

The Demand Review Committee: How It Works, and How It Could Work Better

By Collins J. Seitz, Jr. and S. Michael Sirkin*

Stockholders must ordinarily make a demand on their board of directors before initiating litigation on the corporation's behalf. But the litigation consequences of a stockholder demand—a binding concession of the board's ability to impartially consider a demand—are so harsh in the ensuing litigation that stockholders rarely choose that path. The demand requirement is thus falling short of its promise as an internal dispute resolution mechanism. If, as we suggest, stockholders typically avoid making a demand and instead prefer to initiate litigation and raise demand futility arguments, no matter how weak, they deprive independent boards of the opportunity to consider the merits of potential litigation outside the courtroom. We propose a private-ordering solution, in which stockholders and boards can agree, if they choose, to reserve rights on demand futility arguments while a demand review process is undertaken. This would allow boards to engage with stockholders in the review process, and would replace some demand futility litigation with boardroom deliberation, thereby restoring the internal dispute resolution function to the demand requirement.

I. INTRODUCTION

Stockholder derivative litigation follows a familiar path. The plaintiff files a complaint, alleging that demand is futile. The defendants move to dismiss under Court of Chancery Rule 23.1,¹ arguing that the plaintiff failed to make a demand on the board of directors to bring the suit on behalf of the corporation. The motion is usually coupled with a motion to dismiss under Rule 12(b)(6)² for failure to state a claim. If the Court of Chancery grants the motion to dismiss on either ground, the matter ends. If the Court of Chancery denies the motion, then the parties litigate or propose a settlement of the case, unless and until the corporation forms a special litigation committee to regain control from the plaintiff.³

* Collins J. Seitz, Jr. is a Justice of the Supreme Court of the State of Delaware. S. Michael Sirkin is a partner of Ross Aronstam & Moritz LLP in Wilmington, Delaware. The opinions expressed in this article are those of the authors alone.

1. DEL. CT. CH. R. 23.1.

2. DEL. CT. CH. R. 12(b)(6).

3. See generally *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

What happens, though, if instead of pleading demand futility, the plaintiff actually makes a litigation demand? This path appears to be traveled less frequently, and appears to be less well understood by practitioners and directors alike. Accordingly, this article highlights the review process undertaken by a committee that is formed to consider a demand. It also highlights the differences between demand review committee practice and special litigation committee practice. Finally, it proposes a modest adjustment to our law that would restore some of the functionality of the demand requirement, which has eroded over time.

II. BACKGROUND OF THE DEMAND REQUIREMENT

The board of directors has the statutory authority to manage “[t]he business and affairs” of a corporation,⁴ including its legal claims.⁵ As a corollary, the board also has the fiduciary responsibility to manage the corporation’s legal claims with care and loyalty to the corporation and its stockholders.⁶

The demand requirement balances the board’s statutory authority and its accountability to the corporation and its stockholders.⁷ It requires a stockholder who seeks to litigate derivatively on the corporation’s behalf to first demand that the board pursue the claim, unless she can plead particularized facts tending to show that demand would be futile. A derivative action is thus effectively two suits in one, with the question of demand futility at its fulcrum: “First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.”⁸

Demand is futile if a majority of the board is interested in the underlying claim, lacks independence, or faces a substantial risk of personal liability, including because there is a reasonable doubt about whether the challenged transaction

4. DEL. CODE ANN. tit. 8, § 141(a) (2016).

5. *E.g.*, *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996) (“If a claim belongs to the corporation, it is the corporation, acting through its board of directors, which must make the decision whether or not to assert the claim.”); *In re Ezc Corp. Inc. Consulting Agreement Derivative Litig.*, 130 A.3d 934, 943 (Del. Ch. 2016) (“But when a corporation suffers harm, the board of directors is the institutional actor legally empowered under Delaware law to determine what, if any, remedial action the corporation should take, including pursuing litigation against the individuals involved.”); *McPadden v. Sidhu*, 964 A.2d 1262, 1269 (Del. Ch. 2008) (“A derivative action ‘fetters managerial prerogative’ because it is the directors, not stockholders, who manage the business and affairs of a corporation, which includes determining whether to assert legal claims on behalf of the corporation.” (quoting *Caruana v. Saligman*, C.A. No. 11135, 1990 WL 212304, at *3 (Del. Ch. Dec. 21, 1990))).

6. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *see also* *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 548 (Del. Ch. 2015).

7. *Cochran v. Stifel Fin. Corp.*, C.A. No. 17350, 2000 WL 286722, at *10 n.41 (Del. Ch. Mar. 8, 2000) (“As a historical matter, . . . it appears that the derivative suit was a common law development designed to ensure basic fairness and that the demand requirement was judicially created to guarantee that the statutory power of directors to manage the legal affairs of the company was not disregarded except when necessary to serve the policy purpose justifying the recognition of the derivative suit in the first instance.”), *aff’d in part & rev’d in part on other grounds*, 809 A.2d 555 (Del. 2002).

