armand, 570 So. 2d at 158 (standing lost where merger occurred before filing of suit, but under circumstances suggesting that suit was about to be filed).

65. Shelton, 544 So. 2d at 845 (rejecting Lewis even in the context of merger occurring before the filing of the suit). The American Law Institute recommends that a shareholder who would otherwise be qualified to maintain the derivative suit be permitted to commence and to maintain such a suit despite an involuntary loss of his stock due to corporation action if either (a) the suit was commenced properly before the merger or (b) that person is deemed to be a better representative than any other shareholder who has brought suit. A.L.I., supra note 4, § 7.02(a)(2). Louisiana courts have so far permitted an involuntary loss of standing only where the suit was commenced after the loss of the shares; they have not yet considered whether the same rule would apply where the suit had already been commenced. See Armand, 570 So. 2d at 158.

66. Henn & Alexander, supra note 3, § 362, at 1055-56; Clark, supra note 3, § 15.4. In federal law the rule may also have been designed to prevent the manipulation of the citizenship of the parties for purposes of federal diversity jurisdiction. Id. But see Moore et al., supra note 1, ¶ 23.1.15 [2] (questioning the collusive jurisdiction theory and suggesting that substantive state law should control the champerty-related aspects of the contemporaneous ownership rule).
rule, the Code article appears to make some assumptions about the background law that are not obvious from the language of the article itself. The article says that certain facts and reasons about demand on directors and shareholders must be pled in a derivative suit complaint. But the article does not say what facts and reasons are sufficient to permit the suit to proceed. Presumably, it would not be sufficient for a plaintiff to plead that he had neglected to make a demand on directors because he had just kept forgetting about it, or to plead that he had made a demand but that his demand had been refused by the directors for undeniably sound reasons. On the other hand, it also seems obvious that some circumstances must exist in which a plaintiff is entitled to bring his suit despite a refusal by management of his demand for action, and that sometimes even the demand itself could be excused; otherwise it would not make sense for Article 596 to include these references to excuses and refusals in the context of a description of an adequate complaint.

Similarly, demand on shareholders is required “if necessary,” but the article does not say when the necessity exists. It is not clear whether the necessity phrase refers to requirements of law, i.e., that a recitation of shareholder demand is required under Article 596 only if the substantive law independently requires such a demand, or, instead, whether demand on shareholders is assumed to be required by substantive law in all cases in which it is made “necessary” by management’s refusal of the demand for corrective action.

Thus, the language of Article 596 implies that the law recognizes certain circumstances under which demand in a derivative suit must be made, others under which it may be excused, and still others under which a demand may be refused by the directors or shareholders in a binding way, i.e., without automatically conferring on the plaintiff the right to drag the corporation into an ill-advised suit anyway. Yet the article neither states these circumstances nor moves beyond these ambiguous hints. Therefore, depending on a court’s perceptions about the need for derivative suits, as compared with the need for managerial discretion, the controlling language can be interpreted either to let most legally meritorious suits proceed despite managerial opposition or, instead, to block most management-opposed suits as long as management’s opposition is lawful. This type of ambiguity in the procedural rules of other states has helped make the demand requirement the focal point for a national debate about the role of derivative suits in the governance of large, publicly-traded corporations.

67. The complaint must “[a]llege with particularity the efforts of the plaintiff to secure from the managing directors . . . and, if necessary, from the shareholders . . . the enforcement of the right; and the reasons for his failure to secure such enforcement; or the reason for not making such an effort to secure enforcement of the right.” La. Code Civ. P. art. 596(2).

68. Considerable differences exist among the states in their interpretations of those provisions. See Deborah A. DeMott, Demand in Derivative Actions: Problems of Interpretation and Function, 19 U.C. Davis L. Rev. 461 (1986). Some, particularly Delaware, continue to emphasize demand as a means of protecting management’s prerogatives in the suit. But outside Delaware, the trend is to shift the focus of the debate away from the demand stage to a later motion to dismiss. See infra Part
A. Derivative Suit Debate

The empirical evidence in the debate about derivative suits is reasonably consistent, but subject to differing interpretations. The plaintiffs in these suits tend to own nominal amounts of stock, the same law firms tend to be involved, the suits rarely succeed when they go to trial, those suits not dismissed are nearly always settled, the settlements seldom produce large monetary payments to the corporation or to corporate shareholders, but the settlements usually result in the payment of fees to lawyers even when the monetary recovery to shareholders is small or nonexistent. Defense lawyers also get paid, of course, usually in amounts roughly comparable to amounts paid to plaintiffs' lawyers, and their fees are usually paid by the corporation through its indemnity or insurance
arrangements. Studies on the reaction of stock prices to the announcement of derivative suit developments show only the tiniest of reactions, sometimes in amounts so small as to be statistically insignificant.  

The pro-defense interpretation of this evidence is that derivative suits are profitable mainly for lawyers, and that shareholders do not believe that derivative suits provide any benefits that are economically significant. The pro-plaintiff interpretation is that plaintiffs do receive some form of recovery in a large majority of derivative suits, almost always through settlement, and that a large proportion of these settlements do produce a net benefit to shareholders—even if the benefits are not always paid in cash and even if cash benefits tend to be so small in relation to the size of the corporation that they do not show up in stock price movements. Proponents of derivative suits also argue that the empirical studies examine only the compensatory effects of these suits and do not take into account their deterrent function. Proponents contend that fiduciary duties play an important role in deterring disloyal and careless behavior by corporate officers and directors, and that these duties can be enforced legally only through derivative actions. The empirical studies do not show how much misbehavior is deterred by the very existence of enforceable legal duties, say proponents, or how much more misbehavior would occur if these duties could be violated without threat of legal liability.

B. Three Seminal Cases—Pro-Management Litigation Committees

Clearly, the leading national authorities have been persuaded more by the critics of derivative suits than by the proponents of such suits. Delaware, the


77. According to one commentator, "[the empirical] data make plain that the principal beneficiaries of cash payouts in shareholder suits are attorneys." Romano, supra note 69, at 65.

78. Id. at 65-66; Fischel & Bradley, supra note 76, at 282.

79. Kenneth E. Scott, The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel & Bradley, 71 Cornell L. Rev. 299, 304-05 (1986); Donald E. Schwartz, In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley, 71 Cornell L. Rev. 322, 330-31 (1986) (questioning whether $10 million loss to large corporation, such as I.B.M., ought to be ignored legally simply because the loss is not large enough by itself to affect the company's stock prices); Jones, supra note 69, at 545 (evidence refutes "myth" that plaintiffs rarely recover in derivative suits; they get some remedy 75% of the time).


81. See A.L.I., supra note 4, Reporter's Notes (1)-(3) to Introductory Note, Remedies. Schwartz, supra note 79, at 324-32.

82. The success has not been uniform; some courts have sharply limited the ability of
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state most influential in shaping the law in this area, has made it extraordinarily
difficult for a derivative suit to survive a motion to dismiss. And although some
of Delaware's technical peculiarities have been rejected, its underlying
substantive hostility to derivative suits has been incorporated into the Revised
Model Business Corporation Act and into the American Law Institute's
restatement-like work, the Principles of Corporate Governance.

The pro-defense posture of the national authorities rests, as a matter of legal
document, on two main points: first, that a decision to file or to dismiss a
derivative suit should be treated as a business decision to be made by disinterest-
ed directors, and, second, that directors should always be considered disinterest-
ed—despite their status as defendants in the case or as appointees or associates
of the defendants—unless the plaintiff alleges in his complaint that the directors
engaged in obvious wrongdoing or personally received something of pecuniary
value in the transaction being challenged in the complaint. 83

These pro-defense rules grew out of three seminal cases. The first of these
cases was Gall v. Exxon, a 1976 decision by the federal district court for the
Southern District of New York. 84 The plaintiff in Gall had alleged that several
of Exxon's directors and senior executives had been involved over an eleven-year
period in paying some $59 million in bribes to certain Italian political parties and
officials, and in covering up the payments in Exxon's proxy statements and other
required disclosure documents. Those actions were alleged to have violated both

management to terminate derivative suits. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d
709 (Iowa 1983); Alford v. Shaw, 324 S.E.2d 878 (N.C. App. 1985); Joy v. North, 692 F.2d 880 (2d
Cir. 1982), cert. denied sub nom. 460 U.S. 1051, 103 S. Ct. 1498 (1983); Hasan v. CleveTrust Realty
Investors, 729 F.2d 372 (6th Cir. 1984); In Matter of Continental Sec. Litigation, 732 F.2d 1302 (7th
Cir. 1984).

83. See Coffee & Schwartz, supra note 80, at 262 (describing threat to derivative suits arising
out of formal doctrine that board makes business decisions, combined with judicial willingness to let
such business decisions be made by directors whose independence is purely nominal).

84. Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976). Gall was the first case to approve
of the dismissal of a suit on the recommendation of a litigation committee. Commentators and courts
often cite another case, Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979), as the seminal case for
the business decision theory approved three years earlier in Gall. See, e.g., Houle v. Low, 556
N.E.2d 51, 55 (Mass. 1990); Swanson, supra note 80, at 1362-65. Which case deserves the "seminal
case" honor is unimportant for purposes of this discussion, as Auerbach and Gall were strikingly
similar decisions. Both cases involved efforts by litigation committees to dismiss derivative suits
arising out of past bribery of foreign officials by corporate representatives, both litigation committees
consisted of three directors who had not been on the board at the time of the alleged wrongdoing,
and both cases accepted the committee's recommendations, while rejecting the plaintiff's structural
bias arguments, based on essentially the same reasoning. Auerbach may be preferred by some for
the seminal case honor because it was decided by a state court of last resort, the Court of Appeals
of New York, and not by a federal trial court as Gall was. Nevertheless, this text treats Gall as the
seminal decision because it was the very first decision to permit dismissal of a derivative suit upon
the recommendation of a defendant-appointed litigation committee, and because the court that decided
Gall later played a role in shaping the issues that were presented in the second of the three seminal
cases discussed in the text.
federal securities law and state-law fiduciary duties owed by the officers and directors to Exxon, causing damage to Exxon.

After the plaintiff filed his complaint in *Gall*, the board of directors of Exxon appointed a “Special Committee on Litigation,” consisting of three directors who had been elected to the Exxon board after the Italian scheme had been terminated, and who had signed affidavits denying any personal involvement in the alleged wrongdoing. This Committee was empowered to investigate the plaintiff’s allegations and to take actions on behalf of Exxon in the lawsuit.

After completing its investigation, the Committee concluded that wrongdoing had occurred much as the plaintiff had alleged, but that the Committee, rather than the self-selected plaintiff shareholder, should be in charge of deciding whether and how the corporation was going to address that wrongdoing. In the Committee’s view, the plaintiff’s lawsuit was not the proper way to proceed, and so ought to be dismissed.

For the most part, the court agreed with the Committee:

There is no question that the rights sought to be vindicated in this lawsuit are those of Exxon and not those of the plaintiff suing derivatively on the corporation’s behalf. Since it is the interests of the corporation which are at stake, it is the responsibility of the directors of the corporation to determine, in the first instance, whether an action should be brought on the corporation’s behalf. It follows that the decision of the corporate directors whether or not to assert a cause of action held by the corporation rests within the sound business judgment of the management.85

In reasoning that later became critical to the development of the law on this issue, the court separated the question of the legal merits of the plaintiff’s case from the issue of whether it made sense, from a business standpoint, to pursue the case. Even assuming, said the court, that the payments in Italy had been illegal (and thus would not themselves be protected by the business judgment rule), the business judgment rule was nevertheless applicable to the Committee’s decision whether to pursue a lawsuit to remedy this allegedly illegal conduct:

The decision not to bring a suit with regard to past conduct which may have been illegal is not itself a violation of law and does not result in a continuation of the alleged violation of law. Rather, it is a decision by the directors of the corporation that pursuit of a cause of action based on acts already consummated is not in the best interest of the corporation. Such a determination, like any other business decision, must be made by the corporate directors in the exercise of their sound business judgment . . . . The issue before [the court] . . . is not whether the payments made by Esso Italiana to Italian political parties and other

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85. 418 F. Supp. at 514-15 (emphasis added) (citations omitted).
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unauthorized payments were proper or improper. Were the court to frame the issue in this way, it would necessarily involve itself in the business decisions of every corporation, and be required to mediate between the judgment of the directors and the judgment of the shareholders with regard to particular corporate actions . . . . Rather, the issue is whether the Special Committee, acting as Exxon's Board of Directors and in the sound exercise of their business judgment, may determine that a suit against any present or former director or officer would be contrary to the best interest of the corporation.86

The only issue on which the Committee did not win complete victory concerned the disinterestedness and good faith of the Committee members. The plaintiff had alleged that Committee members might have been involved in the challenged transactions, or at least have been interested in the alleged wrongdoing "in a way calculated to impair their exercise of business judgment . . . ."87 The court ruled that the plaintiff had to be given an opportunity to test the good faith and independence of the Committee through discovery and, if necessary, at a plenary hearing before the court. The court therefore denied summary judgment pending the outcome of this process.

