

SHAREHOLDER SEEKING TO EXCUSE DEMAND AS FUTILE MUST
OVERCOME THE PROTECTION OF THE BUSINESS JUDGMENT
RULE

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

In *Aronson v. Lewis*,¹ the Supreme Court of Delaware established a new test for determining whether a stockholder is excused from making a demand² upon a board of directors prior to commencing a derivative suit.

Harry Lewis, a stockholder of defendant Meyers Parking Systems, Inc. (Meyers), brought a derivative action against Meyers and its board of directors.³ Lewis sought cancellation of an employment contract between Meyers and one of its directors, Leo Fink,⁴ contending that it amounted to a waste of corporate assets.⁵ The defendants moved to dismiss, arguing that Lewis had failed to make a demand on the board prior to suit or to allege, with sufficient particularity, why demand should be excused.⁶

The Court of Chancery denied the motion, finding that Lewis had alleged facts sufficient to permit a reasonable inference that the business judgment rule was inapplicable and that the directors' approval of the

1. 473 A.2d 805 (Del. 1984).

2. A demand consists of "the efforts . . . made by the plaintiff to obtain the action he desires from the directors or comparable authority. . . ." DEL. CH. CT. R. § 23.1 (1981).

3. *Lewis v. Aronson*, 466 A.2d 375 (Del. Ch. 1983), *rev'd*, 473 A.2d 805 (Del. 1984).

4. Fink owned 47% of Meyers' outstanding stock. *Aronson v. Lewis*, 473 A.2d 805, 808 (Del. 1984). Under the employment agreement, Fink was entitled to a salary of \$150,000 per year and a bonus of 5% of Meyers' pretax profits over \$2,400,000. *Id.* Upon termination of the contract, Fink was to become a Meyers consultant for life and receive a gradual decrease in salary to \$100,000. *Id.* Fink agreed to devote his best efforts and the majority of his business time to Meyers, while Meyers assured Fink's compensation regardless of any inability to perform services. *Id.* at 808-09. Meyers agreed to share Fink's consulting services with Prudential Building Maintenance Corp. (Prudential), which until 1979, had held Meyers as a wholly owned subsidiary. Meyers agreed to pay Prudential 25% of the fees that Prudential had paid Fink pursuant to a consulting agreement similar to that entered into between Fink and Meyers. *Id.* at 808.

In addition to seeking cancellation of the employment contract, Lewis requested an accounting by the board to determine Meyers' damages resulting from the contract and the profits that the individual directors, including Fink, had made from the contract. *Id.* at 809.

5. Lewis charged the directors with wasting corporate assets on a transaction devoid of a valid business purpose. *Id.* at 809. He labeled the compensation as grossly excessive because Fink's advanced age made him unable to carry out his obligations, the Fink-Prudential contract prevented Meyers from obtaining Fink's "best efforts," and Fink's compensation was not contingent upon his ability to perform. *Id.* at 809, 817.

6. *Id.* at 809.

Fink-Meyers contract consequently was not entitled to its protection.⁷ The Supreme Court of Delaware reversed⁸ and *held*: Demand is excused only when a shareholder alleges specific facts that create a reasonable doubt that the business judgment rule protects the directors' action.⁹

The derivative suit consists of two aspects: first, the shareholder compels the corporation to sue; second, the corporation sues those liable to it.¹⁰ To protect the managerial authority of the board and discourage strike suits, courts traditionally have required a derivative plaintiff to demand redress from the board prior to commencing suit.¹¹ Equity courts, however, traditionally have excused demand when the effort would be futile.¹² Under this view, demand was necessary only if a majority of the directors could impartially consider the alleged misconduct.¹³

The Chancery courts gradually delineated the circumstances in which they would recognize the partiality of a board of directors and permit a derivative plaintiff to waive demand. In *Dann v. Chrysler Corp.*,¹⁴ a Chancery court waived the demand requirement when the complaint alleged that all members of the board had approved of, acquiesced in, or participated in the fraudulent schemes.¹⁵ The Chancery courts recently interpreted *Dann* to excuse demand only when a shareholder alleges

7. *Lewis v. Aronson*, 466 A.2d 375 (Del. Ch. 1983), *rev'd*, 473 A.2d 805 (Del. 1984). The Chancery court found that the complaint created a reasonable inference that the assurance of Fink's compensation amounted to corporate waste. *Id.* at 384. The court reasoned that the board of directors would be unable to consider impartially a demand because of their fear that they would incur liability as a result of the wasteful transactions. *Id.*

8. The court remanded, instructing the Chancery Court to allow Lewis to amend his complaint. 473 A.2d at 818.

9. *Id.* at 814, 818.

10. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 748 (1960).

11. *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984). See *Bergstein v. Texas Int'l Co.*, 453 A.2d 467, 469 (Del. Ch. 1982); see also *Sohland v. Baker*, 15 Del. Ch. 431, 442, 141 A. 277, 282 (Del. 1927) (shareholder must exhaust intracorporate means to redress his grievance).

The demand requirement also operates to allocate control of the litigation to the corporation. *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983).

12. *Fleer v. Frank H. Fleer Corp.*, 14 Del. Ch. 277, 283, 125 A. 411, 414 (Del. Ch. 1924). Demand is futile where the directors are "under an influence that sterilizes discretion." *McKee v. Rogers*, 18 Del. Ch. 81, 86, 156 A. 191, 193 (Del. Ch. 1931). WEBSTER'S NEW COLLEGIATE DICTIONARY 463 (1981) defines futile as "serving no useful purpose. Completely ineffective."

13. See *Fleer v. Frank H. Fleer Corp.*, 14 Del. Ch. 277, 283-84, 125 A. 411, 414 (Del. Ch. 1924).

14. 40 Del. Ch. 103, 174 A.2d 696 (Del. Ch. 1961).

15. The court noted that directors' involvement in fraudulent acts precludes any expectation of proper redress, regardless of whether their participation was active or passive. *Id.* at 108, 174 A.2d at 700. The court added that the same rule applies to charges of gross negligence. *Id.*

more than mere acquiescence or approval of a wrongdoing.¹⁶ A complaint is sufficient, however, if it alleges that extraneous circumstances affected the actions of directors who otherwise lacked a personal interest in the transaction.¹⁷ Under such circumstances, the courts presumed that the directors failed to use their own independent and informed business judgment.¹⁸

Absent indications of bias the Delaware courts have insisted on strict adherence to the demand requirement, reasoning that the decision whether to litigate on behalf of the corporation is a matter properly left, as are other business decisions, to the business judgment of the board of directors.¹⁹ Under the business judgment rule, the company's directors, who are presumed to act with good faith, honesty, and in the best interests of the corporation,²⁰ consider such matters unless the complaint alleges fiduciary misconduct on their part.²¹ The heavy burden to show

16. Fraud, gross negligence, or similarly egregious wrongs must accompany a director's approval of or acquiescence in a transaction in order to excuse demand. *Haber v. Bell*, 465 A.2d 353, 359 (Del. Ch. 1983). The shareholder must demonstrate such wrongdoing by alleging the "requisite particulars" in the complaint. *Lewis v. Aronson*, 466 A.2d 375, 383 (Del. Ch. 1983) (quoting *Dann v. Chrysler Corp.*, 174 A.2d 696 (Del. Ch. 1961)); *Haber v. Bell*, 465 A.2d 353, 359 (Del. Ch. 1983); see also Comment, *The Demand and Standing Requirements in Stockholder Derivative Suits*, 44 U. CHI. L. REV. 168, 179 (1976) (if mere allegations of approval were sufficient to excuse demand, the requirement would be continuously circumvented).

17. See, e.g., *McKee v. Rogers*, 18 Del. Ch. 81, 156 A. 191 (Del. Ch. 1931) (demand excused where president allegedly dominated the directors); see also cases cited *infra* note 18.

18. In *Mayer v. Adams*, 39 Del. Ch. 496, 499, 167 A.2d 729, 731 (Del. Ch. 1961), the existence of a close personal relationship between the corporation's president and the other directors caused the board to accept the president's judgments in lieu of its own. See also *Kaplan v. Centex Corp.*, 284 A.2d 119, 123 (Del. Ch. 1971) (control and domination refers to "a direction of corporate conduct in such a way as to comport with the wishes or interests" of another).

