1993

Corporate Law - Mergers and Double Derivative Actions: The New Frontiers in Derivative Standing

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CORPORATE LAW—Mergers and Double Derivative Actions: The New Frontier in Derivative Standing

Blasband v. Rales (1992)

I. INTRODUCTION

A derivative action is one of a shareholder's primary instruments for redressing corporate mismanagement.1 To bring a derivative action in Delaware, a shareholder must satisfy two fundamental requirements.2 First, a shareholder must establish standing by proving that he or she owned stock in the corporation at the time of the challenged transaction, and continued to hold stock in the corporation throughout the litigation.3 Second, a shareholder must either demand that the corporation's board of directors initiate the action, or plead that such a demand would be futile.4

The explosion of corporate mergers in the 1980s complicated this framework and, in many cases, eliminated a shareholder's ability to

1. See Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (acknowledging that "derivative action is one method by which shareholders may obtain redress for the misuse of managerial power"). In a shareholder derivative action, a plaintiff-shareholder asserts, on behalf of the corporation, a claim belonging to the corporation. See Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) (stating that "[a] shareholder derivative suit is a uniquely equitable remedy in which a shareholder asserts on behalf of a corporation a claim belonging not to the shareholder, but to the corporation").


In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law.

Id.; see also Lewis v. Anderson, 477 A.2d 1040, 1046 (Del. 1984) (commenting that, in post-merger suits in which § 327 applies, Delaware courts have required that shareholder not only own stock at time of challenged transaction but also when suit is commenced and throughout litigation). For a further discussion of Delaware's standing requirements, see infra notes 19-39 and accompanying text.

4. See Del. Ch. Ct. C.P.R. 23.1. Delaware Chancery Court Rule 23.1 provides that:

The complaint shall also 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 not making the effort.

Id.; see also Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) (stating that Rule 23.1 requires shareholders either to make demand on directors to initiate action or to plead that demand would have been futile). For a further discussion of Delaware's demand requirements, see infra notes 40-53 and accompanying text.
bring a derivative action. Specifically, mergers foreclosed derivative actions by interrupting the shareholder's continuous ownership in the pre-merger corporation, thereby preventing the shareholder from satisfying the standing requirement.

In Blasband v. Rales, the United States Court of Appeals for the Third Circuit bolstered the ability of shareholders to bring derivative actions in a merger environment. In Blasband, Easco Hand Tools (Easco) entered into a merger agreement with Danaher Corporation (Danaher). The agreement required shareholders of Easco to exchange their shares of Easco common stock for shares of Danaher common stock. Subsequent to the merger, Easco became a wholly-owned subsidiary of Danaher. Interpreting Delaware law, the Third Circuit held that the plaintiff-shareholder satisfied the continuous ownership requirement necessary to bring a derivative action challenging the merger on behalf of Easco. However, the Third Circuit further held that the

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5. See, e.g., Kramer v. Western Pacific Indus., Inc., 546 A.2d 348, 350-51 (Del. 1988) (holding that plaintiff who lost shareholder status through cash buy-out merger could not maintain derivative action); Lewis, 477 A.2d at 1042 (holding that plaintiff who exchanged his ownership interest in original corporation for shares in parent company, pursuant to merger agreement, lost ability to maintain derivative action on behalf of original corporation); Bonime v. Biaggini, No. 6925, 6980, 1984 WL 19830, at *2 (Del. Ch. Dec. 7, 1984) (holding that plaintiff was unable to maintain derivative action on behalf of pre-merger corporation when pre-merger corporation became wholly-owned subsidiary of newly-formed parent company and plaintiff exchanged his shares in pre-merger corporation for shares in newly-formed parent company), aff'd without opinion, 505 A.2d 451 (Del. 1985).

6. See, e.g., Kramer, 546 A.2d at 354-55 (noting that shareholder who relinquished ownership as result of cash buy-out merger failed to satisfy continuous ownership requirement); Lewis, 477 A.2d at 1049 (stating that shareholder who relinquished ownership in pre-merger corporation by exchanging his shares in pre-merger corporation for shares in newly-formed parent company failed to satisfy continuous ownership requirement); Bonime, 1984 WL 19830, at *2 (noting that shareholder who relinquished ownership due to merger after suit was filed failed to satisfy continuous ownership requirement).

7. 971 F.2d 1034 (3d Cir. 1992).
8. Id. at 1044, 1046.
9. Id. at 1038.
10. Id.
11. Id.
12. Id. at 1046. The plaintiff actually filed the derivative action on behalf of Danaher, the parent corporation. Id. at 1039. In effect, the action was "akin to a double derivative suit." Id. at 1046. A double derivative action is where: [t]he holding company owes a duty to use its control of the subsidiary to sue to right wrongs to it, and the shareholder may in effect compel specific performance of these connected duties in a double [derivative] action . . . .

In a 'double derivative' action, the shareholder is effectively maintaining the derivative action on behalf of the subsidiary, based upon the fact that the parent or holding company has derivative rights to the cause of action possessed by the subsidiary. The wrong sought to be remedied by the complaining shareholder is not only that done directly
shareholder failed to adequately demonstrate demand futility.\textsuperscript{13} Nevertheless, the court granted the shareholder leave to amend his complaint to allege the additional facts necessary to establish the futility of a proper demand.\textsuperscript{14}

This Casebrief first discusses the standing and demand requirements for shareholder derivative actions in Delaware,\textsuperscript{15} and sets forth the facts and procedural history of \textit{Blasband v. Rales}.\textsuperscript{16} Next, this Casebrief provides a detailed description of the Third Circuit's analysis in \textit{Blasband}.\textsuperscript{17} Finally, this Casebrief asserts that the \textit{Blasband} decision will facilitate shareholder derivative actions involving mergers, and suggests that, in \textit{Blasband}, the Third Circuit effectively clarified the demand requirement in Delaware, in the context of double derivative actions involving mergers.\textsuperscript{18}

\textbf{II. Background}

\textbf{A. Standing}

Under Delaware law, two elements are necessary to establish standing to the parent corporation in which he or she owns stock, but also the wrong done to the corporation's subsidiaries which indirectly, but actually, affects the parent corporation and its shareholders. Notwithstanding that the recognition of double derivative suits relaxes the plaintiff's contemporaneous ownership requirement, the acceptance of the action acknowledges the realities of the changing techniques and structures of the modern corporation. The ultimate beneficiary of a double derivative action is the corporation that possesses the primary right to sue.

\textsuperscript{13} Charles R.P. Keating & Gail A. O'Gradney, \textit{Fletcher Cyclopeda of the Law of Private Corporations} § 5977, at 240 (1991) (footnotes omitted). The action was "akin to a double derivative suit" and not a true double derivative suit because Blasband filed the action as a shareholder of Danaher, the parent company, to "pursue a cause of action on behalf of Danaher's wholly owned subsidiary, Easco," but Blasband was not a shareholder of Danaher at the time of the challenged transaction. \textit{Blasband}, 971 F.2d at 1046.

\textsuperscript{14} Id.

\textsuperscript{15} For a discussion of the Delaware standing requirement for derivative actions, see \textit{infra} notes 19-39 and accompanying text. For a discussion of the Delaware demand requirement for derivative actions, see \textit{infra} notes 40-53 and accompanying text.

\textsuperscript{16} For the facts and procedural history of \textit{Blasband}, see \textit{infra} notes 54-70 and accompanying text.

\textsuperscript{17} For a detailed discussion of the Third Circuit's analysis in \textit{Blasband} as to the standing requirement, see \textit{infra} notes 71-88 and accompanying text. For a further discussion of the Third Circuit's analysis in \textit{Blasband} as to the demand requirement, see \textit{infra} notes 89-106 and accompanying text.

\textsuperscript{18} For a discussion of the conclusions that the \textit{Blasband} decision will facilitate derivative actions and clarify the Delaware demand requirement in the merger context, see \textit{infra} notes 107-16 and accompanying text.
ing in a derivative action. First, Delaware General Corporation Law section 327 creates a statutory requirement that the plaintiff have been a shareholder at the time of the challenged transaction. The purpose of section 327 is to prevent a plaintiff from purchasing shares of stock for the sole purpose of bringing a derivative action. Second, Delaware courts additionally require that the plaintiff have been a shareholder at the time he or she filed the complaint and that the plaintiff remain a shareholder throughout the litigation. This requirement prevents abuses associated with derivative actions, such as shareholder "strike suits," and ensures that the plaintiff has a sufficient stake in the litigation to represent adequately the corporation's interest. Thus, a plaintiff who sells his or her shares after filing suit loses standing to maintain a derivative action.


21. See Brambles USA, Inc. v. Blocker, 731 F. Supp. 643, 648 (D. Del. 1990) (stating that primary purpose of § 327 is to prohibit plaintiffs from buying shares of stock after alleged wrong has occurred for sole purpose of maintaining lawsuit); Newkirk v. W. J. Rainey, Inc., 76 A.2d 121, 123 (Del. Ch. 1950) (acknowledging that purpose of § 51A of General Corporation Law of Delaware, the predecessor statute to § 327, was to prevent individuals who seek to challenge corporate transactions from purchasing stock for sole purpose of bringing derivative suit); Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 (Del. Ch. 1948) (stating that purpose of § 51A, predecessor statute to § 327, was "to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the stock").

