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When the business decisions of corporate directors are challenged in a stockholder's derivative suit,[1] the directors often raise the business judgment rule as a defense. The rule requires a court to presume that the business judgment of directors is sound unless it has been tainted by negligence, bad faith, self-interest, or abuse of discretion.[2] Some courts have recently applied the rule's presumption of soundness to decisions by board committees[3] to recommend dismissal of derivative suits against their fellow directors.[4] However, fearing that the adoption of the business judgment rule in this context could end some derivative suits prematurely because of committee bias toward the defendant directors,[5] the Delaware Supreme Court held in *Zapata Corp. v. Maldonado* that a court may decide in its own business

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1. A derivative suit is a suit brought by stockholders on behalf of their corporation to redress a wrong to the corporation. It is distinguished from a class action, which may be brought to redress a wrong to stockholders as a class. Similarly, it is distinguished from direct or individual actions, which stockholders may bring to enforce individual rights. W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 17.01 (3d ed. 1978).

2. *See* Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 114-30 (1979); Block & Brussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 33-38 (1981).

3. The committees were comprised of directors, often newly appointed, and were authorized to decide whether a suit against other directors on the board should be dismissed as harmful to the corporation's interests. Delegation of managerial powers to board committees is sanctioned by statute in many states. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(c) (1974).

4. *E.g.*, Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980); Rosengarten v. IT&T Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *accord*, Grossman v. Johnson, 89 F.R.D. 656 (D. Mass. 1981); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Bernstein v. Mediobanca Banca di Credito Finaziario-Societa per Azioni, 69 F.R.D. 592 (S.D.N.Y. 1974). *But see* Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980); Watts v. Des Moines Register and Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981); Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713 (E.D. Va. 1980); Maher v. Zapata, 490 F. Supp. 348 (S.D. Tex. 1980); Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980).

5. Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

judgment whether a suit should be dismissed.[6]

I. THE *Zapata* CASE

William Maldonado, a Zapata Corporation stockholder, filed a derivative suit against Zapata's directors in the Delaware Court of Chancery in 1975. In 1977 he filed a derivative suit against the same defendants in the U.S. District Court for the Southern District of New York.[7] Maldonado alleged in both suits that the directors had breached their fiduciary duty to the corporation.[8] In the federal suit he also alleged that they had violated federal securities laws.[9]

In 1979, while these suits were still pending, Zapata's board of directors filled two vacancies on the board. It assigned the new directors, as a committee, to investigate the pending suits to determine whether they should be continued, and the board resolved to be bound by the committee's determination.[10] After investigation, the committee concluded that the suits should be dismissed because their continuance would not be in Zapata's best interests.[11] Zapata, as the true plaintiff party in interest, moved for dismissal or summary judgment in both suits.[12]

The district court granted Zapata's motion for summary judgment.[13] It yielded to the committee's judgment under the business judgment rule, having found that the committee members were disinterested and independent and that they had made their decision in good faith after proper review.[14] Maldonado appealed the decision to the Second Circuit.[15]

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6. *Id.* at 789.

7. *Id.* at 780; Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980).

8. 430 A.2d at 780. Maldonado attacked a 1974 decision by the directors to accelerate the date for exercising options under a 1970 stock option plan. When the directors advanced the exercise date, they were aware that Zapata would soon announce a tender offer for its stock and that the announcement would probably lead to a six- to seven-dollar increase in the market price per share of Zapata stock. Advancing the date for exercising the stock options had enabled optionees—among whom were most of the directors—to limit their immediate capital gains and their corresponding federal income tax liability. Maldonado v. Flynn, 413 A.2d 1251, 1254 (Del. Ch. 1980). Maldonado charged that advancing the exercise date had simultaneously deprived Zapata of a federal income tax deduction equal to the optionees' savings. *Id.* at 1255.

9. 430 A.2d at 780.

10. *Id.* at 781.

11. *Id.*

12. *Id.*

13. Maldonado v. Flynn, 485 F. Supp. 274, 287 (S.D.N.Y. 1980).

14. *Id.* at 285-86.

15. 430 A.2d at 781.

