University of Dayton Law Review

Volume 6 | Number 2 Article 7

1981

Corporation Law: The Business Judgment Rule in Derivative Suits against Directors

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CORPORATION LAW: THE BUSINESS JUDGMENT RULE IN DERIVATIVE SUITS AGAINST DIRECTORS—*Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980).*

INTRODUCTION

The shareholders derivative suit[1] is the principal means available to minority shareholders to correct abuses committed by corporate management.[2] Recent federal court decisions[3] have limited the availability of this action through application of the "business judgment" rule. This rule provides corporate management with a shield to protect their actions concerning the business affairs of the corporation[4] from judicial scrutiny.[5] Applied to a derivative action, the rule operates as a bar to the shareholder's suit, provided the directors seeking its application do not "stand in a dual relation that prevents an unprejudiced exercise of judgment."[6]

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1. A derivative suit is brought by a shareholder on behalf of the corporation against parties who have allegedly wronged the corporation. The corporation itself may sue directly on such a cause of action, but when the corporation does not assert its own rights, the shareholder is entitled to bring suit to enforce the corporation's claim. H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES, § 358 (2d ed. 1970).

2. Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168 (1976). *See also* Hays, *A Study In Trial Tactics: Derivative Stockholders' Suits*, 43 COLUM. L. REV. 275, 277 (1943) ("minority stockholders' suits cannot assure to the corporation an efficient or honest management, but undoubtedly their increasing number and high incidence of success have imposed a real measure of restraint upon faithless or reckless management").

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

4. "The decision not to sue is like other business judgments, ordinarily a matter of internal management." Issner v. Aldrich, 254 F. Supp. 696, 699 (1966).

5. Carson, *Current Phases of Derivative Actions Against Directors*, 40 MICH. L. REV. 1125 (1942); *see, e.g.*, United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Auerbach v. Bennett, 47 N.Y. 2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979). The business judgment rule has been expressed in terms of directors' liability. *See* Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562 (1967) (directors not liable for mistakes of judgment); Comment, *The Business Judgement Rule: A Guide to Corporate Directors' Liability*, 7 ST. LOUIS U. L.J. 151 (1962) ("stated in its simplest form, the rule provides that directors of a corporation are not liable for losses arising from mere errors of judgment, if they acted in good faith and with due care").

6. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917). The "dual relation" referred to by the Supreme Court, is normally expressed in terms of whether or not the directors are personally "interested" or involved in the alleged wrongdoing. *See* Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1970), *cert. denied*, 444 U.S. 1017 (1980) (business judgment rule does not apply where directors themselves are subject to personal liability); Maldonado v. Flynn, 485 F. Supp.

Application of the business judgment rule was the crucial issue confronting the court in *Galef v. Alexander*.[7] Resolution of this issue was further complicated when Galef alleged violations of both state law and the federal proxy requirements of the Securities Exchange Act of 1934. This note evaluates the *Galef* court's application of the business judgment rule and the impact of the court's decision on the policies underlying the business judgment rule, and section 14(a) of the Securities Exchange Act of 1934.

FACTS AND HOLDING

In 1967 and 1973, the stockholders of TRW, Inc. approved two employee stock option plans.[8] The plans were devised by a "Stock Option Committee"[9] composed of four outside directors of TRW, Inc.[10] Under both plans, the Committee was authorized to grant stock options at exercise prices not lower than the fair market price of the stock at the time of the grants.[11]

Between 1971 and 1974, the market price of TRW stock declined in value, and as a result the stock options granted pursuant to the 1967 and 1973 plans went "underwater."[12] Perceiving this as a serious

274 (S.D. N.Y. 1980) (cornerstone of business judgement rule is the independence and disinterestedness of directors charged with responsibility for decisions). *See also* Hawes v. Oakland, 104 U.S. 450 (1882) (plaintiff can maintain derivative suit if he alleges a majority of directors are acting in their own interest).

7. 615 F.2d 51 (2d Cir. 1980).

8. An employee stock option plan is a form of bonus or profit sharing arrangement. The primary purpose of such a plan is the attraction and retention of executive, key and qualified personnel. For that reason, the granting of such options is considered a form of compensation. W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2143.1 (rev. perm. ed. 1976); *see* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 248 at 493 (2d ed. 1970) (stock option plan, in theory is "a form of incentive compensation based on the idea that good management results in higher share prices which render the (stock) option valuable").

9. A "Stock Option Committee" is an executive committee, composed of directors which can act in place of the full board of directors. Comment, *Corporations—The Executive Committee in Corporate Organization—Scope of Powers*, 42 MICH. L. REV. 133 (1943). Such committees, and the board's authority to delegate authority thereto, are regulated by state law. *See* Note, *Executive Committees—Creation, Procedures, and Authority*, 1967, WASH. U.L.Q. 42 (1967).

10. 615 F.2d at 53.

