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[CHAPTER] 135
DERIVATIVE PROCEEDINGS

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§ 13.01501. SCOPE OF [CHAPTER]

In this [chapter], “derivative proceeding” means a civil suit in the right of a
domestic nonprofit corporation or, to the extent provided in Section 13.08508 (applicability to
foreign corporations), in the right of a foreign nonprofit corporation.

Source Note: Patterned after Model Nonprofit
Corporation Act, 3rd Ed. (2008), § 13.01. Cf Model
Revision), § 7.40(†).

CROSS-REFERENCES
“Proceeding” defined, see § 1.40.
The definition of “derivative proceeding” makes it clear that the chapter applies to foreign corporations only to the extent provided in Section 43.08508, which provides that the law of the jurisdiction of incorporation governs except for Sections 43.04504 (stay of proceedings), 43.06506 (discontinuance or settlement) and 43.07507 (payment of expenses). See the Official Comment to Section 43.08508.

§ 13.02502. STANDING

(a) A derivative proceeding may be brought by:

1) A member or members:

i) having five percent or more of the voting power, or by members, whichever is less; or

ii) that do not satisfy the requirements of subparagraph (a)(1)(i), but can fairly and adequately represent the interests of the nonprofit corporation in enforcing the rights of the corporation; or

(2) any director or member of a designated body.

(b) The plaintiff in a derivative proceeding must be a member, director, or member of a designated body at the time of bringing the proceeding. A plaintiff who is a member must also have been a member at the time of any action complained of in the derivative proceeding.


CROSS-REFERENCES

“Derivative proceeding” defined, see § 13.01501.

OFFICIAL COMMENT

The act and the statutes of many states have long required that a plaintiff must have been a member at the time of the transaction in question. This rule has been criticized as being unduly narrow and technical and unnecessary to prevent the transfer or purchase of lawsuits.
The decision to retain the rule of contemporaneous status as a member in Section 43.02502(b) was based primarily on the view that it was simple, clear, and easy to apply. Further, there has been no persuasive showing that the contemporaneous membership rule has prevented the litigation of substantial suits. Where the plaintiff is a director or member of a designated body, however, the plaintiff need only have that status at the time the proceeding is commenced.

Section 43.02502 does not permit a creditor to commence a derivative proceeding.

§ 13.03503. DEMAND

A person may not commence a derivative proceeding until:

1. a demand in the form of a record has been delivered to the nonprofit corporation to take suitable action; and
2. 90 days have expired from the date delivery of the demand was made unless the person has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.


CROSS-REFERENCES

“Derivative proceeding” defined, see § 13.01501.

OFFICIAL COMMENT

Section 43.03503 requires a demand on the nonprofit corporation in all cases. The demand must be made at least 90 days before commencement of suit unless irreparable injury to the corporation would result. This approach has been adopted for two reasons. First, even though no director may be independent, the demand will give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action. Secondly, the provision eliminates the time and expense of the litigants and the court involved in litigating the question whether demand is required. It is believed that requiring a demand in all cases does not impose an onerous burden since a relatively short waiting period of 90 days is provided and this period may be shortened if irreparable injury to the corporation would result by waiting for the expiration of the 90-day period. Moreover, the cases in which demand is excused are relatively rare. Many plaintiffs’ counsel as a matter of practice make a demand in all cases rather than litigate the issue whether demand is excused.
1. Form Of Demand

Section 13.03503 specifies only that the demand must be in the form of a record. The demand should, however, set forth the facts concerning membership and be sufficiently specific to apprise the nonprofit corporation of the action sought to be taken and the ground for that action so that the demand can be evaluated. See Allison v. General Motors Corp., 604 F. Supp. 1106, 1117 (D. Del. 1985). Detailed pleading is not required since the corporation can contact the member for clarification if there are any questions. In keeping with the spirit of this section, the specificity of the demand should not become a new source of dilatory motions.

