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APPLYING THE DEMAND FUTILITY STANDARD TO DERIVATIVE CLAIMS – STOCK OPTION BACKDATING DECISIONS SUGGEST CANADIAN LAW OUTDATED

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Introduction

When seeking leave to commence a derivative action for and on behalf of a corporation, a core requirement[1] is that the complainant demonstrate that (s)he has made demand upon the directors of the corporation to prosecute the claim.

At first blush, since the claim is, by its nature, one that belongs to the corporation, it would appear normal and sensible that the action be authorized and overseen by the board. In the normal course, the complainant should therefore attempt to persuade the directors, whom one would expect to make a decision based on the best interests of the corporation, to initiate proceedings.

In some circumstances, however, the requirement that the directors make the threshold determination may amount to the fox guarding the henhouse. In such situations, Canadian corporate law should be updated to that of contemporary business realities as has been done in some of the states in the U.S.

Whether, and in what circumstances, the complainant may avoid the notice requirement by pursuing *other* statutory or common law remedies such as an oppression or winding-up proceeding or an action founded upon misrepresentation, is beyond the scope of this article and will not be considered here. The availability of alternative remedies will be highly fact-driven.

Prerequisites For Leave

Shareholders, directors, creditors and other interested parties may apply for leave to initiate or defend an action on behalf of a corporation or its subsidiaries, and for directions regarding conduct, control, legal fees and the like. The claim must be for a right, duty or obligation owed to the corporation that could be enforced by the corporation itself.

Where that is the case, Canadian law requires claimants seeking leave to commence a derivative claim to establish that[2]:

(a) the complainant has made efforts to cause the directors to prosecute the proceeding;

(b) notice of the leave application has been given to the corporation;

(c) the complainant is acting in good faith; and

(d) it is in the interests of the corporation for the proceeding to be prosecuted.

At the hearing of the motion, the court will consider such factors as whether the intended claim is properly that of the corporation; the relative cost and benefit of bringing the claim; and whether the complainant has an ulterior motive. The merits of the case may enter into a consideration of whether the claim is *prima facie* in the best interests of the corporation.

Existing Demand Requirements

Since derivative action legislation in Canada differs somewhat amongst jurisdictions, I refer generally to criteria (a) and (b) above as constituting the requirements for demand in Canada.

Specifically, in Alberta and Ontario, and under federal law, the criteria of reasonable efforts and notice are combined in the single requirement that "the complainant has given reasonable notice to the directors of the corporation, or its subsidiary, of the complainant's intention to apply to the Court [for leave] if the directors … do not bring [or] diligently prosecute …the action."[3] The CBCA and Ontario provisions are similar but add a time requirement of 14 days' notice unless otherwise ordered.[4] While these provisions do not include the word 'demand', given the nature of the notice required they are tantamount to a demand prerequisite. British Columbia requires "reasonable efforts" to convince the directors plus notice of the impending leave application; again tantamount to a demand.

Alberta and Ontario have reformed their statutes to obviate the need for notice "when all the directors of the corporation or its subsidiary have been named as defendants."[5] The BCBCA and the CBCA do not contain such provisions. For the reasons set out below, the provisions contained in the Alberta and Ontario statutes may promote the unnecessary addition of innocent defendants in derivative proceedings.

In the author's view, demand provisions across Canada are unnecessarily restrictive and a uniform rule waiving notice should be adopted in cases where the making of a demand is futile. "Demand futility" would be established where the complainant demonstrates that the majority of the board is so tied to the subject matter of the claim as to be incapable of exercising sound business judgment that could persuade them to commence an action. Situations in which demand futility may be established are considered herein.

Deficiencies Of The Current Framework

There are a number of important reasons to dispense with the need for demand where the board cannot be relied upon to exercise sound and disinterested business judgment.

The first is that the giving of notice in such circumstances can lead to serious delay to the litigation. Upon receipt of notice, the matter may be deferred, referred to a litigation committee for study or to a special steering committee, pending which the courts will tend to stay any proceedings which may be initiated by complainants. Where the board is not disinterested, such a delay cannot be justified and represents yet another hurdle in already expensive and complex litigation.

