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Business Judgment Dismissal of Shareholder Derivative Suits by Board Litigation Committees: An Expanded Role for the Courts

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RECENT DEVELOPMENT

Business Judgment Dismissal of Shareholder Derivative Suits by Board Litigation Committees: An Expanded Role for the Courts

I. INTRODUCTION

The shareholder derivative suit has proved to be a useful and essential legal mechanism for corporation shareholders to deter and redress harm to the corporation caused by director malfeasance.[1] Recently, however, some courts have dismissed shareholder derivative suits before a trial on the merits by offensively applying the business judgment rule.[2] Traditionally, the business judgment rule served merely as a defense that insulated directors from personal liability on the merits of a shareholder suit.[3] In these recent cases, however, some courts have expanded the business judgment rule to allow corporation boards to terminate shareholder derivative suits against fellow directors.[4] In jurisdictions that sanction this new offensive application of the business judgment rule, the board of directors of a corporation may obtain dismissal of a shareholder derivative suit when the suit is not in the corporation's best interests. The United States Supreme Court in *Burks v. Lasker*[5] authorized the offensive use of the business judgment rule to dismiss derivative actions brought under federal law. Nevertheless, the Court held that state law was the "first place one must look to determine the powers of corporate directors"[6] to employ the busi-

1. *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949); Brendle v. Smith, 46 F. Supp. 522, 525-26 (S.D.N.Y. 1942); N. LATTIN, THE LAW OF CORPORATIONS § 115, at 457 (2d ed. 1971); Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 77-82 (1967).

2. *See* notes 76-136 *infra* and accompanying text.

3. *See* notes 53-54 *infra* and accompanying text.

4. *See* notes 76-136 *infra* and accompanying text.

5. 441 U.S. 471 (1979). *See* notes 76-101 *infra* and accompanying text.

6. 441 U.S. at 478.

ness judgment rule to dismiss derivative actions.[7]

Recently, in *Zapata Corp. v. Maldonado*[8] the Delaware Supreme Court decided the question whether a board of directors could, under state law, terminate a shareholder derivative suit. The court held that a corporation's board of directors, under proper circumstances, can terminate a shareholder derivative suit when the suit is not in the corporation's best interests.[9] Since Delaware is a very popular domicile for national corporations, *Zapata* is certain to "become the model for derivative suit dismissal decisions in other states as well as in federal courts applying Delaware and other state laws."[10] This Recent Development examines the legal background of the shareholder derivative suit and the business judgment rule and then traces the evolution of the offensive use of the business judgment rule in board of director terminations of stockholder derivative actions. After examining other derivative suit dismissal decisions, the Recent Development analyzes whether *Zapata* adequately balances the competing interests of the shareholder and the corporate board. Finally, the Recent Development discusses the potential effect of *Zapata* on future litigation.

II. LEGAL BACKGROUND

A. *The Nature and Effect of the Shareholder Derivative Suit*

1. Origin and Characteristics of the Derivative Suit

The shareholder derivative suit originated in equity[11] to enable a shareholder to enforce a corporate right or claim in order to protect his ownership interest in the corporation.[12] A shareholder's basis for a derivative suit,[13] then, is a harm to the corporation, not harm to the individual shareholder.[14] Because a derivative action

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7. *Id.* at 478-80.

8. 430 A.2d 779 (Del. 1981).

9. *Id.* at 788.

10. Olson, *Delaware Court Addresses Business Judgment Rule,* Legal Times of Washington, June 8, 1981, at 15, col. 1, at 19, col. 3.

11. For a more detailed discussion of the origins of the shareholder derivative suit, see Prunty, *The Shareholders' Derivative Suit: Notes on its Derivation,* 32 N.Y.U. L. REV. 980 (1957).

12. H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 358, at 749 (2d ed. 1970).

13. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?,* 75 NW. U.L. REV. 96, 96 n.1 (1980). "The derivative suit is to be distinguished from the representative suit, in which the shareholder complains of an injury . . . directly to himself and other shareholders." *Id.*

14. *See* H. HENN, *supra* note 12, § 358, at 750. "In this sense, the derivative action is

asserts a right on behalf of the corporation, rather than a right on behalf of the individual shareholders, any judgment usually[15] goes to the corporation.[16] Moreover, since a derivative suit is based on a corporate claim, it is usually permitted only when the corporation for some reason chooses not to assert the cause of action itself.[17] Thus, if all the conditions are met,[18] a shareholder may use the derivative suit to pursue a legal claim that the corporation's board of directors had chosen to forego.

Although the shareholder's derivative suit has had a major effect on corporate governance, the effect has not been to increase shareholder power in decisionmaking. Rather, the derivative suit has become the minority shareholder's major remedy against management or board misconduct.[19] The shareholder's derivative suit has become most important when the harm to the corporation was perpetrated by insiders[20]—either directors or officers.[21] In *Brendle v. Smith*[22] the Federal District Court for the Southern District of New York discussed the regulatory effect of the shareholder derivative suit on corporate governance:

> [T]hey have accomplished much in policing the corporate system especially in protecting the corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty, . . . encouraged faith in the wisdom of full disclosure to stockholders . . . [and] discouraged membership on boards by persons not truly interested in the corporation. . . . The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to

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unique, for the plaintiff-shareholder does not sue for his own direct benefit or in his own direct right hut rather as a guardian ad litem for the corporation." *Id.*

15. For an enumeration of the circumstances in which a plaintiff-shareholder may share in the recovery, see *id.* § 373, at 787-88.

16. *Id.* § 376, at 787.

17. *Id.* § 360, at 756.

18. *See* notes 35-39 *infra* and accompanying text.

19. N. LATTIN, *supra* note 1, § 115, at 457. *See also* Dykstra, *supra* note 1.

20. *See* Dykstra, *supra* note 1, at 77-82. *See also* H. HENN, *supra* note 12, § 358 at 751.

21. The need for the derivative suit is greatest in cases when the harm was allegedly perpetrated by officers or directors, because they can prevent the corporation from asserting a direct cause of action against themselves. If the insider misconduct impaired the market value of the stock, then individual or representative shareholder actions would be available. Unfortunately, however, redress in the form of individual or representative shareholder actions would result in an unnecessary multiplicity of suits, an impairment of capital, or both. *See* H. HENN, *supra* note 12, § 358, at 751.

Although its most important use is as a remedy for harm committed by insiders, the shareholder derivative suit may also be used to redress a "wrong to the corporation perpetrated by . . . outsiders." *Id.*

22. 46 F. Supp. 522 (S.D.N.Y. 1942).

managements and outsiders.[23]

As the *Brendle* court pointed out, the shareholder derivative suit serves several beneficial functions. First, the availability of the shareholder derivative suit deters corporate misconduct.[24] Second, the derivative suit legitimizes the corporate governance system by providing a means for shareholders to redress harm to the corporation perpetrated by those in control.[25] In other words, the derivative suit serves as an accountability mechanism. Last, the derivative suit fosters judicial economy because it allows a single shareholder to bring an action to obtain complete relief for the corporation as a whole.[26]

The most distinguishing characteristic of a derivative action is its dual nature.[27] A shareholder derivative suit basically comprises two suits.[28] The first suit compels the corporation to sue on its own behalf. The second suit, which is the underlying cause of action, seeks redress for the corporation against the real defendants. Because of the dual nature of the derivative suit, the corporation plays two roles in derivative litigation.[29] On the one hand, the corporation is a nominal party defendant because of its refusal to sue. In some situations the corporation may defend the board's decision to refrain from suit because it is not in the corporation's best interests. If the court agrees with the board's decision, it will dismiss the derivative suit. On the other hand, the corporation is the real party plaintiff if the court does not dismiss the derivative suit because the suit seeks redress for a harm to the corporation.[30]

2. Restrictions on Shareholder Derivative Suits

While the shareholder derivative suit serves several useful purposes, it has also been a vehicle for abuse. The abuses include

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23. *Id.* at 525-26.