2. Upon Whom Demand Should Be Made

Section 13.03503 states that demand shall be made upon the nonprofit corporation. Reference is not made specifically to the board of directors since there may be instances such as a decision to sue a third party for an injury to the corporation, in which the taking of, or refusal to take, action would fall within the authority of an officer of the corporation. Nevertheless, it is expected that in most cases the board of directors will be the appropriate body to review the demand and only in relatively rare cases will a designated body have been given the role of reviewing a demand.

To ensure that the demand reaches the appropriate person for review, it should be recommended that the demand be addressed to the board of directors, chief executive officer, or corporate secretary of the nonprofit corporation at its principal office.

3. The 90-Day Period

Section 13.03503(2) provides that a derivative proceeding may not be commenced until 90 days after demand has been made. Ninety days has been chosen as a reasonable minimum time within which the board of directors can meet, direct the necessary inquiry into the charges, receive the results of the inquiry and make its decision. In many instances a longer period may be required. See, e.g., Mozes v. Welch, 638 F. Supp. 215 (D. Conn. 1986) (eight-month delay in responding to demand not unreasonable). However, a fixed time period eliminates further litigation over what is not a reasonable time. The nonprofit corporation may request counsel for the plaintiff to delay filing suit until the inquiry is completed or, if suit is commenced, the corporation can apply to the court for a stay under Section 13.04504.

Two exceptions are provided to the 90-day waiting period. The first exception is the situation where the plaintiff has been notified of the rejection of the demand prior to the end of the 90 days. The second exception is where irreparable injury to the nonprofit corporation would otherwise result if the commencement of the proceeding is delayed for the 90-day period. The standard to be applied is intended to be the same as that governing the entry of a preliminary injunction. Compare Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch. 1974) with Geico Corp. v. Coniston Partners, 811 F.2d 414 (8th Cir. 1987). Other factors may also be considered, such as the possible expiration of the statute of limitations, although this would depend on the period of time during which the plaintiff was aware of the grounds for the proceeding.
It should be noted that the person bringing suit does not necessarily have to be the person making the demand. Only one demand need be made in order for the nonprofit corporation to consider whether to take corrective action.

4. Response by the Corporation

There is no obligation on the part of the nonprofit corporation to respond to the demand. However, if the corporation, after receiving the demand, decides to institute litigation or, after a derivative proceeding has commenced, decides to assume control of the litigation, the plaintiff’s right to commence or control the proceeding normally ends unless it can be shown that the corporation will not adequately pursue the matter. As stated in Lewis v. Graves, 701 F.2d 245, 247-48 (2d Cir. 1983):

The [demand] rule is intended “to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation’s affairs.”—Permitting corporations to assume control over derivative suits also has numerous practical advantages. Corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation. Deference to directors’ judgment may also result in the termination of meritless actions brought solely for their settlement or harassment value. Moreover, where litigation is appropriate, the derivative corporation will often be in a better position to bring or assume the suit because of superior financial resources and knowledge of the challenged transactions. [Citations omitted.]

§ 13.04504. STAY OF PROCEEDINGS

(a) If the nonprofit corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for such period as the court deems appropriate.

(b) See Section 13.06508 (applicability to foreign corporations).


Compare Revised Model Nonprofit Corporation Act (1987) § 6.30(c). Subsection (b) is new.

CROSS-REFERENCES

Demand, see § 13.03503.

“Derivative proceeding” defined, see § 13.01501.

OFFICIAL COMMENT
Section 13.04504 provides that if the nonprofit corporation undertakes an inquiry, the court may in its discretion stay the proceeding for such period as the court deems appropriate. This might occur where the complaint is filed 90 days after demand but the inquiry into matters raised by the demand has not been completed or where a demand has not been investigated but the corporation commences the inquiry after the complaint has been filed. In any case, it is expected that the court will monitor the course of the inquiry to ensure that it is proceeding expeditiously and in good faith.