But even in providing this limited ruling in favor of the plaintiff, Gall also provided the beginnings of the law's current rejection of the so-called "structural bias" argument.88 The plaintiff had argued that the Committee's decision to dismiss was inherently biased in favor of the defendants. The decision-makers themselves may not have faced personal exposure in the lawsuit, but they had been handpicked as decision-makers in the matter by those who did face such exposure and they continued to serve with these alleged wrongdoers as fellow directors. Under those circumstances, the plaintiff argued, they could not make a truly disinterested decision concerning the best interests of the corporation in the suit.

In effect, the plaintiff was arguing for an unbiased form of decision-making, based on judicial standards in a lawsuit, and not merely a decision that might be "disinterested" enough to preclude personal liability on the part of a decision-maker in an ordinary business transaction. Had these normal standards of judicial objectivity been imposed on the committee members in Gall, it seems obvious that the committee members would not have been permitted to judge the

86. Id. at 518-19.
87. Id. at 519.
case; defendants in litigation do not get to pick their own judges from among their friends and business associates.

But the court rejected the plaintiff's argument. Although the plaintiff was afforded an opportunity to introduce evidence of specific self-interest or bias on the part of the committee members, it was clear that structural bias alone—the fact that they were fellow directors with, and had been appointed by, the defendants in the case—was not going to be sufficient to disqualify the committee members from deciding "disinterestedly" to dismiss the case. The facts about the status and appointment of the committee members were undisputed. Had this structural form of bias been sufficient by itself to preclude a disinterested decision, no new hearing would have been required.

Gall's "business decision" theory provided the beginnings for both halves of the current pro-management doctrine. By treating the dismissal decision as a business decision for management rather than as a legal decision for the court, Gall had not only introduced business considerations into the decision-making calculus, it had also transferred the power to make this critical decision, subject only to a highly deferential "business judgment" review, from a truly unbiased judge to some business associates of the defendants.99 Put simply, the rule in Gall permitted persons who were likely to be biased in favor of the defense to dismiss the suit—even if the suit was legally meritorious—as long as they could come up with some rational business reason for doing so.

1. Delaware Hostility Toward Litigation Committees

At first, Delaware rejected Gall's extraordinarily pro-management approaches both to the structural bias problem and to the application of the business judgment rule to management's decision to dismiss a derivative lawsuit. The rejection came in Zapata Corp. v. Maldonado, decided in 1981.90 The plaintiff in Zapata had sued all of the directors of the corporation on grounds that they had breached their fiduciary duties by voting to accelerate the exercise date of some company-issued, director-owned stock options. The exercise date had been accelerated to permit the affected officers and directors to reduce their tax liability, allegedly at the expense of the corporation.91

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91. The directors knew that the corporation was about to announce a tender offer for its own shares, which would cause the market price for its shares to increase from $18 or $19 per share to $24 or $25 per share. The taxable income attributable to the exercise of the options would have been based on the difference between the $12.15 issuance price of the options and the market price for the company's stock on the date on which the option became exercisable, roughly $6 or $7 per share if exercisable before the tender offer or $12 or $13 per share if exercisable after the tender offer. The reduction in income to the officers and directors was harmful to the corporation because the option
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The main question in Zapata was whether the Delaware Supreme Court was going to accept Gall's suggestion that a management-sponsored motion to dismiss a derivative action should be treated as an ordinary business decision, subject to the protections of the business judgment rule. The same federal court that had decided Gall had already predicted that Delaware law would accept the Gall business judgment theory, and so had already granted management's motion to dismiss a Zapata-related case. But the lower state court in Zapata itself had rejected the Gall theory and had denied the same type of motion. That court had held the business judgment rule to be "irrelevant" to an effort by management to dismiss a derivative suit. According to this lower court, a corporate shareholder enjoyed an individual, personal right to file a derivative suit on the corporation's behalf if the corporation's management refused, for any reason, to cause the corporation itself to bring the suit.

The Delaware Supreme Court rejected both of these competing theories and struck what it viewed as a middle position between the two extremes. In the supreme court's view, a balance needed to be struck:

If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the [Gall litigation] committee mechanism, the derivative suit will lose much, if not all, of its generally well-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

income amounted to corporation-funded compensation to the officers and directors, which was deductible by the corporation in calculating its own income. If the options were exercisable early, the optionees would have had less compensation income and the corporation would have a smaller compensation deduction, while if the options were exercisable later, the optionees would have more compensation income and the corporation would have had a larger deduction. So, the plaintiff alleged, the tax savings that the officers and directors enjoyed caused a loss of tax benefits by the corporation. Not so, the directors argued, the corporation held tax loss carrybacks that were sufficient to shield the corporation from tax liability; the theoretical loss of the tax deductions did not cause any actual harm to the corporation. See Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980).

Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980). The dismissal of the federal case was noted by the Delaware Supreme Court in its own decision in Zapata. Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981). Also noted was the denial of a similar motion to dismiss by the federal district court for the Southern District of Texas in yet another related case.


Maldonado, 413 A.2d at 1257.

Id. at 1260-62.

"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 unbridled plaintiff stockholder control." Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. Supr. 1981).
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 upon by the board of directors, but the corporation can rid itself of detrimental litigation.\(^{97}\)

Thus, rejecting the lower court theory, and agreeing in part with *Gall*, the supreme court held that the board of directors of a corporation did not lose its control over a corporate lawsuit merely because the suit had been commenced as a derivative action; derivative actions remained corporate actions, not personal ones, at all times. The corporation’s board of directors thus retained the power to take over the litigation on behalf of the corporation, and to cause the suit to be dismissed.\(^{98}\) The Delaware court also agreed with *Gall* that the corporation’s board could delegate its decision-making authority to a committee of the board, even if a majority of the directors were “tainted” by their self-interest as defendants in the suit.\(^{99}\)

However, in disagreement with *Gall*, the Delaware court held that the decision of a board committee to dismiss a lawsuit against other corporate directors was *not* the type of decision that should be subject to the protections of the business judgment rule. Strikingly, this rejection of the business judgment rule arose out of the court’s concerns about the structural bias built into any dismissal of a derivative suit filed against management. The court was not convinced that a *Gall*-type hearing on specific allegations of self-interest or lack of good faith by the committee members would be sufficient to overcome the structural biases that were built into the decision-making process:

> [N]otwithstanding 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 as 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.\(^{100}\)

Under these circumstances, the court concluded, the business judgment rule should not be applied;\(^{101}\) the court should not, as *Gall* suggested, automatically

\(^{97}\) *Id.* at 786-87 (citations omitted).

\(^{98}\) *Id.* at 785-86.

\(^{99}\) “We do not think 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.” *Id.* at 786.

\(^{100}\) *Id.* at 787.

\(^{101}\) The court noted that other courts had applied the business judgment rule to a litigation committee’s motion to dismiss, but the Delaware court specifically rejected that approach:
defer to the committee's recommendation unless the plaintiff could establish some specific, nonstructural reason to question the independence or good faith of the committee. Instead, the court should scrutinize a committee-backed motion to dismiss under a rather demanding two-part test.

Under the first part of this test, the committee would bear the burden of proving (i) its own independence and good faith, (ii) that it had conducted an objective and thorough investigation, and (iii) that it had reasonable grounds for its recommendations. At this stage, the plaintiff would be allowed limited discovery for purposes of challenging the committee's position on these questions, but it was the committee, not the plaintiff who bore the burden of proof. If the committee failed to prove any one of these points, then the committee's motion was to be denied.\textsuperscript{102}

But even if the committee did succeed in proving all these points, then the court could still, in its discretion, move to the second part of the test. Under this second step, the court could apply its own business judgment (precisely the opposite of what the business judgment rule would normally permit) to the question of whether the suit should be dismissed. If, despite the strong showing by the committee in the first step of the test, the court concluded that the lawsuit should nevertheless proceed, then the committee's motion to dismiss was to be denied. Only if both parts of the test were satisfied (or the court decided in its discretion not to proceed to the second part of the test) could the committee's motion to dismiss be granted.\textsuperscript{103}

Although \textit{Zapata} certainly did stake out a middle ground between the \textit{Gall} and anti-\textit{Gall} positions, it did not do much to help public corporations deal with strike suits. Under the \textit{Zapata} procedure, a defense-appointed committee essentially had to make out the plaintiff's case for him (so that the committee's investigation could be defended as objective and thorough), and also had to give the plaintiff an opportunity to engage in discovery for purposes poking holes either in the committee's report or in the independence and good faith of the committee members.\textsuperscript{104} And then the trial court might still order the case to proceed, even if the committee had done everything right. As an anti-strike-suit measure, therefore, \textit{Zapata} was a failure. It preserved for the plaintiff most of the nuisance value that made his strike suit feasible.

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\textsuperscript{102} 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.

\textsuperscript{103} \textit{Id.} at 787.

\textsuperscript{104} \textit{Id.} at 788-89.

\textsuperscript{104} \textit{Id.} at 789.

\textit{Id.} at 787.

\textit{See Kaplan v. Wyatt, 484 A.2d 501, 509-12 (Del. Ch. 1984), affirmed, 499 A.2d 1184 (1985).}
2. Delaware Changes Its Mind—The Pro-Management Demand Rule

Judging from its later cases, it appears that the Delaware Supreme Court soon came to regret the balance that it had struck in Zapata.\textsuperscript{105} Just three years later, in Aronson v. Lewis,\textsuperscript{106} the Court essentially rejected the Zapata reasoning. But rather than overruling Zapata, the court chose to distinguish it. Aronson claimed to be addressing a question that had been left unanswered in Zapata, namely, the meaning of the director demand requirement under the Delaware rule of procedure applicable to derivative lawsuits—a rule that was virtually identical in pertinent part to Louisiana’s Code of Civil Procedure article 596 (2) and to the rules applicable in most other states.

As a general rule, before Aronson, demand was thought to be futile—and therefore unnecessary—in any derivative suit that had been filed against a majority of a corporation’s directors. Demand was thought to be futile in those cases for the simple and obvious reason that the defendant directors were not going to vote to sue themselves.\textsuperscript{107} This liberality in the rule on demand futility was actually the impetus for the invention of the Gall-style litigation committee. A Gall committee was supposed to remove from a post-demand dismissal motion the taint of self-interest (the majority directors’ status as defendants) that had made the demand itself so obviously futile. The Gall and Zapata committees were composed strictly of new, non-defendant directors.

\textsuperscript{105} For a strong, though respectful, criticism of the Zapata ruling by a Delaware trial court, see Kaplan, 484 A.2d at 509-12. Although Kaplan was decided after Aronson, it provides a good summary of the problems that had been caused by Zapata:

When the results of . . . an all-out effort by the Committee [to have the suit dismissed] are set against an all-out attack by the plaintiff on each and every item on which he can arguably base a claim of lack of independence, bad faith or questionable investigatory procedure or conclusion on the part of the Committee, the complexity of the adjudicatory task becomes apparent.

In short, the new Zapata procedure, while perhaps laudatory in legal concept, has the pragmatic effect of setting up a form of litigation within litigation. (At this point in this case, we are some three years after the amended complaint was filed, we have had three full-scale, briefed arguments, we have had all of the investigation and activity previously mentioned, and as yet we have not reached the point of any of the normal discovery and motion practice permitted by the Court Rules.) The Zapata procedure adds, in effect, a new party to the derivative litigation—the Special Litigation Committee—and a new battery of lawyers—counsel for the Committee—with the attendant expense to the corporation. It sidetracks derivative litigation as we have heretofore known it for approximately two years at a minimum while the Committee goes through its functions and while the plaintiff passively awaits his chances to resist them. And in the process the Zapata procedure has imposed substantial additional burdens at the trial court level in each such derivative suit in which it had been employed.

\textit{Kaplan, 484 A.2d at 511-12.}

\textsuperscript{106} 473 A.2d 805 (Del. 1984).

\textsuperscript{107} See A.L.I., \textit{supra} note 4, § 7.03 cmts. c & d; Reporter’s Notes (1); Demand on Directors and Shareholders As a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746, 753 (1960) [hereinafter Demand].
because directors who were themselves defendants were not considered disinterested.