24. *See* Dent, *supra* note 13, at 144.

25. *Id.*

26. *See* note 21 *supra.*

27. *See* W. FLETCHER, 13 CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5946 (rev. perm. ed. 1980).

28. *Id.*

> The cause of action when a stockholder sues is dual in composition, consisting of the basic cause of action, which pertains to the corporation and on which it might have sued, and the derivative cause of action, pertaining to the stockholder, consisting in the fact that the corporation will not or cannot sue for its own protection. Both elements are essential.

Id. See also Ross v. Bernhard, 396 U.S. 531, 538 (1970).

29. *See* H. HENN, *supra* note 12, § 358, at 750; 73 HARV. L. REV. 746, 748 (1960).

30. *See* H. HENN, *supra* note 12, § 358, at 750; 73 HARV. L. REV., *supra* note 29, at 750.

the exposure of the corporation to strike suits,[31] the use of manufactured pleadings to gain discovery for the purpose of finding a claim to assert,[32] and the increased potential for private settlements between the corporation and the plaintiff.[33] In addition to these abuses, derivative litigation is "often protracted, time-consuming for corporate management, and very expensive."[34] Moreover, the increased use of the derivative suit tends to shift corporate governance from the centralized board of directors to the shareholders, or even to one shareholder.

Some jurisdictions have constructed barriers to the bringing of shareholder derivative suits to eliminate the perceived problems that accompany these suits. Among these obstacles are various stock ownership requirements, including ownership of stock at the commencement of the suit, during the pendency of the suit, and at the time of the alleged harm to the corporation.[35] Some jurisdictions require the plaintiff-shareholder to post security for expenses, including attorney's fees.[36] In addition, some jurisdictions impose special statutes of limitations.[37]

The most important obstacle facing the shareholder-plaintiff in a derivative action is the requirement that he make a demand on the board of directors to bring suit to remedy the alleged harm,[38] or demonstrate that a demand on the board would be fu-

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31. H. HENN, *supra* note 12, § 358, at 752 n.22. *Black's Law Dictionary* defines a strike suit as a "[s]hareholder derivative action begun with hope of winning large attorney fees or private settlements, and no intention of benefiting corporation on behalf of which suit is theoretically brought." BLACK'S LAW DICTIONARY 1276 (5th ed. 1979). One commentator claims that this "definition is overly broad and raises the spectre of evils that may not exist." Kim, *The Demand on Directors Requirement and the Business Judgment Rule in the Shareholder Derivative Suit: An Alternative Framework*, 6 J. CORP. L. 511, 525 (1981). Hence, a more limited definition may be more appropriate. A "strike suit, therefore, would be a suit commenced for the purpose of obtaining a private settlement or to annoy or embarrass the defendants." *Id.* at 526. Under either definition, the strike suit produces no benefit to society and should be prevented.

32. *See* Dent, *supra* note 13, at 140-42.

33. *See* H. HENN, *supra* note 12, § 358, at 752.

34. *Id.*

35. *Id.* §§ 361-363.

36. *Id.* § 372.

37. *Id.* § 357.

38. *See* Hawes v. Oakland, 104 U.S. 450, 460-61 (1881); H. HENN, *supra* note 12, §§ 364-366. The basis for the requirement of the demand on the board is found in Federal Rule of Civil Procedure 23.1, which requires the shareholder to "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort." FED. R. CIV. P. 23.1.

tile.[39] Several justifications exist for the demand requirement. First, since the shareholder's claim is based on a corporate claim, the corporation is the real party in interest.[40] Second, the demand requirement offers corporate management an opportunity to remedy the matter without the expense, publicity, and delay of litigation.[41] Last, the demand requirement allows the corporation's board of directors to control the litigation of an action that was brought on the corporation's behalf in the first place, and thereby to afford the directors the opportunity to conduct the corporation's affairs.[42] Thus, the underlying rationale for the demand requirement is to ensure that the plaintiff-shareholder has exhausted all intracorporate remedies.[43]

Notwithstanding the compelling reasons for requiring a plaintiff-shareholder to make a demand on the corporation's board of directors, the demand requirement is excused in situations "where hostility on the part of the directors makes such a demand futile."[44] Courts have excused demand when the alleged wrongdoers constituted a majority of the board,[45] when the wrongdoers controlled the board,[46] and when the board approved the alleged wrongful transaction.[47] Thus, while the demand requirement ensures that the shareholder has attempted to obtain relief for the corporation through the normal corporate governance system, judicial waiver of the demand requirement when the board is biased allows the shareholder to obtain relief for the corporation when the internal corporate governance system malfunctions.

Once the shareholder-plaintiff makes demand on the board, the board must decide whether or not to take over the claim. A refusal to sue by the board, however, may not end the litigation.

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39. FED. R. CIV. P. 23.1.

40. *See* 73 HARV. L. REV., *supra* note 29. *See also* H. HENN, *supra* note 12, § 358, at 750.

41. *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 171 (1976).

42. Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975).

43. H. HENN, *supra* note 12, § 364. *See also* 73 HARV. L. REV., *supra* note 29, at 748-49. The demand requirement also serves to notify the directors of the alleged cause of action, notify the shareholders who can remedy the problem by voting out the directors, and give the board an opportunity to settle the dispute without litigation and foster judicial economy. *Id.*

44. H. HENN, *supra* note 12, § 365, at 771.

45. *See, e.g.*, Reed v. Norman, 48 Cal. 2d 338, 309 P.2d 809 (1957).

46. *See, e.g.*, Meltzer v. Atlantic Research Corp., 330 F.2d 946 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964).

47. *See* American Life Ins. Co. v. Powell, 262 Ala. 560, 80 So. 2d 487 (1954).

Most courts conclude "that the board's refusal to sue falls within the business judgment rule"[48] and will dismiss the derivative suit. Courts generally will not dismiss when the shareholder can "demonstrate that the board's decision not to sue was *ultra vires*, . . . [fraudulent], in bad faith, [or] in breach of trust,"[49] or that the board was involved in the wrongdoing.[50] In addition, courts generally will not dismiss a derivative suit that names a majority of directors as defendants.[51] Since a shareholder can bypass the demand requirement and override a board decision not to sue when a majority of the directors are defendants, plaintiff-shareholders invariably name the entire board of directors as defendants.[52]

Even if the court has excused demand, the corporation may still move for dismissal of the derivative action on the ground that the suit is not in the corporation's best interest. Whether the court will dismiss the suit on this motion usually depends upon the applicability of the business judgment rule to the facts of the case.

B. The Applicability of the Business Judgment Rule in the Context of the Shareholder Derivative Suit

1. The Traditional Business Judgment Rule

The courts developed the business judgment rule to encourage the resolution of corporate disputes within the corporate structure and to bolster state statutes that favored the centralization of corporate governance in the board.[53] This rule insulates officers and directors from personal liability for mistakes of judgment made in good faith.[54] The rule stems from the notion that a court should not substitute its judgment for the board's judgment on business matters.[55] Nevertheless, the business judgment rule does not completely absolve directors from personal liability for their acts. If the directors do not in fact exercise their judgment independently, in good faith, and with due care, then courts will not insulate them

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48. *See* Dent, *supra* note 13, at 100. *See also* notes 53-136 *infra* and accompanying text.

