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Heroes in the Law: Alford v. Shaw

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OBSERVATION

HEROES IN THE LAW: *ALFORD v. SHAW*

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It is important to have heroes. Heroes are individuals in whom we can place trust. Their accomplishments serve as bright beacons by which we all try to chart our own actions and values. They remind us of our shared beliefs, which bond society together. Occasionally we bestow the title on someone whose endowments are not extraordinary but who undertook an act that we secretly hope, but doubt, we would have undertaken had we been similarly situated. Generally, the hero's physical prowess attracts our admiration: Americans too frequently exalt the athlete to the status of a hero. I feel more comfortable when we celebrate the purity of the hero's message rather than simply his physical accomplishment. We are all better off because there are heroes.

But who are the heroes of a corporate law professor? The law professor's job is to see and explain phenomena and occasionally act as a guide for others seeking to overcome the bramble bush. In this undertaking, the insight of others is as valuable as the raw physical talent or courage of a Willie Mays, Sergeant York, or John Glenn. Generally, these insights are embodied in cases, which the professor throughout his career continues to reference as important guideposts in dealing with an unceasing array of intractable questions. I have my heroes in the area of derivative suit litigation, and I write here to add to that short list the North Carolina Supreme Court's decision on rehearing in *Alford v. Shaw* (*Alford III*).[1]

I. A JAUNDICED VIEW OF DERIVATIVE SUITS

Derivative suit litigation is much maligned and poorly understood.[2] Be-

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1. 320 N.C. 465, 358 S.E.2d 323 (1987) (*Alford III*). *Alford III* modified and affirmed an earlier North Carolina Supreme Court ruling, Alford v. Shaw, 318 N.C. 289, 349 S.E.2d 41 (1986) (*Alford II*). *Alford II* reversed a court of appeals decision holding the trial court had erred in dismissing a shareholder's derivative suit pursuant to a special litigation committee's recommendation. *See* Alford v. Shaw, 72 N.C. App. 537, 324 S.E. 2d 878 (1985) (*Alford I*).

2. Distrust of the derivative suit is engrained in several areas of the law applicable to this type of action. First, there are limitations on the plaintiff's standing to sue: the plaintiff must be a stockholder when the alleged misdeed occurs. *See, e.g.*, N.C. GEN. STAT. § 55-55(a) (1982). Although this requirement of contemporaneity is consistent with the overall compensatory function of the derivative suit, it more frequently is justified by the objective of discouraging trafficking in derivative suits. *See* Bateson v. Magna Oil Corp., 414 F.2d 128, 131 (5th Cir. 1969), *cert. denied*, 397 U.S. 911 (1970); Note, *Corporate Incapacity To Sue Where Stockholders Would Be Barred From Suing Derivatively—The Vicarious Incapacity Rule: A Public Interest Exception*, 54 B.U.L. REV. 355, 368-71 (1974). Furthermore, in many jurisdictions the plaintiff must post security for the defendant's litigation costs to pursue the action. *See* Comment, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J.L. & SOC. PROBS. 50, 50-53 (1968). Most states and the

cause it is poorly understood, many attacks have been made on the contribution that derivative suits otherwise make to our well-being. Such an attitude prevailed in the North Carolina Supreme Court's first opinion in *Alford v. Shaw* (*Alford II*).[3] The question before the court was straightforward: May a board of directors, a majority of whom are charged with having breached their fiduciary obligations to the corporation, appoint new directors to the board to serve on a committee specially created to consider whether the suit's continuance is in the corporation's interest? The North Carolina Court of Appeals in *Alford v. Shaw* (*Alford I*)[4] held that the defendant-directors lacked the power to appoint their own jury.[5] In reversing that decision, the supreme court in *Alford II* limited its ability to address the issues before it by incorrectly concluding that the matter implicated North Carolina's fidelity to the business judgment rule.[6] This well-established standard of corporate practice protects decisions of boards of directors from further judicial scrutiny, unless the plaintiff establishes that the directors acted unreasonably or in bad faith.[7] Because the *Alford II* court misperceived the question to be whether the directors' control over corporate affairs should be second-guessed, it proferred a solution inappropriate for the problem at hand and drastically out of step with the functions of courts.

A good deal of commercial sense underlies the business judgment rule. Its presumption of director infallibility encourages socially desirable risk-taking.[8] Correlatively, the substantial presumption increases the likelihood that qualified outsiders will serve on the boards of publicly traded corporations. Underlying the rule's presumption is the irrefutable wisdom that as between directors and

federal courts also require that the plaintiff seek to elicit action by the board of directors to cure the problem before filing suit. *See, e.g.*, N.C. GEN. STAT. § 55-55(b) (1982). Although this requirement allows the full weight of the corporation to be brought to bear on the suit, demand-on-directors statutes have more frequently assumed the role of gatekeeper to the courts. No other form of litigation conditions the plaintiff's initiation of a suit on what effectively amounts to the approval of another party. Even the derivative suit's relative, the class action, avoids such prescreening, although the problem of incentives remains the same. Finally, notice and a hearing on the overall fairness of the settlement's terms may be a prerequisite to settlement of a derivative suit. *See, e.g., id.* § 55-55(c) (court may in its discretion direct that notice be given to shareholders or creditors prior to settlement).

3. 318 N.C. 289, 349 S.E.2d 41 (1986), *modified and aff'd*, 320 N.C. 465, 358 S.E.2d 323 (1987).

4. 72 N.C. App. 537, 324 S.E.2d 878 (1985), *rev'd*, 318 N.C. 289, 349 S.E.2d 41 (1986), *modified and aff'd*, 320 N.C. 465, 358 S.E.2d 323 (1987).

5. *Id.* at 547-48, 324 S.E.2d at 886.

6. *Alford II*, 318 N.C. at 299-300, 349 S.E.2d at 47-48.

7. North Carolina memorializes this standard for its directors and officers in N.C. GEN. STAT. § 55-35 (1982) ("Officers and directors shall be deemed to stand in a fiduciary relation to the corporation and to its shareholders and shall discharge the duties of their respective positions in good faith, and with that diligence and care which ordinarily prudent men would exercise under similar circumstances in like positions."). *See generally* Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789 (1984) (discussing issues involved in defining the business judgment rule through the ALI's Corporate Governance Project).