Meanwhile, however, the court of chancery denied Zapata's motion, holding that Delaware law did not sanction dismissal under the business judgment rule.[16] The court held that Zapata, by refusing to assert its own apparently valid cause of action, forfeited control of the litigation to Maldonado.[17] Zapata filed an interlocutory appeal with the Delaware Supreme Court.[18] The court accepted the appeal, agreeing its decision would be necessary to free the parties from the "procedural gridlock" that had resulted from the interplay between the state and federal courts.[19]

The Delaware Supreme Court reversed and remanded.[20] The court held that Zapata's committee was empowered to seek dismissal,[21] but that the business judgment rule would not protect its decision to seek dismissal except in a suit attacking the decision directly.[22] Rather, the court of chancery could, in its discretion, refuse to yield to the committee's decision favoring dismissal.[23] The court gave three reasons for rejecting the traditional business judgment rule approach. First, the committee directors might be biased toward their fellow directors, whom they must judge.[24] The court questioned whether the usual business judgment rule inquiries would sufficiently safeguard against

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16. Maldonado v. Flynn, 413 A.2d 1251, 1262 (Del. Ch. 1980).

17. *Id.* at 1263.

18. 430 A.2d at 781.

19. *Id.* Before the supreme court accepted the appeal, the court of chancery dismissed Maldonado's cause of action, Maldonado v. Flynn, 417 A.2d 378 (Del. Ch. 1980), because he "impermissibly split his claim, and the final adjudication of dismissal in the District Court precludes his prosecution of his common law theory of recovery in this Court." *Id.* at 384. However, the dismissal was to take effect only if the Second Circuit subsequently affirmed the New York district court's decision. *Id.* The Second Circuit stayed the district court appeal until the Delaware Supreme Court could resolve the issues raised on appeal from the original order denying dismissal and summary judgment. 430 A.2d at 781.

20. 430 A.2d at 789.

21. *Id.* at 786.

22. *See id.* at 782, 787.

23. *Id.* at 788.

24. *Id.* at 787. In determining whether to dismiss or proceed with a derivative suit, committee members must pass "judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role." *Id. See also* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 111-17 (1980); Comment, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CALIF. L. REV. 885, 894-900 (1981); Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 619-26 (1980).

"abuse, perhaps subconscious abuse."[25] Second, Maldonado properly initiated the lawsuit.[26] The usual requirement that the shareholder first demand that the board pursue the claim[27] was excused because of futility.[28] Therefore, he had standing to conduct the suit at the time he filed it. Third, a corporation's motion to dismiss a derivative suit is analogous procedurally to a proposal for settlement of a derivative suit when directors are on both sides of the transaction because "there is a request to terminate litigation without a judicial determination of the merits."[29] The motion is also analogous to a plaintiff's motion to dismiss when it follows an answer.[30] Both of these analogous situations require court supervision.[31]

The supreme court next outlined a two-step review procedure for the lower court to follow in determining whether a motion to dismiss should be granted.[32] The first step adopts the usual business judgment rule criteria: reasonableness of the investigation, the committee directors' good faith, their independence from those implicated in the suit, and the reasonableness of their decision to seek dismissal.[33] However, the court shifted the burden of proof on these issues to the corporation.[34] As the moving party, the corporation must "meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that [the corporation] is entitled to dismiss as a matter of law."[35] If the corporation does not satisfy its burden of proof

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25. 430 A.2d at 787.

26. *Id.*

27. Before a stockholder can properly file a derivative suit, he generally must first exhaust intracorporate remedies by demanding that the board of directors pursue the claims. Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 169 (1976). When demand on the board is required and the board refuses to pursue the stockholder's grievances, the stockholder must establish his standing to conduct a derivative suit by showing the board's refusal was wrongful. *Id.* at 191-98.

28. 430 A.2d at 787. Demand may be excused if it would be futile. Comment, *supra* note 27, at 175-76; *see* FED. R. CIV. P. 23.1; DEL. CH. R. 23.1. "[T]he most commonly urged excuse is that a majority of the directors are the alleged wrongdoers." Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 753 (1960).

29. 430 A.2d at 787.