Second, the Board may ultimately decide to initiate proceedings as the best way to get rid of the plaintiffs.

Again, if the Board is not disinterested it may well be more intent on minimizing any damage to the prospective defendants than in maximizing the return to the corporation. Nobody would expect a lawyer to handle a claim where he or she is not personally disinterested in its subject matter; similarly there should be no expectation that board members do so.

Third, while the derivative action provisions do allow complainants to seek leave if the directors do not "diligently prosecute" the action, let us consider the reality of leave proceedings where the parties must argue that the action should be prosecuted in one way rather than another. The process could become so protracted as to be a major barrier to litigation; with a myriad of possible outcomes as the court is urged to minimize cost to the corporation and to heed the "business judgment" rule whereby courts will defer to the directors' judgment provided they have exercised reasonable prudence and diligence in reaching a business decision[6]:

> The law as it has evolved in Ontario and Delaware has the common requirements that the court must be satisfied that the directors have acted reasonably and fairly. The court looks to see that the directors made a *reasonable* decision, *not a perfect* decision. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision. This formulation of deference to the decision of the Board is known as the "business judgment rule". The fact that alternative transactions were rejected by the directors is irrelevant unless it can be shown that a particular alternative was definitely available and clearly more beneficial to the company than the chosen transaction. [italics in original; references omitted.][7]

How reluctant might the court be at this point to wrest control of the proceedings from the board and its counsel? What if the proceeding has been commenced in an inappropriate forum or court or has been mis-framed – would the complainant, on behalf of the corporation, need to seek leave to make these changes, and what costs would be thrown away? What if the Board settles the case and the defendants assert *res judicata* to any future claims?

Under such circumstances, complainants will normally be at a significant evidentiary disadvantage vis-a-vis the board. This is demonstrated in a recent stock option backdating case, *In re F5 Networks, Inc.*[8] in which the Washington Supreme Court applied the demand futility standard to that state. The complainants had primarily circumstantial evidence of market trading histories to compare with the purported option grant dates; while the board had full knowledge of the true facts. In a case such as this, if the complainant must make demand and the corporation does proceed to initiate proceedings, the true facts may never emerge; the wrongdoings, if any, may be whitewashed, and the complainants may find it futile to challenge the conduct of the proceedings.

U.S. Law On Demand Futility And The Business Judgment Rule

The United States has two prevailing trends applied on a state-by-state basis, "demand futility" and "universal demand". The demand futility standard is more generous to complainants in allowing them, under prescribed circumstances, to go directly to court without first asking the corporate board to take action. It is also the more prevalent standard, as led by the influential Delaware Supreme Court in *Aronson v. Lewis*[9].

In *Aronson*, the complainant shareholder challenged certain transactions between the corporation and one of its directors, one Fink, who owned 47% of the outstanding stock. The complainant alleged that the impugned transactions had no valid business purpose and were a waste of corporate assets. He further claimed that the entire board had been approved only because Fink had personally selected each director and officer, and continued to control and dominate them both at the time of the impugned transactions and upon commencement of the proceedings.

In dismissing the complaint, the court set the stage for future futility claims:

> [W]e conclude that the plaintiff has failed to allege facts with particularity indicating that the Meyers directors were tainted by interest, lacked independence, or took action contrary to Meyers' best interests in order to create a reasonable doubt as to the applicability of the business judgment rule. Only in the presence of such a reasonable doubt may a demand be deemed futile.[10]

In arriving at its conclusion, the Court considered the fundamental relationship between a director's impartiality and his ability to properly exercise business judgment:

> In our view the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability. The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). See *Zapata Corp. v. Maldonado*, 430 A.2d at 782. *It is a*

