Shareholder Derivative Suits under the New North Carolina Business Corporations Act

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Shareholder derivative suits afford a means for enforcing corporate directors' fiduciary duties of care and loyalty. Derivative suits allow a shareholder, on behalf of a corporation, to attack wrongdoing by directors who could otherwise avoid liability simply by voting as a board not to sue themselves.¹

Because majority shareholders can control the board's activity directly by their voting power, shareholder derivative suits are primarily a tool minority shareholders can use to attack the activities of the corporation's directors.² However, high litigation costs and the potential to recover attorneys' fees mean that derivative suits are subject to use for strategic purposes which are frequently not in the corporation's best interest. In the worst case, a derivative suit is a frivolous claim to force a settlement benefiting only the plaintiff's attorneys.³ The fact that the corporation itself generally will bear the cost is no deterrent when the plaintiff has only a minimal ownership position in the corporation.⁴

In an attempt to balance these competing concerns, statutes creating the authority to bring a shareholder derivative action also impose procedural requirements to control abuse of derivative suits.⁵ The difficulty for both statute draftsmen and academic commentators is in deciding how restrictive the procedural limitations should be to eliminate strike suits given that such restrictions have the potential for obstructing meritorious suits. As a result of this trade-off, one's opinion about a particular set of derivative suit procedures depends on whether one views derivative suits as a valuable control on management or as a source of strike suits.⁶

In 1989 the North Carolina General Assembly adopted a new set of procedures to control shareholder derivative suits. These procedures are contained in section 55-7-40 of the new North Carolina Business Corporation Act (New Act).⁷ Although the section number under the New Act corresponds to that in

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² See id. at 271-73.
³ Id.
⁴ Id. See also 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) (discussing the lack of incentives for both plaintiffs and defendants to serve the corporation's interests).
⁵ See, e.g., N.C. GEN. STAT. § 55-7-40(a) (1990) (requiring contemporaneous ownership of shares of plaintiffs in derivative proceedings).
⁷ N.C. GEN. STAT. § 55-7-40 (1990). Additional requirements are imposed by the North Carolina Rules of Civil Procedure. See, e.g., N.C.R. CIV. P. 23(b) ("the complaint shall be verified by oath").
the Revised Model Business Corporation Act (Model Act), little else is taken from the Model Act's derivative suit provisions. The New Act carries forward all of the derivative suit provisions of the old North Carolina Business Corporation Act (Old Act). The General Assembly adopted several significant additions affecting where suit may be brought, how suits may be dismissed, and attorney-client privilege, and provided supplemental requirements for "public corporations".

This Note analyzes the statute in four sections based on when the issues arise in a derivative action. Part I examines the statutory requirements for initiating a derivative suit under the New Act. Part II addresses the methods available to a corporation to dismiss a derivative suit brought in its name. Part III focuses on the attorney-client privilege in derivative proceedings. Part IV discusses the barriers to bringing suit against a statutory public corporation. Provisions carried forward from the Old Act are mentioned but the analysis focuses on the significance of the new provisions. The Note concludes that the provision for a court-appointed committee to consider dismissal is a progressive innovation which could reduce litigation costs. The Note further concludes that the provisions restricting actions against statutory public corporations do not distinguish between meritorious and strike suits and recommends that these provisions be repealed.

I. INITIATION OF SUIT

Original jurisdiction over derivative suits is now vested exclusively in the superior court. Although the official comments do not clarify how this provision should work, its sole purpose is to deprive the state district courts of jurisdiction, not to affect federal court jurisdiction.

9. See id. The only derivative suit feature adopted from the Model Act is the authorization for the court to grant a stay until any investigation initiated by the corporation is complete. See N.C. GEN. STAT. § 55-7-40(b) (1990); REV. MODEL BUSINESS CORP. ACT § 7.40(b) (1984). In other subject areas the North Carolina Corporation Act generally follows the Model Act. See generally N.C. GEN. STAT. §§ 55-1-01 to 55-17-05 (1990).
11. See N.C. GEN. STAT. § 55-7-40(a) (1990); see also infra notes 15-16 and accompanying text (discussing jurisdiction).
12. See N.C. GEN. STAT. § 55-7-40(c) (1990); see also infra notes 31-84 and accompanying text (discussing dismissal by special litigation or court-appointed committee).
13. See N.C. GEN. STAT. § 55-7-40(h) (1990); see also infra notes 93-107 and accompanying text (discussing attorney-client privilege in derivative suits).
16. See General Statutes Commission Minutes, March 4, 1988, at 7. This provision originally was drafted in the negative to avoid any implication that the drafters intended to preclude federal jurisdiction but the Corporate Law Study Commission requested that it be reframed as it now appears because a state statute cannot deprive a federal court of its jurisdiction. Id.
The New Act retains the Old Act's contemporaneous ownership rule which requires a plaintiff to have been a shareholder at the time the action complained of occurred.\textsuperscript{17} This requirement is consistent with the Model Act,\textsuperscript{18} federal procedure,\textsuperscript{19} and the requirements of most other state statutes.\textsuperscript{20} This requirement also is satisfied when a plaintiff's shares were received by operation of law from a person who owned the shares at the time of the transaction giving rise to the complaint.\textsuperscript{21} The almost universal requirement of contemporaneous ownership is consistent with the general view of courts that allowing plaintiffs to buy law suits by purchasing shares of stock facilitates strike suits.\textsuperscript{22}

The requirement for a demand on the board of directors also is carried forward from the Old Act.\textsuperscript{23} This requirement closely resembles federal procedure\textsuperscript{24} and the Model Act.\textsuperscript{25} North Carolina law does recognize an equitable exception to the demand requirement when the directors in control of the corporation are primarily responsible for the alleged breaches of duty or are under the control of those who caused the alleged breaches of duty.\textsuperscript{26} This exception is based on the court's recognition that asking directors to sue themselves is futile.\textsuperscript{27} The New Act does not change the need to determine whether demand is excused in any particular case. The court must still determine whether the pleading states with sufficient particularity what demand was made or why it was not made.\textsuperscript{28}

\textsuperscript{17} "An action ... must allege, and it must appear, that each plaintiff was a shareholder or holder of a beneficial interest in such shares at the time of the transaction of which he complains ... ." N.C. GEN. STAT. § 55-7-40(a) (1990) (previously OLD ACT, supra note 10, § 55-55(a)).

\textsuperscript{18} See REV. MODEL BUS. CORP. ACT § 7.40(a) (1984) ("A person may not commence a proceeding ... unless he was a shareholder of the corporation when the transaction complained of occurred ... ").

\textsuperscript{19} See FED. R. CIV. P. 23.1 ("the complaint shall ... allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains ... ").