§ 13.05505. DISMISSAL

(a) The court must dismiss a derivative proceeding if one of the groups specified in subsection (b) or (e) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation.

(b) Unless a panel is appointed pursuant to subsection (e), the determination in subsection (a) shall be made by:

(1) a majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum; or

(2) a majority vote of a committee consisting of two or more independent directors appointed by majority vote of independent directors present at a meeting of the board of directors, regardless of whether or not such independent directors present at the meeting constituted a quorum.

(c) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a member, the complaint must allege with particularity facts establishing either:

(1) that a majority of the board of directors did not consist of independent directors at the time the determination was made; or

(2) that the requirements of subsection (a) have not been met.

(d) If a majority of the board of directors does not consist of independent directors at the time the determination is made, the nonprofit corporation has the burden of proving that the requirements of subsection (a) have been met. If a majority of the board of directors consists of independent directors at the time the determination was made, the plaintiff has the burden of proving that the requirements of subsection (a) have not been met; if not, the nonprofit corporation has the burden of proving that the requirements of subsection (a) have been met.
(e) Upon motion by the nonprofit corporation, the court may appoint a panel of one or more independent persons upon motion by the nonprofit corporation to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

(f) A person is independent for purposes of this section if the person does not have:

1. a material interest in the outcome of the proceeding, or
2. a material relationship with a person who has such an interest.

(g) None of the following shall by itself cause a director to be considered not independent for purposes of this section:

1. the nomination, election, or appointment of the director by persons who are defendants in the derivative proceeding or against whom action is demanded;
2. the naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded; or
3. the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.


CROSS-REFERENCES

Board of directors:
- committees, see § 8.25.
- meetings, see § 8.20820.
- quorum and voting, see § 8.24824.
- Demand, see § 13.031303.
- “Derivative proceeding” defined, see § 13.011301.
- “Material interest” defined, see § 1.40102.
- “Material relationship” defined, see § 1.40102.

OFFICIAL COMMENT

When a board of directors properly rejects a demand to bring an action, judicial decisions indicate that the derivative action should be dismissed. See Aronson v. Lewis, 743 A.2d 805, 813 (Del. 1994). The prior version of the act was silent on the effect of a determination by a special litigation committee of independent directors that a previously commenced derivative action can
be dismissed. Several state business corporation laws have been amended to provide for action by such a committee. IND. CODE ANN. §23-1-32-4 (Burns 1984 & Supp. 1988; N.D. CENT. CODE §10-19.149 (1985). This section adopts for nonprofit corporations those developments in business corporation law. Section 43.05505(a) specifically provides that the proceeding shall be dismissed if there is a proper determination that the maintenance of the proceeding is not in the best interests of the corporation. This determination can be made prior to commencement of the suit in response to a demand or after the commencement upon examination of the allegations of the complaint.

The procedures set forth in Section 43.05505 are not intended to be exclusive. As noted in the comment to Section 43.03503, there may be instances where a decision to commence an action falls within the authority of an officer of the nonprofit corporation depending upon the amount of the claim and the identity of the potential defendants.

I. The Persons Making the Determination

Section 43.05505(b) prescribes the persons by whom the determination in subsection (a) may be made. The subsection provides that the determination may be made by a majority vote of independent directors if there is a quorum of independent directors, or by a committee of independent directors appointed by a vote of the independent directors. These provisions parallel the mechanics for determining entitlement to indemnification in Section 8.55855. In this respect this clause is an exception to Section 8.25825 which required the approval of at least a majority of all the directors in office to create a committee and appoint members. This approach has been taken to respond to the criticism expressed in a few cases that special litigation committees suffer from a structural bias because of their appointment by a vote of non-independent directors. See Hasan v. Cleve Trust Realty Investors, 729 F.2d 372, 376-77 (6th Cir. 1984).

