

## OBSERVATION

### The Corporate Fox and the Shareholders' Hen House: Reflections on *Alford v. Shaw*

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Users and observers of corporate law generally agree that a jurisdiction's corporate law should be "sound, complete, [and] reasonably predictable,"<sup>1</sup> although they may disagree about the preferable resolution of specific issues. Predictability is enhanced if, in interpreting a finely-detailed corporation statute, the judiciary acknowledges the legislature's intent to provide an integrated statutory treatment of corporate organization questions. Even when the statute does not explicitly resolve certain issues, the courts should focus on manifest legislative intent in adjacent statutory provisions. Corporate law is thus an unlikely venue for noninterpretivist judicial strategies.

The North Carolina Supreme Court's recent decision in *Alford v. Shaw*<sup>2</sup> unfortunately departed from this view of the appropriate—or most useful—judicial perspective on issues of corporate law, a perspective that had characterized the court's decisions since the adoption of the North Carolina Business Corporation Act in 1957.<sup>3</sup> The majority opinion in *Alford* substituted an unreflective and unfocused desire to foster "a favorable business climate"<sup>4</sup> and serve "the best interests of all segments of the corporate community in North Carolina"<sup>5</sup> for reasoned analysis of the case's issues in the context of North Carolina's corporate law as a whole. As this Observation explains, the supreme court as a result departed from sound judicial technique and improperly resolved the specific issue before it—whether under the circumstances the trial court should have deferred to the recommendation of a board-appointed shareholder litigation committee—an issue that is itself problematic in many respects.

In *Alford* shareholders brought a derivative action on behalf of All-American Assurance Co. (AAA). The action alleged that a majority of the company's directors, along with the majority shareholders, participated in looting the company's assets through a series of transactions involving companies allied with

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1. R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE § 2-3, at 15 (3d ed. 1983) (describing legislative and judicial structure of corporate law in North Carolina).

2. 318 N.C. 289, 349 S.E.2d 41 (1986) (Billings, C.J.), *rev'g* 72 N.C. App. 537, 324 S.E.2d 878 (1985), *reh'g granted*, No. 132PA85 (filed Jan. 13, 1987).

3. Business Corporation Act, ch. 1371, 1955 N.C. Sess. Laws 1432 (codified as amended at N.C. GEN. STAT. §§ 55-1 to -175 (1982 & Supp. 1985)).

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

5. *Id.* at 304, 349 S.E.2d at 50.

AAA's controlling shareholders.<sup>6</sup> Unfortunately, the supreme court's opinion failed to indicate whether AAA's directors themselves benefitted from these transactions, or whether the direct financial benefit went solely to the controlling shareholders who elected AAA's directors.

Many of the same cast of characters among plaintiffs and defendants appeared in *Swenson v. Thibaut*,<sup>7</sup> an earlier derivative action involving AAA. Plaintiffs in *Swenson* had alleged various improprieties in defendants' management of the company's affairs.<sup>8</sup> Following the transactions challenged in *Swenson*, AAA encountered financial difficulties of such magnitude—to wit, insolvency—that it was placed in involuntary rehabilitation pursuant to a petition from the State's Commissioner of Insurance.<sup>9</sup> The claims asserted derivatively on AAA's behalf in *Alford* apparently arose from post-rehabilitation transactions. The attorney who ultimately represented the *Alford* plaintiffs raised the claims in a letter to AAA's directors, demanding that the directors take action to protect AAA's interests in the problematic transactions. After the directors failed to take the requested actions, plaintiffs filed the derivative action on AAA's behalf and included the directors as defendants on the basis of their involvement in the challenged transactions and their failure to take action on AAA's behalf.<sup>10</sup>

In all jurisdictions the events preceding the *Alford* litigation would raise threshold issues determinant of the plaintiff's right to sue derivatively on the company's behalf. All jurisdictions require that the putative plaintiff make a demand on the corporation's directors prior to filing suit, unless failure to make the demand is excusable under the circumstances.<sup>11</sup> Although demand will be excused if making it would be futile, jurisdictions vary in the stringency with which they define futility and in the consequences they ascribe to the directors' refusal of demand when demand is required.

