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THE MISAPPLICATION OF THE BUSINESS JUDGMENT RULE TO DISMISS SHAREHOLDER DERIVATIVE SUITS AGAINST DIRECTORS

In today's corporate arena, shareholders who challenge director authority through derivative suits may find that the directors are empowered to dismiss these suits on the grounds that such actions are not in the best interests of the corporation. Two conflicting but nonetheless co-existing principles have led to this result.[1] First, shareholders have traditionally expressed dissatisfaction with corporate decisions through the medium of shareholder derivative suits.[2] At the same time, the business judgment rule[3] has protected corporate directors from judicial scrutiny and personal liability for honest errors and mistakes of judgment made in good faith.[4] The developing trend in the federal courts, has been to allow corporate directors to use the business judgment rule to terminate derivative suits by merely asserting that the suit would not be in the best interests of the corporation.[5] This trend, if left unchecked, could easily erode the use

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1. Coffee, *Beyond the Shut-eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1222 (1977).

2. This is not to suggest that this is the only recourse available to shareholders. Many jurisdictions allow more drastic measures such as removal of the antagonistic directors with cause or even without cause. *See, e.g.*, DEL. CODE ANN. tit. 8, §141(k) (1980); FLA. STAT. §607.117(1) (1979). *See generally* H. BALLANTINE, CORPORATIONS §145 (rev. ed. 1946); W. CARY, CASES AND MATERIALS ON CORPORATIONS 868-1006 (4th ed. 1978); 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§5939-6045 (1943); R. STEVENS, CORPORATIONS §§167-68 (2d ed. 1949).

3. Although it is hard to find a precise, all encompassing definition of the business judgment rule, it has been stated as follows: "[T]he law will not hold directors liable for honest errors for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the heading of honest mistakes. This is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs." 3 W. FLETCHER, *supra* note 2 §1030. *See also* Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562, 562-63 (1967).

4. The business judgment rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge. Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 97 (1979). Perhaps the earliest expression of the business judgment rule in America is found in the 1829 Louisiana supreme court decision of Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829). The rule quickly became popular in other jurisdictions. *See, e.g.*, Godbold v. Branch Bank, 11 Ala. 191 (1847); Hodges v. New England Screw Co., 1 R.I. 312 (1850).

The business judgment rule protects directors and officers from personal liability for honest business decisions made in good faith even where such decisions result in substantial loss to the corporation. In effect, the rule prohibits shareholders from second-guessing the directors. The court in *Hodges* stated: "We think a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake." *Id.* at 18. *See generally* 3 W. FLETCHER, *supra* note 2, §1030.

5. *See* Abbey v. Control Data Corp., 603 F.2d 724, 732 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) (applying Delaware law); Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979) (applying California law); Maldonado v. Flynn, 485 F. Supp. 274, 279-80 (S.D.N.Y. 1980) (applying Delaware law); Gall v. Exxon Corp., 418 F. Supp. 508, 518-19 (S.D.N.Y. 1976)

of the derivative suit as one of the most effective restraints upon abusive corporate dealings.[6]

Generally, dissatisfied shareholders must request that the board of directors redress alleged grievances before a derivative suit will be permitted.[7] Directors increasingly use a two-step process to determine whether the corporation should judicially pursue these grievances. Where the majority of the board of directors is accused of wrongdoing,[8] the board first transfers the complaint to a special litigation committee[9] composed of disinterested directors.[10] The committee then investigates the shareholders' allegations and determines whether a suit is in the corporation's best interests.[11] In all reported instances, these special litigation committees have found that the derivative suit was not in the best interests of the corporation and have voted to terminate the action.[12] The federal courts tend to view these committee decisions as legitimate exercises of corporate business judgment. Consequently, shareholder challenges to committee determinations have proven unsuccessful because the federal courts apply the business judgment rule as a bar to judicial scrutiny of committee decisions.[13]

(applying Delaware law). *But cf.* Nussbacher v. Chase Manhattan Bank (N.A.), 444 F. Supp. 973, 977 (S.D.N.Y. 1978) (dismissal denied due to lack of disinterestedness of acting director committee).

6. *See generally* Prunty, *The Stockholders' Derivative Suit: Notes on its Derivation*, 32 N.Y.U.L. REV. 980 (1957).

7. *See* 13 W. FLETCHER, *supra* note 2, at §5963. See text accompanying notes 20-24 *infra*.

8. It is important to note that there are basically two types of shareholder derivative suits: suits against the directors and suits against third parties. This note deals primarily with the problems that result when the distinction between these types of suits is not taken into account. Very different results may occur when both types of suits are treated the same. In actions against corporate directors, courts are beginning to realize the increased danger of placing the fate of the suits "in the hands of those who stand to benefit most from its termination". Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 605 (1980). As the court in *In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 269 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), stated: "[It] [is] hard to imagine that a director . . . who had participated . . . in a major transaction, albeit for a corporate purpose, would authorize a suit, effectively against himself, claiming that the transaction violated the federal antitrust laws."

9. *See, e.g.*, Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 994 (Ct. App. 1979).

10. These committees are theoretically composed of disinterested directors, but the ability of such directors to be truly impartial has been questioned by commentators. *See* text accompanying notes 71-82 *infra*.

11. *Compare* Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976) (where a four month investigation was conducted) *with* S.E.C. v. Zale Corp., S.E.C. Litigation Release No. 8081 (N.D. Tex. 1977), *rev'd* No. 9132 (5th Cir. 1981) (where the S.E.C. concluded the investigation had been a mere sham). *See also* Coffee, *supra* note 1, at 1236.

12. Note, *supra* note 8, at 602. This statement refers to all reported cases where the decision to litigate was found to exist in the board of directors or a committee thereof. Not included are cases like Nussbacher v. Chase Manhatten Bank (N.A.), 444 F. Supp. 973, 977 (S.D.N.Y. 1978), where the court found the directors did not possess the requisite disinterestedness to make the decision.

13. See text accompanying notes 41-50 *infra*. Only two reported cases have specifically disagreed with the trend. Maher v. Zapata Corp., 490 F. Supp. 348, 353 (S.D. Tex. 1980) and Maldonado v. Flynn, 413 A.2d 1251, 1254-55 (Del. Ch. 1980).

This note will examine both the business judgment rule and the shareholder derivative suit in an attempt to clarify their functions in the corporate legal structure. This note will also discuss the current federal trend in applying the business judgment rule to shareholder derivative actions. Consideration will be given to the courts' attitude towards the special litigation committee as a substitute for the full board of directors when it is determined that board members may be involved in the actions complained of. Finally, this note will examine the misapplication of the business judgment rule by the federal courts and will suggest alternative methods of balancing the competing corporate policies.

SHAREHOLDER DERIVATIVE SUITS

Generally, the corporation alone has standing to sue for actionable wrongs committed against it.[14] The shareholder derivative suit[15] is an exception to this principle in that the shareholder is permitted to assert a claim based upon a wrong done to the corporation rather than a wrong solely affecting the individual shareholder.[16] Although the corporation is sued as a nominal defendant and an indispensible party,[17] the true defendant is either a third party or the corporation's management. Consequently, the derivative action has been the minority shareholders' principal weapon with which to attack improper acts of corporate decision-makers.[18]

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14. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917) (whether or not a corporation chooses to enforce a cause of action is, like other business questions, ordinarily a matter of internal management left to the discretion of the board of directors).

15. The basis of our present day derivative suit was established in England. For a complete discussion of the origins of the shareholder derivative suit, *see generally* Prutney, *supra* note 6.

16. Minority shareholders may bring a derivative action no matter how small their stock holdings are. *See* Ashwander v. Tennessee Valley Authority, 297 U.S. 288, 318-19 (1935): "Stockholders otherwise entitled to bring a suit . . . will not be denied relief because of the smallness of their holdings." *Id.*

There are other, more limited methods of shareholder protection besides the derivative suit. One method is the displacement of unfriendly directors through either proxy solicitations or elections, or through formal removal procedures. This process, however, can be quite expensive and time consuming and is useless where the shareholders are in a minority position. Another option is simply the sale of one's investment in the corporation. Such an option, however, might result in extensive losses to the shareholder or may in some cases be impossible due to the lack of a buyer.

17. *See* FED. R. CIV. P. 19(b) which states that, "[i]f a person . . . cannot be made a party, the court shall determine whether in equity and good conscience the action should proceed among the parties before it, or should be dismissed, the absent person thus regarded as indispensible." *See also* F. JAMES & G. HAZARD, CIVIL PROCEDURE 133 (2d ed. 1977).

It has been pointed out that the major reason the corporation's presence is required is to eliminate the possibility of a double recovery. Prunty, *supra* note 6, at 989. *See generally* Note, *Defenses in Shareholders' Derivative Suits — Who May Raise Them?*, 66 HARV. L. REV. 342 (1952).

18. *See* Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 77-82 (1967); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 168 (1967).

Because both federal and state courts have regarded the derivative suit as an extraordinary remedy,[19] shareholders are permitted to bring suit on behalf of the corporation only where there is "no other road to address."[20] Therefore, the shareholder must demand that the corporation redress shareholder complaints before the shareholder can bring suit.[21] This demand requirement[22] serves to notify the directors of the alleged cause of action and to give them the opportunity to pursue the action in the corporate name.[23] Furthermore, the demand requirement informs the shareholders of the directors' refusal to sue.[24] An exception to the demand requirement exists where the stockholder shows

If a shareholder can show that he has sustained damages unique to himself rather than damages common to many or all of the shareholders as a class, he may bring a direct suit against the wrongdoers. Thus, given the right factual situation, a shareholder might elect the alternative of a direct suit as well as a derivative one. *See generally* Note, *Distinguishing Between Direct and Derivative Suits*, 116 U. PA. L. REV. 1147 (1962).

19. *See, e.g.*, Caldwell v. Eubanks, 326 Mo. 185, 191, 30 S.W.2d 976, 978 (1930).

20. *See* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 748-49 (1960).

21. *See* FED. R. CIV. P. 23.1 which states: "The complaint shall also 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."

