QUIS CUSTODIAT CUSTODIUM? CORPORATE OVERSIGHT THROUGH DERIVATIVE ACTION

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I. INTRODUCTION

Corporations are legal entities subject to the pertinent statutes that govern them.[1] In *Trustees of Dartmouth College v. Woodward*, the U.S. Supreme Court defined a corporation as ". . . an artificial being, invisible, intangible and existing only in contemplation of law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it either expressly or as incidental to its very existence"[2]; and also as:

> . . . a collection of individuals, united into one collective body under a special name and possessing certain immunities, privileges and capacities in its collective character which do not belong to the natural persons composing it. Among other things, it possesses the capacity of perpetual succession and of acting by the collected vote or will of its component members, and of suing and being sued in all things touching its corporate rights and duties. It is, in short, an artificial person, existing in contemplation of law and endowed with certain powers and franchises which, though they must be exercised through the medium of its natural members, are yet considered as subsisting in the corporation itself as distinctly as if it were a real personage. Hence, such a corporation may sue and be sued by its own members, and may contract with them in the same manner as with any strangers.[3]

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1 DAVID G. EPSTEIN, RICHARD D. FREER, MICHAEL J. ROBERTS & GEORGE B. SHEPARD, BUSINESS STRUCTURES 148 (2nd ed., Thomson/West 2007).

2 Trustees of Darmouth College v. Woodward, 17 U.S. 518, 636 (1819).

3 *Id.* at 667-668.

Epstein[4] lists the principal sources of laws that define and govern a corporation (i.e., corporate law) as (1) state statutes, (2) the corporations' articles of incorporation, (3) case law, and (4) federal statutes. The authors explain that, regardless of the jurisdiction, state corporation statutes provide that (1) a corporation is a legal entity separate from its owners and, (2) as a general rule, these owners (called shareholders) are not personally liable for the debts of the corporation. At most, the owners' potential loss or liability is limited by the amount of their investment in the corporation; a concept known as *limited liability.*[5]

The order in which Epstein et al.[4] list the previous sources is not by coincidence. Federal courts grant great latitude to state courts except in situations where an exclusive federal statute applies. In *Burks v. Lasker,*[6] the U. S. Supreme Court stated that "federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the [Investment Company Act of 1940] and [Investment Advisers Act of 1940]."[7]

Estes[8] infers from *Burks* that in the absence of a strong congressional expression of intent to the contrary, the Supreme Court still considers state law as controlling in corporate governance matters. He adds that "most state laws have provisions requiring that directors shall manage - or direct the management of - the business of the corporation. Individual versions of this mandate have not resulted in the development of significantly different lines of cases from state to state, as a general proposition."[9]

Davis[10] believes that in comparison to the corporate laws of other countries, the United States' corporate law is flexible and loose. He is of the opinion that those who control and manage a corporation are given ample leeway. Davis identifies two underlying institutions whose strength makes this possible. One is a disclosure system that ensures a full picture to investors of the operational and fiscal state of the corporation. The other is the fiduciary concept, which replaces standardized prohibitions with the opportunity to evaluate managerial conduct on a more holistic basis. The fiduciary concept filters self-opportunistic behavior by those in control of a corporation without deterring good faith efforts to further shareholder welfare in ways that might run afoul of a more technical set of restrictions.

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4 EPSTEIN ET AL., *supra* note 1, at 151.

5 EPSTEIN ET AL., *supra* note 1, at 148.

6 Burks v. Lasker, 441 U.S. 471 (1979).

7 *Id*. at 486.

8 Robert M. Estes, *Corporate Governance in the Courts*, 58(4) HARV. BUS. REV. 50, 51-52 (1980).

9 *Id*. at 64.

10 Kenneth B. Davis Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 388 (2008).

The critical issue is who performs the fiduciary evaluation. Over the last three decades, this task has been assumed by independent members of corporations' boards of directors.