22. See Heit v. Tenneco, Inc., 319 F. Supp. 884, 886 (D. Del. 1970) (citing Hutchinson v. Bernhard, 220 A.2d 782 (Del. Ch. 1965)) (stating that plaintiff must be shareholder when suit is commenced and throughout litigation); Lewis, 477 A.2d 1040, 1046 (Del. 1984) (noting that Delaware courts have consistently required that shareholder own stock when suit is commenced and throughout litigation); Harff v. Kerkorian, 324 A.2d 215, 219 (Del. Ch. 1974) (concluding that "Delaware law seems clear that stockholder status at the time of the transaction being attacked and throughout the litigation is essential.").

23. See Harff, 324 A.2d at 218. A strike suit is a "[s]hareholder derivative action begun with hope of winning large attorney fees or private settlements, and with no intention of benefiting corporation on behalf of which suit is theoretically brought." Black's Law Dictionary 1423 (6th ed. 1990).

24. Lewis, 477 A.2d at 1046 (citing Harff, 324 A.2d at 218) (noting that "[i]n the context of a corporate merger, . . . a derivative shareholder must not only be a stockholder at the time of the alleged wrong and at time of commencement of suit but that he must also maintain shareholder status throughout the litigation"); Brambles, 731 F. Supp. at 648 (same).

25. See, e.g., Hutchinson v. Bernhard, 220 A.2d 782, 784 (Del. Ch. 1965) (granting defendant's motion to dismiss plaintiff's claim for lack of standing, because plaintiff sold her ownership interest after filing derivative action). Courts have interpreted Federal Rule of Civil Procedure 23.1 as imposing a similar contemporaneous ownership requirement. Federal Rule 23.1 states that:

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A shareholder may also lose standing to sue derivatively if a merger occurs. In the merger context, any plaintiff who loses shareholder status because of a merger will generally lose standing to maintain the derivative action.26 As the Delaware Court of Chancery stated in Schreiber v. Carney:27

[It] is clear that a merger which eliminates a complaining stockholder’s ownership of stock in a corporation also ordinarily eliminates his status to bring or maintain a derivative suit on behalf of the corporation, whether the merger takes place before or after the suit is brought, on the theory that upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action.28

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff’s share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have.

Id.; see, e.g., Portnoy v. Kawecki Beryllco Indus., Inc., 607 F.2d 765, 767 (7th Cir. 1979) (noting that Federal Rule 23.1 requires shareholder to hold interest until end of litigation, ensuring that shareholder has adequate interest to vigorously litigate claim). In addition, federal courts have employed the contemporaneous ownership requirement of Federal Rule 23.1 to discourage “the collusive practice of transferring stock to a nonresident for the purpose of manufacturing federal diversity jurisdiction in order to litigate a pre-existing claim owned by the corporation in a federal court.” Brambles, 731 F. Supp. at 649 n.9 (quoting 7C Charles C. Wright et al., Federal Practice and Procedure § 1828, at 64 (1986)).

26. Lewis, 477 A.2d at 1049. In Lewis, the Delaware Supreme Court held that “[a] plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing to continue a derivative suit.” Id.; see Bonime v. Biaggini, No. 6925, 6980, 1984 WL 19830, at *2 (Del. Ch. Dec. 7, 1984) (stating that “a plaintiff [who] loses his [or her] status as a shareholder due to a merger which occurs after the suit is instituted also loses his [or her] ability to maintain the derivative suit”), aff’d without opinion, 505 A.2d 751 (Del. 1985).

27. 447 A.2d 17 (Del. Ch. 1982).

28. Id. at 21. This rule developed from a line of cases interpreting Delaware General Corporation Law § 259(a) (formerly § 253(b)). Section 259(a) provides in relevant part:

[T]he rights, privileges, powers and franchises of each of said corporations, and all property, real, personal and mixed, and all debts due to any of said constituent corporations on whatever account, as well as for stock subscriptions as all other things in action or belonging to each of such corporations shall be vested in the corporation surviving or resulting from such merger or consolidation; and all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting cor-
For example, in *Lewis v. Anderson*, the plaintiff-shareholder brought a derivative action on behalf of Conoco, Inc. (Old Conoco). The shareholder’s claim alleged that Old Conoco’s directors acted improperly when they approved certain employment contracts. The Delaware Supreme Court held that the plaintiff failed to satisfy the continuous ownership requirement and denied the plaintiff standing. Specifically, the *Lewis* court found that the plaintiff failed to meet the continuous

30. "illegal, improper, without a valid business purpose, a fraud upon Old Conoco or a waste of corporate assets." *Id.* at 1042. These employment agreements, known as "golden parachutes," provided the corporate officers with over five million dollars in benefits if Old Conoco was no longer listed on the New York Stock Exchange, if 20% or more of Old Conoco’s common stock was purchased by outside interests, or if the officers were terminated from employment. *Id.* The "golden parachutes" were approved by an independent compensation committee on June 17, 1981, a little more than a month after a successful cash tender offer by Dome Petroleum Ltd. (Dome) for 20% of the common stock of Old Conoco. *Id.*
ownership requirement because Old Conoco had merged with a subsidiary of E.I. DuPont de Nemours and Company (DuPont) and had formed a wholly owned subsidiary (New Conoco). In the merger, the plaintiff exchanged his shares of Old Conoco for shares of DuPont, the parent company. The Lewis court thus denied the plaintiff standing on the basis that any derivative action the shareholders of Old Conoco had against their directors was a property right of Old Conoco that passed to the surviving company, New Conoco.

33. Id. On June 25, 1981, a bidding war began for Old Conoco, and E.I. DuPont de Nemours and Company (DuPont) emerged as the winner. Id. As a result of the bidding contest, DuPont's wholly-owned subsidiary, DuPont Holdings, Inc., acquired Old Conoco thereby triggering the "golden parachutes." Id. Subsequently, Old Conoco merged into DuPont Holdings, Inc., and the resulting corporation became New Conoco. Id.

34. Id. Plaintiff's claim did not involve the propriety of the DuPont-Conoco merger, but rather, contested the pre-merger action of Old Conoco's board of directors in approving the "golden parachute" employment agreements. Id. at 1042-43.

35. Id. at 1049-50. Because the plaintiff filed the derivative action prior to the merger, the plaintiff argued that § 327 was irrelevant to the issue of "standing to continue the derivative action." Id. at 1045-46. The plaintiff argued that § 327 should be strictly construed and should only bar a derivative action brought on behalf of Old Conoco after the merger, when the plaintiff was no longer a shareholder of Old Conoco. Id. The plaintiff further contended that since he filed the derivative action prior to the merger, Delaware General Corporation Law § 261, which governs the effect of mergers upon pending actions, protected his standing to maintain the derivative action and preserved his right to continue the derivative action on behalf of Old Conoco. Id. at 1046. Section 261 states that:

Any action or proceeding, whether civil, criminal or administrative, pending by or against any corporation which is a party to a merger or consolidation shall be prosecuted as if such merger or consolidation had not taken place, or the corporation surviving or resulting from such merger or consolidation may be substituted in such action or proceeding.

Del. Code Ann., tit. 8, § 261 (1991). Moreover, the plaintiff argued that by dismissing this claim, the court would leave a wrong unremedied. Id. at 1044. Thus, the issue before the court was whether § 261 preserved the plaintiff's standing to maintain a derivative action when, as a result of a merger, the plaintiff lost his status as a shareholder in the corporation on whose behalf the plaintiff had originally filed suit. Id. at 1047.

The Delaware Supreme Court rejected the plaintiff's arguments and held that § 261 did not preserve the plaintiff's standing to continue the derivative action. Id. at 1049. In support of this holding, the court reasoned that pursuant to § 259(a), all rights of Old Conoco passed, as a result of the merger, to New Conoco. Id. at 1050. For the text of § 259(a), see supra note 28. Moreover, the court reasoned that such a construction of § 259(a) and § 261 was consistent with the standing requirement in § 327, which the court stated applied to all derivative actions filed before or after a merger. Lewis, 477 A.2d at 1046. In addressing the plaintiff's argument that the denial of standing would leave a wrong unremedied, the court stated that, pursuant to § 259(a) and § 261, the board of directors of New Conoco had the right to determine the disposition of plaintiff's claim. Id. at 1050 n.19. Accordingly, the directors of New Conoco could still proceed against the management of Old Conoco if the directors of New Conoco so desired. Id.
Although continuous ownership is generally necessary to establish standing to bring a derivative action, Delaware courts have recognized two major exceptions to this rule. First, continuous ownership is not required when the merger is the subject of fraud. Second, continuous ownership is not required if "the merger is in reality a reorganization which does not affect plaintiff's ownership of the business enterprise."  

36. For a discussion of the exceptions to the continuous ownership requirement necessary to establish standing, see infra notes 37-39 and accompanying text.