Additional protection is afforded the corporation and its directors by the requirement that the plaintiff fairly and adequately represent the interests of the shareholders similarly situated. *Id.*

22. In Hawes v. Oakland, 104 U.S. 450, 460-61, the United States Supreme Court stated, "[the shareholder] should show, to the satisfaction of the court, that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress for his grievance or action in conformity to his wishes." The court emphasized that the effort must not merely be "simulated" but must be an "earnest effort". *Id.* at 461. FED. R. CIV. P. 23.1 now requires that this effort be set out with particularity in the complaint. The court in *Hawes* further stated that: "[i]f time permits or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body. . . ." 104 U.S. at 461. The court further required that if this demand was not made upon the shareholders, good reason must be shown. *Id.* FED. R. CIV. P. 23.1 requires a demand on shareholders "if necessary." There is some confusion as to what "if necessary" actually means. Professor Moore has argued that the phrase, which was apparently adapted from Hawes v. Oakland, 104 U.S. 450, 461 (1881), meant to incorporate state law on whether shareholders can ratify fraud. 3B J. MOORE, FEDERAL PRACTICE ¶23.1.19 at 23.1-95-96 (2d ed. 1980). For a critique of the Moore view see Note, *The Nonratification Rule and the Demand Requirement: The Case for Limited Judicial Review*, 63 COLUM. L. REV. 1086, 1090 n.36 (1963). The rule applied by most courts concerning demand on shareholders is that state law will control. Some states have adopted the demand on shareholders requirement, some have not. *Compare* ARIZ. R. CIV. P. §23.1 *and* MINN. R. CIV. P. §23.1 (requiring demand on shareholders) *with* CAL. CORP. CODE §834 (West 1955) *and* N.Y. BUS. CORP. LAW §626(c) (McKinney 1963) (no demand requirement).

For an example of the extent to which courts require demand on the directors *compare* Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971) (liberal approach) *with In re* Kauffman Mut. Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) (strict approach).

23. The main purpose of the demand rule "is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975).

24. *See* Note, *supra* note 20, at 748-49.

that such demand would be futile because of director self-interest.[25] Traditionally, allegations of fraud, collusion, dishonesty, or breach of trust suffice to render demand futile.[26]

THE BUSINESS JUDGMENT RULE

It is a well settled doctrine of corporate law that the board of directors is empowered to make the business decisions of the corporation.[27] In order to protect and further this power it is necessary that corporate directors be free to exercise their good-faith discretion in managing business affairs.[28] Hence, the business judgment rule developed defensively[29] to shield a diligent director from personal liability should certain business decisions later prove improvident.[30]

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25. Futility is a term of art left undefined by the Federal Rules of Civil Procedure. Therefore, the practitioner must consult relevant state case law in seeking to define the term. *See In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 261 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). The United States Supreme Court in Doctor v. Harrington, 196 U.S. 579 (1905) held that control of the board of directors by a malfactor is enough to excuse demand even without facts adducing how this control was obtained or exerted. Arguably, all that is required is a prima facie showing of facts such that "[e]very sensible man, out of a court of justice, knows [that a demand under the circumstances] would never be complied with." *In re* Penn Central Sec. Litigation, 367 F. Supp. 1158, 1165 (E.D. Pa. 1973) (quoting Young v. Alhambia Mining Co., 71 F. 810, 812 (N.D. Del. 1895).

26. Gall v. Exxon Corp., 418 F. Supp. 508, 516 (S.D. N.Y. 1976). *See also* Swanson v. Traer, 354 U.S. 114, 116 (1957); Des Moines Bank & Trust Co. v. George M. Bechtel & Co., 243 Iowa 1007, 1083, 51 N.W.2d 174, 217 (1952); Outing v. Plum, 212 Iowa 1169, 1171, 235 N.W. 559, 560 (1931); First Nat'l Bank v. Fireproof Co., 199 Iowa 1285, 1294, 202 N.W. 14, 18 (1925).

27. Courts and commentators have not agreed on an exact definition of the business judgment rule. *See, e.g.*, Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 243-44 (D. Neb. 1971), *aff'd*, 473 F.2d 337 (8th Cir. 1973); Otis & Co. v. Pennsylvania R.R. Co., 61 F. Supp. 905, 910-11 (E.D. Pa. 1945), *aff'd*, 155 F.2d 522 (3d Cir. 1946); Warshaw v. Calhoun, 43 Del. Ch. 148, 157-58, 221 A.2d 487, 493 (Sup. Ct. 1966). *See also* Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157 (1970); Uhlman, *The Duty of Corporate Directors to Exercise Business Judgment*, 20 B.U.L. REV. 488 (1940); Note, *The Business Judgment Rule and the Declaration of Corporate Dividends: A Reappraisal*, 4 HOFSTRA L. REV. 73 (1975).

A fairly complete definition of the rule is given as follows: "A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damage, unless: (1) the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or (2) the directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or (3) in some other way the directors' authorization of the transaction was not in good faith." Arsht, *supra* note 4, at 111-12.

28. *See* 3A W. FLETCHER, *supra* note 2, at §1039.

29. The defensive nature of the rule is of doubtful validity when the rule is used to allow directors to dismiss derivative suits. This unusual prospective application of the rule is not unanimously agreed upon. *See* Maldonado v. Flynn, 413 A.2d 1251, 1256-62 (Del. Ch. 1980), where the court found the prospective use a misapplication.

30. *See* Arsht, *supra* note 4, at 97-100. The primary function of the business judgment

The adherence to the underlying premises of the business judgment rule are crucial for the effective operation of both the modern business community and the judiciary.[31] The rule recognizes that despite the utmost display of good faith, directors are not infallible.[32] Furthermore, if every corporate transaction was subject to judicial review, both business entities and the courts would continuously be involved in evaluating the soundness of financial decisions.[33] The business judgment rule, therefore, establishes a standard[34] flexible enough to allow broad leeway for the vagaries of the human decision-making process.[35]

The business judgment rule does not insulate all corporate directors' actions from challenge.[36] Rather, directors are required to exercise the utmost loyalty to the corporation.[37] The rule is inapplicable when the directors have profited at the corporation's expense,[38] or when they have made fraudulent, illegal or reck-

rule is to give the directors the same protection enjoyed by other professionals, such as doctors and lawyers, when they are sued for tortious malpractice. *Id.* at 97.

31. These underlying principles are not the subject of current concern. As one commentator noted: "If the business judgment rule has at times appeared to excuse deplorable behavior, it has not been because the rule licenses such behavior, but because in such instances either the plaintiff failed to establish the facts necessary to make the defense inapplicable or the then prevailing standards of conduct did not warrant, in the eyes of the court, the imposition of liability under the developed facts." *Id.* at 96. The commentator, however, overlooks one other reason why the rule may appear inequitable. That is, the court may simply misapply the rule.

32. The business judgment rule is founded upon an awareness and understanding of human nature. *See, e.g.*, Godbold v. Branch Bank, 11 Ala. 191, 201 (1847); Percy v. Millaudon, 8 Mart. (n.s.) 68, 76-77 (La. 1829).

The rule is also designed to take into account the need for economy and efficiency in both the courts and industry. *See, e.g.*, Karsik v. Pacific Elec. Corp., 21 Del. Ch. 81, 97, 180 A. 604, 611 (1935); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928).

It should be noted that in the vast majority of day to day decisions the business judgment rule is more pertinent to the officers of a corporation than to its directors. Although the directors are included in the general duty of decision making, the officers have far more occasion to exercise their business judgment on even the most trivial of decisions. Almost without exception, the courts have applied the business judgment rule equally to both officers and directors so long as they act within their powers. *See* Bayne, *The Fiduciary Duty of Management — The Concept in the Courts*, 35 U. DET. L.J. 561, 573-75 (1958).

33. According to the United States Supreme Court, directors are not obligated to pursue all causes of action and may justifiably waive a legal right vested in the corporation in the belief that the corporation's best interests will be served by not litigating. Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903). In Bernstein v. Mediobanca Banca di Credito Finanzario-Societa Per Azioni, 69 F.R.D. 592, 595 (S.D.N.Y. 1974), the court concluded that if this were not the case, litigious shareholders with whatever small holdings, could bring a derivative action after the board had determined the action not to be in the corporation's best interests.

34. The flexibility of the business judgment standard is analogous to the reasonable man principle used in tort. 3 W. FLETCHER, *supra* note 2, §1030. *See also* Note, *supra* note 3, at 562.

35. *See* Arsht, *supra* note 4, at 97-100.

36. *See* Note, *supra* note 3, at 562-63.

37. *See* Arsht, *supra* note 4, at 115-33. Whether a director has maintained a sufficient degree of loyalty to the corporation will vary from court to court. *Compare* Harman v. Willbern, 520 F.2d 1333 (10th Cir. 1975), *with* McDonell v. American Leduc Petrol., Ltd., 491 F.2d 380 (2d Cir. 1974).

38. *See* Note, *supra* note 3, at 564. The business judgment rule is inapplicable "when an objective evaluation of the forces operating to influence the directors at the time of the de-

less decisions.[39] Thus, directors may not invoke the business judgment rule unless they have not have been involved in any alleged misconduct and they have acted in good faith.[40]

Use of the Business Judgment Rule to Dismiss Shareholder Derivative Suits

Several recent federal cases have relied on the business judgment rule as a basis for dismissing shareholder derivative suits against a corporation and its directors.[41] Termination of the suit is allowed when those directors who are not involved in the misconduct or a specially-created committee of such disinterested directors collectively determine that the suit is not in the best business interests of the corporation.[42] Director disinterestedness is generally an essential prerequisite to the use of the rule, but establishing such disinterest may be problematic.

In *Burks v. Lasker*,[43] a group of directors in a registered investment company determined that the corporation should not judicially pursue certain allegations made by two stockholders. The federal district court upheld this corporate decision, stating that the plaintiff shareholders had failed to meet their burden of establishing that the minority directors were not disinterested.[44]

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cision in question discloses that a real conflict could have existed between forces tending toward a decision for the advantage of all the shareholders and those tending to the personal advantage of the directors." *Id. But see* Maldonado v. Flynn, 485 F. Supp. 274, 283 (S.D.N.Y. 1980) (court allowed a special litigation committee to dismiss an action based upon the manipulation of a stock option plan clearly done to aid the directors as optionees at the expense of the corporation).