The members of the board of directors of a corporation are the elected representatives of the shareholders. In Delaware, Section 141(a) of the General Corporation Law states that directors, rather than shareholders, manage the business and affairs of the corporation.[11] In Puerto Rico, Article 4.01(A) of the 2009 General Law of Corporations[12] establishes that the board of directors is responsible for leading the corporation.[13] Smith and Wilson point out that shareholders entrust their interests to these directors,[14] who in turn (ideally) watch out for these interests. Nevertheless, there are times when the interests of the directors diverge from those of the shareholders; at such times, agency conflicts arise. It may be that such differences of opinion are *bona fide* perceptions of what is best for the corporation. However, conflicts of interest may exist between directors' personal interests, shareholders' personal interests, and the going concern of the corporation. On such occasions, Reisberg[15] explains that shareholders have several mechanisms at their disposal to protect their interests in a corporation when agency conflicts arise. In theory, they control directors with the threat or action of substituting them during the annual shareholder meetings. He also cites the professional standards required of managers, oversight by outside directors, the disciplinary power of the market, and shareholder voting as other mechanisms available to shareholders. However, these courses of action are not always feasible in cases where minority shareholders with little effective power are involved. A shareholder can choose to sell his or her interest in the corporation. A shareholder could also dilute his or her risk by having diverse interests in different corporations (a concept also known as diversification).

Regardless of the mechanisms that a market or a corporation provides to reduce a shareholder's risk and protect his or her interest, some form of

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11 DEL. CODE ANN., tit. 8, § 141(a) (West 2011).

12 P.R. LAWS ANN. tit. 14, § 2721 (2011).

13 P.R. LAWS ANN. tit. 14, § 2721 (A) (2011) ("Los negocios y asuntos de toda corporación organizada con arreglo a las disposiciones de esta Ley serán dirigidos por la junta de directores, salvo cuando otra cosa se disponga en esta Ley o en el certificado de incorporación. Cuando el certificado de incorporación contenga tal disposición, las facultades y obligaciones que esta Ley confiere o impone a la junta de directores serán ejercidas o desempeñadas por la persona o personas designadas en el certificado de incorporación.").

14 ROY C. SMITH & INGO WALTER, GOVERNING THE MODERN CORPORATION: CAPITAL MARKETS, CORPORATE CONTROLS, AND ECONOMIC PERFROMANCE,74 (Oxford University Press 2006).

15 Arad Reisberg, *Shareholders' Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions*, 6 EUR. BUS. ORG. L. REV. 227, 229-230 (2005).

statutory or judicial control should be available to them in order to protect their interests.[16] One such judicial control is the possibility of a shareholder suing one or more directors of the board in court. A shareholder suit may take one of two forms, depending on whether the purpose is to protect a personal right or to protect the corporation which he or she owns in part. The former case is considered a direct action; which, for the purpose of the topic discussed herein, falls outside the scope of this paper; and will therefore not be discussed. The latter is a derivative action.

II. DERIVATIVE ACTIONS: CONCEPT DEFINITION

Aronson, Tomkins, Hassi, and Sorah-Reyes[17] identify several cases that provide definitions of what constitutes a derivative action. In *Aronson v. Lewis*,[18] the Delaware Supreme Court observed that a derivative action is actually two causes of action. On the one hand, it is the equivalent of a suit by shareholders to force the corporation to sue. On the other hand, it is a suit by the corporation, asserted by the shareholders on the corporation's behalf, against those parties liable to it.[19] The Illinois Supreme Court in *Brown v. Tenney*[20] stated that a derivative action entails one action against the directors for failing to sue, and another based upon the right that belongs to the corporation. In *Ross v. Bernhard,*[21] the U. S. Supreme Court stated that a derivative action seeks to redress two distinct wrongs: (1) the act whereby the corporation was caused to suffer damage, and (2) the refusal of the corporation itself to redress said act.

A derivative action is not a *qui tam pro corporatus quam pro se ipso*.[22] The shareholder is not demanding a right in his or her name as well as the corporation's; but rather a right solely in the corporation's name. In *Meyer v.*

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16 William M. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporation Rights: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 107 (2008).

17 Seth Aronson, Sharon L. Tomkins, Ted Hassi & Tristan Sorah-Reyes, *Shareholder Derivative Actions: From Cradle to Grave*, 1620 P.L.I./CORP 259, 263 (2007).

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

19 Reisberg, *supra* note 15, at 811.

20 Brown v. Tenney, 532 N.E.2d 230, 232 (Ill. 1988).

21 Ross v. Bernhard, 396 U.S. 531, 534 (1970).

22 Black's Law Dictionary 1282 (8th ed. 2004). The full Latin nomenclature for a *qui tam* statement is *qui tam pro domino rege quam pro se ipso in hac parte sequitur*; translates to "who as well for the king as for himself sues in this matter". An action brought under a statute that allows a private person to sue for a penalty, part of which the government or some specified public institution will receive.