Under the most recent Delaware cases, for example, the key question is whether the plaintiff has alleged with sufficient particularity facts that create a reasonable doubt whether the corporation's directors, in their relationship to the transaction or events challenged in the suit, exercised business judgment.<sup>12</sup> Examples of facts excusing demand under this test would include the directors' receipt of personal pecuniary benefits from the transaction, or if the transactions benefitted the corporation's controlling shareholder but not the directors them-

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6. These transactions by AAA included: Failure to exercise options it held to buy and sell its own shares to or from the affiliated companies and its redemption of debentures held by the affiliates; allegedly excessive payments to the affiliated companies for administrative expenses; allegedly improper reinsurance and coinsurance agreements; release of its majority shareholders from an obligation to buy an office building; and other allegedly improper transactions between AAA and the affiliated companies. *See id.* at 293, 349 S.E.2d at 44.

7. 39 N.C. App. 77, 250 S.E.2d 279 (1978), *disc. rev. denied and appeal dismissed*, 296 N.C. 740, 254 S.E.2d 181-82 (1979).

8. *See id.* at 84 n.2, 250 S.E.2d at 284-85 n.2.

9. *See id.* at 84-85, 250 S.E.2d at 285.

10. *See Alford*, 318 N.C. at 294-95, 349 S.E.2d at 45.

11. *See* D. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS § 5:03 (1987).

12. *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 808 (Del. 1984).

selves, facts showing an exercise of dominion or control over the directors by the shareholder. In applying these criteria or those of other jurisdictions, the court can examine only the plaintiff's pleadings, and the parties cannot expand on the pleadings' factual allegations through discovery.<sup>13</sup> In Delaware, as in many other jurisdictions, simply the fact the plaintiff has named all directors as defendants, or that the directors approved the transaction challenged by the plaintiff, or that the defendant owned sufficient shares to elect the directors does not suffice to excuse demand.<sup>14</sup>

If the prospective derivative plaintiff makes a demand and the directors refuse it, then the derivative action will be dismissed unless the directors' refusal to take action was wrongful. Once again, jurisdictions vary in the rigor with which they define wrongful refusal.<sup>15</sup> Delaware holds that the directors' refusal is not wrongful if they acted independently and in good faith.<sup>16</sup> Courts in other jurisdictions have defined wrongful refusal more broadly to include directors' failure to respond to apparently grave charges presented by the plaintiff.<sup>17</sup>

Although the majority opinion in *Alford* referred to the requirement that the derivative plaintiff "exhaust intracorporate remedies" prior to suing on the company's behalf, it did not attempt to analyze the facts of the case within any framework ascribing consequences to the directors' refusal of the demand.<sup>18</sup> In-

13. See *Kaufman v. Belmont*, 479 A.2d 282, 289 (Del. Ch. 1984).

14. See *Aronson v. Lewis*, 473 A.2d 805, 815-16 (Del. 1984). Compare *Jordan v. Hartness*, 230 N.C. 718, 719, 55 S.E.2d 484, 485 (1949) (demand not excused when plaintiff alleged defendants owned a majority of corporation's stock) with *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809, 814 (D. Colo. 1968) (demand excused in part because defendants controlled corporation's elective process), *aff'd*, 435 F.2d 1223 (10th Cir. 1970).

In *Swenson* the North Carolina Court of Appeals held that demand would be excused when "the directors who are in control of the corporation are the same ones (or under the control of the same ones) as were initially responsible for the breaches of duty complained of . . ." *Swenson*, 39 N.C. App. at 102, 250 S.E.2d at 295. The court held that plaintiff would be excused from making a demand because a majority of the corporation's directors were directors at the time of the transactions contested in the suit and "[f]his, of itself, would relieve plaintiffs of any obligation to make demand upon the board . . ." *Id.* The standard for excuse set forth in *Swenson* is considerably more lenient than the Delaware standard described in the text. Demand is apparently excused under *Swenson* whenever a majority of the corporation's incumbent directors approved the transaction in issue, even if the plaintiff does not allege they benefitted personally, or when the directors were controlled by stockholders who received benefit from the transaction. The *Swenson* decision did not, however, elaborate on the factual circumstances that would support an allegation of control. See generally AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7:03 comment d (Tent. Draft No. 6, 1986) (describing varying tests of demand futility).