49. Dent, *supra* note 13, at 102.

50. *Id.*

51. *Id.* at 105.

52. *Id. See also* Kim, *supra* note 31, at 514; Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 630 n.147 (1980).

53. Estes, *Corporate Governance in the Courts*, HARV. BUS. REV., Jul.-Aug. 1980, at 50.

54. L. SODERQUIST, CORPORATIONS: A PROBLEM APPROACH 325 (1979).

55. *Id.* at 325 n.6.

from personal liability.[56]

2. The Use of the Business Judgment Rule in Shareholder Derivative Suits

With the exception of the Delaware Supreme Court's ruling in *Zapata*,[57] courts generally treat board decisions on whether to pursue shareholder derivative suits the same as they treat other business decisions.[58] If a board makes a good faith decision to refrain from pursuing a legal claim, then the courts will apply the business judgment rule and not interfere with the decision.[59] For example, in *Corbus v. Alaska Treadwell Gold Mining Co.*[60] the United States Supreme Court stated,

> The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right.[61]

The Supreme Court extended the applicability of the business judgment rule to the corporation's motion to dismiss a shareholder derivative suit in *United Copper Securities Co. v. Amalgamated Copper Co.*[62] In *United Copper* the Court used the business judgment rule to protect the board's good faith decision[63] to dismiss a shareholder derivative suit which alleged that the directors violated antitrust laws.[64] According to one court, "the essence of the business judgment rule in this context is that directors may freely find that certain *meritorious* actions are not in the corporation's best interests to pursue."[65] Thus, the business judgment rule evolved from a defensive measure shielding directors from personal

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56. *Id.*

57. *See* notes 159-82 *infra* and accompanying text.

58. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917). The Court found that "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors . . . ." *Id.*

59. *Id.* "Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment . . . ." *Id.*

60. 187 U.S. 455 (1903).

61. *Id.* at 463.

62. 244 U.S. 261 (1917). *See* notes 58-59 *supra.*

63. 244 U.S. at 264.

64. *Id.* at 262-63.

65. Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980) (emphasis in original). *See* notes 146-50 *infra* and accompanying text.

liability into an offensive weapon permitting directors to terminate shareholder derivative suits.[66] The offensive use of the business judgment rule confers considerable powers on the board to terminate derivative litigation, regardless of the merits, and is conditioned only on the board's exercise of good faith and independence.[67]

Although the board usually has considerable control over derivative litigation, courts will limit this control by refusing to apply the business judgment rule when strong evidence demonstrates that the board is biased against the suit.[68] Thus, in cases in which the shareholder names some or all of the directors as defendants, the board likely would be biased and, therefore, would loose its authority over the disposition of the suit. In response to this problem, many corporate boards have delegated to special litigation committees the authority to decide whether to pursue the derivative action.[69]

The special litigation committees are usually composed of disinterested directors, recently appointed outside directors, eminent professors, prominent former judges, and outside counsel.[70] In their investigation of the lawsuit the committees generally consider the cost of litigation, the possibility of interrupting business and undermining personnel morale, the nature and effect on the corporation of the alleged harm, and the likelihood of any recovery. After weighing these considerations, the committee decides whether continuation of the suit is in the best interests of the corporation. The committee then recommends that the corporation either move for dismissal or pursue the suit. Not surprisingly, in all reported cases the litigation committees have recommended termination of the derivative suit on the ground that the suit does not serve the best interests of the corporation.[71]

At least one commentator has claimed that the practice of ap-

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66. *See* Comment, *Offensive Application of the Business Judgment Rule to Terminate Nonfrivolous Derivative Actions: Should the Courts Guard the Guards?*, 12 TEX. TECH. L. REV. 635, 639-40 (1981).

67. *See* Johnson & Osborne, *The Role of the Business Judgment Rule in a Litigious Society*, 15 VAL. U.L. REV. 49, 52-56 (1980).

68. *See* notes 44-47 *supra* and accompanying text.

69. *See* Estes, *supra* note 53, at 52. In these cases most corporate boards delegate full authority over the disposition of the suit to the committee. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981) ("The Committee's determination was stated to be 'final, . . . not . . . subject to review by the Board of Directors and . . . in all respects . . . binding upon the Corporation.' ").

70. *See* notes 196 & 205 *infra*.

71. Dent, *supra* note 13, at 109 n.70.

pointing a special litigation committee to investigate shareholder derivative actions may lead to "the demise of the derivative suit":[72]

> When faced with a derivative suit, defendant directors will invariably request an investigation and decision by some fellow directors as to whether the suit is in the best interests of the corporation. The defendants have nothing to lose in so doing—at worst, the nonimplicated directors will decide to take over the suit, or to take a neutral stance toward the suit, leaving the defendants no worse off than when they started. More important, the prospect of such a decision is minimal; almost invariably, the directors charged with the decision decide to oppose the suit. In most cases, this opposition will result in dismissal of the suit. . . .[73]

Conflicting interests must be balanced in determining the extent to which special litigation committees should be permitted to seek the dismissal of derivative suits. On the one hand, if corporations can consistently terminate bona fide derivative actions through "the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors."[74] On the other hand, if corporations are unable to terminate trivial, meritless, or harmful litigation merely because plaintiffs named directors as defendants, then the derivative suit could prove deleterious to the corporation.[75]

C. *The Offensive Use of the Business Judgment Rule to Terminate Shareholder Derivative Suits*

1. The Test Announced in *Burks v. Lasker*

In *Burks v. Lasker*[76] the United States Supreme Court established the general framework for determining whether a corporation's litigation committee could employ the business judgment rule to dismiss a shareholder derivative suit. In *Burks* two stockholders of an investment company[77] brought a derivative suit against the corporation's investment adviser and half of the board of directors. In 1969 the company purchased $20 million of Penn Central commercial paper.[78] Six months after the purchase, Penn Central filed for a bankruptcy reorganization, and, as a result of

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72. *Id.* at 109.
73. *Id.* (footnotes omitted).
74. Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981).
75. *See id.* at 786-87; Olson, *supra* note 10.
76. 441 U.S. 471 (1979).
77. The investment company was domiciled in Delaware. Lasker v. Burks, 567 F.2d 1208, 1210 n.5 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).
78. 441 U.S. at 473-74.

the bankruptcy, the notes were not paid.[79] The shareholders claimed that the directors breached their fiduciary duties to the corporation by improvidently purchasing the notes.[80] In addition, the shareholders alleged violations of the Investment Company Act of 1940[81] and the Investment Adviser Act of 1940.[82] The corporation's entire board of directors delegated the authority to decide whether to pursue the lawsuit to a special committee, which consisted of the five remaining nondefendant directors.[83] After investigating the shareholders' claims for five months, the committee recommended that the corporation move for dismissal of the derivative suit on the ground that the lawsuit was contrary to the corporation's best interests.[84]

The district court held that the business judgment rule is applicable to the committee's decision to dismiss the derivative suit.[85] Consequently, the district court granted the corporation's motion for summary judgment.[86] The Court of Appeals for the Second Circuit reversed, finding that under the federal statutes the corporation had no authority to dismiss a shareholder derivative suit notwithstanding the committee's independence and good faith.[87] Moreover, the Second Circuit found that the business judgment rule is never applicable to litigation committee decisions on shareholder derivative suits.[88] The court reasoned that a litigation committee composed of nondefendant directors could never be unbiased and independent when evaluating whether to continue derivative litigation brought against other directors:

> It is asking too much of human nature to expect that the [special litigation committee of nondefendant directors] will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned.[89]

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79. *Id.* at 474 n.3.