8. *Compare* Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983) (advocating abolition of derivative suits for duty of care violations because they discourage entrepreneurial risk taking) *with* Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984) (arguing that the duty of care, because it is a minimal standard with a compensatory function, does not discourage director risk-taking).

courts it is only the former who are chosen for their sensitivity to manufacturing, marketing, and finance; these qualities are not entry-level requirements of the judiciary. The role of the business judgment rule in corporate transactions is functionally prescriptive of the role of a reviewing court vis-à-vis the board of directors. To the extent that the rule's presumption is weakened, or even eviscerated, the natural consequence is deciding that directors are liable for losses arising from their decisions, and therefore these decisions are enjoined or altered in fundamental ways.[9] Thus, any judicial activism in disregard of the business judgment rule will have a distinct impact on the traditional manner in which corporations govern their affairs.

But these reasons for courts' "hands-off" practices with respect to business decisions are poorly connected to the question posed in *Alford II.* To be sure, a law suit's continuance does have some similarity to mundane business judgments: a derivative suit may well harm the firm's reputation, damage morale, and deflect employee time. Derivative suits also require cost-benefit judgments as problematic as those posed when the corporation is considering a suit against a third party, where board of directors' judgments enjoy insurmountable protection. The directors' judgments on litigation against third parties are entitled to deference because directors possess a unique perspective on and closeness to the ongoing affairs of the corporation, as contrasted with the more distant perspective of the court. However, in the context of suits brought against a colleague of the directors, additional considerations permit a more active role for the judiciary. In the case of derivative suit litigation, indirect litigation costs, such as the deflection of employee time, are tangential to the suit and are substantial only in exceptional cases.[10] Furthermore, indirect costs and the question of the suit's overall worth are questions in which trial courts have rich experience. Thus, although the directors' input on such issues is desirable in derivative suit litigation, it need not be accompanied by a heavy presumption of either its veracity or dispositive impact. In contrast with the directors' judgment on matters of commerce, the court has the richer background in assessing litigation.

More importantly, there is a profound difference in consequence between the court's disregard of the directors' judgment on a commercial question and its rejection of the directors' recommendation that a derivative suit be discontinued. In the former situation, the court's intrusion disturbs the board's control over commercial undertakings, generally leads to draconian liability for the deciding directors, and consequently discourages the able from serving on boards of directors. Quite a different result occurs when the court disturbs the directors' recommendation that the derivative suit be dismissed. In this context, a court's activism does not expose those deciding directors to liability, its intrusion does

9. The corporate lawyer and the director are all too familiar with this result because of the landmark decision of Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985). In that case the Delaware Supreme Court held the directors of a publicly held corporation breached their duty of care by approving a merger on financial terms that the directors had no reasonable basis to believe were fair. *Id.* at 893.

10. *See, e.g.*, Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982) (permitting courts to consider such indirect corporate losses only if the direct benefits of the suit are believed insubstantial in light of the suit's tangible costs).

not impact on the directors' conduct of the corporation's business, and its decision does not involve the court with unfamiliar questions. Overall, the court's detachment from the directors' recommendations is consistent with the public perception that courts are the final arbiters of disputes. In these ways, active judicial review is far more consistent in theory as well as practice with the roles of independent directors and the judiciary than is *Alford II*'s blunt application of the business judgment rule. A rejected recommendation, therefore, does not expose the deciding directors to any consequences. Furthermore, directors who are aware that their decision on an important corporate governance question[11] will be closely scrutinized are encouraged to fulfill their duties as monitors of their managers' performance.

Instead of considering the sharp distinctions between director decisions on commercial matters and intramural litigation, the majority in *Alford II* supported its decision with the indignity that a lower level of judicial review was desirable to attract corporate chartering to North Carolina.[12] To be sure, the court in *Alford II* believed it was striking an appropriate balance when it installed the business judgment rule as the criterion by which a suit's continuance was to be considered. The majority altered the traditional application of the business judgment rule by placing the burden on the committee to establish its members' independence and the reasonableness of its investigation.[13] Once this burden was met, the court would presume the committee's good faith and not consider the weight, assumptions, and conclusions the committee attributed to the facts before it.[14] Neither inquiry—the directors' independence nor the level of their investigation—afford sufficient assurances that the corporate interest is served by the committee's recommendation.[15] Independence has come to mean that the committee members are not financially linked to the lawsuit.[16] Such a concern deals only superficially with a far wider range of factors that may, and quite likely do, cause directors to give insufficient attention to a suit's upside

11. *See* Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 321 (1981); Coffee, *Beyond the Shut-Eyed Sentry: Toward A Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1229-41 (1977). Derivative suits are a necessary social instrument. They focus on managerial wrongdoing that harms the corporate fisc. Although systematic ineptitude or risk aversion can be cured through the market-disciplining forces of the hostile takeover, the one-shot diversion of corporate assets or business rarely can be expected to so depress a firm's stock prices that it will be taken over. In this area, the derivative suit serves not only the immediate function of recouping for the corporation the harm done to it by its fiduciaries, but also the indirect function of deterring wrongdoing by others. With derivative suits as viable social instruments, managers cannot knowingly harm their corporations without realizing that their unlawful gains may be recouped by the corporation. *See* Cox, *supra* note 8, at 746-55.

12. *Alford II*, 318 N.C. at 306, 349 S.E.2d at 51.

13. *Id.* at 307-08, 349 S.E.2d at 52-53.

14. *Id.*

15. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 976-81.

