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NOTES

THE BUSINESS JUDGMENT RULE IN DERIVATIVE SUITS AGAINST DIRECTORS

Sed quis custodiet ipsos custodes?
—*Juvenal*[1]

The business judgment rule,[2] developed in the late nineteenth century,[3] insulates decisions made by corporate boards of directors from judicial scrutiny. The rule rests on the postulate that shareholders elect the board of directors to make business decisions for the corporation. It preserves a board's authority to manage the corporation and protects directors from liability for honestly-made decisions that subsequently prove unwise.[4] In applying this rule, courts have treated decisions to refrain from pursuing suits on behalf of the corporation the same as any other business decision.[5] As a result, the business judgment rule has often immunized decisions to terminate derivative suits from shareholder challenge.[6]

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[1] "But who is to guard the guards themselves?" 6 JUVENAL, SATIRES 347, *quoted in* Gall v. Exxon Corp., 418 F. Supp. 508, 519 (S.D.N.Y. 1976).

[2] Pollitz v. Wabash R.R. Co., 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912), contains an early statement of the business judgment rule: "Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to [the board of directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint. . . ."

[3] *See, e.g.*, Briggs v. Spaulding, 141 U.S. 132 (1891); Witters v. Sowles, 31 F. 1, 2 (C.C.D. Vt. 1887); Hodges v. New England Screw Co., 1 R.I. 312, 343-44 (1850); H. BALLANTINE, BALLANTINE ON CORPORATIONS § 147 (rev. ed. 1946); 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (1975 ed.); H. HENN, LAW OF CORPORATIONS § 243 (2d ed. 1970).

[4] *See* Polin v. Conductron Corp., 552 F.2d 797, 809 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977); Berman v. Gerber Prods. Corp., 454 F. Supp. 1310, 1319 (W.D. Mich. 1978); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928).

[5] *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 462 (1903); Swanson v. Traer, 249 F.2d 854, 858 (7th Cir. 1957); Goldberg v. Ball, 305 Ill. App. 273, 282, 27 N.E.2d 575, 579 (1940).

[6] *See, e.g.*, United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Hawes v. Oakland, 104 U.S. 450 (1881); Ash v. International Business Mach., Inc., 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); Allegheny Corp. v. Kirby, 344 F.2d 571 (2d Cir. 1965); Issner v. Aldrich, 254 F. Supp. 696 (D. Del. 1966).

"Inextricably linked"[7] to the business judgment rule is the requirement that before suing derivatively, a plaintiff make a demand on the board of directors to pursue the suit. Most states impose this requirement,[8] as do the Federal Rules of Civil Procedure.[9] A court may dismiss without prejudice for failure to make a demand,[10] thereby ensuring that a board will have the opportunity to exercise its business judgment as to "whether . . . a suit on behalf of the corporation would comport with the best interests of the corporation."[11]

Both rules presuppose a disinterested board of directors capable of making an honest and unbiased decision on behalf of the corporation.[12] Courts excuse demand and refuse to apply the business judgment rule when the plaintiff brings forth evidence that the board is biased against the suit.[13] Unfortunately, courts currently take an unsophisticated approach to structural bias in shareholder derivative actions. Reluctant to probe the dynamics of the board room and constrained by the traditional application of the business judgment and demand rules, courts often resort to mechanical formulae to measure actual bias, and display insensitivity to the presence of structural bias.[14]

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[7] Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979). *See* Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975).

[8] *See, e.g.,* CAL. CORP. CODE § 800(b)(2) (West 1977); N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963); DEL. CH. CT. R. 23.1.

[9] FED. R. CIV. P. 23.1 states in relevant part:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association . . . . the complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort.

[10] *See* Shlensky v. Dorsey, 574 F.2d 131, 139-42 (3d Cir. 1978); 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE & PROCEDURE § 1840, at 439 (1972).

[11] Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979).

[12] "When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment — reasonable diligence — has in fact been exercised." Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944). *See* Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint,* 35 GEO. WASH. L. REV. 562, 566-68 (1967).

[13] *See* Ash v. International Business Mach., Inc., 353 F.2d 491, 492-93 (3d Cir. 1965), *cert. denied,* 384 U.S. 927 (1966); Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response,* 63 VA. L. REV. 1099, 1229-30 (1977); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. CHI. L. REV. 168, 173-82 (1976).

[14] "Structural bias" is inherent prejudice against any derivative action resulting from the composition and character of the board of directors. "Actual bias" results from the self-interested posture of a particular director in relation to a particular derivative claim.

Recently, corporate defendants have adopted a new technique to terminate derivative actions. In response to shareholder suits, board majorities accused of wrongdoing have delegated the full board's "authority"[15] to decide whether the corporation will pursue the suit to "special litigation committees" of "disinterested" directors.[16] In all reported cases, special litigation committees have decided that the suits did not serve the best interests of the corporations, and voted to terminate them. Most shareholder challenges to committee decisions have proved unsuccessful; courts have generally viewed the business judgment rule as a bar to judicial scrutiny of such decisions.[17]

As with any shareholder challenge to a board decision, a plaintiff may remove the cloak of judicial protection accorded a special litigation committee decision by showing actual bias on the part of committee members. But by failing to acknowledge any inherent structural bias against such suits, courts have effectively insulated corporate wrongdoers from liability. This insulation highlights the deficiencies of the business judgment doctrine and threatens the policy function of derivative suits. Courts should reevaluate their methodology for identifying bias against suits brought by shareholders against directors in light of the rise of special litigation committees and adopt a more sensitive approach.

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[15] For a discussion of whether the board has authority to delegate such responsibilities, see notes 88-92 and accompanying text *infra*.

[16] *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); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 263-64 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 821-23 (S.D.N.Y. 1979); Gall v. Exxon Corp., 418 F. Supp. 508, 510, 511 (S.D.N.Y. 1976); Burks v. Lasker, 404 F. Supp. 1172, 1175-76 (S.D.N.Y. 1975), *rev'd*, 567 F.2d 1208, 1209 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979); Maldonado v. Flynn, No. 4800, slip op. at 4 (Del. Ch. Mar. 18, 1980); Auerbach v. Bennett, 64 A.D. 2d 98, 102-03, 408 N.Y.S.2d 83, 84-85 (2d Dep't 1978), *rev'd*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 910 (1979); notes 57-79 and accompanying text *infra*. *See also* Galef v. Alexander, FED. SEC. L. REP. (CCH) ¶ 96,758 (S.D.N.Y. Jan. 24, 1979), *rev'd*, 615 F.2d 51 (2d Cir. 1980); Woodcock v. Amer. Invest. Co., 380 N.E.2d 624, 625n.4 (Mass. 1978). "Disinterested" directors are usually "outsiders" as opposed to "insiders." Inside directors are generally officers of the corporation or its affiliates. Outside directors, or "unaffiliated" directors, are not associated with the corporation except for their board membership. *See* H. HENN, *supra* note 3, § 204, at 408-09.

[17] *See* notes 57-79 and accompanying text *infra*.

I

The Business Judgment Rule and Derivative Suits

A derivative suit is, in effect, two causes of action asserted by a shareholder, "namely, one against his own company, of which he is a corporator, for refusing to do what he requested them to do; and the other against the party which contests the matter in controversy with that corporation."[18] When a shareholder sues the directors of his corporation, these two causes of action overlap, and at times are identical. This idiosyncracy of derivative suits against directors renders inapposite the business judgment rule, which was developed to shield board decisions not to litigate suits against third parties. Misled by the superficial similarity between the two types of suits, courts have indiscriminately applied the business judgment doctrine.

A. *Suits Against Third Parties*

In the absence of allegations of fraud or conflict of interest, structural bias on the board is unlikely when a shareholder asserts the corporation's right against a third party. Protecting directors from liability for honest, if unwise, business judgments and preserving the directors' role as "arbiters of the corporation's fate"[19] is most justifiable where suits against third parties are involved.

Indeed, the business judgment rule first arose in the late nineteenth and early twentieth centuries in suits brought by shareholders against third parties. The seminal case was *Hawes v. Oakland*,[20] in which the Supreme Court upheld a water company's decision not to pursue a lawsuit against the city of Oakland. The business judgment rule immunized the board's action because the plaintiff did not allege that bad faith or fraud tainted the decision.[21] In the century since *Hawes*, courts have continued to re-

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[18] Hawes v. Oakland, 104 U.S. 450, 452-53 (1881). *See* Ross v. Bernhard, 396 U.S. 531, 538 (1970); Note, *Demand on Directors as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 748 (1960).

[19] Ashwander v. Tennessee Valley Auth., 297 U.S. 288, 343 (1936) (concurring opinion, Brandeis, J.).

[20] 104 U.S. 450 (1881).

[21] *Id.* at 461-62. The Court described the various situations in which shareholders may sue on behalf of a corporation:

> Some action or threatened action of the managing board of directors or trustees of the corporation which is beyond the authority conferred on them by their charter or other source of organization;

spect good faith board decisions that terminate derivative suits against third parties.[22]

This deference is not unlimited, however. Courts refuse to apply the business judgment rule when the decision not to sue is itself illegal,[23] where there is proof of fraud surrounding the decision,[24] or when fear of retribution by an administrative agency motivates the board.[25] Courts have also held the rule inapplicable when the plaintiff produces substantial evidence of actual board bias against the suit. For example, in *Delaware & Hudson Co. v. Albany and Susquehanna Railroad Co.*,[26] plaintiff-shareholders of the Delaware Company brought a derivative action against the Susquehanna Railroad seeking damages for breach of a lease agree-

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> Or such a fraudulent transaction completed or contemplated by the acting managers, in connection with some other party, or among themselves, or with other shareholders as will result in serious injury to the corporation, or to the interests of the other shareholders;
>
> Or where the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of tbe corporation itself, or of the rights of the other shareholders;
>
> Or where the majority of shareholders themselves are oppressively and illegally pursuing a course in the name of the corporation, which is in violation of the rights of the other shareholders, and which can only be restrained by the aid of a court of equity.

Id. at 560. The Court said the issue of whether a shareholder may sue despite board opposition was one of "standing." *Id.* at 462. *See* Note, *supra* note 13, at 168 n.5.

In United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917), another case frequently cited for the proposition that a board's decision to terminate a derivative lawsuit should be respected by the courts, the Supreme Court held that the board properly terminated the plaintiff's antitrust claim against another corporation. The Court held that the decision to assert the corporation's legal right is "a matter of internal management" that is generally "left to the discretion of the directors." *Id.* at 263.

See Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903); Huntington v. Palmer, 104 U.S. 482 (1881).

[22] *See, e.g.,* Ash v. International Business Mach., Inc., 353 F.2d 491 (3d Cir. 1965), *cert. denied,* 384 U.S. 927 (1966) (antitrust claim); Klotz v. Consolidated Edison Co., 386 F. Supp. 577 (S.D.N.Y. 1974) (claim alleging confiscatory ratemaking policy by state public service commission); Bernstein v. Mediobanca Banca di Credito Finanziario-Societa Per Azioni, 69 F.R.D. 592 (S.D.N.Y. 1974) (claim of improper stock option sale); Issner v. Aldrich, 254 F. Supp. 696 (D. Del. 1966) (claim arising from a corporate contractual obligation).