80. *Id.* at 473-74.

81. 15 U.S.C. §§ 80a-1 to -52 (1976).

82. *Id.* §§ 80b-1 to -21 (1976).

83. Lasker v. Burks, 567 F.2d 1208, 1209-10 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).

84. The committee was very diligent in undertaking its investigation. The committee met in private and retained former chief judge of the New York Court of Appeals, Stanley H. Fuld, as special counsel. *Id.*

85. Lasker v. Burks, 426 F. Supp. 844 (S.D.N.Y. 1977), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).

86. *Id.* at 853.

87. 567 F.2d 1208, 1212 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).

88. *Id.*

89. *Id.*

Disapproving the structural bias[90] argument advanced by the court of appeals, the Supreme Court reversed.[91] The Court held that federal courts should apply the state law that governs the authority of independent directors to discontinue derivative suits unless there is evidence of bias within the board.[92] Since at the time of *Burks*, all state courts employed a business judgment rule analysis,[93] the Supreme Court's decision in effect directed federal courts to determine under the law of the appropriate state whether the particular corporate board may use the business judgment rule to dismiss derivative actions. The Court held that if state law permits business judgment dismissal of the derivative suit, then federal courts must dismiss the action unless the dismissal controverts federal policy.[94] The Court rejected the Second Circuit's structural bias argument: "[L]ack of impartiality may or may not be true as a matter of fact in individual cases . . . , [but] it is not a conclusion of law. . . ."[95] Since the lower courts had not considered state law, the Court remanded the case for further evaluation in light of Delaware law.[96]

In *Burks* the Supreme Court announced a two-step test for federal courts to follow in evaluating a corporation's motion to dismiss a derivative suit. First, the court examines whether the applicable state law permits independent directors to dismiss a derivative action on the basis of the business judgment rule.[97] Second, if the relevant state law permits dismissal of the derivative suit, then the court determines whether dismissal of the suit would conflict with federal policy.[98] If dismissal of the suit conflicts with federal policy, then the suit will not be dismissed; if no such conflict exists, the suit will be dismissed. Most cases since *Burks* have applied the business judgment rule in dismissing shareholder derivative suits.[99] These cases generally fall into two categories—suits alleging illegal foreign payments[100] and suits alleging breaches of fiduciary duty

90. For a discussion approving of the court of appeals' structural bias argument, see Note, *supra* note 52.

91. Burks v. Lasker, 441 U.S. 471, 486 (1979).

92. *Id.* at 485 n.15.

93. *See* text accompanying notes 58-59 *supra*.

94. 441 U.S. at 486.

95. *Id.* at 485 n.15.

96. *Id.* at 486.

97. *Id.* at 478, 480.

98. *Id.* at 480-81.

99. *See* notes 102-36 *infra* and accompanying text.

100. *See* notes 102-14 *infra* and accompanying text.

and federal securities violations.[101] Most of the cases were brought in federal courts and were decided under the *Burks v. Lasker* guidelines.

2. Derivative Suits Alleging Illegal Foreign Payments

Several post-*Burks* derivative suits arose in the context of questionable foreign payments.[102] For example, in *Auerbach v. Bennett*[103] shareholders alleged that directors of General Telephone and Electronics Corporation breached their fiduciary duty to the corporation by making and authorizing bribes and kickbacks to foreigners.[104] A special litigation committee of three nondefendant directors[105] determined that the suit was not in the corporation's best interests and recommended dismissal.[106] The New York Court of Appeals strictly applied the business judgment rule and upheld the lower court's entry of summary judgment.[107] Limiting its review to the independence of the committee,[108] the court noted, "[C]ourts cannot inquire as to which factors were considered by that committee or the relative weight accorded them in reaching that substantive decision. . . . To permit judicial probing of such issues would be to emasculate the business judgment doctrine."[109]

In *Abbey v. Control Data Corp.*[110] a shareholder sued to compel certain officers and directors of the corporation to reimburse the corporation for substantial penalties levied on it as a result of

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101. *See* notes 115-36 *infra* and accompanying text.

102. Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

103. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

104. *Id.* at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. For an extensive review of the facts of *Auerbach*, see 25 VILL. L. REV. 551 (1980).

105. 47 N.Y.2d at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. The three directors joined the board after the questionable payments had been made.

106. *Id.* at 625-26, 393 N.E.2d at 997, 419 N.Y.S.2d at 923-24. The committee cited several reasons to support terminating the derivative suit: (1) the directors had not violated their duty of care; (2) the directors did not personally profit; (3) the continuation of the suit would detrimentally divert corporate resources; (4) the cost of litigation was prohibitive in view of the probability of success; and (5) the suit would bring adverse publicity to the corporation. *Id.*

107. *Id.* at 626, 393 N.E.2d at 998, 419 N.Y.S.2d at 924.

108. *Id.* at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.

109. *Id.* at 633-34, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.

110. 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

illegal payments to foreign officials. The shareholder also alleged securities violations based on misleading proxy statements issued by the corporation. The board appointed a special litigation committee of nondefendant directors. The Eighth Circuit Court of Appeals found that under Delaware law the business judgment rule permits the good faith termination of derivative litigation by a committee of independent directors.[111] In addition, the court found that dismissal of the derivative suit would not conflict with federal policy, because the harm to the corporation was the result of the misuse and waste of corporate assets, ordinarily matters of state law.[112] The misleading proxies, which are governed by federal securities law, were not the cause of the harm.[113] Accordingly, the court dismissed the derivative suit.[114]

Auerbach and *Abbey* held that state law permits an independent committee of disinterested directors to terminate derivative suits in the context of questionable foreign payments. Most cases concerning the dismissal of derivative suits, however, arise in the context of federal securities violations.

3. Federal Securities Violation—Breach of Fiduciary Duty Cases

Courts ruling on corporation motions to dismiss derivative suits alleging federal securities violations[115] have followed the *Burks v. Lasker* two-step test.[116] For example, in *Lewis v. Anderson*[117] minority shareholders sued Walt Disney Productions and a majority of the board for violating the federal securities laws.[118] The board appointed a special litigation committee to investigate the lawsuit and to decide whether the corporation should continue the derivative suit. The special litigation committee included two recently appointed outside directors and a defendant director who had acquiesced in the granting of the stock options.[119] After an ex-

111. *Id.* at 730.

112. *Id.* at 731-32.

113. *Id.* at 732.

114. *Id.*

115. For a discussion of federal securities policy in connection with the business judgment dismissal of derivative litigation, see Block & Barton, *The Business Judgment Rule as Applied to Stockholder Proxy Derivative Suits Under the Securities Exchange Act*, 8 SEC. REG. L.J. 99 (1980).

116. *See* notes 97-98 *supra* and accompanying text.

117. 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

118. *Id.* at 780. The shareholders claimed that a majority of the board violated federal securities laws by granting certain stock options.

