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Jeff J. Friedman

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CORPORATIONS—THE BUSINESS JUDGMENT RULE SHIELDS THE GOOD FAITH DECISION OF DISINTERESTED DIRECTORS TO TERMINATE A DERIVATIVE SUIT AGAINST THE CORPORATION'S DIRECTORS.

_Auerbach v. Bennett_ (N.Y. 1979)

In 1976, Elias Auerbach, a shareholder of General Telephone & Electronics Corporation (GTE), instituted a derivative suit on behalf of GTE alleging that the corporation's directors and auditors, Arthur Andersen & Co., were liable to GTE for breach of their fiduciary duties to the corporation in connection with bribes and kickbacks paid in the United States and abroad by GTE or its subsidiaries. In response to the suit, GTE's board of directors appointed a special litigation committee consisting of three directors who had joined the board after the challenged payments had been made. After the committee concluded that it was not in GTE's best in-

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1. Auerbach v. Bennett, 47 N.Y.2d 619, 625, 393 N.E.2d 994, 997, 419 N.Y.S.2d 920, 923 (1979). In the summer of 1975, GTE's management, prompted by reports that numerous multinational companies had made questionable payments to foreign officials, instituted an investigation to determine if GTE had made similar payments. *Id.* at 624, 393 N.E.2d at 996, 419 N.Y.S.2d at 922. The results of the investigation were made known to the board of directors who referred the matter to the board's audit committee. *Id.* The audit committee, with the help of Arthur Andersen & Co., GTE's outside auditor, sought to discover whether corporate funds had been used "to pay any political party or person or . . . any officer, employee, shareholder or director of any governmental or private customer." *Id.* The audit committee found evidence that, in the period from 1971 to 1975, GTE or its subsidiaries had made payments constituting bribes, possibly totaling over $11 million. *Id.* at 624, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. The audit committee's report, contained in a proxy statement issued before the April, 1976 annual shareholders' meeting, prompted this suit. *Id.*

2. *Id.* at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. The plaintiff agreed not to serve nine of the directors who were named as defendants unless and until their involvement in the actions became apparent. *Id.* at 625 n.2, 393 N.E.2d at 997 n.2. 419 N.Y.S.2d at 923 n.2.

3. *Id.* at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. The complaint alleged two causes of action: 1) that the directors breached their fiduciary duties by permitting the payments to be made and by failing to act to recover them; and 2) that the auditor was negligent in failing to discover and report the payments. Auerbach v. Bennett, 64 A.D.2d 98, 102 n.1, 408 N.Y.S.2d 83, 84 n.1 (1978), rev'd, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

4. 47 N.Y.2d at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. The three directors were Howard Blauvelt, chairman of the board of Continental Oil Company; Dr. John T. Dunlop, Lamont University Professor at the Graduate School of Business Administration of Harvard University; and James R. Barker, chairman of the board and chief executive officer of Moore McCormack Resources, Inc. *Id.* at 631, 393 N.E.2d at 1001. 419 N.Y.S.2d at 927. None of the three had any prior affiliation with GTE. *Id.* at 632, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927. The committee was vested with "all of the authority of the Board of Directors to determine, on behalf of the Board, the position that the Corporation shall take with respect to the derivative claims alleged on its behalf." *Id.* at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923, quoting Resolution of GTE's Board of Directors (April 21, 1976). For a discussion of the significance of this delegation of authority, see note 29 and accompanying text _infra_.

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terests to prosecute the actions, the defendants moved for and were granted summary judgment.

When Auerbach failed to appeal the trial court's grant of summary judgment, Stanley Wallenstein attempted to intervene nunc pro tunc to pursue an appeal. The Supreme Court of New York, Appellate Division, allowed the intervenor to appeal, and reversed the trial court's grant of summary judgment. This decision was appealed by the defendants to the New York Court of Appeals which modified the order of the Appellate Division and reinstated the grant of summary judgment, holding that the committee's decision not to continue the suit was shielded from judicial scrutiny by the business judgment doctrine.

One of the basic principles of the corporate system is that the corporation is managed by, and acts through, its board of directors. This authority enjoyed by directors is protected by the business judgment doctrine, which was summarized in *Pollitz v. Wabash Railroad*:

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 directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.

The business judgment rule also protects, from judicial intervention, the directors' decisions concerning whether or not to pursue a cause of action belonging to the corporation. Justice Brandeis explained that "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors."
Situations may arise in which, for some reason, the directors will not enforce a right of the corporation. If this occurs, a shareholder of the corporation may be permitted to sue on behalf of the corporation through the use of a derivative action. Since the directors are charged with the responsibility of managing the corporation, many states require as a prerequisite to bringing a derivative action that the plaintiff-stockholder request the directors to initiate the legal action. This demand requirement has been held to be a substantive right of the directors which enables disinterested board members, who act in good faith and in the absence of fraud or corruption, to use their sound "business judgment" to decide whether or not it is in the corporation's best interests to pursue the cause of action.