16. A committee member's want of independence appears to disqualify the committee report only in the most extreme cases. *See, e.g.*, Hasan v. CleveTrust Realty Investors, 779 F.2d 372, 379 (6th Cir. 1984) (prior affiliation of the corporation and the singular committee member precludes any affirmative demonstration of disinterest); Lewis v. Fuqua Indus., 502 A.2d 962, 967 (Del. Ch. 1985) (single-member committee must, like a "Caesar's wife," be above reproach).

potential.[17]

Moreover, the necessity of a "reasonable investigation" has yielded an art form that, if nothing else, enriches the legal profession by requiring the preparation of a bulky report at considerable expense to the corporation.[18] That report in other jurisdictions has been the petard on which the recommendation is hoisted by the court's consideration of its internal inconsistencies as well as disagreement with its factual and legal conclusions.[19] Such substantive review, however, was rejected by the *Alford II* court, because the court reasoned that the review should focus only on the insubstantial considerations of the committee's financial linkage to the suit and the report's girth.[20] The indignity of *Alford II* was that in its rush to reach a commercially attractive approach,[21] the court's sweeping embrace of the business judgment rule and the reduced role of judicial review virtually assured that no corporation considering the merits of a derivative suit thereafter would be as careful and thoughtful in considering the suit and the appearance of propriety as was the corporation in *Alford II*. In this respect, *Alford II* stands in stark contrast to the far more insightful judgments rendered by other courts on important derivative suit questions.

II. LASTING JUDICIAL INSIGHTS IN DERIVATIVE SUITS

Criticism may be the easiest, but it is not the only, contribution that law professors far removed from the fray can offer. I hope here not only to offer further criticism of *Alford II* and to celebrate *Alford III*, but more importantly to explain by example what type of decision has a lasting impact on a troublesome legal issue.

17. *See* Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, L. & CONTEMP. PROBS., Summer 1985, at 83 (describing a variety of social and psychological mechanisms that cause committee directors to identify with the derivative suit defendants and therefore maintain a hostile view of the suit). This concern is not limited to the ivory towers of academe, but is reflected even in that most hallowed haven of corporate America, the Delaware Supreme Court:

> [W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role.

Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

18. Chancellor Brown quite aptly remarked that the special litigation committee, rather than being an economic tool for the resolution of corporate disputes, is instead "litigation within litigation." Kaplan v. Wyatt, 484 A.2d 501, 511 (Del. Ch. 1984). In *Kaplan* the attorneys' fees alone for the report were $500,000. *Id.* at 515. There is reason to believe that the costs of the committee in *Alford II* may have exceeded even this figure. *Compare Alford II*, 318 N.C. at 312, 349 S.E.2d at 55 (result of investigation was a 409-page report) *with Kaplan*, 484 A.2d at 511 (156-page report).

19. *See, e.g.*, Holmstrom v. Coastal Indus., [1984 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 91,486, at 98,421-23 (N.D. Ohio 1984); Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311, 1327-29 (S.D. Iowa 1981).

20. *See Alford II*, 318 N.C. at 307, 349 S.E.2d at 52 (adopting view that judicial review should be limited to issues of whether the directors acted independently, in good faith, and pursuant to "appropriate investigative procedures").

21. "A favorable business climate can be fostered in part by recognizing the importance of traditional intra-corporate relationships, and by providing a measure of protection against 'strike suits' . . . ." *Id.* at 306, 349 S.E.2d at 51.

A. *The Problem of Incentives*

The central problem with derivative suit litigation is the weak incentives of each of the suit's participants to serve the corporation's interests.[22] Each party lacks natural economic incentives that guide its actions so as to avoid both an overly aggressive litigation strategy and becoming so passive that a settlement results that is inappropriate to the intrinsic worth of the suit. For example, the derivative suit plaintiff usually has no significant financial interest in the corporation; any recovery will produce equally small economic gains to the individual plaintiff. An ill-advised suit will have little adverse impact on the plaintiff's private welfare and cannot be expected to rein in a maverick plaintiff.

This concern is heightened by the knowledge that most suits are contingency fee arrangements, so that the plaintiff risks little in either initiating or continuing to prosecute the suit. The real engine for this form of corporate therapeutics is the derivative suit's counsel, whose strongest weapon against the defendants' larger arsenal of legal talent is that his participation occurs at a lower unit cost than does that of the defendants.[23] This difference permits somewhat greater staying power for the plaintiff's lawyer, who need not match his opponents' costs dollar for dollar. Furthermore, while the individual defendant focuses only on the outcome of the suit against him, the plaintiff's attorney can assess his outcomes in the context of a portfolio of suits. Because his risks are diversified across a portfolio of suits, the plaintiff's attorney can incur greater risks in some cases than others. Hence, the plaintiff's lawyer may be more willing to assume risks in any individual suit than the individual defendant. What saves the day invariably for the individual derivative suit defendant, however, is that he is able to "play" with other people's money, either the funds provided by an insurance carrier or the corporation. As is too frequently demonstrated, derivative suits are settled with the corporation garnering only a small pecuniary award, if any at all.[24] Under the state corporate indemnification statutes, as well as director and officer insurance policies, the defendant can more easily pass all litigation costs to the corporation or insurer if the suit is settled than if it goes to judgment and the defendant is held to have acted in bad faith.[25]

These are the realities of derivative suits. These forces perhaps do not exist

22. *See, e.g.*, Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 671-77 (1986).

23. *Id.* at 701-04.

24. The nonpecuniary recovery and the "lodestar" formula for awarding plaintiffs' attorney fees can combine to allow worthwhile actions to be settled too early so that the greatest direct benefit is conferred upon the attorneys and the defendant and not the corporation itself. Coffee, *Rescuing The Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215, 243-48 (1983). To overcome this problem, the ongoing American Law Institute Corporate Governance project requires the presence of a real, not illusory, benefit to the corporation before the court approves a settlement calling only for nonpecuniary relief. *See* A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.13(b) (Tent. Draft No. 6, Oct. 10, 1986). The project further directs that the court place a value on such relief before it awards the plaintiff's attorney an amount not in excess of "a reasonable proportion of the value of the relief obtained." *Id.* § 7.18 & comment, at 254-55.

25. *See, e.g.*, REV. MODEL BUSINESS CORP. ACT §§ 8.52, 8.54(2), 8.56(1) (1985).

in all such actions, but they do exist with sufficient frequency[26] to invite realistic responses to the weak incentives that surround those who participate in derivative suits. The decisions that provide meaningful guidance on complex derivative suit procedural questions are those that recognize the inherent realities of derivative suits and avoid mechanistic responses to highly fluid problems. The derivative suit and the American corporation would be better off today if more decisions dealt in such a forthright fashion with these problems.