[23] *See, e.g.,* Miller v. American Tel. & Tel. Co., 507 F.2d 759 (3d Cir. 1974) (corporation's failure to sue National Democratic Committee for expenses incurred during political convention held an illegal campaign contribution).

[24] *See, e.g.,* Ash v. International Business Mach., Inc., 353 F.2d 491, 492 (3d Cir. 1965), *cert. denied,* 384 U.S. 927 (1966).

[25] *See, e.g.,* Hill v. Wallace, 259 U.S. 44, 61-62 (1922) (action to have Futures Trading Act adjudged unconstitutional).

[26] 213 U.S. 435 (1909).

ment.[27] A majority of Susquehanna's board were officers, directors, or employees of Delaware.[28] The Supreme Court did not allow the Delaware board to exercise its business judgment to terminate the suit, and waived the demand requirement, finding that "[t]he Company whose interest it was to assert the right to payment and to demand it was under the control or could be influenced by the company whose interest it was to deny indebtedness and resist payment."[29]

In derivative actions against third parties, the plaintiff has the burden of proving bad faith, fraud, or other exceptional circumstances rebutting the presumption of unbiased judgment normally accorded the board of directors. When the plaintiff can prove such circumstances, the court may also excuse the demand requirement.[30]

B. *Suits Against Directors*

Courts have recognized the increased danger of placing the fate of a lawsuit alleging misconduct by the corporation's own directors in the hands of those who stand to benefit most from its termination.[31] In these cases, the business judgment rule may

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[27] *Id.* at 450.

[28] *Id.*

[29] *Id.* at 451. The Court emphasized that its decision did not rest upon any specific finding of bad faith, but instead on the inevitable structural bias of a board of such composition against the suit: "The attitude of the directors need not be sinister. It may be sincere.... In this case [such] was certainly determined." *Id. Cf.* Rogers v. American Can Co., 305 F.2d 297, 317 (3d Cir. 1962) (shareholder's decision to terminate derivative action alleging antitrust violations held not to bar a minority stockholder's derivative suit because representatives of the potential corporate defendant dominated shareholders).

[30] For examples of conflicts of interest found sufficient to excuse the demand requirement, see Brooks v. American Export Indus., Inc., 68 F.R.D. 506, 510 (S.D.N.Y. 1975) (director of both plaintiff and defendant corporations incapable of exercising unbiased judgment because decision to pursue derivative suit would breach fiduciary duty owed to defendant corporation by voting to sue it); *In re* Penn Central Sec. Litigation, 367 F. Supp. 1158, 1164-65 (E.D. Pa. 1973) (demand on plaintiff corporation futile because defendant was its overwhelmingly dominant shareholder); Dopp v. American Elec. Labs, Inc., 55 F.R.D. 151, 153-54 (S.D.N.Y. 1972) (shareholder of defendant corporation controlled board of plaintiff).

Not all allegations of structural bias in cases involving interlocking directorates succeed. *See, e.g.,* Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 147, 149-50 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974).

[31] *See, e.g., In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 269 (1st Cir.) ("[I]t [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.") (concurring opinion, Coffin, C.J.), *cert. denied,* 414 U.S. 857 (1973); Note, *supra* note 13, at 175-80.

degenerate into a ritualistic incantation invoked by board members to ward off liability.[32] Even if the interested directors approve a derivative suit, "it would be the height of folly to entrust the conduct of the litigation . . . to the very people who are responsible for the wrongs . . . ."[33]

Courts typically respond to the inherent bias against these shareholder suits by excusing demand when the complaint names a *majority* of the directors as wrongdoers.[34] But the courts disagree about the level of involvement necessary to consider a director "interested" for the purpose of excusing demand. The First Circuit has held that mere acquiescence in or approval of other directors' alleged misconduct is insufficient.[35] Other courts[36] deem such a director interested because his passive acquiescence in a wrongful board action might give rise to liability.[37] The Second Circuit recently advocated a third approach. In *Galef v. Alexander*,[38] the court suggested that different standards of "interest-

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[32] *See* Weingand v. Atlantic Sav. & Loan Ass'n, 1 Cal. 3d 806, 818-19, 464 P.2d 106, 112, 83 Cal. Rptr. 650, 656 (1970); Epstein v. Schenck, 35 N.Y.S.2d 969, 981-82 (Sup. Ct. 1939); 7A C. WRIGHT & A. MILLER, *supra* note 10, § 1831, at 378.

[33] Cohen v. Industrial Finance Corp., 44 F. Supp. 489, 495 (S.D.N.Y. 1942). *See In re* Kauffman Mut. Fund Actions, 479 F.2d 257, 269 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973, 977 (S.D.N.Y. 1977).

[34] *See, e.g.*, Nussbacher v. Continental Ill. Nat'l Bank & Trust Co., 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976); Liboff v. Wilson, 437 F.2d 121 (5th Cir. 1971); Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 86 (2d Cir. 1955); Steinberg v. Hardy, 90 F. Supp. 167, 168 (D. Conn. 1950); O'Maley v. ISC Indus., Inc., 519 S.W.2d 346, 349 (Mo. Ct. App. 1975); *cf.* Boyko v. Reserve Fund, Inc., 68 F.R.D. 692, 696-97 (S.D.N.Y. 1975) (one interested director on board of mutual fund renders demand futile). *See also* W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 17.04, at 535-36 (3d ed. 1978); Note, *supra* note 13, at 175-80.

Courts have cautioned, however, that mere conclusory allegations of director wrongdoing will not suffice to excuse demand. *See* Heit v. Baird, 567 F.2d 1157, 1162 (1st Cir. 1977); Walner v. Friedman, 410 F. Supp. 29, 34 (S.D.N.Y. 1975); Jones v. Equitable Life Assurance Soc'y of the United States, 409 F. Supp. 370, 373 (S.D.N.Y. 1975); Royston v. Eastern Empire Corp., 393 F. Supp. 1010, 1014-15 (E.D. Pa. 1975); Kempner v. American Broadcasting Cos., 365 F. Supp. 1272 (S.D. Ohio 1973); W. KNEPPER, *supra*, at 536; 7A C. WRIGHT & A. MILLER, *supra* note 10, § 1831, at 382.

[35] Heit v. Baird, 567 F.2d 1157 (1st Cir. 1977); *In re* Kauffman Mut. Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). *See* Note, *supra* note 13, at 176-80.

[36] *See, e.g.*, Oldfield v. Alston, 77 F.R.D. 735, 739-40 (N.D. Ga. 1978); Boyko v. Reserve Fund, Inc., 68 F.R.D. 692, 696-97 (S.D.N.Y. 1975); Papilsky v. Berndt, 59 F.R.D. 94, 97-98 (S.D.N.Y. 1973); Barr v. Wackman, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975).

[37] *See* McManis, *Questionable Corporate Payments Abroad: An Antitrust Approach*, 86 YALE L.J. 215, 255 (1976).

[38] 615 F.2d 51 (2d Cir. 1980). In *Galef*, the shareholder-plaintiff alleged that by approving amendments to certain executive stock option plans, directors of TRW, Inc., breached their fiduciary duties to the corporation and violated §14(a) of the Securities Exchange Act

edness" apply to cases where the plaintiff has made no demand and those in which a demand has been made and rejected.[39] Most courts, however, have not drawn this distinction, reasoning that if the board is sufficiently disinterested to require demand, courts should defer to its judgment.[40] Although courts may excuse demand if the plaintiff proves that a minority of interested directors controls the board,[41] they generally permit a majority of disinterested directors to terminate a suit against a minority of alleged wrongdoers.[42]

All these permutations of the business judgment and demand rules share a common flaw: they assume the validity of the third-party model for suits against directors. A mechanical minority/majority distinction keyed to direct personal interest in the litigation may reliably detect bias against third-party suits, but it fails to take account of the different, subtler dynamics involved when

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of 1934, 15 U.S.C. § 78n(a) (1976), and Rule 14a-9, 17 C.F.R. § 240.14a-9 (1979), promulgated thereunder.

Nine of the fifteen directors, named as defendants but not recipients of the options, voted to terminate the suit. The district court granted defendants' motion for summary judgment, holding that the business judgment rule protected a disinterested majority's decision to terminate the lawsuit. Tbe Second Circuit reversed and remanded the case for further consideration of whether state law permitted the majority of defendant directors to terminate the action.

[39] If, on the one hand, it were determined that the directors were so interested that a demand on them would be futile, one would expect the applicable body of corporation law not to deem those directors disinterested for purposes of initiating a business judgment dismissal. But the converse is not necessarily true. A determination that directors are not so interested in the underlying transaction as to excuse demand on them does not mean they are so disinterested as to enable them to eliminate the lawsuit.

615 F.2d at 59.

[40] *See, e.g.,* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274-75 (3d Cir. 1978). The *Galef* court contended that *In re* Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), does "not answer the question" of whether the board is interested when directors reject demand. 615 F.2d at 59. This interpretation significantly undercuts the significance of decisions that require demand even if defendant directors acquiesced in the alleged wrongdoing, since plaintiffs may be able to reach the merits even if demand is required by showing a lesser level of director interestedness at a later stage. *See* note 35 *supra.*

[41] *See* Meltzer v. Atlantic Research Corp., 330 F.2d 946, 948 (4th Cir.), *cert. denied,* 379 U.S. 841 (1964); Abbey v. Goss, 411 F. Supp. 923, 924-25 (S.D.N.Y. 1975); de Haas v. Empire Petroleum Co., 286 F. Supp. 809, 814-15 (D. Colo. 1968), *aff'd in part,* 435 F.2d 1223 (10th Cir. 1970).

[42] *See, e.g.,* Galef v. Alexander, [1979] FED. SEC. L. REP. (CCH) ¶ 96,758 (S.D.N.Y. 1979), *rev'd,* 615 F.2d 51 (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, 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 making demand on tbe entire board will be presumed."); Bayne, *A Flaw in the Law: The Demand Rule: A Brief,* 22 ST. LOUIS L.J. 69, 80 (1978).

shareholders call on directors to pursue suits against their colleagues on the board.[43]

II

THE RISE OF THE SPECIAL LITIGATION COMMITTEE

Recently, board majorities defending shareholder derivative suits have employed a new device to circumvent judicial recognition of bias against these suits.[44] They have created special committees composed of disinterested minority directors and delegated to them authority to determine whether the corporation should pursue the suit. Most courts have applied the business judgment rule and refused to review the decisions of these committees.[45]

Whether a special litigation committee may terminate a derivative suit is primarily a question of state law. In *Burks v.*

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[43] In his concurring opinion in *In re* Kauffman Mut. Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), Judge Coffin admitted that he was "reluctant, by resort to formula, to set boundaries to the action or inaction of directors, beyond which demand on them sball always be required." *Id.* at 268. Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22 (1st Cir. 1978) illustrates the questionable validity of blindly applying the minority/majority distinction as a means of ascertaining structural bias against a derivative action. The court excused demand in a derivative suit in which two of the four directors of the corporation were interested, and remarked that "none of the allegations in the complaint would have offered sufficient excuse to satisfy F.R.Civ.P. 23.1, had there been two interested and three disinterested trustees. It is equally clear that no demand would have been necessary had there been three interested and two disinterested trustees." *Id.* at 23 (footnotes omitted). It seems unlikely that arithmetical analysis alone will reliably detect structural bias on a board. *See* notes 146-47 and accompanying text *infra.* For a full discussion of structural bias in suits against directors, see notes 96-111 and accompanying text *infra.*

[44] Ironically, the Securities and Exchange Commission may have inspired boards to form these committees. Since 1973, several settlement agreements terminating SEC enforcement actions have required the appointment of interim outside directors, nominated by the SEC and approved by tbe courts, to ensure that alleged violations of the securities laws would not recur. *See, e.g.,* SEC v. Phillips Petroleum Co. (D.D.C. 1975), S.E.C. Lit. Rel. No. 6770 (Mar. 7, 1975); SEC v. Mattel Inc. (D.D.C. 1974), S.E.C. Lit. Rel. Nos. 6467 (Aug. 5, 1974), 6531 (Oct. 2, 1974), and 6532 (Oct. 3, 1974). *See* Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?,* 76 U. MICH. L. REV. 581, 591-96 (1978).