\textsuperscript{21} N.C. GEN. STAT. § 55-7-40(a) (1990) (previously OLD ACT, supra note 10, § 55-55(a)). ("or that his shares or beneficial interest in such shares devolved upon him by operation of law from a person who was a shareholder or holder of a beneficial interest in such shares at such time"). This provision also is consistent with both the Model Act and federal procedure.

\textsuperscript{22} See, e.g., Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 556 (1949) ("The federal court will not permit itself to be used to litigate a purchased grievance."). But see Harbrecht, The Contemporaneous Ownership Rule in Shareholders' Derivative Suits, 25 UCLA L. REV. 1041, 1064 (1978) (arguing that requiring court approval of settlements and requiring the plaintiff to account to the corporation for any proceeds insures only meritorious suits will be brought and that corporate management will be improved by the actions of attorneys acting as private attorneys general).

\textsuperscript{23} N.C. GEN. STAT. § 55-7-40(b) (1990) (based on OLD ACT, supra note 10, § 55-55(b)) ("The complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort.").

\textsuperscript{24} See FED. R. CIV. P. 23.1. The federal rule also requires that the pleadings describe the efforts made to obtain action from the shareholders, if necessary. Id.

\textsuperscript{25} REV. MODEL BUS. CORP. ACT § 7-40(b) (1984). No mention is made of demand on the shareholders in the Model Act. Id.


\textsuperscript{27} Id. ("In such case, the demand of a shareholder upon directors to sue themselves or their principals would be futile and as such is not required for the maintenance of the action.").

\textsuperscript{28} See, e.g., Hill v. Erwin Mills, Inc., 239 N.C. 437, 442, 80 S.E.2d 358, 361-62 (1954) (discussing application of demand requirement). Because there is no change in the law on this issue it
The New Act grants the court authority to stay a derivative suit while the board of directors investigates the allegations.\textsuperscript{29} Although this provision does create the potential for delay tactics by management, it is available at the court’s discretion and should be used only to allow the directors an opportunity to decide whether the corporation should pursue the claim directly.\textsuperscript{30}

II. DISMISSAL BY THE CORPORATION

The most controversial area of shareholder derivative suit procedures is the ability of the corporation’s board of directors to dismiss a suit after it is initiated. Commonly, a corporation’s board of directors responds to shareholder derivative suits by having a special committee of the board, composed of directors not accused of any wrongdoing, investigate the claims and recommend to the court that the action be dismissed as not in the corporation’s best interest.\textsuperscript{31} Courts have struggled to define their role in assessing the recommendations of these special litigation committees.\textsuperscript{32} Although one court has questioned the authority of a special litigation committee to dismiss a derivative suit against members of the board,\textsuperscript{33} the debate generally focuses on whether the court should show deference to the committee’s decision by applying the business judgment rule\textsuperscript{34} or treat the recommendation as a conflict of interest situation and not apply the business judgment rule.\textsuperscript{35} There is so much variation among courts on this issue will not be considered further in this Note. For a critical discussion of the demand requirement see Demott, \textit{Demand in Derivative Actions: Problems of Interpretation and Function}, 19 U.C. DAVIS L. REV. 461 (1986). For an evaluation of the Delaware demand-excused criteria see Aronson v. Lewis, 473 A.2d 805, 814-17 (Del. 1984) (creating a high threshold requirement for a plaintiff to show demand excused).

29. N.C. GEN. STAT. § 55-7-40(b) (1990) ("Whether or not a demand for action was made, if the corporation commences an investigation of the charges made in the demand or complaint, the court may stay any proceeding until the investigation is completed.") This provision was copied from section 7.40(b) of the Model Act. Business Corporation Act Drafting Committee Minutes, April 16, 1987, at 10-11.

30. REV. MODEL BUSINESS CORP. ACT § 7.40, official comments (1984) ("The purpose of this stay is to preserve the right of the board of directors to consider whether or not to seek to enforce on its own the corporation’s claim.").

31. The Model Act provides that "a board of directors may create one or more committees and appoint members of the board of directors to serve on them." REV. MODEL BUSINESS CORP. ACT § 8.25(a) (1984). "[E]ach committee may exercise the authority of the board of directors under section 8.01." \textit{Id.} § 8.25(d). "All corporate powers shall be exercised by or under the authority of ... its board of directors ...." \textit{Id.} § 8.01(c).


33. See Miller v. Register and Tribune Syndicate, Inc., 336 N.W.2d 709, 718 (Iowa 1983) (board members charged in litigation had no authority to empower committee to dismiss suit). \textit{But cf.} Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981) (interest taint of the majority of the directors does not bar the board from delegating power to independent committee).

34. The business judgment rule requires a court to presume that directors have used reasonable business judgment in exercising their duty of care. See H. HENN & J. ALEXANDER, \textit{LAWS OF CORPORATIONS} § 242 (3d ed. 1983).

35. Although the business judgment rule does not apply to conflict of interest situations, the Model Act allows the transaction to be cleansed and the business judgment rule to be applied if "the material facts of the transaction and the director’s interest were disclosed or known to the board of directors or a committee of the board of directors and the ... committee authorized, approved, or ratified the transaction." REV. MODEL BUSINESS CORP. ACT § 8.31(a)(1) (1984).
that the drafters of the Model Act chose not to take a position.36

In Auerbach v. Bennett,37 for example, the New York Court of Appeals applied the business judgment rule and concluded that the "determination of the special litigation committee forecloses further judicial inquiry."38 Under the Auerbach approach a court may only inquire into the disinterested independence of the committee members39 and the committee procedures.40 The Auerbach court considered the individual interests of the committee members without discussing either the potential influence exerted by interested directors41 or inherent structural bias.42 The court also stated that the special committee's procedures would be improper only if they appeared to be a sham, which requires a finding of either bad faith or fraud.43

In Zapata Corp. v. Maldonado,44 the Delaware Supreme Court adopted a less deferential approach to a motion by the corporation to dismiss a shareholder derivative suit.45 Under the Zapata approach, a court must apply a two-step test when considering a corporation's pretrial motion to dismiss.46 The first step is an inquiry into "the independence and good faith of the committee and the bases