The decisions that have examined the qualifications of directors making the determination have required that the directors be both “disinterested” in the sense of not having a personal interest in the transaction being challenged (as opposed to a benefit which devolves upon the nonprofit corporation or all shareholders; members generally), and “independent” in the sense of not being influenced in favor of the defendants by reason of personal or other relationships. See e.g., Aronson v. Lewis, 743 A.2d 805, 812-16 (Del. 1984). Only the word “independent” has been used in Section 43.05505(b) because it is believed that a person who has an interest in the transaction would not be independent. The concept of an independent director is not intended to be limited to non-officer or “outside” directors but may in appropriate circumstances include directors who are also officers.

Many of the special litigation committees involved in the reported cases consisted of directors who were elected after the alleged wrongful acts by the directors who were named as defendants in the action—Section 43.05505(g)(1) makes it clear that the participation of non-independent directors or members in the nomination, election, or appointment of a new director will not prevent the new director from being considered independent. This sentence Section 505(g)(1) therefore rejects the concept that the mere appointment of new directors by the non-independent directors makes the new directors not independent in making the necessary determination because of an inherent structural bias. Clauses Section 505(g)(2) and (3) also
confirm the decisions by a number of courts provide that the mere fact that a director has been named as a defendant or approved the action being challenged does not cause the director to be considered not independent. See Aronson v. Lewis, 743 A.2d 805, 816 (Del. 1984); Lewis v. Graves, 701 F.2d 245 (2d Cir. 1983). It is believed it is expected that a court will be able to assess any actual bias in deciding whether the director is independent without any presumption arising out of the method of the director’s appointment, the mere naming of the director as a defendant, or the director’s approval of the act where the director received no personal benefit from the transaction.

Section 13.05505(e) also provides for a determination by a panel of one or more independent persons appointed by the court. Cf. VIRGINIA STOCK CORP. ACT §13.1-672D (1987) (court may appoint a committee of two or more persons). The subsection Section 505(a) provides for the appointment only upon motion by the nonprofit corporation. This would not, however, prevent the court on its own initiative from appointing a special master pursuant to applicable state rules of procedure.

This procedure in Section 505(e) may be desirable in a number of circumstances. If there are no independent directors available, the nonprofit corporation may not wish to enlarge the board to add independent directors or may be unable to find persons willing to serve as independent directors. In addition, if there are independent directors, they may not have the available time to conduct the inquiry in an expeditious manner.

Appointment by the court should also eliminate any question about the independence of the person making the determination. Although the nonprofit corporation may wish to suggest to the court possible appointees, the court will not be bound by these suggestions and, in any case, will want to satisfy itself with respect to independence at the same time the person is appointed.

Although subsection Section 505(b)(2) requires a committee of at least two directors, subsection (e) permits the appointment of only one person in recognition of the potentially increased costs to the nonprofit corporation for the fees and expenses of an outside person.

Under Section 8.12812, a designated body may perform the functions of the board of directors under this section.

2. Standards to be Applied

Section 13.05505(a) requires that the determination be made by the appropriate persons in good faith after conducting a reasonable inquiry upon which their conclusions are based. The word “inquiry” rather than “investigation” has been used to make it clear that the scope of the inquiry will depend upon the issues raised and knowledge of the group making the determination with respect to the issues. In some cases, the issues may be so simple or the knowledge of the group so extensive that little additional inquiry is required. In other cases, the group may need to engage counsel and other professionals to make an investigation and assist the group in its evaluation of the issues.
The phrase “in good faith” modifies both the determination and inquiry. The test, which is also included in Section 8.30 (general standards of conduct for directors) and 8.51 (authority to indemnify), is a subjective one, meaning “honestly or in an honest manner.” The Corporate Director’s Guidebook,” 33 BUS. LAW. 1595, 1601 (1978). As stated in Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795, 800 (E.D. Va. 1982), “the inquiry intended by this phrase goes to the spirit and sincerity with which the investigation was conducted, rather than the reasonableness of its procedures or basis for conclusions.”