[45] *See* Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Burks v. Lasker, 426 F. Supp. 844 (S.D.N.Y. 1977), *rev'd,* 567 F.2d 1208 (2d Cir. 1978), *rev'd,* 441 U.S. 471 (1979); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S. 2d 920 (1979); notes 57-70 and accompanying text *infra.*

Lasker,[46] however, the Supreme Court added an overlay of federal law. The plaintiff in *Burks* filed a derivative action alleging violations of the Investment Company Act of 1940,[47] but a special litigation committee voted to terminate the suit. The Court held that the "threshold inquiry" in such cases is whether state law permits a special litigation committee to decide the fate of the suit. Even if the state law component is satisfied, however, that law must also be consistent with the underlying federal law.[48] The Court reversed the Second Circuit's holding in *Burks* that the Investment Company Act of 1940 foreclosed the use of special litigation committees,[49] and remanded the case for a determination of relevant state law.[50]

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[46] 441 U.S. 471 (1979).

[47] 15 U.S.C. §§ 80a-1 to -52 (1976). Section 80a-13(a)(3) was the specific provision involved. The complaint also alleged violations of § 80b-6 of the Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1976), and breach of common law fiduciary duty. Lasker v. Burks, 567 F.2d 1208, 1209 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979). The plaintiffs sought recovery of losses resulting from the fund's purchase of $20 million in Penn Central commercial paper in late 1969. In response to the suit, the fund's board of directors appointed a minority committee of five disinterested directors (as defined by 15 U.S.C. §§ 80a-2(a) (1976)) to determine what action the corporation would take with respect to the suit. Under the fund's bylaws and Delaware corporation law, five of the fund's 12 directors constituted a quorum of the entire board. 567 F.2d at 1210 n.5. The board appointed the five directors after the wrongdoing had allegedly occurred. *Id.*

On the advice of one of the defendant directors, the committee retained a former chief judge of the New York Court of Appeals, Stanley H. Fuld, to serve as special counsel to the committee. After considering his recommendation to terminate and conducting its own investigation, the committee voted to terminate the suit. *Id.* at 1210.

[48] 441 U.S. at 480. *See* notes 66-70 *infra*.

[49] The Second Circuit concluded that the unique congressional concerns underlying the 1940 Act mandate that "disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders . . . for breach of fiduciary duties." 567 F.2d at 1212. The lower court based its reading of the Investment Company Act on the legislative policy "to mitigate and eliminate those aspects of the conduct and administration of the funds which benefitted the managers and adversely affected the stockholders of the fund." *Id.* at 1211. The court concluded:

> The statutes were designed to interpose statutorily disinterested directors as a check on the actions of the majority directors controlled by the investment adviser. It would be contrary to the legislative purpose to permit the independent minority to be used to approve majority action so that no stockholder complaint could survive that approval.

Id. The court carefully based its decision "on the unique nature of the investment company and its symbiotic relationship with its investment adviser" and expressly demurred consideration of "the exercise of similar power by directors of other types of corporations." *Id.* at 1212 n.14.

[50] 441 U.S. at 486.

The state law question[51] has been widely litigated, mostly in derivative suits alleging both violation of federal securities laws and breach of a state fiduciary duty in connection with questionable corporate payments to foreign officials.[52] At least two courts appear to have subjected a special litigation committee's substantive conclusions to a reasonableness test.[53] Most jurisdictions, however, have limited their inquiry to the traditional scope set by the business judgment rule.[54] These courts examine only the committee's methodology, depth of investigation, and independence.[55] If the plaintiff fails to prove bias on these points, the committee's decision is immune from challenge. One court recently adopted a different approach, holding that the business judgment rule does not empower a minority committee to terminate a derivative suit against directors, regardless of the committee's independence or good-faith investigation.[56]

Gall v. Exxon[57] typifies the view most courts have taken of special litigation committees. The plaintiff-shareholder brought a derivative action against the corporation's directors and officers, alleging that bribes and payoffs admittedly made by corporate officers to political parties in Italy violated federal securities laws and breached a common law fiduciary duty.[58] Exxon's board of

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[51] Courts, however, have overlooked the question of the authority of the board to delegate to a committee its power to decide whether to pursue these suits. *See* notes 88-92 and accompanying text *infra*.

[52] "Like hard cases, festering scandals make bad law." Coffee, *supra* note 13, at 1100.

[53] *See* Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Auerbach v. Bennett, 64 A.D.2d 98, 408 N.Y.S.2d 83 (2d Dep't 1978), *rev'd*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); notes 71-79 and accompanying text *infra*.

[54] *See* Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979); Burks v. Lasker, 426 F. Supp. 844 (S.D.N.Y. 1977), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *See also* Meer v. United Brands Co., [1979] FED. SEC. L. REP. (CCH) ¶ 96,794 (S.D.N.Y. Feb. 21, 1979). In *Meer* the district court approved a settlement pursuant to rule 23.1 of a derivative action against the directors of United Brands alleging questionable payments. The court said a special litigation committee's decision to terminate "diminished considerably" the suit's prospects for success. *Id. See* Republic Nat'l Life Ins. Co. v. Beasley, 73 F.R.D. 658 (S.D.N.Y. 1977).

[55] *See, e.g.*, Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

[56] Maldonado v. Flynn, No. 4800, slip op. at 22 (Del. Ch. Mar. 18, 1980).

[57] 418 F. Supp. 508 (S.D.N.Y. 1976).

[58] The complaint contained four counts. Count 1 charged that the defendants filed false and misleading financial statements with the Securities and Exchange Commission in violation of the Securities and Exchange Act of 1934, 15 U.S.C. § 78m (1976) and Rule 13a-1, 17 C.F.R. § 240.13a-1 (1979). Count II alleged violations of § 14(a) of the 1934 Act,

directors created a special committee on litigation to investigate the plaintiff's allegations and determine whether legal action served the corporation's best interests.[59] Two outside directors and a senior vice president sat on the committee,[60] and a former New Jersey Supreme Court chief justice served as special counsel.[61] The committee conducted a four-month fact-finding investigation of the claims underlying the shareholder's suit, and issued a report concluding that a suit against the defendant directors and officers would be "contrary to the interests of Exxon and its shareholders."[62]

The court noted that in the absence of proof that the committee was not independent, the business judgment rule protected the special litigation committee's decision from scrutiny.[63] Rejecting the plaintiff's plea for recognition of the board's structural bias against the suit, the court held that the "focus of the business judgment rule inquiry is on those who actually wield the decision-making authority, not on those who might have possessed such authority at different times and under different circumstances."[64]

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15 U.S.C. § 78n(a) (1976), and 17 C.F.R. § 240.14a-9 (1979) promulgated under § 14(a), by using the interstate mails to file and solicit false and misleading proxies from Exxon's shareholders. Count III charged waste, spoilation and misuse of corporate assets. Count IV alleged that the defendants had breached fiduciary duties by failing to disclose the payments. 418 F. Supp. at 509.

The report of the special litigation committee subsequently revealed that Exxon contributed $27.9 million to political parties in Italy between 1963 and 1971. 418 F. Supp. at 512.

[59] *Id.* at 510.

[60] Both outside directors were chairmen and chief executive officers of large international corporations. They were appointed to the board after the commencement of the suit. *Id.* at 510 n.2. The Exxon officer also received his appointment after the commencement of the suit. Although he left a government post to join Exxon, he had previously been an Exxon employee for 16 years. *Id.*

[61] *Id.* at 514 n.12.

[62] *Id.* at 514.

[63] *Id.* at 516-17.

[64] *Id.* at 517. Although it upheld the authority of the special litigation committee to terminate the action, the court refused to grant summary judgment. Instead, it allowed discovery on the issue of the committee's independence. *Id.* at 520. The complaint was subsequently dismissed. No. 75-3682 (S.D.N.Y. Jan. 17, 1977).

The Eighth Circuit was less sensitive to the plaintiff's position in Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979). Shareholders sued derivatively to compel seven directors and officers of the corporation to repay over a million dollars in criminal and civil penalties levied against the corporation for payments made to foreign governments between 1967 and 1976. *Id.* at 726-27. The board of directors appointed a committee of

This approach to special litigation committee decisions apparently extends beyond claims involving questionable payments[65] to all shareholder derivative suits, including, for example, suits alleging fraud or diversion of corporate opportunity. In *Lewis v. Anderson*,[66] two shareholders of Walt Disney Productions brought a derivative suit against the corporation's directors. The plaintiffs claimed that the board's adoption of a stock option plan that benefited certain directors and its submission to the shareholders for approval[67] violated rule 10b-5, promulgated under section 10(b),[68] and section 14(a) of the Securities Exchange Act of 1934.[69] A special litigation committee, composed of two outside directors and one inside director, voted to terminate the action. The Ninth

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seven outside directors not named as defendants to determine whether the corporation should pursue the suit. The committee voted to terminate the lawsuit. *Id.*

The Eighth Circuit Court of Appeals applied the two-tier analysis set forth by the Supreme Court in *Burks v. Lasker*. *See* notes 46-50 and accompanying text *supra*. First, the court concluded that under Delaware law (Control Data's state of incorporation), a minority of directors may terminate a derivative suit. The court then determined that this state law did not undermine the policies of § 13(a) and § 14(a) of the Securities and Exchange Act of 1934. *Id.* at 731-32. The court concluded that the district court did not err in dismissing plaintiff's claim under the business judgment rule. *Id.*

The court grounded its assessment of Delaware state law on Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971), a derivative action challenging a transaction between directors and the corporation. A minority of disinterested directors had approved the challenged transaction. 283 A.2d at 694. The use of a minority committee for this purpose, however, is readily distinguishable from the special litigation committee situation. *See* notes 90-92 and accompanying text *infra*. *Lewis* was decided before the Delaware Court of Chancery held that Delaware law did not permit a minority committee to terminate a derivative action alleging breach of fiduciary duty in Maldonado v. Flynn, No. 4800, slip op. at 21-24 (Del. Ch. Mar. 18, 1980). *See* notes 80-83 and accompanying text *infra*.

