DIRECTORS' BUSINESS JUDGMENT IN TERMINATING DERIVATIVE SUITS SUBJECT TO JUDICIAL REVIEW

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

The Delaware Supreme Court in *Zapata Corp. v. Maldonado*[1] clarified Delaware law[2] by holding that a committee of disinterested directors may terminate a properly initiated[3] derivative suit[4] only when the trial court, using its independent business judgment, deems termination of the suit proper.

In 1975, plaintiff William Maldonado, alleging breach of fiduciary duty,[5] instituted a stockholder's derivative suit on behalf of Zapata

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1. 430 A.2d 779 (Del. 1981).

2. *See* Hinsey, Maldonado (NY) v. Maldonado (DE): *Which Prevails?*, Legal Times Wash., Aug. 4, 1980, at 18; Note, *Corporations—The Stockholder's Independent Right to Sue Derivatively*—Maldonado v. Flynn *and Its Progeny*, 29 KAN. L. REV. 135 (1980). *Compare* Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) *with* Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), *rev'd,* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

3. *See* note 80 *infra*.

4. *See* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5939 (rev. perm. ed. 1980). Fletcher defines a derivative suit in the following manner:

> In legal effect, a stockholder's suit is one by the corporation conducted by the stockholder as its representative. The stockholder is only a nominal plaintiff, the corporation being the real party in interest.
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> The suit is a derivative one, and is to be distinguished from a representative action brought by a stockholder as an individual and for his own benefit in behalf of himself and other stockholders similarly situated. Where plaintiff does not seek to enforce relief for the benefit of the corporation, it is not derivative and not a stockholder's suit.

Id. at 359. *See* Hawes v. Oakland, 104 U.S. 450, 452-53 (1881) (the nature of a derivative suit is twofold: first, a suit to compel the corporation to sue; second, the suit by the corporation); Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980) (stockholder recourse when dissatisfied with the decision of directors concerning the corporation is a derivative suit, which is an action derived from the corporation); Harff v. Kerkorian, 324 A.2d 215, 218 (Del. Ch. 1974) (the purpose of a derivative action is to enable the stockholder to sue in the corporation's name, given refusal by those in control of the corporation to assert the corporations' rights), *aff'd in part and rev'd in part,* 347 A.2d 133 (Del. 1975). *See generally* DEL CODE ANN. tit. 8, § 327 (1974) (authorizes the use of the derivative suit by a stockholder of the corporation); W. FLETCHER, *supra*, §§ 5939-5985.1 (discusses shareholders' derivative suit). *See also* Foss v. Harbottle, 67 Eng. Rep. 189 (Ch. 1843) (case that is often recognized as the first shareholders' derivative suit).

5. The directors of a corporation owe a fiduciary duty to the stockholders. *See* Zahn v. Transamerica Corp., 162 F.2d 36, 43 (3d Cir. 1947) (under state decisions, the directors owe a duty of managing corporate affairs honestly and impartially on behalf of the corporation and all the stockholders); Valente v. Pepsico, Inc., 68 F.R.D. 361, 364 (D. Del. 1975) (fiduciary duty is borne by the directors); Harriman v. E.I. du Pont de Nemours & Co., 372 F. Supp. 101, 106 (D. Del. 1974) (under Delaware law, when a person affirmatively undertakes to dictate the destiny of a corporation, he assumes a fiduciary duty to the corporation and the stockholders); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975) (directors of a corporation stand in a position of trustee to the stockholders); Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 658

Corporation against ten of the corporation's directors.[6] In 1979, Zapata's board of directors[7] created an Independent Investigation Committee[8] to determine[9] whether the corporation should proceed with the litigation.[10] The Committee recommended that the Corporation seek dismissal of this and the other related suits.[11] Zapata moved alternatively for dismissal or summary judgment.[12] The Delaware Court of Chancery denied both of the corporation's motions.[13] On

(Del. Ch. 1975) (corporate directors stand in a fiduciary relationship to their corporation and its shareholders, and their primary duty is to deal fairly and justly with both), *appeal dismissed,* 365 A.2d 136 (Del. 1976); Wilderman v. Wilderman, 315 A.2d 610, 615 (Del. Ch. 1974) (same); Gottlieb v. McKee, 107 A.2d 240, 243 (Del. Ch. 1954) (same); Lofland v. Cahall, 13 Del. Ch. 384, 118 A. 1, 3 (1922) (same).

In Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), plaintiff alleged that the directors accelerated the exercise date of a stock option plan for the purpose of decreasing their federal income tax liability, thereby depriving the corporation of a federal tax deduction of a comparable amount. *Id.* at 1254-55.