8. *Aronson*, 473 A.2d at 811; *see also* *Ezcorp*, 130 A.3d at 943–44.

was a valid exercise of business judgment.⁹ For purposes of considering a litigation demand, a director is interested if she has a material interest in the subject matter of the demand that is not shared by the corporation or its stockholders.¹⁰ A director lacks independence if she is beholden to a person or entity that is interested in the subject matter of the demand.¹¹ A director who faces a substantial risk of personal liability in the underlying claims is deemed interested in the outcome of the investigation.¹²

The demand requirement thus permits a corporation to dismiss a derivative action “if its board is comprised of directors who can impartially consider a demand.”¹³

III. THE DEMAND REVIEW COMMITTEE

If a stockholder plaintiff makes a litigation demand, the stockholder cedes control of the corporation’s claim to the board of directors.¹⁴ The board determines “the best method to inform itself of the facts relating to the alleged wrongdoing and ‘the considerations, both legal and financial, bearing on a response to the demand.’”¹⁵ In some circumstances, depending on the substance of the demand, the full board will act on the demand without the need for investigation. But if the demand warrants an investigation, the board often forms an *ad hoc* “demand review committee” to investigate the subject matter of the demand and make recommendations to the full board about how to respond.

A. COMMITTEE FORMATION, AUTHORIZATION, AND MEMBERSHIP

By making a demand on the board, the would-be stockholder plaintiff concedes that a majority of the board is capable of impartially considering the demand.¹⁶ Yet, the disinterestedness and independence of the members of the

9. See generally *Rales v. Blasband*, 634 A.2d 927, 933–34 (Del. 1993) (where the board did not make a business decision that is the subject of the underlying litigation, the demand futility test requires the court “to examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations”); *Aronson*, 473 A.2d at 814 (“[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.”).

10. *Rales*, 634 A.2d at 936.

11. *Aronson*, 473 A.2d at 815–16.

12. *Rales*, 634 A.2d at 936.

13. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 939 (Del. Ch. 2003).

14. *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990).

15. *Belendiuk v. Carrion*, C.A. No. 9026-ML, 2014 WL 3589500, at *5 (Del. Ch. July 22, 2014) (quoting *Rales*, 634 A.2d at 935).

16. *Scattered Corp. v. Chi. Stock Exch., Inc.*, 701 A.2d 70, 74 (Del. 1997) (“If the stockholders make a demand, as in this case, they are deemed to have waived any claim they might otherwise have had that the board cannot independently act on the demand.”); *Grimes*, 673 A.2d at 1215; *Spiegel*, 571 A.2d at 775 (“By making a demand, a stockholder tacitly acknowledges the absence of facts to support a finding of futility. Thus, when a demand is made, the question of whether demand was excused is moot.” (citations omitted)). This concession is limited to the issue of demand futility—phase one of the two-part derivative action. *Grimes*, 673 A.2d at 1218–19 (“If a demand is made, the stockholder has

board remain critical concerns in committee formation, even after a demand has been made:

Simply because the composition of the board provides no basis *ex ante* for the stockholder to claim with particularity and consistently with Rule 11 that it is reasonable to doubt that a majority of the board is either interested or not independent, it does not necessarily follow *ex post* that the board in fact *acted* independently, disinterestedly or with due care in response to the demand. A board or a committee of the board may *appear* to be independent, but may not always *act* independently.¹⁷

And, although a stockholder plaintiff concedes the independence of a majority of the board by making a demand, the demand typically does not identify a subset of particular board members to whom the demand is directed.¹⁸ Consider, for example, a five-member board, two of whom are fiduciaries of the corporation's controlling stockholder and the other three of whom are outside independent directors. A stockholder plaintiff might demand that the board investigate claims against the controlling stockholder, thus conceding that a majority of the board—three of five—is capable of impartially considering the demand. But if the board chooses to form a three-member committee and includes the two dual fiduciaries, it will not fare well.¹⁹ As a result, when considering whether to form a demand review committee, a board should identify a subset of directors whose independence, disinterestedness, and impartiality are as unassailable as possible given the underlying allegations and the composition of the board.²⁰

In addition to vetting board members for their independence and disinterestedness, demand review committee members also must prepare, with the assistance of independent counsel and other advisors as necessary, to do the work required to investigate properly the matters at issue in a demand. This has a practical dimension, in that demand review committee investigations can take many months.²¹ But

spent one—but only one—'arrow' in the 'quiver.' The spent 'arrow' is the right to claim that demand is excused."); see also *Scattered*, 701 A.2d at 74–75 ("It is not correct that a demand concedes independence 'conclusively' and *in futuro* for all purposes relevant to the demand.").