In concluding that the federal policies of § 13(a) and § 14(a) did not preempt the operation of the state law on derivative suit termination, the court appeared to place significance on the weakness it perceived with respect to the plaintiff's claims. The court said this weakness "undercuts his argument that the federal policies underlying that section preclude the decision of the district court to dismiss his complaint." 603 F.2d at 731. This analysis is flawed. The court failed to answer the question that *Burks v. Lasker* directed it to ask, and forced the plaintiffs to try the merits of their claim at an unfairly early stage, without the benefit of discovery. *See* notes 137-38 and accompanying text *infra*.

[65] See note 52 and accompanying text *supra*. *But see In re* Kauffman Mut. Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). The First Circuit emphasized "a sharp distinction between a transaction completely undirected to a corporate purpose and one which, while perhaps vulnerable to criticism, is of a character that could be thought to serve the interests of the company," in holding that mere acquiescence or approval of an allegedly excessive fee arrangement did not render directors "interested" for the purpose of excusing demand. *Id.* at 265.

[66] 615 F.2d 778 (9th Cir. 1979).

[67] *Id.* at 780.

[68] 17 C.F.R. § 240.10b-5 (1979), implementing 15 U.S.C. § 78j(b) (1976).

[69] 15 U.S.C. §§ 78m(a), 78n(a) (1976).

Circuit upheld the district court's holding that the business judgment rule precluded judicial scrutiny of the committee's decision.[70]

[70] "[T]he good faith exercise of business judgement by a special litigation committee of disinterested directors is immune from attack by shareholders or the courts." 615 F.2d at 783.

The Lewis case raises serious questions about the importance of the second tier of the Supreme Court's test in Burks v. Lasker, 441 U.S. 471 (1979). The *Lewis* court held that no federal policy of rule 10b-5 would be frustrated by allowing the special litigation committee to terminate the lawsuit. Yet federal policy certainly appears strong in a case alleging insider trading where, unlike *Burks* or Abbey v. Control Data, 603 F.2d 724 (8th Cir. 1979), the directors personally gained from their alleged wrongdoing. The court reasoned that since the business judgment rule protects board actions even if negligent, it is "closely analogous to Rule 10b-5 itself, which affords no cause of action for negligence." 615 F.2d at 784. One commentator criticizes this reasoning:

> [t]he fact that a plaintiff in a private suit under Rule 10b-5 must prove scienter rather than negligence hardly makes the business judgment rule and Rule 10b-5 "close analogous." Indeed, the requirement that the plaintiff prove scienter in a Rule 10b-5 action is a reason to forbid rather than to permit directors to terminate such suits because arguably federal policy should prohibit the termination of a suit alleging a willful violation of the securities laws by directors.

Brodsky, Termination of Derivative Suits by Directors, N.Y.L.J. Jan. 16, 1980, at 2, col. 3. Indeed, in light of *Lewis*, it seems doubtful that courts will construe any federal policy to prohibit the termination of derivative suits.

The *Lewis* court also disposed of plaintiff's § 14(a) claim, concluding that "[s]o long as those accused of manipulating the proxy vote are excluded from deciding whether or not to pursue the claim there is no conflict between the business judgment rule and § 14(a)." 615 F.2d at 783.

In Maldonado v. Flynn, FED. SEC. L. REP. (CCH) ¶ 97,260 (S.D.N.Y. Jan. 24, 1980), the court shared this view of the federal policies underlying § 14(a). In *Maldonado*, a shareholder of the Zapata Corporation brought a derivative action against the board of directors alleging a misleading proxy statement in connection with the board's modification of a stock option plan. *Id.* at 96,824. The board appointed two recently-selected outside directors to decide whether to pursue the suit. The Independent Investigation Committee voted to terminate the action. After concluding that the law of Delaware (Zapata's state of incorporation) permitted such a termination, the Court held that Congress did not regard the underlying policy of § 14(a) "as necessarily inconsistent with the business judgment rule in appropriate circumstances." *Id.* at 96,827. The court placed particular importance on the existence of an additional private remedy for plaintiff, since a § 14(a) claim "can also be asserted by an individual shareholder in his own behalf or as a class action on behalf of all affected shareholders." *Id.* at 96,827 (footnote omitted).

The Second Circuit recently applied the *Burks* test in a more satisfactory manner. In Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980), the court held that a board's termination of a derivative claim against the board alleging misleading proxy statements in connection with an executive stock option plan undermined the federal policies of § 14(a) of the Securities Act of 1934, 15 U.S.C. § 78n(a) (1976):

> Obviously the goal of § 14(a) that communications from management be accurate and complete as to all material facts is a vital one. Its achievement would quite clearly be frustrated if a director who was made a defendant in a derivative action for providing inadequate information in connection with a proxy solicitation were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation.

In contrast, the reasonableness standard apparently adopted by two courts permits a broader judicial inquiry into a committee's decision to terminate. A federal district court in *Rosengarten v. International Telephone & Telegraph Corp.*[71] appropriated the standard of review suggested by the New York Appellate Division, but subsequently rejected by the state Court of Appeals, in *Auerbach v. Bennett.*[72] These courts held that the validity of a special litigation committee's decision "clearly depends on the depth and amplitude of the investigation and *the emphasis placed by the committee on the various factors necessarily to be considered.*"[73] By carefully scrutinizing the factors the committee should have examined,[74] their relative weights, and the reasons articulated by the board supporting its determination,[75] the *Rosengarten* and *Auerbach* courts implied

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Id. at 63. This application of *Burks* properly resolves the federal-state issue without regard to the merits of the plaintiff's underlying claim.

The *Maldonado* court distinguished *Galef* on the ground that the *Galef* court found the directors who terminated the suit interested hecause "[t]hey had authorized the options at issue in the lawsuit, had been elected pursuant to the challenged proxy statements and were named as defendants." FED. SEC. L. REP. (CCH) ¶ 97,260 at 96,831 n.44. Yet the *Galef* court stressed the strong federal policy of promoting complete and accurate proxy statements. *See* note 50 and accompanying text *supra.* A standard that would prohibit termination of a § 14(a) suit only by "interested" directors seems inadequate to vindicate these policies — especially because "interested" has no fixed, certain meaning.

[71] 466 F. Supp. 817 (S.D.N.Y. 1979). In *Rosengarten,* a special litigation committee terminated the suit, which alleged that corporate employees had violated federal securities laws by making the questionable payments. The committee included a university president, a director of another corporation, and the president of an oil company. *Id.* at 821.

[72] 64 A.D.2d 98, 408 N.Y.S.2d 83 (2d Dep't 1978), *rev'd,* 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). In *Auerbach,* shareholders alleged that directors of General Telephone & Electric Corp. were liable to the corporation for more than $11 million in overseas bribes and kickbacks the corporation bad allegedly made between 1971 and 1975. 47 N.Y.2d at 624-25, 393 N.E.2d at 997, 419 N.Y.S.2d at 922-23. G.T.E.'s board of directors adopted a resolution creating a special litigation committee composed of three outside directors to determine whether the corporation should pursue the lawsuit. *Id.* at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. Predictably, the committee decided to terminate the suit. *Id. Rosengarten* was decided before the N.Y. Court of Appeals reversed *Auerbach. See* note 76 *infra.*

[73] 64 A.D.2d at 107, 408 N.Y.S.2d at 87 (empbasis added).

[74] Those factors would include, among others, the reasons for the payments, the advantages or disadvantages accruing to the corporation by reason of the transactions, the extent of tbe participation or profit by the respondent directors and tbe loss, if any, of public confidence in the corporation which might be incurred. Moreover, the hesitancy which might arise in outside directors by their investigation of the activities of fellow directors, especially when personal liability is at stake, is a consideration of moment.

Id., 408 N.Y.S.2d at 87-88.

[75] The Appellate Division stated that it could not sustain defendants' motion for summary judgment until "the record shows that the disinterest of the directors was not refuted, the underlying facts were thoroughly investigated and cogent reasons existed in support of the decision of the committee." *Id.* at 108, 408 N.Y.S.2d at 88.

that a committee's decision to terminate can stand only if it is reasonable.[76] Nonetheless, the *Rosengarten* court dismissed several challenges to the thoroughness of the committee's investigation.[77] The court concluded that the business judgment rule protected the committee's decision, presumably because its findings were reasonable,[78] and granted defendants' motion for summary judgment.[79]

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[76] The N.Y. Court of Appeals rejected the scope of judicial review advanced by the Appellate Division. 47 N.Y.2d 619, 393 N.E.2d 944, 419 N.Y.S.2d 920 (1979). Although it permitted review of the independence and methodology of the special litigation committee, the court of appeals held that "courts cannot inquire as to which factors were considered by that committee or the relative weight accorded them in reaching that substantive decision." *Id.* at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court cautioned that "[t]o permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee." *Id.* at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.

Although the court followed *Gall* and *Abbey* by stating that "[t]he business judgment rule does not foreclose inquiry by the courts into the disinterested independence" (*id.* at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927) of the special litigation committee, it granted defendants' motion for summary judgment before plaintiffs had an opportunity to conduct discovery on that issue. The court found plaintiff had raised no triable issue of fact in his pleadings with respect to the disinterested independence of the directors. *Id.* at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929. Although there is some doubt as to whether the court's limitation on discovery arose from the peculiar way the case was appealed, the *Auerbach* court does appear to place a greater burden on plaintiffs by requiring them to allege with particularity the reasons for the interestedness of the directors. If courts read *Auerbach* broadly, this burden may be heavy because knowledge of matters relating to the independence of the special litigation committee "is peculiarly in the possession of the defendants themselves." *Id.* at 637, 393 N.E.2d at 1004, 419 N.Y.S.2d at 931 (dissenting opinion, Cooke, C.J.) (citing Terranova v. Emil, 20 N.Y.2d 493, 496, 231 N.E.2d 753, 755, 285 N.Y.S.2d 51, 54 (1967)); *see* United States v. Diebold, Inc., 369 U.S. 654, 655 (1962).

[77] These challenges included allegations that the committee delegated all of its functions to counsel, that one of its members participated infrequently in the committee's deliberations, and that two of the members suffered conflicts of interest arising from their positions on boards of other corporations charged with making questionable payments. 466 F. Supp. at 824-25. The court found that none of these allegations substantially affected the board's good-faith review of the shareholder's suit. *Id.*

[78] The court placed much emphasis on the "substantial authority for the Committee's conclusion that [the action would not] withstand a motion to dismiss in federal court." *Id.* at 829. *See* notes 137-38 and accompanying text *infra.*

[79] The Appellate Division in *Auerbach* cautioned against blind judicial acceptance of special litigation committees' decisions:

> The business judgment doctrine should not be interpreted to stifle legitimate scrutiny by stockholders of decisions of management which, concededly, require investigation by outside directors and present ostensible situations of conflict of interest. Nor should the report of the outside directors be immune from scrutiny by an interpretation of the doctrine which compels the acceptance of the findings of the report on their face.