119. *Id.* The committee retained independent legal counsel to assist it in the investigation.

tensive investigation, the committee recommended dismissal of the derivative suit on the basis that the suit was not in the best interests of the corporation, and the district court granted the motion.[120] On appeal, the Ninth Circuit found that the litigation committee was unbiased notwithstanding the presence of a defendant-director. The court held that the defendant-director was disinterested simply because he did not benefit from the stock options.[121] Applying the *Burks* test, the court found that under California law, even when a majority of the board is named as defendants,[122] the business judgment rule is applicable to a litigation committee's decision to terminate a derivative suit. The court stated that "*Auerbach* and *Abbey* reflect a clear trend in corporate law, and we are confident that a California court would follow this trend."[123] After finding that California law would permit dismissal of the derivative suit, the court concluded that dismissal would not frustrate federal policy.[124] Accordingly, the court affirmed the lower court's decision to dismiss the case.[125]

The Second Circuit reached a different result on similar facts in *Galef v. Alexander*.[126] In *Galef* shareholders claimed that all of the corporation's directors had breached their fiduciary duty to the corporation and violated federal securities laws. The shareholders alleged that the entire board allowed several directors to profit unfairly by granting stock options to certain officer-directors at an unauthorized reduction in the exercise price.[127] Plaintiff-shareholders named the remaining directors as defendants because of their acquiescence in the transaction.[128] Also, the shareholders alleged that the board violated the federal securities laws because of inadequate disclosure of the stock option plans in proxy statements issued by the board.[129] Following an investigation by outside counsel, a majority of the board, with only those directors who did not receive options voting, moved to dismiss the derivative suit.[130] The

120. *Id.* at 780.
121. *Id.*
122. *Id.* at 781-83.
123. *Id.* at 783.
124. *Id.* at 783-84. For a criticism of the *Lewis* court's reasoning concerning the frustration of federal policy question, see Block & Barton, *supra* note 115.
125. 615 F.2d at 784.
126. 615 F.2d 51 (2d Cir. 1980).
127. *Id.* at 53-54.
128. *Id.* at 54.
129. *Id.* at 55.
130. *Id.* at 56. Although the six board members who had received stock options were excluded from voting, the potential for bias was arguably not siguificantly reduced because

district court granted the corporation's motion to dismiss.[131] On appeal, the Second Circuit applied the two-step test from *Burks v. Lasker* and reversed.[132] On the state law question, the court found that although Ohio law was unclear, Ohio courts might apply the business judgment rule to a decision by financially disinterested defendant-directors to dismiss a derivative suit.[133] The Second Circuit remanded the case to the district court to ascertain whether Ohio law permits financially disinterested defendant-directors to terminate shareholder derivative suits under the business judgment rule.[134] Nevertheless, applying the second step of the *Burks* test, the court held that even if Ohio law permits dismissal, federal policy requiring full disclosure in proxy statements "would quite clearly be frustrated"[135] if the defendant-directors were permitted a business judgment dismissal of the derivative suit. The court, however, noted that even though the federal claims could not be dismissed, on remand partial summary judgment might be allowed under Ohio law for the state claims.[136]

III. ZAPATA CORP. v. MALDONADO

A. *The Facts*[137]

In 1970 the board of directors of Zapata Corporation adopted a stock option plan for certain of the company's officers and directors. The plan established a purchase price of $12.15 per share for Zapata common stock and an exercise deadline of July 14, 1974. In early 1974, however, Zapata was planning to announce a tender offer for 2.3 million of its own shares prior to the final exercise date of the stock options. The board expected the announcement to increase the market price of Zapata stock from about eighteen dollars per share to the tender offer price of twenty-five dollars per share. Anticipating the tender offer announcement, Zapata's directors, most of whom were holders of the stock options, accelerated

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the nine directors who did vote were all named as defendants in the derivative action. The board's failure to create an independent litigation committee of new, outside directors may be an important distinction between *Galef* and decisions that have allowed dismissal. *See* notes 150, 196 & 205 *infra* and accompanying text.

131. 615 F.2d at 57.

132. *Id.* at 64.

133. *Id.*

134. *Id.* at 64 n.20.

135. *Id.* at 66-67.

136. *Id.* at 63-64.

137. For a complete statement of the facts, see Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980).

the exercise date to July 2, 1974. On July 2 the insider-optionees exercised their options,[138] and on July 8 Zapata announced the tender offer.

In June 1975 Maldonado, a Zapata shareholder, brought a derivative action in the Delaware Court of Chancery against all of Zapata's directors alleging a breach of fiduciary duty. Maldonado also brought a derivative action in federal court against the same defendants alleging both the breach of fiduciary duty and a violation of federal securities laws, particularly section 14(a) of the Securities Exchange Act of 1934.[139] Since all the directors were named as defendants[140] Maldonado was not required to make demand[141] on the corporation to sue. In addition, another shareholder brought a similar derivative action in the Southern District of Texas.[142]

In 1979 the Zapata board created an "Independent Investigation Committee" composed of two recently appointed outside directors to investigate both of Maldonado's actions and the action brought in Texas.[143] The committee determined that continuation of the lawsuits would be "inimical to the Company's best interests."[144] Consequently, Zapata filed a motion for dismissal or summary judgment in all three derivative actions.[145]

B. Maldonado I

The United States District Court for the Southern District of New York was the first court to rule on Zapata's motion to dismiss

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138. *Id.* at 1254. Plaintiff-shareholders alleged that the acceleration of the exercise date enahled the directors to avoid substantial additional federal income tax and accordingly deprived the corporation of a tax deduction of a comparable amount. The insider-optionees saved taxes because the amount of capital gain for federal income tax purposes equals the difference between the option price and the market price on the exercise date of the option. Since the options were exercised before the announcement of the tender offer, the capital gain equaled approximately $6.35—the market price of $18.50 less the option price of $12.15. If the options had been exercised after the tender offer announcement (without the acceleration), the capital gain would have equaled about $12.85—the tender offer price of $25 less the option price of $12.15. Defendants denied these allegations. *Id.* at 1255.

139. 15 U.S.C. § 78n(a) (1976).

140. Zapata Corp. v. Maldonado, 430 A.2d 779, 780 (Del. 1981).

141. For a discussion of the requirement that a plaintiff make demand on the corporation to sue before instituting a derivative action, see notes 38-47 *supra* and accompanying text.

142. Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980).

143. Zapata Corp. v. Maldonado, 430 A.2d at 781.

144. *Id.*

145. *Id.*

the derivative suit.[146] Applying the *Burks v. Lasker* guidelines, the court first examined whether Delaware law permits independent directors to compel the business judgment dismissal of derivative suits against fellow directors. Recognizing that no Delaware court had ruled on the matter, the district court, nevertheless, decided that

> under Delaware law a committee of disinterested directors, properly vested with the power of the board, may in the exercise of their business judgment require the termination of a derivative suit brought on the corporation's behalf even though other directors are disqualified from participating in such a decision because they are named as defendants in the suit.[147]

After deciding that Delaware law would permit dismissal of the action, the court examined whether dismissal would frustrate federal policy. The court reasoned that business judgment dismissal of the derivative suit "does not infringe directly upon the protections accorded investors by the regulatory scheme of section 14(a) . . . [because it] does not condone conduct violative of that section."[148] Moreover, the court noted that dismissal of the derivative action would not preclude private enforcement of Maldonado's claim, because even if the corporation did not bring suit Maldonado could assert a section 14(a) claim either individually or as a class action on behalf of all shareholders.[149] Finally, the court carefully distinguished *Galef* from the *Maldonado* situation. According to the court, *Galef* was based on a determination that the directors responsible for the decision not to terminate the suit were not disinterested. Furthermore, the *Maldonado I* court observed that *Galef* had not addressed "whether a state rule permitting nondefendant directors or an independent committee to initiate a business judgment dismissal contravenes federal policy, the very issue addressed here."[150]

C. Maldonado II

Two months after the federal court decision, the Delaware Chancery Court denied Zapata's motion to dismiss.[151] The chancel-

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

147. *Id.* at 279-80.