11. *Id.*

12. The stock options went "underwater" when the market price of TRW stock fell (from $40.00 to $18.00), and the options to buy stock at the earlier market prices were of no value to the employees receiving the options. There was little incentive for employees to exercise the now "underwater" options since the exercise price of the options was above the current market price of the stock. Thus, "the purpose for which the options had been granted—to provide incentive compensation—was defeated." *Id.* at 54.

threat to employee morale, in December, 1974, the Committee replaced the "underwater" options with options carrying lower exercise prices.[13] The market price of TRW stock continued its decline, however, and in October, 1974, the Committee decided to issue new options at even lower exercise prices than the December grants.[14] As a result of these December and October grants, six officer-directors were able to purchase stock options at prices substantially lower than the market value of the stock at the time of the original grants.[15]

Galef filed this derivative action in the District Court for the Southern District of New York,[16] asserting violations by TRW's directors under state law,[17] and also charging that the solicitation of five proxy statements violated section 14(a) of the Securities Exchange Act of 1934.[18] Galef sought rescission of the 1974 option grants and an ac-

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13. The options were conditioned upon surrender of the "underwater" options issued pursuant to the 1967 and 1973 plans. This fact is crucial to Galef's cause of action, because under the terms of the 1967 and 1973 plans, the Committee was only authorized to issue stock options at exercise prices not lower than the market price of TRW stock at the time of the original grants. *Id.* at 53. Galef alleged that failure to disclose in proxy statements the possibility that these conditional grants could be used to reduce the exercise prices of the 1967 and 1973 options, constituted a violation of section 14(a) of the Securities Exchange Act of 1934. *See* note 18 *infra*.

14. 615 F.2d at 54.

15. According to Galef, this "unauthorized" reduction in the exercise prices of the options permitted these officer-directors to profit unfairly from a temporary decline in the market price of TRW stock. *Id.*

16. "These litigations have tended to become centered in New York . . . because such [derivative] suits can be maintained only where jurisdiction can be obtained over both the corporation on whose behalf it is brought *and* the defendant directors, officers and/or third parties against whom relief is sought." Hays, *A Study In Trial Tactics: Derivative Stockholders' Suits*, 43 COLUM. L. REV. 275, 275 n.2 (1942). Jurisdiction in *Galef* was predicated upon diversity of citizenship and § 27 of the Securities Exchange Act, which provides in pertinent part:

> The district courts of the United States and, the United States Courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1976).

17. Under state law, Galef asserted the option grants were invalid because: (1) they were unauthorized reductions in the exercise price of the options granted pursuant to the 1967 and 1973 plans and (2) the share limitation authorized by the 1967 plan had been exceeded by the 1974 grants. Galef also charged the defendant directors with having breached their fiduciary duties to the corporation, by either participating or acquiescing in these unauthorized grants.

18. Galef charged TRW's directors with having violated § 14(a) of the Securities Exchange Act of 1934 which provides:

> It shall be unlawful or any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the

counting for any losses to the corporation resulting therefrom.[19] In redress of his section 14(a) claims, Galef demanded the 1967 and 1973 option plans be declared void, and that the elections of directors in 1974, 1975 and 1976 be set aside.[20]

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protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1976). Rule 14a-9 promulgated thereunder provides:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Commodity and Securities Exchanges, 17 C.F.R. § 5240, 14a-9 (1980). Galef alleged that the proxy statements soliciting shareholder approval of the 1967 and 1973 stock option plans were false and misleading, because they failed to disclose the possibility of conditional grants, like the ones issued in 1974, that could be used to reduce the exercise prices of the options granted pursuant to the 1967 and 1973 plans.

Galef also charged violations of Rule 14a-3, which requires certain information be furnished to shareholders, and schedule 14A, item 7(f), which requires information to be furnished if any action is taken with regard to (1) election of directors or (2) any bonus, profit sharing or other remuneration plan, in which any director or officer will participate. Proxy statements in 1974, 1975 and 1976 were challenged as not having met these requirements, with regard to directors' remuneration.

Finally, elections of directors pursuant to proxy statements issued in 1975 and 1976 were challenged on the basis of nondisclosure of material facts (i.e., that options granted to directors in 1974 were to replace the higher priced options granted pursuant to the 1967 and 1973 plans).

19. Rescission is a remedy which may be awarded in a proper case, but normally will not be awarded if it would be more detrimental than advantageous to other shareholders, or where "disaster to the corporation will result." W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 6041 (rev. perm. ed. 1976). This is a factor to be considered in *Galef*, because "pursuit of the lawsuit would have a detrimental effect on the morale of key employees by creating uncertainty as to the validity of their options, and that if plaintiff succeeded in his quest to have the 1974 options cancelled, TRW would be injured by the demoralization of key employees." 615 F.2d at 56.