38. Id. at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
39. Id. at 632, 393 N.E.2d at 1001, 419 N.Y.S.2d at 928. ("when individual members of a board of directors prove to have personal interests which may conflict with the interests of the corporation, such interested directors must be excluded").
40. Id. at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929. ("While the court may properly inquire as to the adequacy and appropriateness of the committee's investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment.").
41. See id. at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927. In Auerbach four out of fifteen board members were accused of wrongdoing. Id. The special litigation committee was made up of three directors, none of whom were on the board at the time of the transaction complained of or had any prior association with the corporation. Id. No mention is made of any previous relationships with individual members of the board. Id.
42. See id. But cf., Cox & Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 L. & Contemp. Probs., Summer 1985, at 83, 85-91 (discussion of social and psychological factors that create "structural bias" causing committee members to be hostile to derivative suits against fellow directors).
43. Auerbach, 47 N.Y.2d at 634-35, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929.
44. 430 A.2d 779 (Del. 1981). In Zapata the plaintiff initiated suit against ten officers and directors for breaches of fiduciary duty. Id. at 780. Four years later, while the action was pending and after four of the defendants had left the board, the corporation appointed two new directors, created a litigation committee composed of the new directors, and moved to dismiss the action based on the committee's investigation and recommendations. Id. at 780-81.
46. Zapata, 430 A.2d at 788. The motion must include a complete written record of the committee's investigation and findings and each side may make a record on the motion. Id. The burden
supporting its conclusions."\textsuperscript{47} The business judgment rule does not apply and the court will move to the second step only if it is satisfied "that the committee was independent and showed reasonable bases for good faith findings and recommendations."\textsuperscript{48} Under the second step, the court must decide if the motion should be granted based on "its own independent business judgment."\textsuperscript{49}

Although Zapata provided a favorable environment for complaining shareholders, it limited the application of the two-step test to demand-excused cases.\textsuperscript{50} In cases where demand had been made and refused, the Zapata court stated that it would respect the board's action unless it was "wrongful."\textsuperscript{51} In Aronson v. Lewis\textsuperscript{52} the Delaware Supreme Court made the practical implications of this limitation clear.

Under Aronson, a court may conclude that demand is excused only if "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."\textsuperscript{53} This requirement not only shifts the burden of proof back to the plaintiff\textsuperscript{54} but, as applied to the facts in Aronson where demand was not excused, it makes it almost impossible to have demand excused when less than a majority of the directors approving the transaction are interested.\textsuperscript{55}

The Supreme Court of Iowa took quite a different approach in Miller v. Register & Tribune Syndicate, Inc.\textsuperscript{56} The court held that directors who also were parties in the action lacked the power to establish an independent special committee to dismiss the law suit.\textsuperscript{57} The rationale of the court's decision was that

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  \item is on the moving party to show "that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law." \textit{Id.}
  \item \textsuperscript{47} \textit{Id.}
  \item \textsuperscript{48} \textit{Id. But cf. supra notes 37-43 and accompanying text (Auerbach court applying the business judgment rule under similar conditions).}
  \item \textsuperscript{49} Zapata, 430 A.2d at 789. "The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests." \textit{Id.}
  \item \textsuperscript{50} \textit{Id. at 784.}
  \item \textsuperscript{51} "[A] board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful." \textit{Id.} "The board's decision falls under the 'business judgment rule.'" \textit{Id. at 784 n.10.}
  \item \textsuperscript{52} 473 A.2d. 805 (Del. 1984). For a summary of the facts in Aronson see infra note 55.
  \item \textsuperscript{53} \textit{Id. at 814.} The standard for judging the exercise of business judgment is gross negligence. \textit{Id. at 812.}
  \item \textsuperscript{54} The business judgment rule requires a presumption that directors have satisfied their required duty of care. See H. HENN & J. ALEXANDER, supra note 34. Under Zapata, in interested director transactions, "the directors, once the transaction is attacked, have the burden of establishing its 'intrinsic fairness' to a court's careful scrutiny." Zapata, 430 A.2d at 788 n.17.
  \item \textsuperscript{55} In Aronson, the chairman of the board owned 47% of the outstanding stock and allegedly selected all of the directors. Aronson, 473 A.2d at 808-09. The board then approved a generous employment contract which included payments for life and death benefits regardless of whether he actually performed any services for the corporation. \textit{Id.} The court held that the complaint did not "factually particularize[:] any circumstances of control and domination to overcome the presumption of board independence, and thus render[ed] the demand futile." \textit{Id. at 817.}
  \item The Aronson demand futility test does not apply in cases where the corporation has taken a neutral position on the litigation. Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 732 (Del. 1988). The board's "'position of neutrality excuses Plaintiffs' failure to make demand." \textit{Id. at 731.}
  \item \textsuperscript{56} 336 N.W.2d 709 (Iowa 1983).
  \item \textsuperscript{57} \textit{Id. at 718.} In Miller, all four of the directors at the time of the transaction complained of
because the risk of "structural bias" is so great and difficult to demonstrate, a "prophylactic" rule is required. As an alternative to board-appointed litigation committees, the Miller court held that the corporation could apply to the court for appointment of a "special panel" which would exercise the board of directors' power to investigate the complaint and recommend dismissal.

The Virginia legislature has adopted by statute the concept of a court-appointed committee. Unlike the Miller situation, there is nothing in Virginia law to indicate that special litigation committees are unable to dismiss actions without resort to the court-appointed committee. Further, under the Virginia approach, the court may appoint a committee at its own discretion, while the Miller approach envisions the committee appointment only at the corporation's request. The Virginia statute clearly states that the court has the option to include disinterested directors on the committee. Presumably, interested directors could not be appointed to the committee.

The North Carolina Supreme Court addressed the problem of special litigation committees in Alford v. Shaw. The Alford court adopted a Zapata-type judicial scrutiny approach to special litigation committee recommendations with one significant modification: there is no distinction in the review standard be-

58. _Id._ at 718. "We conclude that we should prevent the potential for structural bias in some cases by effectively limiting the powers of such directors in all cases." _Id._ See generally Cox & Munsinger, supra note 42, at 83 (discussing the basis of structural bias). It is not clear what the Miller court would have decided if less than a majority of the board was interested, because the concerns with "structural bias" would still apply.

59. _Miller_, 336 N.W.2d at 718. A dissenting judge expressed practical concerns about how the trial judge would decide "whether to grant such an application, whom to appoint, and how to decide such matters as who pays the panel . . . [and] [w]hat access will the panel have to internal corporate records." _Id._ at 720-21 (Wolle, J., dissenting).

60. The Virginia statute provides that:

The court may appoint a committee composed of two or more disinterested directors or other disinterested persons to determine whether it is in the best interests of the corporation to pursue a particular legal right or remedy. The committee shall report its findings to the court. After considering the report and any other relevant evidence, the court shall determine whether the proceeding should be continued or not.


62. _See_ VA. CODE ANN. § 13.1-672(D) ("court may appoint a committee").

63. _See_ Miller, 336 N.W.2d at 718 ("a corporation may apply to the court for appointment of a 'special panel'").