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

7. Four of the defendant-directors no longer held board positions by the time of this trial. Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. Ch. 1981).

8. The committee was composed of two newly appointed directors, who were allegedly independent of management. Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980).

Most state corporate statutes permit the board of directors of a corporation to select a committee of directors to act with the authority of the entire board. *See, e.g.,* ARIZ. REV. STAT. ANN. § 10-042 (1977); DEL. CODE ANN. tit. 8, § 141(c) (1974); N.J. STAT. ANN. § 14A:6-9 (West Supp. 1981).

9. "The Committee's determination was stated to be 'final . . . not . . . subject to review by the Board of Directors and . . . in all respects . . . binding upon the corporation.' " Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981).

10. The committee was additionally authorized to determine whether the corporation should litigate two companion actions: Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980) (allegation of breach of fiduciary duty subsequent to breach alleged in Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980)), and Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) (federal claim arising out of same facts as Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980)).

11. *See* Maher v. Zapata Corp., 490 F. Supp. 348, 350 (S.D. Tex. 1980); Maldonado v. Flynn, 485 F. Supp. 274, 277-78 (S.D.N.Y. 1980); Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980). The Committee recommended dismissal of all pending suits for the following reasons:

> (1) the asserted claims appeared to be without merit; (2) costs of litigation, exacerbated by likelihood of indemnification; (3) wasted senior management time and talents on pursuing litigation; (4) damage to company from publicity; (5) that no material injury appeared to have been done to company; (6) impairment of current director-defendants' ability to manage; (7) the slight possibility of recurrence of violations; (8) lack of personal benefit to current director-defendants from alleged conduct; (9) that certain alleged practices were continuing business practices, intended to be in company's best interests; (10) legal question whether the complaints stated a cause of action; (11) fear of undermining employee morale; (12) adverse effects of the company's relations with employees and suppliers and customers.

485 F. Supp. at 284 n.35.

12. Maher v. Zapata Corp., 490 F. Supp. 348, 350 (S.D. Tex. 1980); Maldonado v. Flynn, 485 F. Supp. 274, 277 (S.D.N.Y. 1980); Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980).

13. Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980). "The directors cannot compel the

interlocutory appeal,[14] the Supreme Court of Delaware reversed, remanded, and *held*: The Court of Chancery should apply its own business judgment in determining whether a committee consisting of disinterested directors can terminate a properly initiated stockholder's derivative suit alleging breach of fiduciary duty by certain directors.[15]

The business judgment rule insulates corporate directors from personal liability for good faith business decisions.[16] Courts ordinarily exercise extreme deference when reviewing the propriety of directors'

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dismissal of a pending stockholder's suit which seeks redress for an apparent breach of fiduciary duty, by merely reviewing the suit and making a business judgment that it is not in the best interests of the corporation." *Id.* at 1257. *Accord*, Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980) (alternative motions were denied by the court). *Contra*, Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) (motion for dismissal was granted).

14. Following acceptance of the interlocutory appeal by the Delaware Supreme Court, the Court of Chancery dismissed Maldonado's cause of action. Maldonado v. Flynn, 417 A.2d 378 (Del. Ch. 1980). The court's dismissal, based on the theory of res judicata, was expressly conditioned upon the Second Circuit affirming the earlier New York District Court decision. Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981). The Second Circuit appeal was ordered stayed pending resolution by the Delaware Supreme Court of the Court of Chancery's order denying dismissal and summary judgment. *Id.*

15. Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981).

16. *See* Cramer v. GTE Corp., 582 F.2d 259, 274 (3d Cir. 1978) (absent bad faith or some other corrupt motive, directors are normally not liable to the corporation for mistakes of judgment), *cert. denied,* 439 U.S. 1129 (1979); Penn Mart Realty Co. v. Becker, 298 A.2d 349, 352 (Del. Ch. 1972) (directors are accorded presumption of having acted in good faith and in interests of stockholders); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (decision of a corporate director may come within the business judgment rule); Kelly v. Bell, 254 A.2d 62, 71 (Del. Ch. 1969) (directors are not liable for good faith errors, absent fraud), *aff'd,* 266 A.2d 878 (Del. 1970); Prince v. Bensinger, 244 A.2d 89, 94 (Del. Ch. 1968) (directors not liable for mere good faith errors in judgment); Pollitz v. Wabash R.R., 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912) (same).

The business judgment rule has been defined:

> A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damages, unless [the trier of fact determines]: (1) the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or (2) the directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or (3) in some other way the directors' authorization . . . was not in good faith.

Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111-12 (1979). *See generally* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96 (1980); Johnson & Osborne, *The Role of the Business Judgment Rule in a Litigious Society*, 15 VAL. U.L. REV. 49 (1980); Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157 (1970); Stegemoeller, *Derivative Actions and the Business Judgment Rule: Directorial Power to Compel Dismissal*, 69 ILL. B.J. 338 (1981).

business judgments.[17] Historically, directors have relied on the business judgment rationale in dismissing shareholder derivative suits that they in good faith deem inimical to the corporation's best interests.[18]

The decision to litigate is within the broad class of decisions generally left to the directors' discretion.[19] Statutory and case law promote this policy by requiring the shareholder to make demand upon the directors,[20] unless such demand would be futile.[21] Courts, however, have long recognized that a corporation does not possess unlimited power to dismiss a derivative suit simply by claiming the exercise of business judgment.[22] In *Hawes v. Oakland*,[23] the Supreme Court declared that

17. *See* Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974) (under sound business judgment rule, courts will not intervene in corporate decision making if the judgment of the directors is made in good faith and is uninfluenced by personal considerations); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (decisions of board of directors will not be disturbed by the court if the decision can be attributed to any rational business judgment); Mercantile Trading Co. v. Rosenbaum Grain Corp., 17 Del. Ch. 325, 334-35, 154 A. 457, 461 (1931) (fraud or other ultra vires misconduct must be shown to justify interference by the court in matters of business judgment). *See generally* Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600 (1980).

18. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917) (directors may dismiss derivative suits properly brought, and courts will not interfere with such a decision except when directors are guilty of bad faith); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903) (upholding the idea that directors of a corporation exercising their business judgment may terminate derivative litigation); Hawes v. Oakland, 104 U.S. 450 (1881) (directors may dismiss derivative suits, and the business judgment rule insulates the decision when no fraud or bad faith is alleged). *See generally* Foss v. Harbottle, 67 Eng. Rep. 189 (Ch. 1843) (case that is often recognized as the first derivative suit). *See also* Stegemoeller, *supra* note 16.

19. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917); Maldonado v. Flynn, 485 F. Supp. 274, 279 (S.D.N.Y. 1980); Gall v. Exxon Corp., 418 F. Supp. 508, 514-15 (S.D.N.Y. 1976); Dent, *supra* note 16, at 98.

20. *See* Hawes v. Oakland, 104 U.S. 450, 451 (1881); Sohland v. Baker, 15 Del. Ch. 431, 441, 141 A. 277, 281 (1927); Fleer v. Fleer Corp., 14 Del. Ch. 277, 283, 125 A. 411, 414 (1924); FED. R. CIV. P. 23.1; DEL. CH. CT. R. 23.1. *See generally* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746 (1960); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168 (1976).

In Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), the shareholder did not make demand on directors, and the court upheld this conduct, reasoning that demand was futile. *Id.* at 782. The court found that Zapata's board retained all corporate power concerning litigation decisions and said that the shareholder demand requirement itself "evidence[d] that the managerial power [was] retained by the board." *Id.* at 785-86. *See* note 22 *infra*.

21. Smith v. Sperling, 354 U.S. 91, 97 (1957) (where antagonism exists between directors and shareholders, demand is futile and therefore waived); Doctor v. Harrington, 196 U.S. 579, 587 (1905) (same); de Haas v. Empire Petroleum, 286 F. Supp. 809, 813 (D. Colo. 1968), *aff'd*, 435 F.2d 1223 (10th Cir. 1970) (question of whether demand should be excused is generally left to the discretion of the court). *But see* Siegel v. Merrick, 84 F.R.D. 106, 110 (S.D.N.Y. 1979) (presence or even control of board by interested directors does not necessarily make demand futile).

22. *See, e.g.*, Hawes v. Oakland, 104 U.S. 450, 460 (1881) (shareholder may sue when direc-

the composition of the board determines the stockholder's standing[24] when the board refuses to bring the action.[25]

Justice Brandeis refined the business judgment rule and its relation to the power to dismiss shareholder derivative suits in *United Copper Securities Co. v. Amalgamated Copper Co.*[26] The case involved a derivative suit brought by an individual shareholder asserting an antitrust claim against third parties. The Court held that the directors have the discretion to terminate a derivative suit unless they are guilty of a breach of trust or are unable to make an unprejudiced determination.[27] Justice Brandeis, reiterating the rationale of *Corbus v. Alaska Treadwell Gold Mining Co.*,[28] held in *United Copper* that the decision to pursue a legal cause of action is one of business judgment, provided the directors act in good faith.[29]

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tors act fraudulently, in breach of trust, or ultra vires) (dicta). In *Hawes*, a shareholder brought suit against the City of Oakland for alleged use of company assets without compensation. The board of directors of the company decided not to pursue the suit. *Id.* at 451.