17. *Grimes*, 673 A.2d at 1219.

18. See Elena C. Norman & Richard J. Thomas, *Special Demand Committees: Practical Insights for the General Counsel*, 32 DEL. LAW. 14, 16 (2014).

19. *Thorpe v. CERBCO, Inc.*, 611 A.2d 5, 10 n.5 (Del. Ch. 1991) ("[W]hile the board may have been able to act independently through a fully empowered special committee of independent directors (thus justifying a stockholder in making demand), the board in fact chose not to do so, thus justifying treating the board as not independent.").

20. Although the legal standards for independence and disinterestedness are the same, the stakes are arguably higher in the context of a special litigation committee than for a demand review committee. See *infra* Part III.D; see also *Beam v. Stewart*, 845 A.2d 1040, 1055 (Del. 2004) ("Unlike the demand-excusals context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife'—'above reproach.'" (quoting *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985))).

21. See, e.g., *Ironworkers Dist. Council of Phila. & Vicinity Ret. & Pension Plan v. Andreotti, C.A. No. 9714-VCG*, 2015 WL 2270673, at *26 (Del. Ch. May 8, 2015) ("The Committee . . . over nine months vigorously investigated the circumstances alleged in the Stockholder Demands, including interviewing 23 witnesses, reviewing hundreds of documents, reviewing 25 days of deposition testimony and the entirety of the Monsanto Litigation transcript, and conducting additional research. At the end of this process, the Committee produced the 179–page Report, exclusive of exhibits"), *aff'd*, 132 A.3d 748 (Del. 2016).

it also has a legal element; although the effort expended by the committee should be proportional to the issues at stake in the demand, the vigor with which a demand review committee investigates its subject matter from the outset helps to establish the committee's independence-in-fact.²²

So too does an appropriate committee charter. The charter of a board committee is an important document that delineates the committee's objective and its authority.²³ For a committee process to be successful, the committee's charter must provide it contextually sufficient authority to fulfill its mandate; a committee that is not given sufficient authority may never overcome that obstacle.²⁴

In its charter, a demand review committee should be given all of the power and resources it needs to conduct a proportionately thorough, independent investigation into the facts and circumstances giving rise to the demand.²⁵ Because a stockholder who made a demand has already conceded that a majority of the full board can impartially consider the demand, the demand review committee need only make recommendations to the full board on how to respond to the demand.²⁶ It need not be granted the full power and authority of the board to act on behalf of the corporation. Doing so may give rise to a "counter-concession" that the non-committee members of the board are incapable of faithfully considering the demand, even upon recommendation from the demand review committee.²⁷

To avoid any implications or inferences that could be drawn by committee membership, the demand review committee charter should identify the members of the committee, the rationale for their inclusion, and the rationale for the ex-

22. See *Grimes*, 673 A.2d at 1219.

23. See generally GREGORY V. VARALLO ET AL., *SPECIAL COMMITTEES: LAW AND PRACTICE* 40–53 (2d ed. 2014).

24. See, e.g., *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1221–22 (Del. 2012) ("The resolution creating the Special Committee provided that the 'duty and sole purpose' of the Special Committee was 'to evaluate the [Merger] in such manner as the Special Committee deems to be desirable and in the best interests of the stockholders of [Southern Peru],' and authorized the Special Committee to retain legal and financial advisors at Southern Peru's expense on such terms as the Special Committee deemed appropriate. The resolution did not give the Special Committee express power to negotiate, nor did it authorize the Special Committee to explore other strategic alternatives."); see also *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397, 404 (Del. Ch. 2010) ("The scope of the authority that the CNX Gas board provided to the Special Committee was limited. The Special Committee was authorized only to review and evaluate the Tender Offer, to prepare a Schedule 14D-9, and to engage legal and financial advisors for those purposes. The resolution did *not* authorize the Special Committee to negotiate the terms of the Tender Offer or to consider alternatives.").

25. For efficiency's sake, the demand review committee charter should be broad enough to encompass future demands regarding the same subject matter. See *Kops v. Hassell*, C.A. No. 11982-VCG, 2016 WL 7011569, at *4–5 (Del. Ch. Nov. 30, 2016) (rejecting argument that demand review committee relied on previous demand investigation of similar subject matter); *Andreotti*, 2015 WL 2270673, at *2 (discussing committee's investigation of demands made by "several stockholders").