20. There are normally three types of relief available to a shareholder alleging violations of Rule 14a-9: (1) injunctive relief; (2) monetary relief and (3) rescissionary relief. "This recissionary relief, when obtained by the shareholder, allows consumated corporate transactions to be 'unwound'." Comment, *Shareholders' Remedies for Violation of Proxy Rule 14a-9*, 31 SW. L.J. 1125, 1139 (1977); *See* Mills v. Electric Auto-Life Co., 396 U.S. 375 (1970) (courts are to use "sound discretion" in granting rescissionary relief). The *Galef* court also noted there might be a mootness problem, since the terms of the directors elected pursuant to the challenged proxy statements in 1974, 1975 and 1976 had all expired.

The TRW directors responded to Galef's suit by filing a motion for summary judgment pursuant to Rule 56, Federal Rules of Civil Procedure,[21] seeking to dismiss the action on the basis of the business judgment rule[22] and by seeking dismissal of Galef's claims under Rule 12(b)(6), Federal Rules of Civil Procedure.[23] The directors also moved to limit discovery to the issue of defendants' good faith in exercising their business judgment to dismiss the suit. This motion was granted.[24] Following discovery, the directors renewed their motions to dismiss pursuant to the Federal Rules.[25] Galef argued that TRW's directors could not dismiss the suit by application of the business judgment rule because none of the directors were "independent"[26] for purposes of that rule.[27]

The district court granted summary judgment,[28] and Galef ap-

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21. Rule 56 of the Federal Rules of Civil Procedure provides, in pertinent part:

(b) For Defending Party. A party against whom a claim . . . is asserted or a declaratory judgment is sought may, at any time, with or without supporting affidavits move for a summary judgment in his favor as to all or any part thereof.

(c) Motion and Proceedings Thereon. The judgment sought shall be rendered forthwith if the pleadings, depositions and answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

22. A directors' meeting was held with corporate counsel to discuss the Galef suit. At the meeting, the six officer-directors receiving options under the challenged 1974 grants were dismissed. The remaining directors determined the suit was not in the corporation's best interest, and instructed corporate counsel to dismiss the suit.

23. Rule 12(b)(6) provides, in pertinent part: "[T]he following defenses may at the option of the pleader be made by motion: (6) to dismiss for failure of the pleading to state a claim upon which relief can be granted."

24. Galef also complained of a lack of discovery on the merits of his claims. 615 F.2d at 56. This complaint was well justified, since Galef's suit was dismissed at the district court level on the basis of a preliminary assessment of the merits of Galef's state law claims. *See generally notes* 28 and 56 *infra*.

25. *Id.*

26. *See* note 6 *supra*.

27. Galef alleged that: (1) three directors had approved the 1974 grants as members of the Stock Option Committee; (2) six directors caused the challenged 1967 and 1973 proxy statements to be issued; (3) eight directors had caused the 1974 and 1975 proxy statements to be issued; and (4) all nine directors had caused the 1976 proxy statements to be issued.

28. The district court's determination was based upon a preliminary assessment of the merits of Galef's state law claims. The court concluded that these claims lacked merit, and proceeded to determine whether or not the directors had acted in good faith in seeking to dismiss the suit, i.e., whether the directors were "interested" in the suit. The court found that the directors were disinterested in the suit, based primarily upon the fact that the directors seeking dismissal had not been recipients of the challenged grants, and thus, had no financial stake in the outcome of the suit. The court also re-

pealed to the Court of Appeals for the Second Circuit. The Second Circuit reversed and remanded the case, after concluding that the district court failed to evaluate the impact a summary dismissal under the state-created business judgment rule would have on the policies underlying section 14(a) of the Securities Exchange Act of 1934,[29] and the rules promulgated thereunder.[30] The *Galef* court first analyzed Galef's state law claims[31] and second, the impact of a business judgment summary dismissal upon the federal policies underlying section 14(a). The court concluded that a more complete examination of Ohio law[32] was necessary to determine whether TRW's directors could dismiss the suit on the basis of the business judgment rule.[33] The court also found that the federal policies underlying section 14(a) precluded dismissal of Galef's section 14(a) claims by TRW directors accused of violating that very enactment.[34]

ANALYSIS

The *Galef* decision reflects the problems that develop when a shareholder initiates a derivative action alleging violations of both state and federal law. Permitting the board of directors to dismiss the suit could spell the death of the derivative action and eliminate a crucial source of protection provided by the federal proxy rules for minority shareholders.[35]

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jected Galef's claims that the directors could not be "independent," just because they were named as defendants in the suit. The court stated:

> Indeed, the business judgment rule would be meaningless if it were invalid any time the underlying transaction had been approved by the Board whose members were, as a consequence, named defendants. If that were the rule, any time board action was involved, simply by naming the company's directors as defendants, the business judgment rule would be inoperable.

615 F.2d at 58-59.

29. *See* note 60 and accompanying text *infra*.