148. *Id.* at 281.

149. *Id.* By suggesting that shareholders could bring suits individually, the court failed to take into account one of the major reasons for the derivative suit—the prevention of multiple suits on essentially the same corporate cause of action.

150. *Id.* at 286 n.44.

151. Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980). Nevertheless, the chancery court subsequently dismissed Maldonado's derivative suit on the basis that the federal court

lor found that the business judgment rule does not confer power on a board or board committee to terminate a derivative suit.[152] The chancery court criticized the offensive use of the business judgment rule:

> [T]he business judgment rule is merely a presumption of propriety accorded decisions of corporate directors. It provides a shield with which directors may oppose stockholders' attacks on [their] decisions; . . . hut nothing in it grants any independent power to a corporate board of directors to terminate a derivative suit. The authority to terminate a derivative suit must he found—if at all—outside the rule. . . . While the business judgment rule may protect the Committee of Independent Directors of Zapata from personal liability if they have made a good faith decision that this suit is not in the best interests of Zapata, . . . the business judgment rule is irrelevant to the question of whether the Committee has the authority to compel the dismissal of this suit.[153]

Because derivative suits have a dual nature, the chancellor reasoned that a corporation does not have the authority to dismiss a shareholder derivative suit. The chancellor found that a corporation controls the corporate cause of action but has no authority over the individual cause of action.[154] Once the corporation expressly or impliedly refuses to assert the corporate claim, the individual right to maintain the suit "ripens"; the corporation "can no longer control the destiny of [the] suit . . . and cannot compel the dismissal"[155] of the derivative action.[156]

In *Maher v. Zapata Corp.*[157] the federal district court in Texas closely followed the Delaware Chancery Court's decision. Although the Delaware Supreme Court had not addressed the issue, the district court following the *Burks* approach, concluded, "Since Delaware law does not permit independent directors to terminate a derivative action against other board members, this Court need not address whether . . . dismissal [of the derivative suit] is consistent with the policies of the federal securities act. . . ."[158]

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decision was res judicata. Maldonado v. Flynn, 417 A.2d 378 (Del. Ch. 1980). The court, however, expressly conditioned the dismissal on affirmance of the district court's decision by the Second Circuit. *Id.* at 384. Later, the Second Circuit appeal was stayed pending the ultimate decision by the Delaware Supreme Court. Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981).

152. Maldonado v. Flynn, 413 A.2d at 1262.

153. *Id.* at 1257 (citations omitted).

154. *Id.* at 1262.

155. *Id.*

156. *See* Abramowitz v. Posner, 513 F. Supp. 120, 126-29 (S.D.N.Y. 1981) (specifically rejecting the chancery court result).

157. 490 F. Supp. 348 (S.D. Tex. 1980). The district court quoted extensively from the Delaware Chancery Court's opinion.

158. *Id.* at 353.

IV. THE DELAWARE SUPREME COURT RULES: ZAPATA CORP. v. MALDONADO[159]

As a result of the conflicting decisions concerning Maldonado's derivative suit the Delaware Supreme Court faced a "procedural gridlock."[160] First, the federal district court in New York dismissed Maldonado's derivative suit, and he appealed to the Second Circuit. Second, the Delaware Chancery Court held that Zapata Corporation could not dismiss the suit and the corporation appealed to the Delaware Supreme Court. Third, in a subsequent opinion the Delaware Chancery Court dismissed Maldonado's derivative suit on the ground that the federal court's decision was res judicata. However, the Chancery Court conditioned the dismissal on subsequent affirmance by the Second Circuit. Last, the Second Circuit appeal was stayed pending the decision by the Delaware Supreme Court.

The Delaware court framed the issue narrowly—whether Delaware law authorizes a directors' committee to cause a derivative action to be dismissed.[161] Despite this limitation the court provided a lengthy analysis of the various issues contained in the case and then presented a two-step test for determining whether to dismiss shareholder derivative suits. The court began its analysis by agreeing with the chancery court that the business judgment rule does not authorize corporate boards or their litigation committees to dismiss derivative suits. Rather, the court found that the board's authority, including the authority to dismiss shareholder litigation, derives from section 141(a) of the Delaware Corporation Laws.[162] With the basis for the board's authority settled, the court divided the case into three aspects: (1) Whether a shareholder has a continuing right to maintain a derivative action; (2) whether a duly authorized committee of directors has the power under Delaware law to compel dismissal of a derivative suit; and (3) the role the chancery court should perform "in resolving conflicts between the stockholder and the committee."[163]

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159. 430 A.2d 779 (Del. 1981).

160. *Id.* at 781.

161. *Id.*

162. *Id.* DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1980), provides that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . . "

163. 430 A.2d at 782.

A. *The Shareholder's Right to Maintain a Derivative Action*

The Delaware Supreme Court rejected the chancery court's determination that once demand on the board is made and refused a stockholder possesses an independent right to continue the derivative suit over the corporation's objection. The court found that the stockholder's right to bring suit on behalf of the corporation is not absolute.[164] On the contrary, the court held that the corporation's decision not to sue terminates a shareholder derivative suit unless the refusal was wrongful[165] or demand on the board would be futile.[166]

B. *The Power of the Independent Committee*

The court then addressed the question whether an authorized board committee may dismiss properly initiated shareholder derivative suits. Recognizing that "[e]ven when demand is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests,"[167] the court inquired whether under such circumstances Delaware law would provide a procedure with which a corporation could terminate derivative litigation. The court stated its concern in this way:

> If there is not [such a procedure], a single stockholder in an extreme case might control the destiny of the entire corporation. . . . "To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders." But, when examining the means, including the committee mechanism . . . , potentials for abuse must be recognized.[168]

Nevertheless, because section 141(c) of the Delaware Corporation Laws allows a board to delegate all of its authority to a committee, the court found that an independent committee has the authority of the corporation to move to dismiss a derivative suit.[169] The court found that the board never loses "its statutory managerial authority";[170] rather, when the board's decision not to sue is wrongful, the courts will simply not respect that decision. Simi-

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164. *Id. See also* Abramowitz v. Posner, 513 F. Supp. 120, 128-29 (S.D.N.Y. 1981).

165. 430 A.2d at 784. For example, the board's decision is wrongful if it is made in self-interest as a result of bias.

166. *Id.* Courts generally excuse the demand requirement in cases when demand would be useless. *See* text accompanying notes 44-47 *supra.*

167. 430 A.2d at 785.

168. *Id.* (quoting Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979), *cert. denied,* 449 U.S. 869 (1980)); *see* notes 117-25 *supra* and accompanying text.

169. 430 A.2d at 785.

170. *Id.*

larly, the excusal of demand does not remove the board's authority. The excusal "merely saves the plaintiff the expense and delay of making a futile demand."[171] Hence, the court decided that the actual question presented was whether a tainted board could delegate its managerial authority to an independent committee—a question of "membership disqualification, not the absence of power in the board."[172] The court concluded that a board can legally delegate its authority to a committee of disinterested directors even when a majority of the board is tainted by self-interest.[173]

C. *A Role for the Trial Court: The* Zapata *Two-Step Test*

Having established that an independent committee retains the authority to move for dismissal of a derivative suit, the court then attempted to balance the competing interests presented in shareholder derivative actions.[174] The court rejected the business judgment rule approach, which other courts had used to resolve these cases,[175] because of the risk of abuse inherent in a situation in which directors must decide whether to expose fellow directors to liability.[176]

The court proposed a two-step test for courts to follow when evaluating a corporation's motion to dismiss. First, the trial court should evaluate the independence and good faith of the committee and the reasonableness of its decision.[177] The court placed the burden of proof on the corporation to demonstrate the good faith, independence, and reasonableness of the committee.[178] Second, if the corporation passes the first step of the test, the trial court should

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171. *Id.* at 786.

