

The Past, Present, and Future of Universal Demand

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In 1989, the American Bar Association’s Section on Business Law, acting upon the recommendation of its Committee on Corporate Laws, revised Subchapter D of the Model Business Corporations Act (“MBCA”) pertaining to shareholder derivative suits.¹ One of the most significant changes made to the MBCA was the addition of section 7.42, the so-called “universal demand” requirement. This provision states that a shareholder may not file a derivative suit on behalf of the corporation unless he first makes a written demand to the board of directors to take action and waits ninety days for the board to respond to the demand.² The ninety-day waiting period only may be waived if the board rejects the demand or if irreparable injury would inure to the corporation from the delay in filing.³ The MBCA’s universal demand requirement stands in contrast to Delaware law, which makes the demand requirement voluntary and requires only that the shareholder plaintiff allege with particularity either the efforts to make a demand on the board prior to filing the derivative suit or the reasons that such efforts would

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¹ See *Werbowsky v. Collomb*, 766 A.2d 123, 140 (Md. 2001) (citing *Report of the Committee on Corporate Laws, Changes in the Model Business Corporate Act—Amendments Pertaining to Derivative Proceedings*, 44 BUS. LAW. 543, 554 (1989)).

² MODEL BUS. CORP. ACT § 7.42 (4th ed. 2008).

³ *Id.* at § 7.42(2).

have been futile.⁴ Instead, the MBCA provision looks much like the universal demand recommendation made by the American Law Institute (“ALI”) in its *Principles of Corporate Governance*,⁵ the development of which was ongoing concurrently with the MBCA revisions.

The universal demand requirement has been deemed “the most important difference” between Delaware law and the MBCA with regard to derivative suits.⁶ This distinction between the MBCA and Delaware law on the necessity of demand was, of course, intentional. Indeed, the Official Comment to section 7.42 sets forth two reasons for the adoption of the universal demand provision: (1) to “give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action”; and (2) to “eliminate[] the time and expense of the litigants and the court involved in litigating the question whether demand is required.”⁷ Commentators have expressed skepticism that the universal demand requirement has, as its framers intended, avoided protracted litigation on the issues underlying demand futility.⁸ Yet to date there has not been a comprehensive review of the universal demand

⁴ DEL. CH. R. 23.1(a); *see also* FED. R. CIV. P. 23.1 (establishing a similar procedure for shareholder derivative suits filed in federal court).

⁵ American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03 (1992) (“*Principles of Corporate Governance*”).

⁶ Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 745 (2001).

⁷ MODEL BUS. CORP. ACT § 7.42 cmt.

⁸ *See, e.g.*, Jeffrey M. Gorris, et al, *Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis*, 74-WTR LAW & CONTEMP. PROBS. 107, 118 (2011). The authors characterize the attempt by the MBCA’s drafters to improve upon Delaware’s demand practice as “likely wishful thinking” because “[t]he same issues litigated in demand futility cases (for example, director disinterestedness and independence) must still be litigated, based upon pleadings alone, when the corporation moves to dismiss the derivative proceeding”). *Id.*; *see also* Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973, 999 (“[T]he requirement of universal demand and the Delaware rule allowing it to be excused may amount to much the same thing.”).

provision's reach and impact.⁹ As we near the thirtieth anniversary of the incorporation of universal demand into the MBCA, this article attempts to provide insight into the "lay of the land" of universal demand. This issue is of heightened importance now because, as commentators have noted, derivative and other corporate litigation is increasingly being filed outside of Delaware.¹⁰

Part One of the article provides background regarding the rationale for adoption of the universal demand provision by reviewing the Delaware standard for demand futility to which the universal demand requirement was a response. Part Two looks at the "legislative" history behind both the adoption of section 7.42 by the ABA's Business Law Section and the similar recommendation in section 7.03 of the ALI's *Principles of Corporate Governance*. Part Three summarizes the adoption of the universal demand provision in states whose corporate statutes predominantly follow the MBCA and attempts to categorize appellate court decisions that have addressed the mandatory demand requirement. These decisions include not only those analyzing a state's statutory universal demand requirement, however, but also those adopting universal demand in derivative suits as a common law requirement¹¹ and those declining to adopt a

⁹ Indeed, research has revealed only three comprehensive empirical studies of shareholder derivative suits over the past ten years: two focused on Delaware and the third on shareholder derivative suits filed in federal court. Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. R. 1749 (2010); Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. R. 387 (2008); Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747 (2004). Professor Erickson's study of derivative suits filed in federal court did include a number of suits filed in universal demand jurisdictions. Erickson, *supra*, at 1783.

¹⁰ See, e.g., John Armour, et al, *Delaware's Balancing Act*, 87 IND. L.J. 1345, 1350 (2012) (finding that "the vast majority of option backdating suits involving Delaware companies," which were filed as derivative suits, "were filed outside Delaware").

¹¹ See, e.g., *Cuker v. Mikalauskas*, 692 A.2d 1042 (Pa. 1997).

universal demand requirement without legislative action.¹² The purpose of this analysis is to determine whether the provision is being strictly applied, in states where it has been adopted by statute, or judicially accepted, where it has not been adopted by the legislature. Of course, this analysis is naturally limited. The effect of the universal demand provision may be felt significantly at the filing stage or trial court level, and the difficulties of gathering such data on a state-by-state basis make construction of a true empirical database of state universal demand cases impossible. However, the article concludes by attempting to make sense of the legislative and judicial response to the universal demand requirement that was adopted into both the MBCA and the ALI's *Principles of Corporate Governance* and by discussing possible next steps. It is difficult for us to tell at this point whether the universal demand provision has had the intended effect of streamlining shareholder derivative litigation. However, just past its silver anniversary, there is little empirical evidence available to tarnish the provision.

I. The Delaware Approach to Demand

The MBCA's universal demand provision was adopted as a response to the demand practice in Delaware, a modified form of which had been adopted in numerous other states. The shareholder derivative action finds its origins in the English Court of Chancery but developed uniquely in the United States during the nineteenth century.¹³ In a derivative suit, the

¹² See, e.g., *Werbowsky*, 766 A.2d at ___; *In re Guidant S'holders Derivative Litig.*, 841 N.E.2d 571 (Ind. 2006).

¹³ See generally Ann M. Scarlett, *Shareholder Derivative Litigation's Historical and Normative Foundations*, 61 BUFF. L. REV. 837 (2013) (detailing the origins and development of the derivative suit both England and the United States); see also *Ross v. Bernhard*, 396 U.S. 531, 534-35 (1970) (considering both the history and legal and equitable nature of the derivative suit in determining that it gives rise to a constitutional right to jury trial under the Seventh Amendment).

shareholder brings a claim against third parties or, more commonly, corporate fiduciaries – usually officers or directors – who have allegedly wronged the corporation.¹⁴ Unlike in a direct action, where the shareholder sues to remedy an injury that he or she has suffered personally, in the derivative action the shareholder “steps into the corporation’s shoes . . . to seek in its right the restitution he could not demand in his own.”¹⁵ In other words, the derivative suit represents the third “arrow” in the “quiver” available to the shareholder to express his or her displeasure with the activities of corporate management – “vote, sell, or sue.”¹⁶ The derivative action has two primary goals: compensation of shareholders for injuries inflicted on the corporation and deterrence of future bad acts by corporate management.¹⁷

The shareholder derivative suit has long been compared to the class action, which is another “form of representative litigation long recognized by courts in the United States” where “one or a few persons stand for another or group of persons” and assert claims on their behalf.¹⁸ And like the class action, the derivative action has long had both its supporters and its

¹⁴ JAMES D. COX & THOMAS LEE HAVEN, *BUSINESS ORGANIZATIONS LAW* 439-40 (3d ed. 2011).

¹⁵ *Cohen v. Beneficial Loan Indus. Corp.*, 337 U.S. 541, 548 (1949); see also Ann M. Scarlett, *supra* note 13.

¹⁶ See, e.g. Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board’s Power to ‘Just Say No,’* 67 U. CIN. L. REV. 999, 1001-03 (describing the three options and asserting that “[c]umulatively, these shareholder rights define a limited shareholder role in corporate governance”); Andrew C.W. Lund, *Rethinking Aronson: Board Authority and Overdelegation*, 11 U. PA. J. BUS. L. 703, 708 (2009); see also COX & HAZEN, *supra* note 14, at 349-50 (describing the three classes of shareholder rights as “(1) rights as to control and management, (2) proprietary rights, and (3) remedial and ancillary rights”).

¹⁷ Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation*, 77 MINN. L. REV. 1339, 1345 (1993).