64 A.D.2d at 107, 408 N.Y.S.2d at 88. In Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979), which involved claims arising from the same illegal payments by GTE challenged in *Auerbach,* the district court dismissed the

In *Maldonado v. Flynn*,[80] the Delaware Court of Chancery refused to accord any deference to a committee's decision to terminate a shareholder suit. The court held that under Delaware law, the business judgment rule does not permit a committee to terminate a derivative suit alleging breach of fiduciary duty.[81] The court viewed the business judgment rule as "merely a presumption of propriety accorded decisions of corporate directors"[82] and concluded that the rule does not grant "any independent power to a corporate board of directors to terminate a derivative suit."[83]

III

ANALYSIS

The judicial deference that most courts accord decisions of special litigation committees differs little from that accorded any other board decision. Yet there is substantial justification for exceptional treatment in cases where a minority of directors decide to terminate a suit against their colleagues. The use of special litigation committees, at the behest of a majority accused of wrongdoing, may mask structural bias. Courts probably will fail to detect this bias under either the traditional, indulgent approach to the

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plaintiff's claims as res judicata. *Id.* at 267. In dicta, the Third Circuit suggested a different standard of review — somewhere between the Appellate Division's approach in *Auerbach*, adopted by the *Rosengarten* court, and the majority view of *Gall*. The court suggested that if a decision to terminate a lawsuit is "so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion," a court could "conduct its own analysis" of its reasonableness. *Id* at 275.

[80] No. 4800 (Del. Ch. Mar. 18, 1980).

[81] *Id.*, slip op. at 9. The shareholder alleged that the directors of Zapata Corporation breached their fiduciary duty to the corporation by accelerating the time for the exercise of an executive stock option plan in order to reduce the recipients' federal tax liability. *Id.* at 3. In response to the suit, the directors created an Independent Investigative Committee composed of two newly appointed outside directors, which voted to terminate the action. *Id.* at 4.

[82] *Id.* at 9.

[83] *Id.* at 10. Although the court found the business judgment rule "irrelevant" to the committee's decision, it suggested that even if the rule were relevant, the board "should, at least, bear the burden of showing the independence of their committee." *Id.* at 24.

The board's acceleration of the stock option plan also formed the basis of a suit brought in federal court, alleging violation of the federal securities laws. Maldonado v. Flynn, FED. SEC. L. REP. (CCH) ¶ 97,260 (S.D.N.Y. Jan. 24, 1980). The federal court dismissed the action, holding that the business judgment rule insulated the committee's decision. *See* note 70 *supra*. After the Delaware Court heard arguments on the business judgment defense, it granted defendants leave to pursue a res judicata defense in a separate motion. Maldonado v. Flynn, No. 4800, slip op. at 24n.2. (Del. Ch. Mar. 18, 1980).

business judgment rule or the ostensibly stricter reasonableness test. As a result, courts using these standards permit biased committees to terminate potentially meritorious derivative claims.[84]

A. *The Majority View*

Most courts have accorded great deference to decisions of special litigation committees.[85] This "hands-off" approach suffers from two problems: (1) it assumes that a board has authority to create special litigation committees,[86] and (2) it fails to recognize structural bias.[87]

1. *The Board's Authority to Create Special Litigation Committees*

Although most states impose some restriction on a board's power to delegate authority to committees,[88] no statute appears to prohibit delegation of decision-making authority regarding a derivative suit. Nonetheless, a board cannot delegate authority it does not possess. By excusing the demand requirement and refusing to apply the business judgment rule to decisions to terminate suits alleging wrongdoing by a majority of the board, courts have traditionally restricted the board's right to decide such ques-

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[84] In the questionable payments cases, it is unclear whether courts would have excused demand on the boards, and thus recognized structural bias if the boards had not created special litigation committees. In a jurisdiction following *In re* Kaufmann Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), a court probably would have required demand, because the directors were accused of passive acquiescence in a corporate act designed to forward the interests of the corporation. In other jurisdictions, courts would have excused demand. *See, e.g.,* Barr v. Wackman, 36 N.Y.2d 379, 321 N.E.2d 180, 368 N.Y.S.2d 497 (1975); notes 34-42 and accompanying text *supra.* Presumably, however, a board would not establish a special litigation committee if it believed that the demand rule would suffice to terminate the suit.

[85] *See* Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978); Rosengarten v. ITT, 466 F. Supp. 817 (S.D.N.Y. 1979); Gall v. Exxon Corp., 418 F. Supp. 503 (S.D.N.Y. 1976), Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 910 (1979). *See* notes 57-70 and accompanying text *supra.*

[86] *See* notes 88-95 and accompanying text *infra.*

[87] *See* notes 96-111 and accompanying text *infra.*

[88] For example, state corporation laws commonly prohibit boards from delegating to committees the authority to declare dividends or distributions, *see, e.g.,* ILL. REV. STAT. ch. 32, § 157.38 (1975), to amend bylaws, *see, e.g.,* N.J. STAT. ANN. § 14A:6-9 (1969), or to recommend proposals to shareholders for their required approval, *see, e.g.,* DEL. CODE ANN. tit. 8, § 141(c) (1975). *See* MODEL BUS. CORP. ACT ANN. § 42, ¶3.03, at 863 (2d ed. 1971).

tions.[89] A board should not be able to resurrect such authority by delegating it to a special committee.

Delegating authority to special litigation committees is readily distinguishable from delegating authority to a committee for the purpose of approving transactions between the corporation and a majority of directors.[90] First, state corporation laws do not rescind a board's authority to approve transactions in which a majority of directors is interested.[91] Rather, they outline procedures through which the board can ensure that such transactions will not be subject to attack solely because of the presence of interested directors.[92] The delegation of authority to committees in this context is a precautionary measure designed to immunize the transaction from subsequent shareholder challenge. The purpose of these minority committees is to allow the corporation to enter into commercial transactions with impunity — not to quash shareholder derivative actions.

A second conceptual difficulty with a board's delegation of authority to special litigation committees stems from state statutes providing that committees serve "at the pleasure of the board."[93]

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[89] *See* notes 2-6 and accompanying text *supra.* Courts have, however, split on the issue of the level of director involvement necessary to excuse demand. *See* notes 34-42 and accompanying text *supra.*

[90] *See, e.g.,* Puma v. Marriott; 283 A.2d 693 (Del. Ch. 1971) (cited by the court in *Abbey v. Control Data Corp.*). In this shareholder's derivative action, plaintiffs challenged the fairness of a sale of six corporations principally owned by the Marriott family for 313,000 shares of Marriott stock. The court concluded that "since the transaction complained of was accomplished as a result of the exercise of independent business judgment of the outside, independent directors" it was immune from shareholder challenge. *Id.* at 696.

[91] *See, e.g.,* DEL. CODE ANN. tit. 8, § 144 (1975); N.Y. BUS. CORP. LAW § 713 (McKinney Supp. 1979).

[92] For example, N.Y. BUS. CORP. LAW § 713 (McKinney Supp. 1979) provides in relevant part:

> (a) No . . . transaction between a corporation and one or more of its directors . . . shall be either void or voidable for this reason alone or by reason alone that . . . his or their votes are counted [to approve such a transaction] . . . :
>
> (1) If the material facts as to such director's interest in such contract or transactions . . . are disclosed in good faith or known to the board or committee, and tbe board or committee approves such contract or transaction by a vote sufficient for such purpose without counting the vote of such interested director, or if the votes of the disinterested directors are insufficient to constitute an act of the board . . . , by unanimous vote of the disinterested directors.

See DEL. CODE ANN. tit. 8, § 144 (1975).

[93] *See, e.g.,* CAL. CORP. CODE § 311 (West 1977); MICH. COMP. LAWS ANN. § 450.1527 (1973); N.Y. BUS. CORP. LAW § 712(c) (McKinney Supp. 1979).

One commentator suggests "[b]y providing that the committee is to serve at the pleasure of the board, the statutory draftsmen enable the full board to undo committee action deemed by the board to be unsatisfactory."[94] Such provisions cast doubt on the irrevocability of the board's delegation of authority.[95]

Courts have apparently ignored these objections to a board's authority to create special litigation committees. Unfortunately, they have compounded this neglect by ignoring structural bias in assessing the decisions of special litigation committees.

2. *Structural Bias*

a. *Sources.* In regarding determinations of special litigation committees as conclusive, courts have employed a presumption that a committee "not demonstrably partisan is therefore independent."[96] Such a presumption is unwarranted. Numerous empirical studies have demonstrated the extent to which directors are "economically or psychologically dependent upon or tied to the corporation's executives, particularly its chief executive."[97]

There may be a number of sources for this dependence. First, the corporation's chief executive officer usually recommends new directors, and his recommendations carry considerable weight.[98] Even on boards with nominating committees responsi-

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[94] 3 B. WHITE, NEW YORK CORPORATIONS § 712.03 (1977). The court in Gall v. Exxon, 418 F. Supp. 508 (S.D.N.Y. 1976), contended that the special litigation committee "exercised the full powers of the board", *id.* at 517, and cited as authority N.J. STAT. ANN. § 14A:6-9(1) (1969 & Supp. 1979). Yet this same statute permits a majority of the board to abolish a committee, to appoint alternate members and to remove any director from a committee without cause. *Id.* Thus, existence of the committee clearly depended on the favor of the majority accused of wrongdoing. Of course, this issue of irrevocability may never be litigated, since the committee will invariably decide to terminate the suit.

[95] Also problematic is the rule in most jurisdictions that shareholders may not terminate derivative suits if termination would amount to ratification of a fraudulent or illegal act. *See, e.g.,* Mayer v. Adams, 37 Del. Ch. 298, 141 A.2d 458 (Sup. Ct. 1958); Keenan v. Eshleman, 23 Del. Ch. 234, 2 A.2d 904 (Sup. Ct. 1938); Continental Sec. Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912); Coffee, *supra* note 13, at 1222-24; Note, *supra* note 13, at 185-90. *But see* S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass 99, 93 N.E.2d 241 (1950); Note, *The Nonratification Rule and the Demand Requirement: The Case for Limited Judicial Review,* 63 COLUM. L. REV. 1086 (1963). By allowing a committee's decision to stand virtually unchallenged, courts effectively permit directors to do what is beyond the discretion of shareholders.

[96] Coffee, *supra* note 13, at 1229-30.

[97] M. EISENBERG, THE STRUCTURE OF THE CORPORATION 145 (1976). *See* R. MUELLER, NEW DIRECTIONS FOR DIRECTORS: BEHIND THE BYLAWS (1978); R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 94-102 (1976).

[98] *See* C. BROWN, PUTTING THE CORPORATE BOARD TO WORK 23 (1976); M. MACE, DIRECTORS: MYTH & REALITY 94 (1971). Professor Mace recently concluded that "board prac-

ble for selecting new directors, a chief executive officer's recommendation is often conclusive.[99] Appointment to the board of directors carries at least two benefits that undoubtedly engender loyalty to incumbent management in outside directors: increased status in the business community[100] and significant remuneration for their services.[101] Chief executive officers often rely on this loyalty,[102] and they are likely to consider it an important criterion for selection. Moreover, the chief executive officer often has the power to remove a "disloyal" director because he controls the corporation's proxy machinery.[103] Additionally, outside directors on

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tices have changed little" in the years since the publication of his earlier influential work. Mace, *Directors: Myth and Reality —Ten Years Later,* 32 RUTGERS L. REV. 293, 307 (1979).