Problems arise, however, when the derivative suit is against a majority of the directors. When such a suit is brought, courts generally will not con-
strain themselves with a rigid application of the business judgment rule. 21 Moreover, the demand requirement is generally excused in such a case since it is assumed that the demand would be futile—22—the theory being that the directors would never elect to sue themselves. 23 When, however, a minority of the board is accused of wrongdoing and it is demonstrated that the majority was honest and did not participate in the challenged activity, the decision of the directors to terminate the derivative suit has been protected by the business judgment doctrine. 24

21. See Note, supra note 12, at 562.

There is also support for the proposition that no demand need be made if the directors and stockholders would be unable to ratify the wrongdoing. See Rogers v. American Can Co., 305 F.2d 297 (3d Cir. 1962) (antitrust violation); Mayer v. Adams, 37 Del. Ch. 298, 141 A.2d 458 (Sup. Ct. 1958) (fraud), Continental Sec. Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912) (fraudulent issuance of stock); Note, supra note 22 at 762. But see United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917) (failure to allege wrongdoers controlled the corporation was fatal to derivative suit based on alleged antitrust violations); Ash v. IBM, Inc., 353 F.2d 491, 492 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966) (no evidence that honest business judgment was not used in authorizing arguably nonratifiable acquisition of assets); Lasker v. Burks, 404 F. Supp. 1172, 1180 (S.D.N.Y. 1975), rev'd, 567 F.2d 1206 (2d Cir. 1978), 441 U.S. 471 (1979) (use of business judgment not equivalent to ratification where Federal Investment Company Act has allegedly been violated); S. Soloment & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass. 93, 113-14, 93 N.E.2d 241, 248 (1950) (stockholder ratification of directors' actions valid since stockholders were disinterested).


In Swanson, a minority of the board of directors were accused of fraudulent conspiracy. 249 F.2d at 856 n.1. The court found that a majority of the board was honest and not under the influence or control of the minority; therefore, the majority could, by exercising its business judgment, terminate the suit against the minority directors. Id. at 858-60.

Similarly, in Issner, two corporations created a jointly owned subsidiary and approved an allegedly unfair contract between the subsidiary and one of the joint owners. 254 F. Supp. at 698. Three of the directors of the corporation which received the favorable contract were also directors of the other joint owner, albeit a small minority of the entire board. Id. at 699. The plaintiff, who filed a derivative suit on behalf of the allegedly disfavored joint owner, was unable to disproved the likelihood that the corporation which received the favorable contract did so because of its superior bargaining position. Id. at 701. Therefore, the court held that the plain-
Over the last few years, in an effort to revitalize the business judgment rule when a majority of the directors is implicated, a technique has been developed whereby an accused majority of the board elects a committee of disinterested directors to decide for the board whether the corporation should pursue the derivative action against the directors. This technique was approved by the United States District Court for the Southern District of New York in Gall v. Exxon Corp., where a majority of the board of directors was accused of bribery. The court concluded that, since the three directors appointed by the full board were disinterested, they could terminate a derivative suit if they concluded that it was in the corporation's best interests not to sue. According to the court, the three directors were vested with the full authority of the board to decide what action the corporation should take.

The defendant had failed to establish that a majority of the directors "participated in a fraud," and the board majority was thus permitted to terminate the derivative suit. Id. at 701-02.

Two other cases worthy of note are Republic Nat'l Life Ins. Co. v. Beasley, 73 F.R.D. 658 (S.D.N.Y 1977), and Gilbert v. Curtiss-Wright Corp., 179 Misc. 641, 38 N.Y.S.2d 548 (Sup. Ct. 1942). The Beasley court, in approving a settlement of several derivative actions, rejected claims that the directors' approval of the proposed settlement was improper since some board members were named as defendants. 73 F.R.D. at 664-66, 667-69. The fact that no defendant personally profited from the alleged mismanagement of funds, and that special counsel and outside, disinterested directors approved the plans as well, convinced the court that the business judgment rule should apply. Id. at 668-69.

Similar deference was given to the majority of disinterested directors in Gilbert, where plaintiffs sought to compel the defendant directors to reimburse the corporation for fees incurred when they caused the corporation to plead guilty to a violation of a federal embargo. 179 Misc. at 643, 38 N.Y.S.2d at 550-51. The court held that, absent other proof that sound business judgment had not been exercised in refusing to press claims against the two directors who had pleaded guilty (and who had caused the violation), no bad faith on the part of all the directors can be inferred merely from the guilty pleas of two of the directors. Id. at 643-44, 38 N.Y.S.2d at 551. The guilty pleas bound only those directors who had so pleaded, and, absent independent proof of the guilt of the other directors, their decision not to pursue the claims was final. Id. at 645, 38 N.Y.S.2d at 552.