¹⁸ *Scarlett*, *supra* note 13, at 841; see also *Ross*, 396 U.S. at 541 (“Derivative suits have been described as one kind of ‘true’ class action. We are inclined to agree with the description, at least to the extent it recognizes that the derivative suit and the class action were both ways of allowing parties to be heard in equity who could not speak at law.”). Of course, a major distinction is that the lead plaintiff in a class action has suffered some direct injury along with the other class members, whereas the injury in a shareholder derivative suit is the corporation’s alone.

detractors.¹⁹ On the one hand, derivative suits have been praised as “ingenious”;²⁰ “a needed policeman” that “serves a basic and increasing need in the contemporary economy”;²¹ and, perhaps most famously, as a “potent tool[] to redress the conduct of a torpid or unfaithful management.”²² On the other hand, derivative suits have been disparaged as “nuisance suits whose ‘principal beneficiaries . . . are attorneys’”;²³ and as having “little, if any, beneficial accountability effects” while placing “a high cost constraint and infringement upon the board’s authority.”²⁴

The unique nature of the derivative suit, and concerns about its potential abuses, have given rise to several procedural obstacles that shareholder plaintiffs must overcome before a court will consider the merits of their derivative claims.²⁵ The most significant of these – or at the very least, the most litigated – is the demand requirement,²⁶ which in Delaware is embodied in

¹⁹ Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-First Century*, 21 J. CORP. L. 417, 437 (1996) (“Both ingenuous and uniquely complicated, shareholder derivative suits have been controversial since their inception. . . . Although some view derivative litigation as providing an invaluable procedural remedy for shareholders seeking accountability, others caution that the corporation, not courts, should resolve internal business conflicts.”).

²⁰ Swanson, *supra* note 19, at 1340 (quoting ROBERT C. CLARK, *CORPORATE LAW* § 15.1 (1986)).

²¹ Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 75, 78 (1967).

²² *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

²³ Thompson & Thomas, *supra* note 9, 1748 (2004) (quoting Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55, 65 (1991)).

²⁴ STEPHEN M. BAINBRIDGE, *CORPORATION LAW & ECONOMICS* 404 (2002).

²⁵ See, e.g., Dykstra, *supra* note 21 (“The hurdles referred to are neither simple nor insignificant. They carry such names as ‘security for expenses,’ ‘contemporaneous ownership’ and ‘demands on directors and shareholders.’ They are, for the most part, the by-products of the ‘strike suit’ and represent reactions to abuse of the judicial process by stockholders whose motive in bringing suit is personal gain rather than corporate benefit.”); see also *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) (“[B]ecause the derivative action impinges on the managerial freedom of directors, the law imposes certain prerequisites to the exercise of this remedy.”).

²⁶ Cf. Lund, *supra* note 16, at 703 (“[T]he demand requirement in derivative litigation is one of the most consequential doctrines in corporate law.”).

both the common law and Delaware Chancery Rule 23.1. Rule 23.1 requires the plaintiff to “allege with particularity the efforts, if any, made . . . to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.”²⁷ Delaware’s demand requirement “is a recognition of the fundamental precept,” enshrined in the Delaware General Corporation Law (“DGCL”), “that directors manage the business and affairs of corporations.”²⁸ This requirement exists both “to insure that a stockholder exhausts his intracorporate remedies” and “to provide a safeguard against strike suits.”²⁹ In a recent opinion, Vice Chancellor Travis Laster observed that the “net effect” of Rule 23.1 “is to reduce the overall volume of litigation, constrain the extent of interference with managerial decision-making, and limit the resource-drain that excessive litigation would impose.”³⁰

Whatever the merits of Delaware’s demand requirement, shareholder plaintiffs pursuing their derivative action will rarely, if ever, make a demand on the board. This is because

²⁷ DEL. CH. R. 23.1; *see also* FED. R. CIV. P. 23.1 (requiring the same of derivative suits that are filed in federal court).

²⁸ *Aronson*, 473 A.2d at 812; *see also* DEL. CODE ANN. tit. 8, § 141(a) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors”); *Principles of Corporate Governance*, *supra* note 5 at § 7.03, cmt. c (“Delaware views the demand rule as effecting a substantive allocation of power to the board to dismiss derivative litigation. Not all jurisdictions concur in this view.”).

²⁹ *Aronson*, 473 A.2d at 811-12. Comment c to the universal demand provision of the *Principles of Corporate Governance* cites four purposes of the demand rule. The rule: (1) “protects the court from unnecessarily hearing a case that is not ripe for decision or that might be mooted by subsequent board action; (2) “provides an opportunity for the board to determine if it will pursue other remedies or take other appropriate corrective actions”; (3) “permits the corporation to take over the suit and control the litigation; and (4) “provides the corporation with an opportunity to reject the proposed action or if it is filed, to seek its early dismissal.” *Principles of Corporate Governance*, *supra* note 5, at § 7.03, cmt. c.

³⁰ *In re El Paso Pipeline Partners, L.P. Derivative Litig.*, C.A. No. 7141–VCL, 2015 WL 7758609, at *16 (Del. Ch. Dec. 2, 2015).

Delaware's courts have held that a demand on the board by the shareholder is a concession that a majority of the board is disinterested enough to consider the demand, thus waiving the issue of board independence in the subsequent litigation.³¹ Wanting to avoid the waiver caused by making a demand – particularly since the request of the board will almost certainly be rejected,³² – plaintiffs file suit and then litigate the issue of whether demand should be excused as futile (or, in the language of Rule 23.1, their “reasons for . . . not making the effort). In *Aronson v. Lewis*, the Delaware Supreme Court established two alternative tests for establishing demand futility:

[I]n determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.³³

The first prong of *Aronson* presents a high bar, particularly when the suit involves a public corporation with a majority of the board made up of outside directors,³⁴ in part because the

³¹ See *Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. 1990) (“By electing to make a demand, a shareholder plaintiff tacitly concedes the independence of a majority of the board to respond.”); *Levine v. Smith*, 591 A.2d 194, 212 (Del. 1991) (same); John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1413 (1993); Joseph C. Barsalona II, Comment, *Litigation Supply Should Not Exceed Shareholder ADR Demand: How Proper Use of the Demand Requirement in Derivative Suits Can Decrease Shareholder Litigation*, 90 OR. L. REV. 773, 783-84 (2012).

³² See, e.g., *Morrissey*, *supra* note 8, at 997 (“[I]n practice boards typically reject demands out of hand, claiming that these suits are not in the corporation’s best interest.”).

³³ *Aronson*, 473 A.2d at 814.

³⁴ Coffee, *supra* note 31, at 1412; see *Pogostin*, 480 A.2d at 624 (“Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.”); *Levine*, 591 A.2d at 205 (“When lack of independence is charged, a plaintiff must show that the Board is either

plaintiff, as in cases where demand is made and refused (“demand refused” cases), must meet the “particularized facts” pleading standard without the benefit of any discovery that might support the claim of demand futility.³⁵ Even if the plaintiff succeeds in showing that demand should be excused as futile (a so-called “demand excused” case), the board can appoint a special litigation committee (“SLC”) made up of disinterested directors and delegate to it the power to investigate the plaintiff’s claims to recommend whether the corporation should proceed with the litigation.³⁶ The SLC’s determination regarding whether the corporation should proceed with the litigation will be examined using a two-part test under *Zapata*. First, the court shall inquire into the independence of the members of the SLC, with the defendants having “the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.”³⁷ If the defendants make such a showing, then the court “should determine, applying its own independent business judgment, whether the motion should be granted.”³⁸ Delaware courts have generally affirmed the independence of SLCs, with some notable exceptions.³⁹ *Aronson’s* second prong is no less difficult for plaintiffs to overcome than

dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is ‘sterilize[d].’”).

³⁵ *Levine*, 591 A.2d at 210 (holding that to permit discovery in a “demand refused” case “would be a complete abrogation of the principles underlying the pleading requirements of Rule 23.1”); *see also* Dennis J. Block, et al, *Derivative Litigation: Current Law Versus the American Law Institute*, 48 BUS. LAW. 1443, 1456-57 (1993); Davis, *supra* note 9, at 400 (“Instead, the plaintiff must rely on the ‘tools at hand’ – SEC filings, media reports, and a possible books-and-records inspection under section 220 of the Delaware law.”).

³⁶ *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785-86 (Del. 1980) (citing DEL. CODE ANN. tit. 8, § 141(c)). Unlike in “demand refused” cases, discovery is permitted in “demand excused” cases. *Levine*, 591 A.2d at 209.

³⁷ *Zapata*, 430 A.2d at 788-89.

