

---

2014

## Dismissing Derivative Actions in the Federal Courts for Failure to Allege Demand Futility: Choosing a Standard of Appellate Review—Abuse of Discretion or De Novo?

Andrew S. Hirsch

Follow this and additional works at: <https://scholarlycommons.law.emory.edu/elj>

---

### Recommended Citation

Andrew S. Hirsch, *Dismissing Derivative Actions in the Federal Courts for Failure to Allege Demand Futility: Choosing a Standard of Appellate Review—Abuse of Discretion or De Novo?*, 64 Emory L. Rev. 201 (2014).

Available at: <https://scholarlycommons.law.emory.edu/elj/vol64/iss1/5>

This Comment is brought to you for free and open access by Emory Law Scholarly Commons. It has been accepted for inclusion in Emory Law Journal by an authorized editor of Emory Law Scholarly Commons. For more information, please contact [law-scholarly-commons@emory.edu](mailto:law-scholarly-commons@emory.edu).

**DISMISSING DERIVATIVE ACTIONS IN THE FEDERAL  
COURTS FOR FAILURE TO ALLEGE DEMAND FUTILITY:  
CHOOSING A STANDARD OF APPELLATE REVIEW—  
ABUSE OF DISCRETION OR DE NOVO?**

ABSTRACT

*In the federal court system, when the district courts dismiss shareholders' derivative actions for failure to allege demand futility, the circuit courts have historically reviewed these dismissals for abuse of discretion. This started to change when the Supreme Court of Delaware converted from deferential to plenary review in 2000. Thereafter, many circuit courts expressed doubt about their historical standard of review. Finally, the First Circuit converted to de novo review in 2013, creating a definite circuit split and prompting the Supreme Court to take up the issue. Unfortunately, the case fell from the Court's docket because the plaintiffs lost standing. Thus, the issue continues to percolate in the circuit courts.*

*This Comment assembles all the information and analyses necessary for the reader to fully understand the issue and concludes that the courts should preserve the deferential standard. As an intermediate step to this conclusion, this Comment argues that Rule 23.1 of the Federal Rules of Civil Procedure itself—not Rule 12(b)(6) or any other rule—is the proper procedural vehicle for dismissing a case when a plaintiff fails to allege demand futility—the demand futility dismissal. This selection allows the courts to assign a standard of review to the demand futility dismissal independent of any preexisting standard, since the Rule 23.1 dismissal does not have a default standard of review.*

*After selecting the vehicle of dismissal, this Comment then turns to the task of assigning a standard of review. To do so, it employs the multifactor test that the Supreme Court handed down in *Pierce v. Underwood*. Analysis under this test reveals that the deferential standard's historical pedigree entitles it to a presumption of correctness that the plenary standard does not overcome. This Comment lastly shows that this historical standard is supported by the standards that apply to the other Rule 23.1 dismissals.*

INTRODUCTION .....	203
I. CONCEPTUAL BACKGROUND .....	210
A. <i>The Derivative Action and its Requirements</i> .....	210
B. <i>Standards of Review</i> .....	213
II. APPLYING THE STATE STANDARD OF REVIEW .....	215
A. <i>Directly Applying the State Standard of Review</i> .....	215
B. <i>Indirectly Applying the State Standard of Review</i> .....	217
III. VEHICLE OF DISMISSAL .....	218
A. <i>Vehicles of Dismissal Used by the Circuit Courts</i> .....	220
B. <i>Rule 12(b)(1) as a Contender</i> .....	223
C. <i>Rule 12(b)(6) as a Contender</i> .....	224
D. <i>Rule 41(b) as a Contender</i> .....	227
IV. COMPARING THE DEMAND FUTILITY DISMISSAL TO THE RULE 12(B)(6) DISMISSAL: THE INERTIA BEHIND THE DE NOVO TREND ....	229
A. <i>Dismissal on the Pleadings for Lack of Legal Sufficiency</i> .....	229
B. <i>Two Counterarguments</i> .....	230
V. UNDERWOOD ANALYSIS .....	231
A. <i>Historical Practice</i> .....	232
1. <i>The Deferential Standard's Historical Pedigree</i> .....	233
2. <i>The Plenary Standard's Arbitrary Usurpation</i> .....	235
3. <i>The Merger of Law and Equity as a Nonstarter for         Plenary Review</i> .....	236
B. <i>Language and Structure</i> .....	237
C. <i>Administration of Justice</i> .....	240
D. <i>Rule Formation</i> .....	242
E. <i>Financial Interests</i> .....	242
VI. OTHER 23.1 DISMISSALS .....	243
A. <i>Fair-and-Adequate Representation</i> .....	244
B. <i>Verification</i> .....	245
C. <i>Contemporaneous Ownership</i> .....	246
D. <i>Continuous Ownership</i> .....	246
E. <i>Collusion</i> .....	247
CONCLUSION .....	248

## INTRODUCTION

This Comment resolves a straightforward, but “uncommonly difficult,”<sup>1</sup> issue. It is an issue that currently splits the federal circuit courts and has made it all the way to the Supreme Court of the United States, but remains unsettled. The issue is this: *In the federal court system, which standard of review—abuse of discretion or de novo—should a circuit court apply when reviewing a district court’s dismissal of a shareholder’s derivative action for failure to allege demand futility?*<sup>2</sup>

Before moving forward, it is helpful to unpack the main issue. A “derivative action” is an action in which a shareholder causes his corporation to sue the corporation.<sup>3</sup> In order to bring this action, the shareholder must meet certain requirements, one of which is to first make a demand on the board of directors to bring the action on the corporation’s behalf. The directors usually reject the demand, since they are typically the ones being sued. To circumvent this predicament, the shareholder can abstain from making the demand and argue that so doing would have been futile, given the board’s bias. At this critical point, the district court will either allow the action to proceed, or dismiss it for failure to allege demand futility. If the shareholder appeals, the circuit court will have to review the dismissal and choose a standard by which to do so. Under “abuse of discretion” review, also called “deferential” review, the circuit court reviews the district court’s decision with deference.<sup>4</sup> Under “de novo” review, also known as “plenary” review, the circuit court reviews the district court’s action without deference.<sup>5</sup> This Comment answers the question of which standard of review the circuit court should apply.

To resolve the main issue presented, this Comment must also resolve a sub-issue. The sub-issue—which also is unsettled in the courts—is this: *what is the proper procedural vehicle for making the demand futility dismissal?* Four contenders emerge from the Federal Rules of Civil Procedure (the Rules): (i) Rule 12(b)(1), providing for dismissal for lack of subject-matter jurisdiction; (ii) Rule 12(b)(6), providing for dismissal for failure to state a

---

<sup>1</sup> *Pierce v. Underwood*, 487 U.S. 552, 558 (1988) (characterizing the general task of choosing between abuse of discretion and de novo review).

<sup>2</sup> This Comment does not cover the district court’s denial of a demand futility motion to dismiss, since the circuit courts lack jurisdiction to take this issue on appeal. *E.g.*, *Catlin v. United States*, 324 U.S. 229, 236 (1945) (“[The] denial of a motion to dismiss . . . is not immediately reviewable.”).

<sup>3</sup> *See infra* Part I.A.

<sup>4</sup> *See infra* Part I.B.

<sup>5</sup> *See infra* Part I.B.

claim upon which relief may be granted; (iii) Rule 41(b), providing for dismissal for failure to comply with the Rules; and (iv) Rule 23.1,<sup>6</sup> which provides the requirements to bring a derivative action. Standards of review have already been assigned to the former three vehicles, so placing the demand futility dismissal under any of them would dispose of the main issue. However, no standard has been assigned to Rule 23.1 dismissals.

The main issue emerged only recently, but with great momentum. Since the dawn of demand futility, the standard of review has been abuse of discretion. Delaware—“the Mother Court of corporate law”<sup>7</sup>—changed this. The Supreme Court of that State, in its 2000 case of *Brehm v. Eisner*, abandoned deferential review in favor of plenary review.<sup>8</sup> This decision, and the *de novo* trend in general, is supported by two arguments: (i) the demand futility dismissal is a dismissal on the pleadings for lack of legal sufficiency, which is reviewed *de novo*; and (ii) as a dismissal on the pleadings, the circuit court is in just as good a position to make the determination as is the district court. *Brehm* was met with an immediate and prolonged effect at both the state and federal levels. Outside of federal court, New Jersey,<sup>9</sup> Nevada,<sup>10</sup> and the District of Columbia<sup>11</sup> have all followed *Brehm*.<sup>12</sup>

At the federal level, the response to *Brehm* started as talk, but then turned into action. Three circuits—the Second Circuit,<sup>13</sup> the District of Columbia Circuit,<sup>14</sup> and the Ninth Circuit<sup>15</sup>—all spoke favorably of plenary review, but none abandoned their well-established deferential standards. Finally, in 2013, the First Circuit expressly adopted *de novo* review in *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Financial Services Inc. of*

---

<sup>6</sup> In this Comment, “Rule 23.1” refers to Rules 23.1(a)–(b), but does not include Rule 23.1(c), unless stated otherwise.

<sup>7</sup> *Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990), *rev’d on other grounds*, 500 U.S. 90 (1991).

<sup>8</sup> *Brehm v. Eisner*, 746 A.2d 244, 253–54 (Del. 2000) (overruling *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)).

<sup>9</sup> *In re PSE & G S’holder Litig.*, 801 A.2d 295, 313 (N.J. 2002).

<sup>10</sup> *Shoen v. SAC Holding Corp.*, 137 P.3d 1171, 1180 (Nev. 2006).

<sup>11</sup> *Behradrezaee v. Dashtara*, 910 A.2d 349, 362 (D.C. 2006).

<sup>12</sup> *But see Jerue v. Millett*, 66 P.3d 736, 745 (Alaska 2003) (rejecting *Brehm*).

<sup>13</sup> *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 137 n.6 (2d Cir. 2004); *see also Kautz v. Sugarman*, 456 F. App’x 16, 18 (2d Cir. 2011) (further acknowledging the open question in *Scalisi*).

<sup>14</sup> *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 783 n.2 (D.C. Cir. 2008).

<sup>15</sup> *Israni v. Bittman*, 473 F. App’x 548, 550 n.1 (9th Cir. 2012) (citing in part *Laborers Int’l Union of N. Am. v. Bailey*, 310 F. App’x 128, 130 n.1 (9th Cir. 2009)).

*Puerto Rico (Unión de Empleados)*.<sup>16</sup> This created an apparent circuit split, prompting the Supreme Court to take up the issue.

Although the issue made it before the Nine Justices, it slipped out of their hands before they could decide on it. The Court granted certiorari in *Unión de Empleados* on June 24, 2013.<sup>17</sup> Meanwhile, the case was also on remand to the district court, which dismissed it on July 9, finding that the plaintiffs had lost their derivative standing by selling their shares.<sup>18</sup> Accordingly, the Supreme Court dismissed the petition on August 26.<sup>19</sup> This dismissal does not mean, however, that the issue is now either settled or unimportant. To the contrary, it is an issue that the Court deems worthy of discussion.

The Supreme Court deems the issue worthy of discussion not because of its academic intrigue, but because derivative actions and standards of review are of great practical importance. The derivative action is important for two reasons. First, it is an essential component of American corporate governance,<sup>20</sup> since it is the primary legal mechanism for shareholders to hold directors and officers accountable for wrongdoings against the corporation.<sup>21</sup> Second, these actions are frequently enormous in terms of the financial interests at stake.<sup>22</sup> Standards of review are important because they frame the issue on appeal, thereby establishing the division of labor between the trial and appellate courts, and helping to determine appellate outcomes.<sup>23</sup> The convergence of these two phenomena, which comprises this Comment's main issue, is of great practical importance.

The main issue currently splits the circuit courts, and this split continues to develop at a rapid pace. Just during the *Unión de Empleados* appeal to the Supreme Court, the Seventh Circuit had the opportunity to add its weight to the

---

<sup>16</sup> 704 F.3d 155, 161–63 (1st Cir. 2013).

<sup>17</sup> *UBS Fin. Servs. Inc. of P.R. v. Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan*, 133 S. Ct. 2857, 2857–58 (2013) (mem.).

<sup>18</sup> *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Servs. Inc. of P.R.*, No. 3:10-cv-01141-ADC (D.P.R. filed July 9, 2013).

<sup>19</sup> *UBS Fin. Servs. Inc. of P.R. v. Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan*, 134 S. Ct. 40 (2013) (mem.).

<sup>20</sup> “Corporate governance” means the “management of a corporation for the benefit of its shareholders in compliance with laws and ethical standards.” JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 152 (9th ed. 2014).

<sup>21</sup> *See infra* Part I.A.

<sup>22</sup> *See infra* Part V.E.

<sup>23</sup> *See infra* Part I.B.

discussion. It chose to abandon its forty-seven-year-old deferential standard<sup>24</sup> in favor of the plenary standard.<sup>25</sup> This leaves the circuit split as follows. Six circuits have issued opinions that expressly embrace deferential review—the Second,<sup>26</sup> Third,<sup>27</sup> Ninth,<sup>28</sup> Tenth,<sup>29</sup> Eleventh,<sup>30</sup> and District of Columbia Circuits.<sup>31</sup> Two circuits have expressly converted to de novo review—the First<sup>32</sup> and Seventh<sup>33</sup> Circuits. Two other circuits—the Sixth<sup>34</sup> and Eighth<sup>35</sup> Circuits—also apply plenary review, but they adopted this standard only recently and without even acknowledging the debate. The Fourth, Fifth, and Federal Circuits have not spoken on the issue. Therefore, the circuit split is at least 6–2 and at most 6–4, both in favor of deferential review. But, this numerical advantage is misleading.

The deferential standard is now in a precarious position, opposed by a strong de novo trend and hanging on by only a fragile majority. Since Delaware's decision in *Brehm*, the plenary standard has moved forward with relentless momentum. Three of the six circuits in the deferential majority—the Second, Ninth, and District of Columbia Circuits—have all issued opinions speaking against deferential review.<sup>36</sup> The Eleventh Circuit's position stands on a weak foundation, because it indirectly derives from Ninth Circuit precedent.<sup>37</sup> The Third Circuit's position is also weakened, since it is based mainly on precedent from the Second and Seventh Circuits.<sup>38</sup> The only circuit

---

<sup>24</sup> See *Robison v. Caster*, 356 F.2d 924, 927 (7th Cir. 1966) (adopting deferential standard).

<sup>25</sup> See *Westmoreland Cnty. Emp. Ret. Sys. v. Parkinson*, 727 F.3d 719, 724–25 (7th Cir. 2013).

<sup>26</sup> *Lambrech v. O'Neal*, 504 F. App'x 23, 25 (2d Cir. 2012).

<sup>27</sup> *In re Merck & Co. Sec., Deriv. & ERISA Litig.*, 493 F.3d 393, 399 (3d Cir. 2007).

<sup>28</sup> *Israni v. Bittman*, 473 F. App'x 548, 550 (9th Cir. 2012).

<sup>29</sup> *deHaas v. Empire Petrol. Co.*, 435 F.2d 1223, 1228 (10th Cir. 1970), *cited with approval in Cadle v. Hicks*, 272 F. App'x 676, 677 (10th Cir. 2008) (not a demand futility case).

<sup>30</sup> *Staehr v. Alm*, 269 F. App'x 888, 891 (11th Cir. 2008).

<sup>31</sup> *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 783 n.2 (D.C. Cir. 2008).

<sup>32</sup> *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Servs. Inc. of P.R.*, 704 F.3d 155, 162–63 (1st Cir. 2013).

<sup>33</sup> *Westmoreland Cnty. Emp. Ret. Sys. v. Parkinson*, 727 F.3d 719, 724 (7th Cir. 2013).

<sup>34</sup> *In re Ferro Corp. Deriv. Litig.*, 511 F.3d 611, 617 (6th Cir. 2008).

<sup>35</sup> *Gomes v. Am. Century Cos.*, 710 F.3d 811, 815 (8th Cir. 2013).

<sup>36</sup> See cases cited *supra* notes 13–15.

<sup>37</sup> The Eleventh Circuit adopted the deferential standard in 1990. See *Peller v. S. Co.*, 911 F.2d 1532, 1536 (11th Cir. 1990) (citing *Rothenberg v. Sec. Mgmt. Co.*, 667 F.2d 958, 960 (11th Cir. 1982)). *Rothenberg* in turn cites two cases to support this standard. See *Rothenberg*, 667 F.2d at 960 (citing *Owen v. Modern Diversified Indus., Inc.*, 643 F.2d 441, 443 (6th Cir. 1981) and *Hornreich v. Plant Indus.*, 535 F.2d 550, 552 (9th Cir. 1976)). Further, *Owen* cites *Hornreich* to support the deferential standard. See *Owen*, 643 F.2d at 443.