37. Lewis, 477 A.2d at 1046 n.10 (noting that exception to continuous ownership requirement exists when merger is fraudulent); see Kramer v. Western Pacific Indus., Inc., 546 A.2d 348, 354 (Del. 1988) (stating that merger is fraudulent if purpose of merger is to deprive shareholders of standing to maintain derivative suit); Bokat v. Getty Oil Co., 262 A.2d 246, 249 (Del. 1970) (stating that fraud exists when proposed merger is used for cover-up of wrongful acts of management).

38. Lewis, 477 A.2d at 1046 n.10 (noting that "reorganization exception" to continuous ownership requirement exists when merger constitutes reorganization which does not affect plaintiff's ownership interest); see Schreiber v. Carney, 447 A.2d 17, 22 (Del. Ch. 1982) (concluding that plaintiff had standing to maintain derivative suit when "the merger had no meaningful effect on the plaintiff's ownership of the business enterprise"); Helfand v. Gambee, 136 A.2d 558, 559-60 (Del. Ch. 1957) (upholding plaintiff's equitable right to sue derivatively on behalf of corporation's interest despite subsequent reorganization, pursuant to which plaintiff exchanged shares in former corporation for shares in new corporation). In Schreiber, the plaintiff brought a derivative action on behalf of Texas International Airlines, Inc. (Texas International) challenging the propriety of a loan from Texas International to the defendant, a related corporation. Schreiber, 447 A.2d at 18. After the plaintiff filed the action, Texas International merged with and became a wholly-owned subsidiary of Texas Air Corporation. Id. at 19. As a result of the merger, the plaintiff exchanged his shares in Texas International for an equal number of shares in Texas Air Corporation. Id. at 21. The Delaware Court of Chancery held that the plaintiff had standing to maintain the derivative suit on behalf of the pre-merger corporation because the post-merger corporate structure was essentially identical to the pre-merger corporation. Id. at 22. Thus, "the merger had no meaningful effect on the plaintiff's ownership of the business enterprise." Id. The court further stated that the plaintiff's action was essentially a double derivative suit because the plaintiff possessed the equitable right to sue derivatively for benefits on behalf of the pre-merger corporation's interests as they existed after the merger. Id. The action was not a true double derivative action because the plaintiff was not a shareholder of the parent company at the time of the challenged transaction. Id.

However, the Delaware Court of Chancery has refused to extend Schreiber to corporate reorganizations which result in the shareholders of the pre-merger corporation having a different ownership interest in the post-merger corporation. See, e.g., Bonime v. Biaggini, No. 6925, 6980, 1984 WL 19830, at *3 (Del. Ch. Dec. 7, 1984), aff'd without opinion, 505 A.2d 451 (Del. 1985). In Bonime, the plaintiffs were shareholders of Southern Pacific Company (Southern Pacific). Id. at *1. They brought a double derivative suit on behalf of Southern Pacific for damages allegedly sustained by Southern Pacific's wholly-owned subsidiary, Southern Pacific Transportation Corporation. Id. After the plaintiff filed the action, Southern Pacific and Santa Fe Industries, Inc. entered into a merger agreement and became wholly-owned subsidiaries of a new holding company, Santa Fe-Southern Pacific Company (SFSP). Id. at *2. As a result of the merger, the plaintiffs exchanged their shares of Southern Pacific for an equal number of
Alternatively, continuous ownership is not required for a plaintiff to have standing to maintain an individual action if a plaintiff has cashed out his or her ownership interest as a result of a merger, and he or she seeks to attack directly a specific corporate transaction.\textsuperscript{39}

shares in SFSP. \textit{Id.} The defendant-directors of Southern Pacific Transportation Corp. moved to dismiss on the ground that the plaintiffs failed to meet the continuous ownership requirement for standing. \textit{Id.} The plaintiffs argued that they had standing based upon \textit{Schreiber} because they owned shares in a holding company formed for the purpose of effectuating a merger. \textit{Id. at *3.} The \textit{Bonime} court concluded, however, that the \textit{Schreiber} test is not "whether the surviving corporation is deemed a holding company or an operating company but ... whether the surviving entity is merely the same corporate structure under a new name or a new and different enterprise which has succeeded to the property rights of constituent corporations." \textit{Id.} The \textit{Bonime} court thus distinguished \textit{Schreiber} on the grounds that in \textit{Bonime}, Southern Pacific and SFSP had separate boards of directors, officers, assets and stockholders. \textit{Id.} Moreover, the court found that the \textit{Bonime} reorganization was more like the DuPont-Conoco merger in \textit{Lewis v. Anderson} than the merger at issue in \textit{Schreiber}. \textit{Id.} Therefore, the Delaware Court of Chancery held that the plaintiffs lacked standing to maintain the derivative suit because they failed to satisfy the continuous ownership requirement necessary for standing under § 327. \textit{Id.} For a full discussion of the \textit{Lewis} decision, see supra notes 29-35 and accompanying text.

Similarly, in \textit{Helfand}, the plaintiff was originally a shareholder in Twentieth Century Fox Film Corporation, a New York corporation. \textit{Helfand}, 136 A.2d at 560. However, as a result of a corporate reorganization, she exchanged her shares in the New York corporation for shares in National Theatres, Inc. and Twentieth Century Fox Film Corporation of Delaware, two Delaware corporations. \textit{Id.} The plaintiff brought a derivative action on behalf of National Theatres, Inc. and its wholly-owned subsidiary Fox Midwest Theatres, Inc., challenging actions by the directors of National Theatres, Inc. occurring both before and after her stock ownership in National Theatres. \textit{Id.} at 559. The Delaware Court of Chancery held that the plaintiff had standing to bring a derivative action on behalf of the Delaware companies for alleged wrongful acts occurring prior to the merger and relating to the New York corporation. \textit{Id.} at 561. The \textit{Helfand} court stated that the purpose of § 327 was to prevent a plaintiff from bringing a derivative action based on transactions occurring prior to the plaintiff’s purchase of stock. \textit{Id.} Although the plaintiff’s derivative action in \textit{Helfand} related to acts occurring prior to the reorganization and merger, the court noted that the plaintiff’s action did not offend the purpose of § 327 because the post-merger corporation was a successor to the pre-merger corporation. \textit{See id.} (noting that plaintiff’s stock transactions were pursuant to plan designed to meet terms of consent decree related to antitrust action). The \textit{Helfand} court further recognized that the plaintiff complained of acts preceding the incorporation of one of the post-merger Delaware corporations, and that the post-merger corporation was merely a successor to the pre-merger New York corporation. \textit{Id.} at 562. Thus, the court decided that the fact that the plaintiff held “two pieces of paper rather than one as evidence of her investment” should not foreclose suit. \textit{Id.}

39. \textit{Kramer}, 546 A.2d at 354 (holding that direct attacks against specific corporate transactions involving questions of fair dealing or fair price give shareholders standing to pursue actions individually even after shareholders have relinquished ownership interest through merger); \textit{Cede & Co. v. Technicolor, Inc.}, 542 A.2d 1182, 1188-89 (Del. 1988) (holding that shareholders who relinquish ownership as result of merger may maintain individual actions alleging claims of unfair dealing or breach of duty arising from merger).
B. Demand

To bring suit derivatively, a plaintiff must also satisfy the demand requirement. Under Delaware law, the plaintiff-shareholder must establish that he or she either adequately demanded that the board of directors initiate suit and the board refused to do so, or that such a demand would have been futile. This demand requirement recognizes that the directors' duties in managing the business and affairs of a corporation include handling litigation issues.

40. See Del. Ch. Ct. C.P.R. 23.1. For the text of this rule, see supra note 4. In diversity actions brought in federal district court, Delaware Chancery Court Rule 23.1 remains applicable because the state law demand requirement is considered to be substantive rather than procedural, and the substantive law of the state of incorporation governs the demand requirement. Kamen v. Kemper Fin. Services, Inc., 111 S. Ct. 1711, 1716-17 (1991). Consequently, Federal Rule of Civil Procedure 23.1 applies only to evaluate the adequacy of the facts necessary to satisfy the state's demand requirement, as alleged in the plaintiff's complaint. Id. at 1716. For the text of Federal Rule 23.1, see supra note 25.