30. *Id.* at 788. *See* DEL. CH. R. 41(a)(2).

31. 430 A.2d at 787-88.

32. *Id.* at 788-89.

33. *See id.*

34. *Id.* at 788.

35. *Id.* Limited discovery may be ordered. Also, the motion should include a thorough record of the committee's investigation, findings, and recommendations, and each

and the court of chancery determines[36] that the criteria have not been satisfied, the court should deny the motion to dismiss.[37] However, even if the court determines that the criteria have been satisfied, it may in its discretion proceed to the second step of the review.[38]

If the court of chancery does proceed to the second step, it is to determine by its independent business judgment whether the motion should be granted.[39] It should carefully weigh the corporation's interests in dismissal against its interests in continuing the suit,[40] and, when appropriate, it should give special consideration to matters of law and public policy.[41]

II. ANALYSIS

Zapata's two-step procedure for reviewing motions to dismiss goes one step too far. Because corporations appropriately bear the burden of proof at the first step, judicial scrutiny will adequately increase to counteract possible committee bias in favor of dismissal. Consequently, a court's independent business judgment at the second step is entirely unnecessary.

A. Zapata *Properly Assigns the Burden of Proof*

When committee directors cause their corporations to seek the dismissal of derivative litigation against other board members, questions arise as to the directors' good faith and independence, the reasonableness of their investigation, and the reasonableness of their decision. *Zapata* holds that the corporation, as moving party, should have the burden of proof on these issues. This allocation of the burden of proof conforms to traditional principles of procedure.

Burdens of proof are normally allocated to the party who seeks to change the present state of affairs.[42] By moving to dismiss, a corporation seeks to cut short a derivative suit. Because it seeks this change, the corporation would normally be assigned

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side should have the opportunity to make a record on the motion. *Id.*

36. The court's holding in *Zapata* does not foreclose a discretionary trial of factual issues. *Id.* at n.15.

37. *Id.* at 789.

38. *Id.*

39. *Id.*

40. *Id.* at 788-89.

41. *Id.* at 789.

42. C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE § 337, at 786 (2d ed. 1972).

the burden of proof.

Policy considerations[43] confirm that the corporation should bear the burden of proof. Committee directors are likely to be biased in favor of fellow directors when deciding whether to end derivative suits against them.[44] Because of their bias, the committee directors arguably will tend to minimize corporate interests in continuing the litigation and will consequently favor dismissal. A "judicial estimate of the probabilities"[45] of bias in this situation would dictate that the corporation be assigned the burden of proof. Furthermore, considerations of convenience and fairness[46] suggest that the corporation should have the burden of proof. A corporation has better access than the stockholder does to facts[47] about a board committee's independence and the reasonableness of its conclusions. The corporation is also likely to have greater resources, making the burden of proof easier for it to bear.

B. Shifting the Burden of Proof to the Corporation Adequately Counteracts Committee Bias

The first step of the *Zapata* procedure for reviewing motions for summary judgment or dismissal properly requires a corporation to prove, among other things, that the board committee's decision to recommend dismissal had some reasonable basis.[48] This burden of proof is equivalent to that imposed on interested directors. When stockholders challenge a corporate transaction in which their directors had a personal interest, the directors must prove that the transaction was fair and reasonable to the corporation, or the transaction will be set aside.[49] The extent to which fairness and reasonableness must be proved was indicated recently by the Second Circuit: "[D]irectors can make

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43. Policy considerations may in certain circumstances dictate that the burden be shifted to the party *not* seeking a change. *See* C. McCormick, *supra* note 42, at 786-89; 9 J. Wigmore, Evidence § 2486, at 291-92 (Chadbourn rev. 1981). However, when a corporation moves to dismiss a derivative suit against its directors, policy considerations dictate that the burden remain on the party seeking change—the corporation.

44. *See supra* note 24.

45. *See* C. McCormick, *supra* note 42, at 787-89.

46. *See id.* at 789.

47. *See id.* at 787 (burden should be on the party with peculiar knowledge of the facts).

48. Whereas a corporation must show some reasonable basis for the decision, a stockholder having the burden of proof would be required to show that the decision had no reasonable basis. *See* Arsht, *supra* note 2, at 121-26.