26. *FLI Deep Marine LLC v. McKim*, C.A. No. 4138-VCN, 2009 WL 1204363, at *2 (Del. Ch. Apr. 21, 2009) ("[I]n response to the Plaintiffs' demand letter, the Board formed a special committee to investigate the allegations asserted in the demand letter and to make a recommendation to the Board . . .").

27. Cf. *Sutherland v. Sutherland*, C.A. No. 2399-VCN, 2010 WL 1838968, at *6 (Del. Ch. May 3, 2010) (concluding that by appointing a special litigation committee to investigate claims, defendants conceded that non-committee directors were interested or lacked independence).

clusion of others.²⁸ A demand review committee charter should also permit the committee to hire its own advisors, paid for by the company, and should grant the committee access to management and company resources as needed.²⁹

B. COMMITTEE INVESTIGATION

Once a demand review committee investigation is successfully launched, with independent and disinterested committee members, independent advisors,³⁰ and all of the resources it needs, it has wide latitude to chart its own course, and should follow wherever the facts lead. “In any investigation, the choice of people to interview or documents to review is one on which reasonable minds may differ. . . . Inevitably, there will be potential witnesses, documents and other leads that the investigator will decide not to pursue.”³¹ As with a merger,³² in the demand review context “there is obviously no prescribed procedure that a board must follow.”³³

But if the committee, advised by its own counsel, makes its own decisions about the scope of its investigation, those decisions are given great weight so long as they are well documented and not grossly negligent. Courts have found investigations adequate when the committee chose to interview as few as two³⁴ and as many as “more than 25”³⁵ witnesses. And, courts have rejected arguments that an investigation was deficient for not interviewing certain witnesses, without particularized facts showing that those witnesses had unique knowledge that could have changed the outcome.³⁶

Despite the leeway they are given, demand review committees should consider engaging with the demanding stockholder during the investigation to address in advance any perceived deficiencies.³⁷ They should give serious consideration to

28. See VARALLO ET AL., *supra* note 23, at 66–72.

29. *Id.*

30. To state what should be obvious, the committee’s counsel should not be the same firm who represented the would-be defendants in the underlying claims. See *Taneja v. Familymeds Grp., Inc.*, C.A. No. HHD-CV-09-4045755-S, 2012 WL 3934279, at *5 (Conn. Super. Ct. Aug. 21, 2012).

31. *Mount Moriah Cemetery ex rel. Dun & Bradstreet Corp. v. Moritz*, C.A. No. 11431, 1991 WL 50149, at *4 (Del. Ch. Apr. 4, 1991), *aff’d*, 599 A.2d 413 (Del. 1991); see also *Halpert Enters., Inc. v. Harrison*, C.A. No. 07-1144, 2008 WL 4585466, at *2 (2d Cir. Oct. 15, 2008) (applying Delaware law) (“[T]here is no rule of general application that a board must interview every possible witness who may shed some light on the conduct forming the basis of the litigation.”).

32. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (“Nevertheless, there is no single blueprint that a board must follow to fulfill its duties. A stereotypical approach to the sale and acquisition of corporate control is not to be expected in the face of the evolving techniques and financing devices employed in today’s corporate environment.”).

33. *Levine v. Smith*, 591 A.2d 194, 214 (Del. 1991).

34. *Gatz v. Ponsoldt*, C.A. No. 174-N, 2004 WL 3029868, at *5 (Del. Ch. Nov. 5, 2004).

35. *Scattered Corp. v. Chi. Stock Exch., Inc.*, C.A. No. 14010, 1996 WL 417507, at *5 (Del. Ch. July 12, 1996), *aff’d*, 701 A.2d 70 (Del. 1997).

36. *Ironworkers Dist. Council of Phila. & Vicinity Ret. & Pension Plan v. Andreotti*, C.A. No. 9714-VCG, 2015 WL 2270673, at *26 n.255 (Del. Ch. May 8, 2015).

37. See *Mount Moriah Cemetery ex rel. Dun & Bradstreet Corp. v. Moritz*, C.A. No. 11431, 1991 WL 50149, at *4 (Del. Ch. Apr. 4, 1991) (“During that time, plaintiff was asked to identify potential witnesses and there was a fairly regular exchange of correspondence as well as several meetings between counsel for plaintiff and counsel for the Special Committee.”), *aff’d*, 599 A.2d 413 (Del. 1991).

interviewing witnesses specifically identified by the demanding stockholder as being witnesses who would corroborate the underlying claims.³⁸ At a minimum, demand review committees should ensure they do not overlook any of the facts and circumstances specifically referenced in the demand.³⁹

C. COMMITTEE RECOMMENDATIONS AND JUDICIAL REVIEW

Following its investigation, a demand review committee has broad discretion about how to develop and present its recommendation to the full board. The committee can, and should, think like a plaintiff and assess the expected value of the corporation's litigation assets, taking into account the merits of any claims and defenses, damages, and the collectability of any judgment.