Within the context used herein, a play of words is used, substituting government for the corporation, to highlight that a derivative action is not executed to benefit both the shareholder and the corporation.

Fleming,[23] the U.S. Supreme Court explained that the derivative action allows shareholders a mechanism for protecting the interests of the corporation from negligence and abuse by "faithless directors and managers."[24] As explained in *Willhelm v. Murchison*[25], a shareholder is allowed to enforce a right on behalf of the corporation which the corporation refuses to assert despite being properly able to do so.

In *Alleghany Corp. v. Kirby*,[26] the 2nd Circuit Court of Appeals explained that "[the] theory behind allowing a stockholder to bring a derivative stockholders' action rests upon the belief that wrongdoing directors will not voluntarily sue themselves or willingly admit their wrongful acts; hence, the right to bring an action on behalf of the corporation is given to a stockholder."[27]

Clifford & Maher[28] report that a company law reform package enacted in New Zealand in July of 1994 provided improved judicial remedies for the individual shareholder. Citing the case of *Vrij v. Boyle*[29], the authors explain that the New Zealand High Court allows the shareholder to originate a derivative action, depending on the likelihood of the proceedings succeeding and the costs of the proceedings compared with any likely relief and the interests of the company in having the claim pursued. In relation to the first criterion, the Court held that it was not required to conduct an interim trial on the merits. Instead, the appropriate test was deemed to be whether a prudent business person would bring a claim considering the amount at stake, apparent strength of the claim, likely costs and the prospect of executing any judgment.

A recent article in the Economist[30] describes Hong Kong courts' low tolerance for the cavalier attitude of dominant shareholders towards their minority counterparts and towards corporate governance in general. The article explains that the court, in the recent case of Hong Kong's dominant telecommunications operator, P.C.C.W., cracked down particularly harshly on the operator's Board of Directors due to the extended slump in share prices and because other tycoons who ran similarly convoluted empires did not generate such big returns.

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23 Meyer v. Fleming, 327 U. S. 161 (1946).

24 *Id*. at 167.

25 Wilhelm v. Murchison, 206 F. Supp. 733 (S.D.N.Y. 1962).

26 Alleghany Corp. v, Kirby, 333 F.2d 327 (2d Cir. 1964).

27 *Id.* at 332.

28 Denis Clifford & Chris Maher, *Shareholder Derivative Action*, 14(12) I.F.L. REV. 56 (December 1995).

29 Vrij v Boyle, (1995) 7 NZCLC 260 (HC) 844.

30 *Split Decision,* THE ECONOMIST (April 23, 2009), *available at* http://www.economist.com/node/13527945 (last visited Mar. 13, 2011).

Furthermore, an article in the Business Torts Reporter[31] informs that, just last year, in the case of *Tzolis v. Wolff*[32], a New York Appellate court determined that even a limited liability corporation (LLC) may have a derivative suit brought on its behalf by a member. This determination is more a matter of jurisprudence than statute, given that when New York's Limited Liability Company Law was enacted in 1994, no reference was made to derivative suits. The court interpreted that said omission did not imply that such suits are prohibited; explaining that derivative suits have been recognized in New York corporate law at least since 1832 when a court held it essential to allow shareholders to have some sort of recourse when those who ran the corporation betrayed their duties to the company.[33]

As to the case of limited liability partnerships (LLP), a derivative action brought by a partner on behalf of the partnership is also permitted, as stated by the courts in *Klebanow v. New York Produce Exch.*[34]and *Riviera Congress Assoc. v. Yassky*.[35] In *Quiñones-Reyes v.* Registrar,[36] the Puerto Rico Supreme Court held that although the limited liability partnership has a separate judicial personality, distinct and independent from its partners, this fact should not serve as hindrance to partners who seek to represent the limited liability partnership in actions conducive to the protection and vindication of the partnership's rights before the courts.

The Business Torts Reporter[37] article points out that in both the case of the limited liability corporation as well as the limited liability partnership, the same principle applies as with conventional corporations. Fiduciaries who betray the trust invested in them must be held accountable.

A. Requirements to undertake a derivative action

Federal Rule of Civil Procedure 23.1[38]states that a derivative action may be brought in favor of a corporation solely by a shareholder. Although the rule refers to the state of the shareholder at the time the action is

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31 20, Bus. Torts Rep. 165 (April, 2008).