*Swenson* is complicated by the fact that, as in *Alford*, the prospective plaintiff *did* make a demand on the directors, who refused to pursue the claim. *Swenson*, 39 N.C. App. at 102, 250 S.E.2d at 295. Thus, the discussion of circumstances excusing demand in *Swenson* arose because the court attempted to determine what to make of the directors' refusal of demand. Other jurisdictions address this question directly. See *infra* text accompanying notes 15-17.

15. See DeMott, *Demand in Derivative Actions: Problems of Interpretation and Function*, 19 U.C. DAVIS L. REV. 461, 487-90 (1986).

16. See *Abramowitz v. Posner*, 672 F.2d 1025, 1034 (2d Cir. 1982) (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981)).

17. See, e.g., *Syracuse Television v. Channel 9*, Syracuse, 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966).

18. The majority opinion did state that the issue concerning the litigation committee arises "where the appointment of that committee is necessitated by allegations of misconduct on the part of a majority of the board of directors—misconduct which disqualifies the directors themselves from

stead, the parties apparently litigated *Alford*—and the supreme court clearly considered it—as a case concerning the use of special litigation committees. Consequently, the decision contains many serious flaws.

After their receipt of the demand, but before plaintiffs instituted the derivative action, AAA's directors appointed as special counsel an attorney who had not previously represented AAA or its affiliates; he in turn was requested to recommend two persons of " 'unquestioned reputation, experience, independence, [and] ability' " without prior association with AAA or its affiliated companies.<sup>19</sup> Special counsel recommended persons who were then elected directors of AAA and named as members of a Special Investigative Committee to investigate claims on AAA's behalf. The committee interviewed a number of people, reviewed numerous documents, submitted interrogatories to persons who had served as AAA directors, and ultimately produced a report of 409 pages. In its report the committee recommended that claims against two defendants be settled, and the committee negotiated a settlement of these claims. Based on the report AAA moved for approval of the settlement and for summary judgment dismissing the remaining claims raised in the derivative action.<sup>20</sup> The superior court granted the motion for summary judgment, the court of appeals reversed,<sup>21</sup> and the supreme court by a five-to-two majority reversed the court of appeals.<sup>22</sup>

The supreme court based its decision on the question of how the trial court should have treated the litigation committee's report. The court of appeals, adopting the approach of the Iowa Supreme Court in *Miller v. Register and Tribune Syndicate, Inc.*,<sup>23</sup> held that directors who are defendants in derivative litigation may not confer on a litigation committee the board's powers to determine the company's position with regard to a derivative suit.<sup>24</sup> In the court of appeals' view a number of factors compelled this conclusion: The prospect that even committee members previously unaffiliated with the corporation would so empathize with the defendants who were their fellow directors that their assessment of the merits of the claim would not be impartial; the predictability—and uniformity—with which litigation committees over the preceding decade found

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making an impartial litigation decision." *Alford*, 318 N.C. at 303, 349 S.E.2d at 50. But the law of demand requires greater factual concreteness: one needs to know the specifics of the directors' alleged misconduct. The court of appeals limited its discussion of the demand question to the observation that "[t]he Committee was established in the present case to respond to plaintiffs' demand, made in accordance with the statute, for action against the allegedly self-dealing directors." *Alford v. Shaw*, 72 N.C. App. 537, 540, 324 S.E.2d 878, 881 (1985), *rev'd*, 318 N.C. 289, 349 S.E.2d 41 (1986). Neither the supreme court nor the court of appeals particularized the alleged self-dealing. The statute in question requires that the complaint "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort." N.C. GEN. STAT. § 55-55(b) (1982).

19. *Alford*, 318 N.C. at 310, 349 S.E.2d at 54.

20. *Id.* at 311-12, 349 S.E.2d at 54-55.

21. *Alford v. Shaw*, 72 N.C. App. 537, 324 S.E.2d 878 (1985), *rev'd*, 318 N.C. 289, 349 S.E.2d 41 (1986).

22. *Alford*, 318 N.C. at 290-91, 349 S.E.2d at 42.

23. 336 N.W.2d 709 (Iowa 1983).