<sup>38</sup> See *Blasband v. Rales*, 971 F.2d 1034, 1040 (3d Cir. 1992). *Blasband* cited three cases in support of its holding: *Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983), *Starrels v. First National Bank*, 870 F.2d 1168,

whose position is relatively isolated from the onslaught is that of the Tenth Circuit.<sup>39</sup> However, even this is probably weakened, since the Tenth Circuit's decision that adopted the deferential standard apparently relies on one of the same sources that once supported the Seventh Circuit's defunct deferential standard.<sup>40</sup>

This Comment argues that the federal appellate courts—including the Supreme Court—should reject the *de novo* trend and maintain the deferential standard. As an intermediate step, it first argues that Rule 23.1 itself is the proper procedural vehicle for the demand futility dismissal. Since this vehicle does not already have a standard of review assigned to it, this Comment takes on the task of assignment. To make this assignment, it is necessary to consider the Supreme Court's 1988 case of *Pierce v. Underwood*.<sup>41</sup> This case provides a multifactor test—with historical practice as the threshold factor—for choosing between plenary and deferential review.<sup>42</sup> Analysis under these factors reveals that the deferential standard's historical pedigree entitles it to a presumption of correctness that the plenary standard does not overcome. Although this argument is formalistic, it is also practical. This is because the *Underwood* factors themselves are based on practical considerations regarding the division of labor between the trial and appellate courts.

Some might argue—wrongly—that the answer to the main issue in this Comment is a function of corporate governance policy. Effective corporate governance indeed depends, to a great extent, on the derivative action. Accordingly, any requirement to bring the derivative action—demand futility in this case—is a matter of corporate governance. Likewise, it is tempting to say that the demand futility dismissal's standard of appellate review is a matter

---

1170 (7th Cir. 1989), and *Peller v. Southern Co.*, 911 F.2d 1532, 1536 (11th Cir. 1990). These sources are no longer persuasive. First, the Second Circuit's holding in *Lewis* was recently criticized by a panel of that court. See *Scalisi v. Fund Asset Mgmt.*, 380 F.3d 133, 137 n.6 (2d Cir. 2004). Second, *Starrel* was recently overruled by the Seventh Circuit. See *Westmoreland Cnty. Emp. Ret. Sys. v. Parkinson*, 727 F.3d 719 (7th Cir. 2013). Finally, as explained *supra* in note 37, the Eleventh Circuit's arguments in favor of the deferential standard have been weakened.

<sup>39</sup> See *deHaas v. Empire Petrol. Co.*, 435 F.2d 1223 (10th Cir. 1970).

<sup>40</sup> The Seventh Circuit used the deferential standard in *Fields v. Fidelity General Insurance Co.*, 454 F.2d 682, 684–85 (7th Cir. 1971). To support this, the Seventh Circuit cited a District of Colorado opinion. *Id.* at 685 n.3 (citing *deHaas v. Empire Petrol. Co.*, 286 F. Supp. 809, 813 (D. Colo. 1968)). The Tenth Circuit affirmed the district court's holding in 1970 and explicitly adopted the deferential standard at that time, though it did not provide a rationale for doing so. *deHaas*, 435 F.2d at 1228. It is probable that the Tenth Circuit relied on the district court's reasoning.

<sup>41</sup> 487 U.S. 552 (1988).

<sup>42</sup> *Id.*; see also *infra* Part V.



of corporate governance. This is because the standard affects the likelihood of successfully appealing a demand futility dismissal: deferential review makes it less likely because it gives deference to the district court's decision to dismiss; plenary review makes it more likely because the circuit court can review the matter anew. Thus, a promanagement policy would favor deferential review, and a pro-shareholder policy would favor de novo review. However, neither of these policies guides this Comment's analysis.

Corporate governance policy is a nonissue for selecting a standard of appellate review.<sup>43</sup> This is the case for two reasons. First, standards of review are not concerned with the likelihood of success on appeal, but with "the relation between the trial court and the appellate court"<sup>44</sup> most appropriate to the particular type of case. Second, appellate review should not be used as a tool to effect corporate governance policy. Again, there are two reasons why. First, it is an ineffective tool because there is no certainty that the circuit courts will effect the desired policy. Second, it is an inappropriate tool because it does not exist to effect corporate governance policy, or even give the appellant a second chance on appeal.<sup>45</sup> Rather, it exists to ensure against "reversible error" committed by the trial courts, and to interpret and exposit the law so as to provide "clarity and guidance for citizens and for the lower courts."<sup>46</sup> The proper means for effecting corporate governance policy is not to target the appellate review of decisions based on applicable rules, but to target the rules themselves—which is not the topic of this Comment. The only policies to consider in selecting a standard of review relate to the proper division of labor between the trial and appellate courts. Indeed, these are the policies that the litigants and courts on both sides of the main issue have addressed in the relevant cases, and they are also the policies that this Comment addresses.

This Comment's focus is the demand futility dismissal's standard of review; but, the complexity of this main issue requires that the scope be broader than just that. In Part III, this Comment provides a full analysis of the

---

<sup>43</sup> This is not to say that corporate governance is an irrelevant concept. As explained earlier in the Introduction, the derivative action is important in part because of its role in corporate governance. As such, it is necessary to set forth a consistent standard of review for dismissals. This part of the Introduction merely argues that the standard should not be assigned based on any particular corporate governance policy. *See supra* note 20 and accompanying text.

<sup>44</sup> *In re Abbott Labs. Deriv. S'holders Litig.*, 325 F.3d 795, 803 (7th Cir. 2003).

<sup>45</sup> *Cf. Anderson v. City of Bessemer City*, 470 U.S. 564, 575 (1985) (stating that "the trial . . . should be 'the main event rather than a tryout on the road.'" (quoting *Wainwright v. Sykes*, 433 U.S. 72, 90 (1977) (some internal quotation marks omitted))).

<sup>46</sup> RICHARD D. FREER, *CIVIL PROCEDURE* § 14.2, at 834 (3d ed. 2012).

proper vehicle for dismissing a case for failing to allege demand futility, what this Comment refers to as the “demand futility dismissal” (which easily applies to other derivative action dismissals). This analysis may be useful for addressing other procedural issues related to derivative actions, particularly whether the preclusion doctrines apply with respect to derivative actions. Additionally, in Part VI, this Comment essentially assigns standards of review to the five other Rule 23.1 dismissals. This Comment’s major limitation is that it might not be helpful for analyzing demand-related dismissals where the demand requirement is universal, such that there is no demand-futility exception.<sup>47</sup> Which standard of appellate review applies in these dismissals is a possible area for further research. Additional research may also include an examination of the preclusion doctrines in derivative actions, as well as an empirical study of what effect the conversion to de novo review has precipitated in certain jurisdictions, particularly Delaware.

This Comment proceeds in six parts. Part I provides a brief conceptual background on both the derivative action and its requirements, as well as standards of review. Part II explains and debunks arguments for making the federal courts apply the state standard of review. Part III addresses the vehicle of dismissal sub-issue and argues that Rule 23.1 is the proper vehicle for making the demand futility dismissal. Part IV introduces the two arguments behind the de novo trend, explains the first of these in depth, and presents two counter-arguments. Part V conducts analysis under the *Underwood* test and concludes that the outcome favors deferential review (Part V.C introduces and argues against the second argument behind the de novo trend). Finally, Part VI discusses how the standards of review applied to other Rule 23.1 dismissals support the demand futility dismissal’s deferential standard.

---

<sup>47</sup> Universal demand jurisdictions include the following jurisdictions, twenty-two of which have adopted universal demand by statute, and by one through its case law. *See* ARIZ. REV. STAT. ANN. § 10-742 (2013); CONN. GEN. STAT. ANN. § 33-722 (West 2005); FLA. STAT. § 607.07401(2) (2014); GA. CODE ANN. § 14-2-742 (2003); HAW. REV. STAT. § 414-173 (West 2008); IDAHO CODE ANN. § 30-1-742 (West 2011); IOWA CODE § 490.742 (2013); LA. CODE CIV. PROC. ANN. art. 615 (2013); ME. REV. STAT. tit. 13C, § 753 (West Supp. 2013); MASS. GEN. LAWS ANN. ch. 156D, § 7.42 (West 2005); MICH. COMP. LAWS ANN. § 450.1493a (West 2002); MISS. CODE ANN. § 79-4-7.42 (West Supp. 2013); MONT. CODE ANN. § 35-1-543 (2009); NEB. REV. STAT. § 21-2072 (2012); N.H. REV. STAT. ANN. § 293-A:7.42 (West, Westlaw through ch. 172, 2014 Reg. Sess.); N.C. GEN. STAT. ANN. § 55-7-42 (West 2011); R.I. GEN. LAWS ANN. § 7-1.2-711(c) (West 2006); S.D. CODIFIED LAWS § 47-1A-742 (2007); TEX. BUS. ORGS. CODE ANN. § 21.553 (West 2012); UTAH CODE ANN. § 16-10a-740 (West Supp. 2013); VA. CODE ANN. § 13.1-672.1(B)(1) (West Supp. 2014); WIS. STAT. ANN. § 180.0742 (West 2002); WYO. STAT. ANN. § 17-16-742 (West 2007); *Cuker v. Mikaluskas*, 692 A.2d 1042, 1049 (Pa. 2006).

## I. CONCEPTUAL BACKGROUND

Before entering the analytical parts of this Comment, it is helpful to first provide a background on certain key concepts. This Part does so in two sections. Section A explains the derivative action and its requirements, particularly the demand requirement and its demand-futility exception. Section B explains standards of review, particularly the *de novo* and abuse of discretion standards, as well as the clearly erroneous standard.

### A. *The Derivative Action and its Requirements*

This section A introduces the derivative action and its requirements. It does so in the following five ways. First, it defines the derivative action. Second, it gives an overview of the Rule 23.1 requirements to bring a derivative action. Third, it briefly introduces the first five of these requirements. Fourth, it explains the demand requirement and its demand-futility exception. Fifth, it explains the equitable nature of the derivative action, the demand requirement, and the demand-futility exception.

The derivative action is, at its core, a very simple concept. It is an action that “one or more shareholders or members of a corporation or an unincorporated association<sup>48</sup> bring . . . to enforce a right that the corporation or association may properly assert but has failed to enforce.”<sup>49</sup> In other words, a shareholder perceives that the corporation has been injured, but since neither the directors nor officers will bring the action to remedy the injury, the shareholder brings the action on behalf of the corporation.<sup>50</sup> The shareholder’s right to bring this action, along with the substantive law of derivative actions in general is governed by state law, since corporations are almost always incorporated at the state level.<sup>51</sup>

To bring a derivative action in federal court, the shareholder must comply with Rule 23.1. This rule imposes six requirements: (1) the continuous-ownership requirement;<sup>52</sup> (2) the fair-and-adequate-representation

---

<sup>48</sup> The Comment refers to corporations throughout because derivative actions usually involve corporations, but it also applies to derivative actions involving entities other than corporations.

<sup>49</sup> FED. R. CIV. P. 23.1(a).

<sup>50</sup> 5 JEROLD S. SOLOVY, RONALD L. MARMER, TIMOTHY J. CHORVAT & DAVID M. FEINBERG, MOORE’S FEDERAL PRACTICE § 23.1.02[1] (3d ed. 2013).

<sup>51</sup> *Cf.* *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108–09 (1991) (holding that state law generally governs the substance of demand futility).

<sup>52</sup> *See* FED. R. CIV. P. 23.1(a).

requirement;<sup>53</sup> (3) the verification requirement;<sup>54</sup> (4) the contemporaneous-ownership requirement;<sup>55</sup> (5) the non-collusion requirement;<sup>56</sup> and (6) the demand requirement,<sup>57</sup> accompanied by its demand-futility exception.<sup>58</sup> The sixth requirement is governed in substance by state law; Rule 23.1 merely contemplates its existence and provides the applicable pleading standard.<sup>59</sup> However, this substance-procedure dichotomy does not affect this Comment's analysis (unless otherwise stated) because this Comment only addresses the dismissal where this contemplated requirement actually exists. If the shareholder fails to satisfy any of these requirements, then his potential derivative action is subject to dismissal.

Although this Comment focuses on demand futility, it also discusses the other requirements, so some introduction is in order. (1) The continuous-ownership requirement requires the shareholder to own stock in the corporation at the beginning of and throughout the entire action.<sup>60</sup> This requirement is not explicitly stated in the Rules, but is implied from Rule 23.1's language and based on the derivative action's equitable nature.<sup>61</sup> (2) The fair-and-adequate-representation requirement requires that the shareholder "fairly and adequately represent" the other shareholders.<sup>62</sup> (3) The verification requirement requires the shareholder to verify that he is the plaintiff to the action, that he basically understands the contents of the complaint, and that he believes the contents to be true.<sup>63</sup> (4) The contemporaneous-ownership requirement requires that the claimant was a shareholder in the corporation when the harm allegedly occurred.<sup>64</sup> (5) The non-collusion requirement requires the shareholder to "allege that the action is not a collusive one to confer jurisdiction that the court would otherwise lack."<sup>65</sup>

---

<sup>53</sup> *Id.*

<sup>54</sup> FED. R. CIV. P. 23.1(b).

<sup>55</sup> FED. R. CIV. P. 23.1(b)(1).

<sup>56</sup> FED. R. CIV. P. 23.1(b)(2).

<sup>57</sup> FED. R. CIV. P. 23.1(b)(3)(A).

<sup>58</sup> FED. R. CIV. P. 23.1(b)(3)(B).

<sup>59</sup> *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96 (1991).

<sup>60</sup> *E.g.*, *Lewis v. Knutson*, 699 F.2d 230, 238 (5th Cir. 1983).

<sup>61</sup> 7C CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE AND PROCEDURE § 1826 (3d ed. 2007).

<sup>62</sup> FED. R. CIV. P. 23.1(a).

<sup>63</sup> *See* 7C WRIGHT ET AL., *supra* note 61, § 1827.

<sup>64</sup> FED. R. CIV. P. 23.1(b)(1).

<sup>65</sup> FED. R. CIV. P. 23.1(b)(2).

The demand requirement, along with its demand-futility exception, is the most litigated of the Rule 23.1 requirements. It requires the shareholder to first make a demand on the board of directors to rectify the injury that he believes the corporation has suffered.<sup>66</sup> The purpose of this requirement is to give the directors the opportunity to exercise their reasonable business judgment that the corporation would be best served by not bringing the litigation.<sup>67</sup> As such, it advances “the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders.”<sup>68</sup> The paradox of the demand requirement is that the directors usually reject the demand (since they are usually the alleged wrongdoers), and the shareholder is deemed to concede to the directors’ good judgment and forfeit the derivative action by actually making the demand.<sup>69</sup> To remedy this paradox, the courts crafted an exception to the demand requirement: demand futility. Demand futility excuses the shareholder from making the demand if he can prove that to do so would have been futile, given the directors’ bias.<sup>70</sup>

Demand futility is a doctrine at equity. To understand this, it is necessary to first discuss the derivative action in general. This action is founded on the shareholder’s right to sue on behalf of his corporation. This foundational right was refused by the courts sitting at law.<sup>71</sup> This left the shareholder defenseless against “faithless officers and directors” who abused the corporation.<sup>72</sup> To remedy this mischief, the courts, sitting in equity, recognized the shareholder’s right to bring the action.<sup>73</sup> Thus, the derivative action lay at equity.<sup>74</sup>

Since the derivative action lay at equity, it is fitting that the requirements to this action—including the demand requirement and its demand-futility exception—are also equitable in nature. Indeed, it was the Supreme Court—sitting in equity in the 1881 case of *Hawes v. Oakland*—that established all the requirements (except demand futility) that eventually came to comprise Rule

---

<sup>66</sup> *E.g.*, *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95–96 (1991).

<sup>67</sup> *E.g.*, *id.* at 96.

<sup>68</sup> *Id.* at 101 (quoting *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984)).

<sup>69</sup> *See, e.g.*, SOLOVY ET AL., *supra* note 50, § 23.1.08[1][ii] (discussing tactical advantage of not making demand).

<sup>70</sup> *E.g.*, *id.* (explaining the standard under Delaware law).

<sup>71</sup> *Ross v. Bernhard*, 396 U.S. 531, 534 (1970).

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *E.g.*, *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 264–65 & n.2 (1917).