64. VA. CODE ANN. § 13.1-672(D) ("disinterested directors or other disinterested persons").

tween demand-excused and other cases. Under Alford, before ruling on a motion for summary judgment, the court must consider the committee report and all other relevant facts and circumstances to determine whether the defendants will be able to show that the transaction was fair to the corporation. Even if the special litigation committee is found to be disinterested and independent, the plaintiff may still prove that the committee members were not qualified to assess the claim, that false information was supplied to the committee, or that "structural bias inherent in the use of board-appointed special litigation committees... eviscerates plaintiffs' opportunities as minority shareholders to vindicate their rights under North Carolina law." The court based its decision on the legislative policy of protecting minority shareholders. The statute requires that derivative suits not be discontinued before the court gives notice to any shareholders or creditors whose interests will be "substantially affected by such discontinuance, dismissal, compromise or settlement." The Alford court stated that this determination requires a substantive review of the litigation committee's report.

The New Act introduces a provision authorizing the use of a court-appointed committee to decide whether a derivative action is in the best interests of the corporation. The Drafting Committee's primary concern in adopting this provision was the failure of special litigation committees to provide a cost effective means for corporations to dismiss derivative suits. The Committee rejected a proposal to adopt the Auerbach review standard by statute so as to

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66. Alford, 320 N.C. at 472, 358 S.E.2d at 327. See supra notes 44-51 and accompanying text (discussing Zapata approach).
67. Id. at 473, 358 S.E.2d at 328. 
"[W]hen a stockholder in a derivative action seeks to establish self-dealing on the part of a majority of the board, the burden should be on those directors to establish that the transactions complained of were just and reasonable to the corporation..."
68. Id.
"The Alford court stated that even if the plaintiff was likely to prevail, if "the amount of the recovery would not be sufficient to outweigh the detriment to the corporation, the court could still allow... dismissal." Id. at 471, 358 S.E.2d at 327. When read in conjunction with the board's broad authority to indemnify directors and officers, this provides an efficient way for a corporation to justify dismissal. See N.C. GEN. STAT. § 55-8-57(a) (1990) (indemnification allowed unless party knew or believed his actions were "clearly in conflict with the best interests of the corporation").
69. Alford, 320 N.C. at 470, 358 S.E.2d at 326.
70. Id. (quoting OLD ACT, supra note 10, § 55-55(e)). This provision is retained in the New Act at N.C. GEN. STAT. § 55-7-40(d) (1990).
71. "To rely blindly on the report of a corporation-appointed committee... is to abdicate the judicial duty to consider the interests of shareholders imposed by statute. This abdication is particularly inappropriate... where shareholders allege serious breaches of fiduciary duties owed to them by directors controlling the corporation." Alford, 320 N.C. at 471, 358 S.E.2d at 327.

Upon motion of the corporation, the court may appoint a committee composed of two or more disinterested directors or other disinterested persons, acceptable to the corporation, to determine whether it is in the best interests of the corporation to pursue a particular legal right or remedy. The committee shall report its findings to the court. After considering the report and any other relevant evidence, the court shall determine whether the proceeding should be continued or not.

73. See Business Corporation Act Drafting Committee Minutes, March 14, 1988, at 3. E.g., Kaplan v. Wyatt, 484 A.2d 501, 515 (Del. Ch. 1984) (attorneys' fees alone for the committee report
invalidate the court's holding in _Alford_. The Committee also chose not to address directly the costs of the court-appointed committee, assuming these would be treated as court costs.

This history, combined with the express language of the statute, makes it clear that the court-appointed committee provision is not a substitute for the _Alford_ approach but an alternative. Because both court- and board-appointed committees are now available options, it is appropriate that the court-appointed committee be established only on motion from the corporation. This protects the corporation's right to exercise its own authority to appoint a committee and prove its independence in court. Although the provision granting the corporation a veto over members of the court-appointed committee is troublesome, it is appropriate for two practical reasons. It gives corporations an incentive to use the court-appointed committee rather than appointing its own committee, and it establishes the corporation's role in selecting members of the committee.

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cost $500,000), _aff'd_, 499 A.2d 1184 (Del. 1985); Drafting Committee Minutes, March 14, 1988, at 3 (Professor Cox estimated the cost of the _Alford_ report at $800,000).

74. The Committee adopted the provision primarily to reduce costs, not to deter strike suits. Business Corporation Drafting Committee Minutes, March 14, 1988, at 3. The Drafting Committee believed that the fee shifting provision in § 55-7-40(f) of the New Act would sufficiently deter strike suits. _Id_. At the time of the committee's decision the provision was identical to the Virginia statute, but the General Assembly adopted a modified version which provides a veto to the corporation. See _supra_ note 71 for the text of the provision as adopted. See _supra_ text accompanying notes 37-43 for a discussion of the _Auerbach_ standard of review.

75. Business Corporation Act Drafting Committee Minutes, April 16, 1987, at 11. The court could, under appropriate circumstances, require the plaintiff to pay the expenses under § 55-7-40(f).

76. An alternative which does not require a motion by the corporation may be the appointment of a special master by the court under its inherent equitable authority. _See_, e.g., _In re Hardy_, 294 N.C. 90, 104, 240 S.E.2d 367, 376 (1978) (Lake, J., concurring in part and dissenting in part) (special master may be appointed by the court "to conduct an inquiry, which this Court, itself, could conduct, and make a report to this court."). While the statute does not make the court-appointed committee provision exclusive, this is not the type of situation where a court typically would appoint a special master. _See_, e.g., _In re Edwards_, 243 N.C. 70, 71, 89 S.E.2d 746, 747 (1955) (per curiam) (special master used in property settlement for an incompetent); _Housing Authority v. Montgomery_, 55 N.C. App. 422, 286 S.E.2d 114 (special master used in compensation determination in an eminent domain proceeding), _review denied_, 305 N.C. 585, 292 S.E.2d 570 (1982).

77. _See_ N.C. GEN. STAT. § 55-7-40(c) (1990) ("committee composed of ... disinterested persons, acceptable to the corporation"). One concern is that this would allow the board to influence the committee, but this possibility is unlikely because the court has the primary responsibility for appointing the committee and the committee must report to the court, rather than to the board. _See id_. The court may also refuse to appoint a committee. _Id_. A second concern is whether this affects the level of deference the court will show to the committee's report. _See infra_ notes 82-84 and accompanying text (discussing proper role of court in review of committee report).

78. There is some risk that defendants will avoid use of the court-appointed committee, even with the veto provision, out of fear that the committee will build the plaintiffs' case for them. This is also good for plaintiffs because, under the special litigation committee approach, the committee almost always recommends dismissal and the result generally is an expensive court battle over the independence of the committee rather than the merits of the suit. _See supra_ note 72. This issue is ideal for strike suits and creates an additional litigation problem which must be resolved before addressing the merits of the claim in a legitimate suit.