32 Tzolis v. Wolff, 10 N.Y.3d 100 (2008).

33 Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832).

34 Klebanow v. New York Produce Exchange, 344 F.2d 294 (2d Cir. 1965).

35 Riviera Congress Association v. Yassky, 18 N.Y.2d 540, 223 N.E.2d 876 (1966).

36 Quiñones-Reyes v. Registrar, No. RG-2007-02, 2009 PRSC 63, at 17 (P.R. April 28, 2009). The actual text in Spanish states "*Si bien es cierto que la sociedad especial ostenta una personalidad jurídica independiente a la de sus socios, ello no es óbice para que los socios puedan comparecer en tal carácter y en representación de la sociedad especial en aras de realizar ciertas y determinadas acciones encaminadas a salvaguardar y vindicar los derechos de tal ente jurídico*".

37 Business Torts Reporter, *supra* note 31, at 166.

38 FED. R. CIV. P. 23.1.

brought, a second requirement - called the "contemporaneous ownership" requirement has been established by the federal courts in cases such *as Brambles USA, Inc. v. Blocker*[39] and *In re Penn Central Transportation Co.*[40]in order to ban potential plaintiffs from "buying into" a lawsuit. Except for an extreme reason such as fraud, this requirement is founded on the principle that should a shareholder cease to have shares in the corporation (whether by way of a merger or any other reason), then he or she ceases to have an interest in the corporation and thus loses standing to present a derivative action.

Before a court accepts a derivative suit against one or more corporate directors, state and Federal forums require that the plaintiff shareholder(s) submit a written complaint to the board of directors notifying them of specific facts regarding an alleged offending situation, how the situation adversely impacts the corporation, and the expected remedial actions. In lieu of this action, plaintiff shareholders are hard-pressed by the courts to prove the futility of said notice and procure that this condition be waived.[41]

In addition to presenting a demand to the board, states such as Michigan also require that some proof of fraud or abuse of trust be presented against the board of directors of the corporation in failing or refusing to enforce a corporate right or claim. If a demand to the board was not presented, the shareholder should furnish proof that such a demand would have been useless. Such was the case in *Futernick v. Statler Builders, Inc.*[42]

In *Aronson v. Lewis*,[43] the Delaware Supreme Court addressed the matter of when was a stockholder's demand upon a board of directors to redress an alleged wrong to the corporation excused as futile prior to the filing of a derivative suit. The case overruled a Delaware Chancellory decision that stated that the plaintiff's allegations raised a "reasonable inference" that the directors' action was unprotected by the business judgment rule. Thus, the board could not have impartially considered and acted upon the demand. The Delaware Supreme Court ruled that a demand [against the board of directors] "can only be excused when facts are alleged with such particularity so as to create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule."[44] In other words, the futility of placing a demand to the board of directors cannot be inferred, but rather must be proven "with particularity" by the plaintiff shareholders. The argument of domination or overbearing influence by a particular director

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39 Brambles U.S.A., Inc. v. Blocker, 731 F. Supp. 643 (D. Del. 1990).

40 In re Penn Central Transportation, 341 F. Supp. 845 (E.D. Pa. 1972).

41 Davis, *supra* note 10, at 396.

42 Futernick v. Statler Builders, Inc., 112 N.W.2d 458 (Mich. 1961).

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

44 *Id.* at 807.

over the board is insufficient to justify a waiver of the demand requirement. The Aronson case adds that:

> [T]o properly allege domination of the Board, particularly domination based on ownership of less than a majority of the corporation's stock, in order to excuse a pre-suit demand, must allege ownership plus other facts evidencing control to demonstrate that the Board could not have exercised its independent business judgment.[45]

The court points out that although the General Corporation Law of the State of Delaware invests the board of directors with the authority to administer the corporation, "existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders"[46]; and recognizes that "a stockholder is not powerless to challenge director action which results in harm to the corporation. The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management."[47]

The Aronson case recognizes that, by nature, the derivative action infringes on the managerial freedom of directors. Therefore, it exists at the threshold of the board of directors' authority, primarily to insure that a stockholder exhausts the available intracorporate remedies, and secondarily to provide a safeguard against strike suits. By promoting this form of alternate dispute resolution rather than an immediate recourse to litigation, the demand requirement recognizes the fundamental precept that directors manage the business and affairs of corporations.[48]

In *Hawes v. Oakland*,[49] the U.S. Supreme Court declared that in addition to establishing the existence of grievances, which call for the kind of relief obtainable through a stockholder's derivative action:

> . . . it is equally important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to

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[45] *Id.* at 810.
[46] *Id.* at 811.
[47] *Id.* at 811.
[48] *Id.* at 811-812.
[49] Hawes v. Oakland, 104 U. S. 450 (1881).