³⁸ *Id.* at 789.

³⁹ *See, e.g.*, *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) (holding that Oracle had not met its burden to show the independence of the SLC).

the first prong, as the shareholder must “plead particularized facts creating a reasonable doubt as to the ‘soundness’ of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction.”⁴⁰

Over the years, at least four primary concerns emerged with this Delaware approach to demand: (1) the plaintiff is left between the “rock” of overcoming the *Aronson* test and the “hard place” of conceding the board’s disinterestedness; (2) it leads to collateral litigation over any number of issues pertaining to demand futility;⁴¹ (3) it focuses only on the potential capacity of the board to evaluate the derivative action, rather than on the board’s actual decision-making, because in most cases the demand is never made; and (4) it leaves substantial room for judicial discretion regarding whether demand should be excused.⁴² With these perceived shortcomings at the fore, two influential corporate law committees met in the 1970s and 1980s to craft a better alternative.

II. Adoption of the Universal Demand Provision

A. ALI’s *Principles of Corporate Governance*

Beginning in the late 1970s, the ALI endeavored to create a Restatement of sorts for corporate law. The caveat “of sorts” is necessary here, because the ALI’s best-known

⁴⁰ *Levine*, 591 A.2d at 206.

⁴¹ See *Coffee*, *supra* note 31, at 1414 (listing various issues that give rise to collateral litigation concerning demand and citing cases); Swanson, *supra* note 19 (“In light of the recurring dissatisfaction with the futility exception’s unnecessary prominence in shareholder derivative suits, the modern trend has been decidedly towards requiring pre-suit demand in virtually every instance.”).

⁴² *Id.* at 1412 (observing that *Aronson*’s second prong, in particular, “is susceptible to highly variant interpretation and application”).

Restatements, to which we were all exposed during our first year of law school, have attempted to synthesize the evolving law in specific subject areas governed primarily by decisional common law (*i.e.*, torts, contracts, property).⁴³ Unlike uniform laws or model acts, which are designed to be adopted (usually *in toto*) by state legislatures, Restatements are intended to be adopted, piecemeal, by courts, in order to promote uniformity in the common law.⁴⁴ So concerns with “modern” Restatement efforts notwithstanding,⁴⁵ the ALI’s intent in creating them is ostensibly to present a picture of the law as it exists in a particular area – in other words, to “restate” it – at least in the absence of a statement of intent to the contrary.

Any attempt to create a traditional “Restatement” of corporate law would be exceedingly difficult. First, corporate law is, of course, primarily governed not by common law but rather by the corporations statutes of each state. In addition, two influential sources of law already existed in the late 1970s to influence state legislatures contemplating a change in their state’s corporations laws – an actual statutory code in the leading corporate law jurisdiction (the DGCL), and a model act promulgated by the ABA and adopted by a plurality of states (the MBCA). Thus,

⁴³ Richard B. Smith, *An Underview of the Principles of Corporate Governance*, 48 BUS. LAW. 1297, 1298 (1993); Geoffrey Hazard, *The American Law Institute Is Alive and Well*, 26 HOFSTRA L. REV. 661, 662 (1998).

⁴⁴ Peter A. Alces & Chris Byrne, *Is it Time for the Restatement of Contracts, Fourth?* 11 DUQ. BUS. L. J. 195, 196 (2009); Smith, *supra* note 43, at 1201 (“The ALI’s traditional Restatements and the Model Act each attempt to bring a principled organization and uniformity to bodies of law that, if left unorganized and disparate, would not provide the guidance and stability that is a main purpose of a legal system.”).

⁴⁵ See *Kansas v. Nebraska*, 135 S. Ct. 1042, 1064 (2015) (Scalia, J., concurring and dissenting) (noting that “modern Restatements . . . are of questionable value, and must be used with caution,” because “[o]ver time, the Restatements’ authors have abandoned the mission of describing the law, and have chosen instead to set forth their aspirations for what the law ought to be”); see also Orin Kerr, *Scalia Questions the Value of “Modern” Restatements, The Volokh Conspiracy*, available at <http://www.washingtonpost.com/news/volokh-conspiracy/wp/2015/02/25/scalia-questions-the-value-of-modern-restatements/> (Feb. 25, 2015).

the project to develop the ALI's *Principles of Corporate Governance* was something different, and more aspirational in nature, than the ALI's Restatement projects that had preceded it. Indeed, the original Chief Reporter to the project, Professor Stanley Kaplan, made clear in a statement accompanying Tentative Draft No. 1 of the *Principles of Corporate Governance* that the document would not merely restate the principles of corporate governance as they then existed in the states, but rather would "set forth the law as the American Law Institute thinks it ought to be."⁴⁶

Tentative Draft No. 1 was released on April 1, 1982.⁴⁷ It immediately "evoked substantial criticism . . . from many groups," including the Business Roundtable, the Committee on Corporate Counsel of the ABA's Section on Litigation, and, most significantly, the ABA's Section on Business Law, which is responsible, through its Committee on Corporate Laws, for developing and promulgating changes to the MBCA.⁴⁸ In response to Tentative Draft No. 1, the Business Law Section created the Ad Hoc Committee on the ALI Corporate Governance Project, which was made up of representatives of the Section's Committees on Corporate Laws, Corporate Law Departments, Corporate Counsel, and Federal Regulation of Securities.⁴⁹ This Ad Hoc Committee, which came to be known by the acronym CORPRO, "became not only the Section [on Business Law's] eyes and ears [in the ALI project], but became more deeply involved in the drafting of the

⁴⁶ Elliott Goldstein, *CORPRO: A Committee that Became an Institution* 48 BUS. LAW. 1333, 1333 (1993) (quoting American Law Institute, *Principles of Corporate Governance and Structure: Restatement and Recommendations*, Advisory Group Draft No. 1 (1982), at __) ("Tentative Draft No. 1"); see also Block, et al, *supra* note 35, at 1465 ("Tentative Draft No. 1 did not reflect current law, but instead reflected the previously expressed views of the four Reporters who drafted Tentative Draft No. 1[.]").

⁴⁷ Block, et al, *supra* note 35, at 1465.

⁴⁸ Elliot Goldstein, *The Relationship between the Model Business Corporation Act and the Principles of Corporate Governance: Analysis and Recommendations*, 52 GEO. WASH. L. REV. 501, 503 (1984).

⁴⁹ Goldstein, *supra* note 46, at 1334-35. The Committee's makeup included both experienced corporate counsel and academics with extensive practical experience. *Id.* at 1335.

Project than the Advisers and Consultants to the Project who were appointed by the ALI.”⁵⁰ Both advocates⁵¹ and critics⁵² of the fifteen-year process of developing the *Principles of Corporate Governance*, as well as of the substance of the final product, acknowledge CORPRO’s significant impact, particularly on Section VII of the *Principles* pertaining to shareholder derivative actions.

The derivative provisions were among the most hotly debated of the *Principles of Corporate Governance*,⁵³ and their progression over time is indicative of the deliberative process that led to the final version of the *Principles*. Section VII of Tentative Draft No. 1, the “primary thrust” of which was “to increase judicial oversight” over shareholder derivative actions,⁵⁴ drew immediate fire from critics. The Business Roundtable characterized the provisions as a “Governance by Litigation model”;⁵⁵ more measured views of Section VII still suggested that it extensively revised longstanding principles of derivative suits by “providing more judicial control over dismissals and settlements.”⁵⁶ The critics’ primary concerns with Tentative Draft No. 1 were

⁵⁰ *Id.* at 1335.

⁵¹ Coffee, *supra* note 31, at 1407; Goldstein, *supra* note 48, at 503; *see generally* Goldstein, *supra* note 46.

⁵² Alex Elson & Michael L. Shakman, *The ALI Principles of Corporate Governance: A Tainted Process and a Flawed Product*, 49 BUS. LAW. 1761, 1764 (1994) (describing CORPRO as “an active and well-organized group that had as its objective strengthening the position of management, and who, by persistent pressure, succeeded in securing significant changes in the drafts proposed by the Reporter”). Elson and Shakman accuse CORPRO’s members of having co-opted the process of developing the *Principles of Corporate Governance* in favor of their clients’ interests, thereby damaging the credibility of both the ALI and the *Principles*. *Id.* at 1764-68.

⁵³ David S. Ruder, *Protections for Corporate Shareholders: Are Major Revisions Needed?*, 37 U. MIAMI L. REV. 243, 262 (1983) (observing that “[t]he furor over the suggested changes” to corporate governance procedures with regard to derivative suits was “great”); Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 462 (1992) (“Judging from the vigorous criticism it has provoked, one is tempted to characterize the derivative suit proposals in Part VII of the current ALI Governance Project as the lightning rod of the project.”).