24. *Alford*, 72 N.C. App. at 547, 324 S.E.2d at 886 (adopting *Miller* rule).

claims asserted derivatively to be without merit; and the judiciary's general reluctance to facilitate summary dismissal of actions involving issues of subjective intent, a key consideration in claims of self-dealing like those in *Alford*.<sup>25</sup>

The supreme court's failure to examine those factors relevant to the demand questions described above makes it difficult to evaluate its reversal of the court of appeals. Because the supreme court did not analyze whether, under the circumstances, the plaintiff would have been excused from making a demand on the directors and whether any significance should be ascribed to the directors' refusal of the demand made on them, it is impossible to determine whether AAA's directors possessed the capacity to make decisions on AAA's behalf concerning the claims. It would be easier to endorse the court's summary dismissal of the claims asserted in *Alford* if the plaintiff's complaint had not raised substantial doubts about the directors' ability to assess with disinterest whether the corporation should assert the claims. If no such doubts had been raised in the complaint, so that the plaintiff would not have been excused from making the demand, the only remaining question would be whether the directors' refusal of the demand was wrongful, however that might be defined by a North Carolina court.<sup>26</sup>

*Miller*, the Iowa case on which the court of appeals relied, contains a quintessential example of circumstances excusing demand, because all of the corporation's directors themselves received pecuniary benefit from the challenged transactions.<sup>27</sup> Although *Miller*'s holding restricted the use of litigation committees when directors are parties to derivative litigation, *Miller* does not mean that simply naming a director as a defendant excuses demand.<sup>28</sup> Because it is unlikely the Iowa Supreme Court intended to undo the conventional treatment of the demand requirement, the *Miller* restrictions on litigation committees become pertinent only in demand-excused situations. Thus, litigation committee cases are hard cases because they are demand-excused cases, and in many jurisdictions the only cases to survive the demand threshold are those in which the company's directors did not exercise disinterested business judgment concerning the challenged transactions. Many such cases involve allegations that the corporation's directors themselves received financial benefits from the events or transactions at issue.

In any event, a majority of the North Carolina Supreme Court in *Alford* rejected the view that director-defendants lack authority to appoint a litigation committee.<sup>29</sup> The majority also limited the trial court's review of a committee's report to an assessment of the independence of the committee's members and the adequacy of the investigation they pursued, issues on which the party moving for summary judgment has the burden of proof.<sup>30</sup> The trial court may not,

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25. *See id.* at 546-48, 324 S.E.2d at 885-86.

26. North Carolina does not have as much case law on these questions as do some other jurisdictions; for example, no reported North Carolina case appears to define "wrongful refusal."

27. *Miller*, 336 N.W.2d at 710.

28. *See, e.g.*, *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

29. *Alford*, 318 N.C. at 308, 349 S.E.2d at 52-53.

30. *Id.* at 307, 349 S.E.2d at 52.

however, evaluate the merits of the report and its recommendation. Thus, unless the plaintiff raises issues of fact sufficient to defeat summary judgment as to the committee's independence or the adequacy of its investigation, the court must treat the report as a business judgment and defer to it as it would to directors' discretionary decisions about business transactions.

If the majority intended that this standard of review apply to demand-excused cases, then a trial court cannot examine the merits of a litigation committee's recommendation even if the plaintiff has alleged self-dealing or other breaches of the directors' fiduciary duty of loyalty. The majority's opinion failed to acknowledge the existence of prior North Carolina authorities requiring corporate fiduciaries to establish affirmatively the fairness to the company of their self-dealing transactions.<sup>31</sup> It is discouraging that the majority opinion made no attempt to reconcile this principle with its standard of review for litigation committees, and that it ignored entirely the statutory provision addressing directors' self-dealing transactions.<sup>32</sup>

The *Alford* court's treatment of the litigation committee question is unique. It differs from the position that the Delaware Supreme Court adopted in *Zapata Corp. v. Maldonado*,<sup>33</sup> which gives the trial court discretion to inquire into the merits of the committee's recommendations. It is even at odds with the approach taken by the New York Court of Appeals in *Auerbach v. Bennett*.<sup>34</sup> Although *Auerbach* requires the court to treat the committee's recommendation as a business judgment and thus defer to the committee's assessment of the merits of the claim, it preconditions this judicial deference on the movant's ability to establish the committee's good faith, in addition to its independence and the adequacy of its investigation.<sup>35</sup> *Alford*, in contrast, expressly *presumes* that the committee members acted in good faith in the absence of evidence to the contrary.