The phrase “upon which its conclusions are based” requires that the inquiry and the conclusions follow logically. This provision authorizes the court to examine the determination to ensure that it has some support in the findings of the inquiry. The burden of convincing the court about this issue lies with whichever party has the burden under Section 13.05505(d). This phrase does not require the persons making the determination to prepare a report that sets forth their determination and the bases therefor, since circumstances will vary as to the need for such a report. There may, however, be many instances where good corporate practice will commend include such a procedure.

Section 13.05505 is not intended to modify the general standards of conduct for directors set forth in Section 8.30 of the act, but rather to make those standards somewhat more explicit in the context of a derivative proceeding. In this regard, the independent directors making the determination would be entitled to rely on information and reports from other persons in accordance with Section 8.30(b).

Section 13.05 is similar in several respects and differs in certain other respects from the law as it has developed in Delaware and been followed in a number of other states. Under the Delaware cases, the role of the court in reviewing the board’s determination varies depending upon whether the plaintiff is in a demand required or demand excused situation. Demand is excused only if the plaintiff pleads particularized facts that create a reasonable doubt that a majority of directors at the time demand would be made are independent or disinterested, or that the challenged transaction was the product of a valid exercise of business judgment by the approving board. Aronson v. Lewis, 743 A.2d 805, 814 (Del. 1984).; Levine v. Smith, 591 A.2d 194 (Del. 1991). If the plaintiff fails to make these two showings, demand is required. Since the Aronson requirements are difficult to satisfy, the plaintiff normally must make demand on the board.

In the unusual case where the plaintiff’s demand is excused under either of the Aronson tests, the plaintiff has standing to bring the derivative suit. If the nonprofit corporation seeks to reassert its right to control the litigation, the corporation will form a special litigation committee to determine if the litigation is in the best interests of the corporation. If the corporation files a motion to dismiss the litigation based upon the recommendation of the special committee, Delaware law requires the corporation to bear the burden of proving the independence of the committee, the reasonableness of its investigation, and the reasonableness of the bases of its decision reflected in the motion. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). Zapata also permits the court a discretionary second step to review the special committee’s decision by invoking the court’s “independent business judgment.” Id. At 789.

In the usual scenario where demand is not excused, the member must demand that the
board take action and the Zapata principles do not apply. The board or special committee of independent directors decides whether the nonprofit corporation should take the action the member requests or respond in some other way. As in the case of all board decisions, the board’s response to the member’s demand is presumptively protected by the traditional business judgment rule. Allison v. General Motors Corp., 604 F. Supp. 1106, 1122 (D. Del. 1985). As a result, the member in filing suit bears the normal burden of creating by particularized pleadings a reasonable doubt that the board’s response to the demand was wrongful. Levine v. Smith, No. 591 A.2d 194, 210 (Del. 1991). The plaintiff must allege with particularity a lack of good faith, care, independence, or disinterestedness by the directors in responding to the demand.

In contrast to Delaware’s approach, some jurisdictions have adopted uniform tests to judge both demand-required and demand-excused situations. For example, in New York judicial review is always limited to an analysis of the independence and good faith of the board or committee and the reasonableness of the bases for the board’s decision, nor does the court have the discretionary authority to use its independent business judgment. Auerbach v. Bennett, 47 N.Y.2d 619, 633-34, 419 N.Y.S. 2d 920, 928-29, 393 N.E.2d 994, 1002-03 (1979). In contrast, the North Carolina Supreme Court has interpreted that state’s statutory provisions on derivative actions as requiring the application of the Zapata criteria in both demand-required and demand-excused cases. Alford v. Shaw, 358 S.E.2d 323, 327 (N.C. 1987).