39. Ash v. International Bus. Mach. Corp., 353 F.2d 491, 493 (3d Cir. 1965).

40. All courts allowing dismissal of shareholder actions have found that directors or members of the litigation committees were disinterested. See cases cited in note 8 *supra*. The problem, however, lies with the criteria used by the courts to determine disinterestedness. *See* Arsht, *supra* note 4, at 95-97. The author concluded that if at times the business judgment rule appears "to excuse deplorable behavior," it is because either the plaintiff or the court has misapplied the rule and not because the court licenses such behavior.

41. 441 U.S. 471 (1979). Motions to dismiss shareholder suits have been filed under various provisions of the Federal Rules of Civil Procedure. *E.g.*, Brooks v. American Export Indus., 68 F.R.D. 506 (S.D.N.Y. 1975) (FED. R. CIV. P. 12(C), motion for judgment on the pleadings); Bernstein v. Mediobanca Banca di Credito Finanziario-Societa Per Azioni, 69 F.R.D. 592 (S.D.N.Y. 1974) (FED. R. CIV. P. 56, summary judgment).

Compare Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980) (not allowing dismissal by directors) *with* Genzner v. Cunningham, 498 F. Supp. 682, 692 (E.D. Mich. 1980) (allowing dismissal by directors).

42. Lasker v. Burks, 426 F. Supp. 844, 852 (S.D.N.Y. 1977), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979). *See, e.g.*, Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 829 (S.D.N.Y. 1979).

Commentators have repeatedly stated that directors must exercise due care in determining what course of action is in the corporate best interest. *See* 3 W. FLETCHER, *supra* note 2, §1039, at 42 n.9 H. HENN, LAW OF CORPORATIONS §243 at 482-83 (2d ed. 1970). The majority view is that directors exercise due care if they give reasonable consideration to each such decision. Comment, *Directors' Failure to Bring Suit, Demand and the Business Judgment Rule*, 3 J. CORP. L. 208, 211 n.28 (1977).

43. 441 U.S. 471 (1979).

44. Lasker v. Burks, 426 F. Supp. 844 (S.D.N.Y. 1977).

The Second Circuit reversed and took a more pragmatic view of the relationship between independent and non-independent directors.[45] The court stated "[i]t is asking too much of human nature to expect that the disinterested 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."[46] Moreover, the court noted it was possible that such considerations would prevent directors from reaching truly independent decisions even though these directors had acted in good faith.[47] The United States Supreme Court[48] reversed the appellate decision based on other considerations, but stated that corporate directors were not absolutely forbidden from terminating non-frivolous shareholder actions.[49] Support still exists, however, for the Second Circuit's approach.[50]

Courts vary greatly in defining what actions are sufficient to establish the degree of director self-interest required to bar the use of the business judgment rule.[51] In some cases, a substantial allegation of fraud or lack of good faith appearing on the face of the complaint is sufficient to infer a lack of disinterestedness. Allegations of negligence may also be adequate to require a hearing on the merits if they are great enough to imply fraud or willful recklessness.[52] However, some courts have held that allegations of participation in an illegal activity are not sufficient to waive the business judgment rule absent some showing of self-interest or bias.[53] Because different jurisdictions have applied varying standards, corporate managements have considered alternative methods of establishing director distinterestedness to the satisfaction of the courts.

Special Litigation Committees

The special litigation committee developed as a method for impartially monitoring certain corporate activities.[54] The emergence of these committees

45. Burks v. Lasker, 567 F.2d 1208, 1210-12 (2d Cir. 1978). *See also* Comment, *Minority Directors of a Registered Mutual Fund, Nominated by the Majority Directors as Independent Directors Pursuant to the Investment Company Act, May Not Terminate a Nonfrivolous Stockholder's Derivative Action Against the Fund's Majority Directors and its Investment Advisor*, 47 CIN. L. REV. 349, 352-54 (1978).

46. 567 F.2d at 1212.

47. *Id.* Judge Lumbard pointed out that the independent directors of a mutual fund are forced to rely on the expert opinion and advice of the non-independent directors and the investment advisor. Moreover, the directors must work together each day and would therefore develop ties of loyalty. Such factors make it virtually impossible to have totally disinterested directors. *Id.*

48. 441 U.S. 471 (1979).

49. *Id.* at 473.

50. *See generally* Comment, *supra* note 45, at 352-54. *But see* Comment, *Mutual Fund-Independent Directors Are Not Empowered to Seek Dismissal of a Shareholders-Derivative Suit Brought Against the Affiliated Directors*, 10 RUT.-CAM. L.J. 512, 518 (1979) (circuit court decision was exteme and unnecessary).

51. *See* Coffee, *supra* note 1, at 1229-36.

52. *See, e.g.*, Continental Sec. Co. v. Belmont, 83 Misc. 340, 347-51, 144 N.Y.S. 801, 806-08 (Sup. Ct. 1913). *See also* Note, *supra* note 3, at 562.

53. *See, e.g.*, Issner v. Aldrich, 254 F. Supp. 696, 701-02 (D. Del. 1966).

54. One commentator has suggested that the Securities and Exchange Commission may

was also consistent with the widespread practice of allowing corporate executive committees to exercise director powers.[55] The special litigation committee usually meets to investigate a shareholder claim and presumably is composed of directors who are not involved in the alleged complaint. An interested majority of the board of directors, however, may effectively be permitted to manufacture disinterestedness through its director appointments to these special committees.[56] Such board members may find these committees particularly advantageous since they can be formed by virtually any corporation, except where prohibited by the corporate bylaws.[57]

In *Gall v. Exxon Corp.*,[58] the plaintiff-shareholder brought a derivative action against Exxon Corporation, its officers and directors, to recover allegedly illegal payoffs made by the defendants to political parties in Italy.[59] Upon receiving the plaintiff's demand to sue, the Board of Directors of Exxon, established a special litigation committee to investigate the allegations and determine whether legal action should be taken against any former or current Exxon officers or directors.[60] The committee was composed of three active directors of Exxon[61] and was empowered to act as the full board of directors in

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have inadvertently encouraged the development of special litigation committees. *See* note, *supra* note 8, at 608.

55. For a discussion of the rise in popularity of the delegation of the powers of the board of directors to executive committees, *see* W. CARY, *supra* note 2, at 810-17. For further background on executive committees, *see generally* Mylander, *Management by Executive Committee*, 33 HARV. BUS. REV. 51 (1951).

56. In the majority of decisions, courts have restricted their examination of the committee to the committee's methodology, depth of investigation and independence. *See, e.g.*, Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994 (1979), 419 N.Y.S.2d 920. Generally, if the plaintiff fails to show bias on these points the committee's decision will be immune from challenge. Note, *supra* note 8, at 610. For complete discussion of the rise of the special litigation committee see *id.* at 608-16.

57. The directors may not form such a special litigation committee where it is expressly forbidden by the corporation's bylaws, or where the bylaws do not provide for executive committees. In Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976), one of the first cases involving the use of such a committee, the court even reproduced the applicable section of Exxon Corp.'s bylaws which allowed such actions. *Id.* at 510 n.1.

58. 418 F. Supp. 508 (S.D.N.Y. 1976).

59. *Id.* at 509-14.

60. The resolution creating the committee stated its exact purposes and powers. The committee was empowered to do three things: (1) conduct the investigation into all matters referred to in the demand by the shareholders; (2) make a determination as to whether the action should be pursued; and (3) supervise any actions deemed necessary *Id.* at 510-11.

61. The committee was composed of Jack F. Bennett, who was a senior vice-president of Exxon as well as a director, and two outside directors. The two outsiders were Richard Dobson, chairman and executive officer of British-American Tobacco Co., Ltd. and Edward Harness, chairman of the board and chief executive officer of Proctor & Gamble Corp. *Id.*

This is the typical make-up of such committees. The outsiders on these committees are almost always directors or officers of other major corporations. It is also quite common for well known members of the bar to serve as special counsel to these committees. *See, e.g.*, Lasker v. Burks, 567 F.2d 1208, 1210 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979) (retained Stanley H. Fuld, former Chief Judge of the New York Court of Appeals); Gall v. Exxon Corp., 418 F. Supp. 508, 514 n.2 (S.D.N.Y. 1976) (retained Joseph Weintaub, former Chief Justice of the New Jersey Supreme Court).

matters within its mandate.[62] After an extensive investigation, the committee concluded that further pursuit of the action would not be in the best interests of the corporation.[63] Among the factors cited in the committee's decision to dismiss were: the cost of the suit, the potential consequences of failure, the interruption of business, and the undermining of personnel morale.[64] The committee, however, seemed to ignore the fact that seven of thirteen named defendants knew of the illegal payments.[65]

Prior to the development of special litigation committees, courts had restricted the boards' authority to decide whether to pursue shareholder claims where a majority of board members were connected with the alleged wrongdoing.[66] Such committees, however, have become an increasingly popular method of handling alleged disputes involving corporate director activities.[67] Most courts erroneously assume that state law gives directors the authority to create special litigation committees.[68] Judicial approval of these committees has made it possible for a minority of outside directors to protect their colleagues from personal liability for corporate misdeeds.[69] Some boards have gone so far as to appoint new members for the sole purpose of sitting on these committees.[70] The potential for director manipulation through these special litigation committees has, therefore, become virtually limitless.

In adhering to the committee decisions, the courts have generally failed to consider what one commentator has recently labeled the "structural bias" approach.[71] This approach suggests that the members of special litigation committees should not be presumed to be impartial since other factors unavoida-

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62. 418 F. Supp. at 510-11.

63. The investigation continued for four months and involved interviews with over 100 witnesses. The report contained 32 pages summarizing the committee's findings of fact and recommendations. *Id.* at 511. For results of the investigation *see id.* at 511-14.

64. *Id.* The problem with such a rationale is that if taken to an extreme, it could be used to dismiss all litigation by shareholders. At least in the short run, it would seem likely that any suit involving the corporate officers or directors would be costly for the corporation, either directly or indirectly. Likewise such a suit will normally do little to boost corporate morale. *See* Coffee, *supra* note 1, at 1237. For a brief summary of reasons that courts have accepted in upholding directors' disapproval of suits *see* S. Solomon & Sons Trust, Inc. v. New England Theatres Operating Corp., 325 Mass. 99, 108, 109, 93 N.E.2d 241, 246 (1950).