The *Alford* court's reasons for indulging this presumption of good faith are, at best, elusive. Early in the opinion, following a discussion of judicial deference to corporate management decisions and a reference to *Auerbach*, the court observed that "the decisions of directors are accorded a presumption of propriety which can be overcome only upon a showing of misconduct—lack of good faith, dishonesty, etc."<sup>36</sup> Because *Auerbach* itself does not favor litigation committees with a presumption of good faith, citing it in this context was disingenuous.

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31. See *Smith v. Robinson*, 343 F.2d 793, 797 (4th Cir. 1965) (applying North Carolina law).

32. N.C. GEN. STAT. § 55-30 (1982).

33. 430 A.2d 779 (Del. 1981). Although the *Alford* court's discussion of *Zapata* presupposed that a trial court in Delaware *must* assess the merits of the committee's conclusions in light of its own independent judgment, see *Alford*, 318 N.C. at 302-03, 349 S.E.2d at 49-50, Delaware cases make clear that this step of the review is within the court's discretion, see *Kaplan v. Wyatt*, 499 A.2d 1184, 1192 (Del. 1985).

34. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

35. The majority opinion in *Alford* assumed that *Auerbach* places the burden with regard to the committee's independence and the adequacy of its investigation on the *plaintiff*. See *Alford*, 318 N.C. at 307, 349 S.E.2d at 52. This assumption is mistaken, *Auerbach*, 47 N.Y.2d at 634, 393 N.E.2d at 1002-03, 419 N.Y.S.2d at 929, as cases discussing *Auerbach* make readily apparent, see, e.g., *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 379 (6th Cir. 1984).

36. *Alford*, 318 N.C. at 300, 349 S.E.2d at 48.

Furthermore, the *Alford* court failed to explain why a presumption that concededly applies to managerial decisions about business transactions should also apply to directors' assessments of litigation against fellow directors.

Will the presumption of good faith make a difference to the outcome of cases involving litigation committees? *Alford* itself illustrates the significance of the presumption. In the court's formulation the presumption requires the plaintiff to come forward with "credible evidence of a lack of good faith" to defeat the presumption—and the defendants' motion for summary judgment.<sup>37</sup> One initial difficulty is that the court's allocation of the burden of proof on this issue conflicts with the basic principle it stated to justify allocation of the burden to the defendants on the issues of the committee's independence and the adequacy of its investigation: that the burden of proof on an issue should fall on the party having better access to the relevant facts.<sup>38</sup>

The operation of the good faith presumption in *Alford* demonstrates its inappropriateness in this type of litigation. Courts cannot easily segregate questions concerning the merits of the committee's recommendation from those concerning the adequacy of its work, and further awkwardness results if the plaintiff must produce "credible evidence" of the committee's lack of good faith. For example, plaintiffs in *Alford* argued that the committee had relied on defendants' false factual representations, as well as on defendants' erroneous characterization of the appropriate tax treatment of some of the challenged transactions.<sup>39</sup> Did the tax dispute concern the merits of the committee's assessment of the corporation's interest in pursuing the claim, or did it concern the adequacy of the committee's investigative work? And what would have sufficed as "credible evidence" of the committee's lack of good faith? Evidence that the defendants' and committee's characterization was erroneous? Evidence that no member of the committee understood the tax question? If a committee enjoys a presumption of good faith, and the court defines expansively issues going to "the merits" that are excluded from its review on the defendants' motion for summary judgment, even proof of blatantly erroneous assumptions on the committee's part will not defeat the defendants' motion for summary judgment.

In part these problems in the *Alford* majority opinion proceed from the structure and logic of the opinion itself. The court abstracted from corporate law the general notion of the business judgment rule and applied it to justify judicial deference to the litigation committee's recommendation, ignoring the procedural context before it and the transactional contexts in which the rule originated. As a result, the court has facilitated the summary disposition of claims at the behest of defendants in derivative litigation. North Carolina courts do not favor the summary disposition of actions requiring the determination of a litigant's state of mind,<sup>40</sup> as the claims asserted in *Alford* appear to do. Given

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37. *Id.* at 309 n.12, 349 S.E.2d at 53 n.12.