⁵⁴ Block, et al, *supra* note 35, at 1468.

⁵⁵ *Id.*; Coffee, *supra* note 31, at 1407.

⁵⁶ Ruder, *supra* note 53, at 245.

focused on provisions that contrasted with Delaware law’s emphasis on board primacy. These would have required heightened independence in suits involving officers and directors and taken much of the courts’ review of management’s response to the derivative suit out of the province of the business judgment rule.⁵⁷ The demand futility exception in Tentative Draft No. 1, however, looked markedly similar to the Delaware rule. Specifically, Tentative Draft No. 1 stated that demand would be excused as futile where “a majority of the board was interested in the transaction or alleged wrong or aided or abetted wrongful self-dealing or illegal acts.”⁵⁸ Tentative Draft No. 1 further noted that “[t]he rule that demand be made on the board of directors unless it would be futile, is universally recognized by jurisdictions within the United States, either as a matter of statutory law or judicial interpretation.”⁵⁹

As noted, Section VII of the *Principles of Corporate Governance* underwent significant revisions between Tentative Draft No. 1, released in 1982, and the final version that was adopted in 1992. Depending on one’s perspective, this process created a final product that: (1) departs from settled principles of law to impose a “litigation tax” on corporations and “facilitate more shareholder litigation”;⁶⁰ (2) is “balanced and neutral”⁶¹ and “an intermediate course between the extreme positions in the case law”;⁶² or (3) represents “a radical and regressive vision of

⁵⁷ Block et al, *supra* note 35, at 1467-68.

⁵⁸ Smith, *supra* note 43, at n.23 (quoting Tentative Draft No. 1, *supra* note 43, at § 7.03).

⁵⁹ Elson & Shakman, *supra* note 52 (quoting Tentative Draft No. 1, *supra* note 43, at § 7.03).

⁶⁰ Block, et al, *supra* note 35, at 1482-83.

⁶¹ Smith, *supra* note 43, at 1304-05.

⁶² Coffee, *supra* note 31, at 1408.

corporate governance.”⁶³ Whatever one’s view of the final product, however, all commentators seem to agree that the result of the deliberative process was a section on shareholder derivative suits that was, thanks to the participation of CORPRO and other members of the corporate bar and business community, far friendlier to corporate management than the version that appeared in Tentative Draft No. 1. Moreover, Section VII of the *Principles of Corporate Governance* suggested an approach to derivative suits that differed markedly from both the DGCL⁶⁴ and the prior (but not subsequent) versions of the MBCA.⁶⁵ One prominent feature was the adoption of a universal demand provision, which first appeared in Tentative Draft No. 8 (1988).⁶⁶ In the final version of the *Principles of Corporate Governance*, the universal demand provision reads as follows:

(a) Before commencing a derivative action, a holder [§ 1.22] or a director [§ 1.13] should be required to make a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective measures, unless demand is excused under § 7.03(b). The demand should give notice to the board, with reasonable specificity, of the essential facts relied upon to support each of the claims made therein.

⁶³ Elson & Shakman, *supra* note 52, at 1792; *see also* Swanson, *supra* note 19, at 432 (“[S]ome commentators have voiced concern regarding the ALI’s treatment of the derivative suit remedy, which the ALI made perhaps impossibly difficult[.]”).

⁶⁴ *See* Smith, *supra* note 43, at n.23 (noting that the demand futility provision was “readily dropped by the Reporters” in response to “critique” of the provision “by a number of Institute members”). “Thus, § 7.03(a) became different from the Delaware demand rule.” *Id.*

⁶⁵ In 1989, the ABA’s Corporate Laws Committee made significant revisions to the Model Act’s derivative suit provisions (Subchapter D), including a universal demand requirement that is similar to the one in the *Principles of Corporate Governance*. *See* Part II.C, *infra*.

⁶⁶ Smith, *supra* note 42, at n.23; Block, et al, *supra* note 34, at 1469; *see also* American Law Institute, *Principles of Corporate Governance and Structure: Restatement and Recommendations*, Advisory Group Draft No. 8 (1989) (“Tentative Draft No. 8”).

(b) Demand on the board should be excused only if the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result, and in such instances demand should be made promptly after commencement of the action.

(c) Demand on shareholders should not be required.

(d) Except as provided in § 7.03(b), the court should dismiss a derivative action that is commenced prior to the response of the board or a committee thereof to the demand required by § 7.03(a), unless the board or committee fails to respond within a reasonable time.⁶⁷

Thus, demand “shall be required” in all circumstances, including when a majority of the board may be conflicted or otherwise interested, unless “the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result.” Even in the rare circumstance that the shareholder plaintiff can make such a showing, the plaintiff must make a demand “promptly” after filing the suit. Comment e to Section 7.03 sets forth three reasons for the adoption of the universal demand requirement in the *Principles*:

(1) “[A] universal demand rule eliminates much of the threshold litigation, collateral to the merits of the action, that today slows the pace and increases the cost of derivative actions.”

In his article published in the immediate aftermath of the adoption of the Principles of Corporate Governance, Professor John C. Coffee Jr. of Columbia Law School, the Reporter for

⁶⁷ *ALI Principles of Corporate Governance*, *supra* note 5, at § 7.03.

Section VII, outlined several specific types of collateral suits that tend to arise when demand futility is litigated in Delaware. The issues litigated in such actions may include “whether a demand must be made, what making a demand concedes, the issues to which the demand did or did not relate, and whether shareholders who did not make the demand can attack the board’s independence when other shareholders did not make a demand.”⁶⁸ If demand is required in nearly all circumstances, Professor Coffee argued, then “complex, but ultimately peripheral” actions⁶⁹ could “be simply sidestepped” in favor of “the central question of the board’s or committee’s justifications for dismissal of the action.”⁷⁰

(2) “[B]ecause making demand on the board is a relatively costless step, imposing this requirement places little burden on the plaintiff . . . [and] may sometimes induce the board to consider issues or take corrective action that either moots or permits the early resolution of the action.”

The universal demand provision shifts the focus from a theoretical exercise in determining the Board’s capacity to respond to a potential demand to a concrete review of the board’s actual response to a demand.⁷¹ It also avoids one of the pitfalls of Delaware’s “demand refused/demand excused” dichotomy: shareholder plaintiffs in Delaware generally decline to make a demand on the board and instead plead futility for fear of waiving any future challenge to the board’s

⁶⁸ Coffee, *supra* note 31, at 1415.

⁶⁹ *Principles of Corporate Governance*, *supra* note 5, at § 7.03 cmt. e.

⁷⁰ Coffee, *supra* note 31, at 1415.

⁷¹ *Id.* at 1415.

independence.⁷² The universal demand requirement, therefore, “permits ‘a form of alternative dispute resolution’ that spares the corporation expense and may eliminate some litigation.”⁷³

(3) “[E]liminating the futility exception . . . permits a clearer, more unified standard with respect to judicial review of a motion by a board or committee thereof requesting dismissal of a derivative action.”⁷⁴

This was meant to address the adoption, in Delaware and some other jurisdictions, of a highly deferential standard of review in cases where demand was required. This standard of review had its genesis in the statement in *Aronson* that the Chancery Court had to determine whether one of the two prongs for demand futility was met “in the proper exercise of its discretion.”⁷⁵ This statement had been interpreted as suggesting that the Chancery Court’s determinations of demand futility were subject to an “abuse of discretion” standard.⁷⁶ However, the Delaware Supreme Court ended this misapprehension of *Aronson* in *Brehm v. Eisner*, which was decided fifteen years after the *Principles of Corporate Governance* were adopted. *Brehm* clarified that the Supreme Court’s “review of decisions of the Court of Chancery applying Rule 23.1 is *de novo* and plenary. . . . analogous to that accorded a ruling under [Delaware] Rule [of

⁷² *Id.* at 1415-16; see also *Principles of Corporate Governance*, *supra* note 5, at § 7.03, Reporter’s Note 5; *supra* Part 1.A & n. 28.

⁷³ *Principles of Corporate Governance*, *supra* note 5, at § 7.03 cmt. e.

⁷⁴ *Id.* at § 7.03 cmt. e.

⁷⁵ *Aronson*, 473 A.2d at 814.

⁷⁶ *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000).

Civil Procedure] 12(b)(6).”⁷⁷ Thus, this third rationale no longer holds the significance it did at the time the *Principles of Corporate Governance* were adopted.