41. See Del. Ch. Ct. C.P.R. 23.1. For the text of this rule, see supra note 4. Delaware courts have long recognized the requirement of shareholder demand. In 1955, the Delaware Chancery Court articulated the demand test as follows: [The] stockholder has no right to file a bill in the corporation's behalf unless it has first made demand on the corporation that it bring the suit and the demand has been answered by a refusal, or unless the circumstances are such that because of the relation of the responsible officers of the corporation to the alleged wrongs, a demand would be obviously futile or, if complied with, it is apparent that the officers are not the proper persons to conduct the litigation. Ainscow v. Sanitary Co. of Am., 180 A. 614, 615 (Del. Ch. 1935); see Stepak v. Dean, 434 A.2d 388, 390 (Del. Ch. 1981); Maldonado v. Flynn, 413 A.2d 1251, 1262 (Del. Ch. 1980), rev'd on other grounds sub nom. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

42. See Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984) (noting that demand requirement provides corporate-directors with “opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise”). The demand requirement is consistent with the fundamental principle generally underlying the entire body of Delaware General Corporation Law—that directors, rather than shareholders, manage all of the business and affairs of the corporation. Id. at 811; see Del. Code Ann. tit. 8, § 141(a) (1991). Section 141(a) states, in relevant part, that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.” Id. Because a derivative action tends to impinge upon the managerial freedom of a corporation's board of directors, the demand requirement provides two essential safeguards for corporate management. Aronson, 473 A.2d at 811. First, the demand requirement ensures that a shareholder exhausts all intra-corporate remedies before circumventing the managerial freedom of the directors. Id. Second, the demand requirement provides a safeguard against shareholder strike suits because it ensures, before any litigation occurs, that the directors will have an opportunity to exercise reasonable business judgment with regard to initiating the suit. Id. at 812. Specifically, this opportunity allows the directors to “waive a legal right vested in the corporation in the belief that [the corporation's] best interests will be promoted by not insisting on such [a] right.” Kamen, 111 S. Ct. at 1716 (quoting Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 533 (1984) (quoting Covbus v. Alaska Treadwell
The plaintiff's demand on the board of directors must identify the alleged wrongdoers, the factual basis of the wrongful acts, the harm caused to the corporation, and must also include a request for relief. If the plaintiff makes an adequate demand on the board of directors to initiate the action and the board refuses, then the board's decision is protected unless it constituted an invalid exercise of business judgment. Furthermore, if the demand is inadequate, a plaintiff may not later claim that such a demand would have been futile. Thus, a plaintiff must plead either that an adequate demand was made and refused or that a demand would have been futile and was excused, but in no event may a plaintiff plead both.

Gold Mining Co., 187 U.S. 455, 463 (1903)). Thus, the demand requirement not only promotes recourse to a form of alternate dispute resolution as opposed to immediate litigation, but also honors the broad discretion of directors in managing the business and affairs of Delaware corporations. Aronson, 473 A.2d at 812.


44. Aronson, 473 A.2d at 813; Zapata Corp. v. Maldonado, 430 A.2d 779, 784 & n.10 (Del. 1981). In Zapata, a shareholder instituted a derivative action on behalf of Zapata Corporation against its officers and directors alleging breaches of fiduciary duty. Id. at 780. The shareholder did not make a demand on the board of directors to initiate the cause of action. Id. On appeal, the Delaware Supreme Court clarified the demand requirements existing under Delaware law. See id. at 781 (examining lower court's conclusion concerning right of stockholder to maintain derivative action). The Zapata court stated that when shareholders make a demand on the directors to initiate the suit and the directors reject such a demand, the board's decision is protected by the business judgment rule and will be respected unless it violates the rule. Id. at 784 & n.10.

The Delaware Supreme Court stated that the business judgment rule:

focuses on the substantive nature of the challenged transaction and the board's approval thereof. A court does not assume that the transaction was a wrong to the corporation requiring corrective measures by the board. Rather, the transaction is reviewed against the factual background of the complaint to determine whether a reasonable doubt exists at the threshold that the challenged action was a valid exercise of business judgment.

Pogostin v. Rice, 480 A.2d 619, 624 (1984). If the board's decision is a valid exercise of judgment under the business judgment rule, then the board's refusal of the shareholder's demand acts to terminate the shareholder's power to proceed with the derivative suit. Zapata, 430 A.2d at 784; see Aronson, 473 A.2d at 813 (stating that if board's refusal is valid under business judgment rule then "the shareholder lacks the legal managerial power to continue the derivative action, since that power is terminated by the refusal").

45. Spiegel v. Buntrock, 571 A.2d 767, 775 (Del. 1990) (holding that after stockholder makes demand, he or she " tacitly acknowledges the absence of facts to support a finding of [demand] futility ... [and the] question of whether demand is excused is moot "). The Spiegel court reasoned that is inconsistent for a shareholder to demand that the board of directors bring an action, and then subsequently claim that demand was excused. Id.

46. Allison, 604 F. Supp. at 1119 & n.12; Spiegel, 571 A.2d at 775. In Allison, the court recognized that, in an appropriate case, a Delaware court might render moot a plaintiff's claim that demand is excused if the plaintiff made a subsequent inadequate demand on the board of directors. Allison, 604 F. Supp. at
If a plaintiff seeks to have the demand requirement excused on the basis that such a demand would have been futile, the plaintiff must state particularized facts in support of such a claim.\textsuperscript{1119} In \textit{Aronson v. Lewis},\textsuperscript{148} the Delaware Supreme Court held that the test for determining demand futility is "whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."\textsuperscript{149} Although the \textit{Aronson} court's articulation of this test seems to require that a plaintiff satisfy both prongs, Delaware courts have held that a plaintiff meets the demand futility requirement if he or she meets either prong.\textsuperscript{150}

Under the first prong of the \textit{Aronson} test, the plaintiff may demonstrate reasonable doubt as to the independence of the directors by showing that the transaction at issue was not approved by a majority

\textsuperscript{1119} & n.12. In \textit{Spiegel}, the Delaware Supreme Court subsequently adopted the \textit{Allison} court's reasoning and held that demand by a shareholder would defeat a claim that demand was excused. \textit{Spiegel}, 571 A.2d at 775. Courts have interpreted Federal Rule of Civil Procedure 23.1 to impose an analogous requirement. \textit{See}, e.g., Mozes v. Welch, 638 F. Supp. 215, 218-19 (D. Conn. 1986) (holding that Federal Rule 23.1 requires that plaintiff either make demand on the board or plead demand futility). For the text of Federal Rule 23.1, see supra note 25.

\textsuperscript{147} \textit{See} Stepak v. Dean, 434 A.2d 388, 390 (Del. Ch. 1981) (stating that shareholder has burden of establishing particularized facts to support claim of futility and noting that "conclusory allegation of [director] control [over corporation] was insufficient as a matter of law to excuse failure to make demand on corporation"); Ainscow v. Sanitary Co. of Am., 180 A. 614, 615 (Del. Ch. 1935) (threatening to dismiss shareholder's complaint because it failed to allege demand upon, and refusal by, corporate directors to pursue cause of action which shareholder sought to maintain derivatively).

\textsuperscript{148} 473 A.2d 805 (Del. 1984).

\textsuperscript{149} \textit{Id.} at 814. In \textit{Aronson}, the plaintiff brought a derivative action on behalf of Meyers Parking System, Inc. (Meyers) challenging certain transactions between Meyers and one of its directors, Leo Fink. \textit{Id.} at 808. Fink owned 47\% of the outstanding stock of Meyers. \textit{Id.} The principal allegation in the plaintiff's complaint was that an employment agreement between Fink and Meyers was a "waste of corporate assets" and had "no valid business purpose." \textit{Id.} at 809. The employment agreement provided that for a five year term, which was renewable automatically, Fink was "to advance Meyers' interests" in exchange for $150,000 per year plus five percent of any pre-tax profits over $2,400,000. \textit{Id.} at 808. If the agreement was terminated by either party, the agreement provided that Fink would become a hired consultant for Meyers for $100,000 per year for life. \textit{Id.} At the time of the agreement, Fink was 75 years old. \textit{Id.} at 809. The plaintiff claimed that a demand that the board of directors challenge the employment agreement would have been futile because Fink had selected all of the directors, and thus, controlled and dominated the entire board. \textit{Id.}

\textsuperscript{150} \textit{See}, e.g., Pogostin v. Rice, 480 A.2d 619, 624-25 (Del. 1984) (stating that if plaintiff creates "a reasonable doubt as to either aspect of the \textit{Aronson} analysis, the futility of demand is established"). The Delaware Supreme Court later clarified its formulation of the demand futility test by changing the "and" to "or" in the court's restatement of the standard in Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988).
consisting of disinterested directors.\textsuperscript{51} To satisfy the second prong of the \textit{Aronson} test, the plaintiff must allege particularized facts raising a reasonable doubt as to whether the directors validly exercised business judgment in the transaction at issue.\textsuperscript{52} To determine whether the board of directors exercised proper business judgment, courts examine both substantive and procedural due care on the part of the directors.\textsuperscript{53}

\textsuperscript{51} \textit{Aronson}, 473 A.2d at 812. The \textit{Aronson} court noted that in ascertaining whether the directors were disinterested and independent, the reviewing court should focus on the complaint's factual allegations. \textit{Id.} at 814.

In \textit{Aronson}, the plaintiff alleged that Fink dominated and controlled the board because he owned 47\% of the outstanding stock in the corporation and had personally selected all of the directors. \textit{Id.} at 815. The court held, however, that proof of majority ownership of a company does not overcome the presumption of independence in favor of the directors. \textit{Id.} The court further opined that an allegation of control must include facts demonstrating that "through personal or other relationships the directors are beholden to the controlling person." \textit{Id.}

\textsuperscript{52} \textit{Aronson}, 473 A.2d at 812. The \textit{Aronson} court noted "that the transaction is a wrong to the corporation requiring corrective steps by the board." \textit{Id.} at 814. Rather, a court should substantively review a challenged transaction against the factual background set forth in the complaint. \textit{Id.} If a court thereby determines that the plaintiff has alleged particularized facts which, if true, raise a reasonable doubt that a board exercised valid business judgment, then demand is excused. \textit{Id.} at 815.