In *Gall* the committee tactic had worked beautifully; the defendant directors were allowed to make an end-run around the pro-plaintiff futility rule with a pro-management rule on litigation committees. But in *Zapata*, the reverse had occurred. Delaware had pointedly refused to weaken the effects of the liberal demand futility rule through an easy rule on litigation committees. So when the Delaware court took up the issue in *Aronson* that it said it had left unresolved in *Zapata*, it was not being entirely candid. The distinctions it drew between the two cases were purely technical. The real issue, management’s power to block a derivative suit, was essentially the same and had already been addressed. Unlike the federal court in *Gall*, the Delaware Supreme Court had refused to let management block a derivative suit on business judgment grounds.

Nevertheless, Delaware’s experience with *Zapata* had not been happy—the *Aronson* court itself noted the large number of derivative actions that had been filed in *Zapata*’s wake—so *Zapata* could no longer be allowed to control the critical question. The business judgment rule would have to be applied despite what *Zapata* had said. *Zapata*’s more demanding test might still be allowed to control the litigation committee question, but only if the court could devise a doctrine that would keep the suit from getting that far along.

The demand rule fit the court’s new goals perfectly. The rule had to be satisfied at the very outset of the suit, as part of the pleading standards for the complaint, and it was ambiguous enough to support the court’s new business judgment test. Drawing on this ambiguity, the court in *Aronson* announced that a plaintiff’s complaint satisfied the demand rule only if it alleged facts “with particularity” that were sufficient to create a reasonable doubt about management’s ability to make a decision in the matter that would survive business judgment scrutiny. A complaint that failed to meet the new standards could be dismissed before any discovery was allowed and without the need for any *Zapata*-like investigation by management.

In distinguishing *Zapata*, *Aronson* never admitted that the law was being changed. *Aronson* said that *Zapata* had permitted dismissal of properly-commenced derivative suits under the “exercise of applicable standards of business judgment,” as if a trial court’s rejecting the recommendation of a litigation committee, after that committee had already proven its independence and good faith, was really an application rather than a violation of the business judgment rule. Most of the rest of *Zapata* was simply ignored. *Aronson* did not try to deal with *Zapata*’s statements about the dangers of structural bias, or the need to shift the burden of proof to the management-appointed committee to show its own independence and good faith, or the plaintiff’s entitlement to

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108. *Aronson*, 473 A.2d at 813. The court also listed a *Zapata* motion to dismiss in another section of the opinion as one of the issues in a derivative suit that is governed by the business judgment rule. *Id.* at 812.
discovery. Indeed, Aronson performed a complete about-face on all the critical policy questions. In Aronson, contrary to the teachings of Zapata, the business judgment rule was applied,\(^\text{109}\) the dangers of structural bias were ignored, the plaintiff was made to bear the burden of overcoming the presumptions of independence and good faith created by the business judgment rule, and, on top of all this, the plaintiff was required to accomplish this daunting task at the complaint stage of the litigation, without the benefit of discovery.

Aronson actually made it much more difficult than Gall for the plaintiff to prevail. Aronson was not just Delaware's version of Gall, it was super-Gall. Although Aronson did not formally overrule Zapata, not much role was left of the carefully-drawn Zapata procedures. Aronson’s imposition of the business judgment rule at the complaint and demand stage of the derivative suit made it virtually impossible for a plaintiff ever to get to Zapata.\(^\text{110}\) Zapata was still good law, theoretically, it was just irrelevant good law for most practical purposes.

The only accommodation made by Aronson for the plaintiff was to give him the seemingly easy-to-satisfy “reasonable doubt” standard for his pleadings. This standard did not require the plaintiff actually to prove his case in his complaint—it was not the usual “reasonable doubt” standard of proof—it merely required him to make allegations that created a reasonable doubt about the applicability of the business judgment rule either to the challenged transaction itself or to a possible decision by the directors to discontinue the suit.

But the nominal liberality of the reasonable doubt rule was more than offset by the court’s interpretation of the “particularity” requirement that was imposed by law on the complaint in a derivative suit. Like the Louisiana rule, the Delaware rule required the plaintiff to allege in his complaint “with particularity” either the nature of his demand on the directors for corrective action, or why the plaintiff had not made any such demand. Aronson held the following allegations to be insufficiently particularized:

1. All the directors had been named as defendants in the suit, and would be incapable of making an unbiased decision whether to sue themselves;
2. All of the directors had been nominated and elected to office through the actions of one 47% shareholder, the very shareholder who had received all the benefits of the transaction being challenged in the suit;
3. The challenged transaction provided to this 47% shareholder, a 75-year-old man, an annual salary of $150,000, plus a bonus equal to 5% of the firm’s profits over $2.4 million. The contract had a five-year

\(^\text{109}\) “In our view the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine’s applicability.” Id. at 812.

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were subject to early termination only by the shareholder—not by the company—and even after a shareholder-initiated termination, it still provided six-figure salary payments to the shareholder for life, plus death benefits, and required payments to be made regardless of whether the shareholder was capable of rendering any services to the corporation. All of these benefits were provided in exchange for a vaguely-worded agreement by the 47% shareholder to devote his best efforts and substantially all his business time to advancing the corporation's interests, even though the performance of this commitment would seem to have violated an existing consulting agreement, known to the corporation, between the 47% shareholder and another corporation;

4. In addition to the employment contract, the board had approved $225,000 in interest-free loans to the 47% shareholder, which remained unpaid at the time that the derivative suit was filed; and

5. The 47% shareholder, in fact, performed little or no services for the company and, because of his advanced age, could not be expected to perform any such services.111

These allegations were hardly framed in the vague and conclusory style that should be the normal target of a particularity requirement. The plaintiff's complaint contained more than vague and general allegations about mismanagement and bias. It alleged specific facts about the controlling shareholder's power over every single director in the corporation, and specific facts about a particular contract and a particular set of no-interest loans that would seem to have raised at least a reasonable doubt about the independence of the board and the propriety of the challenged transactions. Yet Aronson held these allegations to be insufficiently particularized. Clearly, Aronson was interpreting "particularity" to mean something more than "specific."

In Aronson's view, an allegation was not particularized unless it contained factual assertions that could not be reconciled with the normal presumptions established by the business judgment rule, i.e., that corporate directors could normally be expected to act independently, in good faith and with due care for the interests of the corporation. Thus, it was not sufficient for the plaintiff in Aronson to plead merely that all of the company's directors had been named as defendants in the suit due to their approval of the transactions being challenged. "Were that so," said the court, "the demand requirements of our law would be meaningless . . ."112 Nor was it sufficient for the plaintiff to allege that the beneficiary of the challenged transaction was the dominant shareholder of the

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111. The plaintiff had also made some truly conclusory allegations: that the challenged transactions had "no valid business purpose," that they were a "waste of corporate assets," and that the amounts paid were "grossly excessive." Aronson, 473 A.2d at 809.

112. Id. at 814.
corporation and that this shareholder had selected every single director of the corporation:

[I]n the demand context, even proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation... [I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence.\textsuperscript{113}

And, finally, it was not sufficient to allege that the controlling shareholder of a corporation was being paid extravagantly for little or no services to the corporation under a contract approved by entirely the shareholder's hand-picked directors, because these directors were still presumed to be independent, and compensation arrangements approved by independent directors were presumed to be lawful under the terms of the business judgment rule.\textsuperscript{114} Mere allegations of "little or no services" for the employment contract, and lack of interest on the interest-free loans, were deemed "conclusory."

Thus, in sharp contrast with Zapata, where the court had implemented procedures to protect even against "subconscious abuse" and "there but for the grace of God go I empathy" on the part of a group of directors who were not defendants in the suit and who had already proven their own independence and good faith, the court in Aronson steadfastly refused to admit any possibility of bias on the part of directors who had been named as defendants, who had done nothing to prove their independence or good faith, and who had actually raised questions about their independence by approving a lopsidedly lucrative deal for the person who had elected each of them to the board. Under these circumstances, much worse than Zapata, it was now the plaintiff rather than the board who had to persuade the court, without the benefit of discovery and in the face of almost Pollyannish presumptions of propriety, that reasonable grounds existed either to distrust the board or to question the challenged transaction. Other courts, less hostile to the plaintiff than the Aronson court, could interpret the reasonable doubt standard in a way that would excuse demand under more liberal

\textsuperscript{113} Id. at 815-16. In a rather startling non sequitur, the court also explained that the business judgment rule's presumptions of propriety and independence were actually the \textit{product} of the "unyielding precept" that directors were required by law to make decisions in accordance with their fiduciary duties, "without regard to or succumbing to influences which convert an otherwise valid business decision into a faithless act." In other words, the law was so unyielding in its demand that directors act faithfully to the interests of the company that the law would presume that they had done so—making it virtually impossible to obtain a remedy when they hadn't. In effect, the duties were so powerful that the law presumed no enforcement was necessary.

\textsuperscript{114} Id. at 817-18.
standards than actually intended by Aronson, but if the teachings of Aronson were applied faithfully, few derivative suits would survive the demand stage.

Of course, the mere fact that Aronson disagreed with Zapata's policy judgments on just about every point did not make Aronson wrong. Zapata had struck a balance between the interests of plaintiffs and defendants in derivative suits that the Aronson court found it could no longer accept. If Aronson rather than Zapata was right about the relative dangers of strike suits versus legally-unaccountable corporate directors, then Aronson rather than Zapata was the better decision from a policy standpoint. Indeed, if one believes that derivative suits are basically bad for corporations, then Aronson, though hardly of model of judicial candor, clearly did a lot of good. However, by refusing to overrule Zapata as a formal matter, and by contending that it really did make a big difference whether a case was in a demand rather than post-demand stage, the Delaware court introduced a considerable degree of unnecessary technical complexity into the law, for which the court has received some well-reasoned criticism.

C. The A.L.I. and R.M.B.C.A. Rules

Acknowledging problems with the Delaware approach, the American Law Institute has adopted a more functional set of rules on shareholder derivative suits. It has disconnected the issue of demand from the question of management's power to dismiss the suit. Demand on directors is always required by the A.L.I., subject to a narrow exception for cases in which demand-related delays would cause irreparable harm to the corporation, but neither the making of demand nor the failure to make demand is connected in any way with the merits of the case, with the independence of the board, or with management's ability to dismiss a suit once the demand requirement has been fulfilled.


117. Executives and management lawyers strongly opposed even the modest levels of judicial review that the A.L.I. rules were to require. They lobbyed heavily to defeat the A.L.I. rules, and did succeed in pushing them more in management's direction. But, having failed to win complete adoption of the Delaware position, they now argue that the A.L.I. rules are inconsistent with established law and should not be followed. See Block et al., supra note 116; Dooley & Veasey, supra note 116; John C. Coffee, New Myths and Old Realities: The American Law Institute Faces the Derivative Action, 48 Bus. Law. 1407 (1993); Swanson, supra note 80.
The effect of demand under the A.L.I. rules is simply to give management a period of time to consider and respond to the demand, before the suit is filed. If the suit is filed before the board has had a reasonable period to consider and to respond to the demand, it may be dismissed. But after the board has responded, or a reasonable time for its response has expired, the suit may be filed. It is only then, after demand, that the Aronson-style particularity rules come into play.

Under the A.L.I. rules, the complaint in a derivative action—even though always filed after demand has been made—must still allege "with particularity" facts that, if true, would "raise a significant prospect" that the challenged conduct or transaction was indeed unlawful. If the complaint fails to meet this standard, the defendants in the suit are entitled to have the suit dismissed without giving the plaintiff any discovery in the case. If the directors have actually rejected demand in the case (and not simply failed to respond), then the simple showing by the plaintiff of a significant prospect of unlawful behavior is no longer sufficient. In that case, the complaint may be dismissed, even before discovery begins, if the rejection of demand was recommended by a board that was composed of a majority of disinterested directors who, after satisfying their obligation to inform themselves, had made a rejection decision that met the controlling legal standards—the business judgment rule if the transaction challenged in the suit would be subject to that standard, and reasonableness in all other cases. The plaintiff may survive this type of rejection-based dismissal motion only by alleging particularized facts that, if true, would create a significant prospect that the requirements for the rejection-based dismissal had not been satisfied.