It may also make non-litigation recommendations, "including the advisability of implementing internal corrective action."⁴⁰ This remedial flexibility is part of the flexibility of the demand requirement and committee process. Even assuming that a stockholder plaintiff's lawyer has the corporation's best interests in mind, she has available only the blunt instrument of litigation. Directors may pursue less costly, more effective remedies, such as changing corporate policies and practices, making personnel decisions, and revising corporate documents.

The committee's recommendation should be followed by the board, absent highly unusual circumstances. A board that does not follow the recommendation of a demand review committee acts at its own peril.⁴¹

Whatever its decision, the board should then communicate its decision to the stockholder plaintiff, along with the bases for its decision.⁴² If the plaintiff seeks books and records pursuant to section 220 of the Delaware General Corporation Law⁴³ in support of a claim that the demand was wrongfully refused, the defendants should expect to produce (1) minutes of any meeting of the board or demand review committee where the demand was discussed; (2) reports and presentations by the demand review committee in support of its recommendation; and (3) other materials that formed the basis for the committee's recommendation.⁴⁴ As a result, the committee and its advisors should proceed with its inves-

38. *Scattered*, 1996 WL 417507, at *5.

39. *Espinoza ex rel. JPMorgan Chase & Co. v. Dimon*, 124 A.3d 33, 37 (Del. 2015) (A committee recommendation could be set aside if a reviewing court found that the committee "ignored a material aspect of the demand letter," depending on "the contextual importance of that issue in the overall scope of what the committee was charged with investigating.").

40. *Rales v. Blasband*, 634 A.2d 927, 933–34, 935 (Del. 1993).

41. *Thorpe v. CERBCO, Inc.*, 611 A.2d 5, 11 (Del. Ch. 1991) ("But in some cases . . . the reasonableness and good faith of the investigation relates to an entity (a special committee) that is not the decision maker. Thus, in such a case, its good faith and prudence may not alone justify deference to someone else's decision.").

42. *City of Orlando Police Pension Fund v. Page*, 970 F. Supp. 2d 1022, 1030–31 (N.D. Cal. 2013) (denying motion to dismiss in part because defendants refused to make review committee's report public and relied exclusively on "conclusory" demand refusal letter).

43. DEL. CODE ANN. tit. 8, § 220 (2016).

44. *La. Mun. Police Emps. Ret. Sys. v. Morgan Stanley & Co.*, C.A. No. 5682-VCL, 2011 WL 773316, at *8 (Del. Ch. Mar. 4, 2011).

tigation and recommendation on the assumption that at least those basic materials will be discoverable.

The plaintiff pleading wrongful refusal faces a high burden. To survive a motion to dismiss, a plaintiff must plead “particularized facts . . . supporting an inference that the committee, despite being comprised solely of independent directors, breached its duty of loyalty, or breached its duty of care, in the sense of having committed gross negligence.”⁴⁵ In addition to disputing the substance of the committee’s investigative determinations regarding the merits, the plaintiff must also contend with the board’s business judgments about the cost and distraction of litigation and the effects litigation could have on the company’s business and operations.⁴⁶

Not surprisingly, it appears that the plaintiffs in only two published Delaware decisions have survived motions to dismiss, and both involved egregious and unusual fact patterns.⁴⁷ In *Thorpe*, a committee investigated the matters at issue in the demand and made recommendations to the board. But the board took no action in response to the demand and did not disclose the substance of the committee’s recommendations. The members of the committee promptly resigned.⁴⁸ And in *Seaford Funding Limited Partnership v. M&M Associates II, L.P.*, the interested general partner of a limited partnership took no action in response to a demand that it investigate claims relating to a debt owed to the partnership by another affiliate of the general partner.⁴⁹

D. DEMAND REVIEW COMMITTEE PRACTICE COMPARED WITH SPECIAL LITIGATION COMMITTEE PRACTICE

As highlighted above, there are many surface-level similarities between the way that a demand review committee functions and that of a special litigation committee formed under *Zapata*⁵⁰ and its progeny. There are important differences, however, between the structure and function of those two kinds of committees, most owing to their origin and the corporate power dynamics at stake.⁵¹

As its name implies, a demand review committee is formed in response to a stockholder demand. And, as discussed above, a stockholder who makes a de-

45. *Espinoza ex rel. JPMorgan Chase & Co. v. Dimon*, 124 A.3d 33, 36 (Del. 2015); see also *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996) (“If a demand is made and rejected, the board rejecting the demand is entitled to the presumption of the business judgment rule unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption.”).

46. *Andersen v. Mattel, Inc.*, C.A. No. 11816-VCMR, 2017 WL 218913, at *7 (Del. Ch. Jan. 19, 2017).