23.1.<sup>75</sup> The futility exception having developed only later, the Court subsequently recounted that the “*equity* courts established as a precondition for the [derivative] suit that the shareholder demonstrate that the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions.”<sup>76</sup> At the same time, the Court carried this history into the present by noting that “[t]his requirement is accommodated by . . . Rule . . . 23.1[(b)(3)].”<sup>77</sup>

### *B. Standards of Review*

This section B provides a conceptual background on standards of review. It does so in the following four ways. First, it defines “standards of review” and explains their importance. Second, it defines the “clearly erroneous” standard and explains both its scope of application and underlying rationale. Third and fourth, this section does the same for both the *de novo* and abuse of discretion standards of review, respectively.

Standards of review—a concept of great importance to the appellate process—are slippery things that often create confusion, but are at least easy to define. Standards of review dictate the degree of deference that the appellate court gives to the trial court’s determination.<sup>78</sup> Thus, they are important to the appellate process for three reasons. First, they help the circuit court “frame [the] issues on appeal” and, second, limit its power to disturb the district court’s decision.<sup>79</sup> Third, they affect the appellant’s likelihood of success on appeal, so much so that “an argument on appeal based on an incorrect standard of review must fail.”<sup>80</sup> Indeed, standards of review are so important that the Federal Rules of Appellate Procedure require litigants to brief the applicable standard of review.<sup>81</sup>

Although the *de novo* and abuse of discretion standards are the focus of this Comment, a brief introduction to the clearly erroneous standard is also in order. This is because it provides a reference point for the two main standards

---

<sup>75</sup> 104 U.S. 450, 461 (1881). For the historical development from *Hawes* to the contemporary Rule 23.1, see *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 n.5 (1984).

<sup>76</sup> *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96 (1991) (citation omitted) (emphasis added).

<sup>77</sup> *See id.*

<sup>78</sup> 1 STEVEN ALAN CHILDRESS & MARTHA S. DAVIS, FEDERAL STANDARDS OF REVIEW §1.01 (4th ed. 2010).

<sup>79</sup> 19 GEORGE C. PRATT, MOORE’S FEDERAL PRACTICE § 206.01 (3d ed. 2013).

<sup>80</sup> *Id.*

<sup>81</sup> FED. R. APP. P. 28(a)(8)(B).

and appears in the discussion later on.<sup>82</sup> The clearly erroneous standard is the only of the three standards that explicitly appears in the Rules. Rule 52(a) provides that the circuit court shall not set aside the district court's "[f]indings of fact . . . unless clearly erroneous."<sup>83</sup> The rationale for affording such great deference to the district court's finding of fact is that district courts are specialized in performing this function, and it would be unfair and inefficient to make the appellee argue the facts again on appeal.<sup>84</sup>

The de novo standard of review gives wide latitude to the circuit court. Under this standard, the circuit court reviews the record anew and renders a decision without showing any deference to the district court's decision.<sup>85</sup> The circuit courts apply this standard to the "trial court's conclusions on questions of the application, interpretation, and construction of law."<sup>86</sup> The rationale behind so doing is that the circuit courts—comprised of judicial panels presented with briefs based on settled records below—are better equipped than the district courts to decide questions of law, and allowing them to do so fosters "doctrinal coherence" within the circuits.<sup>87</sup>

The abuse of discretion standard of review gives narrow latitude to the circuit courts. Under this standard, the circuit court will only overrule the district court's decision if it finds that there was an abuse of discretion. "Abuse of discretion" means that "the district court's decision rests upon a clearly erroneous finding of fact, upon an errant conclusion of law, or upon improper application of law to the facts."<sup>88</sup> This deferential standard applies to the district court's "[d]iscretionary rulings and determinations."<sup>89</sup> Whether such a ruling includes the demand futility dismissal is indeed one way to characterize the main issue of this Comment. The rationale behind the deferential standard is that the district court—having insight that the record does not always capture due to its presence at the proceeding—is best equipped to make the ruling, and the ruling is so particular to the specific facts that the circuit court cannot bring any doctrinal coherence to the case law anyhow.<sup>90</sup>

---

<sup>82</sup> See *infra* Part VI.C.

<sup>83</sup> FED. R. CIV. P. 52(a)(6).

<sup>84</sup> See PRATT, *supra* note 79, § 206.03[3].

<sup>85</sup> *Id.* § 206.04[1].

<sup>86</sup> *Id.*

<sup>87</sup> See *id.* § 206.04[2].

<sup>88</sup> *Id.* § 206.05[1].

<sup>89</sup> *Id.*

<sup>90</sup> See *id.*

## II. APPLYING THE STATE STANDARD OF REVIEW

This Part discusses threshold arguments that must be addressed before moving on to further analysis. Specifically, litigants have made two arguments that circuit courts should apply the same standard of review as would the state whose law governs the derivative action. The first argument proposes direct application of the state standard, while the second proposes indirect application based on a synthesis of Supreme Court precedent. If either of these arguments prevails, then the main issue is resolved and further analysis is unnecessary. Thus, it is appropriate to address them at this point in the Comment. This Part concludes that both arguments fail, presenting the discussion in two sections. Section A addresses direct application, and section B addresses indirect application.

### A. *Directly Applying the State Standard of Review*

The direct application argument seeks to provide an easy resolution to the main issue: simply apply the state's standard of review, whether deferential or plenary. This section A proceeds in two stages. First, it explains how the argument is justified through law and policy. Second, it provides two reasons why this argument must fail.

Proponents of direct application find justification both in law and policy. This discussion begins with law and turns to policy in the next paragraph. The relevant law comes from the Supreme Court's case of *Kamen v. Kemper Financial Services, Inc.*<sup>91</sup> This case held that "a court . . . entertaining a derivative action . . . must apply . . . demand futility . . . as it is defined by the law of the State of incorporation."<sup>92</sup> State law arguably defines both the trial court's discretion to decide on demand futility, as well as the appellate court's power to review the ensuing dismissal.<sup>93</sup> Thus, proponents suggest the circuit court should review the demand futility dismissal under the same standard as would the appellate court of the state of incorporation.<sup>94</sup>

Turning to policy, direct application claims two justifications. First, it could benefit business because corporate managers may derive a sense of certainty from knowing that a derivative action appeal will proceed the same in federal

---

<sup>91</sup> 500 U.S. 90 (1991).

<sup>92</sup> *Id.* at 108–09. This is true, unless it is displaced by or conflicts with federal law or policy. *Id.*

<sup>93</sup> See Lead Plaintiffs-Appellants' Reply Brief at 3–4, *Pirelli Armstrong Tire Corp. Retiree Medical Benefits Trust v. Raines*, 534 F.3d 779 (D.C. Cir. 2008) (No. 07-7108), 2008 WL 838373.

<sup>94</sup> *Id.*



court as in state court.<sup>95</sup> Second, direct application could discourage forum-shopping,<sup>96</sup> which is one of the twin aims of *Erie*.<sup>97</sup> Forum-shopping may result—and perhaps has already resulted—from divergent standards of review in state and federal courts. Imagine that the applicable state standard of review is de novo, and the federal standard is abuse of discretion.<sup>98</sup> In this case, the plaintiff has an incentive to sue in state court, where he gets a second shot on appeal, and management has an incentive to remove to federal court to prevent the plaintiff's second shot. Now, imagine that the applicable state standard of review is abuse of discretion, and the federal standard is de novo.<sup>99</sup> In this case, the plaintiff stands to benefit from suing in federal court. This creates inequity in diversity cases, since only out-of-state plaintiffs can take advantage of this potential benefit. Although this inequity is tempered by the fact that recovery goes to the corporation, not the shareholder, the incentive for forum-shopping is still real.

Although direct application is attractive because it offers an easy answer that carries potential benefits, it is untenable for two reasons. First, it violates principles of judicial federalism. In diversity cases, federal courts must apply state substantive law and federal procedural law.<sup>100</sup> Therefore, “[b]ecause the standard of review is a procedural matter, not a substantive one” it must be governed by federal law.<sup>101</sup> To allow state law to “govern the relation between the trial court and the appellate court” would threaten “the uniform federal-law approach [that] applies to procedural questions which concern the allocation of responsibility between the trial court and appellate court.”<sup>102</sup> Second, direct application would obstruct the development of circuit precedent: to allow the

---

<sup>95</sup> See Appellant's Opening Brief at 22 n.5, *Lynch v. Rawls*, 429 F. App'x 641 (9th Cir. 2011) (No. 09-17379), 2010 WL 6191855.

<sup>96</sup> “Forum-shopping” means “[t]he practice of choosing the most favorable jurisdiction or court in which a claim might be heard.” BLACK'S LAW DICTIONARY 726 (9th ed. 2009).

<sup>97</sup> *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 74–75 (1938); see also *Hanna v. Plumer*, 380 U.S. 460, 468 (1965) (explaining the twin aims of *Erie*).

<sup>98</sup> Indeed, this is now probably the most prevalent situation, since Delaware applies plenary review, *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000), but most federal circuit courts still apply deferential review. See cases cited *supra* notes 27–31.

<sup>99</sup> For example, if the Ninth Circuit converts to de novo review, then this would be the situation for an appeal under Alaska law, since Alaska has refused to convert to de novo review. *Jerue v. Millett*, 66 P.3d 736, 745 (Alaska 2003).

<sup>100</sup> E.g., *Hanna*, 380 U.S. at 465.

<sup>101</sup> *Alison H. v. Byard*, 163 F.3d 2, 4 (1st Cir. 1998); see also *In re Abbott Labs. Deriv. S'holders Litig.*, 325 F.3d 795, 803 (7th Cir. 2003) (“[A]ppellate review is governed by federal law . . .”).

<sup>102</sup> *In re Abbott Labs.*, 325 F.3d at 803.

standard of review—the very “frame” of the opinion<sup>103</sup>—to vary from opinion to opinion based on the applicable state law would make factually similar cases mutually inapposite. To state these two negative arguments in the positive, the standard for reviewing the demand futility dismissal in the federal courts must be uniform and governed solely by federal law.

### *B. Indirectly Applying the State Standard of Review*

The argument for indirectly applying a state’s standard of review uses a more sophisticated approach to achieve the same ends as direct application. This section B proceeds in two stages. First, it explains the argument’s mechanics. Second, it concludes that indirect application fails for the same reasons as direct application.

The indirect application argument proceeds by synthesizing two Supreme Court cases. These two cases are *Kamen v. Kemper Financial Services, Inc.*<sup>104</sup> and *Salve Regina College v. Russell*.<sup>105</sup> *Kamen* provides that state law governs the substance of demand futility.<sup>106</sup> *Salve Regina* provides that the circuit court must review the district court’s determination of state law de novo.<sup>107</sup> Therefore, if the applicable state law says that demand futility is a matter of law,<sup>108</sup> then *Kamen* requires the circuit court to recognize it as so. From there, *Salve Regina* requires that the circuit court review this legal matter de novo.<sup>109</sup> Likewise, if state law says that the matter is discretionary,<sup>110</sup> then deferential review is most appropriate. This argument is compelling because it presents application of the state standard of review as an obligatory effect caused by Supreme Court precedent.

Nevertheless, indirect application is merely a more sophisticated means to the same ends sought by direct application. Since direct application failed based on the ends, not the means, indirect application must fail for the same reason. It obstructs judicial federalism and the development of precedent. In

---

<sup>103</sup> See PRATT, *supra* note 79, § 206.01.

<sup>104</sup> 500 U.S. 90 (1991).

<sup>105</sup> 499 U.S. 225 (1991).

<sup>106</sup> 500 U.S. at 108–09; *see also supra* note 92.

<sup>107</sup> 499 U.S. at 231.

<sup>108</sup> *E.g.*, Brehm v. Eisner, 746 A.2d 244, 253–54 (Del. 2000).

<sup>109</sup> *See* Lead Plaintiffs-Appellants’ Reply Brief, *supra* note 93, at 3.

<sup>110</sup> *E.g.*, James v. James, 768 So. 2d 356, 360 (Ala. 2000) (reaffirming that Alabama’s standard of review for the demand futility dismissal is abuse of discretion).

issuing *Kamen* and *Salve Regina*, the Supreme Court could not have intended them to be read and synthesized so woodenly so as to cause this absurd result.

### III. VEHICLE OF DISMISSAL

Rule 23.1 imposes requirements that a shareholder must satisfy to bring a derivative action, but does not say anything about dismissing the action if the shareholder fails to satisfy a requirement. Thus, the issue is this: *when a court makes a demand futility dismissal, what is the proper procedural vehicle for this dismissal?* The resolution to this sub-issue—which remains elusive in the courts—is essential to resolving the main issue regarding standards of review. This is because different standards of review attach to different vehicles of dismissal.

In resolving this sub-issue, this Part discusses both Rule 23.1 dismissals in general, as well as other specific Rule 23.1 dismissals. This is because a uniform vehicle should apply to all Rule 23.1 dismissals to the greatest extent possible. Uniformity is ideal in a normative sense because it simplifies judicial administration by ensuring that the same standards and procedures apply to these closely related dismissals.<sup>111</sup> Uniformity is also correct in a positive sense because the requirements were conceived and persist in a single group,<sup>112</sup> share the same purpose of “protect[ing] the courts from collusive actions, and . . . corporations and their officers and directors from strike suits,”<sup>113</sup> and are all highly fact specific. Nevertheless, a comprehensive analysis of the appropriate vehicle of dismissal for each Rule 23.1 dismissal is beyond the scope of this Comment. Further, at least one type of dismissal—the collusion dismissal<sup>114</sup>—frustrates the goal of uniformity.<sup>115</sup>

The courts have long struggled to assign a vehicle of dismissal, but have at least narrowed it down to a few contenders. There are four to consider (presented in the order discussed below): (i) Rule 12(b)(1); (ii) Rule 12(b)(6);

---

<sup>111</sup> Cf. 5C CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 1360 (3d ed. 2004) (“The particular rationale the court utilizes to justify hearing a preliminary motion . . . largely determines which principles will govern the presentation and resolution of that motion.”).

<sup>112</sup> See *Hawes v. Oakland*, 104 U.S. 450, 461 (1881) (announcing the derivative action requirements in a single paragraph); see also *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530–31 n.5 (1984) (recounting that *Hawes* conceived the requirements that eventually formed Rule 23.1).

<sup>113</sup> *Pioche Mines Consol., Inc. v. Dolman*, 333 F.2d 257, 265 (9th Cir. 1964).

<sup>114</sup> See FED. R. CIV. P. 23.1(b)(2) (requiring plaintiff to allege non-collusion).

<sup>115</sup> For further discussion, see *infra* Part V.B.

(iii) Rule 41(b); and (iv) Rule 23.1 itself.<sup>116</sup> Rules 12(b)(6) and 23.1 are by far the main contenders, since they are the only ones that the circuit courts have mentioned. Rules 12(b)(1)<sup>117</sup> and 41(b)<sup>118</sup> are less significant because the circuit courts have not employed them, but are worthy of discussion because the district courts have used them more than once. As some of the foregoing cited cases demonstrate, the courts often provide multiple alternative vehicles of dismissal. This practice is undesirable because it both complicates the simple matter of dismissal and may cause problems where different vehicles engender different standards and procedures.<sup>119</sup> Thus, to the greatest extent possible, the courts should avoid this practice by narrowing the dismissal down to a single vehicle.

At this point, it is helpful to briefly introduce each of the contenders (other than Rule 23.1). The Rule 12(b)(1) dismissal is for “lack of subject-matter jurisdiction,”<sup>120</sup> which means the court lacks the “power to adjudicate the case.”<sup>121</sup> The Rule 12(b)(6) dismissal is for “failure to state a claim upon which relief can be granted,”<sup>122</sup> which (at least in relevant part) means the plaintiff

---

<sup>116</sup> There are three other contenders that this Comment does not consider. The first is Rule 12(c) (judgment on the pleadings). *E.g.*, *Lewis v. Graves*, 701 F.2d 245, 247, 250 (2d Cir. 1983) (affirming Rule 12(c) motion to dismiss for failure to allege demand futility). This Comment does not consider Rule 12(c) because it “merely serv[es] as an auxiliary or supplementary procedural device” for raising Rule 12(b) defenses “after the close of the pleadings.” 5C WRIGHT & MILLER, *supra* note 111, § 1367. The other two contenders are Rule 12(e) (motion for more definite statement) and Rule 12(f) (motion to strike). A treatise on federal procedure implies that these are viable vehicles by saying that they are the proper vehicles for dismissing complaints that fail to plead special matters and by discussing the derivative requirements as special matters. However, this Comment does not cover these rules because they are entirely off the judicial radar, and the secondary source itself neither discusses vehicles of dismissal with respect to derivative actions in particular nor cites any authority indicating that these rules are appropriate for channeling demand futility dismissals. *See* DAVID F. HERR, ROGER S. HAYDOCK & JEFFREY W. STEMPEL, MOTION PRACTICE § 9.04[D] (2014).