Even after the plaintiff has satisfied the recommended demand and complaint-particularity standards, the A.L.I. would also permit dismissal of a derivative suit based on a litigation committee recommendation. The level of scrutiny applied to these recommendations is based principally on the identity of

118. The official comments to the demand rule indicate that the delay "should never exceed several months even when a study is undertaken and seldom should be that long." A.L.I., supra note 4, § 7.03 cmt. f.
119. Id. § 7.03. However, even after the suit is filed, discovery is normally stayed during "a reasonable period of any review and evaluation undertaken and diligently pursued" in accordance with the rules concerning management's power to seek dismissal of the suit. Id. § 7.06. However, the period of the stay is supposed to be limited to the time that would be required to complete the review "expeditiously." And "even a diligently pursued evaluation should not be permitted to continue indefinitely." Id. § 7.06 cmt. e. "[T]he burden should be on the corporation both to submit an expeditious timetable for the projected investigation and to demonstrate reasonable diligence in the conduct thereof." Id.
120. Id. § 7.04.
121. Id. § 7.04(a).
122. Id. § 7.04(a)(2).
123. Id.
the defendants in the case and on the nature of their alleged wrongdoing. If the defendants in the case are strictly outsiders—they are not directors, senior executives or associates of directors or senior executives—then the motion to dismiss is to be reviewed under ordinary business judgment principles; no special procedures or standards of review are to be applied.

However, if the suit to be dismissed is a suit against one of the members or associates of management, then the decision to seek dismissal of the suit must be made by an adequately disinterested board or committee, assisted by counsel of its choice and such other agents as it reasonably deemed necessary. This disinterested decision-making body must conduct a review of the case that is adequate to support its recommendation of dismissal under the appropriate standard of judicial review, and must prepare and submit to the court a written report that is adequate to support the appropriate level of judicial review. The standard of judicial review depends upon the nature of alleged wrongdoing. If the wrongs alleged are breaches of the duty of care, then the decision to dismiss need only satisfy the normal standards of the business judgment rule. But if the wrongs alleged are breaches of the duty of loyalty, or are knowing and culpable violations of law, then the court may dismiss the suit upon the committee's recommendation only if the court determines that the committee was adequately informed and had made a reasonable determination that dismissal was in the best interest of the corporation. And if the plaintiff establishes that dismissal would permit a defendant or associate to retain an improper personal benefit as a result of a controlling interest, a misrepresentation, or without the approvals normally required in self-dealing transactions, then the court may dismiss the action only if it determines that injury to the corporation from a continuation of the action compellingly outweighs any adverse impact from the recommended dismissal.

Like the A.L.I. statement of principles, the Revised Model Business Corporation Act rejects the importance attached to demand by the Delaware courts while still implementing the basically pro-defense policies that the

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124. The A.L.I. also distinguishes between suits filed against senior members of corporate management and those filed against outsiders, i.e., against persons other than senior members of management. In suits against outsiders, the A.L.I., like most courts, would apply the business judgment rule to a management-sponsored motion to dismiss. This aspect of derivative suit law is not controversial, as few such suits are filed in modern practice, and as little reason can be found to treat a true arms-length litigation decision by corporate management any differently than any other form of business decision. The controversy that exists in modern derivative lawsuit law is about the propriety of extending the business judgment rule to suits against management itself, where very clear conflicts of interest exist on the part of the decision maker. The text deals principally with these more common, more controversial types of suits.

125. Id. § 7.07(a)(1).
126. Id. § 7.09(a)(1), (2).
127. Id. § 7.10(a)(1).
128. Id. § 7.10(a)(2).
129. Id. § 7.10(b).
Delaware demand rules are designed to protect. Under the R.M.B.C.A., demand is always required, but the effect of demand is simply to trigger the beginning of a required ninety-day delay in the filing of the suit. Ultimately, the dismissal of the suit does not depend upon the making or futility of demand, but rather upon the independence of the board and the quality of its investigation or, if the board lacks independence, on the presence of another means of independent investigation and decision-making.

Although some vestiges of the "demand refused" and "particularity" requirements of Delaware law may be found in the R.M.B.C.A. provision dealing with demand-refused complaints, ultimately a business-judgment-based motion to dismiss may be granted under the R.M.B.C.A. only if an acceptably independent group of directors or outside panelists has conducted a "reasonable inquiry" that provides a basis for its conclusions that the proceeding is not in the best interests of the corporation. If a majority of the board consists of "independent" directors, then the plaintiff bears the burden of proving that the requirements of a reasonable, independent investigation have not been met, while the party seeking dismissal bears this burden if a majority of the board lacks independence.

Like Delaware, both the A.L.I. Principles and the R.M.B.C.A. reject most of the structural bias argument. They do say that heavier judicial scrutiny should be required for dismissal recommendations made by boards or board committees where the majority of the board consists of interested directors. But they suggest a narrow, pro-management test of self-interest. The R.M.B.C.A. agrees with Delaware that none of the following forms of bias or conflicting interest are considered sufficient in and of themselves to make a director "interested" in a decision to dismiss a derivative suit: (a) that the director was nominated or elected by the defendants in the suit; (b) that the director was himself named as a defendant in the suit; or (c) that, without obtaining any personal benefit from it, the director approved of the act or transaction being challenged in the suit.

131. If the board acts quickly enough, and formally refuses demand before the expiration of the 90-day period of delay, then the complaint must allege "with particularity" either that a majority of the board did not consist of "independent" directors, or that the requirements of a reasonable inquiry by acceptably independent persons had not been satisfied. Id. § 7.44(d).
132. The decision to seek dismissal must be made by (a) a majority vote of "independent" directors present at a meeting of the board, if the "independent" directors constitute a quorum, or (b) a majority vote of a committee consisting of two or more "independent" directors appointed by a majority vote of "independent" directors present at a meeting of directors, whether or not the "independent" directors constituted a quorum, or (c), by a panel appointed by the court upon motion by the corporation. Id. § 7.44(b), (f).
133. Id. § 7.44(b), (c).
134. Id. § 7.44(e).
135. Aronson v. Lewis, 473 A.2d 805 (Del. Supr. 1984); R.M.B.C.A., supra note 130, § 7.44(c); A.L.I., supra note 4, §§ 7.09(a)(1), 1.23(c).
The A.L.I fudges a bit more on the question. It agrees with Delaware and the R.M.B.C.A. that neither a director’s simple status as defendant in the suit nor his approval of the challenged transaction is enough by itself to make a director “interested” in a dismissal decision. But unlike the R.M.B.C.A., the A.L.I. does not reject explicitly the possibility that a board member might be “interested” in a derivative suit dismissal decision, even without a personal pecuniary interest in the challenged transaction, as a result of his relationship with another person who held such an interest. The test is whether the relationship could “reasonably be expected to affect the person’s judgment” in a manner adverse to the corporation. Conceivably, directors on a board who were elected entirely by a controlling shareholder, as in Aronson, would be “interested” in a derivative suit that challenged the board’s approval of a self-dealing transaction with that shareholder.

In effect, the A.L.I. Principles and the R.M.B.C.A. have adopted the substantive policies of Delaware law, while rejecting the procedural context, demand, in which the Delaware policies are implemented. The pro-management leanings of Aronson are essentially incorporated into a liberalized Zapata procedure, supplemented in the case of the A.L.I. by some particularity requirements at the complaint stage. Subject to these few differences in the details, however, the decision that management will almost always make in a derivative suit—to dismiss it—will almost always be respected under the Delaware, A.L.I. and R.M.B.C.A. rules. Drawing on the “business decision” theory of derivative suit decisions, managers are permitted in most cases to decide whether they themselves should be sued.

It is fairly easy to point out the logical defects in the “business decision” theory of derivative suit dismissals. The biases of the decision-makers are rather obvious, and their recommendations to dismiss are almost perfectly predictable. Yet the alternative to the business decision approach—to treat the

136. A.L.I., supra note 4, § 1.23(c).
137. Id. § 1.23(a), (c).
138. The black letter provisions themselves do not take an explicit position on this question, and the comments seem split. In one place, the comments state that a recommendation from a seemingly disinterested board could be disregarded if the board was “subject to a controlling influence” by an interested director, and that such an influence was “most likely to occur in the case of a board that [was] dominated by a controlling shareholder.” In another place, the comments state that the term “controlling influence” was not to be interpreted as referring to long-time friendships, social relationships, or service on the same board, and that the mere prospect of the usual directors’ fees, or the prospect of losing those fees, were not to be construed as making a director “interested.” See id. § 1.23 cmt. So it is not clear whether the Aronson directors were “dominated” by the controlling shareholder, or whether they were merely his long-time friends and associates who cared little for their usual and customary directors’ fees.
139. See Cox & Munsinger, supra note 88; Propriety of Judicial Deference, supra note 88; Coffee, supra note 88. But see Haft, supra note 88.
140. As one court has noted, The reality is therefore that special litigation committees created to evaluate the merits of certain litigation are appointed by the defendants to that litigation. It is not cynical to
shareholder plaintiff as any other plaintiff and to deny to the defendants any special powers over his suit—poses serious problems of its own. If the shareholder plaintiff is to be in complete personal control of the corporation's position in a derivative lawsuit, then strike suit lawyers are going to be parties actually in control of the corporation's position as plaintiff in most such suits. And the biases of the strike suit lawyers will be at least as great as those of the directors.

Faced with this unappealing choice between different types of conflicted corporate representation, the leading national authorities have essentially decided to side with management, at least in the case of publicly-traded corporations. Management, after all, is elected by shareholders, faces market-based incentives to enhance overall corporate values, and lacks any interest in generating legal expenses for their own sake. The strike suit lawyer is not elected by those he purports to represent, has no financial interest in enhancing the value of the corporation as a whole, and actually has an interest in maximizing legal expenses that he will be able to inflict upon the corporation. The decision by the national authorities to adopt rules that favor the defense in most derivative suits suggests that these authorities are more distrustful of the plaintiffs' lawyers than of corporate management, and that they are skeptical of the value of derivative suits in the context of publicly-traded corporations.

VI. LOUISIANA LAW—THE WEMBLEY DECISION

Only three decisions have been reported in Louisiana on the subject of derivative suit demand and dismissal powers, two in the fourth circuit, and one in the third. The two fourth circuit decisions are the ones most at odds with the pro-management leanings of national trends. The third circuit case appears more favorable to management, but on grounds different from those advanced by the defendants in the fourth circuit cases and in the national authorities.

The first of the two fourth circuit cases was *Smith v. Wembley Industries, Inc.*, a typical close corporation suit in which three minority sharehold-

> Virtualy all litigation committees recommend dismissal of the suit. Cox, supra note 89. Only a few have recommended that the suit be pursued against some defendants. Kaplan v. Peat, Marwick, Mitchell & Co., 529 A.2d 254, 256 (Del. Ch. 1987); In re Continental Sec. Litigation, 572 F. Supp. 928 (N.D. Ill. 1983); Joy, 692 F.2d at 880.

In an effort to satisfy the requirement of Code of Civil Procedure article 596 concerning the making of demand on directors, the Wembley plaintiffs alleged that demand on the directors to secure enforcement of the corporation's rights would have been futile, and therefore excused. They alleged that, apart from the three defendant directors, the only two remaining directors were two individuals who owed their livelihood to one of the defendant directors. Thus, all of the directors were either named as defendants in the suit or were beholden to those who were.

The defendants filed an exception of prematurity, on grounds that the demand on directors required by Article 596 of the Code of Civil Procedure had not been made and could not be excused as futile. The trial court sustained the exception, but the fourth circuit reversed. Wembley acknowledged that it was the first decision in Louisiana ever to consider the demand requirement, and it looked outside Louisiana, to both federal and other state courts for guidance. But it steadfastly refused to believe that there could be a body of law that actually said what the defendants were arguing, that a plaintiff could file suit only if he first asked the defendants for "an independent and disinterested decision to sue themselves." Wembley cited two federal trial court decisions and two intermediate appellate court decisions in Illinois, the Wembley court concluded that "demand is excused when a majority of directors is involved in the self-dealing and mismanagement that is the subject of the suit." Wembley accepted as the rationale for its rule a quotation from a 1960 student comment in the Harvard Law Review: "[C]ourts have unanimously held that in such a case the demand is futile because it is unreasonable to think that a man will vote to bring suit against himself."

Wembley either missed or rejected the basic Delaware premise, later adopted in the R.M.B.C.A. and in the Principles of Corporate Governance, that the decision whether to pursue any lawsuit on behalf of a corporation is, as a matter of substantive corporation law, a business decision that ordinarily should be made by the management of the corporation. Wempley's perspective on the issue was quite different. Wempley approached the issue as an ordinary question of litigation procedure: should a plaintiff be required, as a condition to his suit, to asked the defendant in the suit for a disinterested decision on whether he, the defendant, ought to be sued. Put that way, the answer to the question obviously was "no," and any other response seemed absurd.