> *presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Kaplan v. Centex Corp.*, Del. Ch., 284 A.2d 119, 124 (1971); *Robinson v. Pittsburgh Oil Refinery Corp.*, Del. Ch., 14 Del. Ch. 193, 126 A. 46 (1924). Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting he presumption. See *Puma v. Marriott*, Del. Ch., 283 A.2d 693, 695 (1971).
>
> *The function of the business judgment rule* is of paramount significance in the context of a derivative action. *It comes into play in several ways -- in addressing a demand, in the determination of demand futility, in efforts by independent disinterested directors to dismiss the action as inimical to the corporation's best interests, and generally*, as a *defense to the merits of the suit. However, in each of these circumstances there are certain common principles governing the application and operation of the rule*. First, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally. *Sinclair Oil Corp. v. Levien*, Del. Supr., 280 A.2d 717, 720 (1971); *Cheff v. Mathes*, Del. Supr., 41 Del. Ch. 494, 199 A.2d 548, 554 (1964); *David J. Greene & Co. v. Dunhill International, Inc.*, Del. Ch., 249 A.2d 427, 430 (1968). See also 8 *Del. C.* § 144. Thus, if such director interest is present, and the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application whatever in determining demand futility...
>
> (emphasis added)

The case failed since the allegations at bar were not supported by specific facts connecting the alleged control by the majority and lack of directors' impartiality.

In 1993, the United States Court of Appeals for the 3rd Circuit accepted that the Court may look either at the board as presently consisted or at the underlying transaction to determine disinterestedness:

> In determining the sufficiency of a complaint to withstand demand futility, the controlling legal standard is well established. The trial court is confronted with two related but distinct questions: (1) whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts; and, if not, (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.[11]

The first prong involves consideration of directorial disinterest or independence at the time of the action:

> Directorial interest exists whenever divided loyalties are present, or where the director stands to receive a personal financial benefit from the transaction not equally shared by the shareholders. Pogostin, 480 A.2d at 624; Aronson, 473 A.2d at 812. *Directorial independence "means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."* Aronson, 473 A.2d at 816. "When lack of independence is charged, a plaintiff must show that the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is 'sterilize[d].' " Levine, 591 A.2d at 205 (quoting Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del.1981)); see also Grobow, 539 A.2d at 188 ("plaintiffs must plead particularized facts demonstrating either a financial interest or entrenchment"); Aronson, 73 A.2d at 816 ("a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to

> comport with the wishes or interests of the corporation (or persons) doing the controlling' ") (quoting Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del.Ch.1971) [12]

Under the second prong, the court will look back at the underlying transaction to determine whether the board had conducted itself in a disinterested manner:

> At that point the inquiry focuses on the substantive nature of the challenged transaction and the board's approval thereof. A court does not assume that the transaction was a wrong to the corporation requiring corrective measures by the board. Rather, the transaction is reviewed against the factual background of the complaint to determine whether a reasonable oubt exists at the threshold that the challenged action was a valid exercise of business judgment. Pogostin, 480 A.2d at 624.
>
> Proper business judgment includes "both substantive due care (purchase terms) ..., and procedural due care (an informed decision)...." Grobow, 539 A.2d at 189. If the plaintiff creates a reasonable doubt that the challenged transaction was a valid exercise of business judgment, then "it may be inferred that the Board is incapable of exercising its power and authority to pursue the derivative claims directly." Levine, 591 A.2d at 205 (emphasis in original). Under the "transaction" prong, the court generally evaluates the futility of requiring demand upon the board at the time of the transaction as distinguished from the inquiry under Aronson's first prong which looks to the time the complaint is filed.[13]

In *Aronson* the test was summarized as follows:

> Our view is that in determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof. As to the latter inquiry the court does not assume that the transaction is a wrong to the corporation requiring corrective steps by the board. Rather, the alleged wrong is substantively reviewed against the factual background alleged in the complaint. As to the former inquiry, directorial independence and disinterestedness, the court reviews the factual allegations to decide whether they raise a reasonable doubt, as a threshold matter, that the protections of the business judgment rule are available to the board. Certainly, if this is an "interested" director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases. In that event futility of demand has been established by any objective or subjective standard. [14]