30. 615 F.2d at 55.

31. There is no "federal" corporation law per se. *See* Burks v. Lasker, 441 U.S 471 (1979) (Congress has never indicated that the entire corpus of a state's corporation law is to be replaced simply because plaintiff alleges a federal cause of action); Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (the first place one must look to determine the powers of corporate directors is the state's corporation law).

32. The *Galef* court, applying New York choice of law principles, determined that the state of incorporation would be the place to find the relevant state law. Since TRW, Inc., is an Ohio corporation, Ohio law is determinative of Galef's state law claims. 615 F.2d at 58.

33. The case was remanded to the district court for determination of the business judgment issue. *Id.* at 62.

34. The *Galef* court, in effect, concluded if Ohio law would permit the defendant directors to dismiss Galef's claims under § 14(a), such a state law would be inconsistent with the federal policies under the federal proxy regulations, and would have to yield to federal policy. *Id.* at 64.

35. Dent, *The Power of Directors to Terminate Shareholder Litigation: The*

If, however, management is precluded completely from dismissing derivative suits, the corporation could be subjected to frivolous actions by hostile shareholders.[36] The *Galef* court weighed these countervailing interests, following a methodology similar to that prescribed by the Supreme Court in *Burks v. Lasker*.[37]

A. The Burks Test: A Two-Tier Analysis

The Supreme Court in *Burks* addressed a factual situation structurally similar to the one in *Galef*. The plaintiff-shareholder in *Burks* alleged violations by corporate management of both state and federal law.[38] The Supreme Court held that the role of a federal court in such a case is limited to two inquiries: (1) a determination of whether the relevant state law permits disinterested directors to exercise their business judgment to dismiss a derivative suit[39]; and (2) if so, whether such a state rule is inconsistent with the policies underlying the federal cause of action. The *Burks* Court arrived at this conclusion upon an analysis of numerous cases.[40] In a footnote, the Court expressed concern that laws applied in suits brought to enforce federal rights meet

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Death of the Derivative Suit, 75 NW. U. L. REV. 96 (1980)[hereinafter cited as Dent]. This is especially true where the plaintiff-shareholder alleges a violation of federal law. The Supreme Court in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), found that a derivative right of action existed under § 27 of the Securities Exchange Act. Such actions can often be the best (and only) private means of redressing violations of § 14(a). *See* Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 77-79 (1967) (such suits play an increasingly essential role in our economy as "corporate policemen"). *But see* Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) (derivative action is not the sole means of redressing violations of proxy rules).

36. 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)[hereinafter cited as Block & Barton]. *See also* Auerbach v. Bennett, 47 N.Y.2d 619, 633, 419 N.Y.S.2d 920, 928, 393 N.E.2d 994, 1002 (1979) ("to disqualify the entire board would be to render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative action").

37. 441 U.S. 471 (1979).

38. In the *Burks* case, shareholders of an investment company registered under the Investment Company Act of 1940, brought a derivative suit against several of the company's directors, alleging that the directors violated, under state law, their fiduciary duties to the corporation and also their duties under the Investment Advisors Act of 1940.

39. The Supreme Court found, using an analysis similar to that invoked by the court in *Galef*, "[t]he first place one must look to determine the powers of corporate directors is the relevant state's corporation law." 615 F.2d at 51 (citing Sante Fe Indus. v. Green, 430 U.S. 462, 469 (1977)).

40. *See, e.g.*, Johnson v. Railway Express Agency, 421 U.S. 454 (1975) (upholding the proposition that "federal courts must be ever vigilant to insure that application of state law poses 'no significant threat to any identifiable federal policy or interest' "); Wallis v. Pan Am. Petroleum Corp., 384 U.S. 63 (1966).

the standards necessary to insure that "prohibition of [the] federal statute . . . not be set at naught."[41]

The *Galef* court did not expressly state its adherence to the *Burks* analysis; in fact, before concluding, the court distinguished *Burks* on the ground that the directors exercising their business judgment in *Burks* were truly "disinterested within the meaning of the Investment Company Act."[42] The structural analysis employed by the *Galef* court, however, was essentially the same as the *Burks* test. First, an analysis of the business judgment rule under state law, followed by a determination of the impact a dismissal on the basis of that state law would have on the policy underlying the federal law.

B. The State Law Claims and the Disinterested Status of Defendant Directors

Consistent with the *Burks* analysis, the *Galef* court first discussed the availability of an Ohio business judgment rule to the defendant-directors of TRW, Inc. In an effort to ascertain the relevant Ohio rule, the court examined the analogous demand requirement under section 23.1 of the Federal Rules of Civil Procedure.[43] The court found the factual situation similar to those cases in which a demand was made on management to bring suit by an aggrieved shareholder, and such demand was thereby refused by the board.[44] The question of whether a board's decision not to sue is dispositive, is dependent upon whether the directors making the determination are "disinterested" in the claims presented.[45] The *Galef* court analogized the demand require-

41. 441 U.S. at 479 n.6 (citing Sola Elec. Co. v. Jefferson Co., 317 U.S. 173, 176 (1942)).