143. Plaintiffs were Lillian Pulitzer Smith, Carol Pulitzer, and a trust for Susan C. Pulitzer in which Lillian and Carol were co-trustees. Wembley, 490 So. 2d at 1107.
144. Defendants were Wembley Industries, Inc., Samuel C. Pulitzer, Sidney C. Pulitzer, and Arthur C. Pulitzer. Id. at 1107.
145. The plaintiffs alleged that the individual defendants had "awarded themselves excessive compensation and extravagant bonuses, despite the fact that the company was in financial trouble." Id.
146. Id. at 1108.
147. Id.
148. Id.
Wembley did not cite any of the leading Delaware cases on the subject, nor any of the extensive debate among more modern commentators, nor the controversy engendered on the subject in connection with the A.L.I.'s then-ongoing project on the Principles of Corporate Governance. The closest that Wembley came to dealing with the ideas that have come to dominate the national thinking on the subject was this curt dismissal of the authorities cited by the defendants: "Each of the cases relied upon by the defendants and cited by the trial court in its Reasons for Judgment in which demand was held not to be excused, involved either a finding that there were independent directors or a holding that the plaintiff had failed to allege with particularity the facts establishing futility." 149 None of the distinguished cases was considered worthy even of a citation. Wembley appeared to believe that the law on the subject really was well-settled, indeed well-nigh universal, and that any contrary authority could stand only for the proposition that the rule might sometimes not apply, as where the corporation's directors were truly independent, or where the plaintiff had failed to satisfy his ordinary burden of alleging the directors' lack of independence with sufficient particularity. Wembley provided no indication that it understood how Delaware had used the particularity requirement to implement the business judgment rule. 150

Despite Wembley's skepticism on the subject, of course, the law is far from well-settled on the issue of demand futility. Indeed, the sharp disagreements that exist among courts and commentators about management's role in a derivative lawsuit revolve around the very issues that Wembley found so easy to dismiss: the circumstances under which a director is considered independent and those under which he is not.

Wembley was undoubtedly right about the meaning of "disinterested" in a literal sense, but it is not in the literal sense that other courts use the term. Unlike Wembley, the leading national authorities fear the strike suit lawyer, and so emphasize a more result-oriented, business-transaction perspective on the term. None of the leading national authorities hold that a director loses his "disinterestedness" in a derivative lawsuit decision merely because he has been named as a defendant in the suit. They hold this way not because directors literally don't care if they're sued, but because a contrary rule would allow a plaintiff's lawyer to take away all of management's powers to stop strike suits merely by naming all of the directors as defendants. 151 It is not clear how Wembley might have responded to these types of arguments, for Wembley not only rejected the national rules, it refused to believe they existed.

149. Id. at 1108-09.
150. See supra part V.B.2.—Delaware Changes Its Mind.
151. See A.L.I., supra note 4, § 7.09 cmt. g ("Although it is recognized that any director who has been sued will have a natural desire to secure the early termination of even a meritorious case, a broader rule that automatically disqualified such a director whenever the director was named as a defendant would create an incentive for the plaintiff to sue all the incumbent directors in order to disqualify them.").
If the reasoning in *Wembley* were taken at face value, demand under Article 596 would play virtually no role in the dismissal of any derivative suit in Louisiana. Despite the breadth of the reasoning in *Wembley*, however, the actual holding in the case may be reconciled with the national authorities in two different ways.

First, the complaint in *Wembley* did contain allegations that a majority of the corporation’s directors were personally involved in direct self-dealing for personal monetary gain. This type of self-interest would render a director too personally interested to make an independent decision even under the leading national rules. Unlike the national authorities, however, *Wembley* did not actually draw distinctions between this form of self-interest and the more benign forms of bias that have been considered acceptable, e.g., having been selected as director by the person whose self-interest is directly at stake, or having approved this other person’s proposed raise or self-dealing transaction as being fair to the corporation at the time it was considered. Yet a later decision might still do so. The majority directors in *Wembley* were not self-interested merely because they approved someone else’s raise, but because they approved their own. Should a later case arise in which just the controlling shareholder’s salary was attacked, management could distinguish *Wembley* on grounds that the defendants in that case had all had a personal pecuniary stake in the transactions under attack, and had not been sued merely for a breach of their duty to oversee the benefits received by others.

More importantly, *Wembley* may be reconciled with the national authorities based on the close corporation setting of the case. The national authorities have adopted pro-management rules as a means of dealing with strike suits against large publicly-traded corporations. *Wembley* may have had difficulty seeing the rationale for the public corporation strike suit rules for the simple reason that it was not dealing with a strike suit against a public corporation.

In a public corporation derivative suit, most shareholders will play no active role. Their interests in the suit will be advanced, or damaged, by what happens to the “corporation’s” interests. Both sides in the dispute will purport to represent those interests, but in fact the doubly-represented corporate person—a legal abstraction standing for the collective interests of thousands of passive shareholders—will actually be caught in the middle of a power struggle between the two active forces in the dispute, the plaintiff’s lawyer and corporate management. The plaintiff’s lawyer will be motivated mainly by the prospect of large legal fees and corporate management will be motivated mainly by its desire for the exoneration of those management members named as defendants in the suit. Under those circumstances, the corporation too often ends up footing everybody’s legal expenses in exchange for little more that an agreement

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152. *See supra* notes 113-138.
between the corporation-indemnified director-defendants and the corporation-paid plaintiff's lawyer to stop the suit.

*Wembley* was not this sort of suit. Rather, *Wembley* involved a genuine dispute among the shareholders of a closely-held family business corporation about the company's financial policies. In that type of case, unlike the public corporation suit, the corporation does not represent merely a big pile of someone else's money, sitting in the middle, to be squandered by the representative parties and their lawyers in a suit over some minor issue of corporate management. The plaintiffs in a *Wembley*-style suit are challenging the compensation of the controlling shareholder-directors not as a means of increasing the size of their lawyers' bills, but as a means of obtaining some relief for themselves, personally. They are suing in an effort to get more of the corporate money distributed to themselves and less distributed to the defendants.

Unlike the public corporation, which typically has thousands of shareholders whose interests are different from those of the named shareholder plaintiff and his lawyer, a closely held corporation, as long as it remains solvent, really has no interests in the suit that are distinct from the interests of the named parties. Those shareholders who are getting little or no money from the corporation will be the plaintiffs. Those who are getting lots of money from the

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154. The plaintiff in a typical strike suit owns a minuscule percentage of the stock in the corporation and acts, in theory, strictly as a representative of the other shareholders in asserting the corporation's rights in the suit. The representative shareholder will generally not be obligated, nor be financially capable, of paying the lawyer's fee personally. Rather, the plaintiff's lawyer initiates the case on behalf of the representative shareholder in the hopes of extracting a judgment or settlement that will force the theoretical beneficiary of his actions, the corporation, to pay his fees. See La. Code Civ. P. art. 595 (representative party may recover attorney's fees if recovery or compromise is beneficial to class).

155. *Wembley*-style suits may seem analogous to strike suits in the sense that plaintiffs may bring claims that they have little chance of winning in an effort to make the defendants pay some money in settlement, merely to avoid the otherwise unavoidable costs of defending the suit. But nuisance suits of this type are a danger in all forms of civil litigation. It is the fact that nuisance suits involving public corporations can be prosecuted and defended with other people's money—that of the corporation's shareholders—that justifies special rules.

156. As a formal matter, the plaintiffs will usually be attacking only the amount of compensation going to the defendants, and not the lack of compensation going to themselves personally. But if they can interfere with the amount of compensation going to the defendants in the form of salaries and other disproportionate distributions, they can create an incentive for the distribution of profits in the form of proportionate dividends. And, more importantly, they can create an incentive for the controlling shareholders to buy out the minority interests so that the defendants do not have to be concerned about a lawsuit every time they give themselves a raise.

157. If the corporation is insolvent, or if the suit might cause insolvency, then creditors of the corporation would usually have interests in the case different from those of the corporate shareholders. But even in the case of insolvency, it seems doubtful that the defendants in the suit would always be better representatives of creditor interests than the plaintiffs; indeed, in the typical case, the plaintiff's challenges to excessive compensation, if successful, would inure to the benefit of the corporation's creditors.
corporation will be the defendants. Each side in this sort of dispute will have all
the incentive it needs to represent its own interests, and to hire lawyers to protect
those interests. The plaintiffs will normally select and pay their own lawyers,
at their own risk if they lose, and if a settlement is reached, the defendants
in the suit will have to bear the lion's share of the settlement costs, whether
directly in their capacity as defendants, or indirectly as the majority owners of
the corporation that makes the indemnity, settlement, and plaintiff-attorney fee
payments.

Thus, in sharp contrast with the public corporation derivative suit, the central
question in a close corporation suit is not whether the corporation's interests are
being adequately represented—the "corporation" in that setting is nothing more
than a collective name for the conflicting shareholder interests that are already
being represented—but whether the defendants should be entitled to get lots of
money out of the corporation, while the plaintiffs get very little. As a matter of
substantive law, a court might say yes, the corporation's compensation scheme
is fair, or, if not fair, at least not a proper subject for courts to judge. But
the court certainly should be skeptical, as the Wembley court was, that the law
would recognize some distinct interest in the case on the part of the corporation
that was supposed to be protected by forcing the plaintiffs to ask the defendants
to sue themselves. The Wembley court may not have seen the public corporation
issues that prompted the pro-management rules in Delaware, but it did see the
close corporation issues in the case before it. In that setting, for different policy
reasons, the ruling in Wembley was perfectly understandable, indeed wise.

As mentioned earlier, the A.L.I. has recognized the sharp distinctions that
exist between derivative suits involving publicly-traded companies and those
involving smaller, closely-held corporations. The A.L.I. recommends that courts
be given the discretion to treat derivative suits by shareholders in closely-held
corporations as direct, not derivative, actions, provided that the direct character-
ization does not harm creditors, interfere with a fair remedy, or pose a risk of
multiplying litigation. The effect of the Wembley rule, if it is interpreted
broadly, is to eliminate one of the important consequences of characterizing a

158. If the plaintiff ultimately succeeds, of course, he may be entitled to recover the fees from
the benefitted party, the corporation.

159. Compensation amounts even for controlling shareholders are generally considered beyond
judicial review as long as the compensation bears a reasonable relationship to the value of the
services rendered. See infra note 177.

160. A Delaware-style rule in the context of close corporation suits would not only be absurd
from a perspective of ordinary litigation procedure—asking the defendants to sue themselves—it
would also destroy what little protection that corporation law might otherwise provide to minority
investors in a closely-held corporation. Unlike the dissatisfied shareholders of a public corporation,
the minority shareholders in a closely-held corporation cannot simply sell their stock. If the minority
shareholders of a closely-held corporation are to have any legal leverage at all in dealing with the
controlling corporate shareholders, they have to have the right to bring derivative lawsuits without
having them dismissed by defendants who claim to be representing the corporation's true interests.

161. A.L.I., supra note 4, § 7.01(d).
suit as derivative, namely, the power of management to cause the suit to be dismissed. In that sense, therefore, Wembley is actually consistent with the A.L.I.'s position on the treatment of such suits in closely-held corporations. The suit may still be called "derivative," but the effect of a broadly-interpreted Wembley rule is to give unfettered control over the suit to the plaintiff shareholder, as if the suit were direct.

Still, a major difference does exist between the A.L.I. and Louisiana approaches to close corporation suits. The A.L.I., consistent with the trend in the substantive law governing closely-held corporations, recommends that plaintiff shareholders be given a direct right of recovery. Louisiana's controlling rule of civil procedure, Article 596, assumes that no such direct right exists. And, so far at least, that assumption has been accurate. Louisiana

162. Model Business Corporation Act, Close Corporation Supplement §§ 41, 42 (1984); Fought v. Morris, 543 So. 2d 167 (Miss. 1989) (imposing partner-like fiduciary duties on shareholders in family business corporation, recognizing "the evolving awareness by courts of the distinctive characteristics and needs of close corporations"); Westland Capitol Corp. v. Lucht Eng'g, Inc., 308 N.W.2d 709 (Minn. 1981) (closely held corporation sui generis, though noting with approval description of closely held corporation as "a partnership in corporate guise," and enforcing agreement that limited salaries and asset expenditures of corporation); Donahue v. Rodd Electroteype Co., 328 N.E.2d 505 (Mass. 1975) (imposing partner-like fiduciary duties on shareholders in closely-held corporation, finding that "the close corporation bears striking resemblance to a partnership," though noting that minority shareholder in even weaker position than partner due to shareholder's inability to trigger a partnership-like dissolution of the business); Galler v. Galler, 203 N.E.2d 577 (Ill. 1964) (upholding long-term shareholder agreement concerning corporate distributions in family business, recognizing the "problems peculiar to the close corporation"); O'Neal's Close Corporations §§ 1.12, 1.13, 8.07, 8.09, 8.11 (3d ed. 1992) (discussing special characteristics of corporation law, dangers of majority abuses of minority rights, and need for protection of minority interests); Clark, supra note 3, at 761-800 (discussing unsuitability of traditional corporation statutes and theories to closely-held corporations); Arthur S. Dewing, The Financial Policies of Corporations 32 (5th ed. 1953) (contrasting large, public corporations with "small, local corporations which are private proprietorships or partnerships wearing the mask of the corporation."); George D. Hornstein, Stockholders' Agreements in the Closely Held Corporation, 59 Yale L. J. 1040 (1950).