B. *Heroics Overcome Harmful Incentives*

No jurist has provided more insight into derivative suit litigation than the late Judge Henry Friendly. Among his numerous important opinions, his dissent in *Alleghany Corp. v. Kirby*[27] forthrightly grappled with the litigants' weak incentives to serve the corporate interest during the most crucial time of a suit—the settlement. In *Alleghany*, the plaintiff sought to set aside a judgment that had resulted from a settlement, on the ground that defendants had withheld critical documents during discovery that bore importantly on the worth of plaintiff's cause of action. The majority refused to reopen the settlement, reasoning that such action was appropriate only when the withheld information was so material as to make it probable that a different settlement would have ensued if plaintiffs had had access to the withheld information.[28] Judge Friendly's vigorous, and now famous, dissent underscored the importance of assuring fairness in all aspects of the settlement process because of the important weakness within the settlement review process:

> Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork—as is vividly shown here where the the stockholders' general counsel sometimes opposed [the objector's] efforts to gain information, although the settlement so vigorously defended before the Referee would have produced less than a quarter as much cash for Alleghany, $700,000, as the $3,000,000 ultimately secured . . . .
>
> This very fact, that directors accused of malfeasance have so much control over the evidence, both documentary and nondocumentary, relating to their misdeed, makes it vital for a court of equity to insist upon a high standard with respect to disclosure at settlement hearings and to subject arguments that a breach was not consequential

26. For example, in *In re* General Tire & Rubber Co. Sec. Litig., 726 F.2d 1075, 1080 (6th Cir.), *cert. denied sub nom.* Schreiber v. Gencorp, Inc., 469 U.S. 858 (1984), damages proximately caused by the directors' and officers' illegal payments exceeded $100 million. The derivative suit seeking recovery for the corporate losses was nevertheless settled on terms that secured for the plaintiff's attorney an uncontested fee award of $500,000, *id.* at 1088 (Wellford, J., concurring in part and dissenting in part), and the only benefit conferred upon the corporation was a term requiring the inclusion of two outside directors on its board for three years. *Id.* at 1079. Such nonpecuniary settlements coupled with significant fee awards to the litigating attorneys rightly prompt skepticism regarding how aggressively the parties serve the corporate interest. *See* Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, L. & CONTEMP. PROBS., Summer 1985, at 5, 9.

27. 333 F.2d 327 (2d Cir. 1964).

28. *Id.* at 334-35.

to a most icy scrutiny. All the dynamics conduce to judicial approval of such settlements.[29]

In view of the fact that settlements occur far more frequently than trials in representative suit litigation, Judge Friendly revealed how the interests of litigants' attorneys could overwhelm the review process: settlement is indeed the soft underbelly in the enforcement of substantive rights in derivative suit litigation. The plaintiff's attorney, satisfied that enough hours have been "put into the case" to justify award of a fee, and aware that the marginal benefits to him of continuing to press the case are overcome by the risks of continuance,[30] is motivated to argue before the court that the settlement is quite reasonable in light of significant weaknesses in the plaintiff's case. The defendants' attorneys, wishing to contain damages, especially when it is possible that most of the burden of any award can be shifted, ironically, to the corporation on whose behalf the suit is sought, are equally motivated to argue that the settlement amount is adequate. Furthermore, the uncertain fate of intervenors, and more importantly the likelihood of their attorneys being compensated, affords little assurance that the review of the settlement will be an adversarial one. So described, *Alleghany* is celebrated both for its honest, albeit poignant, insight into the inherent weaknesses of the litigants' incentives. Judge Friendly's opinion not only dissipates the fog that so clouds settlement procedures in derivative suits, but also makes a straightforward contribution to the problem's solution in his cry for more active involvement of the court in reviewing settlements.

Derivative suits never approach the settlement stage unless they escape the demand requirement. Under most state laws as well as Federal Rule of Civil Procedure 23.1, bringing suit is conditioned on setting forth "the efforts, if any, made by the plaintiff to obtain the action he desires from the directors."[31] In general, the operative effect of the demand requirement is to foreclose any suit whatever, because the directors' negative decision in response to that demand is presumptively valid in the overwhelming number of cases.[32] This operative ef-

29. *Id.* at 347 (Friendly, J., dissenting). On rehearing en banc, the United States Court of Appeals for the Second Circuit divided evenly over whether to accept Friendly's prophylactic approach. *See* Alleghany Corp. v. Kirby, 340 F.2d 311, 312 (2d Cir. 1965) (en banc).

30. *See, e.g.*, Saylor v. Lindsley, 456 F.2d 896 (2d Cir. 1972). In *Saylor* Judge Friendly, speaking for the panel, reiterated the importance of a penetrating active review of settlements by the court. The question before the *Saylor* court was whether a settlement sponsored by defendant's and plaintiff's attorney could be approved over the objections of plaintiff. Judge Friendly held that it could, but only after this observation:

> There can be no blinking at the fact that the interests of the plaintiff in a stockholder's derivative suit and of his attorney are by no means congruent.... The plaintiff's financial interest is in his share of the total recovery less what may be awarded to counsel, *simpliciter*; counsel's financial interest is in the amount of the award to him less the time and effort needed to produce it. A relatively small settlement may well produce an allowance bearing a higher ratio to the cost of the work than a much larger recovery obtained only after extensive discovery, a long trial and an appeal. The risks in proceeding to trial vary even more essentially. For the plaintiff, a defendant's judgment may mean simply the defeat of an expectation, often of relatively small amount; for his lawyer it can mean the loss of years of costly effort by himself and his staff.

Id. at 900-01.