23. 104 U.S. 450 (1881).

24. Standing in derivative suits refers to the ability of minority stockholders to sue despite the opposition of the board of directors or a majority of shareholders. *See* Hawes v. Oakland, 104 U.S. 450, 452-53 (1881); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions, supra* note 20, at 168 n.5.

25. Hawes v. Oakland, 104 U.S. 450, 460 (1881). The court cited self-interest, fraud, illegality, and action beyond given authority as factors that courts should consider in determining whether a stockholder can maintain a suit despite dismissal by the board of directors. *Id.*

26. 244 U.S. 261 (1916).

27. *Id.* at 263-64. Justice Brandeis' decision is cited by one commentator as "the seed for this corporate governance procedure." Hinsey, *supra* note 2, at 18. *See also* Note, *supra* note 17. "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." *Id.* at 600.

28. 187 U.S. 455 (1903). *Corbus* stands for the proposition that directors are not obligated to pursue all causes of action and may justifiably waive a legal right vested in the corporation on the belief that the corporation's best interests will be secured by not litigating. The decision to terminate is thus like any other decision. *Id.* at 463. *See also* Hawes v. Oakland, 104 U.S. 450, 456-57, 460 (1881) (in general, decision whether to sue is within discretion of directors, and shareholder cannot compel suit absent fraud, breach of trust, or ultra vires action by directors); Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) (under Delaware law, decision whether to permit a derivative suit may be made by independent directors with independent business judgment).

29. Thus, a shareholder was not permitted to intervene, as of right, in order to continue litigation that independent members of the board of directors, acting in good faith and in the exercise of sound business judgment, have decided to terminate. Allegheny Corp. v. Kirby, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed sub nom.* Holt v. Allegheny Corp., 384 U.S. 28 (1966). *See also* Ash v. IBM, Inc., 353 F.2d 491, 492-93 (3d Cir. 1965) (minority stockholder lacked standing to maintain derivative action on behalf of the corporation, in absence of showing that refusal of directors to sue was fraudulent, collusive, or represented anything worse than unsound business judgment honestly exercised), *cert. denied,* 384 U.S. 927 (1966); Swanson v. Traer, 249 F.2d 854, 859 (7th Cir. 1957) ("stockholders have no more right to challenge by a derivative suit a decision

United Copper[30] and subsequent cases[31] permitted disinterested boards to terminate derivative actions against third parties.[32] The requirement that the board make an unprejudiced determination, however, precluded boards from terminating actions that named a majority of directors as defendants.[33] *Gall v. Exxon Corp.*[34] departed radically from previous doctrine by extending the power to dismiss actions against third parties to actions against directors themselves.[35] In *Gall*, the board, by appointing a Special Litigation Committee,[36] successfully avoided *United Copper*'s proscription of directors determining whether to terminate suits against their fellow directors. The board of directors authorized the Committee, consisting of disinterested directors, to investigate the merits of the derivative action and determine whether the corporation should pursue the litigation.[37] The court held that the

not to sue than to challenge any other decision by the board"); Issner v. Aldrich, 254 F. Supp. 696, 700 (D. Del. 1966) (business judgments should not be usurped by shareholder unless board of directors has not exercised its judgment in good faith); McKee v. Rogers, 18 Del. Ch. 81, 85-86, 156 A. 191, 193 (1931) (stockholder cannot invade discretionary field of directors and sue in corporation's behalf when managing body refuses).

30. 244 U.S. 261 (1917).

31. Ash v. IBM, 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), *cert. dismissed sub nom.* Holt v. Allegheny Corp., 384 U.S. 28 (1966); Stadin v. Union Elec. Co., 309 F.2d 912 (8th Cir. 1962), *cert. denied,* 373 U.S. 915 (1963); Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957); Beard v. Elster, 39 Del. Ch. 153, 160 A.2d 731 (1960). *Contra*, Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277 (1931) (stockholder may sue in his own name to enforce corporate rights, making the corporation nominally a party defendant, if corporation, on demand of the stockholder, refuses to bring suit).

32. One court has held that dismissal is permitted when a majority of the board members are not involved in the alleged fraud or breach of trust, thus implying that dismissal of a derivative action is permitted in isolated circumstances. Swanson v. Traer, 249 F.2d 854, 858-59 (7th Cir. 1957).

33. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917).

34. 418 F. Supp. 508 (S.D.N.Y. 1976).

35. *See* Note, *supra* note 17, at 607.