163. See Barth v. Barth, 659 N.E.2d 559 (Ind. 1995) (adopting A.L.I. rule permitting minority shareholder to maintain direct, personal action alleging freezeout by majority stockholder); Richards v. Bryan, 879 P.2d 950 (Kan. App. 1994) (applying A.L.I. rule); Crosby v. Beam, 548 N.E.2d 217 (Ohio 1989) (rejecting traditional classification scheme in context of closely held corporations; permitting direct action by minority shareholder against majority shareholders where alleged breaches damaged minority shareholders); Balvik v. Sylvester, 411 N.W.2d 383 (N.D. 1987) (permitting direct action by minority shareholder against majority shareholder for freezeout); Steelman v. Mallory, 716 P.2d 1282 (Idaho 1986) (permitting direct suit by minority shareholder based on allegations that majority, through their control of corporation, were freezing him out); Johnson v. Gilbert, 621 P.2d 916 (Ariz. App. 1980) (testing suit between two 50% shareholders as direct, and applying partnership dissolution principles to determine relative rights); Donahue, 328 N.E.2d at 505 (permitting direct suit by minority against majority shareholders to require equal treatment in corporate share repurchase); Watson v. Button, 235 F.2d 235 (9th Cir. 1956) (permitting direct suit by former shareholder for misappropriation from corporation by other shareholder). But see Welch, supra note 34 (questioning analogy between partnerships and closely-held corporations and arguing for only limited relaxations of traditional rules).

courts have largely ignored distinctions between public and closely-held corporations, and in a few cases have affirmatively rejected special rules even when the distinctions were suggested to them explicitly. With the exception of one intermediate appellate decision, later disagreed with by another panel in the same circuit, Louisiana courts have not yet recognized any theory under which a shareholder could obtain a direct, personal recovery for a breach of a fiduciary duty owed to the corporation.

The effect of the Louisiana approach, unfortunately, is to force minority shareholders to attack the allegedly excessive compensation of controlling directors and shareholders when the real fight is over the undercompensation (or complete lack of compensation) of the minority investors. The trend in the law nationally, i.e., to analogize closely-held corporations to partnerships and to recognize direct, personal rights to a fair share of corporate profits, would seem to be the better approach. And under that approach, the A.L.I. rule on direct suits in closely-held corporations could be accepted easily in Louisiana.

A. Post-Wembley Decisions

Since Wembley, just one reported case has considered the Wembley demand futility issue, and that case, another fourth circuit decision, has simply followed and reinforced the earlier decision. Wembley, recall, had not made it clear whether demand was excused merely because a majority of directors had been named as defendants, regardless of grounds, or only because the basis of liability

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165. Louisiana courts have so far declined to draw the partnership analogies that commentators and other jurisdictions have approved, even when these analogies have been brought explicitly to their attention. See Louisiana Weekly Publishing Co. v. First Nat'l Bank of Commerce, 483 So. 2d 929 (La. 1986) (stock transfer restriction in close corporation strictly construed against the restriction and in favor of free transferability); Goldblum v. Boyd, 341 So. 2d 436 (La. App. 2d Cir. 1976) (noting particular hostility in Louisiana toward shareholder management agreements, despite national trend to the contrary; striking down transfer restriction as unreasonable restraint on alienation). But cf. Succession of Dunham, 393 So. 2d 438 (La. App. 1st Cir. 1980) (recognizing that "a minority interest in a closely held corporation does not generally sell for its true value").


167. E.g., Department of Transp. v. Clark, 548 So. 2d 365 (La. App. 2d Cir. 1989), writ denied, 552 So. 2d 395 (1990); Hinchman v. Oubre, 445 So. 2d 1313 (La. App. 5th Cir. 1984); Mahfouz v. Ogden, 380 So. 2d 646 (La. App. 1st Cir. 1979); Afeman v. Insurance Co. of N. Am., 307 So. 2d 399 (La. App. 4th Cir. 1975).

168. See supra notes 162-163.

169. Not only does Wembley already accept the anti-management effects of the A.L.I. rule, Article 611 of the Louisiana Code of Civil Procedure already provides a mechanism—actual joinder of all parties—that takes care of the A.L.I. concerns about a multiplicity of litigation.
of the defendants was their alleged self-dealing for personal pecuniary gain. In the next case, Robinson v. Snell's Limbs and Braces of New Orleans, Inc., the court seemed to confirm that the broader meaning was the one intended.

The Robinson plaintiff had sued all of the directors of the corporation, alleging excessive compensation, use of corporate funds for personal expenses, and acquisition of automobiles not for the benefit of the corporation. Reversing the trial court, the fourth circuit held that the following allegation, set forth verbatim from the reported case, was sufficiently particularized to excuse the plaintiff's making any prior demand on the directors before filing his derivative complaint:

Plaintiff has made no effort to secure action from the directors or other shareholders of the corporation . . . for the reason that the individual defendants herein constitute the entire board of directors of the corporation and its other shareholders and any demand on the board or other shareholders that it or they bring action in the name of the corporation would have been futile.

In approving this sort of allegation, Robinson reinforced the impression created earlier in Wembley that no director named as a defendant in the suit could make an adequately disinterested decision to sue himself. Although Robinson did recite the nature of the allegations being made against these directors as part of its general introduction of the facts and issues in the case, the nature of these allegations was never discussed in connection with the plaintiff's obligation to make demand. According to Robinson, "the reasoning behind [the Wembley] rule is that it would be futile to ask a person to sue himself." Under this reasoning, the only allegation deemed necessary to support the court's conclusion on demand was the bare allegation, quoted above, that the plaintiff had named all of the other directors and shareholders in the corporation as defendants in the suit. "[A]s we held in [Wembley]," the court said, "the fact that the defendants being sued constitute a majority of the [corporation's] Board of directors is dispositive."

170. In Wembley, the court justified its result in one place based on the allegations that a majority of directors was "involved in the self-dealing or mismanagement that is the subject of the suit," suggesting that something about the nature of the defendant's alleged wrongdoing might be important in excusing demand, while in another place, the rule seemed much broader: no demand was required where a majority of directors had been named as defendants for the simple reason that a defendant could never be expected to make a disinterested decision to sue themselves. Smith v. Wembley Indus., Inc., 490 So. 2d 1107, 1108-09 (La. App. 4th Cir. 1986). National authorities would excuse demand only on the latter basis; merely naming the directors as defendants would not be sufficient by itself to disqualify them from making an "independent," legally-enforceable decision to dismiss the suit. See supra at notes 135-138.

171. 538 So. 2d 1045 (La. App. 4th Cir. 1989).

172. Id. at 1047.

173. Id.

174. Id.
Hence, to extent that Wembley had left the question open, Robinson seemed to conclude that the nature of the allegations against the directors was irrelevant to their ability to insist that demand be made under Article 596. The mere fact that they had been sued was sufficient to disqualify them from deciding whether the corporation should pursue the suit. The business decision rationale of the national authorities had once again been rejected in favor of a common-sense, litigation-based approach: plaintiffs should not be required to ask the defendants to make a disinterested decision to sue themselves.

Robinson still could be reconciled with the national cases on the same grounds as Wembley: that it involved a closely-held, not public, corporation, and that, despite the breadth of the court’s rationale, the actual result in the case was more narrow—all of the directors had been accused of direct self-dealing for personal pecuniary gain. Nevertheless, Robinson’s re-emphasis of the Wembley theory that it is always futile to ask a person to sue himself seems to have made it a least a little more difficult to defend the narrower, nature-of-the-allegations interpretation of the limited Louisiana jurisprudence on the subject.

The one case in Louisiana that does seem to have come close to adopting the national hostility toward shareholder derivative suits is a 1988 third circuit decision, Bordelon v. Cochrane. The plaintiff in Bordelon alleged that the defendants had violated not only their fiduciary duties to the corporation and to the plaintiff, but also a shareholders’ agreement with the plaintiff personally, by engaging in a series of actions that threatened to (or did) dilute the plaintiff’s interest in the corporation, interfere with the plaintiff’s efforts to sell his interest, preclude attractive financing arrangements for the corporation, and provide excessive compensation to the corporation’s controlling shareholder and his family. The Bordelon court first distinguished between those claims that were derivative in nature and those that were direct—belonging to the shareholder personally—and then for various reasons (most not pertinent here), affirmed the dismissal of all of the derivative and most of the direct claims. The only claim that survived was one alleging the payment of excessive compensation to one of the defendants and to certain of his family members in violation of the terms of a shareholders’ agreement to which the plaintiff and this defendant were parties.

In rejecting the derivative claims, the Bordelon court relied on a 1902 recitation by the supreme court of various formulations of what today would be called the “business judgment rule.” And it was in this respect, in relying on the business judgment rule as grounds for a dismissal of the plaintiff’s derivative claims, that Bordelon so closely resembled the national authorities in their approaches to public corporation derivative suits. The business judgment rule lies at the very heart of the Delaware, A.L.I. and R.M.B.C.A. derivative suit schemes. Those schemes permit most derivative suits to be dismissed,

176. See supra notes 113-138.
theoretically at the instance of the corporate plaintiff, either upon the business-judgment-based recommendation of the corporation's director-defendants (or their appointees) or as a result of the shareholder-plaintiff's failure to make demand on the directors so that such a "disinterested" business judgment could be made by the directors on the corporate plaintiff's behalf.

But while Bordelon accomplished the same substantive result as might be accomplished under the national rules, the procedural theory that was used to justify the result was very different. The exception that was sustained in Bordelon was the ordinary defense exception of no cause of action. Thus, the Bordelon dismissal was not based on the seemingly preposterous theory—already rejected by the fourth circuit in Wembley—that the law required the shareholder plaintiff in a derivative action to give to the director-defendants the opportunity to decide for the plaintiff corporation whether they, the directors, ought to be sued. Instead, the Bordelon defendants utilized the more straightforward theory that derivative suits could be allowed only in "extreme" cases, where the normal deference afforded to directors in the management of their corporations was not appropriate.

Unlike the Wembley and Robinson defendants, the Bordelon defendants were not purporting to speak for the corporate plaintiff, they were simply arguing that, as a matter of substantive corporate law, the shareholder plaintiff had not stated a cause of action against them unless he, the representative plaintiff, had made allegations that would overcome the normal business judgment presumptions in favor of corporate directors. Bordelon readily accepted this more straightforward, openly defense-controlled version of the business judgment argument.177

177. Bordelon ruled that the plaintiff's allegations of excessive compensation did not state a cause of action because they did not allege either that the payments made were illegal or that the recipient had failed to perform any services in exchange for his pay. This interpretation of the business judgment rule seems overbroad, as it would preclude all attacks on compensation that was merely excessive, rather than illegal or completely without justification, even if the compensation was ten or twenty times the amount that was appropriate under the circumstances. Louisiana courts, like those in most other jurisdictions, generally permit any reasonable salary to stand, but they would not permit a controlling shareholder to keep payments that were clearly outside the range of reasonableness. See La. R.S. 12:41(B)(9) (1994) (corporation empowered to pay compensation and pensions); 12:84 (1994) (self-dealing transaction not void or voidable if proper approvals obtained or if fair to corporation at the time authorized); Hingle v. Plaquemines Oil Sales Corp., 399 So. 2d 646 (La. App. 4th Cir. 1981) (salaries upheld; not shown to be unfair); Fincher v. Claiborne Butane Co., 349 So. 2d 1014, 1019 (La. App. 2d Cir. 1977) ("The hiring of a particular employee and the amount of compensation paid an employee are judged by their comparative reasonableness as against the duties and responsibilities being performed."); Clark, supra note 3, § 6.1 ("A conventional statement of the chief judge-made limitation on executive compensation is that it must be based on services rendered and must be 'reasonable' in amount."). Perhaps Bordelon was ruling simply that the plaintiff's allegations of "excessive" compensation was too conclusory, and that more particularized allegations were necessary to suggest in what way, or measured against what standard, the compensation was excessive. Under this interpretation, Bordelon would seem similar to the Aronson decision in Delaware, which held allegations of excessive pay inadequate, in the context of a dispute about demand futility, because the allegations were not particular enough to overcome the presumptions of the business judgment rule. See supra text accompanying notes 111-114.
Had the *Bordelon* defendants sought dismissal of the suit on grounds that it was a big waste of the corporation's time and money (since no allegations had been made that could ultimately result in liability), the dismissal surely would have been denied by the Fourth Circuit under the *Wembley-Robinson* rule. But for some reason—perhaps a different court, perhaps a failure to see the similarity of the issues—the third circuit in *Bordelon* accepted the business judgment argument in the context of an exception of no cause of action.