172. *Id.*

173. *Id.*

174. *Id.* at 786-87. The shareholders have an interest in preventing the board of directors from unfairly terminating shareholder derivative suits, and the corporation has an interest in dismissing trivial and harmful litigation. *See* notes 74-75 *supra* and accompanying text.

175. *See, e.g.*, Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

176. 430 A.2d at 787. The *Zapata* court noted that under the traditional business judgment rule a court would review only the independence, good faith, and reasonable investigation of the committee. "The ultimate conclusion of the committee, under that view, is not subject to judicial review." *Id.*

177. *Id.* at 788-89. The trial court may authorize discovery to assist it in its evaluation of the committee's good faith and independence and the reasonableness of its decision. *Id.*

178. *Id.*

apply its own business judgment to determine whether dismissal is appropriate.[179] The Delaware court recognized that under its second step situations might arise in which a corporation's motion for dismissal would be denied even though the committee could establish its independence and the good faith and reasonableness of its decision.[180] Instead of limiting the chancery court's examination to its own business judgment, the court added that the chancery court should "give special consideration to matters of law and public policy in addition to the corporation's best interests"[181] when judging a corporation's motion to dismiss a shareholder derivative suit. If the corporation satisfies both steps, the court may grant the motion. The Delaware court remanded the case for further consideration in light of the newly announced test.[182]

V. ANALYSIS

In *Zapata Corp. v. Maldonado* the Delaware Supreme Court recognized the need to balance adequately the competing interests of the shareholder in maintaining a derivative action and the corporation in dismissing detrimental litigation. It is questionable, however, whether the court's two-step test adequately balances those interests. This section of the Recent Development analyzes

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179. *Id.* at 789.

180. *Id.* The Delaware court did not give an example of a situation in which dismissal would be denied despite a showing of good faith, independence, and reasonableness. When a corporation has passed this first step of the *Zapata* test, the court might still find dismissal inappropriate in two types of cases. First, a court would deny dismissal if it found the committee's decision to be incorrect. In close cases the court might find that although the committee's decision was reasonable, the court disagrees and believes that it would be in the best interests of the corporation to deny dismissal. This type of ruling is never appropriate. The court should defer to the committee's business judgment and not intrude on the corporation's decisionmaking process by requiring it to conduct litigation that it believes to be detrimental. *See* note 199 *infra.*

Second, a court would deny dismissal if, after giving "special consideration to matters of law and public policy," 430 A.2d at 789, the court finds that the litigation should be pursued. Perhaps a court would find that public policy outweighs the deleterious effects on the corporation when the corporation's board of directors has committed a technical violation of the securities laws. Litigation of the matter might reasonably be concluded to be more harmful to the corporation than the benefit to be received when the litigation fees and the corporate embarrassment are weighed against the potential recovery. Nevertheless, the court might conclude that public policy demands rigid enforcement of the law. This type of judicial determination will almost always be inappropriate. A corporation is not likely to vigorously pursue a claim it has determined is not in its best interests. *See* note 199 *infra.*

181. 430 A.2d at 789. The second step of the *Zapata* test is very similar to the second step of the *Burks* test. Both require the court to examine "matters of law and public policy" in addition to the corporation's best interests. *See* text following note 199 *infra.*

182. 430 A.2d at 789.

the Delaware court's holding that the business judgment rule is not applicable in determining whether the board of directors has the authority to seek dismissal of shareholder derivative suits. This section also examines both steps of the *Zapata* test and the effect of the *Zapata* decision on future federal cases that apply Delaware law.

Zapata correctly held that the business judgment rule is irrelevant in determining whether the board of directors has the power to seek the dismissal of shareholder derivative suits.[183] In most circumstances the rule becomes relevant only when a shareholder attacks as improper the board's, or a board committee's, decision to seek termination of the derivative lawsuit.[184] By opposing the corporation's motion to dismiss, the shareholder in *Zapata* did attack the committee's decision as improper. Not only did Maldonado challenge the committee's ultimate decision as incorrect, he also claimed the committee's decision was wrongful by asserting that the litigation committee was not independent.[185] Under similar fact situations other courts have applied the business judgment rule to decide whether to dismiss shareholder derivative suits.[186] Nevertheless, the Delaware court was correct in not following the *Lewis*, *Auerbach*, and *Maldonado I* line of cases, which dismissed the shareholder's derivative suit on the basis of the business judgment rule alone. The court properly concluded that the limited judicial review required by the business judgment rule would not sufficiently safeguard against abuse when directors were passing judgment on fellow directors.[187] The court designed a two-part judicial review to provide the shareholder with necessary protection while allowing the corporation to "rid itself of detrimental litigation."[188]

The first step of the test requires the trial court to examine the independence, good faith, and reasonableness of the committee.[189] Under the business judgment rule, prior courts had limited their review to the issues of independence and good faith.[190] While

183. The business judgment rule does not create authority in the board, but merely insulates directors from personal liability for decisions made in good faith. *See* text accompanying notes 152-53 & 162 *supra*.

184. 430 A.2d at 782.

185. Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980).

186. *See* text accompanying notes 60-67 & 76-150 *supra*.

187. 430 A.2d at 787.

188. *Id.* at 787.

189. *Id.* at 788.

190. *See* Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920

the business judgment rule usually places the burden of proving these initial matters on the plaintiff, the *Zapata* court shifted the burden of proof to the corporation.[191] While the shift of the burden may, as one commentator has suggested,[192] increase the time and expense of litigation and further clog the court system, at least three reasons support the shift of the burden of proof to the corporation. First, the corporation should have the burden of proof because it has better access to the relevant information.[193] Second, since dismissal of a derivative suit prevents a full hearing on the merits, the corporation, as movant for dismissal, should bear the burden of proving that a hearing on the merits of the shareholder's claim is unnecessary.[194] Last, to preserve the effectiveness of the derivative suit as a regulatory mechanism, "director judgments alone, no matter how independent, should not be decisive"[195] in terminating derivative suits. Thus, the court's decision to shift the burden of proof to the corporation on the issues of good faith, independence, and reasonableness appears sound. However, as an account of the case noted, the *Zapata* court should have established some guidelines that explain how the corporation can meet this burden of proof.[196]

The second step of the *Zapata* test requires the trial court to apply its own business judgment to determine whether a corporation's motion to dismiss a shareholder derivative suit should be granted. This step presents at least two problems for the courts. First, the notion that the judiciary can competently make business decisions for the corporation based on " 'ethical, commercial, pro-

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(1979). *See also* text accompanying notes 103-09 *supra*.

191. 430 A.2d at 788. The corporation now has the burden of persuasion to show that the committee, in fact, decided to dismiss the suit independently, in good faith, and on reasonable grounds.

192. According to one commentator, shifting the burden of proof to the corporation will "require fairly extensive presentation of evidence . . . , cross-examination . . . , and some independent review . . . on the merits by the judge. More work for lawyers. More expense for corporations . . . . " Olson, *supra* note 10, at 19, cols. 2 & 3.

193. *See* Dent, *supra* note 13, at 133-34.

194. *Id.* at 134.