The \textit{Aronson} test's second prong requires a reviewing court to focus on factual allegations existing at the time of the challenged transaction. \textit{Id.} at 814-15. The Delaware Chancery Court has noted that in establishing this requirement, the \textit{Aronson} court focused on the most common scenario, in which the board existing at the time of the challenged transaction was the same board existing when the complaint was filed. Harris v. Carter, 582 A.2d 222, 230 (Del. Ch. 1990). The \textit{Harris} court noted, however, that alternative scenarios are possible. \textit{Id.}

For instance, in \textit{Harris}, a minority shareholder of Atlas Energy Corporation (Atlas) brought a class action after a group of shareholder-directors sold a controlling interest in the corporation to Frederic Mascolo and then resigned, allowing Mascolo to appoint new directors to the Atlas board. \textit{Id.} at 223-24. The plaintiff later withdrew this class action and amended his complaint asserting derivative claims on behalf of Atlas that included breaches of fiduciary duties. \textit{Id.} at 224. Because there was a change in the board between the plaintiff's filing of the original and amended complaints, the \textit{Harris} court was confronted with the question of whether the plaintiff was required to show demand futility as of the time of the amended complaint. \textit{Id.} at 229. The \textit{Harris} court held that the original complaint was essentially derivative in nature, and that demand futility must be determined as of the time of the original complaint. \textit{Id.} The court also held that if a derivative suit has been properly initiated before a change in the board of directors, a plaintiff need not make an additional demand upon the new independent board. \textit{Id.} at 231. Moreover, the \textit{Harris} court noted that a subsequent change in the board has no effect on the pleadings and suggested that it is "[f]or this reason \textit{Aronson} has been criticized as focusing the test for futility on the wrong time." \textit{Id.} at 229; cf. \textit{Starrels v. First Nat'l Bank of Chicago}, 870 F.2d 1168, 1174-76 (7th Cir. 1989) (Easterbrook, J., concurring) (criticizing focus of second prong of \textit{Aronson} test because it fails to consider that disinterested, post-merger board of directors existing at time of filing of complaint could adequately assume managerial powers over litigation).

\textsuperscript{53} \textit{Starrels}, 870 F.2d at 1171 (examining information possessed by direc-
III. FACTS/PROCEDURAL HISTORY

In May 1987, Alfred Blasband acquired 1,100 shares of stock in Easco Hand Tools, Inc. (Easco).54 On September 1, 1988, Easco made a public offering of $100 million of 12.875% Senior Subordinated Notes.55 Easco violated the terms of the prospectus for the public offering by investing $61.9 million of the proceeds in junk bonds.56 In its December 31, 1989 Annual Report, Easco reported that the market value of these junk bond investments had declined by $14 million.57 Easco reported an additional $1 million loss in the March 31, 1990 Quarterly Report.58

In February 1990, Easco entered into a merger agreement with the Danaher Corporation and its wholly-owned subsidiary, Combo Acquisition Corporation (collectively, “Danaher”).59 Easco and Danaher shared two of the same corporate officers and directors.60 As a result of

55. Id. at 1037. Easco’s prospectus for the public offering indicated that the corporation planned to use the proceeds of the sale to repay outstanding debt, to finance both internal expansion and acquisitions, and for other general corporate purposes. Id.
56. Id. The prospectus indicated that until the proceeds were available for the stated corporate purposes, the corporation would invest the proceeds in government and other marketable securities bearing lower expected rates of return than the interest on the public offering. Id. Despite these statements in its prospectus, Easco invested at least $61.9 million of the public offering proceeds in high yield, high risk securities. Id. For the year ending December 31, 1988, Easco disclosed these investments in its Form 10-K to the Securities and Exchange Commission (SEC) as “temporar[y] invest[ments] in marketable securities and cash equivalents.” Id. (alterations in original).
57. Id. at 1038. Easco’s Annual Report and Form 10-K for December 31, 1989 revealed that Easco still maintained these investments. Id. at 1037-38. During the period from 1988 to 1989, however, the market for these securities had declined, causing a loss of over $14 million. Id. at 1038. Easco stated that further losses would be suffered even if the company sold the junk bond investments. Id. Easco explained that the decline in the value of these investments was due to a volatile and “thinly traded market,” and the greater risk associated with these securities. Id.
58. Id. at 1037-38. In its March 31, 1990 Form 10-Q filed with the SEC, Easco disclosed its additional losses. Id.
59. Id. The merger agreement provided that Easco shareholders would receive .4175 shares of Danaher common stock for each share of Easco common stock. Id.
60. Id. Mitchell Rales, Chairman of the Board of Directors of Easco, owned approximately 25% of Easco’s common stock at the time of the merger. Id.
the merger, Blasband received 458 shares of Danaher common stock. As of June 1990, Easco survived as a wholly-owned subsidiary of Danaher.

On October 25, 1990, Blasband's counsel sent a letter to the boards of directors of Danaher and Easco highlighting the discrepancy between the stated use of the public offering proceeds in the prospectus and the actual use of the proceeds in the purchase of the junk bonds "and requesting additional information." In response, Danaher and Easco contended that because Easco had complied with all federal securities laws and regulations, it would be inappropriate to provide the requested information. After receiving this response from Danaher and Easco, Blasband filed a derivative action in the United States District Court of Delaware on behalf of Danaher against Steven and Mitchell Rales and twelve unnamed officers and directors of pre-merger Easco. Blasband claimed the Easco board of directors violated its fiduciary duties to Easco by improperly investing the public offering proceeds in junk bonds.

The district court granted the defendant-director's motion to dismiss on two grounds. First, the district court held that the merger

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Steven Rales, Mitchell's brother, was also a member of Easco's board of directors and owned 27% of its common stock. Id. At the time of the merger, Mitchell Rales was also the president and director of Danaher and Steven Rales was Chairman of the Board of Directors of Danaher. Id. Steven and Mitchell Rales together owned 42% of Easco's common stock and 44% of Danaher's common stock. Id.

61. Id.
62. Id. at 1038.
63. Id. The letter requested: (1) an explanation as to why Easco investments had declined $14 million in one year; (2) a description of all securities bought and sold by Easco between September 1, 1988 and December 31, 1989, including pricing and brokerage information; (3) the names of Easco officers and directors that approved or selected the purchases and sales; and (4) the reason why Easco utilized the proceeds contrary to the investments set forth in the prospectus. Id.

64. Id. Danaher and Easco's response, dated December 17, 1990, indicated that providing the requested information would be both time-consuming and disruptive of the day-to-day management of the corporation. Id. at 1038-39.

65. Id. at 1039. In his complaint, Blasband named both Mitchell and Stephen Rales as defendants, as well as 10 other individuals, who were officers and directors of pre-merger Easco at the time of the public offering. Id. Because Blasband brought the derivative action on behalf of Danaher, Danaher was joined as a nominal defendant. Id. At trial in the district court, Blasband never identified the ten unnamed defendants listed in the complaint; consequently, Mitchell and Stephen Rales were the actual defendants in the suit. Id.

66. Id. Blasband alleged that the Rales brothers invested in the junk bond market as consideration for Drexel Burnham's services in helping the Rales brothers to establish a corporate acquisition strategy. Id. at 1039. Blasband claimed that the use of proceeds in this manner was not for a legitimate corporate business purpose. Id.

interrupted the continuous ownership requirement necessary for standing.\textsuperscript{68} Second, the district court held that demand futility should only be assessed with regard to Danaher's board of directors, and that Blasband had failed to adequately plead such demand futility.\textsuperscript{69} Consequently, the district court rejected Blasband's argument because Blasband's allegation itself acknowledged that Easco survived as a wholly-owned subsidiary of Danaher.\textsuperscript{Id.} Alternatively, Blasband contended that Danaher, as Easco's sole shareholder, succeeded to all of Easco's rights and responsibilities, including all derivative claims.\textsuperscript{Id.} at 856-57. The district court rejected this argument as well, noting that because Easco survived the merger, Easco maintained control over all such rights.\textsuperscript{Id.}