27. Id. at 509.

28. Id. at 516-19. It should be noted that when the board's failure to sue is itself illegal, neither the board nor a disinterested committee thereof could legally terminate the derivative suit. See Miller v. American Tel. & Tel. Co., 507 F.2d 759 (3d Cir. 1974). In Miller, the Third Circuit, applying New York law, found that failure to bring suit for a debt owed to the corporation by the Democratic National Committee constituted an illegal campaign contribution. Id. at 761, 765. Accordingly, the court held that the directors' decision not to sue was unprotected by the business judgment rule. Id. at 762. The court in Gall distinguished Miller on the ground that the refusal to sue the directors for prior actions in Gall was not itself an illegal act, nor did it perpetuate an illegal act. 418 F. Supp. at 518 n.19. For a discussion of the potential impact of Miller, see note 82 infra.

29. 418 F. Supp. at 517. The bylaws of the corporation, in accordance with a New Jersey statute, required an executive committee of at least three directors and provided that "each such committee shall have and may exercise all the authority of the board." Id. at 510 n.1. See N.J. STAT. ANN. § 14A: 6-9 (West 1969). The plaintiff argued that the full board, including the interested directors, had the power to overrule any decision made by the executive committee, and, therefore, the committee's decision not to sue was not made independently of the
In Lasker v. Burks, the same district court that decided Gall again permitted a committee of "disinterested" directors, who were appointed by an interested majority, to terminate a derivative suit against the board. The Court of Appeals for the Second Circuit reversed, holding that federal law governed the fiduciary duties of the directors and that, under federal law, this technique could not be used to terminate a nonfrivolous derivative suit. The United States Supreme Court reversed, however, holding that state law applied because Congress did not intend the federal statute, which the directors allegedly violated, to create federal standards governing the directors' fiduciary duties.

Against this background, the Auerbach court began its analysis by acknowledging that it was precluded from inquiring into the good faith actions of defendant directors. The court rejected this contention, however, finding that the statute placed the committee's decision beyond the control of the board. The court withheld a grant of the defendant's motion for summary judgment pending discovery because the plaintiff alleged that the committee may have been involved or interested in the wrongdoing.


31. Id. at 1180. The district court in Lasker, unlike the Auerbach court, examined the factors which the committee weighed in making its decision and, upon concluding that they were sufficient to enable an informed decision, permitted discovery as to the good faith of the directors. Id. at 1181. See notes 45-47 & 69-71 and accompanying text infra. It is also worth noting that in Lasker, Gall and Auerbach, the disinterested directors received the advice of former chief jurists from either the New York Court of Appeals or the New Jersey Supreme Court, who acted as special counsel. See Lasker v. Burks, 567 F.2d at 1210; Gall v. Exxon Corp., 418 F. Supp. at 514 n.13; Auerbach v. Bennett, 64 A.D.2d at 102, 408 N.Y.S.2d at 85.


34. Before reaching the merits, the court disposed of the procedural issue of whether intervention was properly permitted by the court below. 47 N.Y.2d at 627, 393 N.E.2d at 998, 419 N.Y.S.2d at 924. The court agreed with the lower court's holding that "when a stockholder undertakes to sue on behalf of the corporation, his action concerns other stockholders as well." Id., quoting Auerbach v. Bennett, 64 A.D.2d at 104, 408 N.Y.S.2d at 86. Thus, the court held that a dismissal on the merits of one derivative suit bars suits by other shareholders on the same cause of action, the intervenor here was clearly an "aggrieved party" who could properly appeal under New York's rules of civil procedure. 47 N.Y.2d at 627-28, 393 N.E.2d at 999, 419 N.Y.S.2d at 925, citing Grant v. Greene Consol. Copper Co., 169 A.D. 206, 215-16, 154 N.Y.S. 596, 603, aff'd, 223 N.Y. 655, 119 N.E. 1046 (1918). See N.Y. Civ. Prac. Law § 5511 (McKinney 1978) (an "aggrieved party" may appeal from any appealable order). In support of this holding, the court pointed out that the defendants had attempted to terminate Wallenstein's separate derivative suit on this cause of action on the ground that the case at bar was res judicata. 47 N.Y.2d at 626, 393 N.E.2d at 998, 419 N.Y.S.2d at 925. See note 7 supra.