79. Under _Miller v. Register & Tribune Syndicate_, Inc., 336 N.W.2d 709 (Iowa 1983), the practical problem of selecting committee members was not addressed. In complex litigation it would be inappropriate to ignore totally the board's special expertise and resources in selecting members of the court-appointed committee since, under _Alford_, the plaintiff is given the right to challenge a committee's qualifications to assess complicated information. _Allford v. Shaw_, 320 N.C. 465, 473, 358 S.E.2d 323, 328 (1987). There is little incentive for the board to abuse this authority because the court retains the authority to consider the report "and any other relevant evidence" in deciding whether to dismiss the suit. _See_ N.C. GEN. STAT. § 55-7-40(c) (1990). Any indication that the
The court’s authority to appoint committee members gives it the opportunity to address the “structural bias” concerns mentioned in Alford.

The last issue implicated by the court-appointed committee provision is the role the court will play in reviewing the committee’s report. The court is not bound by the committee’s determination, but there is no reason for the court to appoint a committee if it will still face the same problems raised in Alford in assessing the board-appointed litigation committee’s recommendation. To effectuate this provision, the court should not appoint a committee unless it is willing to give the committee a presumption of good faith and independence. This shifts the burden of challenging the independence of the committee to the plaintiff. The plaintiff thus should challenge the independence of the board at the time of its appointment rather than after the report is issued because the court is unlikely to reverse its own determination that the board was independent. It is less clear what impact this provision will have on the deference given to the substantive contents of the committee’s report. Although the court is free to exercise its own judgment based on the report, for practical reasons, the court is likely to show a great deal of deference to its own committee.

III. PROCEEDINGS AND RESOLUTION OF ACTION

One area of academic dispute in shareholder derivative suits is the corporation’s invocation of the attorney-client privilege to resist discovery requests made by its shareholders. The danger in allowing a broad attorney-client privilege in derivative suits is that it may disable the capacity of minority shareholders to prove legitimate grievances.

board was trying to control the committee could leave the corporation in the same position it would have been in if it had used a board-appointed committee.

80. See N.C. GEN. STAT. § 55-7-40(c) (1990).
81. See Alford, 320 N.C. at 473, 358 S.E.2d at 328. See also Cox & Munsinger, supra note 42, at 134 (committee “should not include any of the defendants’ colleagues (past or prospective) or even those likely to share a cultural identity with the defendants”).
82. See supra note 54 discussing burden of proof under corporate motion to dismiss in a derivative action; cf Alford, 320 N.C. at 473, 358 S.E.2d at 328 (“burden should be upon [self-dealing] directors to establish that the transactions complained of were just and reasonable”).
83. Alford stressed the “judicial duty to consider the interests of shareholders imposed by the statute.” Alford, 320 N.C. at 471, 358 S.E.2d at 327.
84. See Business Corporation Act Drafting Committee Minutes, March 14, 1988, at 3. This is especially true in complex disputes where the court is already dependent on “expert” opinion in exercising its independent judgment.

An additional factor favoring deference to the committee’s recommendation is that the court’s reason for not showing deference in Alford was the statutory duty to consider shareholder interests. See supra text accompanying notes 68-70. The current statute shows significantly less concern for the rights of minority shareholders and more concern for creating barriers to derivative suits. See infra notes 127-39 and accompanying text.

85. See D. Demott, supra note 20, § 4:15, at 140-43. The United States Supreme Court has recognized and given an expansive scope to the right of a corporation to assert the attorney-client privilege against third parties. Upjohn Co. v. United States, 449 U.S. 383, 396-97 (1981) (adopting a case by case factual approach to determining which employees could be considered clients for purposes of the privilege rather than a “control group” test limiting the privilege to communications to senior management).
86. See, e.g., F. O’Neal & R. Thompson, O’Neal’s Oppression of Minority Shareholders § 7.08 (2d ed. 1985).
The federal courts have developed most of the case law addressing this issue. The leading case is *Garner v. Wolfinbarger*, in which a federal district court held that the attorney-client privilege applies to shareholder derivative suits. However, the court recognized that in a suit claiming corporate action inconsistent with shareholder interests, the shareholders should have the opportunity to show good cause why the privilege should not apply to a specific request. The court attempted to balance the adverse impact on attorney-client disclosure and the interest of nonparty shareholders against the potential benefits of correct disposal of the litigation that would result from making the information available to those "for whom it is, at least in part, exercised." In subsequent cases, the federal courts have limited the *Garner* derivative suit exception by refusing to apply it to "communications exchanged between the party alleged to have committed the offenses and an attorney acting in his professional capacity to represent the party in proceedings involving the alleged offenses."

In *Swenson v. Thibaut*, the North Carolina Court of Appeals refused to allow a corporation to assert a claim of attorney-client privilege against complaining shareholders in a derivative suit. The *Swenson* decision is, however, distinct in its fact pattern. The corporation did not assert the privilege to avoid discovery but to prevent a law firm that had previously worked for the corporation from representing the plaintiff shareholders in the derivative suit. The *Swenson* court also based its holding on legal reasoning completely different from that used by the federal courts. Although the company was nominally aligned as a defendant in the action, the court elected to treat the company as a

87. 430 F.2d 1093 (5th Cir. 1970).
88. Id. at 1103-04.
89. The claim in *Garner* was based on an issuance and sale of stock and the plaintiffs' desire to depose the attorney who had advised the corporation on the transaction. Id. at 1095-96. The attorney in question had since joined the corporation and at the time of this suit was its president. Id.
90. Id. at 1103-04.
91. Id. at 1101. A variety of factors were considered relevant including: the number of shareholders and the percentage of stock they represent; the bona fides of the shareholders; the nature of the shareholders' claim and whether it is obviously colorable; the apparent necessity or desirability of the shareholders having the information and the availability of it from other sources; whether the communication related to past or to prospective actions; whether the communication is of advice concerning the litigation itself . . . .
92. In re *LTV Secur. Litig.*, 89 F.R.D. 595, 607 (N.D. Tex. 1981). The standard for avoiding the attorney work-product privilege in derivative suits is the normal "substantial need/undue hardship" requirement of Federal Rule of Civil Procedure 26(b)(3). See *In re International Systems & Controls Corp.*, 693 F.2d 1235, 1239 (5th Cir. 1982) (basis for the exception only exists where there is "mutuality of interest" between management and shareholders).
94. Id. at 110-12, 250 S.E.2d at 300-01.
95. Id. at 82-87, 250 S.E.2d at 283-87. The law firm previously had been hired to determine the company's compliance with North Carolina law in connection with an involuntary rehabilitation action several years before. Id. The law firm's role in the rehabilitation was adverse to the individual defendants, as indicated by the court's refusal in the earlier action to allow the company to change to different counsel. Id. at 110-12, 250 S.E.2d at 300-01.
96. See supra text accompanying notes 87-91 for discussion of the federal court treatment of the attorney-client privilege in shareholder derivative suits.
plaintiff, and the company therefore lacked standing to assert the attorney-client privilege or any other defenses on the merits.\footnote{97} The New Act includes a provision which assures the corporation in derivative suits the same attorney-client privilege it would have in actions against third parties.\footnote{98} Although this provision clearly overrules the unusual basis for the \textit{Swenson} decision, it would not require a different result on the distinct facts of that case.\footnote{99} Its primary effect is to eliminate the good-cause exception articulated in \textit{Garner v. Wolfinbarger}.\footnote{100} It is less clear whether the provision is designed to facilitate attorney-client communications\footnote{101} or if it is simply one more example of a statutory shift from concern for the rights of minority shareholders to protection of management.\footnote{102}