47. *Belendiuk v. Carrion*, C.A. No. 9026-ML, 2014 WL 3589500, at *7 (Del. Ch. July 22, 2014) (discussing cases).

48. *Thorpe v. CERBCO, Inc.*, 611 A.2d 5, 8 (Del. Ch. 1991).

49. 672 A.2d 66, 72 (Del. Ch. 1995).

50. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

51. See *Grimes v. Donald*, 673 A.2d 1207, 1216 n.13 (Del. 1996) (“The use of a committee of the board formed to respond to a demand or to advise the board on its duty in responding to a demand is not the same as the [special litigation committee] process . . . It is important that these discrete and quite different processes not be confused.”).

mand has effectively conceded that demand is not excused.⁵² In the parlance of the dual-natured derivative suit, a stockholder who makes a demand has conceded phase one—the “suit by the shareholders to compel the corporation to sue.”⁵³ The stockholder thus lacks the power to assert the corporation’s claim, and demands that the board do so instead.

A special litigation committee, by contrast, typically comes into existence only after a stockholder has established demand futility, whether by judicial decision or by the defendants’ concession. Accordingly, a special litigation committee operates to wrest control of the litigation away from a stockholder plaintiff who had assumed “the legal managerial power to maintain a derivative action to enforce the corporation’s claim.”⁵⁴ The statutory power to do so is retained by the board under sections 141(a) and 141(c) of the Delaware General Corporation Law, notwithstanding that the board is “tainted by the self-interest of a majority of its members.”⁵⁵ The power vests, however, only in a special litigation committee whose members are independent and disinterested, and which conducts a reasonable investigation in good faith.⁵⁶

As a result, the independence and disinterestedness inquiries that are important for a demand review committee are vital to a special litigation committee. The independence and disinterestedness of the members of a special litigation committee are the committee’s font of corporate power. And because the board’s power is vested in the special litigation committee, its charter should reflect that power, and should authorize the committee to ultimately decide, on the corporation’s behalf, how to proceed with respect to the claims without interference from other board members. It should not merely make a recommendation.⁵⁷

The skepticism about the potential structural bias in the special litigation committee context also recommends a higher standard of judicial review than the business judgment rule deference that is given to a demand review committee process and recommendation.⁵⁸ The *Zapata* court was “mindful” that in the special litigation committee context, “directors are passing judgment on fellow directors in the same corporation,” which raises the potential for “perhaps subcon-

52. *Scattered Corp. v. Chi. Stock Exch., Inc.*, 701 A.2d 70, 74 (Del. 1997) (“If the stockholders make a demand, as in this case, they are deemed to have waived any claim they might otherwise have had that the board cannot independently act on the demand.”); *Grimes*, 673 A.2d at 1218–19 (“If a demand is made, the stockholder has spent one—but only one—‘arrow’ in the ‘quiver.’ The spent ‘arrow’ is the right to claim that demand is excused.”); *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990) (“By making a demand, a stockholder tacitly acknowledges the absence of facts to support a finding of futility. Thus, when a demand is made, the question of whether demand was excused is moot.” (citations omitted)). This concession is limited to the issue of demand futility—phase one of the two-part derivative action.

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

54. *Levine v. Smith*, C.A. No. 8833, 1987 WL 28885, at *2 (Del. Ch. Dec. 22, 1987).

55. *Zapata*, 430 A.2d at 786 (citing DEL. CODE ANN. tit. 8, § 141(a), (c)).

56. *Id.* at 788.

57. See VARALLO ET AL., *supra* note 23, at 70 (“We recommend that an SLC delegation include a specific statement that the determinations made by the SLC shall be final and binding upon the corporation and shall not be subject to review by the board. Such language is a clear statement of the exclusive authority of the committee with respect to the pending litigation.”).

58. See *Zapata*, 430 A.2d at 787–89.

scious abuse.”⁵⁹ As a result, the court crafted a two-step standard of judicial review. A special litigation committee seeking to terminate derivative litigation must establish (1) the independence, good faith, and reasonableness of its investigation; and also (2) that the termination or course of action is in the corporation’s best interests, in the business judgment of the Court of Chancery.⁶⁰ This standard is far more rigorous than the business judgment rule standard applicable to demand review committees. It has also been shown empirically to deter special litigation committees from being used as a tool for dismissing meritorious cases.⁶¹

IV. THE DEMAND REQUIREMENT’S INTERNAL DISPUTE RESOLUTION PROBLEM AND THE *AIG* SOLUTION

An aggrieved stockholder who believes that the corporation is sitting on a valuable claim faces a stark choice between making a demand and attempting to plead demand futility. In theory, the interests of a stockholder plaintiff and those of a disinterested, independent board majority should merge. Both should be seeking to maximize the same long-term interests of the corporation, with the directors best suited to deploy the corporation’s assets, including its legal claims, to achieve those goals. Accordingly, in the ideal world of stockholder litigation, a stockholder should be confident of a good outcome for the corporation when she entrusts independent directors with a valuable corporate asset by making a demand, even at the cost of conceding demand futility.