<sup>117</sup> *See, e.g.*, *Arnold v. McClendon*, No. CIV-11-986-D, 2012 WL 4483159, at \*1 (W.D. Okla. Sept. 28, 2012) (“[T]he ‘case law is unclear’ as to whether the issue is analyzed under Rule 12(b)(1) or 12(b)(6). . . . [M]ost courts appear to conclude that the issue . . . ‘can be raised on either a Rule 12(b)(1) or a Rule 12(b)(6) motion.’” (citations omitted)).

<sup>118</sup> *See, e.g.*, *C.R.A. Realty Corp. v. Scor U.S. Corp.*, No. 92 CIV. 2093 (LMM), 1992 WL 309610, at \*1 (S.D.N.Y. Oct. 9, 1992) (“Dismissal . . . is appropriate, pursuant to Rule 41(b) . . . for failure to . . . verif[y] [the] complaint.”); *Baffino v. Bradford*, 57 F.R.D. 79, 80 (D. Minn. 1972) (making demand futility dismissal pursuant to Rules 12(b)(6), 12(c), 41(b), and 56); *see also* 7C WRIGHT ET AL., *supra* note 61, § 1827 (stating that Rule 41(b) is proper vehicle for verification dismissal); Edmund C. Ursin, Recent Development, *Verification as a Safeguard Against Abuse of Stockholders’ Derivative Suits*, 18 STAN. L. REV. 1221, 1225 & n.23 (1966) (same).

<sup>119</sup> *Cf.* 5C WRIGHT & MILLER, *supra* note 111, § 1360.

<sup>120</sup> FED. R. CIV. P. 12(b)(1).

<sup>121</sup> 2 MILTON I. SHADUR, MOORE’S FEDERAL PRACTICE § 12.30[1] (3d ed. 2014).

<sup>122</sup> FED. R. CIV. P. 12(b)(6).

has failed to file a complaint containing “sufficient factual matter” to state “a claim to relief that is plausible on its face.”<sup>123</sup> The Rule 41(b) dismissal is for failure to “prosecute or to comply with [the] [R]ules or a court order”<sup>124</sup> and is made “to prevent undue delays in the disposition of pending cases and to avoid congestion in the calendars of the courts.”<sup>125</sup>

Vehicles of dismissal are an important concept because they may dictate how the appellate court will review the grant or denial of a motion. If it is 12(b)(1)<sup>126</sup> or 12(b)(6),<sup>127</sup> then the standard is de novo. If it is Rule 41(b), then it is abuse of discretion.<sup>128</sup> If it is Rule 23.1 itself, then the courts are not bound by the dictates of any other rule and can choose the standard most appropriate for the demand futility dismissal.

This Part proceeds in four sections. Section A collects circuit court cases, located after an exhaustive search, that have announced a standard of review for the demand futility dismissal and surveys what vehicle they used for the demand futility dismissal. Section B discusses and debunks Rule 12(b)(1) as a contender. Sections C and D discuss Rules 12(b)(6) and 41(b) respectively, and conclude that they are possible, but weak, contenders. Through the process of eliminating the above contenders, this Part ultimately concludes that Rule 23.1 is the most appropriate vehicle for making the demand futility dismissal.

#### A. *Vehicles of Dismissal Used by the Circuit Courts*

This section A collects circuit court cases that have announced a standard of review for the demand futility dismissal and surveys what vehicle of dismissal they have used. This survey yields three findings. First, the courts generally neglect the issue and announce inconclusive rulings, even when directly faced with the issue. Second, (despite the first finding) the circuit court cases fall into two camps: those that favor Rule 23.1 and those that favor Rule 12(b)(6). Third, a slight majority of the cases favor Rule 23.1. This is to be expected, since the traditional rule of deferential review is incompatible with the Rule 12(b)(6) dismissal, which is reviewed de novo. This survey provides the necessary starting point for further analysis: Rules 23.1 and 12(b)(6) both

---

<sup>123</sup> See SHADUR, *supra* note 121, at § 12.34[1][a].

<sup>124</sup> FED. R. CIV. P. 41(b).

<sup>125</sup> 8 CHARLES L. BRIEANT, MOORE'S FEDERAL PRACTICE § 41.50[1] (3d ed. 2014).

<sup>126</sup> *E.g.*, Sanchez v. United States, 740 F.3d 47, 52 (1st Cir. 2014).

<sup>127</sup> *E.g.*, Haag v. United States, 736 F.3d 66, 69 (1st Cir. 2013).

<sup>128</sup> *See, e.g.*, Link v. Wabash R.R. Co., 370 U.S. 626, 633 (1962) (stating that dismissing a case for failure to prosecute—which falls under Rule 41(b)—is within district court's discretion).

enjoy credibility and are the main contenders. From here, this Comment goes on to argue that Rule 23.1 should prevail. This section A proceeds by analyzing the cases in the Rule 23.1 camp, then the Rule 12(b)(6) camp.

The Rule 23.1 camp and the Rule 12(b)(6) camp each consists of different case groups. Within the Rule 23.1 camp, there are four groups: (i) those that speak of the Rule 23.1 dismissal and the Rule 12(b)(6) dismissal as separate procedures (including cases from the Second<sup>129</sup> and Ninth<sup>130</sup> Circuits); (ii) those that *ostensibly* make Rule 23.1 the vehicle of dismissal (including cases from the Second,<sup>131</sup> Third,<sup>132</sup> Seventh,<sup>133</sup> Ninth,<sup>134</sup> and District of Columbia<sup>135</sup> Circuits); (iii) those that *definitely* make Rule 23.1 the vehicle of dismissal (including cases from the Seventh and Eleventh Circuits);<sup>136</sup> and (iv) those that cast doubt on deferential review, favor de novo review, or do both, but still make Rule 23.1 the vehicle of dismissal—either ostensibly<sup>137</sup> or definitely.<sup>138</sup> These groups all support the notion of the independent “Rule 23.1

<sup>129</sup> See, e.g., *Lambrecht v. O’Neal*, 504 F. App’x 23, 25 (2d Cir. 2012) (referring separately to “dismissals pursuant to Rule 12(b)(6)” and “dismissals based on FED. R. CIV. P. 23.1”).

<sup>130</sup> See, e.g., *Ind. Elec. Workers Pension Trust Fund, IBEW v. Dunn*, 352 F. App’x 157, 159 (9th Cir. 2009) (similar to *Lambrecht*).

<sup>131</sup> See, e.g., *Kautz v. Sugarman*, 456 F. App’x 16, 21 (2d Cir. 2011) (affirming dismissal for failure to “comport with the requirements of FED. R. CIV. P. 23.1”).

<sup>132</sup> See, e.g., *Baca v. Crown*, 458 F. App’x 694, 698 (9th Cir. 2011) (affirming dismissal “for failure to allege demand futility”).

<sup>133</sup> See, e.g., *Garber v. Lego*, 11 F.3d 1197, 1207 (3d Cir. 1993) (affirming dismissal for failure “to set forth sufficient pleadings to excuse demand pursuant to Federal Rule 23.1”).

<sup>134</sup> See, e.g., *Starrels v. First Nat’l Bank of Chicago*, 870 F.2d 1168, 1172 (7th Cir. 1989) (affirming demand futility dismissal for failing to “allege with particularity facts which would have excused [the plaintiff] from making a demand upon the directors”).

<sup>135</sup> See, e.g., *Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59, 61 (D.C. Cir. 1988) (affirming dismissal because plaintiff’s “allegations of demand futility lacked the requisite particularity”).

<sup>136</sup> See *Peller v. S. Co.*, 911 F.2d 1532, 1535–36 (11th Cir. 1990) (“The Companies initiated their motion to dismiss . . . pursuant to FED. R. CIV. P. 12(b)(6) . . . . However, . . . derivative suits are governed by FED. R. CIV. P. 23.1, and the district court correctly reviewed the Companies’ motion under this rule.”); *Robison v. Caster*, 356 F.2d 924, 926 & n.3 (7th Cir. 1966). In *Robison*, the district court presented failure to state a claim as the basis for dismissal in its order, but the modern equivalent of Rule 23.1 as the sole basis in the memorandum opinion. 356 F.2d at 926 & n.3. The circuit court explicitly noticed this discrepancy and selected the procedure in the memorandum opinion to affirm the dismissal. *Id.*

<sup>137</sup> See *Israni v. Bittman*, 473 F. App’x 548, 550 n.1 (9th Cir. 2012) (questioning propriety of discretionary review), *aff’g Fosbre v. Matthews*, No. 3:09-CV-0467-ECR-RAM, 2010 WL 2696615, at \*8 (D. Nev. July 2, 2010) (granting motion to dismiss based on Rule 23.1).

<sup>138</sup> See *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 783 n.2 (D.C. Cir. 2008) (endorsing de novo review), *aff’g In re Fed. Nat’l Mortg. Ass’n Sec., Deriv., & “ERISA” Litig.*, 503 F. Supp. 2d 9, 11 n.1 (D.D.C. 2007) (making clear distinction between Rule 12(b)(6) dismissals and Rule 23.1 dismissals and deliberately dismissing under latter); *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 137 & n.6 (2d Cir. 2004) (endorsing conversion from deferential to plenary review, yet ruling as follows: “[T]he

dismissal.” The fourth group merely adds that this vehicle of dismissal should carry plenary review.

The Rule 12(b)(6) camp also consists of different case groups. There are three: (i) the Sixth<sup>139</sup> and Eighth<sup>140</sup> Circuit cases, which make Rule 12(b)(6) the vehicle and apply de novo review; (ii) those that make Rule 23.1 the vehicle, but are prefaced in the district court decision by a discussion of Rule 12(b)(6) standards;<sup>141</sup> and (iii) those that make Rule 12(b)(6) the vehicle of dismissal, yet apply deferential review.<sup>142</sup> The first group (i.e., the Sixth and Eighth Circuit cases) firmly supports Rule 12(b)(6) as a contender and is logically coherent in that the cases apply the standard of review that applies to that vehicle (i.e., plenary review). The second group could support Rule 12(b)(6) or Rule 23.1: on one hand, since Rule 12(b)(6) standards are necessary for analyzing demand futility dismissals, they are in fact Rule 12(b)(6) dismissals; on the other hand, the overlap in standards may merely indicate that they share similarities as dismissals on the pleadings, not that they are one in the same.<sup>143</sup> The third group represents both the conceptual difficulty of this Comment’s main issue and the unfortunate blunders that sometimes result. That is, the circuit court knows that it should review the demand futility dismissal deferentially; it doesn’t know which vehicle of dismissal to use and mistakenly uses Rule 12(b)(6); this is wrong, since Rule 12(b)(6) dismissals are reviewed de novo.

---

district court . . . [denied] Defendants’ . . . Rule 12(b)(6) motion, but grant[ed] Defendants’ motion pursuant to Rule 23.1. . . . [W]e affirm.”)

<sup>139</sup> See *In re Ferro Corp. Deriv. Litig.*, 511 F.3d 611, 617 (6th Cir. 2008); *McCall v. Scott*, 239 F.3d 808, 817, 826 (2000) (reviewing demand futility dismissal as Rule 12(b)(6) dismissal and under plenary standard), *amended on denial of reh’g*, 250 F.3d 997 (6th Cir. 2001).

<sup>140</sup> See *Gomes v. Am. Century Cos.*, 710 F.3d 811, 815 (8th Cir. 2013) (reviewing demand futility dismissal as failure to state a claim and under plenary standard).

<sup>141</sup> See, e.g., *Staehr v. Alm*, 269 F. App’x 888, 891 (11th Cir. 2008) (reviewing for abuse of discretion without mentioning 12(b)(6)), *aff’g In re Coca-Cola Enters., Inc. Deriv. Litig.*, 478 F. Supp. 2d 1369, 1373–74, 1381 (N.D. Ga. 2007) (prefacing discussion with Rule 12(b)(6) standards, but dismissing pursuant to Rule 23.1).

<sup>142</sup> See *Simmonds v. Credit Suisse Sec. (USA) LLC*, 638 F.3d 1072, 1087 & n.6 (9th Cir. 2011) (deliberately categorizing demand futility dismissal under Rule 12(b)(6), yet reviewing deferentially), *vacated and remanded on other grounds*, 132 S. Ct. 1414 (2012); *Kanter v. Barella*, 489 F.3d 170, 174–75 (3d Cir. 2007) (affirming Rule 12(b)(6) dismissal, yet reviewing for abuse of discretion).

<sup>143</sup> Cf. *Fogel v. Chestnutt*, 533 F.2d 731, 738 n.7 (2d Cir. 1975) (Friendly, J.) (denying demand-futility motion to dismiss because not made until post-answer—as applies to Rule 12(b)(6) motions—but not mentioning Rule 12(b) in any fashion).

### B. Rule 12(b)(1) as a Contender

The first contender to discuss is Rule 12(b)(1). Although Rule 12(b)(1) is not a main contender, its discussion is appropriate at this point because it dovetails into the Rule 12(b)(6) discussion, which appears in the next section. The argument for Rule 12(b)(1)<sup>144</sup> is that demand futility is a matter of “standing”<sup>145</sup> or “derivative standing,”<sup>146</sup> and dismissals for lack of standing fall under Rule 12(b)(1).<sup>147</sup> This section B proceeds in three stages. First, it explains the different types of standing. Second, it explains that these different types fall under different rules. Third, it explains how this understanding debunks Rule 12(b)(1) as a contender.

Standing comes in two different types, as explained by the Ninth Circuit’s case of *Cetacean Community v. Bush*.<sup>148</sup> In general, “standing” refers to “[a] party’s right to make a legal claim or seek judicial enforcement of a duty or right.”<sup>149</sup> “Standing involves two distinct inquiries. First, an Article III federal court must ask whether a plaintiff has suffered sufficient injury to satisfy the ‘case or controversy’ requirement of Article III.”<sup>150</sup> This is called “Article III standing.” “Second, if a plaintiff has suffered sufficient injury to satisfy Article III, the court must ask whether a statute has conferred ‘standing’ on that plaintiff.”<sup>151</sup> This is called “statutory standing” or “prudential standing.”

Dismissals for lack of Article III standing and statutory standing fall under different rules. A dismissal for lack of Article III standing falls under Rule 12(b)(1) because a lack of Article III standing equates to a lack of subject-matter jurisdiction, which falls under Rule 12(b)(1).<sup>152</sup> In contrast, a dismissal for lack of statutory standing has nothing to do with the court’s

---

<sup>144</sup> See Lead Plaintiffs-Appellants’ Reply Brief, *supra* note 93, at 4–5 & nn. 1–2 (arguing that the demand futility dismissal should be reviewed de novo because it is for lack of standing).

<sup>145</sup> *E.g.*, 19 AM. JUR. 2D *Corporations* § 1961 (2004) (“The requirement of demand upon directors is a matter of *standing* . . .” (emphasis added)).

<sup>146</sup> *E.g.*, *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1290 (Fed. Cir. 1999) (“The shareholder *derivative standing* requirements of Federal Rule of Civil Procedure 23.1 involve prudential limitations, not constitutional limitations.” (emphasis added)).

<sup>147</sup> *E.g.*, *United States v. AVX Corp.*, 962 F.2d 108, 114 n.6 (1st Cir. 1992) (choosing Rule 12(b)(1) as vehicle for lack-of-standing dismissal when faced with choice between that rule and Rule 12(b)(6)). *But see* *Rental Hous. Ass’n of Greater Lynn, Inc. v. Hills*, 548 F.2d 388, 391 (1st Cir. 1977) (dismissing for lack of standing pursuant to Rule 12(b)(6)).

<sup>148</sup> 386 F.3d 1169, 1174–75 (9th Cir. 2004).

<sup>149</sup> BLACK’S LAW DICTIONARY 1536 (9th ed. 2009).

<sup>150</sup> 386 F.3d at 1174.

<sup>151</sup> *Id.* at 1175.