There is no evidence that application of the good-cause exception in the North Carolina courts has had a chilling effect on the flow of information between attorneys and their corporate clients.\footnote{103} In light of the narrow interpretation federal courts have given \textit{Garner},\footnote{104} the practical impact of this provision is unlikely to advance the policy objectives of the attorney-client privilege.\footnote{105} By

\footnote{97. \textit{Swenson}, 39 N.C. App. at 101, 112, 250 S.E.2d at 294, 301.}
\footnote{98. In proceedings hereunder, no shareholder shall be entitled to obtain or have access to any communication within the scope of the corporation's attorney-client privilege which could not be obtained by or would not be accessible to a party in an action other than on behalf of the corporation. N.C. GEN. STAT. § 55-7-40(h) (1990).}
\footnote{99. \textit{Swenson} did not directly involve "access to any communication," N.C. GEN. STAT. § 55-7-40(h) (1990), but rather an attempt to disqualify the plaintiffs' attorney. \textit{See supra} notes 94-95 and accompanying text.}
\footnote{100. 430 F.2d 1093 (5th Cir. 1970). \textit{See supra} notes 87-91 and accompanying text.}
\footnote{101. This is a uniformly accepted objective. \textit{See}, e.g., Upjohn Co. v. United States, 449 U.S. 383 (1981) (recognizing a broad attorney-client privilege for corporations); \textit{see also} Saltzburg, Corporate Attorney-Client Privilege in Shareholder Litigation and Similar Cases: Garner Revisited, 12 Hofstra L. Rev. 817, 835-44 (1984) (asserting that Garner failed to facilitate attorney-client communication); \textit{Note}, The Shareholders' Derivative Claim Exception to the Attorney-Client Privilege, 48 L. & Contemp. Probs., Summer 1985, at 199, 227 (arguing against any exception since it discourages full and frank disclosure).}
\footnote{102. \textit{See} F. O'Neal & R. Thompson, \textit{supra} note 86, § 7.08. The old North Carolina Act put a minority shareholder "‘in a more favorable position to seek redress on behalf of his corporation for wrongs allegedly done to it by the majority of shareholders, the directors and officers, or outside third parties.’" Alford v. Shaw, 320 N.C. 465, 470, 358 S.E.2d 323, 326 (1987) (quoting R. Robinson, NORTH CAROLINA CORPORATION LAW AND PRACTICE § 14-1 at 214 (3d ed. 1983)). \textit{See also} N.C. GEN. STAT. § 55-2-02 (1990) (articles of incorporation may eliminate director liability unless bad faith/improper personal benefit); § 55-6-30(a) (no preemptive rights unless elected in articles of incorporation); § 55-7-28 (no cumulative voting unless provided in articles of incorporation); § 55-8-57(a) (authority to indemnify directors in derivative actions unless director knew his activities were "clearly in conflict with the best interests of the corporation"); § 55-11-03(e) (simple majority vote is sufficient to approve merger or share exchange); § 55-13-02(b) (dissenters' rights exclusive remedy unless "unlawful or fraudulent" action by directors).}
\footnote{103. In fact the Corporate Law Study Commission, rather than the Drafting Committee, introduced this provision along with the restrictive provisions of § 55-7-40(g). General Statutes Commission Minutes, June 3, 1988, at 5. The Drafting Committee actually expressed concern that the provision unintentionally might "limit the availability to a corporation's management of material falling within the corporation's attorney-client privilege." Business Corporation Act Drafting Committee Minutes, June 1, 1988, at 2.}
\footnote{104. \textit{See supra} note 92 and accompanying text.}
\footnote{105. The \textit{Swenson} decision could have been overturned by recognizing the attorney-client privilege without making it coextensive with actions brought by non-shareholders. \textit{See supra} text accompanying note 97.}
creating an absolute rule, it does provide an opportunity for abuse, especially in the close corporation context. In individual cases, a court still may turn to other exceptions to avoid inequities. By preventing the courts from considering the unique relationships between shareholders and their corporation in deciding when the attorney-client privilege should not apply, this statute inadvertently may cause an overly broad interpretation of other exceptions to the privilege. It would be unfortunate if courts expanded the general exceptions to avoid inequities to minority shareholders. Such broad interpretation could undercut the legitimate goals of the attorney-client privilege in other cases.

Two additional aspects of the shareholders' derivative action statute, both carried forward from the Old Act, address important issues related to resolving derivative suits. One provision requires court approval of derivative suit termination. Before approving termination, the court must decide if the interests of any class of shareholders or creditors will be “substantially affected” and may provide notice to any class so affected. These requirements are similar to those in the Model Act. The court approval provision ensures representation of the corporation’s best interests under circumstances when the plaintiffs could be more concerned with their narrow interests or maximizing attorney fees.

The new statute also retains the Old Act’s provisions for awarding attorneys’ fees both to successful plaintiffs and to successful defendants. The

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106. See F. O’NEAL & R. THOMPSON, supra note 86, § 7.08.
107. See Note, supra note 101, at 211-17, 227 (the existing joint-client, crime-fraud and fiduciary duty exceptions to the attorney-client privilege provide sufficient flexibility and any derivative suit exception will lead to uncertainty in application of the good-cause requirement).
108. “Such action shall not be discontinued, dismissed, compromised or settled without the approval of the court.” N.C. GEN. STAT. § 55-7-40(d) (1990) (previously OLD ACT, supra note 10, § 55-55(c)).
109. If the court shall determine that the interest of the shareholders or any class or classes thereof, or of the creditors of the corporation, will be substantially affected by such discontinuance, dismissal, compromise or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to such shareholders or creditors whose interests it determines will be so affected.
N.C. GEN. STAT. § 55-7-40(d) (1990) (previously OLD ACT, supra note 10, § 55-55(c)).
110. REv. MODEL BUSINESS CORP. ACT § 7.40(c) (1984). One difference is that when a class’s interest is substantially affected, the Model Act provides that the court “shall direct that notice be given.” Id. Another distinction is that the Model Act mentions only shareholders and not creditors. Id.
111. REv. MODEL BUSINESS CORP. ACT § 7.40, official comments (1984). (“This requirement seems a natural consequence of the proposition that a derivative suit is brought on behalf of the class of all shareholders and avoids many of the evils of the strike suit by preventing the individual shareholder-plaintiff from settling privately with the defendants.”). But see generally Coffee, supra note 4, at 671-77 (discussing the lack of incentives for parties to serve the corporation’s interests).
112. If the action on behalf of the corporation is successful, in whole or part, whether by means of a compromise and settlement or by a judgment, the court may award the plaintiff the reasonable expenses of maintaining the action, including reasonable attorneys’ fees, and shall direct the plaintiff to account to the corporation for the remainder of any proceeds of the action.