42. 441 U.S. at 474 n.4.

43. FED. R. CIV. P. 23.1 provides, in pertinent part:

> In a derivative action brought by one or more shareholders or members to enforce a right of the corporation or of an unincorporated association having failed to enforce a right which may properly be asserted by it the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority. . . .

This requirement must be met before a shareholder can bring a derivative action, unless the requirement is excused. *See* Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973, 976 (S.D.N.Y. 1977) (business judgment rule is in addition to demand requirement under Rule 23.1). One circumstance in which a demand will be excused is when the shareholders allege that the demand would be futile because directors participated or acquiesced in the challenged transaction, and, therefore, it would be unreasonable to expect them to enforce rights of the corporation when in effect they would be suing themselves. Comment, *The Demand and Standing Requirements in Stockholder Derivative Action*, 44 U. CHI. L. REV. 168 (1976) [hereinafter cited as *Demand and Standing Requirements*]. *See, e.g.*, Bernstein v. Mediobanca Banca di credito Finanziario-Sp. A., 69 F.R.D. 592 (2d Cir. 1974).

44. 615 F.2d at 60.

45. *Id. See generally* note 49 *infra*.

ment to the facts at bar, and speculated that directors who are accused of wrongdoing and subsequently made defendants in the suit could not be expected to exercise an honest business judgment to bar suit based on the justification that the suit was not in the corporation's best interests. Despite authority supporting the proposition that "interested" directors cannot dismiss a suit brought against them, the *Galef* court found that Ohio law controlled resolution of the business judgment issue,[46] and the Ohio cases cited to the court on appeal were inconclusive.[47] The case was remanded to the district court for a further exploration of Ohio law relevant to the business judgment issue.[48]

Inextricably related to a determination of whether or not a business judgment dismissal will be available to corporate directors is an inquiry into the disinterested status of the directors initiating the defense.[49]

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46. The *Galef* court cited a number of cases, among them *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980), in which the court stated that "where the directors themselves are subject to personal liability in the action, [they] *cannot* be expected to determine impartially whether it is warranted." 615 F.2d at 61 (quoting Abbey v. Control Data Corp., 603 F.2d 724, 727, *cert. denied*, 444 U.S. 1017 (1980). *See also* Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973, 977 (S.D.N.Y. 1977).

47. The *Galef* court examined three Ohio cases dealing with the demand requirement pursuant to Rule 23.1 of the Ohio Rules of Civil Procedure. This rule has been fashioned after Federal Rules of Civil Procedure. Roderick v. Canton Hog Ranch Co., 46 Ohio App. 475, 189 N.E. 669 (1933); Cooper v. Central Alloy Steel Corp., 43 Ohio App. 455, 183 N.E. 439 (1931); Rice v. Wheeling Dollar Savings and Trust Co., 71 Ohio Abs. 205, 130 N.E. 2d 442 (1954). The court found these cases to be consistent with the general notion that shareholders are excused from bringing a demand on directors who are charged with participating in the alleged wrongdoing. Analogizing this demand requirement to the present situation, the court concluded that it might be inferred "that an Ohio court would deem it a futility that directors have the corporation sue them, and consider a summary dismissal of a suit against them to be unavailable." 615 F.2d at 61.

48. The Ohio Supreme Court has not ruled on the business judgment issue. *See* Dent *supra* note 35, at 146. According to Dent, this is not suprising since most business judgment cases arise in federal courts that try to "apply state law that [is], except as to New York, almost nonexistent." *See also* Block & Barton, *supra* note 36, at 102, 103. (many federal courts have allowed business judgment dismissal, despite absence of state court authority). The district court on remand will no doubt "sit as a state court" and make a determination of how Ohio law would treat the business judgment issue. Comm'r v. Estate of Bosch, 387 U.S. 456 (1967). *See also* Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (federal court must "sit as a state court" in applying state law to business judgment rule). Due to the virtual lack of state law on the subject, the dicta in the *Galef* decision with regard to the possible availability of an Ohio business judgment rule may be invaluable at the district court level. *See generally* note 47 *supra*. The lack of state law authority also calls into question the utility of the first tier of the *Burks* analysis.

49. "Disinterestedness" is often expressed in terms of lack of participation in the challenged transactions, Auerbach v. Bennett, 47 N.Y.2d. 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979), or lack of any "disqualifying personal interest" of the directors in the suit. Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980).