49. *E.g.*, Treadway Companies v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980).

a sufficient showing of fairness by demonstrating that the transaction was entered into for a proper corporate purpose; they need not also prove that the actual terms of the transaction were fair."[50] Likewise, *Zapata*'s "reasonable basis" inquiry requires a corporation to prove that its board committee had some reasonable basis for believing dismissal would serve the corporation's best interests. The corporation does not have to prove that the committee's decision was correct.

The *Zapata* court recognized the equivalence of these two burdens of proof: "Our approach here is analogous to and consistent with the Delaware approach to 'interested director' transactions, where the directors, once the transaction is attacked, have the burden of establishing its 'intrinsic fairness' to a court's careful scrutiny."[51] Although the court thus noted the equivalence between the two burdens, it missed the significance of their sameness. If the burden of proof and corresponding level of judicial scrutiny are adequate in interested director transactions to counteract the effects of a demonstrable conflict of interest, they are a fortiori adequate to counteract the effects of nondemonstrable bias. Substituting a court's business judgment for that of committee directors is entirely unwarranted; therefore, the second step of *Zapata*'s review procedure is unnecessary. The *Zapata* court should have adopted only the first step of its review procedure, thus retaining the business judgment rule presumption of sound judgment.

Perhaps the *Zapata* court mistakenly authorized judicial business judgment because of a casual reading of precedent. When it discussed proposals for settlement as a procedural analogy, the court quoted the following from its own opinion in *Neponsit Investment Co. v. Abramson*:[52] " 'In determining whether or not to approve a proposed settlement of a derivative stockholders' action [when directors are on both sides of the transaction], the Court of Chancery is called on to exercise its *own business judgment*.' "[53] *Neponsit* also mentioned that the court exercised "*independent* judgment."[54] But in *Neponsit*'s factual

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50. *Id.* at 382 n.47. *See also* Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964); Kaplan v. Goldsamt, 380 A.2d 556, 568-69 (Del. Ch. 1977).

51. 430 A.2d at 788-89 n.17.

52. 405 A.2d 97 (Del. 1979).

53. 430 A.2d at 787 (quoting Neponsit Investment Co. v. Abramson, 405 A.2d 97, 100 (Del. 1979) (emphasis added)).

54. 405 A.2d at 100 (emphasis added).

context, these expressions about independent judicial business judgment had a more narrow meaning than they did in *Zapata*. There was no exercise of the *Zapata* brand of judicial business judgment in *Neponsit*, nor any need for it. The proposal for settlement in *Neponsit* simply constituted an interested director transaction, and the directors' burden of proof was the usual burden of proving fairness.[55] *Neponsit*'s concept of independent judicial business judgment was simply that a court which assessed the reasonableness of a corporate transaction must independently determine the *limits* of reasonableness. The *Zapata* court erred when it concluded that a court could substitute its own judgment for that of a board committee even though the committee's judgment was reasonable and proper in light of the business judgment rule criteria.

III. Conclusion

The procedural stance of a corporation that moves to dismiss a derivative suit against its directors is, without more, sufficient to justify assigning the burden of proof on the motion to the corporation. Policy considerations—fairness, convenience, and the probability of bias—confirm that the burden should be on the corporation. Since the corporation must prove the reasonableness of its board committee's decision to seek dismissal, it bears the burden of proof equivalent to the burden allocated to interested directors. The danger posed by a director's self-interest are greater than those posed by a director's bias in favor of fellow directors; therefore, the burden of proof and judicial scrutiny considered adequate with respect to interested-director transactions should be more than adequate with respect to decisions colored by bias. Judicial business judgment is thus an extreme and unnecessary solution to committee bias. Accordingly, the *Zapata* court should have retained the business judgment rule presumption of sound judgment to protect a board committee's decision to end a derivative suit if the committee has shown that it made its decision in accordance with the business judgment rule criteria. The court should not have nullified the presumption of sound judgment by granting the court below dis-

55. *Id.* at 99-101.

cretion to decide for itself whether or not dismissal would serve the corporation's best interests.

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