<sup>152</sup> *Id.* at 1174.



jurisdiction; rather, it concerns only the claimant's ability to state a claim upon which relief can be granted, which is handled by Rule 12(b)(6).<sup>153</sup>

After *Cetacean Community*, the Ninth Circuit in *Simmonds v. Credit Suisse Securities (USA) LLC*<sup>154</sup> tackled head-on the tension between Rules 12(b)(1) and 12(b)(6). Based on the reasoning from *Cetacean Community*, the *Simmonds* court held that demand futility is a matter of statutory standing,<sup>155</sup> so the ensuing dismissal falls under Rule 12(b)(6).<sup>156</sup> This holding aligns with the understanding that “[j]urisdiction is conferred by act of Congress,” not the Rules.<sup>157</sup> Thus, *Simmonds* debunks Rule 12(b)(1) as a viable contender. At the same time, it makes a strong case for Rule 12(b)(6). However, *Simmonds* doesn't win the case for either Rule 12(b)(6) or de novo review. As for Rule 12(b)(6), the case merely veils “statutory standing” in the language of Rule 12(b)(6). It is equally, if not more, viable to take off the veil and let the statutory standing dismissal fall under the rule or statute whose requirement is not satisfied. As for de novo review, *Simmonds* works against it and in favor of deferential review because the opinion still reviewed the dismissal for abuse of discretion.<sup>158</sup>

### C. Rule 12(b)(6) as a Contender

The second contender to discuss is Rule 12(b)(6). The primary argument that has been made for Rule 12(b)(6) is that the language of Rule 23.1 does not provide for dismissal, so the demand futility dismissal falls under Rule 12(b)(6). The secondary argument, which is original to this Comment, is that history also supports Rule 12(b)(6). This section C proceeds in five pieces. First, it discusses a major problem of placing the demand futility dismissal under Rule 12(b)(6), which is preclusion. Second and third, it explains and then refutes the primary argument in favor of Rule 12(b)(6), respectively. Fourth and fifth, it does the same for the secondary argument.

---

<sup>153</sup> *Id.* at 1175.

<sup>154</sup> 638 F.3d 1072 (9th Cir. 2011), *vacated and remanded on other grounds*, 132 S. Ct. 1414 (2012).

<sup>155</sup> *Simmonds*, 638 F.3d at 1087 n.6; accord *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1290 (Fed. Cir. 1999) (stating that “Rule . . . 23.1 involve[s] prudential limitations, not constitutional limitations” and that the Supreme Court case of *Franchise Tax Board of California v. Alcan Aluminum Ltd.*, 493 U.S. 331 (1990) “associat[ed] the ‘shareholder standing rule’ with prudential standing requirements”).

<sup>156</sup> 638 F.3d at 1087 n.6.

<sup>157</sup> *Pioche Mines Consol., Inc. v. Dolman*, 333 F.2d 257, 265 (9th Cir. 1964).

<sup>158</sup> 638 F.3d at 1087.

The major problem with placing the demand futility dismissal under Rule 12(b)(6) relates to the preclusion doctrines. The preclusion doctrines include “claim preclusion” and “issue preclusion.” *Claim preclusion* provides that a claimant cannot bring a claim that he has already brought in a prior case.<sup>159</sup> *Issue preclusion* bars relitigation of issues already decided in a prior case.<sup>160</sup> In general, Rule 12(b)(6) dismissals are claim preclusive.<sup>161</sup> In contrast, demand futility dismissals are generally issue preclusive at most.<sup>162</sup> This means that subsequent claimants can pursue the action, but not relitigate the issue of demand futility. Accordingly, it would cause significant confusion to meld issue preclusive and claim preclusive procedures.

The primary argument against Rule 23.1 and in favor of Rule 12(b)(6) is textual in nature. The text of Rule 23.1 imposes (or contemplates) requirements, but provides no grounds for actually dismissing a case. The only place where the Rules provide for dismissing a case on the pleadings is Rule 12(b), of which Rule 12(b)(6) is the only appropriate option in this context. Thus, the only vehicle through which to dismiss an action for failure to satisfy a Rule 23.1 requirement is Rule 12(b)(6).<sup>163</sup> This argument is persuasive, but unsatisfactory.

The above argument is too rigid and ignores the inherent power of the courts. “In practice numerous . . . preliminary motions are presented to and

---

<sup>159</sup> See, e.g., FREER, *supra* note 46, § 11.2, at 574.

<sup>160</sup> See, e.g., Bobby v. Bies, 556 U.S. 825, 829 (2009).

<sup>161</sup> See 27A TRACY BATEMAN FARRELL, JOHN R. KENNEL, KARL OAKES, ELIZABETH WILLIAMS, ANN K. WOOSTER, FEDERAL PROCEDURE § 62:465 (Lawyers ed. 2008); 2 SHADUR, *supra* note 121, § 12.51. *But see* 5B CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 1357 (3d ed. 2004) (stating that claim preclusive effect of Rule 12(b)(6) dismissal is constant in federal question cases, but depends on state law in diversity cases).

<sup>162</sup> E.g., *In re Sonus Networks, Inc., S’holder Deriv. Litig.*, 499 F.3d 47 (1st Cir. 2007). In *Sonus*—the leading federal case on preclusion in derivative actions—the court compared Rule 12(b)(6) dismissals with demand futility dismissals and found that they are “not entirely analogous.” *Id.* at 62. Rule 12(b)(6) dismissals are for failure to state a claim, so they are claim preclusive. In contrast, demand futility dismissals are for failure to satisfy a precondition to the action; such a failure, if cured, would permit a second action. *Id.* at 61. As such, the dismissal should not be claim preclusive. However, issue preclusion should apply to the determination in the prior action that the precondition was required. *Id.* at 62. *But see* Bazata v. Nat’l Ins. Co. of Wash., 400 A.2d 313, 316 (D.C. 1979) (holding that demand futility dismissal is claim preclusive “[i]n light of the particularity of Rule 23.1’s instructions and the particularity with which the facts surrounding the demand must be pleaded”). For an in-depth discussion of preclusion in derivative actions, see 2 JOSEPH M. McLAUGHLIN, McLAUGHLIN ON CLASS ACTIONS §§ 9:25–9:27 (10th ed. 2013).

<sup>163</sup> Opening Brief of the Plaintiff-Appellant at 28, *Lambrecht v. O’Neal*, 504 F. App’x 23 (2d Cir. 2012) (No. 11-1285), 2011 WL 3796595. The appellant also mentioned Rule 12(c) as a viable vehicle, *id.*, but this Comment has already dispelled Rule 12(c) as a candidate. See *supra* note 116.

determined by the federal courts” outside of Rule 12(b).<sup>164</sup> Relying on their “inherent power,” “[f]ederal courts . . . traditionally have entertained certain pre-answer motions that are not expressly provided for by the [R]ules or by statute” including those that “are necessary to effectuate other specific provisions in the [R]ules.”<sup>165</sup> To effectuate Rule 23.1, the Rules require the dismissal of actions that fail to meet its requirements, and the courts have the inherent power to determine the vehicle through which to make these dismissals. They are not confined to Rule 12(b)(6) due to the less than explicit language of Rule 23.1.

The secondary argument against Rule 23.1 and in favor of Rule 12(b)(6) is that the merger of law and equity has so affected motions practice that dismissal for failure to meet any of the derivative requirements under Rule 23.1 must fall under Rule 12(b)(6). Two premises lead to this conclusion. First, as explained in Part I, section A, the derivative requirements developed at equity; before the merger of law and equity, the vehicle for the derivative requirement dismissal was the dismissal “for want of equity.”<sup>166</sup> Second, the subsequent merger of law and equity gave rise to a new motion—the Rule 12(b)(6) motion to dismiss for failure to state a claim. According to the Eighth Circuit, this motion “is a substitute . . . for the motion to dismiss for want of equity.”<sup>167</sup> The logical summation of these two historical premises is that the derivative requirement dismissal—including the demand futility dismissal—falls under Rule 12(b)(6).

But, this historical argument is unsatisfactory for the same reasons as is the primary textual argument. The Eighth Circuit made a sweeping statement that leaves the courts with no flexibility. It would be an absurd result to let this rigid rule mandate the classification of dismissals under Rule 12(b)(6) that do not belong. Such a mandate would also undermine the inherent power of the federal courts.

To conclude the Rule 12(b)(6) discussion, this Comment contends that the two formalistic arguments in favor of Rule 12(b)(6) are inherently unsatisfactory and fail to outweigh the problem regarding preclusion. Further, all those cases that place the demand futility dismissal under Rule 12(b)(6)—specifically those from the Sixth and Eighth Circuits—should not affect the

---

<sup>164</sup> 5C WRIGHT & MILLER, *supra* note 111, § 1360.

<sup>165</sup> *Id.*

<sup>166</sup> *See Venner v. Great N. Ry. Co.*, 209 U.S. 24, 34 (1908).

<sup>167</sup> *Dennis v. Vill. of Tonka Bay*, 151 F.2d 411, 412 (8th Cir. 1945).

courts' future analyses,<sup>168</sup> since they assigned that vehicle without acknowledging the problem with this approach.

#### *D. Rule 41(b) as a Contender*

The third contender to discuss is Rule 41(b). Rule 41(b) is an even weaker contender than Rule 12(b)(6). This section D proceeds in two stages. First, it narrows the discussion to a specific part of Rule 41(b) and concedes that it is viable as a textual matter. Second, it argues that Rule 41(b) is a very weak contender as a practical matter.

Before entering the analysis, it is necessary to first establish which part of Rule 41(b) proponents argue addresses the Rule 23.1 requirements. The pro-Rule 41(b) sources<sup>169</sup> do not zealously support their contender. Not only do they neglect to make any actual argument for Rule 41(b), they do not even state which part of Rule 41(b) applies. This Comment can only make an educated guess. Rule 41(b), in its first sentence, provides that the defendant may move for the plaintiff's involuntary dismissal if the plaintiff fails to do any of the following: (i) prosecute the case; (ii) comply with the Rules; or (iii) comply with a court order.<sup>170</sup> Only the second scenario—noncompliance with the Rules—can be said to address failure to satisfy a Rule 23.1 requirement. This classification indeed makes sense, but only as a textual matter.

As a practical matter, Rule 41(b) it is not a serious contender. This is the case for two reasons. First, it enjoys sparse and weak support. Second, it carries with it many problems, similar to Rule 12(b)(6)'s problem regarding preclusion. As for the first reason, no circuit courts appear to have endorsed this vehicle. Very few district courts have used it.<sup>171</sup> And, the Northern District of California, in an unpublished opinion, rejected its use, saying it “is not well-suited to serve as a mechanism for challenging the adequacy of allegations of demand futility.”<sup>172</sup> Although the California court declined to state its reasoning, this Comment once again makes an educated guess, pointing out three difficulties with this potential vehicle.

---

<sup>168</sup> See *supra* notes 139–40 citing cases.

<sup>169</sup> See sources cited *supra* note 118.

<sup>170</sup> See FED R. CIV. P. 41(b).

<sup>171</sup> See cases cited *supra* note 118.

<sup>172</sup> *In re Oracle Corp. Deriv. Litig.*, No. C 10-3392 RS, 2011 WL 5444262, at \*1 (N.D. Cal. Nov. 9, 2011).

First, the Rule 41(b) and Rule 23.1 dismissals differ in application and purpose. The Rule 41(b) dismissal “is intended to serve as a rarely employed . . . tool of judicial administration available to district courts in managing their specific cases and general caseload.”<sup>173</sup> In contrast, the derivative requirement dismissal is a common event (at least in derivative actions). Further, it is not an administrative or case-management tool; rather, it is a procedural mechanism for enhancing corporate governance: “[t]he purpose of Rule [23.1] is to protect the courts from collusive actions, and to protect corporations and their officers and directors from strike suits.”<sup>174</sup>

Second, the two dismissals are analytically different. Whether to grant a Rule 41(b) dismissal requires the district court to conduct a multifactor test, which varies among the circuits.<sup>175</sup> The Rule 23.1 requirements are already numerous and carry their own requirements and standards, which vary according to the applicable state law.<sup>176</sup> To meld the Rule 41(b) tests with the Rule 23.1 requirements would create an unwieldy analysis.

Third, the method for raising the dismissal may also cause a problem. Rule 41(b) “permits a district court to dismiss *sua sponte*.”<sup>177</sup> Although the *sua sponte* dismissal of a derivative action for failure to satisfy a Rule 23.1 requirement does not smack of impropriety, it is at least not common practice.<sup>178</sup> Rather, the common practice is for the plaintiff to allege satisfaction of the requirements, the defendant to move to dismiss for failure to satisfy the requirements, and the court to make a ruling.

To conclude the Rule 41(b) discussion, this rule is not a viable contender because it lacks judicial support and poses many practical problems.

As the sub-conclusion to this Comment, this Part concludes that Rule 23.1 is the best vehicle for making the demand futility dismissal. This conclusion is supported by the foregoing process of elimination. To use any of the other contenders would be to force a square peg into a round hole: they are not well-suited to handle the demand futility dismissal. In contrast, by allowing

---

<sup>173</sup> Wynder v. McMahon, 360 F.3d 73, 79 (2d Cir. 2004).

<sup>174</sup> See Pioche Mines Consol., Inc. v. Dolman, 333 F.2d 257, 265 (9th Cir. 1964).

<sup>175</sup> See 9 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 2369 (3d ed. 2008).

<sup>176</sup> See *supra* note 59 and accompanying text.

<sup>177</sup> FREER, *supra* note 46, § 7.4, at 356.

<sup>178</sup> Of all the cases cited in this Comment that involve Rule 23.1, none were dismissed *sua sponte*.

Rule 23.1 to stand on its own weight, the courts can apply and develop procedures that make sense for this particular type of dismissal.

#### IV. COMPARING THE DEMAND FUTILITY DISMISSAL TO THE RULE 12(B)(6) DISMISSAL: THE INERTIA BEHIND THE DE NOVO TREND

The inertia behind the de novo trend has not been the merger of the demand futility dismissal with the Rule 12(b)(6) dismissal; rather, it has been their comparison. At its greatest elaboration, the comparison is twofold: first, both are dismissals on the pleadings for lack of legal sufficiency; second, as dismissals on the pleadings, the circuit court is in just as good a position to make the determination as is the district court.<sup>179</sup>

This Part proceeds in two sections. Section A explains the first point of comparison and its scope of acceptance. Section B then presents two relevant counterarguments. The first counterargument addresses the first point of comparison, and the second addresses the overall comparison. Later on, this Comment further debunks the comparison in Part V, and specifically address the second point of comparison in Part V, section C.

##### A. *Dismissal on the Pleadings for Lack of Legal Sufficiency*

This section A explains the first point of comparison and its scope of acceptance. The first point of comparison is best explained through the following syllogism. Since a shareholder can only bring a derivative action by successfully alleging demand futility, demand futility goes to the legal sufficiency of the pleadings. The legal sufficiency of the pleadings is a matter of law.<sup>180</sup> Matters of law are reviewed by the appellate courts de novo.<sup>181</sup> Therefore, de novo review should apply to the demand futility dismissal.

Many of the federal courts leading the de novo trend have endorsed the first point of comparison. The Second Circuit spoke in favor of de novo review on the basis of this comparison.<sup>182</sup> The District of Columbia Circuit did the same: “the question whether demand is excused turns on the sufficiency of the complaint’s allegations; and the legal sufficiency of a complaint’s allegations

---

<sup>179</sup> See *Brehm v. Eisner*, 746 A.2d 244, 253–54 (Del. 2000) (making both arguments).

<sup>180</sup> *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 137 n.6 (2d Cir. 2004).

<sup>181</sup> *Id.*

<sup>182</sup> See *id.*

is a question of law we typically review de novo.”<sup>183</sup> Finally, the First Circuit delivered its decision in *Unión de Empleados*, noting this as one of its reasons: “[a]s a general matter, rulings concerning the legal sufficiency of pleadings are reviewed de novo. There is no justification for treating the pleadings in a derivative suit differently.”<sup>184</sup>

Other courts that also review the demand futility dismissals de novo are less explicit in their reasoning, but would probably accept the first point of comparison. The Sixth and Eighth Circuits don’t even need a comparison, since they directly place the demand futility dismissal under Rule 12(b)(6).<sup>185</sup> The Seventh Circuit just recently made the formal conversion to de novo review in *Westmoreland County Employee Retirement Systems v. Parkinson*.<sup>186</sup> Although it did not explain its reasoning, it did cite its previous holding in *In re Abbott Laboratories Derivative Shareholders Litigation*.<sup>187</sup> In that derivative action, the court reviewed a demand futility dismissal de novo on the basis that “[a]ppellate review of the legal precepts used by the district court and the court’s interpretation of those precedents is plenary.”<sup>188</sup> Thus, all of the courts in the de novo camp are in agreement: demand futility is a matter of law.