36. 418 F. Supp. at 510. A "special litigation committee" is a group of disinterested directors authorized by the full board to determine whether to pursue a derivative action naming directors as defendants. *See generally* Dent, *supra* note 16; Stegemoeller, *supra* note 16; Note, *supra* note 17; Comment, *Novel Application of the Business Judgment Rule: Independent Directors Are Permitted to Terminate Derivative Actions Against Fellow Interested Directors*, 11 CUM. L. REV. 389 (1980).

37. Gall v. Exxon Corp., 418 F. Supp. at 510-11. The court reasoned that "[t]he 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." *Id.* at 517.

Special Litigation Committee's decision not to sue the defendant directors constituted a proper exercise of business judgment.[38]

State law generally governs whether a special litigation committee may terminate a derivative suit.[39] In *Burks v. Lasker*,[40] the Supreme Court addressed a federal law-state law conflict in a situation involving a special litigation committee and alleged violations of federal statutes.[41] Justice Brennan developed a two-tiered test to determine whether the committee could terminate a derivative suit.[42] First, the state's corporation law must permit delegation of the board's power to terminate derivative suits to a committee consisting of independent directors. Second, the termination of the derivative suit must be consistent with the policies underlying federal law.[43] The Supreme Court reversed and remanded the case because the lower courts failed to determine the scope of the state law.[44]

Subsequently, several federal courts employed *Burks'* two-tiered test and allowed a special committee to terminate derivative actions.[45] In *Abbey v. Control Data Corp.*[46] the Eighth Circuit interpreted Delaware

38. *Id.* at 518. The court nevertheless denied the motion for summary judgment in order to permit plaintiff an opportunity to conduct discovery concerning the independence of the special committee. *Id.* at 520.

39. Burks v. Lasker, 441 U.S. 471, 478 (1979) ("[t]he first place one must look to determine the powers of corporate directors is in the relevant State's corporation law"); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (same); Cort v. Ash, 422 U.S. 66, 84 (1975) (same). *See also* Note, *supra* note 17, at 608 (whether a special litigation committee may terminate a derivative suit is primarily a question of state law).

40. 441 U.S. 471 (1979).

41. *Id.* at 473. The shareholder alleged violation of the Investment Company and Investment Advisers Acts, 15 U.S.C. §§ 80a-1, -b-1 (1976).

42. Burks v. Lasker, 441 U.S. at 480. No formal special litigation committee was established in *Burks*. Rather, *Burks* involved a termination decision made by a quorum of disinterested directors. Nevertheless, the principle announced in *Burks* is applicable to cases in which a formal special litigation committee has been established.

43. *See id.* at 480, 486. *See generally* Note, *Director Dismissal of Shareholder Derivative Suits Under the Investment Company Act:* Burks v. Lasker, 11 LOY. CHI. L.J. 519, 519-26 (1980); Comment, *supra* note 36, at 396-407.

The decision in Burks v. Lasker, 441 U.S. 471 (1979), sets the standard that all federal courts will follow when deciding questions of a similar nature in the future. *See* note 47 *infra*.

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

45. Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (applying California law), *cert. denied,* 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979) (applying Delaware law), *cert. denied,* 444 U.S. 1017 (1980); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980) (applying Michigan law); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) (applying Delaware law).

46. 603 F.2d 724 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980).

law[47] as permitting a full board to delegate its dismissal power to a committee of disinterested directors.[48] The court found that termination of the suit did not contradict underlying federal policy[49] and granted a motion for dismissal. Adhering to precedent,[50] the court did not investigate the reasonableness of the independent directors' determination.[51] Such a decision fell within the domain of the business judgment rule.[52] In *Maldonado v. Flynn*,[53] the District Court for the Southern District of New York, relying primarily on the holding in *Abbey*,[54] permitted termination of a derivative suit alleging federal

47. The relevant Delaware statute that confers authority upon directors to delegate their power is DEL. CODE ANN. tit. 8, § 141 (c) (1975), which reads, in relevant part:

> The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. . . . Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it . . . .

48. Abbey v. Control Data Corp., 603 F.2d 724, 729-30 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980). The *Abbey* court cited Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) and quoted Beard v. Elster, 39 Del. Ch. 153, 165, 160 A.2d 731, 738 (1960) for the proposition that Delaware case law permits disinterested directors to exercise their own independent business judgment and, in appropriate cases, to dismiss derivative suits. Thus the court in *Puma* held that dismissal was appropriate. "[S]ince the transaction complained of was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uninformed opinion for that of the experienced, independent board members . . . ." 283 A.2d at 696. The *Abbey* court cited Gall v. Exxon Corp., 418 F. Supp. 508, 518 (S.D.N.Y. 1976), for the proposition that dismissal did not constitute a ratification of an illegal act.