In his response brief, Blasband asserted a third ground for standing.\textsuperscript{Id.} at 857. Blasband claimed that he had double derivative standing on behalf of Danaher, in its capacity as the sole shareholder of Easco.\textsuperscript{Id.} The district court rejected this argument because Blasband failed to establish that Danaher was a shareholder of Easco at the time of the challenged transaction.\textsuperscript{Id.} At the hearing on defendants' motion to dismiss, Blasband raised a fourth argument for standing.\textsuperscript{Id.} Blasband contended that Danaher possessed a direct cause of action as a result of Danaher's breaches of fiduciary duty.\textsuperscript{Id.} The district court rejected this argument because the breaches of fiduciary duty asserted by Blasband would have depressed Easco's stock value, thereby offsetting any liability Danaher might have acquired by becoming Easco's sole shareholder.\textsuperscript{Id.} Finally, Blasband contended that he had standing because he continued to have an indirect interest in Easco as a shareholder of Danaher.\textsuperscript{Id.} Blasband cited the United States Supreme Court decision of Gollust v. Mendell, 111 S.Ct. 2173 (1991), as support for his position.\textsuperscript{Blasband, 772 F. Supp. at 857.} The district court stated that Gollust did not apply because the Court had confined its analysis in Gollust to standing under § 16(a) of the Securities and Exchange Act of 1934, which did not require contemporaneous ownership.\textsuperscript{Id.} Instead, the district court found that the Delaware Supreme Court's decision in Lewis v. Anderson, 477 A.2d 1040 (Del. 1984) was controlling.\textsuperscript{Id. at 857-58.} Blasband had contended that Lewis should not control because the court in Lewis did not consider an indirect standing theory.\textsuperscript{Id.} The district court responded that although Lewis did not directly address the issue of indirect standing, the Delaware Court of Chancery had considered the argument following Lewis and had rejected it. See Bonime v. Biaggini, No. 6925, 6980, 1984 WL 19830, at *3 (Del. Ch. Dec. 7, 1984) (rejecting indirect standing theory), aff'd without opinion, 505 A.2d 451 (Del. 1985). After considering all of Blasband's arguments, the district court held that Blasband failed to satisfy the continuous ownership requirement necessary to establish standing.\textsuperscript{Blasband, 772 F. Supp. at 858-59.}

\textsuperscript{69} Blasband, 772 F. Supp. at 855-56. Blasband argued that demand was futile because Danaher denied all wrongdoing, refused to provide the information requested by plaintiff and refused to conduct any inquiry in response to Blasband's letter.\textsuperscript{Id. at 855.} Moreover, Blasband argued that by virtue of the Rales brothers' ownership of 44% of Danaher's stock, the Rales brothers dominated and controlled the Danaher board.\textsuperscript{Id.} Blasband posited that such domination and control of the board, coupled with the size of the junk bond investments and the misleading statements in the prospectus, created a reasonable doubt as to whether the Easco board exercised sound business judgment.\textsuperscript{Id.} However, the court recognized that in order to establish demand futility, a plaintiff must create a reasonable doubt as to the independence and disinterestedness of the board or as to whether the directors had employed sound business judgment.\textsuperscript{Id. (citing Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).} The
subsequently, Blasband appealed to the Third Circuit.\(^70\)

**IV. The Third Circuit's Analysis**

A. Standing

In *Blasband v. Rales*, the Third Circuit began its analysis by discussing the requirements and purpose of Delaware General Corporation Law section 327.\(^71\) The Third Circuit preliminarily noted that in order to establish standing, section 327 requires a plaintiff to have been a shareholder at the time of the challenged transaction.\(^72\) and Delaware courts require a plaintiff to have remained a shareholder at the time of filing and throughout the suit.\(^73\) The Third Circuit next articulated the purpose of section 327, to prevent the "purchase of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of stock."\(^74\)

The Third Circuit additionally noted that because a plaintiff ordinarily has no interest in a corporate recovery after a cash-out merger, he or

district court found that Blasband failed to create a reasonable doubt as to either requirement. *Id.*

Specifically, applying the first prong of the *Aronson* test, the district court held that Blasband's allegation that the Rales brothers' ownership of 44% of Easco's outstanding stock allowed them to dominate and control the board was insufficient to raise a reasonable doubt that the board was independent. *Id.* The court reasoned that stock ownership alone is not sufficient to infer domination and control, but rather that a plaintiff must plead particularized facts indicating that the board of directors comports with the interests of an alleged controlling party. *Id.* The district court further concluded the second prong of the *Aronson* test was not met because the lack of business judgment alleged by Blasband was on the part of Easco, and not the Danaher board, and because Blasband did not allege the boards were identical. *Id.*

Blasband next argued that based upon Danaher and Easco's response to his letter, any formal demand made by Blasband would have been refused. *Id.* at 855-56. The district court responded, however, that the test for demand futility is not whether the board will respond to a demand affirmatively, but rather whether the board has the managerial authority and legal capacity to consider the demand disinterestedly. *Id.* at 856 (citing D. DrexlEr et al., *Delaware Corporation Law and Practice* § 42.05[2], at 42-11 (1991)). Thus, the district court concluded that Danaher and Easco's response to Blasband's letter failed to establish demand futility, because it failed to raise any doubt as to the Danaher board's ability to exercise its business judgment soundly. *Id.*

70. Blasband v. Rales, 971 F.2d 1034, 1039 (3d Cir. 1992). The Third Circuit vacated the district court's order and remanded the matter to the district court. *Id.* at 1055. Additionally, Blasband was given leave to amend his complaint, to allege demand futility and to add Easco as a party to the litigation. *Id.*

71. *Id.* at 1040-41. For the text of § 327, see supra note 9.


73. Blasband, 971 F.2d at 1040. For a discussion of the continuous ownership requirement imposed by Delaware courts, see supra notes 20-21 and accompanying text.

74. Blasband, 971 F.2d at 1040 (quoting Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 (Del. Ch. 1948)).
she lacks standing to bring a derivative action. The court recognized, however, that "where, as here, the plaintiff receives shares of a new corporate entity, the standing issue is less clear, as the plaintiff will have a financial interest in the derivative action." The Third Circuit also acknowledged that Delaware courts have consistently permitted a derivative action to proceed if the merger is, in reality, a mere reorganization.

Furthermore, the Third Circuit commented that although the Delaware Supreme Court in Lewis v. Anderson had rejected standing in a merger transaction similar to Blasband, the plaintiff in Lewis had not

75. Id. at 1041.
76. Id.
77. Id. The Third Circuit first discussed Helfand v. Gambee, 136 A.2d 558 (Del. Ch. 1957), which held that a plaintiff had standing following a merger because the merger was in reality a reorganization, and because the plaintiff's interest in the entity was unaffected. Id. at 562. Second, the court discussed Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982), which held that a plaintiff maintained standing because a "merger had no meaningful effect on the plaintiff's ownership in the enterprise." Id. at 22. The court stated that these cases illustrate the Delaware courts' "reorganization exception" to the continuous ownership requirement of standing. Blasband, 971 F.2d at 1041. For a further discussion of Helfand and Schreiber and the "reorganization exception" to the continuous ownership requirement, see supra note 38 and accompanying text.

The Third Circuit also noted that these Delaware cases are wholly consistent with the United States Supreme Court's decision in Gollust v. Mendell, 111 S. Ct. 2173 (1991). Blasband, 971 F.2d at 1041 n.7. In Gollust, the plaintiff was a shareholder of Viacom International, Inc. (Viacom) who commenced a derivative action under § 16(b) of the Securities Exchange Act of 1934, against various insiders of Viacom to recover "short-swing profits." 111 S. Ct. at 2176. Section 16(b) states, in relevant part, that:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer . . .

15 U.S.C. § 78p(b) (1992). "Short-swing profits" are profits earned by an insider, which includes directors and certain officers of the issuer, who trades on non-public information. Gollust, 111 S. Ct. at 2178. After the plaintiff filed the complaint, Viacom merged with another corporation, and the shareholders of Viacom received a mixture of cash and stock of the newly formed parent company. Id. at 2176-77. Because the plaintiff owned stock in the parent company, the Supreme Court held the plaintiff had an indirect, yet sufficient, financial interest in the litigation to satisfy the standing requirement under § 16(b). Id. at 2181.