19. See, e.g., *Lewis v. Curtis*, 671 F.2d 779, 786 (3d Cir. 1982); *Bergstein v. Texas Int'l Co.*, 453 A.2d 467 (Del. Ch. 1982); see also *supra* text accompanying note 11.

20. Under Delaware law, the board is responsible for the management of corporate affairs. DEL. CODE ANN. tit. 8, § 141(a) (1983). This authority, however, entails a fiduciary obligation to act in the corporation's best interest. *Guth v. Loft*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939).

21. See *Sohland v. Baker*, 15 Del. Ch. 431, 442, 141 A. 277, 282 (Del. 1927) (because the law leaves business judgments in directors' hands, shareholders and courts should not lightly question directors' decisions); see also *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) (court applied the business judgment rule in the absence of any indication of bad faith or gross abuse of discretion on the directors' part).

Several purposes underlie the business judgment rule: (a) by giving the directors broad discretion, it prevents judicial interference with corporate policy-making; (b) it encourages competent individuals to become directors because courts will respect their decisions; and (c) it insulates the courts from the burden of reviewing corporate decision-making. Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 32-33 (1981).

such impropriety falls upon the shareholder.²²

The Supreme Court of Delaware considered the business judgment of boards of directors in a slightly different context in *Zapata Corp. v. Maldonado*.²³ In *Zapata*, the plaintiff brought a derivative action against several corporate officers and directors without making a demand.²⁴ Without deciding whether the plaintiff properly had waived demand, the court addressed the issue of when a corporate committee could cause the dismissal of a properly initiated derivative action.²⁵ The court refused to defer to the corporate committee's decision to discontinue the derivative suit.²⁶ Instead, the court, balancing the legitimacy of the claim against recognition of the committee's managerial authority, applied a two-tiered test. Under the first tier, the corporation must prove that the committee was independent and had engaged in a good faith investigation.²⁷ Even if the corporation fulfills this burden, however, the court may exercise its own business judgment to determine whether the suit should continue.²⁸

In *Haber v. Bell*,²⁹ the Delaware Chancery had its first opportunity

22. See *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (Del. Ch. 1962) (plaintiff alleging corporate waste must show that "no person of ordinary, sound business judgment" would consider the transaction of value); *Gimbel v. Signal Co.*, 316 A.2d 599, 609 (Del. Ch.) (rule weighs in favor of directors unless shareholder can dispute presumed facts), *aff'd*, 316 A.2d 619 (Del. 1974); *cf. Schreiber v. Pennzoil Co.*, 419 A.2d 952, 957 (Del. Ch. 1980) (at trial on the merits, a shareholder's showing of director's benefit at expense of corporate detriment places the burden on directors to prove the intrinsic fairness of the transaction).

23. 430 A.2d 779 (Del. 1981).

24. *Id.* at 780.

25. *Id.* at 785. The court acknowledged the corporation's authority to control derivative litigation and to delegate power to an authorized committee. *Id.* at 782, 785-86; see *Zapata v. Maldonado*, 430 A.2d 779, 785 & n.13 (Del. 1981); DEL. CODE ANN. tit. 8, § 141(c) (1983) (board of directors has the power to delegate its power to a committee).

26. The court had previously excused the aggrieved shareholder from making a demand on the board. 430 A.2d at 787. The court recognized the difference between the issues of refusal to litigate and waiver on the demand requirement. *Id.* at 784, 787. Board refusal involves the propriety of the directors' decision, subject to the business judgment rule, while the demand-excused situation begins with the issue of the board's power to dismiss. *Id.* at 784 n.10.

In *In re Continental Ill. Sec. Litig.*, 572 F. Supp. 928 (N.D. Ill. 1983), however, the court extended *Zapata* by holding that a court could also exercise its independent business judgment in a demand-refused case. *Id.* at 929.

27. *Id.* at 788.

28. 430 A.2d at 789. This inquiry represents a clear abrogation of the business judgment rule. The court noted that placing the burden on the corporation to prove the integrity of its decision directly conflicted with the business judgment rule's presumption of "independence, good faith and reasonableness." *Id.* at 788. The court also stressed that, under certain circumstances, the court's inquiry under the second step could include not only the corporation's best interests, but also "matters of law and public policy." *Id.* at 789.