### B. Two Counterarguments

This section B presents two counterarguments against plenary review. The first counterargument specifically addresses the first point of comparison; the second addresses the overall comparison. The first point of comparison is not entirely accurate because the demand futility dismissal and Rule 12(b)(6) dismissal serve different purposes. The Northern District of Illinois has explained the difference as follows:

“In contrast to a motion to dismiss pursuant to Rule 12(b)(6), a Rule 23.1 motion to dismiss for failure to make a demand is not intended to test the legal sufficiency of the plaintiffs’ substantive claim. Rather, its purpose is to determine who is entitled, as between the

---

<sup>183</sup> *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 783 n.2 (D.C. Cir. 2008).

<sup>184</sup> *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Servs. Inc. of P.R.*, 704 F.3d 155, 162 (1st Cir. 2013).

<sup>185</sup> *See supra* Part III.A.

<sup>186</sup> 727 F.3d 719 (7th Cir. 2013).

<sup>187</sup> 325 F.3d 795, 803 (7th Cir. 2003).

<sup>188</sup> *Id.*

corporation and its shareholders, to assert the plaintiff's underlying substantive claim on the corporation's behalf."<sup>189</sup>

The question of who is best positioned to control the corporation by carrying it into litigation is arguably best left to the sound discretion of the trial court to resolve.

The overall comparison of the demand futility dismissal to the Rule 12(b)(6) dismissal is inaccurate because they are procedurally different. If a Rule 12(b)(6) dismissal is reversed, the facts will be reheard at trial. In contrast, if a demand futility dismissal is reversed, the facts surrounding the demand are forever silenced. Therefore, the decision on demand futility is essentially the "trial" for these facts. The outcome of this trial has a real-world effect: it determines who—the board or the shareholder—has the right to take the corporation into litigation. Given the trial-like nature of the demand futility decision, it is best left to the discretion of the district court.<sup>190</sup>

#### V. UNDERWOOD ANALYSIS

Having debunked the threshold arguments and left a clean slate by making Rule 23.1 the vehicle for dismissal, this Comment now turns to the task of assigning a standard of review to the demand futility dismissal. To make this assignment, it is necessary to consider the Supreme Court's 1988 case of *Pierce v. Underwood*.<sup>191</sup> This case provides a multifactor test specifically designed to determine whether a particular action of the district court is best reviewed de novo or for abuse of discretion. Given the pertinence of *Underwood*, it is odd that it has not been applied by any of the courts or litigants that have passed on the main issue presented by this Comment.

The *Underwood* test is not a mathematical equation for calculating standards of review, but is a very useful analytical framework—not to mention the law of the land. The Court in *Underwood* began by recognizing that it can

---

<sup>189</sup> *Oakland Cnty. Emps.' Ret. Sys. v. Massaro*, 772 F. Supp. 2d 973, 976 (N.D. Ill. 2011) (quoting *In re Veeco Instruments, Inc. Sec. Litig.*, 434 F. Supp. 2d 267, 273 (S.D.N.Y. 2006) (quoting *Levine v. Smith*, Civil Action No. 8833, 1989 WL 150784, at \*5 (Del. Ch. 1989) (reviewing demand futility dismissal for abuse of discretion), *aff'd* 591 A.2d 194 (Del. 1991), *overruled by Brehm v. Eisner*, 746 A.2d 244, 253 n.13 (Del. 2000) (reviewing demand futility dismissal for abuse of discretion))). Although Delaware, the source of this reasoning, eventually discarded it, nothing prevents the federal courts from continuing to use it.

<sup>190</sup> See Reply Brief for Petitioners at 8, *UBS Fin. Servs. Inc. of P.R. v. Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan*, 133 S. Ct. 2857 (2013) (No. 12-1208), 2013 WL 2152646.

<sup>191</sup> 487 U.S. 552 (1988).



be “uncommonly difficult” to assign a standard of review.<sup>192</sup> As such, the Court announced that it was not setting forth “a comprehensive test,”<sup>193</sup> nor one that was “rigorously scientific.”<sup>194</sup> Despite this humble disclaimer, the *Underwood* test is “instructive” and provides “helpful direction” when choosing between deferential and plenary review.<sup>195</sup> Therefore, even if one disagrees with this Comment’s interpretation or analysis of *Underwood*, the courts should nevertheless apply *Underwood* to assign the demand futility dismissal’s standard of review.

The Supreme Court in *Underwood* constructed the test as follows. It requires the courts to first consider the historical standard of review, followed by four “significant relevant factors:”<sup>196</sup> (i) the language and structure of the governing law; (ii) the judicial actor who is best positioned to decide the issue; (iii) the extent to which the issue lends itself to rule-making; and (iv) the financial interests at stake. This Part proceeds in five sections: Sections A through E. These sections track the *Underwood* factors, beginning with historical practice.

This Comment concludes that the *Underwood* test favors the demand futility dismissal’s deferential standard. This conclusion is supported by the following three reasons. First, the deferential standard’s historical pedigree entitles it to a presumption of correctness as per *Underwood*’s historical practice factor. Second, the deferential standard prevails under the second and third significant relevant factors—administration-of-justice and rule-formation. Third, although the standard fails under the first and fourth factors—language-and-structure and financial-interests—this failure does not justify abandoning the standard.

#### A. *Historical Practice*

The demand futility dismissal’s deferential standard of review is presumptively correct because of its historical pedigree. Historical practice is a factor that holds a special place in the *Underwood* test. This is the case for the following two reasons. First, the Court separately discussed historical practice

---

<sup>192</sup> *Id.* at 558.

<sup>193</sup> *Id.* at 559.

<sup>194</sup> *Id.* at 563.

<sup>195</sup> See 1 CHILDRESS & DAVIS, *supra* note 78, § 4.01[2].

<sup>196</sup> *Underwood*, 487 U.S. at 559. See generally, 1 CHILDRESS & DAVIS, *supra* note 78, § 4.01 (providing a holistic discussion of *Underwood*).

before discussing the “significant relevant factors.”<sup>197</sup> This indicates that historical practice is the threshold factor, or at least a relatively more important factor. Second, the Court stated that (for most trial court determinations) the standard of review “is provided by a long history of appellate review.”<sup>198</sup> Thus, “precedential characterizations of specific issues should weigh heavily in a given application.”<sup>199</sup>

To the extent that historical practice does not seriously conflict with contemporary necessity, deference to historical practice is ideal. This is because doing so brings certainty to the law, which fosters integrity in the legal system and thus greater efficiency in business. As the old saying goes, “if it ain’t broke, don’t fix it.”<sup>200</sup> With respect to standards of review, historical pedigree is particularly important. This is because the standard of review is the foundation of any appellate opinion. To change the standard of review is to undermine the validity of past appellate opinions. This causes uncertainty in the development of precedent, which undermines integrity in the legal system and thus diminishes efficiency in business.

This section proceeds in three subsections. Subsection 1 explains the deferential standard’s historical pedigree. Subsection 2 argues that the plenary standard wrongly flouts the historical standard. Subsection 3 discusses and debunks the strongest argument to disturb historical practice.

### *1. The Deferential Standard’s Historical Pedigree*

This subsection 1 argues that the deferential standard’s historical pedigree entitles it to a presumption of correctness, and makes the following three points. First, the deferential standard is an old, prevalent, and uniform standard. Second, the standard has persisted into the modern era. Third, the historical standard does suffer a major—but not fatal—weakness.

The demand futility dismissal’s deferential standard of review emerged generations ago, has become very prevalent, and has been uniformly applied. This standard of review finds authority dating back at least 100 years. As the Supreme Court recounted in *Daily Income Fund, Inc. v. Fox*, the demand-futility exception entered the Equity Rules in 1912, “apparently

---

<sup>197</sup> See *Underwood*, 487 U.S. at 558–59.

<sup>198</sup> *Id.* at 558.

<sup>199</sup> 1 CHILDRESS & DAVIS, *supra* note 78, § 4.01[2].

<sup>200</sup> See HUGH RAWSON & MARGARET MINER, *THE OXFORD DICTIONARY OF AMERICAN QUOTATIONS* 297 (2d ed. 2006) (spoken by Bert Lance).

intended to codify a judicially recognized exception . . . where, *in the discretion of the court*, a demand may be excused.”<sup>201</sup>

Moving into the modern era, the circuit courts have reinforced the deferential standard over the past half-century. In 1963, the Ninth Circuit was the first circuit court to explicitly endorse the deferential standard.<sup>202</sup> In 1966, the Seventh Circuit followed suit.<sup>203</sup> In the 1970s, three circuits—the First,<sup>204</sup> Second,<sup>205</sup> and Tenth<sup>206</sup> Circuits—all adopted the standard. In the 1980’s, two circuits—the Third<sup>207</sup> and District of Columbia<sup>208</sup> Circuits—both adopted the standard. In 1990, the Eleventh Circuit finally joined the bunch.<sup>209</sup> Within just one year of the writing of this Comment and notwithstanding the strong trend in favor of plenary review, the circuit courts have handed down two abuse-of-discretion opinions.<sup>210</sup>

The deferential standard’s major—but not fatal—weakness is its lack of judicial rationale. Among the numerous abuse-of-discretion cases, very few state a satisfactory rationale for employing the standard. The only apparent reason for this omission is that the courts thought that deferential review was obviously the correct choice, so no discussion was necessary. The Second and Ninth Circuits can trace their practices back to the conclusory statement that “probably the most straightforward approach is to admit frankly that it lies within the sound discretion of the court to determine the necessity for a demand.”<sup>211</sup> Even worse, the First,<sup>212</sup> Third,<sup>213</sup> Seventh,<sup>214</sup> and Tenth<sup>215</sup>

---

<sup>201</sup> 464 U.S. 523, 530 n.5 (1984) (emphasis added).

<sup>202</sup> *DePinto v. Provident Sec. Life Ins. Co.*, 323 F.2d 826, 830 n.7 (9th Cir. 1963).

<sup>203</sup> *Robison v. Caster*, 356 F.2d 924, 927 (7th Cir. 1966), *abrogated by* *Westmoreland Cnty. Emp. Ret. Sys. v. Parkinson*, 727 F.3d 719 (7th Cir. 2013).

<sup>204</sup> *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977), *abrogated by* *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Servs. Inc. of P.R.*, 704 F.3d 155, 162 (1st. Cir. 2013).

<sup>205</sup> *Elfenbein v. Gulf & W. Indus., Inc.*, 590 F.2d 445, 451 (2d Cir. 1978).

<sup>206</sup> *deHaas v. Empire Petrol. Co.*, 435 F.2d 1223, 1228 (10th Cir. 1970).

<sup>207</sup> *Lewis v. Curtis*, 671 F.2d 779, 783 (3d Cir. 1982), *abrogated by* *Garber v. Lego* 11 F.3d 1197 (3d Cir. 1993).

<sup>208</sup> *Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59 (D.C. Cir. 1988).

<sup>209</sup> *Peller v. S. Co.*, 911 F.2d 1532, 1536 (11th Cir. 1990).

<sup>210</sup> *Lambrech v. O’Neal*, 504 F. App’x 23, 25 (2d Cir. 2012); *Israni v. Bittman*, 473 F. App’x 548, 550 (9th Cir. 2012).

<sup>211</sup> The language quoted here appeared in various iterations of the second edition of *Moore’s Federal Practice* treatise. See, e.g., 3B JAMES WM. MOORE, *MOORE’S FEDERAL PRACTICE* ¶23.1.19 (2d ed. 1975); 3 JAMES WM. MOORE, *MOORE’S FEDERAL PRACTICE* ¶23.19 (2d ed. circa 1963). The Second Circuit in *Elfenbein v. Gulf & Western Industries, Inc.*, and the Ninth Circuit in *DePinto v. Provident Security Life Insurance Co.*, both quoted this language as it appears in the text of this Comment. See *Elfenbein v. Gulf & W. Indus., Inc.*, 590 F.2d 445, 450 (2d Cir. 1978); *DePinto v. Provident Sec. Life Ins. Co.*, 323 F.2d 826, 830 n.7 (9th Cir. 1963).

Circuits all adopted the standard without stating any rationale. The District of Columbia Circuit then arrived at its standard by relying on precedent from the Second and Seventh Circuits.<sup>216</sup> Finally, the Eleventh Circuit showed some ingenuity, making an analogy to the fair-and-adequate representation dismissal's deferential standard of review, which in turn came from an analogy to the class action denial.<sup>217</sup> Nevertheless, this lack of judicial rationale is not fatal: to overcome the presumption of correctness, the plenary standard cannot rely on the deferential standard's own lack of judicial rationale; rather, it should rely on its own rationale to overcome the presumption. This it fails to do.

## 2. *The Plenary Standard's Arbitrary Usurpation*

This subsection makes two points. First, the plenary standard stands on a relatively stronger judicial rationale than the deferential standard. Second, the plenary standard's emergence is nevertheless unsound because it is arbitrary. In contrast to the deferential standard, the plenary standard has received substantial judicial rationalization. This is not surprising, since the establishment of a rule from scratch inherently requires less justification than the abandonment of that rule in favor of a new one. As explained in Part IV, the plenary standard's rationale is twofold: first, the demand futility dismissal is (supposedly) a dismissal for lack of legal sufficiency on the pleadings; second, as a dismissal on the pleadings, the circuit court can make the determination just as well as the district court.<sup>218</sup> Given the plenary standard's stronger judicial rationale—that is, compared to no rationale for the deferential

---

<sup>212</sup> See *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977), *abrogated by* *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Servs. Inc. of P.R.*, 704 F.3d 155, 162 (1st Cir. 2013).

<sup>213</sup> See *Lewis v. Curtis*, 671 F.2d 779, 783 (3d Cir. 1982), *abrogated by* *Garber v. Lego* 11 F.3d 1197 (3d Cir. 1993).

<sup>214</sup> See *Robison v. Caster*, 356 F.2d 924, 927 (7th Cir. 1966), *abrogated by* *Westmoreland Cnty. Emp. Ret. Sys. v. Parkinson*, 727 F.3d 719 (7th Cir. 2013).

<sup>215</sup> See *deHaas v. Empire Petrol. Co.*, 435 F.2d 1223, 1228 (10th Cir. 1970).

<sup>216</sup> *Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59, 68 n.10 (D.C. Cir. 1988) (citing *Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983); *Fields v. Fid. Gen. Ins. Co.*, 454 F.2d 682, 684–85 (7th Cir. 1971)).

<sup>217</sup> See *Peller v. S. Co.*, 911 F.2d 1532, 1536 (11th Cir. 1990). *Peller* cited *Rothenberg v. Security Management Co.*, 667 F.2d 958, 960 (11th Cir. 1982), which reviewed a dismissal of a class action for lack of adequate representation for abuse of discretion. *Rothenberg* cited two other such cases, with the former citing the latter in support of applying an abuse of discretion standard: *Owen v. Modern Diversified Industries, Inc.*, 643 F.2d 441, 443 (6th Cir. 1981) and *Hornreich v. Plant Industries, Inc.*, 535 F.2d 550, 552 (9th Cir. 1976). *Hornreich* in turn borrows the standard applied to class-certification denials. For further discussion, see *infra* Part VII.A.

<sup>218</sup> See *supra* Part IV.

standard—the courts’ adoption of it is understandable. But, they have done so in haste. The courts have ignored *Underwood*, and in so doing have ignored the weight of the deferential standard’s historical pedigree.

The conversion from deferential to plenary review<sup>219</sup> is unsound because it arbitrarily disregards the deferential standard’s historical pedigree. The rationale for plenary review is nothing more than a delayed reaction to the original and inherent qualities of the demand futility dismissal: it’s a dismissal on the pleadings, which go before both the district and circuit courts. These qualities—too obvious to have ever been overlooked—are the exact same qualities that faced the judges of old. With this knowledge, those judges repeatedly set down the deferential standard for future judges to follow. Nothing—except perhaps judicial temperament—has changed so as to permit the conversion. Unless the de novo courts can cite some change—either in doctrine, thought, society, or elsewhere—their conversion is arbitrary and thus unjustifiably flouts an historical practice integrally built up with the law of derivative actions.

### 3. *The Merger of Law and Equity as a Nonstarter for Plenary Review*

There is only one change that could possibly—but ultimately does not—justify the conversion. This change is the merger of law and equity. Given this change’s significance, it is worth discussing. This subsection 3 proceeds in three stages. First, it explains the argument that the deferential standard is equitable in origin. Second, it explains how this origin threatens its survival. Third, it explains why this threat is not real.