38. *Id.* at 308 n.11, 349 S.E.2d at 53 n.11.

39. *Id.* at 312-13, 349 S.E.2d at 55.

40. *See, e.g.,* *Johnson v. Phoenix Mut. Life Ins. Co.*, 300 N.C. 247, 260, 266 S.E.2d 610, 619 (1980).

the types of claims shareholders typically assert in a demand-excused action, under *Alford* the litigation committee operates to make summary judgment available to the defendants when it otherwise would not be if the claims were prosecuted in any style other than through a derivative action. By framing the case to be solely "about" principles of corporate law and directors' powers, the *Alford* court failed to recognize that the case was "about" summary judgment as well.<sup>41</sup>

In addition, the majority opinion in *Alford* made no attempt to reconcile its treatment of the litigation committee with provisions of the Business Corporation Act that deal with derivative suits. Section 55-55(c) of the North Carolina General Statutes provides that no derivative action may be "discontinued, dismissed, compromised or settled" without the court's approval.<sup>42</sup> Even if the court could have somehow distinguished this requirement from a motion for summary judgment to dismiss at the behest of a litigation committee, and from the committee's negotiated settlement of claims with individual defendants, the majority in *Alford* did not even attempt to do so. Not even the *Alford* committee's negotiated settlement of claims with individual defendants prompted the court to examine the meaning of section 55-55(c). But the majority did refer to section 55-55(c) in one telling passage. The reference appears in a footnote following the assertion in text that "[a] favorable business climate can be fostered in part by recognizing the importance of traditional intra-corporate relationships and by providing a measure of protection against 'strike suits' (nuisance suits brought to extort settlement)."<sup>43</sup> As the footnote acknowledged, section 55-55(c) requires judicial approval in order to preclude the extortionate settlement of nuisance suits.<sup>44</sup> Far from justifying the court's legitimation of the litigation committee device, section 55-55(c)'s existence establishes that the North Carolina General Assembly has addressed the *Alford* court's stated policy concern. Indeed, the section demonstrates that the general assembly can aptly act to further the creation of a "favorable business climate," through means it deems appropriate.<sup>45</sup>

This passage in the majority opinion also tellingly suggests that a majority

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41. The federal cases interpreting Federal Rule of Civil Procedure 56, providing for summary judgment, demonstrate an extreme reluctance to grant motions for summary judgment in derivative actions. See *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969); *Subin v. Goldsmith*, 224 F.2d 753 (2d Cir.), cert. denied, 350 U.S. 883 (1955); *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949); *Fogelson v. American Woolen Co.*, 170 F.2d 660 (2d Cir. 1948). North Carolina has adopted rule 56 verbatim. See FED. R. CIV. P. 56; N.C. GEN. STAT. § 1A-1, rule 56 (1983).

42. N.C. GEN. STAT. § 55-55(c) (1982).

43. *Alford*, 318 N.C. at 306 & n.9, 349 S.E.2d at 51 & n.9.

44. *Id.* at 306 n.9, 349 S.E.2d at 51 n.9.

45. For example, N.C. GEN. STAT. § 55-55(e) (1982), permits the court to assess attorneys' fees against an unsuccessful plaintiff, if it finds on final judgment that the plaintiff brought the action without reasonable cause. See *Lowder ex rel. Doby v. Doby*, 79 N.C. App. 501, 340 S.E.2d 487, disc. review denied, 316 N.C. 732, 345 S.E.2d 388 (1986). Indeed, by encouraging the use of litigation committees and prohibiting judicial review of the merits of the committee's report, the majority in *Alford* has vitiated the effectiveness of § 55-55(e). How can the court determine on final judgment whether the plaintiff brought the action "without reasonable cause" if it may not inquire into the merits of the action? Admittedly, that inquiry could occur after the court dismisses the action based on the litigation committee's recommendations, but surely the court's factual finding could not rely