While acknowledging that they were obligated to adhere to Delaware law, the Third Circuit noted that Gollust was nevertheless instructive. Blasband, 971 F.2d at 1041-42 n.7. The court found the instructional value of Gollust to be limited, however, because § 16(b), unlike Delaware § 327, does not require continuous ownership. See 15 U.S.C. § 78p(b) (1992); Gollust, 111 S. Ct. at 2180.
raised a claim of indirect financial interest.\footnote{Blasband, 971 F.2d at 1043-44. For a discussion of the facts and holding of Lewis, see supra notes 29-35 and accompanying text.} Accordingly, distinguishing Lewis, the Third Circuit concluded Lewis was not dispositive on the issue of indirect financial interest in Blasband.\footnote{Blasband, 971 F.2d at 1043-44. The court distinguished Lewis on three grounds. Id. First and most significantly, the Third Circuit observed that the plaintiff in Lewis had asserted standing on behalf of the pre-merger corporation, Old Conoco, and not the post-merger corporation, DuPont, of which the plaintiff was a shareholder. Lewis, 477 A.2d at 1041-42. In contrast, in Blasband, Blasband had asserted standing on behalf of Danaher, the post-merger parent company of which the plaintiff was a shareholder. Blasband, 971 F.2d at 1040. Additionally, Blasband had asserted standing based upon the indirect financial interest of a parent company in the affairs of its subsidiary. Id. at 1043. Although Blasband had asserted that he possessed "successor derivative standing and not double derivative standing," the Third Circuit found no real distinction between the two. Id. at 1040, 1046 n.14. Thus, while the plaintiff in Lewis had asserted "straight" derivative standing, Blasband had essentially asserted double derivative standing. Id. at 1043; see Lewis, 477 A.2d at 1042. A second factor distinguishing Lewis and Blasband was that the plaintiff in Lewis had made no attempt to amend his complaint to assert double derivative standing. Blasband, 971 F.2d at 1043-44. In contrast, Blasband had brought a double derivative action at the outset. Id. Third and finally, the Third Circuit explained that the Lewis court could not have implicitly rejected the plaintiff's standing to bring a derivative action on behalf of the parent, DuPont, without foreclosing the plaintiff's ability to bring a double derivative action. Id. at 1044. In order for the Lewis court to have granted standing, it would first have had to decide whether a shareholder could bring a double derivative action. Id. By contrast, in Blasband, the Third Circuit began its analysis recognizing that the Delaware Supreme Court after the Lewis decision recognized double derivative actions in Sternberg v. O'Neil, 550 A.2d 1105 (1988). Blasband, 971 F.2d at 1042.} In Sternberg, the court permitted a plaintiff to bring a double derivative action. Sternberg, 550 A.2d at 1109. The jurisdiction issue was particularly important because in a double derivative suit, both corporate parties are indispensable to the action. Id. at 1124. In Sternberg, a shareholder of GenCorp Inc. (GenCorp), the parent company, brought a double derivative action against GenCorp, RKO
derivative action, which is "brought on behalf of one corporation (e.g. a parent) to enforce a cause of action in favor of a related corporation (e.g. its subsidiary)." The Third Circuit reasoned that because the Sternberg plaintiff’s stake in the litigation was sufficient to confer standing and because that interest was no greater than Blasband’s, Blasband also had a sufficient indirect interest to satisfy the standing requirement. Consequently, the Third Circuit concluded that Blasband satisfied the continuous ownership requirement and had standing to maintain the derivative suit.

General, Inc. (RKO), GenCorp’s wholly-owned subsidiary, and certain officers and directors of both corporations. Id. at 1108. GenCorp was an Ohio corporation, while RKO was a Delaware corporation. Id.

The Delaware Supreme Court held that GenCorp had sufficient contacts with Delaware to create in personam jurisdiction. Id. at 1125-26. The court decided to extend jurisdiction based upon the need to provide a "forum for shareholder derivative litigation involving the internal affairs of its domestic corporations." Id. at 1125.

82. Sternberg, 550 A.2d at 1124-25.
83. Blasband, 971 F.2d at 1042-43. For a further description of double derivative actions, see supra note 12.
84. Blasband, 971 F.2d at 1043. The Third Circuit specifically stated: The plaintiff’s personal stake in the litigation in Sternberg—which was sufficient to confer standing—was no greater than Blasband’s stake in this action. Blasband continues to own shares in Danaher, the parent of the corporation, Easco, that has the primary right to sue to redress the wrongs asserted in his complaint and thus he has an indirect financial interest in the litigation. Id. The defendants in Blasband unsuccessfully argued that Blasband’s interest differed from that of the plaintiff in Sternberg. In Sternberg, the parent company, GenCorp, owned the subsidiary at the time of the transaction challenged by the plaintiff, and remained the subsidiary’s owner throughout the time the plaintiff’s complaint was filed and litigated. Sternberg, 550 A.2d at 1108. In Blasband, however, Danaher did not own Easco until after the occurrence of the transaction challenged by Blasband. Blasband, 971 F.2d at 1037-38. Thus, the shareholder in Sternberg arguably had a stronger interest because the parent company had an ownership interest both at the time of the challenged transactions and throughout the litigation. See Sternberg, 550 A.2d at 1108. In Blasband, by contrast, Danaher only had an ownership interest in Easco at the time the complaint was filed. Blasband, 971 F.2d at 1037-38. In rejecting this argument, the Third Circuit reasoned that because Blasband was a shareholder of Easco at the time of the challenged transaction, he, rather than Danaher, satisfied the "ownership at the time of the challenged transaction" component of the standing requirements. Id. at 1043, 1046 & n.14.

The Delaware Chancery Court rejected reasoning similar to that adopted by the Third Circuit in favor of applying the reorganization exception to standing. See, e.g., Bonime, 1984 WL 19830, at *3. The Bonime court emphasized the necessity of a common identity between the parent and the subsidiary. Id. If the parent and the subsidiary had separate boards, officers, assets and stockholders, the Bonime court opined that the "reorganization exception" would not apply and the plaintiff would lack standing. Id. For a discussion of the "reorganization exception" to the continuous ownership requirement, see supra note 38 and accompanying text.

85. Blasband, 971 F.2d at 1044. Moreover, the court noted that because Blasband was a shareholder at the time of the alleged inappropriate investment,
Finally, the Third Circuit noted that both Easco and Danaher had refused to assert the Easco claim following the merger. Recognizing that Delaware courts have widely permitted shareholders to sue on behalf of the company when the board refuses to assert the claim, the Third Circuit determined that Blasband should have been allowed the opportunity to assert the Easco claim himself.

B. Demand

In discussing the demand requirement, the Third Circuit first recognized that Delaware Chancery Court Rule 23.1 requires that a plaintiff either make an adequate demand on the board of directors which is refused, or show that such a demand would have been futile. Because Blasband did not plead that an adequate demand was made on either the Danaher or Easco board of directors, the Third Circuit limited its analysis to demand futility.

as required by § 327, he had clearly not purchased shares in order to initiate a strike suit. Id. at 1043; see Del. Code Ann. tit. 8, § 327 (1991). The Third Circuit reasoned the “literal requirements as well as the purposes underlying both components of shareholder derivative standing—ownership at the time of the challenged transaction and continuing ownership during the litigation”—were satisfied under Delaware law. Blasband, 971 F.2d at 1043. The Third Circuit noted, however, that this decision might “not fit neatly into existing Delaware corporation law.” Id. at 1044.

86. Blasband, 971 F.2d at 1044.

87. Id. The Third Circuit acknowledged that the Supreme Court of Delaware has recognized that directors have exclusive control over the business and affairs of the corporation. See Del. Code Ann. tit. 8, § 141(a) (1991); Blasband, 971 F.2d at 1044 (citing Lewis v. Anderson, 477 A.2d 1040, 1050 n.19 (Del. 1984)). Nonetheless, the Third Circuit additionally noted the Supreme Court of Delaware’s consistent recognition of a shareholder’s right to sue on the corporation’s behalf if the board of directors has failed to assert a claim properly belonging to it. Id. (citing Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)). Moreover, the Third Circuit indicated a shareholder may assert a claim that the directors refuse to assert, if the shareholder can prove that demand was futile or was wrongfully refused based upon the business judgment rule. See, e.g., Stepak v. Dean, 434 A.2d 388, 390 (Del. Ch. 1981) (holding that plaintiff failed to establish demand futility); Maldonado v. Flynn, 413 A.2d 1251, 1262 (Del. Ch. 1980) (holding that demand was made by plaintiff and wrongfully refused by board of directors), rev’d on other grounds sub nom. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). According to the court, however, this shareholder right is a right arising from the concept of demand and is not a component of standing. See Aronson, 473 A.2d at 811-14 (stating that shareholders may bring derivative action only after satisfying requirements of demand).

88. Blasband, 971 F.2d at 1044.

89. Id. at 1048; see Del. Ch. Ct. C.P.R. 23.1. For the text of Rule 23.1, see supra note 4. In Aronson v. Lewis, the Delaware Supreme Court stated that the demand requirement “exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits.” Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984). For a full discussion of the demand requirement, see supra notes 40-53 and accompanying text.

90. Blasband, 971 F.2d at 1048.
In evaluating demand futility, the Third Circuit applied the Aronson two-part test. Under the first prong of the test, the court reviewed the complaint's factual allegations to ascertain whether a reasonable doubt existed as to the disinterestedness and independence of the Easco and Danaher boards of directors at the time Blasband filed the complaint. Blasband argued the boards' response to his inquiry about the use of the public offering proceeds indicated that any further demand would have been futile. In reply, the defendants argued that a response to an inadequate demand should not be used as evidence of demand futility for two reasons. First, the defendants argued that the use of an inadequate demand to substantiate demand futility would reduce the demand requirement to a mere formality. Second, the defendants argued that Easco and Danaher's response did not cast a reasonable doubt on the boards' inability to consider a pre-suit demand. The Third Circuit rejected the defendants' first argument, opining that any use of the de-

91. Id. at 1048-55. For a full discussion of the Aronson test, see supra notes 48-53 and accompanying text. Initially, the Third Circuit had to determine to which board of directors the Aronson test was properly applied. Id. at 1049. The district court had held that an analysis of demand futility should focus only on the Danaher board's business judgment at the time the complaint was filed. Blasband v. Rales, 772 F. Supp. 850, 855 (D. Del. 1991). The Third Circuit disagreed. Blasband v. Rales, 971 F.2d 1034, 1049 (3d Cir. 1992). Specifically, the court reasoned that because the case was essentially a double derivative action, the demand required of a plaintiff in such an action should apply to Blasband. Id. at 1050. The court noted that a plaintiff in a double derivative suit must make a demand twice, upon the parent and also the subsidiary. Id. (quoting Keating & O'Grady, supra note 12, at 13). The Third Circuit further noted that although no Delaware court had considered the demand requirement necessary in a double derivative suit, demand upon both the parent and the subsidiary seemed consistent with the Delaware policy of preventing shareholders from impinging on the managerial freedom of directors. Id. at 1050. Consequently, the court imposed this double derivative requirement upon Blasband.