Having regard to this two-pronged test, Ralph Ferrara *et al* in their text *Shareholder Derivative Litigation – Besieging the Board*[15], cite a variety of circumstances under which a pleading of demand futility may succeed. These include not only where directors are named as defendants for having a direct financial interest, but where there has been entrenchment of the board, an exercise of domination and control by one or more directors or shareholders, and/or subsequent ratification or acquiescence which may demonstrate that directors' conduct is not based on the corporate merits of the subject before the board rather than extraneous considerations or influences.[16]

The "Universal Demand" rule is the secondary approach taken by a lesser number of U.S. states, and requires demand except in extraordinary circumstances. Most states that have adopted this standard have done so by statute rather than by statutory interpretation.[17]

U.K. Law

Recent overhaul of the *UK Companies Act*[18] includes extensive provisions related to derivative claims replacing the limiting exceptions to the rule in *Foss v Harbottle*[19].

However, notwithstanding an earlier recommendation by the Law Commission[20] that 28 days' notice be given to the company specifying the grounds of the proposed derivative action, no explicit demand or notice requirement was mandated by Parliament for actions in England, Wales or Northern Ireland.[21]

The absence of a demand requirement may flow from the limited scope of the provisions which permits the bringing of derivative claims "only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company."

Due to the narrower scope of permitted derivative claims in the United Kingdom, it would be inappropriate to draw inferences from the absence of a specific demand or notice requirement to the Canadian statutory regime.

Suggested Test For Demand Futility In Canada

In the author's view, the Delaware standard, adopted in most of the United States, should be adopted and applied in common law Canada.

As noted by Delaware Vice-Chancellor Strine, Delaware law has at least "some modest importance in the American scheme of corporate governance."[22] According to the Delaware secretary of state, half of publicly traded corporations and more than 60 percent of the Fortune 500 have chosen to incorporate there.[23]

Canadian courts have paid deference to Delaware jurisprudence in the application of the business judgment rule. [24]

In *People's Department Stores*[25], the Supreme Court of Canada noted the statutory origin of the power giving rise to the business judgment rule, at paras 34-35:

> Considerable power over the deployment and management of financial, human, and material resources is vested in the directors and officers of corporations. For the directors of CBCA corporations, this power originates in s. 102 of the Act. For officers, this power comes from the powers delegated to them by the directors. In deciding to invest in, lend to or otherwise deal with a corporation, shareholders and creditors transfer control over their assets to the corporation, and hence to the directors and officers, in the *expectation that the directors and officers will use the corporation's resources to make reasonable business decisions that are to the corporation's advantage.*
>
> The statutory fiduciary duty requires directors and officers to act honestly and in good faith *vis-à-vis* the corporation. They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. They must maintain the confidentiality of information they acquire by virtue of their position. *Directors and officers must serve the corporation selflessly, honestly and loyally*: see K. P. McGuinness, *The Law and Practice of Canadian Business Corporations* (1999), at p. 715.
>
> (emphasis added)

As set out by the Ontario Court of Appeal in *UPM-Kymmene Corp. v. UPM- Kymmene Miramichi Inc.* [26]:

> …the court is not entitled simply to second-guess the Board's decision. As the trial judge said, the court looks to see whether the Board made a reasonable decision, not a perfect decision. She stated that the business judgment

> rule “recognizes the autonomy and integrity of a corporation and the expertise of its directors” since they are “in the advantageous position of investigating and considering first-hand the circumstances that come before it and are in a far better position than a court to understand the affairs of the corporation and to guide its operation.”

The two-pronged test in *Aronson* arises from the principle that directorial independence "means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[27] This is consistent with the standards enuciated by the Supreme Court of Canada in *People's.* It is tantamount to a requirement that directors serve the corporation selflessly, honestly and loyally and that they use the corporation's resources to make reasonable business decisions that are to the corporation's advantage.