But in practice, much of stockholder litigation is lawyer-driven.⁶² And in many cases, from the perspective of a plaintiff’s lawyer seeking control of a lucrative fee opportunity, making a demand is less appealing than taking a shot at pleading demand futility. The aggregate result is that the demand requirement is underused and falls short of its promise as a tool for promoting internal dispute resolution.⁶³

In *Starr International Co. v. United States*,⁶⁴ a recent case that arose from the U.S. government bailout of AIG during the 2008 financial crisis, the AIG board crafted

59. *Id.* at 787.

60. *Id.* at 788–89.

61. See generally C.N.V. Krishnan et al., An Empirical Study of Special Limitation Committees: Evidence of Management Bias and the Effect of Legal Standards (Oct. 16, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3053449.

62. Laborers’ Dist. Council Constr. Indus. Pension Fund v. Bensoussan, C.A. No. 11293-CB, 2016 WL 3407708, at *11 (Del. Ch. June 14, 2016) (“Each of these contentions is, unfortunately, reflective of undesirable practices that pervade representative litigation as lawyers for stockholders jockey for control of a case in an effort to secure a payday for themselves, assuming they ultimately can confer a benefit upon the stockholders or the corporation.”).

63. Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) (“The demand requirement serves a salutary purpose. First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether.”); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (“Thus, by promoting this form of alternate dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations.”).

64. 111 Fed. Cl. 459 (2013), *vacated in part*, 856 F.3d 953 (Fed. Cir. 2017).

an innovative demand procedure that, if deployed in an appropriate case, could help fulfill the internal dispute resolution function of the demand requirement.⁶⁵ The plaintiff, Starr International Company, asserted derivative claims on AIG's behalf against the federal government, challenging transactions by which the government extended up to \$85 billion of credit to AIG to stave off a liquidity crisis.⁶⁶ Starr alleged in its complaint that demand on AIG's board would be futile, but "Starr and AIG entered into an agreement in which Starr agreed to make a demand on the AIG Board with respect to all derivative claims."⁶⁷ Critically, notwithstanding the default rule that under Delaware law a stockholder who makes a demand concedes that demand is not excused as futile,⁶⁸ the agreement permitted Starr to reserve the right, if its demand was refused, to "challeng[e] the Board's decision to refuse the demand by filing amended complaints alleging that the demand was wrongfully refused and/or not required as a matter of law."⁶⁹

Under this agreement, Starr made its demand, and the parties presented the AIG board with three rounds of adversarial briefing and in-person presentations.⁷⁰ The board asked pointed questions of counsel for the parties, consulted with its own counsel, and ultimately decided unanimously to reject the demand.⁷¹

As the agreement allowed, Starr amended its complaint to advance demand futility and wrongful refusal arguments.⁷² Citing *Grimes* and *Spiegel*, the Court of Federal Claims surprisingly rejected Starr's demand futility argument, reasoning that Starr's demand "conclusively waive[d] any right to assert demand futility."⁷³ The court further held that "Starr's September 5, 2012 agreement with AIG, in which Starr purportedly reserved 'the right to assert that demand was . . . excused,' is insufficient to overcome binding black letter law."⁷⁴

As a matter of corporate power, the black-letter law cited in *Starr* that a stockholder concedes any arguments about demand futility by making a demand traces back through *Grimes* and *Spiegel* to the Delaware Supreme Court's decision in *Stotland v. GAF Corp.*⁷⁵ In *Stotland*, the plaintiffs tried and failed to establish

65. See generally *id.*

66. *Id.* at 466.

67. *Id.*

68. *Scattered Corp. v. Chi. Stock Exch., Inc.*, 701 A.2d 70, 74 (Del. 1997) ("If the stockholders make a demand, as in this case, they are deemed to have waived any claim they might otherwise have had that the board cannot independently act on the demand."); *Grimes*, 673 A.2d at 1218–19 ("If a demand is made, the stockholder has spent one—but only one—'arrow' in the 'quiver.' The spent 'arrow' is the right to claim that demand is excused."); *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990) ("By making a demand, a stockholder tacitly acknowledges the absence of facts to support a finding of futility. Thus, when a demand is made, the question of whether demand was excused is moot." (citations omitted)). This concession is limited to the issue of demand futility—phase one of the two-part derivative action.

69. *Starr*, 111 Fed. Cl. at 467.