65. 418 F. Supp. at 512-14. *See* Comment, *supra* note 42, at 210-11.

66. *See, e.g.,* Continental Sec. Co. v. Belmont, 206 N.Y. 7, 15-19, 99 N.E. 138, 141-42 (1912); Montgomery Light Co. v. Lahey, 121 Ala. 131, 135-37, 25 So. 1006, 1008 (1899).

67. *See, e.g.,* Lewis v. Anderson, 615 F.2d 778, 780 (9th Cir. 1979); Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 265-66 (3d Cir. 1978); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 821-22 (S.D.N.Y. 1979).

68. Note, *supra* note 8, at 617-29.

69. One solution available to defendant directors is to expand the board and appoint new directors to the committee who cannot be disqualified because they were not in office at the time of the transaction. Coffee, *supra* note 1, at 1230. However, if the courts are not careful, such appointments could become a handsome reward for a proper vote.

70. Such a change in the composition of the board has been held to make demand necessary even where it was previously excused as futile. *See* Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975).

71. Note, *supra* note 8, at 619-26.

bly limit such impartiality. In particular, the commentator notes that there are certain structural, financial, psychological, and social attachments among corporate directors which undercut any presumption of automatic disinterestedness.[72] The Fifth Circuit became the first court to officially recognize this theory in *Clark v. Lomas & Nettleton Financial Corp.*[73] In that case, the shareholders of Booth, Inc. brought a derivative action against a corporate shareholder, and the president of Booth, the corporation's largest stockholder.[74] The complaint alleged that a previous corporate merger had been effected through various securities frauds.[75] Joined by other named defendants, the directors of Booth petitioned the court for dismissal of the suit.[76] Upon denial of this motion, the directors of Booth negotiated and reached a settlement with other Booth shareholders without consulting the plaintiffs.[77] Plaintiffs subsequently challenged this settlement in federal district court, but the court determined that Booth's directors were disinterested, and that the compromise was reasonable.[78]

The Fifth Circuit reversed the lower court on appeal.[79] Referring to the structural bias theory, the *Clark* court suggested that the directors' control over corporate litigation presupposed that the Booth directors were not disinterested.[80] Because Booth's charter prohibited cummulative voting, every director who ratified the settlement was elected by the combined vote of the two defendants, the two largest shareholders in the Booth corporation.[81] The court apparently concluded that since the other directors served at the sufference of these majority leaders, a structural bias existed which was sufficient to make Booth's directors interested.[82]

The rationale of the *Clark* decision could be extended to the area of special litigation committees. Just as the directors in *Clark* were potentially controlled by the majority shareholders, the members of special litigation committees may serve at the discretionary will of the board. Therefore, sufficient structural bias may exist to raise questions concerning the disinterestedness of committee members.

The Board's Decision Not To Sue

The legal effect of a decision by a board of directors, not to bring suit is currently unsettled. In the Delaware decision *Sohland v. Baker*,[83] a shareholder

72. *Id.*
73. 625 F.2d 49, 53 (5th Cir. 1980).
74. *Id.* at 51-52.
75. *Id.*
76. *Id.* at 51.
77. *Id.*
78. *Id.* at 51-52.
79. *Id.* at 53.
80. *Id.*
81. *Id.* at 52.
82. *Id.* at 53. *See* N. LATTIN, CORPORATIONS 239 (2d ed. 1971). This is so for many reasons including their knowledge of the inner workings of the corporation, the knowledge of the current proxy control situation, and in many situations their established affiliation with other corporate insiders.
83. 15 Del. Ch. 431, 141 A. 277 (1927).

sought cancellation and an accounting of certain stocks issued in the names of the defendants.[84] The court found that if the directors refused to sue after sufficient demand had been made upon them then, the shareholder could proceed independently with the suit.[85] The court concluded the reasons for such refusal to sue were irrelevant, and that, therefore, the right to bring suit vested in the plaintiff shareholder.[86]

The *Sohland* view is not a unanimous interpretation.[87] Some commentators have argued that courts should find the directors' refusal to sue is indefensible before allowing the shareholders to proceed independently.[88] This restrictive

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84. *Id.* at 432-33, 141 A. at 277-81.

85. *Id.* at 443, 141 A. at 282. The court stated the generally accepted rule that, "a cause of action belonging to a corporation can be asserted only by such corporation by a suit in the corporate name." The court, however, went on to find that, "conditions exist . . . whereby a stockholder may sue in his own name for the purpose of enforcing corporate rights. . . ." The conditions which allow such an action by the shareholder exist where after proper demand the corporation refuses to sue. *Id.* at 441, 141 A. at 281.

The court also made it clear that shareholders needed a means to enter the court system to protect themselves. The court stated that: "While the conclusion may be drawn that the corporate management was not hostile to action by the complainant, the fact, nevertheless, remains that the corporation itself refused to litigate an apparent corporate right. The reasons for such refusal need not be considered. The corporation, having refused to institute proceedings, the only way that its rights could be brought before the court was by a bill filed by a stockholder. That the complainant, for the prevention of injustice, therefore, had the right to file the bill in the court, seems clear." *Id.* at 282.

86. *Id.* at 443, 141 A. at 282. *Accord*, Papilsky v. Berndt, 503 F.2d 554, 556 (2d Cir.), *cert. denied*, 419 U.S. 1048 (1974). *Papilsky* suggested that once the exhaustion requirement had been satisfied, either by a refusal of the corporation to act after demand or by a determination that demand is not required, shareholders may bring a derivative action. *But see* Note, *supra* note 18, at 191-92 where it was suggested that "the better view is that shareholders may not maintain a derivative action until they have demonstrated their standing to sue."

This standing requirement has been referred to as the "sine qua non of the stockholder's derivative right to sue." Stadin v. Union Elec. Co., 309 F.2d 912, 921 (8th Cir. 1962), *cert. denied*, 373 U.S. 915 (1963).

87. *E.g.* Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957), where the court found the board's mere refusal to act upon demand did not, ipso facto, clear the way for a suit by the shareholder. *Id.* at 858. The court also found that unless an equitable basis for interference is shown, stockholders have "no more right to challegene by a derivative suit a decision by the board of directors not to sue than to so challenge any other decision by the board." *Id.* at 859. *See*, H. BALLANTINE, *supra* note 2, at 349, where it was stated that a decision by the directors not to sue, "is a bar to the beginning of a derivative suit by a shareholder." *See also* United States Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Klotz v. Consolidated Edison Co. of New York, Inc., 386 F. Supp. 577, 581-82 (S.D.N.Y. 1974).

88. *See* Blake, *The Shareholders' Role in Antitrust Enforcements*, 110 U. PA. L. REV. 143, 144 n.6 (1961). *See also* N. LATTIN, *supra* note 82, at 349-52 (1959). Recognizing that standing is the threshold question, several district courts have either ordered separate trials or limited discovery on the standing issue. *See, e.g.*, Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Lasker v. Burks, 404 F. Supp. 1172 (S.D.N.Y. 1975), *rev'd*, 441 U.S. 471 (1979); Bernstein v. Mediobanca Banca di Credito Financio-Societa Per Azioni, 69 F.R.D. 592 (S.D.N.Y. 1974).

Federal Rules of Civil Procedure 42(b) authorizes separate trials only "in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition and economy." Implicit in rule 42(b) is the power to limit discovery to segregated issues. Ellingson

view appears to be the prevailing view of the federal courts.[89] Consequently, directors may be able to use the business judgment rule in federal court to bar shareholders from initiating deriavtive actions when the corporation has refused to sue.[90]

The Misapplication of the Business Judgment Rule in the Federal Courts

Federal courts applying the business judgment rule must generally follow the law of the state of incorporation in determining whether disinterested directors have the power to terminate derivative suits.[91] In the recent decision *Burks v. Lasker*,[92] the United States Supreme Court established a two-pronged inquiry to determine the permissibility of such a dismissal. The threshold question was whether the applicable state law permited independent directors to terminate the suits.[93] If state law allowed dismissal, the second consideration was whether dismissal of the suit was consistent with all federal law upon which the action was based.[94] Where state laws significantly impacted upon the en-

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Timber Co. v. Great N. Ry. Co., 424 F.2d 497, 499 (9th Cir.), *cert. denied*, 400 U.S. 957 (1970). *See* Note, *supra* note 18, at 199.

89. *But see* Galef v. Alexander, 615 F.2d 51, 59 (2d Cir. 1980), where the court suggested different standards of interestedness apply to cases where the plantiff has made no demand and those in which a demand has been made and rejected. *Id.*

90. Although some courts may excuse demand altogether, if the plaintiff proves that a minority of interested directors control the board, the courts generally allow a majority of disinterested directors to terminate a suit against a minority of alleged wrongdoers. Note, *supra* note 8, at 606-07. *See, e.g.*, Calef v. Alexander, 615 F.2d 51, 57 (2d Cir. 1980); Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361, 369-70 (N.D. Ill. 1974). *But see* Boyko v. Reserve Fund Inc., 68 F.R.D. 692, 696 (S.D.N.Y. 1975) ("where there is at least one affiliated or interested director on the board of a mutual fund, the futility of demand on the entire board will be presumed"); Bayne, *A Flaw in the Law: The Demand Rule: A Brief*, 22 St. Louis L.J. 69, 80 (1978).

91. *See* Burks v. Lasker, 441 U.S. 471, 475-76 (1979); Cort v. Ash, 422 U.S. 66 (1975); Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 545 (1948). *See also* Coffee, *supra* note 1, at 1224 n.455-56.

92. 441 U.S. 471 (1979). This suit was instituted by the shareholders of Fundamental Investors, Inc., a mutual fund, to recover losses suffered by the fund as a result of its purchase of twenty million dollars in Penn Central Transportation Co. short term notes. Seven months later Penn Central filed for bankruptcy. The shareholders alleged that the directors had violated their duties under the Investment Company Act of 1940, 15 U.S.C. §§80a-1 to 52 (1976), and certain common law principles regarding commercial paper. For a discussion of the Investment Company Act and the special problems related to mutual funds *see generally* Lobell, *The Mutual Fund: A Structural Analysis*, 47 Va. L. Rev. 181 (1961). For a discussion of the duties of directors under the Investment Company Act *see generally* Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799 (1976); Lipton, *Directors of Mutual Funds: Special Problems*, 31 Bus. Law. 1259 (1976); Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179 (1971); Radmer, *Duties of the Directors of Investment Companies*, 3 J. Corp. L. 61 (1977); Comment, *Duties of the Independent Director in Open-End Mutual Funds*, 70 Mich. L. Rev. 696 (1972).