A recent study indicates that in 1978 about 75% of the boards of 380 New York Stock Exchange companies select outside directors on the basis of the chief executive officer's recommendation. KORN/FERRY INTERNATIONAL, BOARD OF DIRECTORS; SIXTH ANNUAL STUDY 22 (Feb. 1979). Another shows that about 61% of outside directors are chosen as a result of previous contact with management. HEIDRICK & STRUGGLES, INC., DIRECTOR DATA: CHARACTERISTICS OF OUTSIDE DIRECTORS (June 1978). *See* ABA Subcomm. on Functions and Responsibilities of Directors, Committee on Corporate Laws, *Corporate Directors Guidebook,* 32 BUS. LAW. 35, 35-36 (1976).

[99] *See* C. BROWN, *supra* note 98, at 23. *But see* M. SCHAEFFLER, THE LIABILITIES OF OFFICE: INDEMNIFICATION AND INSURANCE OF CORPORATE OFFICERS AND DIRECTORS 48-50 (1976), suggesting that the use of a nominating committee reduces the chief executive officer's authority in selecting new directors.

[100] As one corporate president reflected:

> Presidents and chairmen of large and respected companies enjoy the prestige of serving on similar large and respected company boards .... [I]t is a little bit like being knighted to say 'I'm a director of General Motors, or General Electric, or AT & T.' "

M. MACE, *supra* note 98, at 88.

[101] *See* Solomon, *supra* note 44, at 584-85. In 1978, the annual compensation for directors of New York Stock Exchange companies averaged $11,250. KORN/FERRY INTERNATIONAL, *supra* note 98, at 14.

[102] One attorney who has served as counsel to outside directors considering the liability of their colleagues observed:

> [W]e are dealing with a situation in which the president of the company, the man or men who helped build it, and who the directors view as an irreplaceable asset, has his honor and future under attack. Such men look to "their" board of directors to support them.

Klein, *Conduct of Directors When Litigation is Commenced Against Management,* 31 BUS. LAW 1355, 1359 (1976). The chief executive officer's expectation of loyalty is most often well rewarded. One chief executive officer commented that although a "maverick" on his ten man board often disagrees with him, "he repeatedly tells me when the chips are down and it comes time to vote, he is either going to vote for me, or he will resign from the board." THE CONFERENCE BOARD, THE BOARD OF DIRECTORS: NEW CHALLENGES, NEW DIRECTIONS 30 (1972). One commentator suggested that "[a] malefactor is not tolerated on the board unless he is among friends, who certainly will not sue him." Bayne, *supra* note 42, at 80.

[103] *See* C. BROWN, *supra* note 98, at 24; M. EISENBERG, *supra* note 97, at 147. A recent study indicates that 37% of chief executive officers have removed directors. HEIDRICK & STRUGGLES, INC., PROFILE OF THE BOARD OF DIRECTORS 11 (1971).

a typical board who are lawyers, bankers, or major customers of the corporation[104] are "likely to be responsive to subtle pressure to support the incumbent management with whom [they hope] to have future dealings."[105]

Besides the structural and financial ties that typically exist between outside directors and management, unavoidable psychological and social attachments to management and other directors are bound to affect outside directors' neutrality. Directors and officers often mingle socially, serve on different boards together, and have had at least some positive relationships prior to their election.[106] Indeed, such prior attachment is often a prerequisite to appointment.

A "disinterested" outside director is often an inside director on a board of another large corporation.[107] His consideration of derivative suits alleging common forms of corporate misconduct, especially widespread practices like questionable payments to foreign officials,[108] is likely to be partial. He may have a personal interest in terminating the suit to deter future derivative suits by shareholders of his own corporation. Such strains on the disinterested independence of a director need not result from bad faith.[109] As the Second Circuit observed in *Burks v.*

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[104] One study indicates that nearly one-third of NYSE corporations have attorney-directors who provide legal services to the corporation. KORN/FERRY INTERNATIONAL, *supra* note 98, at 12. The extent to which lawyers serve as directors on boards of corporate clients is well illustrated by NEW YORK LAW JOURNAL, OUTSIDE COUNSEL: INSIDE DIRECTOR, LAWYERS ON THE BOARDS OF AMERICAN INDUSTRY 29-134 (1974). Such a practice is obviously profitable; one New York law firm had partners on boards of 22 corporations that paid the firm $4.6 million in legal fees in 1973. *Id.* at 115-16. Approximately 31% of the directors of major corporations are investment bankers, while 41% are commercial bankers. KORN/FERRY INTERNATIONAL, *supra* note 98, at 12. *See* C. BROWN, *supra* note 98, at 100; M. EISENBERG, *supra* note 97, at 146; Feis, *Is Shareholder Democracy Attainable?*, 31 BUS. LAW 621, 624-26 (1976); Smith, *Interlocking Directorates Among the "Fortune 500,"* 3 ANTITRUST L. ECON. REV. 58 (1970).

[105] Feis, *supra* note 104, at 624-25. *See* R. NADER, M. GREEN & J. SELIGMAN, *supra* note 97, at 112-13.

[106] *See* E. MCSWEENEY, MANAGING THE MANAGERS 106 (1978).

[107] HEIDRICK & STRUGGLES, INC., *supra* note 98.

[108] STAFF OF THE SENATE BANKING, HOUSING, AND URBAN AFFAIRS COMM., 94TH CONG., 2D SESS., REPORT OF THE SECURITIES & EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 37 (Comm. Print 1976).

[109] *See The Role of the Shareholder in the Corporate World: Hearings Before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 110-11 (1977) (testimony of Arthur J. Goldberg, former Associate Justice, U.S. Supreme Court).

On the other hand, a director might feel frustrated by his ties to management:

> [The outside director] is nearly always a loyal friend of the CEO belonging to the same clubs, holding the same views and moving in the same social strata.

Lasker,[110] "[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."[111]

The fact that the very directors accused of wrongdoing appoint the members of a special litigation committee accentuates the bias against the derivative suit. When selecting members to decide, in effect, the question of their liability, the implicated directors will probably place particular emphasis on the extent to which a potential committee member has economic, social, and psychological ties to the inside directors.

These factors should undermine the presumption of impartiality courts have attached to decisions of special litigation committees. Yet courts have continued to apply the presumption. This practice creates adverse direct effects on derivative suits and deleterious collateral effects in other areas.

b. *Direct Effects.* The consequences of the use of special litigation committees fall most heavily on derivative plaintiffs. Committees rarely provide plaintiff-shareholders with a meaningful opportunity to establish their claim. Courts have failed to ask: "Who represents the minority shareholders in the factual and legal in-

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> And he is often himself a CEO who feels an obligation to protect another member of this exclusive fraternity who is probably a director on his own board . . . . [A]lmost all outside directors who have thought seriously about their responsibilities are frustrated and disillusioned by the impotence of their positions.

E. McSweeney, *supra* note 106, at 106.

[110] 567 F.2d 1208 (2d Cir. 1978), *rev'd,* 441 U.S. 471 (1979).

[111] 567 F.2d at 1212 (footnote omitted). Two commentators caution that the outside director:

> should have a clear conception of where his duty lies. His loyalty should be to the shareholders . . . rather than to the management and fellow directors. Since his working relationships with management and other members of the board are often intimate, it may be difficult for the outside director to understand this intellectually or to feel it emotionally.

Leech & Mundheim, *The Outside Director of the Publicly Held Corporation,* 31 Bus. Law. 1799, 1821 (1976).

One attorney who has counseled outside directors during their deliberations on inside directors' liability observed that often at the first meeting of such a committee,

> an effort is made by one of the outside directors promptly to pass a resolution affirming the faith of the board in the integrity and wonderfulness of the chief executive officer. If such a resolution did not come from the outside board members spontaneously . . . [it] is likely to pervade the entire course of a representation.

Klein, *supra* note 102, at 1359. *See* McManis, *supra* note 37, at 255-56.

quiries made by and arguments put to the Special Committee of the board of directors?"[112] Certainly the committee itself, composed of colleagues of implicated directors to whom the prospect of any derivative action is always distasteful,[113] will not vigorously argue the plaintiff's case.[114] The use of special litigation committees deprives plaintiffs of a forum in which to argue the merits of their claim.

Even if a special litigation committee decided to pursue a lawsuit against inside directors,[115] the inescapable bias of the outside directors would probably preclude a vigorous prosecution. The committee would presumably retain control of the litigation on behalf of the corporation.[116] Entrusting control of a lawsuit to a group selected, funded, and empowered by the defendants offers substantial potential for abuse.[117]

Judicial disregard of structural bias against shareholder derivative actions creates a loophole through which directors can escape liability for wrongful acts.[118] If a special litigation commit-

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[112] Bernstein, *An Extension of Business-Judgment 'Cloak,'* N.Y.L.J., March 28, 1977, at 1, col. 1.

[113] *See* notes 132-34 and accompanying text *infra.*

[114] It is a basic principle of justice, as Coke said, that "one may not be judge and attorney for any of the parties." Dr. Bonham's Case, 77 Eng. Rep. 646, 652 (K.B. 1611).

[115] This result is unlikely, for the reasons stated above. Moreover, the defendants control the sources of information within the corporation. Even if the plaintiff proves that the defendant directors provided the committee with false or misleading information, the business judgment rule would presumably still protect its decision, since the committee's judgment would be at most mistaken and not tainted by bad faith or other corrupt motive. DeMott, *Reweaving the Corporate Veil: Management Structure and the Control of Corporate Information,* 41 J. LAW & CONTEMP. PROB. 182, 220 (1977).

[116] After all, the demand requirement and the business judgment rule recognize "the right of the corporate directory to corporate control . . . even when its rights are to be protected or sought through litigation." Delaware & Hudson Co. v. Albany & Susquehanna R.R., 213 U.S. 435, 446 (1909).

[117] Indeed, courts have excused demand when a shareholder's derivative action "would be placed in the control of Directors who are Defendants." G.A. Enterprises, Inc. v. Leisure Living Communities, Inc., 66 F.R.D. 123 (D. Mass. 1974). It is possible that the third sentence of rule 23.1 would apply in such a case: a derivative action may be dismissed "if it appears that the plaintiff [i.e., the special litigation committee] does not fairly and adequately represent the interests of the shareholders." FED. R. CIV. P. 23.1. The burden, however, is on the plaintiff shareholder to show such inadequacy. *See* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 592 n.15 (5th Cir.), *cert. denied,* 419 U.S. 873 (1974); 7A C. WRIGHT & A. MILLER, *supra* note 10, § 1833, at 392.

[118] The plaintiff's brief in Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), predicted that judicial approval of special litigation committees will create a formula for "the evasion of responsibility . . . by corporate managers."

> It will only be necessary, after the commencement of a derivative action, to follow these steps: (1) create a minority "Special Litigation Committee" of non-

tee conducts a reasonably thorough investigation, provides tenable justifications for terminating the lawsuit (necessary only in some jurisdictions),[119] and no obvious conflicts of interest exist,[120] its decisions will probably be inviolate.[121] This limited scope of inquiry

> makes it very unlikely that the representative shareholder will ever prevail on the merits in such litigation. The fact that the likelihood of success in such shareholders' litigation is so slim virtually eliminates one potential way of enforcing directors' and officers' duty of care to the corporation, by ensuring that their actual behavior will not even be litigated.[122]

> defendant directors or if there are none or not enough, add a few to the board for this purpose; (2) give the Committee full power . . . ; (3) conduct an "investigation" using resources under the defendants' control; (4) prepare a limited report exonerating the defendants . . . . (5) seek summary judgment in one derivative action . . . (6) seek dismissal, using *res judicata* principles, of all other derivative actions . . . .