49. Abbey v. Control Data Corp., 603 F.2d 724, 730-32 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980).

50. *See* notes 19 & 31 *supra*.

51. The business judgment rule limits the role of the court to determine whether the committee acted in good faith. It places the burden of proving impropriety on the shareholder. *See* Rosengarten v. IT&T Corp., 466 F. Supp. 817, 824-25 (S.D.N.Y. 1979); Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971); Beard v. Elster, 39 Del. Ch. 153, 160, 160 A.2d 731, 738-39 (1960). *Contra,* Auerbach v. Bennett, 64 A.D.2d 98, 408 N.Y.S.2d 83 (1978), *rev'd,* 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). The Appellate Division in *Auerbach* rejected the presumption of propriety afforded by the business judgment rule and instead adopted a standard of reasonableness, which permits broader judicial review into the committee's decision to terminate. It stated that the appropriateness of the Special Committee's decision "[c]learly depends on the depth and amplitude of the investigation and the emphasis placed by the committee on the various factors necessarily to be considered." 64 A.D.2d at 107, 408 N.Y.S.2d at 87. *See also* Note, *supra* note 17.

52. *See* notes 19 & 31 *supra*.

53. 485 F. Supp. 274 (S.D.N.Y. 1980).

54. 603 F.2d 724 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980).

security violations.[55] Federal courts in California[56] and Michigan[57] reached similar results.

Although few courts have applied the *Burks* test to determine whether a special committee can dismiss a derivative suit,[58] nearly all relevant federal cases interpret state law to allow termination and hold that such termination is consistent with underlying federal policy.[59] Contrary to federal court interpretations of Delaware law,[60] the Delaware Court of Chancery in *Maldonado v. Flynn*[61] held that a special

55. Maldonado v. Flynn, 485 F. Supp. at 286.

56. Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied,* 449 U.S. 869 (1980). The court held that "the good faith exercise of business judgment by a special litigation committee of disinterested directors is immune to attack by shareholders or the courts." *Id.* at 783.

57. Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980). In permitting dismissal, the *Genzer* court emphasized that the proper role of the court is limited to inquiry into the independence of the committee. Given independence, the business judgment rule "shields the deliberations and conclusions of the chosen representatives of the board." *Id.* at 693 (quoting Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927 (1979)).

58. It is well settled that directors properly decide whether to litigate when they act in good faith. *See* notes 29 & 32 *supra* and accompanying text. However, the development of the special litigation committee as a means of terminating derivative suits that the board as a whole could not terminate is a recent phenomenon, and only a small number of reported cases have addressed this problem. *See, e.g.,* Burks v. Lasker, 441 U.S. 471 (1979); Lewis v. Anderson, 615 F.2d 778 (8th Cir. 1979), *cert. denied,* 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980); Cramer v. GTE Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980); Rosengarten v. IT&T Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976).

59. *See, e.g.,* Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert denied,* 444 U.S. 1017 (1980); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980). Few state courts have ruled on this question, as the majority of derivative suits alleging director improprieties are brought in federal court and allege federal securities act violations. In the absence of state court decisions on the authority of the special litigation committee, federal courts have had wide latitude to interpret state law. Typically, they have permitted termination. *See* note 47 *supra*; note 61 *infra*. *But see* Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980). *Galef* represents an exception to what the Ninth Circuit called a "clear trend in the law." Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979), *cert. denied,* 449 U.S. 869 (1980). The Second Circuit in *Galef* reversed and remanded a lower court decision that permitted dismissal of a derivative suit upon recommendation of a special litigation committee. The Second Circuit held that the district court had failed to consider the effect of the state law of incorporation, as well as the federal law underlying the cause of action. In opposition to the majority of recent federal decisions that permit disinterested directors to exercise virtually unbridled discretion in deciding the fate of a derivative suit, *Galef* seems to embrace the argument that "[t]he shareholder's right to bring a derivative action, and not the directors' judgment regarding the best interest of the corporation, is the primary factor in reviewing a business judgment dismissal." Comment, *supra* note 36, at 412-13.

60. *See, e.g.,* Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980).

61. 413 A.2d 1251 (Del Ch. 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779

litigation committee composed of independent board members could not dismiss certain derivative suits against fellow directors.[62] The Vice Chancellor explained that the business judgment rule does not give directors the power to dismiss such suits.[63] The court went on to assert that in certain actions a shareholder retains an independent right to sue derivatively, regardless of any board determination about the suit's potential harm or benefit to the corporation.[64]

In *Zapata Corp. v. Maldonado*,[65] the Delaware Supreme Court attempted to strike a balance between a corporation's legitimate need to avoid meritless litigation and a shareholder's right to check corporate mismanagement through use of a derivative suit.[66] The court rejected the opposing positions of the Court of Chancery[67] and the federal courts[68] because each sacrificed the needs of either the corporation or the shareholder for the benefit of the other. The court sought a middle

(Del. 1981). The suit alleged breach of a fiduciary trust by a majority of the directors. *See* note 5 *supra*.