> induce remedial action on their part, and this must be made apparent to the court. If time permits or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body, in the matter of which he complains. And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.

The efforts to induce such action as complainant desires on the part of the directors, and of the shareholders when that is necessary, and the cause of failure in these efforts should be stated with particularity, and an allegation that complainant was a shareholder at the time of the transactions of which he complains, or that his shares have devolved on him since by operation of law, and that the suit is not a collusive one to confer on a court of the United States jurisdiction in a case of which it could otherwise have no cognizance, should be in the bill, which should be verified by affidavit.[50]

Kemper[51] explains the three purposes of the "demand requirement", in respect to both the demand on the directors and the demand on the other stockholders prior to the commencement of a stockholder's derivative suit. Its purposes are the following: (a) to relieve the courts of the need for interfering in the management of routine, internal, corporate business affairs; (b) to afford a measure of protection to corporate directors against harassment by dissident minority shareholders who may disagree with such directors on matters involving business judgment; and (c), to discourage "strike" suits in which stockholders make charges, without regard to the truth, for the purpose of coercing corporate management into settling worthless claims in order to get rid of them.

The Supreme Court of Delaware's solution in *Aronson v. Lewis*[52] was to link the demand requirement to the availability of the business judgment rule. Specifically, to establish demand futility, the complaint must allege "particularized facts" that create a reasonable doubt that "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."

Furthermore, plaintiff shareholders that seek to bring a derivative action on behalf of the corporation must seek their own legal counsel. Under no circumstance should the corporate counsel be used. In *Liquilux Gas v. Berríos*[53], the Puerto Rico Supreme Court stated that a corporation's legal counsel has a lawyer-client relationship with the entity rather than the

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50 *Id.* at 460-461.

51 J.R. Kemper, Annotation, *Circumstances Excusing Demand Upon Other Shareholders Which is Otherwise Prerequisite to Bringing of Stockholder's Derivative Suit on Behalf of Corporation*, 48 A.L.R. 3d 595 (1973).

52 *Aronson,* 473 A.2d at 814.

53 Liquilux Gas v. Berríos, 138 P.R. Dec. 850 (1995).

entity's members. Rule 21 of the Puerto Rico Bar's Ethical Canons[54] states that a corporate lawyer owes the corporation complete loyalty to it as a juridical entity and not to its associates, directors, employees or shareholders; and can only represent the interests of these persons when these interests are not in conflict with those of the corporation. Citing Fletcher's Cyclopedia of the Law of Private Corporations[55], the court recommends that in order to insure the corporation the freedom of alignment that will serve its best interest, it seems that independent counsel should be retained - either by the corporation or the shareholder - whenever there is a potential for abuse and suggestion of conflict.

Nevertheless, in *Elfenbein v. Gulf & Western Industries, Inc.*,[56] the court established that the demand requirement is not absolute. It explains that the purpose of the "demand" rule is to give the corporation the opportunity to take over a suit, which was brought on its behalf, and allow the directors the chance to occupy their normal status as drivers of the corporation's affairs. However, the demand need not be made on the directors or shareholders when such a demand would be futile, useless, or unavailing. Where said directors and controlling shareholders are antagonistic, adversely interested, or involved in the transaction attacked, a demand on them is presumptively futile and need not be made.

When looking to determine whether the demand requirement is futile, courts apply what has come to be known as the Aronson Test.[57] For demand to be excused, the plaintiff shareholder must allege facts that if taken as true raise a reasonable doubt that (1) a majority of the directors are disinterested and independent or (2) that the challenged transaction was otherwise the product of a valid business judgment. Both conditions must be met in order for the demand requirement to be excused.

Pogostin v. Rice[58] explains the concept of interest by a director. The case states that interest exists wherever the potential for conflict exists between a director's loyalty to the corporation and his or her personal interests. This condition arises where a director has received, may receive, or is entitled to receive, a personal benefit through the transaction being challenged; and no such benefit is extended to the stockholders.