of the *Alford* court simply stereotyped the action as a "strike suit," although the opinion does not state any facts to support such a finding. Oddly enough, the possible stereotyping of the plaintiffs as strike suiters demonstrates the power of one of the court of appeals' arguments, one specifically addressed in the supreme court's opinion. The North Carolina Court of Appeals,<sup>46</sup> like the Iowa Supreme Court,<sup>47</sup> rejected the litigation committee as a device when the directors who appointed the committee members are defendants in the action. Both courts acted partly out of a fear of "structural bias"—a concern that even independent and disinterested directors may, as committee members, nonetheless yield to the personal, moral, or financial influence of the appointing directors. "Structural bias" is also a product of committee members' likely propensity to perceive the derivative plaintiff as an outsider, a maverick, indeed a "strike suiter," independent of the merit of the claims asserted on the company's behalf.<sup>48</sup>

The North Carolina Supreme Court rejected the "structural bias" argument with a patronizing reference to the "predisposed prejudice on the part of some courts that a special litigation committee is, due to the potential of some inherent structural bias, incapable of acting independently."<sup>49</sup> It ignored entirely the court of appeals' demonstration that the "potential" for structural bias has become reality in at least some instances: what else explains the uniformity and consistency with which litigation committees opine against the merits of claims asserted derivatively?<sup>50</sup> Surely in the seven years since *Auerbach* legitimated the litigation committee device some shareholder derivative actions have warranted corporate endorsement? If not, the fabled "strike suiters" need to find a new line of work.

The dissenting opinions in *Alford* proposed different resolutions for the central issue in the case. Justice Martin's dissent would permit the trial court to appoint a litigation committee, thus reducing the risk of "structural bias," and would permit the court to examine the merits of the committee's recommendation.<sup>51</sup> The difficulty with this resolution is that if the trial court conducts an intensive fact-finding inquiry, little time or cost will be saved through the committee's own investigative efforts. Justice Frye's dissent proposed that North Carolina adopt the Delaware approach stated in *Zapata*; that is, permit corporate directors to appoint a litigation committee even in demand-excused cases, but not bind the court to adopt the committee recommendation if it concludes the corporation's best interests would best be served by an alternative resolution.<sup>52</sup> This approach presupposes that the trial court will be aggressive and discerning in its review of the committee's recommendations.

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solely on the litigation committee's report, because the statute clearly requires a finding made by the court.

46. See *Alford*, 72 N.C. App. at 545-46, 548, 324 S.E.2d at 884, 886.

47. See *Miller*, 336 N.W.2d at 716, 718.

48. See Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 103-08 (1985).

49. *Alford*, 318 N.C. at 307, 349 S.E.2d at 52.

50. See *Alford*, 72 N.C. App. at 548, 324 S.E.2d at 886.

51. *Alford*, 318 N.C. at 325-26, 349 S.E.2d at 62-63 (Martin, J., dissenting).

52. *Id.* at 314-17, 349 S.E.2d at 56-58 (Frye, J., dissenting).

Notwithstanding the alternative approaches proposed by the dissenters, the *Alford* court's attempt to deal with the difficult issues before it is unsatisfactory. The litigation committee device, like opera, requires a considerable suspension of disbelief on the part of most observers. As the barnyard metaphor in Justice Martin's dissent illustrates,<sup>53</sup> the litigation committee can readily appear to undermine the very fiduciary restraints that protect investors. Even apart from this perspective, the majority opinion in *Alford* contains so many flaws that its endorsement of the use of litigation committees is not persuasive. The North Carolina Supreme Court should reconsider its resolution of the specific issue addressed in *Alford* and should consider the preliminary issue of demand that it inexplicably ignored. However, optimism about the future of the *Alford* litigation may be warranted. The court recently granted plaintiff's motion for rehearing<sup>54</sup> and thus may rectify the many deficiencies in the majority opinion in *Alford*. In addition, the court may wish to state its resolution of the preliminary issues concerning demand in derivative litigation and to clarify their relationship to the use of litigation committees.

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53. Justice Martin's dissent began with the observation that "[t]he Court today has placed the corporate fox in charge of the shareholders' hen house." *Id.* at 318, 349 S.E.2d at 58 (Martin, J., dissenting).

54. *Alford*, Order for Rehearing, No. 132PA85 (filed Jan. 13, 1987).