Since Section 13.03 requires demand in all cases, the distinction between demand-excused and demand-required cases does not apply. Subsections Section 13.05(c) and (d) of Section 13.05 carry forward the distinction, however, by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of independent directors. Subsection (e), like Delaware law, assigns the plaintiff the threshold burden of alleging facts establishing that a majority of the board is not independent. If there is an independent majority, the burden remains with the plaintiff to plead and establish that the requirements of Section 13.05(a) have not been met. If there is no independent majority, the burden is on the nonprofit corporation on the issues delineated in Section 13.05(a). In this case, the corporation must prove both the independence of the decision makers and the propriety of the inquiry and determination.

Subsections (c) and (d) of Section 13.05 thus follow the first Aronson standard in allocating the burden of proof depending on whether the majority of the board is independent. The committee decided, however, not to adopt the second Aronson standard for excusing demand (and thus shifting the burden to the corporation) based on whether the decision of the board that decided the challenged transaction is protected by the business judgment rule. The committee believes that the only appropriate concern in the context of derivative litigation is whether the board considering the demand has a disabling conflict. See Starrels v. First Nat’l Bank, 870 F.2d 1168, 1172-76 (7th Cir. 1989) (Easterbrook, J. concurring).

Thus, the burden of proving the requirements of Section 13.05(a) have not been met will remain with the plaintiff in several situations. First, in subsection (b)(1), the burden of proof will generally remain with the plaintiff since the subsection requires a quorum of independent directors and a quorum is normally a majority. See Section 8.24. The burden will also remain with the plaintiff if there is a majority of independent directors which appoints the committee under subsection (b)(2). Under Section 13.05(c), the burden of proof also remains with the plaintiff in the case of a determination by a panel appointed by the court.
The burden of proof will shift to the nonprofit corporation, however, where a majority of
directors is not independent, and the determination is made by the group specified in subsection
(b)(2). It can be argued that, if the directors making the determination under subsection (b)(2)
are independent and have been delegated full responsibility for making the decision, the
composition of the entire board is irrelevant. This argument is buttressed by the section’s
method of appointing the group specified in subsection (b)(2) since subsection (b)(2) departs
from the general method of appointing committees and allows only independent directors, rather
than a majority of the entire board, to appoint the committee which will make the determination.
Nevertheless, despite the argument that the composition of the board is irrelevant in these
circumstances, the committee adopted the provisions of subsections (b)(2) and (d) of Section
13.05 to respond to concerns of structural bias.

Finally, Section 13.05 does not authorize the court to review the reasonableness of the
determination. As discussed above, the phrase in Section 13.44(a) “Upon which its conclusions
are based” limits judicial review to whether the determination has some support in finding of the
inquiry.

3. PLEADING

Section 13.05(c) sets forth a modified pleading rule to cover the typical situation where
plaintiff makes demand on the board, the board rejects that demand, and the plaintiff commences
an action. In that scenario, in order to state a cause of action, subsection (c) requires the
complaint to allege facts with particularity demonstrating either (1) that no majority of
independent directors exists or (2) why the determination does not meet the standards in
subsection (a). Discovery is available to the plaintiff only after the plaintiff has successfully
stated a cause of action by making either of these two showings.

§ 13.06506. DISCONTINUANCE OR SETTLEMENT

(a) A derivative proceeding may not be discontinued or settled without the court’s
approval. If the court determines that a proposed discontinuance or settlement will substantially
affect the interests of the members or a class of members of the nonprofit corporation, the court
shall direct that notice be given to the members affected.

(b) See Section 13.08508 (applicability to foreign corporations).

Source Note: Patterned after Model Nonprofit
Corporation Act, 3rd Ed. (2008), § 13.06, C. Model
Revision), § 7.45. Subsection (b) is new.

CROSS-REFERENCES

“Derivative proceeding” defined, see § 13.04501.

OFFICIAL COMMENT

Section 13.06 follows the Federal Rules of Civil Procedure and the statutes of a number
of states, and requires that all proposed settlements and discontinuances must receive judicial
approval. This requirement seems a natural consequence of the proposition that a derivative suit
is brought for the benefit of all members and avoids many of the evils of the strike suit by
preventing the individual member-plaintiff from settling privately with the defendants.