31. FED. R. CIV. P. 23.1.

32. *See* Bach v. National W. Life Ins. Co., 810 F.2d 510, 512-14 (5th Cir. 1987); Note, *The*

fect, however, is not free from doubt.[33] For example, in *Daily Income Fund, Inc. v. Fox*[34] the United States Supreme Court grappled with the question whether an investment company's directors could cause the dismissal of a derivative suit for plaintiff's failure to make a demand as required by Rule 23.1. Although the majority avoided this issue by deciding the substantive action was not a derivative action at all,[35] Justice Stevens embraced the position taken by some lower courts that the demand requirement is merely a formal matter of pleading and not a substantive independent basis for dismissal of the suit.[36] Nevertheless, the prevalent view remains that, unless excused for futility, a demand required is a suit foregone.[37] Hence, the derivative suit exists only within that range of cases in which a demand on the board is excused on the basis it would have been a futile gesture.

Jurisdictions have various configurations of facts or pleadings sufficient to establish futility of demand. A minority of the jurisdictions excuse a demand on proof that a majority of the current directors approved or acquiesced in the acts or transaction attacked in the derivative suit.[38] A larger number of courts, however, would require a demand in the face of such allegations, unless the plaintiff also proved that a majority of the directors were corrupted by self-interest or bias.[39] Even under these facts, however, the quite correct view that directors are unlikely to approve a suit against themselves does not remove the presumption of their detachment. It is most disturbing that a majority of the courts have uncritically accepted this position. Under this approach, a demand's excuse is treated with little insight. A notable exception to the status quo is Judge Seitz's consideration of both the demand requirement and the directors' control over a derivative suit in *Lewis v. Curtis*.[40]

Defendants in *Lewis* sought a ruling that would have excused demand when a majority of the directors had approved the challenged transaction only if the

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Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. CHI. L. REV. 168, 191-93 (1976). One of the few cases to hold the directors' rejection of the demand improper is Syracuse Television v. Channel 9 Syracuse, Inc., 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966), in which the directors' financial and personal interests were connected to the defendants' interests and to the underlying transaction. The directors' prolonged indisposition to respond to the very real and significant charges of wrongdoing were sufficient grounds for the court to decide they did not act in good faith.

33. *See generally* DeMott, *Demand in Derivative Actions: Problems of Interpretation and Function*, 19 U.C. DAVIS L. REV. 461, 484-94 (1986) (discussing the "potentially inconsistent functions" of the demand requirement).

34. 464 U.S. 523 (1984).

35. *Id.* at 535.

36. *Id.* at 542-44 (Stevens, J., concurring).

37. A plaintiff successfully overcomes the board of directors' rejection of his demand in only a few cases. *See generally* Note, *supra* note 32, at 193-98 (discussing situations in which a shareholder may sue on the corporation's behalf because of the board of directors' wrongful refusal to sue). If an independent board decides in good faith that the suit should be dismissed, the court will almost always dismiss the case. *See, e.g.*, Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 263 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Robinson v. Caster, 356 F.2d 924, 927 (7th Cir. 1966).

38. *E.g.*, deHaas v. Empire Petroleum Co., 286 F. Supp. 809, 814 (D. Colo. 1968), *aff'd*, 435 F.2d 1223 (10th Cir. 1970).

39. *See, e.g.*, *In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 265 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

40. 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).

transaction was "facially improper."[41] After an exhaustive review of the various bases for excusing a demand, Judge Seitz provided the most easily administrable response to the question yet offered. Eschewing the formalisms of other jurisdictions, he offered a highly pragmatic yet insightful answer. He resolved the question on the basis whether from all the facts it appeared that a demand on the directors would likely "prod them to correct a wrong."[42] In making this inquiry, Judge Seitz stated that the likelihood the directors can render a detached evaluation of the suit is far more important than the substantive violation alleged.[43] Hence, the fact the complaint did not set forth a basis for believing the transaction was facially improper did not determine whether a demand was required.[44] Judge Seitz further reasoned that to make a demand depend on the likelihood the suit might succeed would introduce a pleading defense into a factual dispute.[45] The plaintiff must be able to prove his factual allegations at trial yet may well fail to do so, resulting in expense and inconvenience to the corporation, but this possibility should not spare corporate fiduciaries from their obligation to respond to a complaint against them.[46]

Both *Alleghany* and *Lewis* involved several distinctive aspects. In both cases the ultimate question was the trustworthiness of the process: in *Alleghany* it was the settlement of a derivative suit and in *Lewis* it was whether the existing board could render an impartial judgment on how well the suit served the corporation's interests. Both Judge Friendly and Judge Seitz avoided a technical resolution of the question. Instead, they evaluated the troublesome incentives of the parties and then molded a response calculated to overcome the perceived problems. Each favored an active judicial review after a sufficient record developed through the adversarial process. In such a troubled area, no party is more detached and thus able to ensure a fair resolution than the court. In this respect, both decisions clearly established that it is the judge who ensures the corporate interest is served, whether through settlement or the suit's continuance.

III. The Purity of *Alford III*

Alford III is a significant decision. It already has generated national interest because it shows so clearly the way for others to follow. One might expect that the North Carolina Supreme Court would in its rehearing of the case choose to station itself somewhere between its prior decision in *Alford II* and the court of appeals' holding that the defendants could not create a committee to consider whether the suit's continuance served the corporate interest.[47] Cer-

41. *Id.* at 786.

42. *Id.*

43. *Id.*

44. Contrast the approach in Delaware, where a demand is excused only if the complaint creates a reasonable doubt that the transaction is beyond the protections of the business judgment rule. Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

45. *Lewis*, 671 F.2d at 786.

46. *Id.* at 786-87.

47. Sister states have embraced two alternative approaches toward the court's review of special litigation committee recommendations. The approach that most limits the court's prerogative is that established in Auerbach v. Bennett, 47 N.Y.2d 619, 634-35, 393 N.E.2d 994, 1002-03, 419 N.Y.S.2d

tainly discrete tinkering with the approach embraced in *Alford II* was in order. The court, however, avoided such an intermediate and problematic response.