The Model Act does not expressly provide for an award of fees to the plaintiff because the right “is so universally recognized . . . that specific reference was thought to be unnecessary.” REV. MODEL BUSINESS CORP. ACT § 7.40, official comments (1984).
Drafting Committee considered the provision for awarding defendants attorney fees where plaintiffs brought actions "without reasonable cause" to be the primary deterrent to strike suits. This provision does not affect the court's ability to sanction either the defendants or the plaintiffs under Rule 11 of the Rules of Civil Procedure.

IV. SPECIAL RULES FOR PUBLIC CORPORATIONS

In the 1940's, under the impetus of the Wood Report, many states adopted "security for expense" statutes to control abuse of derivative proceedings for strike suit purposes. These statutes allow the court to require plaintiffs to post a bond with the court to indemnify the corporation against any expenses, including attorneys' fees, incurred in successfully opposing the action. The primary objective of these statutes was to discourage actions by plaintiffs with only a limited interest in the corporation without discouraging suits by plaintiffs who were more likely to represent the corporation's best interests. This aim was accomplished by allowing an exemption to the security bond requirement when the plaintiffs represented more than five percent of the corporation's stock.

During the 1960's, a new analysis effectively undercut the reasoning of the Wood Report and security for expense statutes lost academic support. Secur-

113. In any such action the court, upon final judgment and a finding that the action was brought without reasonable cause, may require the plaintiff or plaintiffs to pay to the defendant or defendants the reasonable expenses, including attorneys' fees, incurred by them in defense of the action. N.C. GEN. STAT. § 55-7-40(f) (1990) (previously OLD ACT, supra note 10, § 55-55(e)). See Lowder v. Doby, 79 N.C. App. 501, 340 S.E.2d 487 (applying the Old Act), review denied, 316 N.C. 732, 345 S.E.2d 388 (1986).

114. See Business Corporation Act Drafting Committee Minutes, April 11, 1988, at 3. The Committee even considered making the fee shifting provision mandatory. Id.

115. See N.C.R. Civ. P. 11. Rule 11 also allows the court to sanction the attorney directly, but the standard for an award of fees is presumably higher. Id. (court may certify "after reasonable inquiry [that] it is well grounded in fact" and "not interposed for any improper purpose"). Even if the standard was the same, a court is far more likely to exercise its discretion to award fees in a context where the legislature has expressed a specific desire that it do so.

116. F. Wood, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS (1944) [hereinafter WOOD REPORT].

117. The study included a survey of cases indicating that it was rare that anyone other than the attorney benefited, and concluded that plaintiffs were not adequately representing the corporation's interest because, in many cases, only a small percentage of shares was represented. WOOD REPORT, supra note 116.

118. See, e.g., N.C. GEN. STAT. § 55-7-40(g)(iii) (1990) (at court's discretion plaintiffs may be required to post a bond to indemnify corporation for all expenses connected to the proceeding).


120. See id. at 18.

121. See Note, Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience, 4 COLUM. J.L. & SOC. PROBS. 50 (1968). A survey found that plaintiffs and their attorneys evaded the statutes by a variety of techniques, including asserting federal claims to avoid the state security statutes, intervention to satisfy the five percent requirement, or arranging to sue in a sister state without a security for expense statute, either in that state's courts or in federal court using diversity jurisdiction. Id. at 59-64. See also Conard, A Behavioral Analysis of Directors' Liability for Negligence, 1972 DUKE L.J. 895, 901 n.21 (1972) (Wood Report analysis understates benefits of derivative suits by categorizing all private settlements as nonbeneficial); Garth, Nagel & Plager, Empirical Research and the Shareholder Derivative Suit: Toward a Better Informed Debate, 48 L. & CONTEMP.
ity for expense statutes now are used only in a minority of states. The Revised Model Business Corporation Act deleted the security for expense provision, and the North Carolina legislature, after specifically considering the issue, also chose not to include any such provision in the old Business Corporations Act.

The New Act Drafting Committee expressly rejected the security for expense statute which the General Assembly subsequently adopted. The Committee preferred to use the fee shifting provisions to deter strike suits. The Committee must have believed that security for expense provisions had failed to have the desired deterrent effect, as indicated by the move away from these provisions in other states.

Although the Drafting Committee did not support the security for expense provision, the Corporate Law Study Commission added it to the New Act. The Drafting Committee later modified the new provision by limiting its application to "public corporations." The Senate Judiciary Committee amended the provision to make imposition of the bond subject to the court's discretion.

In addition to requiring security for expenses, the "public corporation" section also includes an unusual modification of the contemporaneous ownership rule. To qualify as plaintiffs, shareholders must have owned shares of the corporation for a minimum of one year before bringing suit. This section also imposes a two-year statute of limitations on all derivative actions.

The special requirements in the public corporations section may lead to

PROBS., Summer 1985, at 83 (reviewing prior studies on derivative suits and recommending additional research to make up for the inadequacies of prior studies); Jones, An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits, 60 B.U.L. REV. 542 (1980) (study indicating a significantly higher “success” rate in derivative actions than the Wood Report).

122. One author noted that as of 1987 only 19 states had security for expense statutes. See D. DEMOTT, supra note 20, § 3:02. Most of these statutes follow the initial Model Business Corporation Act § 49, which provides an exemption if the plaintiffs hold more than five percent of the outstanding shares of any class of stock of the corporation. Id.


126. Id. See, e.g., GA. CODE ANN. § 14-2-123, official comment (1981) (legislature deleted the security for expense provision). See also Note, supra note 121 (pointing to failure of security for expense statutes to accomplish their objective).

127. General Statutes Commission Minutes, June 3, 1988. For text of the provision as adopted see infra note 130.


130. In addition to all other provisions of this section, any action brought on behalf of a corporation that is a public corporation at the time of such action against one or more of its directors for monetary damages the plaintiff or plaintiffs must (i) allege, and it must appear, that each plaintiff has been a shareholder or holder of a beneficial interest in shares of the corporation for at least one year; (ii) bring the action within two years of the date of the transaction of which he complains; and (iii) execute and deposit with the clerk a written undertaking with sufficient surety, approved by the judge, in an amount to be fixed by the judge to indemnify the corporation against any and all expenses expected to be incurred by the corporation in connection with the proceeding, including those arising by way of indemnity, if the court in its discretion so requires.