Section 43.06506 also requires notice to all affected members if the court determines that
the proposed settlement may substantially affect their interests. This provision permits the court
to decide that no notice need be given if, in the court’s judgment, the proceeding is frivolous or
has become moot. The section also makes a distinction between classes of members, an approach
which is not in Federal Rule of Civil Procedure 23.1, but is adapted from the New York and
Michigan statutes.

Unlike the statutes of some states, Section 43.06506 does not address the issue of which
party should bear the cost of giving this notice. This is a matter left to the discretion of the court
reviewing the proposed settlement.

§ 13.07507. SECURITY FOR COSTS; PAYMENT OF EXPENSES

(a) In any derivative proceeding brought under Section 13.02502(a)(1) (standing), the
nonprofit corporation shall be entitled may seek an order at any stage of the proceeding to seek an
order requiring the plaintiffs to give security for reasonable expenses, including attorney fees and
expenses, that may be incurred by the corporation in connection with the proceeding, to which
security the corporation may have recourse to the security in such amount as the court
determines upon termination of the proceeding. The amount of security may be increased or
decreased in the discretion of the court upon a showing that the security provided has or may
become inadequate or excessive. Security may be denied or limited in the discretion of the court
upon a preliminary showing, by application and upon such types of proof as may be required by
the court, establishing prima facie that the requirement of full or partial security would impose
undue hardship on plaintiffs and serious injustice would result.

(b) On termination of the derivative proceeding the court may order:

(1) order the nonprofit corporation to pay the plaintiff’s reasonable expenses
(including counsel fees) incurred in the proceeding if it finds that the proceeding has resulted in a
substantial benefit to the corporation;

(2) order the plaintiff to pay any defendant’s reasonable expenses (including
counsel fees) incurred in defending the proceeding if it finds that the proceeding was commenced
or maintained without reasonable cause or for an improper purpose; or

(3) order a party to pay an opposing party’s reasonable expenses (including
counsel fees) incurred because of the filing of a pleading, motion, or other paper, if it finds that
the pleading, motion, or other paper was not well grounded in fact, after reasonable inquiry, or
warranted by existing law or a good faith argument for the extension, modification, or reversal of
existing law and was interposed for an improper purpose, such as to harass or cause unnecessary
delay or needless increase in the cost of litigation.
(c) See Section 13.08508 (applicability to foreign corporations).


CROSS-REFERENCES

“Derivative proceeding” defined, see § 13.01501.

OFFICIAL COMMENT

The requirement in Section 13.07507(b)(1) is intended to be a codification of existing case law. See, e.g., Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970). It provides that the court may order the nonprofit corporation to pay the plaintiff’s reasonable expenses (including counsel fees) if it finds that the proceeding has resulted in a substantial benefit to the corporation. The subsection requires that there be a “substantial” benefit to the corporation to prevent the should discourage a plaintiff from proposing inconsequential damages in order matters to justify the payment of counsel fees. While the subsection The provision does not specify the method for calculating attorneys’ fees since given that there is a substantial body of court decisions delineating case law that delineates this issue, it does require that the expenses be reasonable which would include which usually includes taking into account the amount or character of the benefit to the corporation.

Section 13.07(b)(2) provides that on termination of a proceeding the court may require the plaintiff to pay the defendants’ reasonable expenses, including attorney’s fees, if it finds that the proceeding “was commenced or maintained without reasonable cause or for an improper purpose.” The phrase “for an improper purpose” has been added to parallel Federal Rule of Civil Procedure 11 in order to prevent proceedings which may be brought to harass the nonprofit corporation or its officers or to divert assets to a purpose not consistent with the purposes of the nonprofit corporation. The test in this section is similar but not identical with the test utilized in Section 13.31 of the Model Business Corporation Act, relating to dissenter’s rights, where the standard for award of expenses and attorneys’ fees is that dissenters “acted arbitrarily, vexatiously or not in good faith” in demand a judicial appraisal of their shares. The situation of a derivative action involving a nonprofit corporation is sufficiently different from the dissenter’s rights situation to justify a different and less onerous test for imposing costs on the plaintiff. The test of Section 13.07(b)(2) that the action was brought without reasonable cause or for an improper purpose is appropriate to deter strike suits, on the one hand, and on the other hand to protect plaintiffs whose suits have a reasonable foundation.