Writing for the *Alford III* court, Justice Martin held that the defendant directors were not disabled by self-interest from establishing a committee to review the impact of the ongoing derivative suit on the corporation.[48] The supreme court acknowledged the distinct risk that defendants may prefer committee members who are more likely to recommend that the suit be dismissed, and also noted the unremarkable tendency of such committees to protect a colleague.[49] The court nonetheless tempered its concerns by expressing faith in the court's power to review, with the aid of the plaintiff's participation, the report and recommendations of the committee. In this respect, the court resolved that risks of collegial or appointive bias are reduced through full utilization of an adversarial review when a court confronts a recommendation that the suit be dismissed. *Alford III* thus avoids the prophylaxis of *Alford I*'s sweeping rejection of the defendants' power to appoint a committee. Moreover, *Alford III* emphasizes that it is wrong to give great deference to the decisions of such corporate committees. This conclusion is the greatest departure from its earlier decision in *Alford II*, in which the majority made a meretricious bow toward attracting corporate chartering in North Carolina[50] by according more deference to a committee's recommendation than had any other jurisdiction. *Alford III* restores the court to its former role as the ultimate arbiter of the corporate interest served by a derivative suit.[51]

Much like the result in *Lewis v. Curtis*,[52] *Alford III* avoids the perils of allowing artificial characterizations and compartmentalization to introduce a pleading defense to a substantive issue. Justice Martin, after a review of the

920, 929 (1979), which, like *Alford II*, restricts the court's review to the independence and good faith of the directors and, therefore, does not entail questioning the committee's weighing of legal, ethical, commercial, public relations, or fiscal grounds for its decision. A more active inquiry is that embraced by the Delaware Supreme Court in Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981), which places the burden on the committee to establish its independence, good faith, and bases for its decision. Furthermore, the court in its discretion may overturn the committee's recommendation if in the exercise of its independent judgment the court believes this serves either the corporation's or the public's interest. *Id.* at 789. A close review of the cases reveals that the standard for review has not been a variable in the few instances in which courts have rejected the committee's recommendation. *See, e.g.*, Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 380 (6th Cir. 1984); Holmstrom v. Coastal Indus., [1984 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 91,486 (N.D. Ohio 1984). Yet a third paradigm exists, which was embraced in *Alford I*: the defendants constituting a majority of the board may not appoint a committee after the suit is initiated. *See* Miller v. Register & Tribune Syndicate, 336 N.W.2d 709, 718 (Iowa 1983). Under this approach, review standards are eschewed for a clean prophylaxis out of concern that the committee's bias may be both substantial and too subtle for detection.

48. *Alford III*, 320 N.C. at 469, 358 S.E.2d at 326.

49. *Id.*

50. *Alford II*, 318 N.C. at 306, 349 S.E.2d at 51.

51. The entire governance question raised by the creation of a special litigation committee, as well as the demand requirement, was aptly summarized by the court in assessing why its review in each situation is required: "To rely blindly on the report of a corporation-appointed committee which assembled such materials on behalf of the corporation is to abdicate the judicial duty to consider the interests of shareholders imposed by the statute." 320 N.C. at 471, 358 S.E.2d at 327.

52. 671 F.2d 779 (3rd Cir.), *cert. denied*, 459 U.S. 880 (1982); *see supra* text accompanying notes 40-46.

North Carolina Business Corporation Act,[53] aptly concluded that North Carolina law left no room for either judicial review or the level of the court's scrutiny to depend on whether it was a demand-required or demand-excused case. Section 55-55(b) of the North Carolina General Statutes, while requiring the complaint to set forth whether a demand was made or the reasons for not making such a demand, makes no reference to the consequences that flow from either situation.[54] Indeed, any suggestion that North Carolina should follow those cases which accord only cursory review to a board of directors' decision that the derivative suit was not in the corporation's best interests is defeated by the statute's later exhaustive description of the type of review that must precede any derivative suit's dismissal.

Finally, the directors' response to a derivative suit against one of their colleagues is a form of conflict of interest transaction,[55] because such a suit directly affects the defendant directors' interests. In the more typical conflict of interest situation, the suspect transaction undergoes a reasonably penetrating review process in which the transaction, even if approved by noninterested directors, is evaluated in terms of its costs and benefits to the corporation.[56] It is appropriate, therefore, that suits against directors also undergo some appropriate level of review. The analogy to conflict of interest transactions, however, is not a perfect one. In the case of commercial transactions involving a conflict of interest, some level of deference to the judgment of the directors or stockholders is merited by a legitimate concern that the transactions are uniquely commercial. As seen earlier, such commercial considerations do not attach to the evaluation of derivative suits, and so an even higher level of judicial review should attach to directors' judgments respecting derivative suits.[57] Such judicial intrusion does not disrupt the corporation's operations as it would if the question concerned the financial, marketing, or manufacturing practices of the corporation. Therefore, strong judicial review of the directors' opinions respecting a suit's merits is not only consistent with the language of the North Carolina Business Corporation Act, but also places the ultimate decision in the hands of the body having the most experience in such matters.

Alford III's holding that even demand-excused cases should undergo judicial review avoids a further incongruity existing in those jurisdictions that accord sharply different judicial responses to demand-required and demand-excused cases.[58] As seen, all courts have subjected the work of special litigation

53. 320 N.C. at 469-73, 358 S.E.2d at 326-28.

54. N.C. GEN. STAT. § 55-55(b) (1982).

55. The analogy to state conflict of interest statutes is a powerful one which requires that a higher level of judicial scrutiny attach to director recommendations regarding derivative suits than the scrutiny currently existing in sister states. *See* Buxbaum, *Conflict of Interests Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CALIF. L. REV. 1122, 1125-26 (1980).

56. *See, e.g.*, Scott v. Multi-Amp Corp., 386 F. Supp. 44 (D.N.J. 1974); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); Hadden v. Krevit, 186 Conn. 587, 442 A.2d 944 (1982); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976); Aronoff v. Albanese, 85 A.D.2d 3, 446 N.Y.S.2d 368 (1982).

57. *See supra* text accompanying notes 10-11.