B. Revised MBCA Demand Provisions

At the same time that the ALI was developing the *Principles of Corporate Governance*, the Committee on Corporate Laws of the ABA’s Business Law Section was considering revisions to the derivative suit provisions of MBCA (Subchapter D). When these revisions were enacted in 1989, they bore a close resemblance to the derivative suit provisions in Section VII of the *Principles of Corporate Governance*. Given the level of participation of many members of the ABA’s Business Law Section in the *Principles of Corporate Governance* project, these similarities should not have come as a surprise.⁷⁸ While it is true that the changes to Subchapter D of the MBCA technically preceded the *Principles of Corporate Governance* because they were adopted in 1989, three years prior to the final version of the *Principles*, the Subchapter D revisions also came along one year after the universal demand requirement first appeared in a Tentative Draft of the *Principles*.⁷⁹ Thus, in retrospect, it appears that the work on the *Principles* informed and

⁷⁷ *Id.* at 253-54; *see also* DEBORAH A. DEMOTT & DAVID F. CAVERS, SHAREHOLDER DERIVATIVE ACTIONS L. & PRAC. § 5:12 2014-2015) (describing the *de novo* standard of review of decisions made by the Chancery Court to dismissing claims where the plaintiff pled demand futility, and observing that “[t]he *de novo* standard reflects the fact that the lower court’s determination is whether the pleading is legally sufficient, as opposed to a discretionary determination, such as whether to grant equitable relief or whether a witness is credible”).

⁷⁸ *See* discussion Part II.A, *supra* & nn. 49-52.

⁷⁹ *See* Tentative Draft No. 8, *supra* note 69.

influenced the revisions to the MBCA's derivative suit provisions, rather than the other way around.⁸⁰

The universal demand provision of the MBCA reads very similarly to its sister provision in the *Principles of Corporate Governance*:

No shareholder may commence a derivative proceeding until:

(1) a written demand has been made upon the corporation to take suitable action;

and

(2) 90 days have expired from the date delivery of the demand was made unless

the shareholder has earlier been notified that the demand has been rejected by

the corporation or unless irreparable injury would result by waiting for the

expiration of the 90-day period.⁸¹

The Official Comment to section 7.42 sets forth two reasons for the insertion of a universal demand provision into the MBCA: (1) to “give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action”; and (2) to “eliminate[] the time and expense of the litigants and the court involved in litigating the question whether demand is required.”⁸² The commenters believed the universal demand

⁸⁰ *Principles of Corporate Governance*, *supra* note 5, at § 7.03, Reporter’s Note 2 (stating that the 1989 revision to the MBCA adding a universal demand requirement “closely parallels the earlier proposals made in the Tentative Drafts of these Principles”); Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258, 274-75 (1993) (“The Reporters for the American Law Institute Corporate Governance Project pointed the way for the ABA. . . . To avoid trial within trial, and in the name of logical consistency, the ALI Reporters proposed universal demand. . . . The ABA Committee on Corporate Laws has copycatted the ALI universal demand rule.”).

⁸¹ MODEL BUS. CORP. ACT § 7.42.

⁸² MODEL BUS. CORP. ACT § 7.42 cmt.

requirement would “not impose an onerous burden” on plaintiffs because: (1) there is a “relatively short waiting period of 90 days,” and even that can be shortened by a showing of “irreparable injury to the corporation,”⁸³ and (2) “[m]any plaintiffs’ counsel as a matter of practice make a demand in all cases rather than litigate the issue [of] whether demand is excused.”⁸⁴

The MBCA’s universal demand provision cannot be fully understood unless read in context with section 7.44, which sets forth the standard for dismissal of a derivative proceeding under the MBCA. Section 7.44 provides that the “derivative proceeding shall be dismissed by the court on motion by the corporation” if a majority of either the independent directors or an SLC appointed by a majority of independent directors “has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation.”⁸⁵ Recall that in Delaware, the court’s review of a board’s determination not to proceed with a law suit varies depending upon whether it is a “demand refused” or “demand excused” situation.⁸⁶ Of course, section 7.42 universally requires demand, thus doing away with the “demand excused” standard and any proceedings to consider the merits of the plaintiff’s futility plea.⁸⁷ However, section 7.44 “carr[ies] forward th[e]

⁸³ *Id.*; see also *id.* at § 7.42 cmt. 3 (“Ninety days has been chosen as a reasonable minimum time within which the board of directors can meet, direct the necessary inquiry into the charges, receive the results of the inquiry and make its decision.”).

⁸⁴ MODEL BUS. CORP. ACT § 7.42 cmt.

⁸⁵ *Id.* at § 7.44(a). Uniquely under the MBCA (as compared to Delaware or under the ALI’s Principles of Corporate Governance), the court may also, upon motion by the corporation, appoint a panel to make this determination, made up of “one or more independent persons.” *Id.* at § 7.44(f).

⁸⁶ See discussion *supra* Part 1.A.

⁸⁷ MODEL BUS. CORP. ACT § 7.44 cmt. 2.

distinction” between “demand refused” and “demand excused” cases “by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of qualified directors on the board.”⁸⁸ Just as in Delaware, the court will not disturb management’s decision not to proceed with the litigation unless the shareholder plaintiff is able to “allege with particularity facts establishing either (1) that a majority of the board did not consist of independent directors at the time the determination was made or” (2) that the board’s decision was not made in good faith, after a reasonable inquiry, and in the best interests of the corporation.⁸⁹ If facts are not pleaded that, for example, the board refusing the demand was made up of a majority of disinterested directors, then the board’s decision receives the benefit of the business judgment rule.⁹⁰

A crucial difference between reviews of management’s decision not to proceed with the litigation under the MBCA and Delaware law is found in the situation where a majority of the board is not disinterested and independent and the board has appointed an SLC to consider the merits of the plaintiff’s demand. Just as in Delaware, under the “first step” of *Zapata*, the defendants bear the burden under MBCA section 7.44 of proving that the SLC acted in good faith and undertook a reasonable inquiry in deciding to reject the plaintiff’s demand.⁹¹ However, the “second step” of *Zapata*, wherein the court may apply its own “independent business judgment”

⁸⁸ *Id.* at § 7.44 cmt. 2; Block, et al, *supra* note 34, at 1464.

⁸⁹ MODEL BUS. CORP. ACT § 7.44(d).

⁹⁰ Block, et al, *supra* note 34, at 1464.

⁹¹ MODEL BUS. CORP. ACT § 7.44(e); *id.* at § 7.44 cmt. 2 (stating that the placement of the burden of proof on the corporation in such circumstances is the provision’s “response to objections suggesting structural bias . . . despite the fact that the [special litigation] committee making the determination is composed exclusively of qualified directors”).

and potentially overrule the decision of the SLC, is not present in the MBCA.⁹² Official Comment 2 to section 7.44 makes this clear: “[S]ection 7.44 does not authorize the court to review the reasonableness of the determination to reject a demand or seek dismissal. This contrasts with the approach in some states that permits a court, at least in some circumstances, to review the merits of the determination”⁹³ The reference to “some states” here means Delaware and states following it. The effects of this procedural variation in the MBCA are still not entirely clear.

C. Three Criticisms of Universal Demand

Commentary has generally been favorable regarding the shift away from the futility exception to a universal demand requirement.⁹⁴ However, criticisms of universal demand have emerged, both contemporaneously with its adoption as part of the MBCA and *Principles of Corporate Governance* and in the decades since. These criticisms generally fall into three categories:

⁹² *Zapata's* “second step,” or something like it, is present in the *Principles of Corporate Governance*. Branson, *supra* note 79 at 275-76 (citing *Principles of Corporate Governance*, *supra* note 5, at §§ 7.08, 7.11).

⁹³ MODEL BUS. CORP. ACT § 7.44 cmt. 2; *see also* Dooley & Goldman, *supra* note 6, at 746 (“[Section 7.44] does not leave room for the application of the court’s independent ‘judicial business judgment’ of the best interests of the corporation, as is discretionary in those Delaware cases involving a majority of interested directors and the appointment of a special litigation committee (which is a fairly rare occurrence).”); Branson, *supra* note 79, at 275-76.

⁹⁴ *See, e.g.*, Coffee, *supra* note 30, at 1415-16; Swanson, *supra* note 19, at 1386-87 (stating that this “unified procedural approach” is preferable to the “morass of litigation surrounding the futility doctrine in recent years”); Jeffrey S. Facter, *Fashioning a Coherent Demand Rule for Derivative Litigation in California*, 40 SANTA CLARA L. REV. 379, 397-401 (2000); Barsalona, *supra* note 30, at 789-94; Bradley T. Ferrell, Comment, *A Hybrid Approach: Integrating the Delaware and ALI Approaches to Shareholder Derivative Litigation*, 60 OHIO ST. L.J. 241, 272-75 (1999).