93. 441 U.S. at 474.

94. *Id.* at 476. The Court cited J.I. Case v. Borak, 377 U.S. 426, 434 (1964) which stated: "the overriding federal law applicable here would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law. . . ." *Id.*

forcement of federal rights, federal law would prevail.[95]

Due to the federal courts' disregard or misinterpretation of state law, different results have been reached when federal and state courts purport to apply the same law to the same facts. An example of such a conflict appears in the two separate opinions of *Maldonado v. Flynn.*[96] A minority shareholder in *Maldonado,* brought a derivative suit claiming that the directors of Zapata Corporation had avoided substantial federal tax liability at the expense of the corporation by accelerating the date upon which their stock options could be exercised.[97] Zapata's directors subsequently formed an independent investiga-

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95. 441 U.S. at 476.

96. 485 F. Supp. 274, 286-87 (S.D.N.Y. 1980); 413 A.2d 1251 (Del. Ch. 1980). The action was first brought in the Federal District Court for the Southern District of New York in 1978, where it was dismissed for failure to state a cause of action. Maldonado v. Flynn, 448 F. Supp. 1032 (S.D.N.Y. 1978). The Court of Appeals affirmed, except as to the plaintiff's claim that misleading proxy materials were used in a subsequent director election. Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979). The plaintiff filed an amended complaint based upon the same facts but alleging only a single cause of action for violations under §14(a) of the Securities Exchange Act. The claim in the state court of Delaware was based upon a breach of the directors' fiduciary duty to the corporation. 413 A.2d at 1254. The suits in both jurisdictions were based upon the same set of facts which were not in dispute. Therefore, the facts enumerated will be taken from both decisions in an effort to give a complete understanding of the situation.

Adding to the confusion, the Delaware Chancery Court was recently forced to reconsider its decision in *Maldonado* and has dismissed the action on res judicata grounds. Maldonado v. Flynn, 417 A.2d 378, 380. Therefore, the precedential value of the Delaware Court's original decision in *Maldonado* is questionable. *See, e.g.,* Maher v. Zapata Corp., 490 F. Supp. 348, 353 (S.D. Tex. 1980) (federal district court relied heavily on the Delaware Chancery Court decision in *Maldonado*). Although the Delaware version of *Maldonado* is technically invalid, it was invalidated on procedural grounds and the court's reasoning will most likely still carry considerable force and weight.

97. 413 A.2d at 1254-55. In 1970, the board of directors adopted a stock option plan in which certain Zapata officers and directors were granted options to purchase common stock installments. Prior to the exercise of the final option installments, however, Zapata planned a tender offer for 2,300,000 of its shares which was predicted to increase the market value of the stock. Zapata's directors, most of whom were optionees, realized that substantial additional tax liability would be incurred if their options were exercised after the tender offer announcement. Therefore, the directors modified the stock option plan to allow acceleration of the date at which the option could be exercised. The amendments to the stock option plan applied only to Zapata's six senior officers. 597 F.2d at 792. Four of the six senior officers were also directors of Zapata. *Id.* at 791 n.1. Three resolutions were adopted by the board of directors in connection with the modification of the stock option plan. One resolution accelerated the exercise date of the final option from July 14, 1974 to July 2, 1974. The other two resolutions modified the plan to authorize the corporation to make interest-free loans to the six optionees in the amount of the purchase price for the options exercised and for tax liability incurred as a result of their exercising the options. 597 F.2d at 792.

The board made these amendments to the plan contingent upon shareholder approval. For some unexplained reason, however, the modifications were never submitted to the shareholders. *Id.* The defendant optionees denied the shareholder's allegations and asserted that any such deduction would have been minimal or nonexistent due to operating and capital loss carrybacks which were available to the corporation. 413 A.2d at 1255.

Note that this suit was against the corporate directors rather than against a third party. Thus, the directors had a direct stake in its outcome. Such may not be the case when shareholders seek to enforce the corporation's rights against third parties because the directors may

tive committee[98] composed of two ostensibly independent outside directors.[99] After an investigation of the minority shareholder's allegations, the committee determined the litigation was contrary to Zapata's best interests and recommended dismissal of all pending suits.[100] The federal district court consequently granted a dismissal of the suit, holding that the directors had the authority to use their business judgment in refusing to pursue the shareholder's claims.[101] Shortly thereafter, the Delaware Chancery Court arrived at a contrary result on identical facts, finding the business judgment rule contained no independent grant of power to dismiss such suits.[102]

In both *Maldonado* decisions, the courts appropriately referred to the *Burks* decision as the foundation for their analysis.[103] The two *Maldonado* courts started with the *Burks* proposition that federal courts must apply state law.[104] The courts, however, took divergent paths in their interpretation of the substantive law of Delaware. The New York federal district court stated that the Delaware courts had not faced the precise issue of whether disinterested directors may terminate derivative suits.[105] Consequently, the court turned to an Eighth Circuit decision[106] which held that Delaware law permitted such dismissal.[107] The Delaware Chancery Court, on the other hand, cited *Sohland v. Baker*[108]

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have no personal stake in the outcome. The courts have been misled by the superficial similarity between these two forms of derivative action and consequently have indiscriminately applied the business judgment rule to both. Note, *supra* note 8, at 603-08.

98. 413 A.2d at 1255. This committee was formed nearly four years after Maldonado filed his complaint. The committee was authorized to investigate the claims of both the state and federal actions and take any course of action it deemed appropriate. *Id.*

99. It is not clear whether these two newly appointed directors were appointed because of a lack of other disinterested directors. At the time of the modification of the stock option plan, the board had four directors who were non-employees and thus ineligible to be optionees. The directors who were optionees did not participate directly in the meeting and did not vote on the modification of the plan. 597 F.2d at 791-92.

100. 413 A.2d at 1255.

101. 485 F. Supp. 274, 283.

102. 413 A.2d at 1263.

103. 485 F. Supp. at 283.

104. See text accompanying notes 91-95 *supra*. Both courts point out that no Delaware court had previously considered the exact issue faced in *Maldonado*, 485 F. Supp. at 278, 413 A.2d at 1257. The Delaware court further found no statutory authority addressing the question. However, the Delaware court, relying upon other Delaware case law, found the answer to the issue in state court interpretation of the business judgment rule. *Id.*

105. 485 F. Supp. at 278 (S.D.N.Y. 1980). The court cited Delaware law which recognized the business judgment rule but based its ultimate decision on other federal case law. *Id.*

The district court found it insufficient for the plaintiff to merely allege that the directors were interested or lacked good faith. The court held that a showing of fact was necessary to find the directors interested and thus remove the decision from them. *Id.* at 284.

106. Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1070 (1980).

107. The *Abbey* decision failed to cite any Delaware cases allowing the application of the business judgment rule to dismiss derivative suits where the directors were charged with misdoings. The court did, however, cite the Delaware case of Beard v. Elster, 39 Del. Ch. 153, 160 A.2d 731 (1960) which found that the internal affairs of Delaware corporations are controlled by Delaware law.

108. 15 Del. Ch. 431, 141 A. 277 (1927). See text accompanying notes 83-86 *supra*.

for the proposition that the shareholder possesses an independent right to bring a derivative suit in the corporation's name.[109] Because of this right, the directors could not invoke the business judgment rule as an independent grant of authority with which to dismiss derivative suits.[110] The authority to terminate such a suit, if it existed at all, must be found outside the business judgment rule.[111]

The contradictory *Maldonado* decisions indicate that federal courts facing this issue may have to make broad assumptions concerning the proper interpretation of state law.[112] Few state courts, however, have spoken directly on the subject.[113] Consequently, a separate federal common law concerning the application of the business judgment rule has developed despite the established proscription against developing such federal law.[114] Nevertheless, federal courts

109. 413 A.2d at 1260. The Delaware court concluded that *Sohland*, standing alone, was probably sufficient to deny Zapata's motion for dismissal. The court also pointed out that neither party had cited *Sohland*. *Id.* at 1261.

110. Maldonado v. Flynn, 413 A.2d at 1257-61. The court reasoned that the "[nature of the derivative suit] not the existence of the business judgment rule, determines whether the directors of a Delaware corporation have the authority to prevent the stockholders from bringing or continuing a cause of action to enforce a corporate right of action against the corporate directors for breach of fiduciary duty when the corporation refuses, explicitly or by implication, to bring the action." *Id.*

The Delaware court in *Maldonado* also concluded that once a shareholder has demanded that the corporation sue for a proper cause and has been met with refusal, "he may assert his individual right and the corporate right together in a derivative suit, and the corporation no longer controls the corporate right to which the plaintiff's individual right attaches." *Id.* at 1262. *See also* 3 C. POMEROY, POMEROY'S EQUITY JURISPRUDENCE §1095 (1970).

111. 413 A.2d at 1257. The court classified the business judgment rule as, "merely a presumption of propriety accorded decisions of corporate directors." *Id.* The court went on to conclude that the rule, "provides a shield with which directors may oppose stockholders' attacks on the decisions made by them." *Id.* The court further found that what the business judgment rule was not, was an independent grant of authority to dismiss derivative suits. *Id.*

112. *See, e.g.*, Abbey v. Control Data Corp., 603 F.2d 724, 728-29 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979).

In *Lewis* the court summed up the problem that exists in attempting to determine state law by stating: "The California Supreme Court has never faced the issue presented here; we therefore 'sit as a state court' and look for guidance from intermediate appellate courts in California, and from courts in other jurisdictions which have recently considered the question." *Id.*

The Court in *Burks* was proceeding on a federal cause of action under the Investment Company Act of 1940 §1, 15 U.S.C. §80a-1 (1976) and the Investment Advisors Act of 1940 §201, 15 U.S.C. §80b-1 (1976); therefore their decision was not made under Erie R.R. v. Tompkins, 304 U.S. 64 (1938), and state law does not operate of its own force. 441 U.S. at 476. For a further explanation *see* Hart, *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489, 529 (1954).