The "disinterestedness" or independence of the directors seeking dismissal entails an issue of fact,[50] and this issue alone has been the subject of trials separate from the merits of a shareholder's claim.[51] While a separate trial on the business judgment issue will not always be appropriate,[52] a factual determination must be made with regard to whether the defendant-directors charged with wrongdoing are truly "disinterested" in the derivative shareholder's claims.[53]

In a recent case, *Maldonado v. Flynn*,[54] the court expressly followed the *Burks* test and examined first, whether Delaware corporation law permitted a derivative action against the corporation's directors to be terminated by a disinterested litigation committee; second, whether such a rule was inconsistent with the policies underlying section 14(a) of the Securities Exchange Act (the applicable federal law); and third, the issue of whether the committee seeking dismissal was indeed disinterested in the claims presented. The *Maldonado* court obviously separated the question of whether the relevant state law empowers directors to dismiss a suit, from the factual determination of whether the directors seeking dismissal were truly disinterested enough to dismiss the suit in good faith. The *Galef* court failed to make this distinction.[55] Even if Ohio law empowered directors to dismiss a suit brought against them solely on the basis of their business judgment, despite their being named defendants in the suit, the question still remains whether the particular directors seeking dismissal are disinter-

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50. *See* Dent, *supra* note 35, at 101 n.28.

51. *See Demand and Standing Requirements*, *supra* note 43. *See also* Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 473 (2d Cir. 1977) (separate trial held on "merits question presented by the matter of business judgment"); Gall v. Exxon, 418 F. Supp. 508 (2d Cir. 1976) (premature for court to grant summary judgment until plaintiff is given opportunity to test good faith and independence of directors).

52. *See Demand and Standing Requirements*, *supra* note 43. Separate trial will not be necessary where there is a substantial overlap between the issues relevant to the directors' independence and the merits of the claims against the wrongdoers, i.e., as in *Galef*, in which there may be an overlap between the issue of the directors' breach of fiduciary duty, and the merits of Galef's claims.

53. *See* Block & Barton, *supra* note 36. The authors note that "the cases reflect considerable confusion on the issue of disinterestedness, due in great part to the court's failure to analyze separately the nature of the state and federal claims asserted, the relief sought, and the participation of potential liability of the moving directors."

54. 485 F. Supp. 274 (S.D.N.Y. 1980).

55. The *Galef* court's language indicates that the court considered the "disinterestedness" question one of law, and not of fact, as evidenced by the following passage: "It may be that under Ohio law a director's being sued merely on account of having authorized, without financial interest, the underlying transaction does not make him sufficiently 'interested' to deprive him of the power to initiate a business judgment summary dismissal of the suit." 615 F.2d at 61.

ested in the suit and capable of an unprejudiced exercise of judgment.[56] This is a factual determination that must be made upon the facts of the particular case.

The district court on remand must therefore determine how an Ohio court would rule on the power of directors to exercise a business judgment dismissal, and also make a factual determination of whether TRW's directors are sufficiently disinterested in the suit to exercise that power. Assuming that TRW's directors were sufficiently disinterested to invoke the business judgment defense against Galef's state law claims, the *Galef* court concluded that such a defense would not be available to dismiss Galef's federal claims under section 14(a) of the Securities Exchange Act of 1934.

C. The Federal Claims and the Burks "Consistency" Test

The second tier of the *Burks* analysis was referred to by the Supreme Court as the "consistency test."[57] The *Galef* court applied this test to Galef's section 14(a) claims, and found the policies underlying section 14(a) precluded business judgment dismissal of those federal claims.[58] This conclusion was based upon two factors: (1) the federal policies underlying section 14(a) of the Securities Exchange Act as expounded by the Supreme Court in *J.I. Case Co. v. Borak*;[59] and (2) the fact that the directors who attempted to dismiss the federal claims were defendants in the suit, and were alleged to have participated in the challenged proxy solicitations.

The *Galef* court emphasized the Supreme Court's decision in *Borak* and quoted the Court as defining the policies underlying section 14(a) as follows:

> The purpose of section 14(a) is to prevent management or others from

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56. It must be remembered that the business judgment issue is a separate issue from the merits of the plaintiff's claims, concentrating upon the directors' interest in the suit. *See Demand and Standing Requirements, supra* note 43; *see generally* note 51 *supra*. The district court's determination in *Galef* that the directors' lacked interest in the suit was based upon an assessment of the merits of Galef's state law claims. *See* note 24 *supra*. The determination of whether the derivative shareholders' claims have merit can be made according to Rule 56 of the Federal Rules of Civil Procedure, without reference to the business judgment rule. *See also* Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979) (judicial scrutiny under business judgment rule limited to inquiry into disinterested independence of board chosen to dismiss the suit, and methodologies and procedures conducted by board in determination of legal liability).

57. Burks v. Lasker, 441 U.S. at 446 (citing Board of Comm'rs v. United States, 308 U.S. 343, 349-50 (1939)). *See generally* note 40 *supra*.

58. 615 F.2d at 64.

59. 377 U.S. 426 (1964).

> obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. . . . It was intended to 'control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders.'[60]

The *Galef* court also emphasized that the Supreme Court had expressly found a derivative right of action to exist under section 27 of the 1934 Act, and "if the law of the State happened to attach no responsibility to the use of misleading proxy statements, the whole purpose of the section might be frustrated."[61] Finally, the *Galef* court stated:

> Obviously the goal of §14(a) that communications from management be accurate and complete as to all material facts is a vital one. Its achievement would quite clearly be frustrated if a director who was made a defendant in a derivative action for providing inadequate information in connection with a proxy solicitation was permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation. The very premises which give life to a derivative right of action to enforce §14(a) must save it from a premature death. In short, we conclude that to the extent that a complaint states claims against directors under §14(a) upon which relief may be granted, federal policy prevents summary dismissal of those claims pursuant to the business judgment of those defendant directors.[62]

This language strongly suggests that a second factor pervaded the court's analysis: the directors in *Galef* were defendants and alleged to have participated or acquiesced in the solicitation of the challenged proxies. This factor distinguishes *Galef* from other federal cases allowing the dismissal of federal claims by corporate management.[63] In fact,

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60. 615 F.2d at 63 (quoting 377 U.S. at 431-32).
61. *Id.* (quoting 377 U.S. at 434-35).
62. *Id.* at 63-64.
63. *See* Burks v. Kasker, 441 U.S. 471 (1979) (directors permitted to dismiss shareholders' derivative suit when they were found to be "disinterested" within the meaning of the Investment Company Act); Maldonado v. Flynn 485 F. Supp. 274 (S.D.N.Y. 1980) (appointed committee of disinterested directors may dismiss derivative suit on the basis of their business judgment, despite fellow directors being named as defendants); Abbey v. Control Data Corp., 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) (derivative suit dismissed upon reasonable good-faith determination by independent board of directors, that suit was not in the corporation's best interests). *But see* Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980) (corporation's directors, charged with wrongdoing and named as defendants in suit, were incompetent to compromise shareholders' derivative claims); Nussbacher v. Chase Manhattan Bank 444 F. Supp. 973 (S.D.N.Y. 1977) (court refused to grant summary dismissal where directors were charged with complicity in alleged wrongful conduct).

the *Galef* decision has already been distinguished on this basis. In *Maldonado v. Flynn*,[64] the court granted business judgment summary dismissal and opined, in a footnote:

> Since the drafting of this opinion . . . the Court of Appeals has decided a case, *Galef v. Alexander*. . . . That case and the instant one are distinguishable. The Court of Appeals holding was premised on the fact that the directors making the determination to terminate the suit were not disinterested. They had authorized the options at issue in the lawsuit, had been elected pursuant to the challenged proxy statements and were named as defendants. Thus a discontinuance of the derivative action would have been to their personal benefit.[65]

Thus while the *Galef* court emphasized the federal policy underlying section 14(a), a decision that precludes summary dismissal on the basis of that policy alone would be inconsistent with numerous cases decided subsequent to *Burks*[66] and would be contrary to the Supreme Court's express statement in *Burks* that "[t]here may well be situations in which the *independent* directors could reasonably believe that the best interests of the shareholders calls for a decision not to sue. . . "[67] (emphasis added). The precedential impact of the *Galef* decision will depend upon whether the particular court examining the case concludes that the *Galef* decision was based upon the lack of disinterest of TRW's directors under the facts, or upon the significant policy underlying section 14(a). If the decision is considered restricted to its

64. 485 F. Supp. 274 (S.D.N.Y. 1980).

65. *Id.* at 286 n.44.

66. *See, e.g.*, Lewis v. Anderson, 615 F.2d 778, 784 (9th Cir. 1979) (allowing disinterested directors to exercise their business judgment to dismiss what they see as groundless causes of action would in no way weaken the regulatory provisions of the federal securities laws: so long as those accused of manipulating the proxy vote are excluded from deciding whether or not to pursue the claim, there is no conflict between the business judgment rule and § 14(a)); Abbey v. Control Data Corp., 460 F. Supp. 1242, 1245 (D. Minn. 1978), *aff'd*, 603 F. 2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Maldonado v. Flynn, 485 F. Supp. 274, 282 (S.D.N.Y. 1980). "If the Court [in *Burks*] finds the state law consistent with the Investment Company and Investment Advisors Acts, which were intended to deal with the especially difficult problems of conflicts of interest of investment advisors and directors of investment companies, it will probably also find the state law to be consistent with most or all federal laws expressly providing for derivative suits." Dent, *supra* note 35, at 105.