(1) Universal demand does not really avoid protracted litigation on the same issues that are litigated in demand futility suits.

The primary criticism of universal demand is that it is much ado about nothing. The same issues that would typically be litigated in a demand futility in dispute in Delaware – namely, board independence – are still likely to be litigated when the demand is made and refused. Our own U.S. Supreme Court, in considering the merits of adopting the universal demand requirement as a matter of federal common law, “noted its doubts about the supposed contributions of a universal demand requirement to judicial economy”:⁹⁵

Requiring demand in all cases, it is true, might marginally enhance the prospect that corporate disputes would be resolved without resort to litigation; however, nothing disables the directors from seeking an accommodation with a representative shareholder even after the shareholder files his complaint in an action in which demand is excused as futile. At the same time, the rule . . . is unlikely to avoid the high collateral litigation costs associated with the demand futility doctrine. So long as a federal court endeavors to reproduce through independent review standards the allocation of managerial power embodied in the demand futility doctrine, [the] universal-demand rule will merely shift the focus of threshold litigation from the question whether demand is excused to the question whether the directors’ decision to terminate the suit is entitled to deference under federal standards.⁹⁶

⁹⁵ Dooley, *supra* note 52, at 503.

⁹⁶ *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 106 (1991); *see also* Dooley, *supra* note 52, at 503.

A recent article discussing the “symbiosis” between the DGCL and the MBCA agreed with this assessment. In the article, three experts on Delaware law, including Leo Strine, the current Chief Justice of the Delaware Supreme Court, had words of praise for the MBCA’s “deeply deliberate style,” which has “led to useful refinements in Delaware law.”⁹⁷ In the authors’ view, Delaware has primarily been an “innovator” in corporate law over the past twenty-five years – something it must do “to maintain its preeminence”⁹⁸ – while the MBCA has been a “refiner,” improving on and influencing Delaware law.⁹⁹ The authors singled out a few occasions, however, where in their view, “the MBCA’s refinements achieve a false, or at least dubious clarity”; one of these is the universal demand requirement.¹⁰⁰ The authors believe that the universal demand requirement’s attempt “to improve upon Delaware’s practice . . . is likely wishful thinking,” because “[t]he same issues litigated in demand futility cases (for example, director disinterestedness and independence) must still be litigated, based on pleadings alone, when the corporation moves to dismiss the derivative proceeding.”¹⁰¹ Other commentators have concurred.¹⁰²

This argument tends to downplay or completely ignore the problems inherent with having these issues litigated at the demand futility standard, at least under *Aronson* and its progeny. As

⁹⁷ Gorris, et al, *supra* note 9, at 107.

⁹⁸ *Id.* at 115-16.

⁹⁹ *Id.* at 116.

¹⁰⁰ *Id.* at 118.

¹⁰¹ *Id.*

¹⁰² See, e.g., Robert B. Thompson, *Delaware’s Disclosure: Moving the Line of Federal-State Corporate Regulation*, 2009 U. ILL. L. REV. 167, 174 (2009) (opining that the result of the MBCA’s universal demand requirement “is to move the point of judicial review a bit deeper into the litigation, but not necessarily to produce a more determinate result”).

discussed in Part I.A, *supra*, these include the placing of restrictions on discovery while still requiring pleading of “particularized facts” with regard to board independence. It also seems to be based on little empirical evidence from the state courts themselves. It is notable that at least one study, which focused on derivative suits filed in federal courts over a twelve-period in 2005 and 2006, suggested “that universal demand requirements greatly increase the number of cases in which the board has an opportunity to take control of the suit on the front end,” and that “[u]niversal demand requirements may not eliminate litigation over demand, but they certainly do reduce it.”¹⁰³

(2) Universal demand may make sense for large public corporations, with access to independent outside directors, but not close corporations that are more likely to have interested directors and are far more prevalent in MBCA jurisdictions.

While corporation statutes in only a few states are modeled on the DGCL, the MBCA “is the dominant model for state corporation statutes.”¹⁰⁴ Moreover, the MBCA has been adopted primarily in “noncommercial” states in New England, the South, the Midwest, and the Mountain West.¹⁰⁵ Thus, the MBCA is much more likely than the DGCL to govern primarily small and mid-sized firms that are closely held.¹⁰⁶ Closely held corporations are often defined by their number of shareholders (relative to publicly held corporations) and the overlap between management (the board and officers) and ownership (the shareholders).¹⁰⁷ In such corporations, “director

¹⁰³ Erickson, *supra* note 9, at 1783.

¹⁰⁴ Dooley & Goldman, *supra* note 6, at 738.

¹⁰⁵ See discussion Part II, *supra*.

¹⁰⁶ Branson, *supra* note 79, at 277.

¹⁰⁷ COX & HAZEN, *supra* note 14, at ___.

independence is a matter of shades of gray.”¹⁰⁸ Moreover, although the comment to section 7.42 suggests that the universal demand requirement does not “impose an onerous burden” on shareholders, the requirement and 90-day waiting period are most likely to prejudice vulnerable minority shareholders who are financially dependent on the corporation as a source of income.¹⁰⁹ Thus, the “tortured judicial inquiries”¹¹⁰ over demand futility in Delaware may be needed in MBCA jurisdictions to protect the interests of minority shareholders.

The obvious response to this criticism is that many MBCA jurisdictions, unlike Delaware, provide separate statutory protections and causes of action for oppressed minority shareholders.¹¹¹ Moreover, both the MBCA and the Principles of Corporate Governance contain an exception to the universal demand requirement if making the demand will cause an irreparable harm to inure to the corporation.¹¹² This exception “allow[s] the investor to resort to immediate court involvement in the face of extraordinary circumstances.”¹¹³

¹⁰⁸ Branson, *supra* note 79, at 277 (proposing that in MBCA states, “neither media attention nor any semblance of a Delaware-like plaintiffs’ bar serves to monitor director activity”).

¹⁰⁹ See Michael L. Mason, *Taking Exception: The Universal Demand Requirement and Close Corporations*, MASS. BAR ASSN. LAWYERS JOURNAL (Feb. 2012), available at <http://www.massbar.org/publications/lawyers-journal/2012/february/taking-exception-the-universal-demand-requirement-and-close-corporations> (“One of the distinguishing features of a close corporation is the vulnerability of the minority shareholder. . . . Because he or she likely relies upon the corporation for his or her livelihood, the longer the waiting period, the greater the risk that the shareholder will suffer an irretrievable loss.”).

¹¹⁰ Swanson, *supra* note 19, at 1387.

¹¹¹ See generally F. Hodge O’Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121 (1987).

¹¹² MODEL BUS. CORP. ACT § 7.42(2); Principles of Corporate Governance § 7.03(b); see also Swanson, *supra* note 19, at 1387.

¹¹³ Swanson, *supra* note 19, at n.280.

(3) *Universal demand takes the qualitative power of review from the courts and places it in the hands of the board (which will almost always reject the demand) or the SLC (which will almost always recommend against proceeding with the suit).*

At the time Subchapter D was revised, one commentator expressed concern that the MBCA's elision of *Zapata's* "second step" "would signal true death for derivative litigation," because astute corporate counsel will always ensure a supply of independent directors for the SLC who will create the appearance of good faith and a reasonable inquiry.¹¹⁴ In other words, "[t]he relief valve of possibly judicial review" is necessary to "counterbalance the prejudice to shareholders a universal demand requirement introduces."¹¹⁵

This criticism of universal demand assumes that courts will accept the prospect of being neutered. Indeed, the data discussed below show that, even in universal demand states, courts are likely to interpret the demand requirement narrowly or approve more claims as direct rather than derivative if necessary to ensure that shareholder plaintiffs' claims, if meritorious, are heard.¹¹⁶

III. The States' Response to Universal Demand

A. Adoption of Section 7.42 by State Legislatures

¹¹⁴ Branson, *supra* note 79, at 276.

¹¹⁵ *Id.* at 275; *see also Kamen*, 500 U.S. at 103 (declining to adopt a federal common law rule of universal demand in derivative actions based upon the Investment Company Act of 1940 because, in part, "[s]uperimposing" such a rule over the doctrine of Delaware and states following it "would clearly upset the balance that they have struck between the power of the individual shareholder and the power of the directors to control corporate litigation").

¹¹⁶ *See* discussion part II, *infra*.