B. Directors v. Shareholders: the Business Judgement Rule as Defense

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54 P.R. LAWS ANN. tit. 4, app. IX (1970).

55 13 WILLIAM MEADE FLETCHER, FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6025, at 442-443 (1991).

56 Elfenbein v. Gulf & Western Industries, Inc., 590 F. 2d 445 (1978).

57 *Aronson,* 473 A.2d at 814.

58 Pogostin v. Rice, 480 A.2d 619, 624-625 (Del. 1984).

The primary defense against a derivative suit available to directors and officers is the business judgment rule. In summary, this rule holds that a director cannot be held accountable for a decision made in the performance of his or her duties as an officer of the corporation as long as two conditions are met. The first condition is one of diligence. It requires that the decision be based upon reasonable information provided by trustworthy sources: information which would make a prudent, proficient director arrive at a similar decision. The second condition is one of loyalty towards the corporation: no conflict of interest should exist between the interests of the corporation and those of the deciding director. The protection against liability provided by the business judgment rule is predicated upon compliance of both conditions. Delaware acknowledges the business judgment rule as one of the managerial prerogatives of directors under Section 141(a) of the state's Corporation Law.[59] In Puerto Rico, Article 4.01(I) of the 2009 General Law of Corporations defines the business judgment rule. Translated from Spanish, it reads in the following manner:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall be, upon conducting his functions, completely protected and exempt from liability when trusting in the good faith of the corporate records and in the information, opinions, reports and communications presented to the corporation by any corporate officer or employee, or board of directors committee, or by any other person regarding matters that the member reasonably believes to be within the scope of professional competency or expertise of said person that was selected with reasonable care by or for the corporation.[60]

That a plaintiff shareholder complies with the demand requirement to the board does not necessarily entail that the board of directors is forced to proceed with the litigation. Aronson[61] identifies several cases that explain the possible actions open to a board of directors that has received a demand

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59 DEL. CODE ANN., tit. 8, § 141(a) (West 2011).

60 P.R. LAWS ANN. tit. 14, § 2721(I) (2011). (Original text reads: "*Un miembro de la junta de directores, o un miembro de cualquier comité designado por la junta de directores, estará, en el desempeño de sus funciones, completamente protegido* y exento de responsabilidad*al confiar de buena fe en los récords de la corporación y en la información, opiniones, informes o ponencias presentados a la corporación por cualquiera de los oficiales o empleados de la corporación, o comités de la junta de directores, o por cualquiera otra persona sobre asuntos que el miembro razonablemente cree están dentro del ámbito de la competencia profesional o experta de dicha persona que fue seleccionada con cuidado razonable por o para la corporación.*").

61 Aronson et al., *supra* note 17, at 303.

from a shareholder. Estes[62] presents the following example: A shareholder, in the name of the corporation, sues management individuals in a lawsuit alleging that the corporation has been disadvantaged by inappropriate management performance and that the board of directors has refused or would refuse to represent the corporation in seeking redress. Then, the board - or a committee of the board - determines, after investigation, that it would not be in the best interests of the corporation to have the charges litigated. The board petitions the court to dismiss the shareholder lawsuit on the theory that under state law such decisions are in the exclusive province of the board.

Estes explains that the business judgment rule applies to the facts of the case; and adds that the rule is a judicial invention of the turn of the century that, in matters involving corporate governance, reflects both a preference for the resolution within the corporate structure of disputes concerning the management of the corporation and a reliance on state statutes that exalt the power of management at the expense of the traditional power of stockholders.

In *Corbus v. Alaska Treadwell Gold Mining Co.,*[63] the U.S. Supreme Court took the following position:

> The directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interests of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors or the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs.[64]

Based upon the previous decision of the courts, Reisberg[65] states that a traditional view of the decision to proceed (or not) with a litigation is that

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62 Estes, *supra* note 8, at 50.

63 *Corbus v. Alaska Treadwell Gold Mining Co.,* 187 U.S. 455 (1903).

64 *Id.* at 463.

65 Reisberg, *supra* note 15, at 231.

said decision is a commercial one which involves balancing risks and expenses against possible advantages and is usually one for the board of directors to analyze and take.