As noted above, under the Delaware standard, demand is excused as futile if “under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”[28]

Furthermore, in cases where the current board of directors did not approve the challenged transaction, demand is excused as futile if the complainant establishes reasonable doubt that the board could exercise “its independent and disinterested business judgment in responding to demand.”[29]

In the author's view, the Delaware standard is entirely consistent with the Canadian business judgment rule, and with the duties of reasonableness, selflessness and loyalty which we impose on corporate directors.

Will Demand Futility Open The Floodgates Of Litigations?

Cases involving stock option plans demonstrate that, for this standard to be met, the allegations must be specific, logical and convincing. Where the facts pleaded are not specific or do not logically support the inference urged, demand will not be excused as futile.

In *Ryan v. Gifford*[30], the Delaware Chancery Court termed the process of backdating a “fundamental, incontrovertible lie”. The use of a compensation committee to approve the grants did not save the board from being disqualified because of the overlapping membership of the two entities:

> Backdating options qualifies as one of those ‘rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.’ [31]

In that case, the shareholder-approved option plan specifically required all options to be granted at the current fair market value, and accordingly, any director who knowingly authorizes backdated stock options is acting disloyally.

The Washington Supreme Court applied similar logic in *Re F5 Networks*[32], stressing that its finding was based on the threshold question before it and not to be taken as a conclusion to be drawn from the facts of the case:

> *Ryan* follows naturally from Delaware's demand futility standard. It allows plaintiffs to rely on circumstantial evidence that tends to show a pattern indicative of wrongdoing as part of their initial case. Further, in our view, evidence based on an analysis of the dates stock options were granted, the amount of comparative change in the value of the stock generally and the value of the stock options, the change in value of the stock within 20 days of the option grants, and evidence suggestive of wrongdoing, such as the restatements of compensation here, may be

> sufficient to show demand futility. *See id.* at 344. Whether or not that evidence is sufficient to prove the *case* will depend on the evidence as a whole. But we agree with the chancery court that "[g]iven the choice between improbably good fortune and knowing manipulation of option grants, the Court may reasonably infer the latter," at least for the purposes of meeting the threshold burden of showing that a demand upon the board would be futile. *Id.* at 355 n.34.[33]

However, in *Desimone v. Barrows*[34], also a 2007 Delaware decision, the court was sharply critical of the factual inferences urged by the complainant. Three sets of options were at issue in that case, termed respectively Employee Grants, Officer Grants and Outside Director Grants. As for the Employee Grants, since there was no allegation that the board was aware employees were being awarded backdated options, it could not be said that demand would be futile. As for the Officer Grants, there were no facts suggesting intent on the part of the board that it intended the options to be a "form of hidden bonus to be concealed from regulatory authorities and from Sycamore's stockholders."[35] It was noted that the corporation did not have a shareholder-approved stock option plan requiring all options to be priced at fair market value on the grant date.

With respect to the Outside Director Grants, demand was excused on the basis that of an inherent conflict of interest-: the majority could not be disinterested in stock options that they, themselves, received. Nevertheless, the claims were dismissed due the absence of any allegation that there was "deviation from the precise terms of the *non-discretionary plan*" at the time the stock options were awarded.[36] Notably, the court observed that the complainant had not plead sufficient facts to infer even a "hint of a culpable state of mind on the part of any director."[37]

This was a logical application of the business judgment rule rather than applying an all-encompassing principle to all backdating cases:

> …in a situation where directors are expressly permitted under the terms of a stockholder-approved option plan to issue below-market options, it would be well within the realm of business judgment to choose to issue all options to a set of similarly-situated employees at a uniform strike price reflecting the stock's low point for the quarter. But even in that situation, a director could not, with impunity, secretly backdate the option grants while falsely representing that they were made at fair market value on the dates of the grants or account for them as such. [38]

In the author's view, *Desimone* demonstrates that maintaining the business judgment rule as the overriding consideration in applying the demand futility standard obviates concerns over frivolous lawsuits, provided that particularized pleading is required (discussed *infra*). This is more sensible than the current exception applicable in Ontario and the CBCA whereby complainants may be tempted to needlessly name additional defendants.

Is Legislative Change Necessary To Excuse Demand?