113. At this time it appears that only the Delaware Chancery Court has spoken directly on the subject in *Maldonado.*

114. The landmark decision Erie R.R. v. Tompkins, 304 U.S. 64 (1938) established that federal courts must generally apply state substantive law except in matters governed by the Federal Constitution or Acts of Congress. The *Erie* decision also stated that there is no federal general common law. Nevertheless, a type of federal common law has developed as the result of the federal courts relying upon pre-*Erie* decisions concerning the powers of directors. Since no state courts have spoken on the subject until recently, the pre-*Erie* based federal common law has continued to be applied in the federal sphere.

have continued to follow previous federal decisions concerning the application of the business judgment rule even though state law should be the controlling precedent.[115]

The errors resulting from the federal courts' reliance upon federal rather than state law has been compounded by their tendency to misinterpret the relevant federal law. Even the federal precedents do not appear to support dismissal of derivative actions in a case like *Maldonado*.[116] For example, in the oft-cited opinion *Corbus v. Alaska Treadwell Gold Mining Co.*,[117] the Supreme Court dismissed a shareholder's suit to enjoin the collection of a tax from a corporation.[118] The Court held that the shareholder lacked standing to bring the suit since the corporation itself would not have been entitled to an injunction.[119] Therefore, the dismissal in *Corbus* was predicated upon the legal impossibility of the suit. Additionally, the plaintiff in *Corbus* did not allege that the directors breached their fiduciary duty or acted for their own gain,[120] whereas the directors in *Maldonado* were accused of corporate misconduct.

The landmark decision *Hawes v. Oakland*[121] has also been misused to support the dismissal of shareholder suits. The complaintant in *Hawes* sought to compel the City of Oakland to pay for water services that were being gratuitously provided by the corporation.[122] The Court stated that the directors could reasonably have determined this public service was in the best interests of the corporation, and therefore the business judgment rule insulated the directors' decision.[123] Unlike *Maldonado*, the business judgment rule was used in *Hawes* as a defense to the allegations in the complaint, not to terminate the suit before it began.[124] Moreover, the complaint contained no allegations of fraud or misconduct on the part of the directors. Consequently, although *Hawes*, *Corbus* and similar federal decisions resulted in the dismissal of share-

115. *See* Coffee, *supra* note 1, at 1223-24. Three of the most frequently cited Supreme Court decisions are: United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903); Hawes v. Oakland, 104 U.S. 450 (1881). For a discussion of these cases see text accompanying notes 116-125 *infra*.

116. In *Maldonado*, the directors themselves were charged with wrongdoing. This factor was not present in the frequently-cited pre-*Erie* decisions.

117. 187 U.S. 455 (1903).

118. *Id.* at 465.

119. This distinguishing factor was pointed out by the Delaware Court in *Maldonado*. 413 A.2d at 1258.

120. *Id.* Only the government could have gained from the situation. The directors were preparing to pay a tax to the government upon which the shareholder objected. In effect, the shareholder wanted the directors to do something they could not legally do.

121. 104 U.S. 450 (1882).

122. *Id.* at 451. The city had only been given permission to use the water free of charge "in case of fire or other great necessity," however, they had used it for various other municipal services. It was the contention of the directors of the Waterworks Co. that it would not be in their long-run best interests to sue the city. *Id.* at 451-53.

123. This is actually the precise interpretation of the business judgment rule. The directors were taking a business risk that allowing the city to have this water would be of long-term corporate benefit.

124. Although the case was dismissed, both sides had had time to perform necessary discovery even though no formal discovery rules were in effect. *Id.* at 450-56.

holder suits, these precedents may not be applicable to factually dissimilar cases like *Maldonado*.[125]

In applying the business judgment rule to shareholder derivative suits, federal courts have also failed to distinguish between suits in which a third party is the defendant and suits in which the directors are the defendants. Where the alleged wrong directly results from some questionable director action, the application of the rule may be less justifiable than where third parties are accused of misdoings.[126] Allowing the directors to dismiss shareholder suits against corporate defendants may effectively permit the misfeasants to act as judges in in their own case.[127]

The potential inequity of permitting corporate defendants to impede derivative actions becomes particularly apparent when considered in light of the shareholder demand requirement and the accompanying "futile" exception. The demand requirement mandates that the shareholders show they have requested the directors to pursue the alleged complaint and that the directors have refused.[128] An exception to the demand requirement exists where the shareholders indicate that demand would be futile because of director self-interest.[129]

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125. *See also* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917), which stands for the proposition that a shareholder may not bring a derivative action against an extracorporate defendant where no allegation has been made that the directors acted improperly in refusing to sue.

Despite the apparent misapplication of pre-*Erie* cases, modern federal courts have continued to cite these pre-*Erie* cases as a basis for director power. *See, e.g.*, Lewis v. Anderson, 615 F.2d 778, 782 (9th Cir. 1980); Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Ash v. International Bus. Mach. Inc., 353 F.2d 491, 493 (3d Cir. 1965); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 822 (S.D.N.Y. 1979); Klotz v. Consolidated Edison Co. of N.Y., Inc., 386 F. Supp. 577, 581 (S.D.N.Y. 1974).

126. *See* Hawes v. Oakland, 104 U.S. 450 (1881).

127. If the business judgment rule is given automatic application, the rule could degenerate into a ritualistic incantation designed to ward off liability. Weingard v. Atlantic Sav. & Loan Ass'n, 1 Cal. 3d 806, 818-19, 464 P.2d 106, 112, 83 Cal. Rptr. 650, 656 (1970); Note, *supra* note 8, at 605-06.

A further problem exists where interested directors approve a derivative suit, because [i]t would be the height of folly to entrust the conduct of the litigation . . . to the very people who are responsible for the wrongs." Cohen v. Industrial Fin. Corp., 44 F. Supp. 489, 495 (S.D.N.Y. 1942). In such a case, justice would be attained only where shareholders control the suit.

The failure of directors or officers to act on behalf of the corporation can often be more damaging than improper action. For example, in Miller v. American Tel. & Tel. Corp., 507 F.2d 759 (2d Cir. 1974), stockholders brought a derivative suit against AT&T and all but one of its directors. The suit was based upon the failure of AT&T to collect an outstanding debt incurred for communications services provided during the 1968 Democratic National Convention owed by the Democratic National Committee. Such inaction was made illegal under the Federal Election Campaign Act of 1971, 18 U.S.C. §610 (1970). Nevertheless, the complaint was dismissed because it lacked specificity.

A board of directors' disapproval of a derivative action against unrelated third parties should require less justification than a refusal to sue corporate insiders. Coffee, *supra* note 1, at 1238. *See also* Note, *supra* note 8, at 603-08.

128. See text accompanying notes 20-24 *supra*.

129. See text accompanying notes 25-26 *supra*.

In *Smith v. Sperling*,[130] the United States Supreme Court noted that demand is futile when the board of directors is antagonistic to the shareholder derivative action.[131] Where demand is found to be futile, the directors are to some degree interested.[132] Application of the business judgment rule, however, presupposes the existence of disinterested directors.[133] Therefore, where demand is found to be futile,[134] directors should not be permitted to use the business judgment rule to avoid shareholder suits.[135]

Another troublesome aspect of the federal trend in applying the business judgment rule to dismiss shareholder derivative suits is that the trend seems inconsistent with the corporate ratification doctrine. Generally speaking, this doctrine permits shareholders to ratify and thereby legitimatize certain unauthorized management decisions. Substantial case law, however, supports the proposition that even a clearly disinterested majority of shareholders can not ratify illegal managerial conduct.[136] If the shareholders can not ratify these illegal acts, it may be inappropirate to allow the directors to invoke the business judgment rule and perhaps release the perpetrators from liability by declining to sue them.[137] One commentator has noted that "[a]t least from the standpoint

130. 354 U.S. 91 (1957).

131. *Id.* at 101.

132. This principle is true unless the *Smith* rule, is taken to its most extreme conclusion, at which point any indication that the directors might not sue would make demand futile. Justice Frankfurter stated that the majority in *Smith* was overturning half a century of Supreme Court precedent. 354 U.S. at 98 (Frankfurter, J., dissenting). However, many courts adhere to Justice Frankfurter's "conflict of interest" definition of futility. *See* Gall v. Exxon Corp., 418 F. Supp. 508, 515 (S.D.N.Y. 1976). *See also* Ash v. International Bus. Mach., Inc., 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966) (cited with approval in *Gall*).

133. The business judgment rule will be applied only when an objective evaluation of the context surrounding a decision indicates that forces influencing the judgment of the decision-makers uniformly tended to motivate a decision for the benefit of all shareholders. *Judicial Restraint, supra* note 3, at 564.

134. According to the majority in *Smith*, mere opposition by a board of directors to a derivative suit will render demand futile even if good business reasons were cited by the board for refusing to bring the suit. However, this lenient standard of futility is not accepted by all courts. In a lengthy dissent in *Smith*, Justice Frankfurter found the majority's view far too mechanical. He defined antagonism by looking to the parties involved and found the all important determination to be the relation of the parties to the corporation. The Justice was unwilling to accept the approach which found demand automatically futile where directors opposed the suit. *Id.* at 110.

135. *See* Ash v. International Bus. Mach., Inc., 353 F.2d 491, 492-93 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); Coffee, *supra* note 1, at 1229-30; *Demand & Standing, supra* note 18, at 173-82.

136. *See* Rogers v. American Can Co., 187 F. Supp. 532 (D.N.J. 1960), *aff'd*, 305 F.2d 297 (3d Cir. 1962) (where the court indicated that even a clearly disinterested majority of the shareholders may not ratify illegal or fraudulent acts). This problem arises generally with regard to the question of demand on shareholders. The majority of courts have held that where the attacked transaction is nonratifiable, demand on shareholders is excused. *See, e.g.*, Continental Sec. Co. v. Belmont, 206 N.Y. 7, 16-20, 99 N.E. 138, 141-42 (1912). Such decisions are based upon language like that in Hawes v. Oakland, 104 U.S. 450, 461 (1881) where the court found that demand should be made on shareholders unless it was "not reasonable to require it." *Id. See also* Note, *supra* note 3, at 185-90.