It has been argued that the deferential standard originated at equity. As explained in Part II, section A, demand futility originated at equity. This origin, according to the *Union de Empleados* petitioner, both explains and justifies deferential review.<sup>220</sup> At equity, the trier of fact enjoys a wide degree of discretion in shaping and delivering relief. The Supreme Court has said so repeatedly: “[t]he essence of equity jurisdiction has been the power of the Chancellor to do equity and to mold each decree to the necessities of the

---

<sup>219</sup> There was arguably no conversion in the Sixth and Eighth Circuits, since they adopted plenary review without having previously adopted deferential review. *See* *McCall v. Scott*, 239 F.3d 808, 817, 826 *amended on denial of reh’g*, 250 F.3d 997 (6th Cir. 2001); *Gomes v. Am. Century Cos.*, 710 F.3d 811, 815 (8th Cir. 2013). However, the deferential standard was already so well established that for these cases to hold otherwise makes them conversionary.

<sup>220</sup> *Petition for Writ of Certiorari at 8, UBS Fin. Servs. Inc. of P.R. v. Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan*, 133 S. Ct. 2857 (2013) (No. 12-1208), 2013 WL 1400213.

particular case. Flexibility rather than rigidity has distinguished it.”<sup>221</sup> Given this flexibility, the circuit courts have traditionally deferred to the district courts in exercising their equitable powers. Therefore, as a ruling at equity, the district court’s demand futility dismissal should be reviewed for abuse of discretion.

Ironically for the *Unión de Empleados* petitioners, their argument is easily turned against them. As the Supreme Court stated bluntly in the derivative action of *Ross v. Bernhard*, “[u]nder the [R]ules, law and equity are procedurally combined; *nothing* turns now upon the form of the action or the procedural devices by which the parties happen to come before the court.”<sup>222</sup> Therefore, the petitioners’ theory cannot possibly serve as a justification for deferential review in the modern era. Further, if the deferential standard is in fact based on equitable origins, then it arguably lacks any support and should be replaced by the more robust plenary standard.

The “equity theory turn around” does not defeat deferential review. There are four reasons why, all of which mainly hinge on the equity theory’s own failings. First, the circuit courts explicitly adopted deferential review<sup>223</sup> only after the merger of law and equity,<sup>224</sup> so they probably did not even consider equity in crafting the standard. Second, the circuit courts have never invoked equity to support the deferential standard. Third, the standard is not necessarily a product of equity, since there is no hard-and-fast rule requiring that matters at equity be reviewed deferentially.<sup>225</sup> Fourth, even if deferential review originated at equity, this does not mean that it is not justified today by the *Underwood* factors, particularly the historical practice factor.

## B. Language and Structure

After historical practice, the first of *Underwood*’s significant relevant factors, requires the courts to consider “the language and structure of the

---

<sup>221</sup> *Swann v. Charlotte-Mecklenburg Bd. of Educ.*, 402 U.S. 1, 15 (1971) (quoting *Hecht Co. v. Bowles*, 321 U.S. 321, 329–30 (1944), cited with approval in *Brown v. Bd. of Educ.*, 349 U.S. 294, 300 (1955)).

<sup>222</sup> 396 U.S. 531, 540 (1970) (emphasis added).

<sup>223</sup> *DePinto v. Provident Sec. Life Ins. Co.*, 323 F.2d 826, 830 n.7 (9th Cir. 1963) (announcing standard in explicit terms for the first time).

<sup>224</sup> See 4 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 1004 (3d ed. 2002) (stating that the “Rules . . . came into effect on September 16, 1938”).

<sup>225</sup> See Lead Plaintiffs-Appellants’ Reply Brief, *supra* note 93, at 6 n.6 (citing in part *Trudeau v. FTC*, 456 F.3d 178, 182–83 (D.C. Cir. 2006), which reviewed de novo the district court’s determination regarding declaratory and injunctive relief, both equitable remedies)).

governing statute.”<sup>226</sup> On this factor, this Comment concedes that the language and structure do not favor deferential review. However, as explained below,<sup>227</sup> this is not fatal to the deferential standard. This section B proceeds as follows. To begin, it resolves a threshold issue that determines the course of analysis under the first *Underwood* factor. It then moves into a two-stage analysis. The first stage considers the language itself. The second stage considers the structure by comparing the language to two other closely related rules.

The threshold issue is this: *what is the “governing statute” for analyzing the demand futility dismissal under Underwood?* This Comment concludes that the answer is Rule 23.1. This rule “speaks only to the adequacy of the shareholder representative’s pleadings” and does not govern the substance of demand futility.<sup>228</sup> Thus, the governing statute as to the substantive law is generally a state statute in diversity cases, and a federal statute in federal question cases.<sup>229</sup> However, neither of these should serve as the “governing statute” for purposes of *Underwood* analysis. Regarding the state statute, Part II has already argued that state law cannot determine the federal standard of review. Regarding both state and federal statutes, to allow a particular statute to determine the standard of review would undermine uniformity; this is best avoided unless the applicable federal statute explicitly establishes a standard of review. This process of elimination leaves Rule 23.1 as the only option. Indeed, this is correct option, since it provides for a uniform standard derived from federal law. Although it is only the “governing law” with respect to procedure, this should suffice; the standard of review is also *just* a matter of procedure.<sup>230</sup>

Having established Rule 23.1 as the governing statute for purposes of *Underwood*, this section B now turns to the language and structure analysis. The language of Rule 23.1 does not support deferential review. To analyze Rule 23.1’s language, *Underwood* itself provides a useful point of comparison. In that case, the governing statute read in critical part “unless the court finds.”<sup>231</sup> This language, according to the Court, “emphasizes the fact that the determination is for the district court to make, and thus suggests some

---

<sup>226</sup> *Pierce v. Underwood*, 487 U.S. 552, 559 (1988).

<sup>227</sup> *See infra* Part V.E.

<sup>228</sup> *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96 (1991).

<sup>229</sup> *See id.* at 100 n.6.

<sup>230</sup> *See Alison H. v. Byard*, 163 F.3d 2, 4 (1st Cir. 1998).

<sup>231</sup> *Underwood*, 487 U.S. at 559 (citing 28 U.S.C. § 2412(d)(1)(A) (1988) (current version at 28 U.S.C. § 2412(d)(1)(A) (2012))).

deference to the district court upon appeal.”<sup>232</sup> In contrast, no such language appears in Rule 23.1.

Rule 23.1’s structure also lends no support to deferential review. To analyze structure, it is necessary to compare Rule 23.1 with other provisions in the Rules. The most apt points of comparison are Rules 23.1(c) and 23(c)(1)(A). This comparison arguably requires expanding the governing statute to include the Rules in general; this may or may not be technically correct for purposes of *Underwood*, but the comparisons are nevertheless useful.

The comparison with Rule 23.1(c) is particularly revealing and damaging to the demand futility’s deferential standard of review. This rule—which immediately follows the demand-futility exception—provides that “[a] derivative action may be settled, voluntarily dismissed, or compromised *only with the court’s approval*.”<sup>233</sup> Rule 23.1(c) explicitly invokes the discretion of the district court. Indeed, the circuit courts routinely review such decisions for abuse of discretion.<sup>234</sup> Given Rule 23.1(c)’s clear language and close location to demand futility, it is reasonable to infer that the drafters knew how to direct appellate deference in the context of derivative actions and deliberately chose against doing so with respect to demand futility.<sup>235</sup>

A separate comparison with Rule 23(c)(1)(A) is also useful, as well as damaging to the demand futility dismissal’s deferential standard. Rule 23(c)(1)(A) governs class action certification<sup>236</sup> and is an appropriate point of comparison because of its close relationship with the Rule 23.1 requirements.<sup>237</sup> This rule provides that “*the court must determine . . . whether to certify the . . . class*.”<sup>238</sup> Like Rule 23.1(c), Rule 23(c)(1)(A) clearly invokes the discretion of the trial court. And, as with derivative action settlements, the circuit courts routinely review class certification denials for abuse of

---

<sup>232</sup> *Id.*

<sup>233</sup> FED. R. CIV. P. 23.1(c) (emphasis added).

<sup>234</sup> *E.g.*, *City P’ship Co. v. Atl. Acquisition Ltd. P’ship*, 100 F.3d 1041, 1043–44 (1st Cir. 1996).

<sup>235</sup> *But see* *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 n.5 (1984) (recounting demand futility as “a judicially recognized exception . . . where, *in the discretion of the court*, a demand may be excused” (emphasis added)).

<sup>236</sup> FED. R. CIV. P. 23(c)(1)(A).

<sup>237</sup> *See infra* Part V.A.

<sup>238</sup> FED. R. CIV. P. 23(c)(1)(A) (emphasis added).



discretion.<sup>239</sup> This comparison thus further indicates that drafter deliberately withheld deference with respect to the demand futility requirement.

### C. Administration of Justice

The second significant relevant factor under *Underwood* requires the courts to determine whether, “as a matter of the sound administration of justice, one judicial actor is better positioned than another to decide the issue in question.”<sup>240</sup> This has been one of the main battlegrounds in the plenary versus deferential war. Many de novo opinions have claimed total victory on this front. This Comment concludes that the victory belongs to deferential review.

This section C proceeds in three stages. First, it argues that district courts are better positioned to determine demand futility. Second, it presents the de novo courts’ counterargument. Third, it argues that the de novo courts’ counterargument is unpersuasive because it ignores broader principles that underpin the trial–appellate court relationship.

District courts are better positioned to determine demand futility because it is a fact-specific inquiry. Under Rule 23.1(b)(3), “the complaint must *plead facts with particularity* that are specific to the individual board members and the specific claims at issue.”<sup>241</sup> Demand futility thus “depends on the unique pleadings of each case under consideration”<sup>242</sup> and is “essentially a factual issue.”<sup>243</sup> It is precisely this understanding that led the circuit courts to review only for abuse of discretion: “the decision as to whether a plaintiff’s allegations of futility are sufficient to excuse demand *depends on the particular facts of each case* and lies within the discretion of the district court.”<sup>244</sup> Most recently, the Supreme Court of Alaska, in declining to follow Delaware’s conversion to plenary review, acknowledged that “the question of

---

<sup>239</sup> E.g., *Harden Mfg. Corp. v. Pfizer, Inc. (In re Neurontin Mktg. & Sales Practices Litig.)*, 712 F.3d 60, 70 (1st Cir.), *cert. denied*, 134 S. Ct. 786 (2013).

<sup>240</sup> *Pierce v. Underwood*, 487 U.S. 552, 559–60 (1988) (quoting *Miller v. Fenton*, 474 U.S. 104, 114 (1985)) (internal quotation marks omitted).

<sup>241</sup> *Petition for Writ of Certiorari*, *supra* note 220, at 21–22.

<sup>242</sup> *Kaster v. Modification Sys., Inc.*, 731 F.2d 1014, 1020 (2d Cir. 1984).

<sup>243</sup> *In re Oxford Health Plans, Inc. Sec. Litig.*, 192 F.R.D. 111, 118 (S.D.N.Y. 2000).

<sup>244</sup> *Gaubert v. Fed. Home Loan Bank Bd.*, 863 F.2d 59, 68 n.10 (D.C. Cir. 1988) (emphasis added) (quoting *Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983)); *see also Blasband v. Rales*, 971 F.2d 1034, 1040 (3d Cir. 1992) (“Generally, the district court’s determination of demand futility *depends upon the facts of each case* and is reviewed for abuse of discretion.” (emphasis added)).

demand excuse potentially also involves *fact-based analysis* which is better reviewed under the abuse of discretion standard.”<sup>245</sup>

But, the de novo courts prefer to take the facts upon themselves. According to them, the trial court is in no better position to determine demand futility. This is because the facts surrounding demand futility are all in the pleadings, which all go into the appellate record. This gives the appellate court the opportunity to decide the issue just as well as the trial court. As the Delaware Supreme Court has explained, “[i]n a Rule 23.1 determination of pleading sufficiency, the Court of Chancery, like this Court, is merely reading the English language of a pleading and applying to that pleading statutes, case law and Rule 23.1 requirements.”<sup>246</sup> The First Circuit subsequently adopted this reasoning in *Unión de Empleados*: “[a] district court is no better positioned than we are to read and evaluate a complaint” in a derivative action.<sup>247</sup> In the terms of *Underwood*, this argument admittedly carries some weight, since none of the information surrounding demand futility is “known only to the district court.”<sup>248</sup>

However, the de novo courts’ position is unpersuasive because it focuses on just one aspect of appellate review, ignoring broader principles that underpin the trial-appellate court relationship. There are four principles to consider. First, although the relevant *facts* are all on the record, “the district court may [still] have *insights* not conveyed by the record,” such as “whether particular evidence was worthy of being relied upon.”<sup>249</sup> Second, even where the circuit court can acquire “the district judge’s full knowledge of the factual setting[,] . . . that acquisition will often come at unusual expense, requiring the court to undertake the unaccustomed task of reviewing the entire record.”<sup>250</sup> Third, this high-cost endeavor yields little benefit, since “[d]uplication of the trial judge’s efforts in the court of appeals would very likely contribute only negligibly to the accuracy of [the] fact[-based demand futility] determination at a huge cost in diversion of judicial resources.”<sup>251</sup> Fourth, “the [management defendants] to a case on appeal have already been forced to concentrate their energies and resources on persuading the trial judge that their account of the

---

<sup>245</sup> *Jerue v. Millett*, 66 P.3d 736, 745 (Alaska 2003) (emphasis added).

<sup>246</sup> *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

<sup>247</sup> *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Serv. Inc. of P.R.*, 704 F.3d 155, 162 (1st Cir. 2013).

<sup>248</sup> *Pierce v. Underwood*, 487 U.S. 552, 560 (1988).

<sup>249</sup> *Id.* (emphasis added).

<sup>250</sup> *Id.*

<sup>251</sup> *See Anderson v. City of Bessemer City*, 470 U.S. 564, 574–75 (1985).

[demand] is the correct one; requiring them to persuade three more judges at the appellate level is requiring too much.”<sup>252</sup> The shareholder’s opportunity to argue demand futility before the district court “should be ‘the main event rather than a tryout on the road,’”<sup>253</sup> especially since demand futility is not reheard at trial.<sup>254</sup>

#### D. Rule Formation

The third significant relevant factor under *Underwood* requires the courts to determine whether demand futility is “a multifarious and novel question, little susceptible, for the time being at least, of *useful* generalization.”<sup>255</sup> If it is, then it is “likely to profit from the experience that an abuse-of-discretion rule will permit to develop.”<sup>256</sup> This section D concludes that deferential review prevails under this factor.

The issue of demand futility is not susceptible to useful generalization. This is because demand futility depends on the particular facts of each case.<sup>257</sup> *Underwood* itself provides a useful point of comparison. In that case, the Court determined the propriety of awarding attorney’s fees under a certain federal statute.<sup>258</sup> Although the Court could have reasonably generalized the facts that would have justified the attorney’s fees, it declined to do so.<sup>259</sup> Rather, it held that each case is so particular that the determination is best directed to the sound discretion of the district court.<sup>260</sup> Likewise, while the circumstances that trigger demand futility may be susceptible to *reasonable* generalization, they are resistant to *useful* generalization.

#### E. Financial Interests

The fourth and final of the significant relevant factors under *Underwood* requires the courts to consider the financial interests that hinge on the district court’s demand futility ruling.<sup>261</sup> The larger the financial interests, the greater

---

<sup>252</sup> See *id.* at 575.

<sup>253</sup> See *id.* (quoting *Wainwright v. Sykes*, 433 U.S. 72, 90 (1977)) (some internal quotation marks omitted).

<sup>254</sup> See *supra* Part IV.B.

<sup>255</sup> *Pierce v. Underwood*, 487 U.S. 552, 562 (1988) (emphasis added).

<sup>256</sup> *Id.*

<sup>257</sup> See *supra* Part V.C.

<sup>258</sup> *Underwood*, 487 U.S. at 555.

<sup>259</sup> See *id.* at 562.

<sup>260</sup> *Id.*

<sup>261</sup> See *id.* at 563.

the case for plenary review; the smaller the financial interests, the greater the case for deferential review. The financial interests at stake in derivative actions are significant. For example, in *Unión de Empleados*, the shareholders were seeking to recover at least \$75.7 million.<sup>262</sup> In comparison, the Court in *Underwood* indicated that the \$1,129,450 legal fee at issue in that case could be substantial enough.<sup>263</sup> Thus, the fourth *Underwood* factor does not favor the demand futility dismissal's deferential standard. Nevertheless, as explained below, this defeat is not fatal to the standard.