The principle that a prescribed step should be excused where futile was applied by the Supreme Court of Canada in *Levi v. MacDougall* [1941] 4 D.L.R. 340[39] in the case of an allegedly disinterested majority. In *Levi* the plaintiff minority shareholders alleged that were it not for the connivance and collusion of the two defendants the corporation would not, and should not have lost its property. Specifically, it was alleged:

> …that the defendant MacDougall acting in his capacities of president and director and as the solicitor of the company, and in breach of his fiduciary duty, connived with defendant Trites in such manner and with the result that Trites, through the deliberate failure of the company to defend an action brought by Trites to foreclose a mortgage held by him upon the assets of the company, obtained a final order for foreclosure and, having obtained title to such assets, sold the same at a large personal profit.[40]

Preceding B.C. derivative action legislation, the action in *Levi* was brought under a recognized "fraud" exception to the rule in *Foss v Harbottle*[41] that to redress a wrong to the corporation or to recover money or damages for the corporation *prima facie* it must launch the action.

Macdonald C.J.B.C., in his dissenting judgment in the Court of Appeal subsequently adopted by the Supreme Court of Canada in allowing further appeal, considered an earlier decision of the B.C. Court of Appeal in *Rose v. B. C. Refining Co.,* (1911)[42]:

If the transaction were one which could be ratified by the shareholders, then it is quite clear that under no circumstances could these appellants [the plaintiffs in the action] succeed; if, on the other hand, the transaction was fraudulent or *ultra vires*, the appellants were entitled to bring this form of action only after the company had refused to take one, *or where it appeared that it would be idle to apply to the company to take action*. (emphasis that of Macdonald J.A. at para. 12)

Macdonald C.J. B.C. then applied these *dicta* in *Levi*[43]:

> One exception arises where the defendant controls a majority of the shares; another where the impugned transaction is fraudulent, as in this case; in that event shareholders may sue "where it appeared that it would be idle to apply to the company to take action." *This is a statement of a well-known principle: one is not called upon to do a futile thing.*
>
> (emphasis added)

Today, given the breadth of derivative action legislation it is not necessary for a complainant to invoke an exception to *Foss* to seek a lawsuit on behalf of the corporation. The question then arises whether, since the demand requirements are now statutory, the principle of demand futility can be applied without statutory reform. In *Re Daon Development Corp*[44], the British Columbia Supreme Court, without considering *Levi* or *Rose*, held that the principle is not applicable to the facts before it given that province's test of "reasonable efforts" at paras 28-29:

> Mr. Wilder submitted that the law should not compel a person to perform a futile act before granting the relief to which one would otherwise be entitled.
>
> I do not accept this proposition as applied to the facts of this case. Firstly, it is a statutory requirement that the applicant make reasonable efforts to cause the directors to prosecute the claim and that, in my view, at the very least involves giving reasonable notice to the directors of the request together with details of the nature of the claim it wishes the directors to prosecute. Secondly, the condition can be easily performed without undue expense or effort and, if performed, any suspected futility in making the request, if such exists, would be readily exposed.

The CED (Ontario) analyzes the issue this way[45]:

> Under Ontario's Business Corporations Act, no action may be brought and no intervention in an action may be made unless the court is satisfied that the complainant has given notice not less than 14 days before bringing the application or as otherwise ordered by the court. Ontario's Business Corporations Act provides that, where a complainant, on application made without notice, can establish to the satisfaction of the court that it is not expedient to give the \required notice, the court may make any interim order which it thinks fit pending the complainant giving notice as required. Similarly, Ontario's Business Corporations Act provides that, where a complainant on an application can establish to the satisfaction of the court that an interim order for relief should be made, the court may make any order it thinks fit. *The wording of these provisions falls short of granting to the*

> *court authority to dispense with the requirement of prior notice; on the contrary, it expressly contemplates interim relief pending the complainant giving notice, thus it would seem to follow that notice is always required.* (emphasis added, footnotes omitted)

In addition to rules of statutory interpretation is concern over the need to check frivolous suits by requiring highly particularized pleadings, as is the case in Delaware and other U.S. jurisdictions. As the author is unaware of any rule requiring leave applications to be supported by highly particularized pleading, the danger exists that complainants will take a 'kitchen sink' approach to demand futility without providing the board with sufficient detail as to enable them to bring all relevant facts before the court.