Brief for Plaintiff at 31-32.

Counsel for defendant-directors in derivative actions will undoubtedly appreciate the usefulness of such a recipe. In a recent article examining judicial reaction to special litigation committees' decisions, two practitioners concluded that "[t]hese recent decisions . . . confirm that it is feasible in many instances to dispose of burdensome and unwarranted derivative litigation in a relatively efficient and inexpensive manner." Wachtell & Pedowitz, *Staving Off Derivative Action Suits*, NATIONAL L.J., Mar. 3, 1980, at 20, col. 4.

[119] *See* notes 71-79 and accompanying text *supra*.

[120] In Rosengarten v. ITT, 466 F. Supp. 817 (S.D.N.Y. 1979), a case involving questionable payments, the court dismissed plaintiffs' claims that two members of the special litigation committee were biased. One of the committee members was a member of the board of another corporation that had also made questionable payments; the second, also a director of another corporation, was a named defendant in a derivative suit alleging liability for questionable payments made by that company. *Id.* at 825. The court held these factors insufficient to show bias, since "the plaintiffs failed to establish that either man was personally involved in the payments." *Id.* Forcing plaintiffs to prove the elements of a separate lawsuit placed a nearly insurmountable burden on them.

In Maldonado v. Flynn, FED. SEC. L. REP. (CCH) ¶ 97,260 (S.D.N.Y. Jan. 24, 1980), the court refused to infer bias from the fact that one of the two directors on the Independent Investigation Committee became a director the day the committee was created. Rejecting the view that the director's appointment to the board was "for the sole purpose of serving on the Committee," the court instead regarded this as evidence "that he had no ties to [the Corporation] other than those growing out of his duties on the Committee." *Id.* at ¶ 96,828. In selecting the new director, however, the board was undoubtedly mindful that he would be deciding whether to terminate a lawsuit that sought to hold them liable for alleged violations of federal securities laws, and their choice probably reflected this concern.

[121] Judicial reaction might differ if the creation of a special litigation committee is a blatantly meaningless act. For example, a majority of the board may announce its opposition to the suit prior to establishing a committee with only advisory authority. In Swenson v. Thibaut, 39 N.C. App. 77, 250 S.E.2d 279, *appeal dismissed*, 296 N.C. 740, 254 S.E.2d 181 (1978), the North Carolina Court of Appeals refused to shield such a committee's decision to terminate a derivative suit with the business judgment rule, holding that there was no good faith reason for the directors not to proceed with the action. *Id.* at 107.

[122] DeMott, *supra* note 115, at 218.

Indeed, in each reported case involving a special litigation committee, the committee decided to terminate the shareholder suit, and—with one exception—the court upheld that decision. The business judgment rule, designed to preserve the board's authority to manage the corporation,[123] has been transformed into a nearly impregnable barrier to shareholders promoting the corporation's rights.[124]

c. *Collateral Effects*. The rise of special litigation committees carries serious implications beyond its effect on the derivative suit. First, placing responsibility for suits against management in the hands of outside directors may undermine the outsiders' other functions.[125] If the committee members undertake their task with any vigor at all, their adversarial relationship with the defendant directors may jeopardize the outsiders' effectiveness as directors in general. This result runs counter to the current demand for increased active participation by outside directors in board decisionmaking.[126] Moreover, by defusing the threat of derivative suits — particularly in undeveloped areas of director liability law[127] — the widespread use of special litigation committees may diminish outside directors' incentive to perform a monitoring function, despite a recent judicial trend expanding liability for nonfeasance.[128] Anomalously, special litigation com-

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[123] *See* notes 2-6 and accompanying text *supra*.

[124] Judicial deference to the board's termination of a derivative action binds future litigants seeking to assert similar corporate claims. In Blecker v. Araskog, N.Y.L.J., Jan. 28, 1980, at 7, col. 3 (S.D.N.Y. Jan. 27, 1980), the court held that the derivative plaintiff was collaterally estopped from asserting claims involving questionable foreign payments that had been dismissed by the court in Rosengarten v. ITT, 466 F. Supp. 817 (S.D.N.Y. 1979). *See* notes 71-79 and accompanying text *supra*.

[125] The outside directors' close ties with inside management may, of course, independently undermine these functions.

[126] *See* Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1356-60 (1979). One commentator has concluded:

> The solution to the reluctance of outside directors to monitor effectively is, however, simple enough: courts must impose sanctions on them for failing to assume monitoring responsibility when that failure causes shareholder injury.

Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors*, 52 N.Y.U. L. REV. 1341, 1362 (1977).

At least one commentator has suggested that the involvement of outside directors in special litigation committees will increase their effectiveness and "crystalize a greater sense of self-awareness" on the part of the board. Coffee, *supra* note 13, at 1239. The involvement surely comes too late; outside directors should exercise oversight authority at the time of the alleged wrongdoing—not after the act has occurred. *See also* Gammon, *Derivative Suits*, 12 REV. SEC. REG. 887, 891 (1979).

[127] *See* notes 129 & 137-39 and accompanying text *infra*.

[128] *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976); Doyle v. Union Ins. Co., 202 Neb. 599, 277 N.W.2d 36 (1979); Barr v. Wackman, 36 N.Y.2d 371,

mittees, by depending on "disinterested" directors, may discourage their independent participation in corporate affairs.

Additionally, special litigation committees will succeed in terminating derivative suits that touch upon unsettled areas of the law. Indeed courts have not yet settled the issue underlying most of the cases involving the use of special litigation committees: whether directors are liable to their corporation for questionable payments to foreign officials.[129] The use of these committees leaves these issues muddled because courts will rarely reach their merits.

The direct and collateral problems caused by the use of special litigation committees reflect the inadequacy of the "hands off" approach to their decisions. The "reasonableness" test suggested by some courts is not, however, an adequate solution.

B. *The Reasonableness Test*

The reasonableness standard[130] suffers from conceptual problems similar to those that plague the "hands off" approach.[131] Courts employing this standard review the factors weighed by a special litigation committee and determine whether its decision to terminate the lawsuit was reasonable.[132] Yet, given the unique nature of the derivative suit, it seems likely that almost any decision to terminate a derivative action will appear "reasonable" to a "reasonable" special litigation committee. At least in the short run, a derivative action is invariably harmful to the corporation. It is costly for the corporation to litigate; the action often paralyzes the board, and inevitably disrupts management.[133] If the corporation

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380-81, 329 N.E.2d 180, 187-88, 368 N.Y.S.2d 497, 507-08 (1975); Note, *Outside Directors' Liability for Breach of Fiduciary Duty to Investigate,* 13 CREIGHTON L. REV. 383 (1979).

The SEC has criticized directors for their inactive role in overseeing corporations that have been mismanaged. *See SEC Staff Study of the Financial Collapse of the Penn Central Co. — Summary,* [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,931 (1972); *Report of the Investigation in the Matter of Stirling Homex Corp. Relating to Activities of the Board of Directors of Stirling Homex Corp.,* [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,219, at 85,462-63 (1975).

[129] *See* McManis, *supra* note 37, at 229.

[130] *See* notes 71-79 and accompanying text *supra.* The SEC advocated a reasonableness standard in its amicus brief in Burks v. Lasker, 441 U.S. 471 (1979). Amicus Brief for SEC at 19. *See* Note, *Mutual Fund Independent Directors: Putting a Leash on the Watchdogs,* 47 FORDHAM L. REV. 568, 580-84 (1979).

[131] *See* notes 57-70 and accompanying text *supra.*

[132] *See* Amicus Brief for SEC, *supra* note 130, at 19-20.

[133] For example, the special litigation committee in Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979) terminated the derivative suit, in part, because "legal action

indemnifies the defendant or director, a "victory" on the corporation's behalf may turn out to be as economically costly as a defeat.[134]

But the benefit of derivative suits should accrue to the shareholders, and possibly to society in general.[135] Asking directors whether a decision to terminate a suit is reasonable from the directors' viewpoint will invariably generate an affirmative answer. From the perspective of society-at-large or the long-term health of the corporation, however, there seems little reason why a derivative suit against its directors should not proceed to the merits. Moreover, the application of a reasonableness standard embroils courts in the business judgment of corporations. To conduct a meaningful review of a committee's decision, courts would have to place themselves in the position of the directors, have access to confidential documents that may bear on the issue, and, in essence, measure the directors' judgment against their own. It is inconsistent for courts to review a decision of the board that the business judgment rule shields: either the rule protects a corporation's good-faith judgment or it does not.[136] To steer a middle course is inconsistent with the purpose of the rule.

If, as the *Rosengarten* court suggested, a reasonable justification for terminating a derivative suit is that the corporation is un-

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against the defendants could significantly impair their ability to manage corporate affairs." *Id.* at 727.

[134] Directors' resources "are usually small in comparison with the losses their mistakes can cause.... In the case of a director's liability to the corporation itself, [when the directors are indemnified], the circularity is complete—that is, the corporation pays back whatever it collects plus substantial legal expense." Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L. REV. 895, 910-11.

[135] Derivative suits

> have educated corporate directors in the principles of fiduciary responsibility and individual loyalty. They have encouraged faith in the wisdom of full disclosure to stockholders.... The minority effect of such actions has undoubtedly prevented the diversion of large amounts [of money] from stockholders to managements and outsiders.

Brendle v. Smith, 46 F. Supp. 522, 525-26 (S.D.N.Y. 1942). *See* Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966); Cramer v. GTE, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979); Hornstein, *The Shareholder's Derivative Suit in the United States,* 1967 J. BUS. L. 282, 288. ("There is no dispute that these derivative suits have materially raised the standards of fiduciary relationships and of other economic behavior"). *See also* Ballantine, *Abuses of Shareholder Derivative Suits: How Far is California's New "Security for Expenses" Act Sound Regulation?,* 37 CALIF. L. REV. 399, 416 (1949); Dykstra, *The Revival of the Derivative Suit,* 116 U. PA. L. REV. 75, 77-82 (1967).

[136] One commentator has suggested that courts review decisions of special litigation committees as they would those of administrative agencies. Confronted with an unsatisfactory justification,

likely to prevail on the merits,[137] courts applying a reasonableness test will inevitably conduct mini-trials on the underlying claim.[138] Derivative plaintiffs will thus face another barrier, because such a review would force them to try the merits of their lawsuits at an unfairly early stage without the benefit of discovery.

A reasonableness standard might also have the undesirable effect of "freezing" the law of directors' fiduciary duties. "In order to approve the committee's decision not to pursue these lawsuits, it is not necessary to rule conclusively that none of the actions state a claim; it is enough to point out that [they] . . . suffer from substantial weaknesses."[139] Thus, the reasonableness approach, like the "hands-off" approach, would tend to prevent courts from hearing novel claims.

Neither approach adequately accounts for structural bias against derivative suits that inevitably colors decisions of special litigation committees. These courts currently permit alleged wrongdoers on the board to select a judge and jury to determine their own liability.[140] By uncritically accepting the committee's conclusions, courts are abdicating their role as fact-finders and arbiters of the law.

> the court will remand for reconsideration, thereby prodding the agency to articulate its decision more fully, to consider other possibilities or simply to utilize the greater expertise it presumptively possesses. Similarly, it seems equally inappropriate for a court to substitute its own judgment when considering whether a corporation should institute a lawsuit.