29. 465 A.2d 353 (Del. Ch. 1983).

after *Zapata* to evaluate a shareholder's allegation that demand would have been futile. The court held that if the challenged transaction has a valid business purpose, it would presume impartiality on the board's part.³⁰ To overcome this presumption,³¹ the shareholder must plead facts sufficient to permit a reasonable inference³² that the directors' actions were unprotected by the business judgment rule.³³

In *Aronson v. Lewis*,³⁴ the Supreme Court of Delaware finally formulated a rule for determining demand futility.³⁵ Rejecting the Chancery's reasonable inference standard, the court concluded that demand is unnecessary only if the stockholder alleges facts sufficient to create a reasonable doubt³⁶ that the directors are disinterested and independent, and that the disputed transaction was otherwise the result of a proper exer-

30. *Id.* at 357. The court maintained that under such circumstances, directors would not fear personal liability. *Id.* The *Haber* court followed the reasoning expressed in *Lewis v. Curtis*, 671 F.2d 779, 785-86 (3d Cir. 1982). The *Lewis* court argued that when allegations of fact create an inference of bias on the part of the board, the court should not defer to its refusal to litigate. *Id.* at 785. The *Lewis* court, however, cautioned against allowing a pleading defense to defeat a fact dispute. *Id.* at 786.

31. 465 A.2d at 359. The purpose of the transaction is questionable if no person of reasonable judgment would agree that the corporation received adequate consideration for the payments made to its officers and directors. *Lewis v. Aronson*, 466 A.2d 375, 383 (Del. Ch. 1983) (citing *Saxe v. Brady*, 184 A.2d 602 (Del. Ch. 1962)); *Haber v. Bell*, 465 A.2d 353, 359 (Del. Ch. 1983); *see also supra* note 22.

In *Lewis v. Aronson*, the Court of Chancery found that board approval of the Fink contract may have amounted to approval of corporate waste because Fink's compensation was not linked to his ability to perform. 466 A.2d at 383; *see supra* note 5. The court analogized the alleged facts of *Lewis v. Aronson* to the proven facts of an earlier case, *Fidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 92 A.2d 311 (Del. Ch. 1952). In *Fidanque*, the court held that an employment agreement amounted to corporate waste because of one of the parties' physical inability to perform. 33 Del. Ch. at 278, 92 A.2d at 320. The *Lewis v. Aronson* court acknowledged, however, the difficulties inherent in a pretrial determination of corporate waste. 466 A.2d at 383-84.

32. BLACK'S LAW DICTIONARY 700 (5th ed. 1979) defines an inference, in part, as "a process of reasoning by which a fact . . . sought to be established is deduced as a logical consequence from other facts . . . already proven or admitted." Under this definition, the shareholder need not allege that the challenged decision could never be the product of an exercise of valid business judgment. *See Haber v. Bell*, 465 A.2d 353, 359 (Del. Ch. 1983); *Lewis v. Aronson*, 466 A.2d 375, 381 (Del. Ch. 1983).

33. *Lewis v. Aronson*, 466 A.2d 375, 381 (Del. Ch. 1983); *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983).

34. 473 A.2d 805 (Del. 1984).

35. The court noted that the *Zapata* decision had left open the issue of when demand is futile. *Id.* at 814. Numerous derivative suits, filed after *Zapata*, contained allegations that demand was futile. 473 A.2d at 813.

36. The court did not explain how a reasonable doubt works to overcome a presumption. BLACK'S LAW DICTIONARY 441 (5th ed. 1979), however, suggests that a reasonable doubt is proof that allows no other conclusion.

cise of business judgment.³⁷

The court began with the notion that it should defer to an impartial board's managerial decisions. Thus, it placed the burden of pleading bias on the aggrieved shareholder.³⁸ This burden, however, would be meaningless if it consisted only of conclusory charges of misconduct.³⁹ As a result, the court required the aggrieved shareholder to plead facts sufficient to raise a reasonable doubt concerning the business judgment rule's applicability.⁴⁰