58. For example, the Delaware Supreme Court in devising its review standards for special litigation committees nevertheless recognized that in demand-required cases the directors' judgment is

committees to some level of review; however, the prevalent view is that a demand-required case is a case foregone. This result occurs because of the courts' unwillingness in such cases to scrutinize dismissal recommendations rendered by a majority of the board of directors. Contrary to the insights and advice of Judge Seitz, the result has been the introduction of a major pleading defense to substantive allegations in the form of a demand requirement. Most troubling of all is the complete dearth of insight as to how such disparate treatment is justified. To be sure, one has less concern for retaliation against a committee recommending a suit against a fellow director when that panel constitutes a majority of the board.[59] Such a situation gives reason to presume the panel's independence. However, it is now well recognized that retaliation is not the fount of collegial bias; a wide range of social and psychological mechanisms bond directors into a mutually supportive group.[60] If tasting should be the test of bad pudding, then we should be informed as well by the experience of defendant directors before their boardroom colleagues. In no reported case has a special litigation committee recommended continuance of the suit against a colleague.[61] Even more telling is the absence of any reported instance in which the directors have approved a suit's continuance in response to the plaintiff's demand. These are troubling statistics; one would have expected the plaintiffs to have scored before impartial boards or committees at least as well as they have before the courts.

As incongruous as these statistics are, they become doubly so in light of the overall record of plaintiffs' successes in derivative suits when neither a demand nor a special litigation committee thwarted the suit's continuance. The most comprehensive study of derivative suit litigation found that derivative suit plaintiffs have prevailed no less frequently than have plaintiffs in other types of litigation.[62] On the other hand, if we accept the judgment of special litigation committees and the defendants' colleagues in demand-required cases, derivative suits have no significant chance of success. Because the derivative suit plaintiff *consistently* encounters the same result whether before a committee or a majority of the board of directors, it is appropriate to question whether the courts' response to the directors' dismissal recommendation should be different in those two cases. *Alford III* wisely answered that courts have an important review function in each situation.

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presumptively valid. Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n.10 (Del. 1981). This presumption is further heightened by the narrow bases on which a demand will be excused. *See supra* note 44 and accompanying text.

59. *See Zapata Corp.*, 430 A.2d at 786-87.

60. *See supra* note 17.

61. Not surprisingly, committees have embraced only actions against noncolleague subordinate employees within the corporation. *See, e.g.*, Schwartz v. Bankamerica Corp., 826 F.2d 905 (9th Cir. 1987); *In re* Continental Ill. Sec. Lit., 732 F.2d 1302 (7th Cir. 1984).

62. Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U.L. REV. 306, 323 (1980). Indeed, evidence suggests that a significant percentage of derivative suits result in either judgments or settlements. *See* W. CARY & M. EISENBERG, CASES ON CORPORATIONS 888 (unabr. ed. 1980); *cf.* Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 906 (many derivative suits never brought because director mistakes go undetected).

IV. RISKY CHOICES AND STUNTED GROWTH

Certainly an important function of judicial review is overcoming any skewing of legal outcomes arising from unique phenomena of the corporate culture. Although it may be too easy to attribute the directors' consistent rejection of derivative suits against their colleagues to some level of collegial bias, it is entirely possible that their response is a natural reaction to such risky choices. The outcome of a derivative suit is not certain. Thus, a board or committee asked to assess the suit's impact on the corporate interest can evaluate it in a manner akin to other risky choices they confront in the boardroom. Under emerging theory and evidence of how managers make such choices, there is every reason to believe that the proposed derivative suit would be systematically disfavored.

Although older views of management decision making suggest that directors are risk averse, the current view is that they are both risk preferring and risk averse. Their aversion to and preference for risk depends on the outcomes of choices in relation to a "target point."[63] When all the outcomes of a choice fall above the target point, managers select the less risky choice, and thus act in accord with the widely held view that they are risk averse.[64] In the context of the derivative suit, the less risky choice would be the certainty of a suit's dismissal. Only when most of the choices confronting managers fall below the desired target level will they select the more risky options out of an apparent hope they may be able to achieve a result above the target point.[65] This theory may explain why directors are more willing to authorize suits against corporate personnel (but not directors) when the enterprise has failed than when it enjoys record performance.

To the extent that directors are risk averse, an important area of inquiry is whether their aversion is unusual vis-á-vis that of the judiciary, which otherwise controls the decision whether a suit should be dismissed because it is unlikely to further the corporate interest. For example, assume that the judiciary is usually unwilling to dismiss a suit that has a thirty percent or better chance of obtaining through settlement or judgment a recovery at least equal to the suit's costs. It would be disturbing if corporate jurisprudence deferred uncritically to the judgment of directors regarding corporate derivative suits if a thirty percent success rate was generally believed by directors to be insufficient for any continued action to serve the corporate interest. Just such a skewing appears probable for firms whose alternative choices for profitable undertaking are all above the accepted target point. Even if the risk level is not low, directors may be biased against the derivative suit that offers a strong upside potential simply because

63. *See* Fishburn, *Mean-Risk Analysis with Risk Associated with Below Target Returns*, AM. ECON. REV., March 1977, at 116; Kahneman & Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979). The significance of a target point in managerial decision making has been observed in a consistent body of research. *See, e.g.*, Holthausen, *A Risk-Return Model with Risk and Return Measured as Deviations from a Target Return*, AM. ECON. REV., March 1981, at 182; Payne, Laughhunn & Crum, *Further Tests of Aspiration Level Effects in Risky Choice Behavior*, 27 MGMT. SCI. 953 (1981).

64. Payne, Laughhunn & Crum, *supra* note 63, at 954.

65. *See* Laughhunn, Payne & Crum, *Managerial Risk Preferences for Below-Target Returns*, 26 MGMT. SCI. 1238, 1246 (1980).

the magnitude of its gains pale in comparison with the gains the firm derives through other undertakings.

A final concern with the proposal in *Alford II* favoring a dormant judiciary vis-à-vis the board's or committee's prerogatives over derivative suits is its impact on the development of normative conduct. To the extent that directors render their judgment about a suit's probable impact on the corporate interest by casting a careful eye to the existing state of the law, it assures that any future legal developments will be stillborn. To the historian's delight, this assures that past becomes prologue. With unwavering deference to the directors' judgments, society's emerging consciousness as to the appropriate roles and conduct of corporate managers will neither be captured by nor incorporated into the litigation process. For example, the evolving view that outside directors serve as monitors of managers has contributed immensely to expansion of the duty of care in recent cases involving corporate defensive maneuvers[66] as well as organic transactions.[67] But these legal developments would never have occurred[68] if such litigation had first been subject to a prescreening mechanism permitting the defendants' colleagues not only to gauge the suit narrowly by considering its impact only on the fisc of that corporation, but also to apply a retrospective and conservative view of the defendant managers' fiduciary obligations.