CONCLUSION

The business judgment rule is premised on directors exercising their knowledge and understanding of the corporate business and acting selflessly, honestly and loyally in all decisions made. Where directors do not act in a disinterested manner the business judgment rule can have no application.

In certain circumstances, evidence may support a finding that there is reasonable doubt whether the board can exercise its discretion in a disinterested fashion. Those situations extend beyond cases of director fraud and collusion.

In Canada today, complainants must first make demand upon the directors to cause the action to be started and to give them time to do so before seeking leave of the court to commence derivative proceedings. Where the cause of action involves one or more impugned prior transactions entered into by the corporation, reasonable doubt may exist as to the board's inability to make a disinterested decisions as to whether and how to move forward with an action.

The courts of Delaware have developed a two-pronged test to determine whether such reasonable doubt exists. If it does, the business judgment rule is inapplicable and demand is deemed futile. Under this test, the court must consider whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. This involves two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof.

The Delaware standard, since adopted in many of the United States, is a well-balanced approach which obviates concerns over opening the litigation floodgates as demonstrated by a series of cases involving impugned stock options. When considering each prong of the test, the facts alleged must be carefully particularized and the complainant bears the onus of raising a reasonable doubt. The court does not assume either that the majority of the board is "interested" or that the underlying transaction is a wrong to the corporation requiring corrective steps by the board. Only in the presence of such a reasonable doubt may a demand be deemed futile.

Given the explicit notice requirements in Canadian derivative action legislation today, statutory reform will likely be necessary to allow our courts to dispense with demand where it is shown to be futile. The exemption adopted by the CBCA and OBCA in the mid-2000s, is a blunt instrument which fails to contemplate all situations of demand futility and may have the effect of promoting the unnecessary addition of defendants.

End Notes

1 *Business Corporations Act* (Alberta) (ABCA), RSA 2000 cB-9, s. 240(2) , *Business Corporations Act (B.C.)* (BCABC), S.B.C. 2002, c. 27, 233(1); *Canada Business Corporations Act* (CBCA), R.S.C. 1985, c. C-44, s. 239(2) ; *Corporations Act* (Manitoba) S.M. 2008, c. 42, s. 232(2); *Business Corporations Act* (Ontario) (OBCA), R.S.O.

1990, c. B.16, s.246(2); *Business Corporations Act* (New Brunswick), S.N.B. 2000, c. 9, s. 164(2); *Corporations Act* (Nfld and Labrador) R.S.N.L. 1990, c. C-36 s. 369; *Companies Act* (Nova Scotia), R.S.N.S. c. 81, 3rd Sch., s. 4(2), *Business Corporations Act* (Saskatchewan) , R.S.S. 1978, c.B-10, s.232(2), including in each case amendments to June 15, 2009.

2 This is a summary of the requirements of corporate law statutes in Canada as listed in footnote 1. Prince Edward Island does not have any statutory provincial regarding derivative proceedings and is thus subject to the common law regime discussed *infra*. The requirements of Quebec provincial corporate law are beyond the scope of this paper.

3 ABCA, s. 240 (2)(a)

4 CBCA s, 239(1)(a), OBCA s. 246(2)

5 ABCA, s. 240(3), OBCA s. 246(2.1)

6 Canadian test developed in *Maple Leaf Foods Inc. v. Schneider Corp.,* (1998) 42 O.R. (3d) 177 (C.A.) and applied by the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461, 2004 SCC 68.

7 *Maple Leaf Foods*, *supra,* footnote 6, at p.192

8 May 21, 2009, Supreme Court of the State of Washington, Docket No. 81817-7

9 473 A.2d 805 (Del. Supreme Court, 1984)

10 *Ibid*, at p. 818.