As noted, the MBCA is the predominant corporate statute in the United States, with thirty-four states and the District of Columbia adopting it in whole or substantially in part. Twenty-two of these states have adopted the universal demand provision: Arizona,¹¹⁷ Connecticut,¹¹⁸ Florida,¹¹⁹ Georgia,¹²⁰ Hawaii,¹²¹ Idaho,¹²² Iowa,¹²³ Maine,¹²⁴ Massachusetts,¹²⁵ Michigan,¹²⁶ Mississippi,¹²⁷ Montana,¹²⁸ Nebraska,¹²⁹ New Hampshire,¹³⁰ North Carolina,¹³¹ Rhode Island,¹³² South Dakota,¹³³ Texas,¹³⁴ Utah,¹³⁵ Virginia,¹³⁶ Wisconsin,¹³⁷ and Wyoming.¹³⁸ The District of Columbia also recently adopted the universal demand requirement.¹³⁹

Conversely, twelve states have not adopted the universal demand provision, and continue to allow shareholder plaintiffs to argue the demand requirement should be excused as futile, even though they predominantly follow the MBCA. These states include: Alabama, Arkansas,

¹¹⁷ ARIZ. REV. STAT. ANN. § 10-742 (1994).

¹¹⁸ CONN. GEN. STAT. ANN. § 33-722 (1994).

¹¹⁹ FLA. STAT. ANN. § 607.07401(2) (1997).

¹²⁰ GA. CODE ANN. § 14-2-742 (1988).

¹²¹ HAW. REV. STAT. ANN. § 414-173 (2000).

¹²² IDAHO CODE ANN. § 30-1-742 (1998).

¹²³ IOWA CODE ANN. § 490.742 (2002).

¹²⁴ 13-C MAINE REV. STAT. ANN. § 753 (2001).

¹²⁵ MASS. GEN. LAWS ANN. c. 156D § 7.42 (2004).

¹²⁶ MICH. COMP. LAWS ANN. § 450.1493a (1989).

¹²⁷ MISS. CODE ANN. § 79-4-7.42 (1993).

¹²⁸ MONT. CODE ANN. § 35-1-543 (1991).

¹²⁹ NEB. REV. STAT. § 21-2072(1) (1995).

¹³⁰ N.H. REV. STAT. § 293-A:7.42 (19__).

¹³¹ N.C. GEN. STAT. ANN. § 55-7-42 (1995).

¹³² R.I. GEN. LAWS ANN. § 7-1.2-711(c) (2004).

¹³³ S.D. CODIFIED LAWS § 47-1A-742 (2005).

¹³⁴ TEX. STAT. & CODES ANN. § 21.553 (2003).

¹³⁵ UTAH CODE ANN. § § 16-10a-740(3)(a) (1992).

¹³⁶ VA. CODE ANN. § 13.1-672.1(B) (1992).

¹³⁷ WISC. STAT. ANN. § 180.0742 (19__).

¹³⁸ WYO. STAT. ANN. § 17-16-742(a) (1997).

¹³⁹ D.C. CODE ANN. § 29-305.52 (2013).

Colorado, Illinois, Kentucky, Maryland, New Mexico, North Dakota, Oregon, South Carolina, Tennessee, and Washington.

B. Interpretation of § 7.42 by the State Courts

Of the twenty-two MBCA states adopting the universal demand provision, appellate courts in nine states have either explicitly determined or sent strong signals regarding whether a futility exception has survived the requirement's adoption. These decisions can be roughly divided in two categories: those that have applied the universal demand statute strictly and holding that the universal demand provision did not survive the legislature's action, and those that have not.

1. Strict Application of the Universal Demand Provision

Courts in six MBCA states have held that the universal demand statutes adopted by their state legislatures unequivocally did away with any common law right to plead demand futility. For example, shareholders filed a derivative suit against the officers and directors of a closely held corporation in Mississippi that was in the business of recording and distributing gospel and rhythm and blues music.¹⁴⁰ The claims alleged that the three sole directors and officers of the corporation, who owned over 85% of the corporate shares,¹⁴¹ breached their fiduciary duties by, among other things, awarding themselves excessive compensation.¹⁴² Mississippi had adopted

¹⁴⁰ Speetjens v. Malaco, Inc., 929 So.2d 303 (Miss. 2006).

¹⁴¹ *Id.* at 311 (Easley, J., dissenting).

¹⁴² *Id.* at 307 (majority opinion).

the MBCA's universal demand provision in 1993,¹⁴³ and it was undisputed that the shareholder plaintiffs had not made a written demand on the board.¹⁴⁴ The shareholder argued that demand would have been futile, however, because the directors were "in absolute control of the corporation and unlawfully breached their fiduciary duties, usurped corporate opportunities and awarded themselves excessive salaries and extravagant bonuses."¹⁴⁵ The Mississippi Supreme Court rejected the plaintiffs' argument out of hand, deciding as an issue of first impression that

Determination of whether Miss. Code Ann. section 79-4-7.42 would be better if it contained an exception for futility, or even how other state courts have interpreted their comparable, but not identical, corporate law statutes is not required of us in the present case. The fact is, Mississippi's written demand statute does not contain an exception for futility, and unless and until the Legislature decides to include one, it does not exist.¹⁴⁶

Similarly, the Idaho Supreme Court has construed that state's universal demand provision strictly.¹⁴⁷ A minority shareholder filed a derivative claim on behalf of the corporation owned primarily by his brother and him only ten days after making a formal demand on the board, rather than waiting the ninety days required by the universal demand provision.¹⁴⁸ However, the

¹⁴³ See note 126, *supra*.

¹⁴⁴ Speetjens, 929 So.2d at 308.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 309.

¹⁴⁷ McCann v. McCann, 61 P.3d 585 (Idaho 2002).

¹⁴⁸ *Id.* at 591. The court determined that earlier letters that the plaintiff had sent to the corporation's attorney did not constitute a sufficient demand because the letters were not served on all of the directors,

shareholder argued that he did not need to wait ninety days to file his suit after serving the demand because to do so would have been futile.¹⁴⁹ Applying well-recognized principles of statutory interpretation,¹⁵⁰ held that by including the “prior rejection of demand” and “irreparable injury” exceptions in the universal demand statute but not the futility exception,¹⁵¹ the Idaho state legislature had clearly demonstrated its “intent to no longer recognize ‘futility’ as an exception to the requirement of demand as a condition preceding the institution of a shareholder’s derivative action.”¹⁵²

Intermediate appellate courts in Arizona,¹⁵³ Georgia,¹⁵⁴ North Carolina,¹⁵⁵ and Wisconsin¹⁵⁶ have similarly held that by adopting the MBCA’s universal demand provision, their state legislatures intended to abrogate the common law futility exception that had previously been recognized in their jurisdiction, A number of federal courts interpreting state universal

did not specify in adequate detail the allegedly wrongful conduct, and did not demand the corporation take suitable action to remedy these wrongs. *Id.*

¹⁴⁹ *Id.* at 592.

¹⁵⁰ *Id.* at 593 (quoting *Druffel v. Dept. of Transp.*, 41 P.3d 739, 742 (Idaho 2002) (“Statutes are construed under the assumption that the legislature was aware of all other statutes and legal precedence at the time the statute was passed.”)).

¹⁵¹ *McCann*, 61 P.3d at 593 (“Accordingly, we presume the legislature was aware of the common law futility exception when the statute including two exceptions to the demand requirement was adopted, but the legislature chose not to add a provision expressing the concept of futility as an exception.”).

¹⁵² *Id.*

¹⁵³ *Alderson v. Eldelson Tech. Partners, Inc.*, 31 P.3d 821, 829 (Ariz. Ct. App. 2001) (“Tempting as it might be to imply a futility exception, we must follow the language of [the statute], which is clear and admits of no exception. It requires a pre-suit demand.”).

¹⁵⁴ *Dunn v. Ceccarelli*, 489 S.E.2d 563, 568 (Ga. Ct. App. 1997) (concluding “that the ‘doctrine of futility,’ as it is known in some states, is not applicable in Georgia to business or nonprofit corporation derivative claims”).

¹⁵⁵ *Norman v. Nash Johnson & Sons’ Farms, Inc.*, 537 S.E.2d 248, 262 (N.C. Ct. App. 2002) (holding that the legislature intended to repeal the demand futility exception when it enacted the universal demand provision).