Furthermore, the deference of the courts towards the business judgment rule increases if the board of directors is able to demonstrate ample due diligence in assessing the shareholder claims, particularly in actions such as the use of external counsel and the establishment of a special litigation committee that is truly independent from the rest of the board.[66]

However, despite the U.S. Supreme Court decision in *Corbus*, the Michigan Supreme Court ruled to the contrary more than a decade later. In the extreme the landmark case of *Dodge v. Ford Motor Co.*[67] the Michigan Court stated that:

> [A] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes. . . . it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others.[68]

Estes[69] observes that the earlier cases had established a presumption that independent directors would act honestly in the exercise of their best judgment, that they would be free of personal conflicts of interest, and that they would otherwise act in good faith. This presumption placed a burden of proof on shareholder plaintiffs that has in practice been virtually impossible to meet successfully. By late 1979, there was a clear trend in corporate law that the good faith exercise of business judgment by a special litigation committee of disinterested directors is immune to attack by shareholders or the courts.

In *Burks v. Lasker*,[70] the U.S. Supreme Court highlighted state law as controlling in corporate governance matters in the absence of a strong

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66 *See, e.g.,* Evans v. Paulson, 2007 WL 1549242 (D. Minn. May 24, 2007). (The Minnesota court establishes the primary factor to determine the independence of the special litigating committee as whether the Board delegated its power to control the litigation to a disinterested party.)

67 Dodge v. Ford Motor Co., 204 Mich. 459, 507 (1919); 170 N.W. 668, 684 (Mich. 1919).

68 *Id.* at 507; 684.

69 Estes, *supra* note 8, at 51.

70 Burks v. Lasker, 441 U.S. 471 (1979).

congressional expression of intent to the contrary; and reaffirmed the presumption of objectivity and good faith. Thus the burden continues to be on the plaintiff to disprove the exercise of independent good faith judgment. In *Burks*, the U.S. Supreme Court stated that:

> [T]he structure and purpose of the [Investment Company Act of 1940] indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders. There may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue . . . for example, where the costs of litigation to the corporation outweigh any potential recovery. . . .[71]

Estes[72] points out that the derivative lawsuits currently reaching the courts demonstrate that directors involved in the cases have been paying meticulous attention to the criteria being developed by the courts for the proper handling of these responsibilities. Directors tend to be individuals of independent stature who are experienced in the handling of complex controversial issues and thus avoid getting involved in inappropriate conduct. They take great pains in selecting counsel who themselves procure to be diligent in developing and evaluating independent sources of information. Among the determinations made by directors is judging the merits of a plaintiff's cause of action. Where merit is found, the rationale for nevertheless seeking dismissal of the action has been painstakingly developed and recorded.

The Aronson[73] case explains that requirements for the protection of the business rule are twofold. Firstly, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction; nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders. Secondly, to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. The Delaware court further explains that the business judgment rule operates only in the context of

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71 *Id.* at 484-485.

72 Estes, *supra* note 8, at 52.

73 Aronson v. Lewis, 473 A.2d 805, 812-813 (Del. 1984).

director action. It has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. However, the court recognizes that "a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule."[74]

An article from the International Financial Law Review[75] states that in recent years, Japanese corporate governance has undergone major reform to limit director liability and the power of derivative actions. Changes to Japan's Commercial Code that took effect in 2002 allow directors' liability to be limited with respect to violations of the law or a corporation's articles of incorporation when directors do not knowingly misperform their duties and when such misperformance is not grossly negligent. So long as a company's articles of incorporation allow such a limitation, and subject to certain conditions being satisfied, a company may set a limit on the amount of damages that its directors will be required to pay. One such condition is that the board of directors issues a resolution to that effect; or in the alternative, a majority of shareholder may also issue a special resolution. If a shareholder sues with a derivative action, once the action has begun, public notice or a notice to all shareholders must be provided in order to ensure that each shareholder has an opportunity to participate in the proceeding.

C. The Derivative Action And Corporate Oversight

In *Aronson v. Lewis*,[76] the Delaware Supreme Court observed that the machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid and unfaithful management. In *Rank v. Lease Associates, Inc.*,[77] the Wisconsin Supreme Court stated that derivative actions are an effective remedy for corporate abuses and that the constant potential threat of derivative action has done much to keep corporate directors responsive to the interests of the shareholders.

Based upon analysis of statistical data, Vafeas[78] understands that shareholder litigation is a more useful alternative when a firm's ownership is dispersed and neither insiders nor major unaffiliated blockholders (entities such as fund managers which control the votes of a significant quantity of directors or shareholders) are likely to guard shareholder interests. Vafeas observes that, based upon research of conflicting interests between

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74 *Id.* at 813.