V. Conclusion

What unifies the vision of *Alford III* with the decisions of Judges Friendly and Seitz is a devotion to the review function of the court. Furthermore, each judge avoided setting forth mechanistic approaches to this review function, which could only serve to trivialize the undertaking. Finally, each judge realized that the ultimate concern of the court must be the overall fairness of the

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66. For example, the Delaware courts' handling of defensive maneuvers today is quite different from how they reviewed such tactics in the past. In an earlier case the Delaware Supreme Court accepted any measure of defensive tactic, so long as the board acted on a sincere belief that the "raider" intended some form of business change to the corporation. *See, e.g.*, Cheff v. Mathes, 199 A.2d 548, 556 (Del. 1964) (raider seen as a potential "liquidator," and one who would change the distribution methods of the company). More recently, the Delaware Supreme Court imposed a requirement that any defensive maneuver must also be proportional to the threat posed to the corporation or its stockholders and further held that the independent directors have an obligation when an auction is in progress not to disturb the procedures for a fair auction for its control. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 181-82 (Del. 1986).

67. The careful inspection of the price at which the company or a division will be sold, required in recent cases, underscores the emerging view that the central role of outside directors of public corporations is to monitor the corporation's affairs for the benefit of the stockholders. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 277 (2d Cir. 1986); Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985).

68. The second level of review embraced by the Delaware Supreme Court in Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), invites courts also to give "special consideration to matters of law and public policy in addition to the corporation's best interests." *Id.* at 789. Such a development would, of course, portend a significant shift of the derivative suit's mission—from seeking to compensate to serving a deterrent function by establishing normative standards for others rather than reaching a result that improves the treasury of the corporation. *See generally* Cox, *supra* note 8, at 763-76 (discussing the deterrent function of derivative lawsuits). Although such a result would be an important change in how derivative suit litigation is viewed, it nevertheless would be a most honest and justified perception of the derivative suit's operation. Such a forthright statement of the mission of this important therapeutic vehicle is long overdue.

process and that this process is threatened by the weakness of the parties' incentives.

The review required after *Alford III* applies to both demand-required and demand-excused cases.[69] The court thus avoids the Delaware result, in which a marked difference in review occurs if the plaintiff can skillfully implicate a majority of the directors as primary defendants.[70] In addition, the Delaware approach leaves no room for recognizing that one may have greater trust in the judgment rendered by a committee appointed by independent counsel to the firm, as occurred under the facts of *Alford III*, than a committee selected by the defendants. Moreover, one should have more confidence in a committee not only nominated by outsiders, but whose members never shared any boardroom experiences with the defendants until after they rendered their decision. This situation also occurred in *Alford III*. These are all problems of the rigid Delaware dichotomy between demand-required and demand-excused cases, but just such rigidity also was introduced by *Alford II* with even less sympathy for the demand-excused case than Delaware would extend. Furthermore, if *Alford II* had not been reconsidered, North Carolina corporations would have no incentive to perform as admirable a job as the corporation in the *Alford* litigation did in assuring the independence of its committee members.

The most significant contribution of *Alford III*, therefore, is that it invites a most flexible and pragmatic judicial review of the directors' recommendation. It recognizes a continuum of cases in which the court can interact with a host of variables, including the level of detachment of the deciding directors from the controversy and from the defendants, the nature and depth of the investigation rendered, the nature and magnitude of the alleged misbehavior, and the importance of the issue raised in the suit to evolving corporate norms. To be sure, the review contemplated does not lend itself to any formula-like approach.[71] As occurred in the proceedings before Judge Friendly and Judge Seitz, the reviewing court can find assurances only in its own commitment to making a decision in the corporate interest.[72] This is the commitment of heroes and we are all better off when such commitments are made.

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69. *Alford III*, 320 N.C. at 472, 358 S.E.2d at 327. In this respect, North Carolina adopts the position recommended in the proposals currently before the American Law Institute. *See* A.L.I., *supra* note 24, §§ 7.03, 7.08 (preserving the demand requirement as a means of imparting notice to the board, but subjecting board recommendations to the same review procedures whether a demand is required or excused). North Carolina, however, is not the only state to take such steps. Furthermore, the *Alford III* court concluded demand was excused because the plaintiff alleged that the directors on the reviewing committee permitted the alleged fraudulent acts to occur and were also nominated and elected by the defendants. 320 N.C. at 472, 358 S.E.2d at 327. The court's requirement of a review in all cases overcomes commentators' earlier concerns that a proper disposition of *Alford III* required a predetermination whether the case was a demand-required or demand-excused case. *See* DeMott, *The Corporate Fox and the Shareholders' Hen House: Reflections on* Alford v. Shaw, 65 N.C.L. REV. 569, 578 (1987).

70. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n.10 (Del. 1981).

71. A veritable cookbook approach is prescribed in the current proposals to the ALI. *See* A.L.I., *supra* note 24, § 7.08(c)-(d). Although the standards imposed by the ALI address the major concerns related to the decision whether the directors' recommendation should cause the suit to be dismissed, their rigidity risks trivializing the important review function of the courts and, more importantly, robbing the courts of the self-imposed responsibility to assess which result best serves the corporate interest.

72. The reviewing court's central role as the final arbiter of the corporate interest complements its responsibility to tax the plaintiff with the defendants litigation expenses, including attorneys fees, when the court believes the action was brought "without reasonable cause." N.C. GEN. STAT. § 55-55(e) (1982). Such a fee shifting device, responsibly enforced by the courts, offers far greater promise of protecting the corporate interest than does the special litigation committee which is both expensive and fraught with the potential corrupting influence of the defendant's associations with the committee members. Conard, *Winnowing Derivative Suits Through Attorneys Fees*, 47 LAW & CONTEMP. PROBLEMS, Winter 1984 at 269.