67. 441 U.S. at 48. The *Galef* court expressed no opinion with regard to whether a truly *disinterested* group of directors could exercise their business judgment to dismiss claims brought against them under the federal proxy rules. 615 F.2d at 64 n.20. The court's emphasis on the distinction between "interested" and "disinterested" directors, for purposes of a business judgment dismissal, leads to the conclusion that in *Galef*, the crucial consideration was that the directors were named as defendants in the suit, and therefore were incompetent to decide that the action should not be brought.

particular facts, corporate directors will continue to have an opportunity to appoint "disinterested" committees to determine if the derivative action is in the corporation's best interests, and retain the benefit of the business judgment rule shield in cases alleging violations of the federal proxy rules. Federal courts confronted with the issue will normally dismiss a derivative suit if the decision not to pursue the cause of action is made by an independent "special litigation committee."[68] Even this general proposition, however, is being questioned and challenged by commentators and judges alike. Professor Dent states:

> Even genuinely independent directors cannot be expected to investigate alleged wrongs by their colleagues with the zeal of a plaintiff's attorney motivated by the prospect of receiving a large fee if he is successful. . . . Accordingly, the board should be able to terminate suits against unaffiliated persons subject only to compliance with the business judgment rule, but the board should never be able to block a derivative suit in which a majority of the directors is implicated.[69]

If, however, the *Galef* opinion is construed to put new life into the federal policy underlying section 14(a) of the Securities Exchange Act, it will be more difficult for directors to dismiss a derivative suit involving violations of section 14(a) and provide an added measure of protection to shareholders suing derivatively. As opposed to those commentators who would constrict directors in their discretion to dismiss derivative suits, some authors are concerned about a "carte blanche"

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68. Most of the cases decided prior and subsequent to *Galef* (*see* note 66 *supra*) have involved "special litigation committees," composed of allegedly independent directors appointed by the defendant-directors in the suit to investigate the derivative shareholders' allegations. *See* Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (special litigation committee composed of two outside directors, appointed by the board after the challenged transaction occurred); Abbey v. Control Data Corp., 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) (special litigation committee composed of seven of corporation's outside directors); Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979) (special litigation committee established to investigate derivative shareholder's claim composed of three disinterested directors who joined the board after the challenged transaction occurred).

69. *See* Dent, *supra* note 35, at 110. *See also* Maldonado v. Flynn, 413 A.2d 1251, 1257 (Del. Ch. 1980), a recent Delaware state court opinion concluding the business judgment rule is unavailable for purposes of dismissing a derivative suit. The court states:

> This is so because the business judgment rule is merely a presumption of propriety accorded decisions of corporate directors. . . . It provides a shield with which directors may oppose shareholder's attacks on decisions made by men; but 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 be found—if at all—outside the rule.

rule prohibiting dismissal of section 14(a) claims on the basis of federal policy alone. Block and Barton outline the dangers as follows:

> Tempting though it may be to conclude that a well-pleaded claim under § 14(a) may not be dismissed under the business judgment rule, the court should consider the potential adverse consequences of an absolute rule precluding business judgment dismissals of such actions. As the federal courts have long recognized, the derivative action procedure carries with it the inherent possibility for abuse by shareholders who may bring derivative actions as 'strike suits' designed principally to achieve an early settlement. Accordingly, it would be necessary to ensure that derivative actions will be discouraged while at the same time providing for a mechanism by which meritorious claims may be adjudicated.[70]

Whether directors will be able to dismiss federal claims under section 14(a) of the Securities Exchange Act in future cases similar to *Galef* will depend upon a balancing of these concerns and the significance each particular court attaches to the federal policy underlying section 14(a).

CONCLUSION

The business judgment rule is a defense mechanism for corporate management, derived from the general principle that business decisions of the corporation are left to the board of directors. Where, however, the corporation has been injured, and the very defendants accused of the wrongdoing seek to dismiss a derivative suit brought by a shareholder on behalf of the corporation, new developments arise. The shareholders' interests, as well as those of the corporation whom he represents, must be protected. This can only be assured if the directors deciding whether to pursue the suit are personally disinterested in its outcome and able to exercise a good faith business decision, free from conflicts of interests and personal concerns. The *Galef* court, although emphasizing the federal policies underlying section 14(a), recognized this overriding concern and refused to grant summary dismissal to defendant-directors on the basis of their judgment that the suit should be terminated.

The *Galef* decision also illustrates that the *Burks* two-tier test may be an illusory one.[70] Subsequent to the *Burks* decision, federal courts have applied practically non-existent state law, and found federal policies left intact, so long as the directors seeking summary dismissal are disinterested in the suit and not implicated in the wrongdoing. The

70. *See* Block & Barton, *supra* note 36, at 114-115.

ultimate concern is always whether the directors seeking to terminate the shareholders suit are disinterested and able to exercise a business judgment that will be in the best interest of the corporation. By leaving the question open with regard to whether truly disinterested directors can dismiss a derivative suit, the court reaches a compromise between the view that the business judgment rule should never be applied to dismiss a derivative action, and the opposing concern that the rule is a necessary tool for directors to avoid frivolous and vexatious litigation.

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