Overall, the *Underwood* test supports the demand futility dismissal's deferential standard of review. The standard's historical pedigree entitles it to a presumption of correctness as per *Underwood*'s threshold factor. It then prevails under the second and third significant relevant factors—administration of justice and rule formation. Although it does not prevail under the first and fourth factors—language-and-structure and financial-consequences—this is not fatal. This is the case for two reasons. First, the former three winning factors outweigh the latter two losing factors. Second, the standard's failure under these two standards does not inherently justify its abandonment. This is because the relevant circumstances pertaining to these two factors—the language of Rule 23.1 and the financial interests at stake in derivative actions—are the same now as when the circuit courts first explicitly announced the deferential standard. For the courts to now change the historical standard while the underlying circumstances remain unchanged is unjustifiably arbitrary.

## VI. OTHER 23.1 DISMISSALS

The standards of review applied to five other Rule 23.1 dismissals further support the demand futility dismissal's deferential standard of review.<sup>264</sup> This comparison is appropriate because courts should review all Rule 23.1 dismissals under a uniform standard, to the greatest extent possible, for the same reasons that justify a uniform vehicle of dismissal.<sup>265</sup> To determine the uniform standard, this Comment proposes that the standard for any other Rule

---

<sup>262</sup> See *Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Serv. Inc. of P.R.*, 704 F.3d 155, 161 (1st Cir. 2013). The shareholders complained that defendants caused them to lose 10% on a \$757 million investment. See *id.*

<sup>263</sup> See 487 U.S. at 557, 559 (holding fourth factor still favored deferential review because legal fee at issue was an abnormally high outlier).

<sup>264</sup> For an overview of the other Rule 23.1 dismissals, see *supra* Part I.A.

<sup>265</sup> See *supra* Part III.

23.1 dismissal should guide or follow the demand futility dismissal's standard depending on the strength of its foundation, considering factors such as historical pedigree, prevalence, and judicial rationale. This Part consists of five sections that conduct this analysis for each of the five other Rule 23.1 dismissals, respectively.

#### A. *Fair-and-Adequate Representation*

The demand futility dismissal's deferential standard of review receives strong support from the representation dismissal. This dismissal is reviewed for abuse of discretion (including, in chronological order of adoption, in the Ninth,<sup>266</sup> Sixth,<sup>267</sup> Fifth,<sup>268</sup> Eleventh,<sup>269</sup> and Third<sup>270</sup> Circuits) and is well founded. As these cases indicate, the standard is both time-honored and prevalent. Also, no circuit court appears to have challenged it. The Eleventh Circuit has even relied on this standard to reach its deferential standard of review for demand futility dismissals.<sup>271</sup>

The representation dismissal's deferential standard is also based on strong judicial rationale. It began in the Ninth Circuit's 1976 case of *Hornreich v. Plant Industries, Inc.*<sup>272</sup> *Hornreich* serves as the foundation for this standard in all other circuits (except the Third Circuit, which has provided no case law to support its standard). Looking backward, *Hornreich* based its standard on an analogy to class certification denials, which the circuit courts review for abuse of discretion.<sup>273</sup> The rationale for reviewing the certification denial deferentially is found in the Second Circuit's 1969 case of *City of New York v. International Pipe & Ceramics Corp.*<sup>274</sup> According to that case, class

---

<sup>266</sup> *Hornreich v. Plant Indus., Inc.*, 535 F.2d 550, 552 (9th Cir. 1976); accord *Larson v. Dumke*, 900 F.2d 1363, 1364 (9th Cir. 1990) (citing *Hornreich*, 535 F.2d at 552); see also *Biophotonic Tech., Inc. v. Davis*, No. 91-15103, 1992 WL 31850, at \*1 (9th Cir. Feb. 20, 1992) (citing *Larson*, 900 F.2d at 1364).

<sup>267</sup> *Owen v. Modern Diversified Indus., Inc.*, 643 F.2d 441, 443 (6th Cir. 1981) (citing *Hornreich*, 535 F.2d 550).

<sup>268</sup> *Smith v. Ayres*, 977 F.2d 946, 948 (5th Cir. 1992) (citing *Larson*, 900 F.2d at 1364).

<sup>269</sup> *Rothenberg v. Sec. Mgmt. Co.*, 667 F.2d 958, 960 (11th Cir. 1982) (citing *Owen*, 643 F.2d at 443).

<sup>270</sup> *Vanderbilt v. Geo-Energy Ltd.*, 725 F.2d 204, 205 (3d Cir. 1983).

<sup>271</sup> See *Peller v. S. Co.*, 911 F.2d 1532, 1536 (11th Cir. 1990) (citing *Rothenberg*, 667 F.2d at 960).

<sup>272</sup> 535 F.2d at 552.

<sup>273</sup> *E.g.*, *Harden Mfg. Corp. v. Pfizer, Inc. (In re Neurontin Mktg. & Sales Practices Litig.)*, 712 F.3d 60, 70 (1st Cir.), cert. denied, 134 S. Ct. 786 (2013).

<sup>274</sup> 410 F.2d 295 (2d Cir. 1969). The jurisprudential link from the class certification denial to the representation denial is as follows: *Hornreich* cites *Rutledge v. Electric Hose & Rubber Co.*, 511 F.2d 668, 673 (9th Cir. 1975) and *Clark v. Watchie*, 513 F.2d 994, 1000 (9th Cir. 1975). *Ruteledge* directly cites *International Pipe & Ceramics Corp.*, and *Clark* indirectly cites it through *Price v. Lucky Stores, Inc.*, 501 F.2d 1177, 1179 (9th Cir. 1974).

certification denials are best reviewed for abuse of discretion because the fact-intensive inquiry of whether it is most fair and efficient for a litigation to proceed as a class or individual action is best decided “by a trial judge who has knowledge of the actual problems presented in the courtroom by these multi-plaintiff, multi-defendant cases.”<sup>275</sup> Likewise, although the class action is perhaps more complex than the derivative action in terms of the number of parties involved, the question of whether it is fair for a shareholder to assert a claim on behalf of a corporation is also best to left to the trial judge.

### B. Verification

The verification dismissal is (and should remain) reviewed for abuse of discretion, which further supports the demand futility dismissal’s deferential standard. However, the rationale that supports the verification dismissal’s standard should be rejected. The Third Circuit established the standard in the 1982 case of *Lewis v. Curtis* by adopting the demand futility dismissal’s deferential standard.<sup>276</sup> The court’s linking of verification to demand poses no problem, but its linking of demand to deferential review most certainly does. The court made the link to deferential review based on a rule announced in *Cramer v. General Telephone & Electronics Corp.*,<sup>277</sup> and this is where it erred.

The *Cramer* rule has no bearing on standards of review. In that case, the shareholder alleged demand futility based on the special litigation committee’s<sup>278</sup> opposition to the action after the commencement of the suit.<sup>279</sup> The district court rejected this argument, and the Third Circuit affirmed, stating, “[t]he futility of making the demand . . . must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight.”<sup>280</sup> The *Lewis* court read this to mean that the demand futility dismissal should be subject to only deferential review because the circuit court

---

<sup>275</sup> See 410 F.2d at 297–98.

<sup>276</sup> 671 F.2d 779, 787 (3d Cir. 1982), *abrogated by* *Garber v. Lego*, 11 F.3d 1197, 1206–07 (3d Cir. 1993).

<sup>277</sup> 582 F.2d 259 (3d Cir. 1978); see *Lewis*, 671 F.2d at 787 (citing *Weiss v. Temp. Inv. Fund, Inc.*, 520 F. Supp. 1098, 1100 (D. Del. 1981)). The court in *Weiss*, in turn, cited *Cramer*. *Weiss*, 520 F. Supp. at 1100.

<sup>278</sup> A “special litigation committee” is “[a] committee of [unbiased] directors assigned to investigate the merits of a . . . derivative [action] and . . . to recommend maintaining or dismissing the [action].” BLACK’S LAW DICTIONARY 1526 (9th ed. 2009). A special litigation committee is useful where some of the directors are biased, such that a demand on them would be futile.

<sup>279</sup> See 582 F.2d at 276.

<sup>280</sup> *Id.*

has the benefit of hindsight. This reading is wrong. The circuit court has no benefit of hindsight in this respect. The managers argue demand required at the district court level. Both courts have the benefit of hindsight in this respect. Both must ignore it.

### C. Contemporaneous Ownership

The contemporaneous-ownership dismissal is reviewed for abuse of discretion, which further supports the demand futility dismissal's deferential standard. In 2008, the Tenth Circuit said that the standard of review for contemporaneous-ownership dismissals is generally abuse of discretion, although it applied de novo review because a question of law was at stake.<sup>281</sup> In 1969, the Fifth Circuit held a contemporaneous-ownership dismissal "erroneous,"<sup>282</sup> indicating application of the clearly erroneous standard. The holding is not technically correct, since this standard applies to the district court's findings, not actions.<sup>283</sup> However, this holding does not necessarily discredit the case. The clearly erroneous standard is also deferential,<sup>284</sup> so the Fifth Circuit may have meant abuse of discretion instead. Alternatively, the court may have meant that the contemporaneous-ownership requirement is so fact-specific that the finding of fact and ultimate dismissal are inseparable. Both theories favor and justify deferential review.

### D. Continuous Ownership

The standard of review for the continuous-ownership dismissal is de novo, but should be abandoned because it is an ill-founded rule that is apparently isolated to one circuit. As such, it should have no bearing on any of the other Rule 23.1 dismissals. The continuous-ownership dismissal's plenary standard is only clearly supported by the Ninth Circuit's 1999 case of *Kona Enterprises, Inc. v. Estate of Bishop* and its progeny.<sup>285</sup> *Kona's* only basis is a case stating that Rule 12(b)(6) dismissals are reviewed de novo.<sup>286</sup> The link between Rule 12(b)(6) and continuous ownership goes unstated by the court. The link can perhaps be inferred from the court's reference to the requirement as a matter of

---

<sup>281</sup> *Cadle v. Hicks*, 272 F. App'x 676, 677 (10th Cir. 2008).

<sup>282</sup> *Bateson v. Magna Oil Corp.*, 414 F.2d 128, 131 (5th Cir. 1969).

<sup>283</sup> See *infra* Part II.B.

<sup>284</sup> See *infra* Part II.B.

<sup>285</sup> 179 F.3d 767, 769 (9th Cir. 1999), cited with approval in *Quinn v. Anvil Corp.*, 620 F.3d 1005, 1012 (9th Cir. 2010).

<sup>286</sup> See 179 F.3d at 769 (citing *Cohen v. Stratosphere Corp.*, 115 F.3d 695, 700 (9th Cir. 1997)).

“derivative standing”<sup>287</sup> (i.e., statutory or prudential standing). As explained above with the discussion of *Cetacean Community* and *Simmonds*, the lack of statutory standing can be addressed to Rule 12(b)(6).<sup>288</sup> However, this doesn’t help *Kona*, since *Simmonds* applied deferential review even after holding that the dismissal was under Rule 12(b)(6).<sup>289</sup> Further, *Kona* breaks from the Ninth Circuit’s long tradition of reviewing other Rule 23.1 dismissals for abuse of discretion,<sup>290</sup> without providing any reason for so doing.

### E. Collusion

The way in which courts review collusion dismissals also supports the demand futility dismissal’s deferential standard of review. The collusion dismissal comes in two different types: (i) the “type 1 collusion dismissal” is for actual collusion; and (ii) the “type 2 collusion dismissal” is for failure to allege non-collusion. Each dismissal is subject to a different standard of review. This is because, as alluded to above,<sup>291</sup> each type is handled by a different vehicle of dismissal. This section E explains both types of collusion dismissals in terms of their vehicles of dismissal and standards of review.

The type 1 collusion dismissal is reviewed de novo, but this is has no bearing on the demand futility dismissal’s standard of review. This is because the two dismissals go through different vehicles of dismissal. As explained above, the demand futility dismissal cannot proceed through the Rule 12(b)(1) dismissal for lack of subject-matter jurisdiction.<sup>292</sup> In contrast, the type 1 collusion dismissal *must* proceed through Rule 12(b)(1) or a similar rule because it is a dismissal for lack of jurisdiction. This is because collusion destroys federal jurisdiction under 28 U.S.C. § 1359. As such, while the dismissal *may additionally* invoke Rule 23.1, it *must* invoke a jurisdictional rule, such as § 1359,<sup>293</sup> Rule 12(b)(1),<sup>294</sup> or Rule 12(h)(3).<sup>295</sup> And, as a jurisdictional dismissal, the standard of review is de novo.<sup>296</sup>

---

<sup>287</sup> *Id.*

<sup>288</sup> See *supra* Part III.B.

<sup>289</sup> See *supra* Part III.B.

<sup>290</sup> See cases cited *supra* notes 202 and 266.

<sup>291</sup> See *supra* notes 115–18 and accompanying text.

<sup>292</sup> See *supra* Part III.B.

<sup>293</sup> In *City of Detroit v. Dean*, the Court dismissed a derivative action for actual collusion pursuant to the Act of March 3, 1875. 106 U.S. 537, 541 (1883) (citing Act of March 3, 1875, ch. 137, 18 Stat. 470, 472). The Act of March 3, 1875 is “the predecessor to § 1359.” 7C WRIGHT ET AL., *supra* note 61, § 1830.

<sup>294</sup> FED. R. CIV. P. 12(b)(1) (“[A] party may assert the following defenses by motion: (1) lack of subject-matter jurisdiction[.]”).



In contrast, the type 2 collusion dismissal goes through the same vehicle as the other Rule 23.1 dismissals, and its standard of review supports the demand futility dismissal's deferential standard. Turning first to the vehicle of dismissal, if the shareholder fails to allege non-collusion, and the court does not suspect actual collusion, then the ensuing dismissal is for lack of statutory standing, not jurisdiction. Accordingly, it is improper to invoke a jurisdictional rule, and proper to invoke a procedural rule, such as Rule 23.1 itself.<sup>297</sup> As for the standard of review, the type 2 collusion dismissal is reviewed for abuse of discretion.<sup>298</sup>

## CONCLUSION

For the reasons presented above, the circuit courts should review demand futility dismissals under Rule 23.1 and for abuse of discretion. Rule 23.1 is the best vehicle for this dismissal because it would enable the courts to tailor standards and procedures for the demand futility dismissal. None of the other contenders—Rules 12(b)(1), 12(b)(6), or 41(b)—are well suited to handle this dismissal. With Rule 23.1 as the vehicle of dismissal, the courts would be free to assign the standard of review that best suits the demand futility dismissal. The standard of review should be abuse of discretion. This historical standard prevails under the Supreme Court's *Underwood* test, which enumerates several factors of vital importance for achieving the proper division of labor between the district and circuit courts. The demand futility dismissal's deferential standard of review is further supported by the standards of review that apply to the other Rule 23.1 dismissals. In maintaining the historical standard, the

---

<sup>295</sup> FED. R. CIV. P. 12(h)(3) ("If the court determines at any time that it lacks subject-matter jurisdiction, the court must dismiss the action."). In *Amar v. Garnier Enterprises, Inc.*, the court dismissed a derivative action pursuant to Rule(h)(3) based on collusion. 41 F.R.D. 211, 217–18 (C.D. Cal. 1966). As the *Federal Practice Treatise* notes, the *Amar* court "concluded that the transaction [at issue] was a sham, which justified dismissal under Section 1359, as well as Rule 23.1." 7C WRIGHT ET AL., *supra* note 61, § 1830.

<sup>296</sup> *E.g.*, *Haag v. United States*, 736 F.3d 66, 69 (1st Cir. 2013).

<sup>297</sup> *See* 7C WRIGHT ET AL., *supra* note 61, § 1830 n.1 (citing *City of Quincy v. Steel*, 120 U.S. 241, 246 (1887)) (noting that, where shareholder neglected to allege non-collusion, the Court dismissed under Equity Rule 94—"the predecessor to Rule 23.1").

<sup>298</sup> *See* *Kautz v. Sugarman*, No. 10 Civ. 3478 (RJS), 2011 WL 1330676, at \*3, \*6 (S.D.N.Y. Mar. 31, 2011) (dismissing for failure to allege non-collusion), *aff'd*, 456 F. App'x 16, 18 (2d Cir. 2011) (reviewing for abuse of discretion).

courts should reject the arguments for de novo review, both those advanced by the courts and others presented in this Comment.

ANDREW S. HIRSCH\*

---

\* J.D. candidate, class of 2015, Emory University School of Law. B.A., class of 2008, University of Colorado at Boulder. I thank all those who have supported me, including my wife, my parents and grandparents, and my advisor—Richard D. Freer, Robert Howell Hall Professor of Law, Emory University School of Law.