137. *See* Gottesman v. General Motors Corp., 268 F.2d 194, 197-98 (2d Cir. 1959); Mayer

of internal consistency, it seems incongruous that disinterested directors have powers denied the disinterested owners of the corporation who appointed them."[138] Furthermore, a claim that the decision not to sue realistically differs from a decision to ratify the underlying conduct elevates form over substance.[139]

The United States Supreme Court addressed the question of ratification in *Ashwander v. Tennessee Valley Authority*.[140] In that case, a shareholder questioned the constitutionality of various contracts between the Alabama Power Company and the Tennessee Valley Authority.[141] Although the Court found that the contracts were constitutional, the justices disagreed as to whether allowing directors to obtain dismissal of derivative suits amounted to ratification of an illegal act. Chief Justice Hughes and three concurring justices concluded that the business judgment defense did not operate where the complaint alleged illegal conduct by corporate management.[142] Justice Brandeis and three other justices concurred in the result, but stated that the issue of illegality was irrelevant because "shareholders are not the guardians of the public."[143] Justice Brandeis also noted that guarding the public from illegal acts was the responsibility of public officials.[144] Justice Brandeis' opinion appears to have become the prevailing standard in contemporary federal courts.[145] This standard seems

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v. Adams, 37 Del. Ch. 298, 301, 141 A.2d 458, 460 (1958). Directors are in effect the shareholders' agents or representatives for deciding matters of corporate concern. Consequently, directors derive their power through the shareholders.

138. Coffee, *supra* note 1, at 1223.

139. *Id.* To further heighten this anomaly, virtually all recent decisions upholding the business judgment defense have come from federal courts. See note 8 *supra*. However, almost all cases holding illegal acts nonratifiable have come from state courts. *See, e.g.*, Parish v. Maryland & Va. Milk Producers Ass'n, 250 Md. 24, 102-05, 242 A.2d 512, 556-57 (1968); Groel v. United Elec. Co., 70 N.J. Eq. 616, 61 A. 1061 (1905). *See also* Coffee, *supra* note 1, at 1223 n.452.

140. 297 U.S. 288 (1935).

141. *Id.* The contracts were for a $1,000,000 purchase of certain transmission lines, substations and auxiliary properties. Also included in the contracts were the purchase of some real property and the sale of Alabama Power's surplus power to the government through the T.V.A. A shareholders derivative suit challenged the contracts as illegal on constitutional grounds. *Id.* at 315-18.

142. Chief Justice Hughes was joined by Justices Van Devanter, Butler and Sutherland. The Chief Justice's opinion stated "that if the directors were guilty of yielding, without appropriate resistance, to governmental demands that were unlawful, then the plaintiff was entitled to protect the corporation from this 'breach of duty' ". *Id.* at 319. *See also* Coffee, *supra* note 1, at 1225.

143. 297 U.S. at 341-56. Justice Brandesis was joined by Justices Cardozo, Stone and Roberts. *Id.* at 343. Brandeis found that: "the fact that the bill calls for an inquiry into the legality of the transaction does not overcome the obstacle that ordinarily stockholders have no standing to interfere with the management. Mere belief that corporate action, taken or contemplated, is illegal gives the stockholder no greater right to interfere than is possessed by any other citizen." *Id.* This reasoning, however, fails to consider all of the characteristics of a "stockholder". Generally, a shareholder in a corporation has more at stake in the decisions made by that corporation than does the public at large. The shareholder must have some sure means of protecting his investment.

144. *Id.*

145. *See, e.g.*, Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 824 (S.D.N.Y. 1979) where the court said, citing *Ashwander*: "[t]he plaintiffs also contend that the

to promote the incongruous result of allowing dismissal where defacto ratification exists.[146]

The federal trend towards granting motions to dismiss derivative suits is also subject to criticism because of the courts' timing in granting such motions.[147] The dismissal of shareholder actions usually occurs shortly after initiation of the suit but prior to any discovery into the merits of the allegations.[148] Many courts require a showing that the directors were involved in some wrongdoing before shareholders can defeat a motion for dismissal.[149] The information necessary for this showing, however, is often in the possession of the corporation and its directors.[150] Without extensive discovery, it is virtually impossible

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business judgment rule does not permit ratification of illegal acts. This argument misses the point. A derivative action is designed to redress wrongs to the corporation and not wrongs to the public. If the directors legitimately determine that such an action will not benefit the corporation, then, regardless of the illegality of the underlying transaction, the business judgment rule permits termination of the suit." *Id.* The *Rosengarten* court in fact cited page 343 of *Ashwander* which is the dissenting part of Brandeis' concurrence.

146. There has been a split in the interpretation of *Ashwander* by the courts. The court in Klotz v. Consolidated Edison Co. of New York, Inc., 386 F. Supp. 577 (S.D.N.Y. 1974), proposed a very restrictive interpretation, limiting *Ashwander's* applicability to situations in which the statute [upon which the litigation is based] is itself unconstitutional, as opposed to cases of unconstitutional action by state officials under a valid statute. Conversely, *Ashwander's* reasoning seems implicit in Miller v. American Tel. & Tel. Co., 507 F.2d 759 (3d Cir. 1974), where it was found that it would be illegal not to sue. Coffee, *supra* note 1, at 1225 n.461.

147. The timing question must be dealt with in a manner that is equitable for both the shareholder and the corporation. If a suit is prematurely dismissed, shareholders might not be able to obtain sufficient discovery to build their case and potentially meritorious claims might be lost. On the other hand, if meritless suits are dismissed too late, the corporations may be unnecessarily injured.

148. This problem has prompted some to call for separate trials on the standing requirement. Note, *supra* note 18, at 198-200. Several federal district courts have called for such separation or for discovery limited to that issue. *See, e.g.*, Gall v. Exxon Corp., 418 F. Supp. 508, 520 (S.D.N.Y. 1976); Bernstein v. Mediobanca Banca di Credito Finanziar-Societa Per Azioni, 69 F.R.D. 592, 597 (S.D.N.Y. 1974).

149. *See, e.g.*, Ash v. International Bus. Mach., Inc., 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966).

150. This is the root of the problem of allowing the corporation, through its directors or a committee of directors, to carry out their own investigation and make an irrevocable decision to terminate the litigation. The problem is that neither the court nor the plaintiff may compel the directors or their committee to disclose what considerations were made in reaching their decision. As the Court of Appeals of New York said in Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979): "[T]he courts cannot inquire as to which factors were considered by [a special litigation committee] or the relative weight accorded them in reaching that substantive decision. . . . Inquiry into such matters would go to the very core of the business judgment made by the committee. To permit judicial probing of such issues would be to emasculate the business judgment doctrine. . . . Its substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach." *Id.* at 633-34, 419 N.Y.S.2d at 928, 393 N.E.2d at 1002. Directors who wished to insulate their decisions from shareholders could, therefore, appoint a litigation committee of reputable outside directors who only had a superficial knowledge of the internal workings of the corporation. The information given to such a committee by the interested parties could thus be less than accurate or complete and the courts would be precluded from any inquiry into its nature.

to show that the directors were involved in the transaction,[151] acted fraudulently, or did not proceed in good faith.[152]

At least one federal court has allowed limited discovery directed to the disinterestedness of the members of a special litigation committee.[153] The New York decision *North v. Ringling*[154] suggested that complete discovery should be conducted before dismissal is permitted. The shareholders in *North* brought a derivative action against the managers and directors of Ringling Brothers Circus for gross negligence in connection with a fire.[155] Although the directors did not attempt to use the business judgment rule to dismiss the suit, they argued that the conduct upon which the suit was based was protected by the business judgment rule.[156] The court declared that since negligence was charged, the efficacy of the business judgment defense could not be determined from the face of the complaint.[157] The court concluded that, "only when the facts are developed can an appropriate conclusion be reached."[158] Accordingly, the *North* case suggests that without reasonable discovery on the merits of the case, the courts can not intelligently evaluate the propriety of the corporate directors' actions. Therefore, to determine accurately what possible conflicts exist, the plaintiff-shareholders should be given the opportunity to conduct a sufficient discovery on the merits.

In adopting the federal trend, the courts have effectively subordinated the basic policy of protecting minority shareholders from management abuses, to the policy of guarding the corporation from unfounded derivative suits.[159]

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151. *See* Bernstein v. Mediobanca Banca di Credito Finanziario-Societa Per Azioni, 69 F.R.D. 592, 598 (S.D.N.Y. 1974). *See also* Note, *supra* note 18, at 175-80 where the commentator points out that mere accusations of director involvement are insufficient to show their interest. Rather, some factual evidence must be submitted to remove the decision from them.

152. For an example of where lack of good faith has been successfully proven *see* S.E.C. v. Zale Corp., Securities Litigation Release No. 8081 (N.D. Tex. 1977).

153. *See* Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976). The *Gall* court only withheld summary judgment on the directors' decision pending confirmation of their disinterestedness. *Id.* at 520. See text accompanying notes 58-65 *supra*. Proper discovery is possibly more important in suits against directors of a corporation, because most of the evidence needed to determine whether a director is interested may be found in the records of the corporation. These records may often be under the control of the accused directors. Thus, unless discovery of corporate records is allowed, hidden conflicts of interest may go unnoticed.

154. 187 Misc. 621, 63 N.Y.S.2d 135 (App. Term 1946).

155. *Id.* at 622, 63 N.Y.S.2d at 137-38.

156. *Id.*, 63 N.Y.S.2d at 138-39.

157. 187 Misc. at 622, 63 N.Y.S.2d at 139-40. For further discussion of this case see Bayne, *supra* note 32, at 574-75.

158. 187 Misc. at 622, 63 N.Y.S.2d at 139-40.

159. *See* Note, *supra* note 18. Prunty, *supra* note 6, at 985-92. It seems fairly clear that favoring one party's interests to the exclusion of the other would be more harmful than beneficial. The business judgment defense could be degenerated into a ritualistic procedure by which a servile board, exercising no meaningful judgment, protects its management from lawsuits. However, the rule protects the corporation's autonomy by allowing the corporation to decide for itself whether it has been injured. Most importantly, the rule may provide positive incentive for the board to seek full disclosure of information, since case law clearly establishes that a release from liability given to a corporate official by an uninformed board of directors is ineffective. *See* Burt v. Irvine Co., 237 Cal. App. 2d 828, 863-64, 47 Cal. Rptr.