The implications of *Bordelon* are uncertain, particularly when *Bordelon* is compared with *Wembley* and *Robinson*. Although *Bordelon* dealt, in theory, with a different legal issue than either *Wembley* or *Robinson*, the underlying policy question was essentially the same in all three cases: whether the deference owed to management decisions under the business judgment rule was sufficient to bar the plaintiff's pursuit of his derivative suit. In *Bordelon*, the answer was "yes," while in *Wembley* and *Robinson*, the answer was "no."

Perhaps Louisiana courts really do see a difference between a defense motion that seeks to dismiss a suit for a failure to ask the defendant-directors to exercise their business judgment about suing themselves, i.e., a *Wembley-Robinson* motion, and one in which the defendant directors seek a dismissal based on the fact that they have already exercised their business judgment in approving the transactions under attack, i.e., a *Bordelon* motion. In theory, dismissal on the first ground would permit dismissal even of legally-meritorious suits, while dismissal on the second ground would be permitted only if the suit lacked legal merit.

But in fact, the plaintiffs in *Wembley* and *Robinson* were making the same kinds of generalized allegations of excessive compensation as the plaintiff was making in *Bordelon*. If the *Wembley* and *Robinson* courts were truly as hostile to these types of claims, on the merits, as the *Bordelon* court appeared to be, then it seems unlikely that the *Wembley-Robinson* courts would have been as concerned as they were about the plaintiff's ability to pursue such non-meritorious allegations over the objections of the corporation's elected directors. Certainly, there was nothing in the reasoning in the *Wembley* or *Robinson* case that suggested that the defendants would have been successful had they simply raised their business judgment arguments in a different context. If the

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178. The *Bordelon* plaintiff did enjoy some advantages over the typical *Wembley-Robinson*-style plaintiff that made it easier for the court to be hostile to his derivative suit claims without actually denying the plaintiff a remedy. In addition to the usual fiduciary-duty-based allegations of excessive compensation, the *Bordelon* plaintiff also alleged that the actions of the defendants had been in violation of a shareholders' agreement that the plaintiff and defendants had earlier executed. This contract-based claim gave the *Bordelon* plaintiff two advantages over the typical excessive compensation plaintiff. First, he had a direct, personal right to enforce the shareholders' agreement to which he was a party, thus eliminating all derivative suit issues as to that claim. Second, he could rely on a specific limit on compensation that had been established as a matter of contract law, thus eliminating the defendants' normal corporation law defense that compensation levels, as long as they remain reasonable, are supposed to be controlled by a corporation's board of directors and not by the courts.
differences between these cases did arise merely out of confusion about the policy questions being posed, with the business judgment issues being more obvious in *Bordelon* than in *Wembley* and *Robinson*, the inadvertent distinctions thus created should not command much respect in future decisions. The question to be asked in future cases is which of the two approaches, *Wembley-Robinson* or *Bordelon*, is the better approach to the management-control issues posed in a derivative lawsuit.

As a matter of policy, in the context of closely-held corporations, the *Wembley* and *Robinson* decisions seem superior to the *Bordelon* decision. Minority shareholders in closely-held corporations have few enough protections. The courts should not deny them the last bit of protection they still enjoy, i.e., the ability to keep the compensation levels of the corporation's shareholders within reasonable limits. The *Bordelon* suggestion that allegations of excessive compensation should be handled at the complaint stage, and should be dismissed in the absence of allegations of illegality or outright gifts of funds, eliminates virtually all judicial scrutiny of self-dealing compensation levels.

Judicial deference to salary decisions is indeed appropriate, but deference does not require courts to decide compensation cases based purely on the pleadings. Courts can rule in favor of the defendants in such a case if, after trial, the challenged compensation does indeed appear reasonable. Or courts can grant summary judgment for the defendant if, after discovery, the plaintiff has failed to create a genuine issue of material fact concerning the reasonableness of the compensation. But courts should not dismiss an excessive compensation suit just because the complaint lacks allegations of illegality or a lack of services. Nor should they dismiss a complaint because the plaintiff failed to ask the defendants to sue themselves. The *Wembley* rule is the better rule in the typical excessive compensation case.

VII. SHAREHOLDER DEMAND

Most of the national debate concerning the demand requirements in a derivative lawsuit has revolved around the issue of director demand. But Article 596, like many traditional derivative lawsuit provisions, also requires that the complaint in a derivative suit describe the efforts made by the plaintiff, or reasons for not making efforts, to obtain relief from shareholders for the alleged wrongdoing if such efforts are "necessary." This requirement is known generally as the "shareholder demand" requirement, and it differs from the director demand requirement in two related respects: shareholder demand concerns the making of demand on persons who normally would not possess the managerial power to make litigation decisions for the corporation, and, perhaps

180. See DeMott, supra note 68, at 474-84.
in part because of this lack of power on the part of shareholders, this type of
demand is conditioned on necessity of some unspecified kind.

Based on the distinctions between director and shareholder demand, the trend
in the law nationally is to abolish or to minimize the impact of the shareholder
demand requirement.\textsuperscript{181} Delaware has done so in the face of language virtually
identical to that in Louisiana by ruling, first, that the "if necessary" phrase in the
statutory language refers strictly to any necessity imposed by substantive
corporation law (and not the need for relief after a refusal of demand by
directors), and, second, that substantive corporation law imposes no such
necessity.\textsuperscript{182}

Despite Delaware's hostility, the A.L.I. has retained some vestige of the
shareholder demand requirement in its Principles of Corporate Governance.
Demand itself is not required,\textsuperscript{183} but it remains possible for a derivative suit to
be dismissed based on shareholder approval of a management recommendation
to dismiss.\textsuperscript{184} The shareholder action is effective only if management has first
conducted an adequate investigation and has made adequate disclosures
concerning its investigation and recommendations, but if the standards for the
shareholder-requested dismissal have been satisfied, then the court must dismiss
the suit as requested unless dismissal would result in a waste of the corporation's
assets.\textsuperscript{185}

Louisiana courts have not yet distinguished the issue of shareholder demand
from the issue of director demand. Only two cases have been reported on the
issue of demand of any kind, and in both of those cases, the court simply
accepted the same types of demand futility allegations on the issue of shareholder
demand as they accepted on the issue of director demand. According to these
decisions, a plaintiff is not required to ask the defendants to make a disinterested
decision to sue themselves regardless of the capacity, director or shareholder, in
which the defendants are being asked to make the decision.\textsuperscript{186}

In theory, shareholder demand might help avoid the conflict of interest
problems inherent in asking the directors to sue themselves; if the directors
themselves were too self-interested because of their roles as defendants in the
suit, shareholders who were not so self-interested might be able to make a truly
disinterested decision on the point. In reality, however, the shareholders in most
close corporation suits will already be participating in the suit, either as part of
the minority group bringing the suit or as part of the majority group defending
the suit. Rarely will any substantial portion of the corporation's stock be owned
by persons sitting on the sidelines just waiting to be asked for a disinterested

\textsuperscript{181} See A.L.I., supra note 4, § 7.03(c), Reporter's Comment (8).
\textsuperscript{182} Mayer v. Adams, 141 A.2d 458 (Del. 1958).
\textsuperscript{183} A.L.I., supra note 4, § 7.03(c).
\textsuperscript{184} Id. § 7.11.
\textsuperscript{185} Id.
\textsuperscript{186} Smith v. Wembley Indus., Inc., 490 So. 2d 1107 (La. App. 4th Cir. 1986); Robinson v.
decision on whether the suit should be pursued or dismissed. And without such a group of disinterested investors, moving the decision from the directors to the shareholders will accomplish nothing of any real value. The same conflicts of interests that would invalidate the directors’ decision should also invalidate the shareholder decision.

In public corporations, adequate numbers of disinterested shareholders probably could be found, so that the conflicts of interests inherent in a director decision on the derivative suit could be avoided. However, as Delaware has noted, demand on shareholders in a public corporation is expensive and time-consuming, requiring compliance with proxy solicitation rules imposed by federal securities law, and then produces a rather unreliable measure of the merits and value of the case.\textsuperscript{187} Passive investors in public corporations will rarely invest the time and effort necessary to determine the facts and to resolve the issues posed in a derivative lawsuit, and even if they wished to make the effort to understand the case, they would face almost insurmountable difficulties in investigating the facts of the case; they would be forced to rely on management’s reports to them. And, finally, even if the shareholders did make the effort, and did make a good decision, their decision would be advisory only; corporation law confers virtually all managerial powers—including powers to make litigation decisions—on the board of directors, not on shareholders.\textsuperscript{188} For these reasons, demand on shareholders in a public corporation is generally not considered “necessary” as a condition to filing suit.

As long as Louisiana courts continue to make it easy to get past both types of demand, director and shareholder, no reason will exist to explore the different functions that the two forms of demand might serve, or to delineate differences in rules applicable to the two different forms of demand. But the trend in the law, even when distinctions are recognized, is to excuse demand on shareholders, and to require it only on directors. Rarely would such a demand serve any purpose that would outweigh the costs involved.

\textbf{VIII. Litigation Committees}

Before the Delaware Supreme Court decided to attach tremendous substantive importance to the demand requirement, in its 1984 decision in \textit{Aronson v. Lewis},\textsuperscript{189} most states viewed the demand requirement mainly as a device that required a plaintiff to exhaust his internal corporate remedies before filing suit; excusing demand because of some apparent conflict of interest by board members was a relatively easy thing to accomplish.\textsuperscript{190} At that time,
before Aronson, the critical issue was not demand, but the power of so-called "litigation committees" to seek dismissal of the suit even after demand had already been excused. Demand became the more important issue after Aronson only because the Delaware Supreme Court decided in that case to use the demand requirement to undercut the anti-management effects of an earlier decision concerning litigation committees. The leading model provisions on corporation law, i.e., the Revised Model Business Corporation Act and the American Law Institute's Principles of Corporate Governance, have now rejected this emphasis on demand, and have attempted to shift the managerial-powers debate back to the litigation-committee question.

Citing the older authorities, Louisiana courts have so far rejected the managerial prerogatives attached by Delaware to the demand requirements in a shareholder derivative suit; demand can be excused rather easily if a majority of the directors of the corporation are alleged to have been involved in the wrongdoing that is the subject of the suit. But, like many states, Louisiana has yet to address, directly, the powers of management-appointed litigation committees in such suits. In effect, Louisiana law now stands where Delaware law stood before the Delaware Supreme Court issued its Zapata decision: the demand requirement is rather easily satisfied, but it is not clear whether satisfaction of the demand requirement is enough to preclude all further efforts by management to take over the suit on behalf of the real party in interest, the corporation.

One view, rejected in Zapata and by most authorities, is that management has no power to act on behalf of the corporation in the suit, that the shareholder plaintiff is in complete control of the corporation's pursuit of its claim. The majority view, at least in the jurisdictions in which the question has been considered, is that management retains the power to seek dismissal of the suit, even after demand has been excused on grounds of management's self-interest, by delegating its managerial powers to a duly-constituted litigation committee composed of persons who hold no personal interests in the suit.

Although

191. See Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982); Coffee & Schwartz, supra note 80; Dent, supra note 89.
192. See supra part V.B.2, Delaware Changes Its Mind—The Pro-Management Demand Rule.
194. State law is controlling on the question. Kamen v. Kemper Fin. Sec. Servs., Inc., 500 U.S. 90, 111 S. Ct. 1711 (1991); Burks v. Lasker, 441 U.S. 471, 99 S. Ct. 1831 (1979). A few states have adopted statutes and a few have rendered judicial decisions on the subject. But outside of Delaware, most decisions on the subject have been rendered by federal courts that are anticipating state law on the subject. See A.L.I., supra note 4, § 7.08, Reporter's Note (2).
some courts disagree, the A.L.I. and R.M.B.C.A. position is that a court must dismiss a derivative action upon the recommendation of a litigation committee if the court finds that the committee’s decision was made by adequately disinterested persons, after an adequately careful investigation.

Only one reported case, Robinson v. Snell’s Limbs and Braces of New Orleans, Inc., has even hinted at Louisiana’s position on the powers of litigation committees, and those hints are provided in the context of a discussion of the role of defense counsel in such a derivative suit. Reviewing a trial court denial of a motion to disqualify defense counsel, Robinson held that the same lawyer could represent both the individual defendants and the corporation, as defendant, in a derivative suit. This dual representation posed no conflict of interest for the defense lawyer, said Robinson, because the corporation had no interests in the suit as defendant; it was merely a nominal defendant in the case. The corporation’s true role in the suit was that of a passive plaintiff, the corporation would receive any recovery in the suit, but its interests in seeking this recovery would be represented by the shareholder plaintiff and his counsel.