62. Maldonado v. Flynn, 413 A.2d at 1257. "[D]irectors cannot compel the dismissal of a pending stockholder's derivative suit which seeks redress for an apparent breach of fiduciary duty by merely reviewing the suit and making a business judgment that it is not in the best interests of the corporation." *Id. Flynn* provided the basis for two other district courts to disallow attempts by disinterested directors to dismiss shareholder derivative actions against fellow directors. *See* Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713 (E.D. Va. 1980) (applying Virginia law, the court relied on *Flynn* to hold (1) that the business judgment rule is irrelevant to dismissal of derivative suits and (2) that the special committee cannot dismiss a case of this nature because the full board has no such power and the committee derives its authority from the board); Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980) (applying Delaware law, the court relied directly on the *Flynn* court's interpretation of Delaware law and refused to grant the special committee authority to dismiss the action).

63. Maldonado v. Flynn, 413 A.2d at 1257. The Chancery Court stated:

> While the business judgment rule may protect the Committee of Independent Directors . . . from personal liability if they have made a good faith decision that this suit is not in the best interests of [the corporation] and should be dismissed, an analysis of the character of a derivative suit shows that the business judgment rule is irrelevant to the question of whether the Committee has authority to compel dismissal of this suit.

Id.

64. *Id.* at 1262.

65. 430 A.2d 779 (Del. 1981).

66. *Id.* at 786-87.

67. The court rejected the contention set forth by the Delaware Court of Chancery in Maldonado v. Flynn, 413 A.2d 1251, 1252 (1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), that the stockholder retains an independent right to sue derivatively. Zapata Corp. v. Maldonado, 430 A.2d at 782-85. *See* note 71 *infra* and accompanying text.

68. The court contradicted the holding in Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980), by holding that disinterested directors cannot rely unilaterally on the business judgment rule to dismiss derivative suits alleging a breach of fiduciary duty. Zapata Corp. v. Maldonado, 430 A.2d at 787. *See* note 62 *supra* and accompanying text; note 76 *infra* and accompanying text.

ground that would allow the stockholder to retain the power to bring a derivative action and yet maintain the board's ability to avoid meritless litigation.[69]

The court dismissed the Court of Chancery's contention that the shareholder has an independent right to maintain a derivative suit when the cause of action is against the corporate directors.[70] Such a rule, the Delaware Supreme Court explained, would elevate the interests of one person or group within the corporate structure and ignore all others.[71]

The court determined that Delaware law[72] permits delegation of the full board's power to an independent committee composed of disinterested directors.[73] The majority's interest does not necessarily preclude an authorization for disinterested directors to act on the board's behalf.[74] The committee may properly move to dismiss derivative suits upon the determination that continuance of the action is not in the corporation's best interest.[75]

The court refused to allow the traditional business judgment rule to serve as a defense to the committee's decision to seek dismissal of a suit naming fellow directors as defendants.[76] Deferring to the committee's judgment, the court declared, would ignore the possibility of subconscious bias when directors judge fellow directors.[77] The court reasoned that a greater degree of judicial review is necessary to prevent impropriety.[78]

The Delaware Supreme Court concluded that the Delaware Court of Chancery must not blindly defer to the judgment of the special litigation committee once a derivative suit is properly initiated.[79] The court

69. Zapata Corp. v. Maldonado, 430 A.2d at 787-89.
70. *Id.* at 782-83.
71. *Id.* at 785.
72. DEL. CODE ANN. tit. 8, § 141(c) (1975). *See* note 47 *supra*.
73. Zapata Corp. v. Maldonado, 430 A.2d at 785.
74. *Id.* at 786.
75. *Id.*
76. *Id.* at 787.
77. *Id.*
78. *Id.*
79. The court explained that a derivative suit is composed of two "phases," the shareholder's suit to compel the corporation to sue and the corporation's suit. *Id.* at 784. The first phase concerns the shareholder's method of initiating the suit: by demand that the directors sue, unless such demand is futile. *Id.* at 783-84. *See* notes 21-22 *supra* and accompanying text. The *Zapata* court treated phase two as the properly initiated suit on the merits. 430 A.2d at 784. Demand was futile in *Zapata*, and thus the suit was properly initiated. The threshold issue was whether the board

invoked a two-step test to determine when a committee's dismissal of a shareholder's derivative suit is proper.[80] First, the lower court must inquire into the good faith and independence of the committee.[81] Second, if the court finds the committee to be disinterested, it may proceed to the next step which requires the court to employ its own business judgment to ascertain whether the motion to dismiss should be granted.[82]