70. *Id.*

71. *Id.* at 468.

72. *Id.* at 469.

73. *Id.* at 471.

74. *Id.*

75. 469 A.2d 421 (Del. 1983).

demand futility, and their derivative action was dismissed.⁷⁶ They appealed.⁷⁷ With that appeal pending, one of the plaintiffs made a demand, and the board referred the demand to a demand review committee.⁷⁸ Citing *Zapata*,⁷⁹ the *Stotland* court reasoned “that once a demand has been made, absent a wrongful refusal, the stockholders’ ability to initiate a derivative suit is terminated.”⁸⁰

But *Zapata* itself does not answer the timing question. It holds merely that “[a] demand, when required and refused (if not wrongful), terminates a stockholder’s legal ability to initiate a derivative action. But where demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation’s behalf.”⁸¹ *Zapata* does not hold that a plaintiff, as in *Starr*, lacks corporate power to make a demand, provisionally, before it is determined whether demand was, in fact, required or not. Thus, it is questionable whether demand futility in this context should be deemed conclusive, rather than treated as a default rule in the absence of an agreement between the complaining stockholder and the corporation.

It is hard to see the case to be made against private ordering by sophisticated parties to permit a conditional demand. As the landscape currently exists in Delaware, a stockholder gets two bites at the apple if she litigates futility first, then makes a demand as a fallback. If the same stockholder makes a demand first, however, then the futility door is closed.⁸² This is backwards, if the demand requirement is expected to fulfill an out-of-court dispute resolution function.

In weak cases, defense lawyers would likely adopt the same posture they do in the current regime, which is to wait for a stockholder to act and respond accordingly, with either a Rule 23.1/12(b)(6) dismissal motion or a demand refusal. But in stronger cases, a stockholder could make a provisional demand and her attorneys could participate in the dispute resolution process. The parties could follow in the footsteps of the AIG board and make a faithful demand decision, informed by a deep, adversarial process involving a stockholder plaintiff’s counsel. This would allow the demand requirement to once again fulfill its oft-repeated promise of serving as an internal dispute resolution mechanism, and would lead to more informed demand decisions.

V. CONCLUSION

The demand requirement, and the demand review committee process that often follows a demand, are vital cogs in the corporate governance machinery. But they are underused, in part because of the harsh consequences of a stock-

76. *Id.* at 421.

77. *Id.* at 421–22.

78. *Id.* at 422.

79. 430 A.2d 779, 784–86 (Del. 1981).

80. *Stotland*, 469 A.2d at 422.

81. *Zapata*, 430 A.2d at 784.

82. *Thorpe v. CERBCO, Inc.*, 611 A.2d 5, 11 (Del. Ch. 1991) (“Thus, the current rule may be thought to exact a heavy price from shareholders who elect to try (in a context when they will not have much information) to employ internal corporate mechanisms before filing a claim on behalf of the corporation.”).

holder making a demand. If the law allowed for a conditional demand, as we believe it should, the demand requirement could serve an internal dispute resolution function that is often discussed, but rarely put into practice.

In our view, Delaware law does and should allow for a conditional demand. But it does not do so expressly, and making that position more clear to stockholders and their counsel would be a welcome addition to our law. The change could be implemented on a legislative level, by amendment to the Delaware General Corporation Law. But the derivative suit mechanism and the demand requirements are judge-made creatures of equity,⁸³ making a legislative pronouncement seem unnecessary and perhaps out of place. In our view, a judicial decision in an appropriate case by the Delaware Court of Chancery or Delaware Supreme Court could address the matter, but the wait for an appropriate case might be interminable, as a stockholder plaintiffs' lawyer aware of the *Starr* decision might rightly be reluctant to follow a similar path. Perhaps the most appropriate solution, therefore, would be an addition to Court of Chancery Rule 23.1,⁸⁴ which codifies and implements the demand requirement.

Regardless of the form, we believe that Delaware law currently supports the making of a provisional demand with agreement by the parties, and that stockholders, corporations, and their counsel would benefit if that were clearly expressed.

83. *Cochran v. Stifel Fin. Corp.*, C.A. No. 17350, 2000 WL 286722, at *10 n.41 (Del. Ch. Mar. 8, 2000), *aff'd in part, rev'd in part*, 809 A.2d 555 (Del 2002). ("As a historical matter, . . . it appears that the derivative suit was a common law development designed to ensure basic fairness and that the demand requirement was judicially created to guarantee that the statutory power of directors to manage the legal affairs of the company was not disregarded except when necessary to serve the policy purpose justifying the recognition of the derivative suit in the first instance."); *see also* *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) ("Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'" (quoting *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949))).

84. DEL. CT. CH. R. 23.1.