Robinson is relevant to the litigation committee issue because the power of a litigation committee to seek dismissal of a derivative suit is tied to the assumption that the corporation’s role in a derivative suit is not purely nominal and passive. Despite the satisfaction of the demand requirement, the majority view is that management does retain the power to cause the corporation to take an active role in seeking dismissal of the suit. Whether this power is rationalized as the assertion of a defense, in the corporation’s role as defendant, or as a voluntary withdrawal of the suit in the corporation’s role as plaintiff is not important. What is important is management’s retention of the power to seek dismissal of the suit on grounds that the suit, even if legally meritorious, is not in the best interests of the corporation. Robinson implicitly assumed that no such power existed. Management’s role was limited to defending itself. The corporation’s true interests as plaintiff were represented by the plaintiff shareholder.


201. Id. at 1048-49.

202. Id. Robinson’s suggestion that a corporation’s true interest would always be represented by the plaintiff in a derivative suit seems misleading. The plaintiff is praying for relief in favor of the corporation, so the corporation’s interests are aligned with those of the plaintiff in that sense. But
Obviously, Robinson is weak authority on the litigation committee issue. Logically, if one accepts Robinson’s reasoning, then committees of this kind should have no power under Louisiana law. But Robinson really was not discussing litigation committees, it was discussing legal representation where no such committee had been appointed, and where all the directors of the corporation were alleged to have engaged personally in self-dealing that resulted in financial gain. These are not the type of directors empowered to make binding decisions even in jurisdictions that do recognize the power of disinterested litigation committees to seek dismissal of a suit. Thus, pragmatically, the management of the corporation in Robinson really did not have any role to play in representing the corporation’s interests in the suit. In a later case, where disinterested directors or agents of the corporation were appointed to make decisions about the corporation’s position in the suit, Robinson’s views about the corporation’s role in the suit, as well as the lawyer’s ethical conflicts, could be distinguished. With a disinterested committee, a role for the corporation may exist, and a need for independent counsel may be recognized.

Still, the important question is not whether Robinson’s views on managerial powers could be distinguished in future case, but whether they should be. And as long as this question is posed in the context of closely-held corporations, the answer to the question is “no.” As discussed earlier, derivative lawsuits in closely-held corporations bear little resemblance to the public corporation suits that have spawned the pro-management rules at the national level. In closely-held corporations, Robinson’s conclusion that the corporation has no role to play will usually be accurate. Unless the corporation is insolvent, or the suit might result in insolvency, all of the relevant corporate interests normally will be protected. Defense counsel will represent the interests of those in control of the corporation and plaintiff’s counsel will represent those not in control. The prevailing rules on public corporation litigation committees should be accepted only in a case that poses the strike suit dangers that the rules were designed to address.

IX. Conflicts in Legal Representation

Robinson v. Snell’s Limbs and Braces of New Orleans, Inc. is the only reported decision in Louisiana that considers the propriety of management-
appointed lawyers representing both the corporation and the corporate managers individually as defendants in a derivative lawsuit. The Robinson plaintiff had sued all of the directors of a closely held corporation on grounds of excessive compensation. After counsel for the defense filed answers in the suit both on behalf of the individual defendants and on behalf of the corporation, the plaintiff moved to have the defense lawyers disqualified from representing the corporation in the suit. The plaintiff argued that this sort of dual representation created a conflict of interest in violation of Rules 1.7 and 1.13 of the Model Rules of Professional Conduct.

Rule 1.7 provides that a lawyer “shall not represent a client if the representation of that client will be directly adverse to another client unless: (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client, and (2) each client consents after consultation.”

Rule 1.13 (e) provides that an organization, such as a corporation, may consent to dual representation under the terms of Rule 1.7 only if the consent is provided by “an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.”

Thus, if a conflict of interest existed in Robinson between the interests of the corporation and those of the directors in their personal capacities as defendants, the same law firm could not represent both the corporation and the directors unless it obtained the consent of both the directors and of the corporation, speaking through some “appropriate official” other than the directors themselves, or through the shareholders. Because all of the corporate directors were individually defendants in the case, it was clear that the directors could not approve of any conflict in their capacity as directors, and, because the same conflicts of interest would have existed in any decision made in their capacities as shareholders, it was at least doubtful whether a mere shift to the shareholder approval scheme would have made any legal difference. Thus, if a conflict did exist, it might have been impossible as a practical matter for the defense firm to obtain the consents required by Rule 1.7 as a condition to the defense firm representing both the corporation and its directors.

But Robinson ruled that no such conflict of interest existed, thus eliminating the need to construe the organizational consent requirements of Rule 1.13. According to Robinson, the real party plaintiff in a derivative action was the corporation, even though its interests as plaintiff were being represented by the shareholder plaintiff rather than by management, as was normally the case. As a defendant, Robinson reasoned, the corporation really had no interests; it was named as a defendant simply because Article 596 of the Code of Civil Procedure

205. Cf. Woodstock Enter., Inc. v. International Moorings & Marine, Inc., 524 So. 2d 1313 (La. App. 3d Cir. 1988) (interpreting La. R.S. 12:84(A)(1) & (2) concerning director and shareholder approval of self-dealing transactions to require disinterested approval in both cases, director and shareholder, even though statute mentions disinterest requirement only in the case of director approvals); Rivercity v. American Can Co., 600 F. Supp. 908 (E.D. La.), aff’d, 753 F.2d 1300 (5th Cir. 1984) (same as Woodstock).
required it. Thus, although named as a defendant, the corporation was actually the plaintiff in the case, but purely a passive plaintiff whose interests were advanced by the representative shareholder plaintiff. Because the corporation lacked any real interests as defendant, *Robinson* ruled, the defense firm could continue its representation of both the real defense interests of the director-defendants and the purely nominal, essentially nonexistent, interests of the corporation as defendant. No true conflict of interest really existed.

The *Robinson* decision on legal representation says more about the court’s perception of the role of a corporation (and its management) in a derivative suit than it does about legal ethics. For if *Robinson* was right—that a corporation’s role in a derivative suit is either passive (as plaintiff) or nominal (as defendant)—then no conflict of interest could exist in a law firm’s representation of both the nominal corporate defendant and the true director-defendants in such a suit. But if, as other states have suggested, a corporation’s management does have an important role to play in deciding whether and how to pursue all suits brought in the corporation’s name, including derivative suits, then the ethics issue is not nearly as clear-cut. Separate counsel might indeed be required.

In considering the issues of legal representation, however, it is important to think clearly about the lawyer’s role in the case. The human beings to whom the lawyer is supposed to be giving advice, and from whom the lawyer is supposed to be receiving his instructions, will need to be identified explicitly, for the corporation itself—a legal abstraction—cannot think or act on its own. Merely naming the “corporation” as the lawyer’s client will put the lawyer in the untenable position of choosing either to follow or to reject the instructions of the corporation’s normal representatives, the very directors whose self-interest in the suit were thought to make the appointment of independent counsel necessary to begin with.

If the lawyer follows the instructions of the corporation’s normal representatives, its defendant-directors, then not much will have been accomplished through the appointment of independent counsel; the “independent” corporate lawyer will end up following the same instructions as the defendants’ personal lawyers. But if the independent counsel actually asserts his independence, if he refuses to follow the instructions of his client’s human representatives in the ordinary way, then the lawyer will have stepped out of his normal role as counselor and

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206. The court did not suggest why Article 596 would require the corporation to be named as a defendant if its interests were really aligned with those of the plaintiff. Courts in other states have suggested that derivative suits are essentially two suits in one: the first is the substantive suit itself, the suit in which the corporation is seeking some recovery from the defendants, and the second is a suit against the corporation, brought by the shareholder plaintiff, to force the corporation to bring the first suit. Under this theory, the corporation is a defendant in the sense that it is being forced against its will (as expressed by management) to bring the first suit. A simpler explanation of the “name the corporation” rule is that the corporation must be joined in the suit to make any judgment in the suit binding on it as the legal owner of the claim being adjudicated. See supra Part IV—Requirements for Derivative Suits Generally.
advocate, and will have taken on a troublesome new dual role as combined corporate counselor and guardian ad litem.

The first situation is merely wasteful; the second undercuts all the normal rules of corporate management. If a court believes that it has the power, and appropriate grounds, for the appointment of a special-purpose receiver or guardian ad litem for the corporation, then it should make those appointments. But it should not presume that it is really resolving an ethical problem for the lawyers in the case by appointing an "independent" lawyer to represent the legal abstraction known as the corporation. Without independent managerial representation for the corporation, the independent lawyer's role will be confusing at best; he will either be acquiescing to the defendant-directors' control of the case, or he will constantly be fighting their instructions and usurping their traditional managerial functions. For an independent lawyer to do his job properly, his appointment must be tied to the naming of some independent manager or management group, such as an independent committee of the board of directors, to act as his client contact. Without this independent managerial contact, the independent lawyer will either be too powerful or not powerful enough.

Once such an independent managerial committee has been established, it seems likely that the committee will figure out on its own, without judicial intervention, that it will need independent legal representation. If the committee does not come to this conclusion on its own, then a court might either grant a Robinson-like motion to prohibit the planned dual representation, or it might still leave the choice of legal counsel to the committee and simply take into account the committee's lack of independent legal representation in considering what weight the court should give to the committee's recommendations in the suit.

X. CONCLUSION

Louisiana law on derivative suits shares a common foundation with that in other states, based on the language of the Federal Rules of Civil Procedure and on the assumptions made in those rules about the underlying substantive law of corporations. Under those common principles, shareholders ordinarily are not permitted to enforce corporate claims, but so-called contemporaneous shareholders are nevertheless provided with a procedural mechanism for filing and maintaining control over corporate suits under certain unspecified circumstances in which management itself has refused to pursue the matter.


208. See A.L.I., supra note 4, § 7.09(a) (calling for independent counsel for disinterested litigation committee).

Yet the procedural similarities among the states mask a very basic disagreement among the states about the role of management in such suits. The leading national authorities have sided heavily with management in restricting the power of plaintiff shareholders to bring such suits, while some states have been far more liberal. Louisiana courts have not perceived the division among the states in this field, nor the strong pro-management leanings of the national authorities. As a result, the decisions that they have produced so far have been ambiguous. Narrowly interpreted, these decisions may be reconciled with the national authorities. But read more naturally, the decisions seem to reject the very idea that the national authorities could be saying what they are, i.e., that plaintiffs in a derivative suit should be forced to ask the defendant directors for a disinterested decision to sue themselves. Such a notion strikes the Louisiana courts as absurd.

Logically, from a litigation decision perspective, the Louisiana courts are surely right; it is absurd to think that the defendants in a suit could ever be disinterested in whether they are sued. But pragmatically, from a business perspective, a director's mere status as a defendant in a case cannot be allowed to disqualify him from exercising all managerial control over the suit unless one is willing to give enormous control over the suit to any lawyer who can find a shareholder willing to act as plaintiff.

Which of the two perspectives makes better sense depends on the type of corporation involved. As the A.L.I. has suggested, anti-strike suit measures should be limited in application to public corporations, where strike suits are a serious danger. In closely-held corporations, the greater danger is a freezeout of minority investors. Anti-strike suit measures should not be used to strengthen even further the enormous advantages already held by majority shareholders in a closely-held corporation.

Perhaps Louisiana courts agree with the A.L.I. distinction, but it seems more honest to say they haven't seen it yet. They appear to be siding with a position that favors plaintiffs and they happen to be doing so in close corporation cases. However, they seem to believe that the same pro-plaintiff rule should apply in all cases for the simple reason that defendants are not literally disinterested in whether they are sued. Stated that broadly, Louisiana's position has been rejected by most leading authorities, and so it ends up looking weaker and less reliable than it should.

Louisiana is not really at odds with the national authorities in the context of the cases that it has decided so far; indeed, it has gained recent support for its position, in context, from the A.L.I. rule on suits involving closely-held corporations. Whether shareholders should be given direct, personal rights of action as the A.L.I. suggests is a question that may be saved for later.210 But if the law as it now stands really is intended to give directors absolutely no role

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210. The author should admit that he hopes the answer is "yes" when the question is finally asked.
in deciding whether they should be sued, then Louisiana—perhaps unknowingly—has already moved in the direction that the A.L.I. has suggested. Under those circumstances, the A.L.I. distinction between public and closely held corporations should be acknowledged explicitly as a justification for the law that already exists. Otherwise, doubts will continue to exist about the strength and scope of decisions that seem so far out of touch with the leading national authorities.