75 *Japan: Corporate Governance Amendments Introduced*, 21(5) I.F.L. REV. 70 (May 2002).

76 *Aronson,* 473 A.2d at 811. .

77 Rank v. Lease Associates, Inc., 45 Wis. 2d 689 (1967).

78 Nikos Vafeas, *Shareholder Lawsuits and Ownership Structures*, 16(1) J. APPL. BUS. RES..35 (2000).

management and shareholders over a score of years, a theme that has emerged from academic research is that agency conflicts may be reduced through: a) the disciplining effects of corporate control, product and other factor markets, or b) through intra-firm mechanisms such as the board of directors, executive compensation policy, and corporate ownership structure.[79] Put simply, external blockholders help monitor management and, in their presence, shareholder lawsuits become less likely.

This is not to say that there is general agreement on the benefits of derivative actions. Authors such as Kalchev[80] have presented evidence that the quality of corporate governance has a predictive power upon shareholder litigation. Kalchev states that different measures of corporate governance appear to be significant, whether in present or lagged values. He expresses preference for having better corporate governance in order to decrease the probability of litigation and risks for managers, and ultimately protect shareholder wealth. Nevertheless, there is common agreement that – at the very least – derivative actions are a necessary mechanism to rein in directors who, to quote Uebler,[81] view law violations as a rational means of maximizing shareholder wealth (even to the detriment of said shareholders).

Reisberg[82] endeavors to go beyond the traditional view of compensation for the derivative action. He states that merely seeing the action as a form of recovering damages will keep the derivative action as subordinate to the business judgment rule when a simple cost-benefit analysis may rule out a corporation deciding on pursuing litigation. The author compares the principles behind the derivative action against those that underlie most penal codes. In effect, Reisberg proposes to establish a justification for pursuing derivative action as a deterrence mechanism against unwanted behavior; even if there is no financial compensation to the corporation or the shareholders. He makes the assumption that what shareholders lose by pursuing a costly litigation on behalf of a corporation, they'll recover through other corporations whose shares they own and whose management will refrain from illicit actions that would have otherwise forced their own derivative actions.

Although Reisberg[72] makes a fair case for extending the role of derivative actions towards enforcement of directors' duties and filling gaps in what he calls "incomplete contracts between shareholders and managers", he recognizes that selling this approach is an uphill battle. The advantage of

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79 *Id.*, at 37.

80 Georgi Kalchev, *Corporate Governance and Shareholder Litigation*, 8(2) THE ICFAI UNIVERSITY JOURNAL OF CORPORATE GOVERNANCE 41 (2009).

81 Thomas A. Uebler, *Shareholder Police Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 DEL. J. CORP. L..199, 221-222 (2008).

82 Reisberg, *supra* note 15, at 241.

taking a traditional view on derivative actions, as a compensation mechanism is that there exists over a century of jurisprudence throughout the world establishing a direct correlation between shareholder litigation and a monetary value. On the other hand, deterrence is much harder to value. As with ethical and licit behavior, there is general agreement that they constitute accepted behavior, which should be encouraged; but at times, suffers when it comes to placing a corporation's money where its mouth is. Reisberg[83] concludes that any possible advantages to a deterrent approach towards derivative actions are outweighed by the action's costs.

III. CONCLUSION

Regardless of the preference or rejection that most authors may feel towards or against the derivative action, all agree that this type of litigation limits the protection that directors enjoy under the business judgment rule. The shareholder who owns a corporation and the director who leads it are the two most important stakeholders to the going concern of the corporation. Oftentimes, both have conflicting views regarding what decisions are best for the corporation. More often than not, conflicts arise because of a divergence between the corporation's interests and those of the person making a decision that has an impact on the corporation. As a matter of fact, conflict may arise merely because of fear and mistrust.

Under these circumstances, the derivative action is more than a mere channel through which a shareholder can protect his or her interest. Neither is it the inconvenience perceived by some corporate directors; who see the derivative action as a hindrance on their right to steer a corporation. Ultimately, it is a valid trigger that allows the court, as an unbiased third party, to bring both sides (shareholder and director alike) under its jurisdiction. By using applicable statutes – and sometimes common sense - the courts can mediate to protect the corporation even from itself.

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83 Reisberg, *supra* note 15, at 267.