The standard under section 507(b)(2) for the court to require the plaintiff to pay the defendants’ expenses if the action was commenced without reasonable cause or for an improper purpose is intended to discourage proceedings brought for the sole purpose of obtaining early settlement payments by defendants to avoid significant defense costs, while also protecting plaintiffs whose suits have a reasonable foundation.
Section 13.075(b)(3) has been added to deal with other abuses in the conduct of derivative litigation which may occur on the part of the defendants and their counsel as well as by the plaintiffs and their counsel. This section follows generally the provisions of Federal Rule of Civil Procedure 11. Section 13.07(b)(3) will not be necessary in states which already have a counterpart to Rule 11; provision may be unnecessary if these abuses are already addressed under applicable rules of civil procedure.

§ 13.08508. APPLICABILITY TO FOREIGN CORPORATIONS

In any derivative proceeding brought in the right of a foreign nonprofit corporation, the matters covered by this [chapter Chapter] shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation except for Sections 13.04, 13.06, and 13.07 (stay of proceedings), 506 (discontinuance or settlement), and 507 (security for costs, payment of expenses).


CROSS-REFERENCES

“Derivative proceeding” defined, see § 13.01501.
Foreign corporations, generally, see §§ 15.01-15.32 Ch. 13.

OFFICIAL COMMENT

Under generally prevailing practice, a court will look to the choice of law rules of the forum state to determine which law shall apply. If the issue is “procedural,” the law of the forum state will apply; if the issuance is “substantive,” relating to the internal affairs of the nonprofit corporation, the law of the state of incorporation will apply. See, e.g., Hausman v. Buckely, 299 F.2d 696, 700-06 (2d Cir. 1962); Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980). Compare Restatement (Second) of Conflict of Laws) §§302, 303, 304, 306, 309 (1988) (the local law of the state of incorporation will be applied except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in Section 6 of the Restatement to the parties and the corporation or the transaction).

However, the distinction between what is procedural and what is substantive is not clear. See, e.g., Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 555-57 (1949). For example, in Susman v. Lincoln American Corp., 550 F. Supp. 442, 446 n.6 (N.D. Ill. 1982), the court suggested that the standing requirement might be considered a federal procedural question under Federal Rule of Civil Procedure 23.1 and a matter of substantive law under the Delaware statute. In view of the uncertainties created by these decisions, Section 13.08 sets forth a choice of law provision for derivative proceedings involving foreign nonprofit corporations. It provides, subject to three exceptions, that the matters covered by the
Chapter 5 shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation.

The three exceptions to the general rule are areas which are traditionally part of the forum’s oversight of the litigation process: (i) Section 13.04504, dealing with the ability of the court to stay proceedings; (ii) Section 13.06506, setting forth the procedure for settling a proceeding; and (iii) Section 13.07507, providing for the assessment of reasonable expenses (including counsel fees) in certain situations.

§ 13.09509. NOTICE TO ATTORNEY GENERAL

The plaintiff in a derivative proceeding must notify the attorney general within ten days after commencing the proceeding if it involves a charitable corporation.


CROSS-REFERENCES

“Charitable corporation” defined, see § 1.40102.
“Derivative proceeding” defined, see § 13.01501.

OFFICIAL COMMENT

Notice to the attorney general when a derivative proceeding involves a charitable corporation. The notice under Section 509 provides the attorney general with an opportunity to learn of and evaluate the dispute. The attorney general may, but does not have required to, join in the action. See Section 1.70140.
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