N.C. GEN. STAT. § 55-7-40(g) (1990).

131. Id. § 55-7-40(g)(ii).
forum shopping by plaintiffs. In most suits against public corporations, the plaintiffs should be able to raise either a federal claim, allowing the action to be brought in federal court, or sue in a sister state's courts where the corporation is subject to jurisdiction. As a result, rather than deterring shareholder derivative suits, the statute may drive them to less convenient forums.

These three requirements establish barriers to derivative actions that are totally unrelated to the merits of the cause of action. Although contemporaneous ownership assures that derivative suits cannot be bought, there is no reason to believe that an additional year of ownership will make the plaintiffs less likely to bring suit for improper purposes. The two-year statute of limitations on derivative actions is significantly shorter than the statute of limitations which would apply to the underlying action. This constraint is incapable of discriminating between strike suits and legitimate grievances. The security for expense statute fails to satisfy even the objectives of the discredited Wood Report, because the statute does not provide an exception for plaintiffs who hold a minimum percentage of the corporation's stock.

The across-the-board deterrent potential of the security for expense provision may go far beyond the burden of requiring posting of a bond in advance. This section, unlike the fee-shifting provision, does not articulate the standard for awarding costs to the corporation from the security bond. In most states with security for expense statutes, the corporation has recourse to the security unless the plaintiff is successful in the litigation. Hopefully, the courts will read this provision in conjunction with the fee shifting provision and limit awards to suits brought without reasonable cause. This result is not required, however, because the security for expense provision applies only to public corporations and is available to the corporation and not to third party defendants.

132. See J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964). In Borak, a shareholder brought both federal and state claims in the federal court. Id. at 430. The state claim was barred by state law because the plaintiff had not satisfied the security bond requirement for bringing a shareholder derivative suit. Id. The court held that this presented no barrier to providing appropriate remedies on the federal claim, even if state issues were involved. Id. at 434.

133. The security for expense provision of the corporation's state of incorporation would not be relevant. Only the forum state's requirements would apply. See Berkowitz v. Humphrey, 130 F. Supp. 142, 145 (N.D. Ohio 1955). In a shareholder's derivative action on behalf of a Pennsylvania corporation instituted in an Ohio court, the court noted that Ohio state courts would not apply the Pennsylvania security bond requirement, nor would the federal court in a diversity suit. Id. Presumably this same logic would apply to the one-year share ownership requirement.


135. It therefore does not serve the Wood Report's objective of insuring that plaintiffs adequately represent the corporation's best interests. See supra text accompanying notes 119-20.


137. N.C. GEN. STAT. § 55-7-40(f) (1990) (fee-shifting allowed "on a finding that the action was brought without reasonable cause").

138. See D. DEMOTT, supra note 20, § 3:02.

139. Compare N.C. GEN. STAT. § 55-7-40(g) (1990) with N.C. GEN. STAT. § 55-7-40(f) (1990) (only the former is limited to public corporations and expenses incurred by the corporation).
V. CONCLUSIONS

The new North Carolina derivative procedures carry forward the Old Act’s provisions relatively intact. The General Assembly has added three important new provisions. One of the new provisions, allowing a court-appointed committee to recommend dismissal, attempts to reduce the costs of weeding out non-meritorious suits. However, the other new provisions act as barriers to derivative actions.

The provision for a court-appointed committee to consider dismissal of a derivative action is a progressive attempt to address the high costs associated with overcoming the directors’ conflict of interest taint in many derivative actions. It will serve the best interests of both plaintiffs and defendants by avoiding much of the traditional litigation over the recommendations of board-appointed litigation committees. It also provides an opportunity to advance the public policy interest in disposing of these actions by giving the court an opportunity to appoint committee members in a manner which will overcome the inherent structural bias found in special litigation committees. This should not only reduce the costs of derivative actions but also improve the record of litigation committees in providing a fair hearing of minority shareholder grievances.

The practical impact of the second new provision, the attorney-client privilege section, is less clear. Because there is no indication of a significant problem with the privilege presently, combined with the narrow scope of the good-cause exception developed by the federal courts in derivative suits and the availability of other exceptions to avoid inequity, this provision should have little effect. It does, however, have the potential to introduce unjust results in specific cases, particularly in the close corporation context. Therefore, this provision should either be repealed or applied only to public corporations to allow courts to continue handling specific situations on a case-by-case basis.

The third new provision, containing three restrictions on derivative actions against public corporations, fails to discriminate between strike suits and legitimate actions. The principal result of these provisions may be to drive shareholder derivative suits against public corporations out of North Carolina courts limitation to the corporation and not to third party defendants may be rendered meaningless by the indemnification provisions of the act. See N.C. GEN. STAT. § 55-8-57 (1990). The board can vote to indemnify “directors, officers, employees, or agents against liability and expenses” in a derivative action by “bylaws or by contract or resolution” unless he “believed” at the time the actions were taken that they were “clearly in conflict with the best interests of the corporation.” Id. For a public corporation, a director’s vote in favor of indemnification is not considered a conflict of interest transaction. Id. Taken in conjunction with the security for expense statutes provision including any liability the corporation may have by way of indemnity, this statute would seem to cover all likely third party defendants.

140. N.C. GEN. STAT. § 55-7-40(c) (1990).
141. See supra notes 71-84 and accompanying text.
142. See supra notes 80-81 and accompanying text.
143. See supra note 76.
144. N.C. GEN. STAT. § 55-7-40(h) (1990).
145. See supra notes 87-99 and accompanying text.
146. N.C. GEN. STAT. § 55-7-40(g) (1990). See supra notes 125-39 and accompanying text.
and into either federal courts or sister state courts as plaintiffs seek to avoid the restrictions. The fee-shifting and court-appointed committee provisions along with the contemporaneous ownership requirement provide sufficient safeguards against strike suits without creating unreasonable barriers to meritorious suits. The only positive aspect of the public corporation provision is that it affects only the limited number of "public corporations" incorporated in North Carolina. This provision should be repealed, because the fee-shifting and court-appointed committee provisions adequately resolve the problem of strike suits.

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147. See supra notes 132-33 and accompanying text.
149. Id. § 55-7-40(c).
150. Id. § 55-7-40(a).
151. While considering the North Carolina Shareholder Protection Act, N.C. GEN. STAT. § 55-9-05 (which also applies to public corporations), the Drafting Committee estimated that only about two dozen companies would be affected, many of them banks and utilities which are also subject to heavy federal regulation which provides additional opportunities to avoid bringing suit in state court. Corporate Law Drafting Committee, Data Concerning Corporations Covered by the North Carolina Shareholder Protection Act, March 30, 1988.