Coffee, *supra* note 13, at 1239. This argument misses the mark. Courts will, in fact, substitute their judgment for the board's by ruling that the reasons advanced by the committee are inadequate and remanding for further articulation. In addition, this practice would erect an even greater barrier to derivative plaintiffs by affording directors repeated opportunities to concoct adequate reasons for termination.

137 466 F. Supp. 817, 827 (S.D.N.Y. 1979).

138 One commentator applauded the prospect of separate trials on standing since "[t]his procedure has the advantage of focusing on the question of the shareholders' right to bring the action before plunging into the merits of the complex corporate transaction underlying the claim." Note, *supra* note 13, at 199. Although the author cautioned that such an approach may be unwarranted when there is "substantial overlap" between issues of standing and the merits, *id.* at 200, the difficulty with the approach is that such an overlap will too frequently occur and hamper plaintiffs.

139 Rosengarten v. ITT, 466 F. Supp. 817, 827 (S.D.N.Y. 1979).

140 In Maldonado v. Flynn, No. 4800, slip op. at 23 (Del. Ch. Mar. 18, 1980), the court observed,

> Under our system of law, courts and not litigants should decide the merits of litigation. Aggrieved stockholders of Delaware corporations ought to be able to expect that an impartial tribunal, and not a committee appointed by the alleged wrongdoers, will decide whether a stockholder's derivative suit alleging breach of fiduciary duty has any merit.

In *Maldonado v. Flynn*,[141] the Delaware Court of Chancery adopted a more satisfactory approach to the business judgment rule. The court rejected the view that "a stockholder's right to sue is always secondary and subordinate to that of the corporation, and . . . subject to a corporate power to preempt its continuance.[142] Instead, the court characterized the derivative suit against directors as "a primary and independent right"[143] of redress that arises when shareholders make a demand on the corporation and that demand is refused.[144] Under this view, then, the business judgment rule becomes "irrelevant to the question of whether the committee has the authority to compel"[145] dismissal of a derivative suit. This judicial treatment of special litigation committee decisions comports with the policies underlying the business judgment rule and avoids the problems inherent in the "hands off" or reasonableness approaches. The decision in *Maldonado* should serve as a catalyst for a judicial policy more sensitive to structural bias in derivative suits against directors.

IV

RESTRICTING THE BUSINESS JUDGMENT RULE

The failure of most courts to recognize structural bias in suits against a majority of board directors highlights the more general deficiencies in judicial treatment of suits against directors. The same forces that undercut the neutrality of a special litigation committee exist when a majority of board members carries the responsibility of deciding whether to pursue a suit against a minority of directors. It is naive to contend that structural bias disappears simply because the complaint accuses fewer directors of wrongdoing.[146]

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[141] No. 4800 (Del. Ch. Mar. 18, 1980). *See* notes 80-83 and accompanying text *supra*.

[142] *Id.* slip op. at 16.

[143] *Id.* at 22.

[144] "The stockholder's right to litigate is secondary to the corporate right to bring suit only for so long as the corporation has not decided to refuse to bring suit." *Id.*

[145] *Id.* at 10. In Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951), a disinterested quorum voted to terminate a suit against a minority of directors. In dicta, the court questioned whether "such a quorum could be expected to weigh impartially a charge against their accused colleagues." *Id.* at 344.

[146] In Cohen v. Industrial Fin. Corp., 44 F. Supp. 491 (S.D.N.Y. 1942), the court recognized structural bias against a derivative suit by excusing demand on a board appointed by the majority shareholder accused of wrongdoing:

> The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after ac-

Allowing a derivative action to bypass board review process only if the complaint implicates a majority of directors in the wrongdoing is surely an inaccurate method of measuring structural bias against the suit. Such an approach only guards against the most obvious type of bias: self-interest. Courts should approach board bias against derivative suits with more sophistication.[147] The early cases developed the business judgment rule and the demand requirement in the context of derivative suits against third parties, not directors.[148] Courts have failed to acknowledge that their extension of the business judgment rule to suits against directors compels them to engage in a fundamentally different analysis.

The New York Court of Appeals in *Auerbach v. Bennett*[149] described this analysis as having a "two-tier aspect."[150] The first tier concerned alleged "liability on the part of defendants based on the payments made to foreign governmental customers . . . *i.e.* . . . first tier bribes and kickbacks."[151] The second tier was the special litigation committee's decision "that it would not be in the best interests of the corporation to press claims against defendants based on their possible first-tier liability."[152] In *Auerbach* the defendants successfully contended that "this second-tier corporate action insulated the first-tier transactions from judicial inquiry and was itself subject to the shelter of the business judgment doctrine."[153]

> cusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority. Where we know that puppet directors would at best only go through the motions, are we barred from considering who would be manipulating the wires?

Id. at 494. Courts considering the determinations of special litigation committees would do well to ask the same question. *See* Boyko v. The Reserve Fund, 68 F.R.D. 692 (S.D.N.Y. 1975); note 42 *supra.*

[147] Judicial emphasis on the *number* of directors alleged to have participated in the underlying act undoubtedly encourages sham pleading, since a plaintiff can only reach the merits if he can succeed in bypassing the board review process. Thus, plaintiffs will be tempted to name as many directors as possible in their complaints. *See* Note, *supra* note 13, at 179. In some jurisdictions, however, merely naming a majority of directors as defendants will not, without more, excuse demand. *See* cases cited in note 35 *supra.*

[148] *See* Maldonado v. Flynn, No. 4800 slip op. at 16 (Del. Ch. Mar. 18, 1980); notes 19-21 and accompanying text *supra.*

[149] 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

[150] *Id.* at 630, 393 N.E.2d at 1000-01, 419 N.Y.S.2d at 926-27.

[151] *Id.*

[152] *Id.*

[153] *Id.*

This two-tiered inquiry is unique to the application of the business judgment rule in derivative actions against directors. In derivative suits against third parties, there is only one action of the board at issue: the decision not to sue a third party for allegedly wrongful acts. Courts initially designed the business judgment rule to protect a "first-tier" corporate action. They should not sanction a procedure that allows a board to insulate a "first-tier" corporate action — which itself may or may not fall under the protective umbrella of the business judgment rule — with a "second-tier" decision to terminate the lawsuit that is not demonstrably biased.

The business judgment rule should only protect "first-tier" transactions,[154] such as board decisions to terminate a suit against a third party or to bribe foreign officials.[155] Under this approach, if a shareholder derivative suit alleges liability for a corporation's questionable payments,[156] the defendant directors could invoke the business judgment defense at a trial on the merits.[157] Similarly, if a derivative action alleges an unfair stock option plan,[158] whether the directors exercised good faith business judgment in approving the plan should be a triable issue of fact. The purpose of the business judgment rule is to protect the board's authority to manage the corporation, not to insulate directors from liability. The high standard of fiduciary duty imposed on directors also supports this approach. A shareholder asserting the corporation's rights against directors should be allowed to proceed to the merits of his case even where the board would protect the alleged wrongdoers.[159]

Courts should always require shareholders to make a demand on the board of directors. Such demand would only "give the de-

[154] *See, e.g.,* Polin v. Conductron Corp., 552 F.2d 797, 809-16 (8th Cir.), *cert. denied,* 434 U.S. 857 (1977) (directors' decision to merge corporation within bounds of business judgment rule); Berman v. Gerber Prods., 454 F. Supp. 1310, 1318-19 (W.D. Mich. 1978) (directors' opposition to tender offer protected).

[155] *See, e.g.,* Gall v. Exxon, 418 F. Supp. 508 (S.D.N.Y. 1976).

[156] *See* Hornstein v. Paramount Pictures, Inc., 22 Misc. 2d 996, 37 N.Y.S.2d 404 (Sup. Ct. 1942), *aff'd,* 292 N.Y. 498, 55 N.E.2d 740 (1944). *But see* Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351 (Sup. Ct. 1909) (payment of blackmail not within business judgment rule).

[157] In Maldonado v. Flynn, No. 4800, slip op. at 10 (Del. Ch. Mar. 18, 1980) the court suggested that although the business judgment rule did not insulate the committee's decision to terminate the suit, the rule could be invoked at a later stage to insulate the first-tier transaction — accelerating the exercise date of the executive stock option plan. *See* notes 80-83 and accompanying text *supra.*

[158] *See, e.g.,* Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979).

[159] *See* Note, *supra* note 18, at 746.

rivative corporation itself the opportunity to take over a suit which was brought on its behalf."[160] The demand rule should not impede the demanding shareholder's derivative suit if the corporation fails to exercise this opportunity. Indeed, such a reformulation of the way courts view suits against directors would relegate the demand requirement to its proper place as a procedural requisite for plaintiffs rather than as a substantive roadblock.[161]

Similarly, the business judgment defense would not serve as an impediment to derivative suits. Derivative lawsuits have the potential for abuse, but there are other, more direct ways to eliminate "strike suits."[162] Mandating judicial review of derivative settlements, requiring plaintiffs to post security for expenses,[163] or granting summary judgment motions are more appropriate means of quashing frivolous actions. Using the business judgment rule for this purpose is overinclusive — it erects a bar to meritorious derivative claims.

By refusing to apply the protection of the business judgment rule where a board opposes a suit against directors, courts can give recognition to the board's structural bias against such suits and establish a fair, workable policy appropriate for derivative suits against directors.

CONCLUSION

Current judicial treatment of derivative actions against directors threatens to eliminate the utility of such suits. By applying

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[160] Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975); Coffee, *supra* note 13, at 1226 n.464. In Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966), the Supreme Court observed that "Rule 23(b)[now 23.1] was not written in order to bar derivative suits."

[161] The Second Circuit recently stated that the purpose of the demand requirement "is not that the directors can *preclude* suit despite being defendants, but rather that they might cause the corporation to *pursue* the suit despite being defendants." Galef v. Alexander, 615 F.2d 51, 59 (2d Cir. 1980). *See* Maldonado v. Flynn, No. 4800, slip op. at 20 (Del. Ch. Mar. 18, 1980).

[162] *See, e.g.*, Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308 (1934).

[163] *See, e.g.*, CAL. CORP. CODE §§ 800(d) & 834(b) (West 1976); N.J. STAT. ANN. § 14A:3-6 (West Supp. 1979); N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1979); MODEL BUS. CORP. ACT § 59, ¶ 2(1976). In addition, built-in controls on strike suits have resulted from the staggeringly high costs of litigation: One commentator suggests that "although some lawyers are willing to make the investment for such suits, they are likely to do so only when the probable rewards of success are rather high and can be perceived to be high even before the investigation has begun." Conard, *supra* note 134, at 907.

the business judgment and demand rules originally designed for derivative suits against third parties to suits against directors, most courts have failed to recognize the inherent structural bias that corporate boards exhibit toward actions against directors. The use of special litigation committees has magnified the problem. Courts should only allow directors accused of wrongdoing to raise the business judgment rule as a defense to the alleged violation at a trial on the merits. They should retain the demand rule as a procedural requisite for derivative plaintiffs to give the corporation an opportunity to conduct the litigation. If the corporation declines that invitation, courts should allow the shareholder-plaintiff to pursue the claim.

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