The *Zapata* court's refusal to give disinterested directors unbridled discretion in dismissing derivative suits against directors is laudable. Applying the business judgment doctrine as a defense to such actions creates too great a potential for abuse[83] and impinges upon the spirit of early cases developing the business judgment rule.[84] Conversely, denial of the shareholder's independent right to bring an action conforms to the established doctrine that the directors of a corporation determine whether a party may bring a suit on behalf of the corporation.[85]

The Delaware Supreme Court's conclusion that disinterested directors cannot unilaterally dismiss derivative suits naming fellow directors as defendants does not contradict the Delaware statutory law authorizing directors both to manage the coporation[86] and to delegate the full board's power to a committee.[87] The board of directors, of course, cannot confer upon the committee a power that the board itself does not

had the power *to seek* dismissal once the suit was properly initiated. *Id.* at 784 n.10. The court distinguished phase one from phase two, because phase one involves either making demand on the board or demonstrating an excuse for not making such demand. The court noted that the traditional business judgment rule is still the appropriate test for phase one. "[W]hen stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met." *Id.* at 784 n.10 (citing Dent, *supra* note 16, at 100-01 & nn. 24-25). The *Zapata* court's two-step test, *see* notes 81-83 *infra* and accompanying text, for determining whether a board (or special litigation committee) can seek dismissal of a properly initiated suit applies only to phase two of a derivative suit. *Zapata* does not affect the validity of the business judgment rule as applied to phase one determinations involving demand or futility of demand.

80. *Id.* at 788-89.

81. *Id.*

82. *Id.* at 789.

83. *See* Dent, *supra* note 16, at 111-13. *See generally* Note, *supra* note 17.

84. *See* United Cooper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Hawes v. Oakland, 104 U.S. 450 (1881). *See also* notes 24-33 *supra* and accompanying text.

85. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied,* 449 U.S. 869 (1980); notes 18-20 *supra*.

86. DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1980).

87. DEL. CODE ANN. tit. 8, § 141(c) (1975).

possess.[88] The *United Copper*[89] line of cases prohibits a board of directors from dismissing an action if board members are involved in the suit.[90] Using a special committee to terminate such an action represents an attempt to exercise a right that the board as a full body does not enjoy.

The court's authorization for the Court of Chancery to exercise its own business judgment[91] is an extremely large expansion of the judiciary's role in such matters. Business judgment consideration as a shield from attack was traditionally applicable solely to the decisions of corporate management.[92] Courts historically have reviewed the integrity and good faith of management, but they rarely substitute their own business judgment for that of the board.[93] If courts make business decisions in the context of the shareholder derivative suit, they, and not the board, will decide what is best for a corporation in a variety of circumstances.[94] Such a broad and far reaching doctrine is perhaps unnecessary to effectuate the desired end of the *Zapata* court. A possible alternative to both the *Zapata* approach and the traditional business judgment rule is to shift the burden of proving reasonableness of action from the shareholder to the board.[95]

The Delaware Supreme Court in *Zapata* conceivably overextends judicial authority by empowering the Court of Chancery to employ its own business judgment.[96] *Zapata* nevertheless signifies a determina-

88. *See* Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713, 716-17 (E.D. Va. 1980). *See generally* Stegemoeller, *supra* note 16.

89. 244 U.S. 261 (1917).

90. *See* notes 24-27 *supra*.

91. *See* note 83 *supra*.

92. Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713, 717 (E.D. Va. 1980) (dicta). *See* notes 17-18 *supra*.

93. *See* Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974) (court will not intervene if corporate decision making is uninfluenced by personal considerations and is exercised in good faith). *See* note 18 *supra*. *See generally* Comment, *supra* note 36, at 391-93.

94. The business judgment doctrine traditionally permits directors to institute actions and policies that require no justification other than that the judgment is made in good faith for the best interests of the corporation. *See* note 16 *supra*. Although the rationale for permitting directors broad discretion in deciding matters of corporate policy is well documented and generally accepted, this rationale does not logically extend to the court's power to review the decision. *See generally* Note, *supra* note 17.

95. *See* note 51 *supra*. *See generally* Comment, *supra* note 36.

96. *See* notes 91-95 *supra* and accompanying text.

tion by the court that the shareholder's derivative suit will remain a vital check on corporate mismanagement.

J.L.M.