¹⁵⁶ *Jorgenson v. Water Works, Inc.*, 582 N.W.2d 98, 108 (Wisc. 1998).

demand provisions have held similarly even where the appellate courts of those states have not yet addressed the issue.¹⁵⁷

2. Recognizing a Futility Exception to Universal Demand

By way of contrast, courts in three states have, despite the adoption of a seemingly unambiguous mandatory demand requirement, either conducted a demand futility analysis or implied that a demand futility argument might be entertained. Nebraska adopted section 7.42 of the revised MBCA in 1995.¹⁵⁸ However, in a case decided nine years later, the Nebraska Supreme Court recognized a futility exception to the “universal” demand requirement.¹⁵⁹ In that case, a minority shareholder filed a derivative suit against the two majority shareholders in a close corporation, who also happened to be his brother and sister.¹⁶⁰ The minority shareholder plaintiff’s attempt at demand failed to comply with the specificity requirements that the Nebraska Supreme Court had set forth previously.¹⁶¹ This procedural flaw did not compel the court to dismiss the derivative suit, however; to the contrary, the court granted the plaintiff leave to amend his complaint to allege demand futility, an argument he had not even raised in the court below.¹⁶² In so doing, the court relied upon both prior to and since the adoption of the

¹⁵⁷ See, e.g., Ark. Teacher Ret. Sys. ex rel. Progress Software Corp. v. Alsop, No. 06–11459–RCL, 2007 WL 7069609, at *6-10 (D. Mass. Sept. 22, 2007) (applying Massachusetts law); Firestone v. Wiley, 485 F. Supp. 2d 694, 701-02 (E.D. Va. 2007) (determining that that “the plain text of the [Virginia] statute . . . provides, without exception, that to maintain a derivative action a written demand must be made on the corporation”).

¹⁵⁸ See note 128, *supra*. Effective January 1, 2016, the universal demand provision will be renumbered as section 21-277 as part of a significant overhaul to Nebraska’s Business Corporation Act.

¹⁵⁹ Kubik v. Kubik, 683 N.W.2d 330 (Neb. 2004).

¹⁶⁰ *Id.* at 332.

¹⁶¹ *Id.* at 336 (citing Ass’n of Commonwealth Claimants v. Hake, 507 N.W.2d 665, 670 (Neb. 1993)).

¹⁶² *Id.* at 337.

MBCA's universal demand provision to reaffirm that a "shareholder is not required to make [a demand] if it would be unavailing."¹⁶³

Similarly, the Utah Supreme Court has continued to recognize a demand futility exception, despite the Utah legislature having adopted the MBCA's universal demand provision in 1995.¹⁶⁴ In a case involving a derivative suit by a shareholder brought on behalf of a non-profit corporation,¹⁶⁵ the Court engaged in an extensive analysis of the demand futility exception. It cited the "prior demand rejected" and "irreparable injury" exceptions to the universal demand statute as authority that the demand requirement may be waived "if a plaintiff alleges with particularity why demand was not made."¹⁶⁶ For the demand futility exception to be satisfied, "the circumstances [must be] such that such a demand would be futile and unavailing."¹⁶⁷ The court even went on to state two circumstances in which demand might be excused as futile: (1) "if the corporation had specifically and explicitly stated that it would not pursue the claims brought in the derivative action"; and (2) "when doing so would be substantively detrimental" and "risk further injury to the corporation."¹⁶⁸ The court also acknowledged the impact of Utah

¹⁶³ *Id.* at 336 (quoting *Sadler v. Jorad, Inc.*, 680 N.W.2d 165, 170 (Neb. 2004)); *see also* *Anderson v. Clemens Mobile Homes*, 333 N.W.2d 900 (Neb. 1983) (determining that a minority shareholder is not required to make a demand on the board where the proposed action would require the majority shareholder to require his own accounting to the corporation).

¹⁶⁴ *See* note 134, *supra*.

¹⁶⁵ The demand requirement in the Utah Revised Non-Profit Corporation Act, UTAH CODE ANN. § 16-6a-612(3)(a)(2001), is identical to the corresponding provision in the Utah Revised Business Corporation Act, *see* note 134, *supra*.

¹⁶⁶ *Dansie v. City of Herriman*, 134 P.3d 1139, 1146 (Utah 2006). The court also acknowledged the impact of UTAH R. CIV. P. 23.1, the text of which matches Delaware's demand futility statute and which would seem to conflict with a universal demand requirement. *Id.*

¹⁶⁷ *Id.* (quoting *Tripp v. Dist. Ct.*, 56 P.2d 1355, 1359 (Utah 1936)).

¹⁶⁸ *Id.* at 1147.

Rule of Civil Procedure 23.1, the text of which matches Delaware’s demand futility statute.¹⁶⁹ So it appears that, despite the intent behind the mandatory demand provision, the Utah courts continue to read it co-extensively with the futility provision and permit shareholder plaintiffs to plead an exception to the demand requirement.¹⁷⁰

Most recently, the Rhode Island Supreme Court dismissed a derivative suit because the shareholders failed to comply with the statutory universal demand provision.¹⁷¹ An employer brought a class action on behalf of 14,000 policyholders against the state-chartered workers’ compensation provider of last resort.¹⁷² The policyholder’s primary argument was that its claims were direct rather than derivative in nature; once the court determined that the claims were, in fact, derivative, the court turned to the plaintiff’s failure to comply with the procedural requirements regarding demand. In addition to citing the mandatory demand statute,¹⁷³ however, the court referred to Rhode Island Rule of Civil Procedure Rule 23.1,¹⁷⁴ which, like the correspondingly numbered rules in Delaware, many other states, and the federal system, anticipates a demand futility analysis.¹⁷⁵ The policyholder plaintiff had neither made a demand on the insurer’s board nor set forth the reasons for failing to making the effort, and the court

¹⁶⁹ *Id.* at 1146.

¹⁷⁰ *Id.*; *see also* *Macris v. Sevea Int’l, Inc.*, 307 P.3d 625, 635-36 (Utah Ct. App. 2013) (recognizing the futility exception).

¹⁷¹ *Heritage Healthcare Servs., Inc. v. Beacon Mut. Ins. Co.*, ___ A.3d ___, 2015 WL 500878 (R.I. Feb. 6, 2015).

¹⁷² *Id.* at *1.

¹⁷³ *See* note 126, *supra*.

¹⁷⁴ R.I. R. Civ. P. 23.1 (“The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.”).

¹⁷⁵ *Heritage Healthcare Servs.*, 2015 WL 500878, at *6.

held that “[f]ailure to satisfy these prerequisites mandates the dismissal of a derivative action.”¹⁷⁶ The reference to both the universal demand statute and the procedural rule regarding the pleading of demand futility as prerequisites implies that the latter might allow a derivative suit to survive the motion to dismiss stage in Rhode Island, even in the absence of a demand being made.

C. Courts in Non-MBCA States Considering Principles of § 7.03

Recall that the adoption of a universal demand provision in the MBCA’s Subchapter D amendments was very much guided by the shareholder derivative principles in the ALI’s *Principles of Corporate Governance*, which also included universal demand. Any efforts to track the spread of universal demand must include an overview of those courts (some in MBCA states, some not) that have considered the shareholder derivative provisions of the ALI’s *Principles of Corporate Governance*, including the universal demand requirement.

The Pennsylvania Supreme Court provided the most thorough discussion of the derivative suit provisions of the *Principles of Corporate Governance* in a 1997 opinion, *Cuker v. Mikalauskas*.¹⁷⁷ In *Cuker*, has adopted the derivative suit provisions of the *Principles of Corporate Governance*, observing that Delaware’s *Zapata* test, which allows the court to apply its own independent business judgment in “demand excused” cases, “is a defect which could eviscerate the business judgment rule and contradict a long line of Pennsylvania precedents.”¹⁷⁸

¹⁷⁶ *Id.*

¹⁷⁷ 692 A.2d at 1042.

¹⁷⁸ *Cuker*, 692 A.2d at 1049.

The Maryland Court of Appeals adhered to demand futility exception but characterized it “very limited,” only to be applied where the plaintiff shows irreparable harm to the corporation¹⁷⁹ or “a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a command in good faith and within the ambit of the business judgment rule.”¹⁸⁰

And most recently, the Indiana Supreme Court kept the demand futility exception, noting that the state legislature had adopted other portions of the revised MBCA but “left the demand statute unchanged.”¹⁸¹

¹⁷⁹ This exception exists, of course, in section 7.42.

¹⁸⁰ *Werbowsky*, 766 A.2d at 144.

¹⁸¹ *Guidant S’holders*, 841 N.E.2d at 573-74; *see also id.* at 574 (“We think the doctrine of futility is sufficiently implanted in the interpretation and operation of Indiana corporate law that we should not deem it cast aside by indirect statutory hint.”).