195. Olson, *supra* note 10, at 19, col. 3.

196. Hinsen & Dreizen, *Delaware Court Addresses Business Judgment Rule*, Legal Times of Washington, June 8, 1981, at 18, col. 4. Ideally, the guidelines would establish standards that corporations could strive to meet in appointing personnel to the litigation committee. Also, the standards could provide metbods of investigation to be used by a litigation committee in its determination whether or not to dismiss the suit. To establish the guidelines the courts could look at the performance of and techniques employed by other litigation committees. In general, these committees have been very diligent in performing their duties. *See* note 205 *infra*.

motional, public relations, employee relations, [and] fiscal as well as legal' " considerations[197] is open to question. Second, the power given to the trial court to continue derivative litigation even though the suit is actually detrimental to the corporation is especially troublesome. As the Delaware court stated,

> This means, of course, that instances could arise where a committee can establisb its independence and sound bases for its good faith decisions and still have the corporation's motion denied. . . . The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.[198]

On the basis of the preceding language, the trial court could "force a corporation to litigate a novel issue, in circumstances that would not serve its best interests."[199]

Tlie second step of the *Zapata* test is unnecessary because the first step satisfactorily balances tlie shareholder's interest in preserving a meaningful remedy for corporate harms and tlie corporation's interest in dismissing detrimental litigation. Under tlie first step tlie corporation must prove not only the good faith and independence of tlie committee but also tlie reasonableness of the committee's decision to dismiss the derivative suit. Tliis requirement adequately accounts for tlie corporation's interest because the corporation can rid itself of detrimental litigation by demonstrating a reasonable basis for its decision not to continue tlie derivative suit. In addition, tlie first step protects the sharelioIder's interest because tlie court will not dismiss tlie derivative suit unless it is convinced that tliere is a sound basis for tlie board committee's determination that tlie suit is not in the best interests of the corporation. Since tlie derivative suit is based on a corporate claim and is brought on tlie corporation's behalf, the court lias no reason not to dismiss tlie derivative suit once it is convinced that the litigation committee reasonably acted in good faith to seek the corporation's best interest. If, however, the court finds tliat the committee acted independently and in good faith, but that it did not

197. 430 A.2d at 788 (quoting Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980)).

198. *Id.* at 789.

199. Hinsen & Dreizen, *supra* note 196, at 19, col. 1. *See* note 180 *supra*. In an adversary system it is unlikely that justice will be served by forcing a corporation to litigate an issue when it does not stand to gain in the outeome. Since the suit has already been found to be detrimental to the corporation even if it is successful, one cannot expect the corporation to vigorously pursue the matter. The situation is analogous to a case in which a party must spend more in legal costs than what the legal claim is worth. Hence, the second step of the *Zapata* test may be not only a waste of the corporation's resources, but also a waste of judicial resources.

reasonably conclude that the derivative suit is detrimental to the corporation, then the court will not dismiss the suit. Therefore, the first step of the *Zapata* test sufficiently balances the competing interests of the shareholder and the corporation.

Another interesting aspect of *Zapata* is the potential interplay with the *Burks v. Lasker* test[200] in federal courts. Under the *Burks* test a federal court considering a corporation's motion to dismiss must first determine whether the law of the state of incorporation permits dismissal. If dismissal is appropriate under state law the federal court will grant the corporation's motion unless the dismissal would conflict with federal policy. A federal court applying the *Burks* test would, when confronted with a Delaware corporation's motion for dismissal, begin its analysis with an examination of whether Delaware law permits dismissal—the *Zapata* test.[201] Assuming that the corporation's board or litigation committee can meet the good faith, independence, and reasonableness standard of the first step of *Zapata,* the federal court would then apply its own business judgment to determine whether dismissal should be granted. At this second step of the *Zapata* test, Delaware law requires the court to "give special consideration to matters of law and public policy."[202] If, under this rather deferential standard, the federal court finds that dismissal is inappropriate the court will not dismiss the action. Even if the federal court finds no violation of federal policy, it may still refuse to dismiss if it perceives that Delaware public policy would somehow be thwarted. If, however, dismissal is deemed appropriate under Delaware's "special consideration" standard, the federal court then proceeds to the second step of *Burks*—an examination of federal policy. The *Burks* policy examination does not give as great a deference to the court as the *Zapata* standard; *Burks* allows a court to refuse dismissal only if the dismissal would conflict with federal policy.[203]

Before *Zapata* a federal court could refuse to dismiss a derivative action against a Delaware corporation only if federal policy would be obstructed. Now, however, a federal court may deny dismissal much more freely; the court is no longer restricted to considerations of federal policy alone, but may deny dismissal anytime it determines that denial is justified on general grounds of law and public policy. The *Zapata* court has thus implied that it will not

200. *See* notes 76-101 *supra* and accompanying text.
201. *See* text accompanying notes 177-82 *supra.*
202. 430 A.2d at 789.
203. Burks v. Lasker, 441 U.S. 471, 480-81 (1979).

place a strong emphasis on granting corporations incorporated in its state freedom to dismiss derivative suits—even federal derivative suits not in the corporation's best interest. *Zapata*, however, is unlikely to cause substantial problems for Delaware corporations defending derivative suits in the federal courts. Rather, federal courts probably will continue to conduct only one policy analysis and to adhere to the strict *Burks* standard—a standard with which the federal courts are familiar and one that is easy to apply.

VI. CONCLUSION

The *Zapata* court's method of balancing the shareholder's right to maintain a derivative suit with the corporation's right to terminate derivative litigation is basically sound. By adding the second step—that the trial court should apply "its own independent business judgment"[204] in determining whether the motion to dismiss should be granted—the court may have unnecessarily overprotected the shareholder. Although the court's test may favor the shareholder, special litigation committees will reduce the corporation's disadvantage. One commentator has already noted that the independent directors serving on the litigation committees have been "setting high performance standards and meeting them."[205] Perhaps the litigation committees, recognizing not only the financial interests of the corporations, but also the corporation's important role in modern society, should themselves consider pub-

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204. 430 A.2d at 789.

205. *See* Estes, *supra* note 53, at 56. The committees have held themselves to high performance standards in an attempt to increase their credibility in the eyes of the courts. First, in most cases the directors selected have not participated in any inappropriate conduct. Second, the directors chosen tend to be individuals with impeccable credentials and experience in handling complex problems. *See* text accompanying note 70 *supra*. Third, the committees generally retain preeminent outside counsel. For instance, in *Burks* the committee retained former chief judge of the New York Court of Appeals, Stanley H. Fuld, as special counsel. Lasker v. Burks, 567 F.2d 1208, 1210 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979). Similarly, in Gall v. Exxon Corp., 418 F. Supp. 508, 514 n.12 (S.D.N.Y. 1976), the litigation committee retained former Chief Justice of the New Jersey Supreme Court, Joseph Weintraub, as special counsel. Last, the investigations have typically been diligent and extensive. The committee members have obtained independent sources of information and have actively participated in evaluations of both the data discovered and the involvement of company personnel. Estes, *supra* note 53, at 52. The performance standards set by the litigation committee in *Abbey*, *see* notes 110-14 *supra* and accompanying text, led the district court to remark that "given the impeccable credentials of the committee members and the thoroughness of their investigation, it would he impossible to establish bad faith or lack of independence on the part of the committee." Abbey v. Control Data Corp., 460 F. Supp. 1242, 1244 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

lic policy questions in determining whether the corporation should pursue a derivative suit. The independent committee should function like a self-regulating arbitration board that resolves disputes between shareholders and the board. Perhaps with a broader view future boards may avoid courtroom conflicts with their shareholders.

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