Corporate directors, however, have a legitimate fear that a shareholder's claim will actually be a meritless "strike suit"[160] brought to harass or embarrass the corporation and its management.[161] Additionally, while the claim may have some merit, the costs of litigation,[162] the interruption of daily business practices,[163] and the commercial disadvantages[164] of the suit, may be detrimental to the corporation.[165] Therefore, it might be reasonable for a group of directors to balance these factors against the probable recovery and conclude that a suit would not be economically rational.[166]

392, 415 (1965); Parish v. Maryland & Virginia Milk Producers Ass'n, 250 Md. 24, 103-05, 142 A.2d 512, 556-58 (1968). *See also* Coffee, *supra* note 1, at 1229.

160. *See generally* Ballantine, *Abuses of Shareholder Derivative Suits*, 37 CAL. L. REV. 339 (1949).

161. *See, e.g.*, Shapiro v. Magaziner, 418 Pa. 278, 281, 210 A.2d 890, 894 (1965). Suits that are not brought in good faith are often referred to as strike suits. A strike suit has been defined as: "shareholder derivative actions begun with [the] hope of winning large attorney fees or private settlements, and with no intention of benefiting the corporation on behalf of which suit it was theoretically brought." H. BLACK, BLACK'S LAW DICTIONARY 1591 (4th ed. 1968).

But cf. Blake, *supra* note 88. (a corporate management's general distaste of becoming a plaintiff in an antitrust suit may heavily influence whether management decides to sue).

Another commentator has noted that such suits are often disfavored by management because they frequently result in a adverse publicity to the corporation. Note, *supra* note 18, at 759-60 n.81.

162. The litigation costs are both direct and indirect in nature. The direct costs include any legal fees the corporation may incure in addition to the expenses of its own investigation and discovery. Even in suits involving only the corporate directors, the corporation is still a nominal defendant and as such requires representation by counsel. The corporation must also bear the burden of time and expense required for any plaintiff's discovery into its records.

The indirect costs of shareholder litigation may include the expenses of other party defendants in connection with the suit for which the corporation may become legally liable. *See* FLA. STAT. §607.147(3) (1980). Moreover, derivative suits may impair friendly business relations, especially with valued customers and suppliers. *See* Simon, *Must We Sue?*, 17 BUS. LAW. 888, 894-95 (1962). *See also* Blake, *supra* note 88, at 149.

163. *See, e.g.*, Gall v. Exxon Corp., 418 F. Supp. 508, 514 (1976).

164. *See* Blake, *supra* note 88, at 149; Simon, *supra* note 163, at 892, 895-96.

165. In many of these suits, the potential recovery for the corporation could amount to a great deal of money. The corporation may also be entitled to special forms of recovery such as antitrust treble damages or attorneys fees. Directors should consider the potential for recovering such damages in evaluating shareholder claims. Blake, *supra* note 88, at 149.

In determining whether a suit is in the best interests of a corporation, directors must consider the corporation's long-term as well as short-term best interests. This can be especially important where the alleged wrong is a continuing offense. The cases have often distinguished decisions not to bring suit where a wrong has admittedly occurred, from a refusal to bring suit as an invalid attempt to ratify an illegal act. *Compare* Kessler v. Ensley Co., 123 F. 546, 558 (N.D. Ala. 1903), *cert. denied*, 205 U.S. 541 (1906) *and* S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass. 99, 111, 93 N.E.2d 241 (1950) *with* Mayer v. Adams, 141 A.2d 458, 459-60 (Del. 1958) *and* Continental Sec. Co. v. Belmont, 206 N.Y. 7, 14-15, 99 N.E. 138, 141 (1912). For a good discussion of continuing offenses *see* Blake, *supra* note 88, at 150-52.

166. There might be justifiable circumstances, however, where derivative suits would be proper despite an attendant loss in corporate profits. Modern courts presumably would not accept the contention that improper actions are in the best interests of the corporation simply because such actions might be profitable for the corporation. *Accord*, Ashwander v. Tennessee

The possibility of meritless or expensive litigation, however, should not cause the courts to summarily deny the minority shareholder an opportunity to petition the courts.[167] Other methods are available to curb such abuses which would adequately safeguard the competing interests of the parties.[168] For example, state laws often impose security-for-expenses bonds, to prevent strike suits or harassing litigation.[169] These bond requirements can be extremely expensive, even to the point of burdening legitimate complaints.[170] Similarly, the contemporaneous ownership rule[171] which requires that the shareholder-plaintiff own stock at the time of the alleged wrong restricts the initiation of strike suits.[172] These types of legislative innovations or judicial doctrines might better

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Valley Authority, 297 U.S. 288, 318-19 (1935) where the court found that a stockholder would not be denied relief because of the smallness of his holdings in the corporation.

See, e.g., Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (where directors of Walt Disney Productions granted a new stock option plan which was unjustly favorable to their own interests); Miller v. American Tel. & Tel. Co., 507 F.2d 759 (1974) (where by refusing to sue to collect a debt owed by the Democratic National Committee, the corporation had in effect made an illegal domestic polictical contribution); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976) (where certain directors of Exxon Corp. made payoffs to help assure the election of certain Italian officials).

In the above mentioned situations, some of the wrongful actions taken by the directors amounted to short-term monetary profits to the corporation. However, long-term involvement in such activities is likely to cause damage and embarrassment to the corporation and its investors. *See also* Coffee, *supra* note 1, at 1237.

167. In the recent decision, Gezner v. Cunningham, 498 F. Supp. 682, 692 (E.D. Mich. 1980). The district court held that dismissal of a shareholder derivative action challenging overseas payments to foreign officials was proper because shareholders could bring some of their claims directly. Generally, however, most of these suits involve claims on behalf of the corporation itself which may not be pursued directly by shareholders. Thus in most cases it should prove fairly easy to distinguish cases like *Gezner*.

168. *See* 13 W. FLETCHER, *supra* note 2, at §5971.1.

169. Strike suits are now somewhat less of a problem because of the protection provided by state security-for-expenses statutes. *See, e.g.*, FLA. STAT. §607.147(3) (1980) which states: "If the . . . plaintiffs hold less than 5 percent of the outstanding shares . . . , then, unless the stock . . . held by such . . . plaintiffs shall then have a fair value in excess of $50,000, the court may at any time before final judgment require the . . . plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by the corporation in connection with such action. . . ."

170. For a criticism of the various aspects of security-for-expenses legislation, *see generally* Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CAL. L. REV. 123 (1944).

171. The plaintiff in a derivative suit must allege ownership as of the time of the transaction of which he complains and as of the time of bringing suit. 3 J. MOORE & J. KENNEDY, FEDERAL PRACTICE ¶¶23.1.17 to .18 (2d ed. 1980). He must continuously retain his status in the corporation from the time of the alleged improper acts until after judgment is entered on the case. Gresov v. Shattuck Denn Mining Corp., 40 Misc. 2d 569, 570, 243 N.Y.S.2d 760, 763 (S. Ct. 1960).

172. *See, e.g.*, FLA. STAT. §607.147(1) (1980). Courts also refuse to apply the business judgment rule when the decision not to sue is itself illegal, where there is proof of fraud surrounding the decision or when fear of retribution by an administrative agency motivates the board. *See, e.g.*, Hill v. Wallace, 259 U.S. 44, 61-62 (1922) (action to have Futures Trading Act adjudged unconstitutional); Ash v. International Bus. Mach., Inc., 353 F.2d 491, 492 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); Miller v. American Tel. & Tel. Co., 507 F.2d 759 (3d

protect both shareholders and corporate management and thereby avoid unnecessary policymaking by the federal courts.[173]

CONCLUSION

The shareholder derivative suit provides the shareholders with an independent means to protect their investment when corporate channels remain unresponsive. On the other hand, the business judgment rule protects the directors from personal liability for business decisions made in good faith. Corporate directors have used the rule to obtain dismissal of shareholder suits by claiming that such suits are not in the best business interests of the corporation. An analysis of the policies behind both the derivative suit and the business judgment rule, however, reveals that the business judgment rule is irrelevant to the question of whether the directors have the authority to compel dismissal. The business judgment rule protects the board's decision to dismiss; it does not provide independent authority for the dismissal itself.

The federal trend of applying the business judgment rule to shareholder dismissals potentially enables misfeasant directors to escape liability for their wrongdoings. Such application of the rule threatens the continuing viability of the shareholder derivative suit as a means of safeguarding the interests of shareholders. Nowhere else in our legal system will courts enforce a decision which was reached outside of court, lacked sufficient procedural safeguards and was based solely upon undisclosed evidence entirely within the control of the defendants. Yet this is precisely what the court does when it allows a special litigation committee appointed by the board of directors to conduct an independent investigation upon which they may make an irrevocable decision not to pursue a shareholder action. Even if the members of the special litigation committee were not involved in any misconduct, they still might not be sufficiently disinterested to determine whether their colleagues should be sued.[174]

Despite the apparently endangered status of the shareholder derivative suit, the *Burks* test continues to mandate that the courts apply the relevant state law on corporate powers. If state courts preempt the area as the Delaware Chancery Court did in *Maldonado,* the federal courts will have little choice but

Cir. 1974) (corporation's failure to sue Democratic National Committee for expenses incurred during political convention held an illegal campaign contribution).

173. Therefore, a balance must be struck between absolute rights accorded the directors and the rights accorded the shareholders. This balance must take into account the relative equities and burdens of both directors and shareholders. *See* Coffee, *supra* note 1, at 1229.

174. Despite the problems in assuring the disinterestednesss of committee members, the basic theory behind special litigation committees could prove useful to parties involved in corporate litigation. If restructured, such committees might prove to be a quick, inexpensive and just means of settling shareholder grievances with the corporate management. In formulating an alternative to the present special litigation committee, some guidance can be gained from an examination of the structure of many arbitration committees. These committees consists of one member from each side of the dispute plus an independent third member agreed upon by both sides. If the special litigation committee was so structured, not only would the committee's structural bias be eliminated and the shareholders afforded their needed protection, but the directors would also have an opportunity to expose any insincere motives of the shareholders and protect the interests of the corporation.

to follow their lead. As a result, the states could effectively undercut the expanded director powers supported by the federal trend by judicially or statutorily limiting the scope of the business judgment rule.

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