Applying this strong presumption of propriety, the Delaware Supreme Court rejected the lower court's finding of possible corporate waste,⁴¹ labeling the shareholder's allegations as mere conclusory statements.⁴²

The *Aronson* court sought to further the policies behind the demand requirement by rigidly adhering to the business judgment rule.⁴³ Such deference to board authority will force more shareholders to make a demand, thus giving the directors an adequate opportunity to select the least costly method of resolving the dispute.⁴⁴ The rule's presumption, encountered before litigation begins, will also discourage strike suits, for a corporation will rarely settle if the shareholder cannot meet his burden at the pleadings.⁴⁵

Inevitably, however, many shareholders will be unable to pursue legitimate grievances as a result of the *Aronson* decision. Before a shareholder

37. 473 A.2d at 814.

38. *Id.* at 815. The court admitted that instances of obvious board interest and egregious abuse of fiduciary duty could never meet the test of propriety. 473 A.2d at 815. The court cited *Bergstein v. Texas Int'l. Co.*, 453 A.2d 467 (Del. Ch. 1982), to illustrate a transaction involving an interested director that did not merit the business judgment rule's presumption of propriety. 473 A.2d at 815. The court stated that the business judgment rule operates if the director is disinterested and meets the test of business judgment and reaches his decision after considering all information relevant to the corporation's interests. *Id.* at 812.

39. 473 A.2d at 815-16.

40. *Id.* The Chancery Court had applied a more lenient test, requiring the shareholder to allege facts creating a "reasonable inference" of impropriety by the board. *See supra* note 7 and accompanying text.

41. 473 A.2d at 810, 817. The Supreme Court of Delaware disagreed with the Court of Chancery's reliance on the facts of *Fidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 92 A.2d 311 (Del. Ch. 1952). *Id.* at 817. The supreme court contended that *Fidanque* presented a far more persuasive allegation of corporate waste. *Id.* *But see supra* note 31.

42. 473 A.2d at 817-18. The court believed Lewis' allegations presented nothing more than a board's approval of a legitimate corporate transaction. *Id.* at 817. *See supra* notes 4-5.

43. *See supra* note 11 and accompanying text.

44. This policy consideration is consistent with *Zapata's* contention that a board's managerial authority includes a continued right to control derivative litigation. *See supra* note 24.

45. *See supra* note 11 and accompanying text.

will be able to reach the stage in litigation at which he can invoke *Zapata* and its favorable test,⁴⁶ he will first have to pass the rigorous test established in *Aronson* for determining when waiving demand is proper.⁴⁷ In many cases, the shareholder will not have access, at the pleading stage, to those facts necessary to overcome the *Aronson* court's presumption of propriety. Although many derivative plaintiffs probably could meet the *Haber* court's "reasonable inference" of impropriety test, few will be able to meet the *Aronson* court's much tougher "reasonable doubt" standard.⁴⁸

The only alternative for shareholders who cannot meet the *Aronson* test will be to initiate a demand on the board. Of course, if the board exercises its business judgment and refuses to initiate suit, the shareholder will have the demanding task of proving that the decision not to sue was improper.⁴⁹ Even if the shareholder can make this showing, however, to do so would cost a great deal of time and money.⁵⁰

The shareholder acting without the blessing of the board of directors thus now faces almost insurmountable obstacles whether or not he makes a demand on the board. The *Aronson* decision consequently has strengthened the position of corporate boards of directors, making it highly unlikely that many derivative actions will proceed without their support.

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46. See *supra* notes 25-28 and accompanying text.

47. See *supra* notes 36-37 and accompanying text.

48. A comparison of the inference and reasonable doubt standards indicates that an inference may permit a court to reach various conclusions while a reasonable doubt suggests only one result. Compare *supra* note 32 with note 36.

Although the *Aronson* court attempted to articulate a test for cases exhibiting something less than a clear abuse of fiduciary duty, the difficult burden suggests that only flagrant wrongs will evidence the circumstances sufficient to raise a reasonable doubt of futility. See *supra* note 38.

49. The board of directors' decision not to sue is protected by the business judgment rule. See *supra* notes 19-22 and accompanying text.

50. See Note, *supra* note 10, at 759.