11 *Rales v Blasband* 971 F.2d 1034, at para. 47 (3d Cir. 1993)

12 *Ibid,* at para. 50.

13 *Ibid*, at paras. 52-55

14 *Aronson, supra*¸ footnote 9, at pp. 815-6.

15 Ferrara, Abikoff and Gansler, *Shareholder Derivative Litigation – Besieging the Board*, ring-bound (Law Journal Press, 1995), at s. 6.04

17 *Re F5 Networks, supra*, footnote 8, at p. 10.

18 *UK Companies Act 2006*, c. 46, Part 11.

19 (1843) 2 Hare 461, 67 E.R. 189

20 LC246, Shareholders Remedies (1997), at p. 92; http://www.lawcom.gov.uk/lc_reports.htm. The Commission's terms of reference were "... to carry out a review of shareholder remedies with particular reference to:- the rule in *Foss v Harbottle* (1843) 2 Hare 461{ TA\l "*Foss v Harbottle* (1843) 2 Hare 461" \s "Foss v Harbottle (1843) 2 Hare 461" \c 1 } and its exceptions; sections 459 to 461 of the Companies Act 1985; and the enforcement of the rights of shareholders under the articles of association; and to make recommendations.

21 *UK Companies Act 2006, supra*, footnote 18, at ss. 260-264.

22 Leo E. Strine, Jr., "The Inescapably Empirical Foundation of the Common Law of Corporations" (2002), 27 Del. J. Corp. L. 499 at p. 501

23 State of Delaware: The Official Website of the First State, http://www.corp.delaware.gov/aboutagency.shtml ; *F5 Networks*, *supra*, footnote 8, at p. 13

24 *Supra*, footnote 6, per Weiler J.A. of the Ontario Court of Appeal at p. 192. After citing these *dicta* with approval, Major and Deschamps JJ. further directly applied Delaware authority, at para. 66: "In order for a plaintiff to succeed in challenging a business decision he or she has to establish that the directors acted (i) in breach of the duty of care and (ii) in a way that caused injury to the plaintiff: W. T. Allen, J. B. Jacobs and L. E. Strine, Jr., "Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law" (2001), 26 *Del. J. Corp. L.* 859, at p. 892.

25 *Supra*, footnote 6*,* per Major and Deschamps JJ

26 (2004), 250 D.L.R. (4th) 526 (Ont. C.A.), at para. 6

27 *Aronson*, *supra*, footnote 9, at p. 816.

28 *Ibid*, at p. 814; *Beneville v. York,* (2000) 769 A.2d 80 at 85-86 (Del. Ch.).

29 *Rales*, supra, footnote 11, at pp. 933-34

30 (2007), 918 A. 2d 341 (Del. Ch. Ct), also sometimes referred to as the *Maxim Integrated Products* case.

31 *Ibid.* at pp. 355-56.

32 *Supra,* footnote 8

33 *Ibid,* at p. 15

34 2007, WL 1670255; C.A. No. 2210-VCS (Del. Ct of Chancery)

35 *Ibid*, at pp. 7-9

36 *Ibid,* at p. 10

37 *Ibid,* at p. 36

38 *Ibid*, at p. 41
39 Allowing the appeal, the Supreme Court of Canada expressly concurred with Macdonald C.J.B.C..'s dissenting opinion in the B.C. Court of Appeal at [1941] 2 D.L.R. 171.
40 Per Mcdonald J.A. in the majority judgment of the B.C. Court of Appeal, at para. 32. Note that the majority judgment was delivered by Mcdonald J.A. and the dissenting opinion by Macdonald C.J.B.C.
41 *Supra*, footnote 19
42 16 B.C.R. 215, 18 W.L.R. 299 , which dealt with another *Foss* exception, where the underlying transaction was alleged to be *ultra vires* the corporation.
43 *Supra*, footnote 39, at para. 13
44 54 B.C.L.R. 235 (S.C.)
45 *Canadian Encyclopedic Digest Business Corporations (Ontario) IX* – Shareholders at §937