92. Blasband, 971 F.2d at 1050-52; see Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984). In Blasband, the Third Circuit noted that directorial interest exists when a director's loyalties are divided or when he or she stands to reap personal financial gains from a transaction not equally benefitting the shareholders. Blasband, 971 F.2d at 1048 (citing Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) and Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)).

93. Blasband, 971 F.2d at 1048. Blasband argued that the board's response demonstrated that any demand would be futile because the board denied all wrongdoing, refused to provide easily obtainable information and refused to conduct an investigation. Id. Moreover, Blasband argued that the response demonstrated the Danaher board's complete unwillingness to inquire into the Rales brothers' conduct. Id.

94. Id. at 1050-52.

95. Id. at 1050. The defendants argued that a shareholder could circumvent the demand requirement by making an inadequate demand, and then using the response to the inadequate demand to show the futility of the demand. Id.

96. Id. at 1051-52. The defendants argued that the Easco and Danaher's response stated that Easco had complied with its disclosure requirements as required under federal securities law, and gave no indication of whether a potential claim for breach of fiduciary duty existed. Id. at 1051. Thus, the defendants
fendants' response as evidence was irrelevant because plaintiff bore the burden of proof. The Third Circuit agreed with defendants' second argument, however, and held that the defendants' response did not raise a reasonable doubt of director independence.

After determining that the plaintiff failed to satisfy the first prong of the Aronson test, the court next examined the second prong of the test. The second prong requires the plaintiff to show that the board of directors invalidly exercised its business judgment in the transaction. The Third Circuit noted that the second prong of the Aronson test focuses on the board in office at the time of the challenged transaction, which in Blasband was the pre-merger Easco board. After reviewing the complaint, the Third Circuit held that Blasband had sufficiently pleaded facts demonstrating that the pre-merger Easco board was incapable of validly responding to a demand. However, the Blasband court acknowledged a problem with focusing on the pre-merger Easco board. The court commented that the relevant inquiry was not whether the transaction was approved by the board exercising reasonable business judgment, but rather, whether the present board had the legal and managerial capacity to control corporate litigation. The court reasoned that the letter did not raise a reasonable doubt that the board was disinterested. Id.

97. Id. at 1051. The Third Circuit held that the plaintiff always retains the burden of demonstrating reasonable doubt as to the disinterestedness of the directors, and that the plaintiff's use of such a response does not lessen the plaintiff's burden. Id.

98. Id. at 1052. The court held that the defendants' failure either to provide information or to take action did not raise a reasonable doubt that the defendants were disinterested. Id.

99. Id. at 1052-55.

100. See Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984). For a discussion of the second prong of the Aronson test, see supra notes 52-53 and accompanying text.


102. Blasband, 971 F.2d at 1052. The Third Circuit held, assuming that the allegations in the complaint were true, that Blasband established a reasonable doubt as to whether the use of the proceeds from the public offering was a valid exercise of business judgment. Id.

103. Id. at 1054.

104. Id. The Delaware Chancery Court had previously addressed this issue in Harris v. Carter, 582 A.2d 222, 230 (Del. Ch. 1990):

In the special case, however, where there is a change in board control between the date of the challenged transaction and the date of suit, it might open the way to error to focus on the board existing at the time of the challenged transaction. What, in the end, is relevant is not whether the board that approved the challenged transaction was or was not interested in that transaction but whether the present board is or is not disabled from exercising its right and duty to control corporate litigation.

I do not consider that Aronson intended to determine that demand under [Delaware Court of Chancery] Rule 23.1 upon an independent
that even though Blasband had satisfied the second prong of the Aronson test as to the pre-merger Easco board, the focus of the Aronson inquiry at the time of the transaction would be rendered irrelevant if control of Easco's board had changed.\textsuperscript{105} Therefore, the Third Circuit concluded that demand futility would only be satisfied as to the Easco board "[i]f Blasband [could] show upon remand that a controlling group of Easco board members existing at the time of the challenged transactions continued to control the board at the time he filed his complaint."\textsuperscript{106}

V. IMPACT

In Blasband \textit{v.} Raies, the Third Circuit strengthened the plaintiff-shareholder's ability to bring a derivative action. As a result of this decision, plaintiffs currently maintain a competitive advantage in litigating claims in the Third Circuit forum rather than in Delaware state courts. Blasband sets important precedent in two respects. First, Blasband established that a plaintiff-shareholder may bring a double derivative suit on behalf of a parent company for alleged wrongs to a subsidiary where the plaintiff was not a shareholder of the parent at the time of the alleged wrongs and only became a shareholder of the parent through a merger.\textsuperscript{107} By allowing the plaintiff to bring such a double derivative suit and establish standing, the Third Circuit relaxed the continuous ownership requirement. This change is important because earlier, a shareholder who had exchanged his or her shares in a merger failed to

\footnotesize{105. Blasband, 971 F.2d at 1054-55.}

\footnotesize{106. Id. The Third Circuit thus vacated the district court's order on the standing issue. Id. at 1055. Regarding the demand issue, the Third Circuit remanded the case to the district court with leave to add Easco as a party to the suit, and to determine whether the Easco board changed in composition from the time of the challenged transaction to the time of the filing of the complaint. Id.}

\footnotesize{107. Blasband, 971 F.2d at 1046. This result is inconsistent with established Delaware law, which recognizes that the reorganization exception to the continuous ownership requirement may only be applied if the post-merger corporation is virtually identical to the pre-merger corporation. See, e.g., Bonime \textit{v.} Biaggini, No. 6925, 6980, 1984 WL 19830, at *3 (Del. Ch. Dec. 7, 1984) (denying use of reorganization exception where new corporation had identity significantly different than old corporation), aff'd \textit{without opinion}, 505 A.2d 451 (Del. 1985); Schreiber \textit{v.} Carney, 447 A.2d 17, 22 (Del. Ch. 1982) (applying reorganization exception where new corporation was identical to old corporation).}
satisfy the continuous ownership requirement necessary for standing.\textsuperscript{108} Significantly, the Third Circuit's opinion is sensible when the post-merger corporation is identical to the pre-merger corporation.\textsuperscript{109} If, however, the post-merger entity has different directors, officers, assets and stockholders, the logic of Blasband is not as sound.\textsuperscript{110} If the two corporations are different, the plaintiff-shareholder may not possess a sufficient interest in litigating a claim for a corporation in which he or she is no longer a shareholder.\textsuperscript{111}

Second, in Blasband, the Third Circuit clarified the demand requirements necessary in double derivative suits involving mergers.\textsuperscript{112} The Blasband court reinforced the proposition that the focus of the second prong of the Aronson test is properly upon the corporation at the time of the challenged transaction.\textsuperscript{113} If at the time the complaint is filed the composition of the board of directors has changed, under Blasband, the plaintiff must also show demand futility as to that board.\textsuperscript{114} This rule will force the post-merger corporation's board of directors to assume responsibility for a pre-merger corporation's actions.\textsuperscript{115} Moreover, the post-merger corporation, in order to avoid a derivative suit, must determine whether the post-merger corporation's interests would be furthered by not pursuing the action.\textsuperscript{116}

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\textsuperscript{108} For a full discussion of the continuous ownership requirement, see supra notes 20-39 and accompanying text.

\textsuperscript{109} See, e.g., Schreiber, 447 A.2d at 22 (applying reorganization exception to continuous ownership requirement where new corporation is identical to old corporation).

\textsuperscript{110} See, e.g., Bonime, 1984 WL 19830, at *3 (rejecting use of reorganization exception to continuous ownership requirement where new entity had “corporate mix” that was distinctively different than new corporation).

\textsuperscript{111} For a discussion of the importance of having a sufficient stake in the litigation to bring the derivative action, see supra notes 21, 23, 24 & 26 and accompanying text.

\textsuperscript{112} Blasband, 971 F.2d at 1050.

\textsuperscript{113} Id. at 1052.

\textsuperscript{114} Id. at 1054-55.

\textsuperscript{115} Harris v. Carter, 582 A.2d 222, 229-30 (Del. Ch. 1990). The Harris court described this responsibility as whether the [post-merger corporation's] board [of directors] is or is not disabled from exercising its right and duty to control corporate litigation.” Id. at 230.

\textsuperscript{116} See, e.g., R. Franklin Balotti et al., \textit{Defense of Derivative Claims}, in 2 \textit{Securities Litigation} 1990, at 77, 93 (PLI Litig. & Admin. Practice Course Handbook Series No. 400, 1990) (“As a theoretical matter there is little justification in requiring the court to examine the prior board or its action because even if the action challenged was not the product of a valid exercise of business judgment, the current board might well determine that the corporation’s interests would be best served by not pursuing the cause of action.”)