Along similar lines, the court rejected the defendants' argument that Wallenstein should have intervened much earlier, ruling that a party should intervene only when 1) his interests are not being adequately represented by the parties to the proceeding. Id. at 628, 393 N.E.2d at 999, 419 N.Y.S.2d at 925, citing N.Y. Civ. Prac. Law §§ 1012-1013 (McKinney 1976); 7 J. Weinstein, H. Korn & A. Miller, New York Civil Practice §§ 5511.04, at 68-69 (1979). According to the court, Wallenstein's interests were being adequately represented until Auerbach decided he did not wish to pursue the matter on appeal, at which time the intervenor's interests were completely unrepresented. 47 N.Y.2d at 628, 393 N.E.2d at 999, 419 N.Y.S.2d at 925.
corporate directors exercised with honest judgment in furtherance of legitimate corporate purposes. Judge Jones, writing for the majority, suggested that courts are "ill equipped" to evaluate business judgments, essentially because no objective standard exists by which a court could do so. "Thus, absent bad faith or fraud," the decision whether and to what extent to pursue a derivative claim rests with the corporate board of directors. The court noted, however, that it is never foreclosed from inquiring into the disinterested independence of the members of the committee chosen to make the board's decision.

Having concluded that the business judgment rule "shields the deliberations and conclusions . . . only if [the directors] possess a disinterested independence and do not stand in a dual relation which prevents an unprejudicial exercise of judgment," the court considered whether the committee possessed that independence, noting that to disqualify the entire board would leave the corporation powerless to make a business judgment regarding the prosecution of the derivative action. In finding that the committee's decisions were shielded by the business judgment rule, the court recognized that an inherent conflict exists in allowing directors to investigate fellow directors, but held that this conflict is an "inescapable, given aspect of the corporation's predicament." Moreover, the court refused to allow others to perform this investigatory function for the corporation, reasoning as follows:

To assign responsibility of the dimension here involved to individuals wholly separate and apart from the board of directors would, except in the most extraordinary circumstances, itself be an act of default and breach of the nondelegable fiduciary duty owed by the members of the board to the corporation and to its shareholders, employees and creditors. For the courts to preside over such determinations would similarly work an ouster of the board's fundamental responsibility and authority for corporate management.

35. 47 N.Y.2d at 629, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926. For an explanation of the business judgment rule, see notes 12-16 and accompanying text supra.
36. 47 N.Y.2d at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
37. Id. at 631, 393 N.E.2d at 1000, 419 N.Y.S.2d at 927.
38. Id. at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927.
39. Id. Cf. note 16 and accompanying text supra.
40. 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court rejected Wallenstein's argument that any committee appointed by defendant directors must be held legally infrim. Id. at 632, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927. Judge Jones noted that "[c]ourts have consistently held that the business judgment rule applies where some directors are charged with wrongdoing, so long as the remaining directors making the decision are disinterested." Id. at 632, 393 N.E.2d at 1001-02, 419 N.Y.S.2d at 928, citing Swanson v. Traer, 249 F.2d 854, 858-59 (7th Cir. 1957); Republic Nat. Life Ins. Co. v. Beasley, 73 F.R.D. 658, 668-69 (S.D.N.Y. 1977); Gall v. Exxon Corp., 418 F. Supp. 508, 515 (S.D.N.Y. 1976); Issner v. Aldrich, 254 F. Supp. 696, 701-02 (D. Del. 1966); Gilbert v. Curtiss-Wright Corp., 179 Misc. 641, 645, 38 N.Y.S.2d 548, 552 (Sup. Ct. 1942). For a discussion of Gall v. Exxon, see notes 26-29 and accompanying text supra. For discussion of the remaining cases, see note 24 supra.
41. 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.
42. Id. See notes 72-75 and accompanying text infra.
Since the court found that the committee's deliberations were protected by the business judgment rule, it limited its examination to a consideration of the appropriateness of the committee's investigative procedures.\(^{43}\) In holding that the committee members may reasonably be required to prove that they pursued their chosen investigative methods in good faith, and that these methods were "reasonably complete,"\(^{44}\) the court added that the nature and extent of the evidentiary proof required would depend upon the particular investigation, and that the extent of pretrial discovery by shareholders would relate inversely to the extent of disclosure by the committee members.\(^{45}\) The court stated, however, that "what has been uncovered and the relative weight accorded in evaluating and balancing the several factors and considerations are beyond the scope of judicial concern."\(^{46}\) Qualifying this statement, the court noted that proof of a restricted, shallow, or otherwise pro forma investigation would be evidence of bad faith or fraud and, hence, would be unshielded by the business judgment doctrine.\(^{47}\)

Turning to the record, the court considered whether there was a triable issue of fact concerning the adequacy or appropriateness of the committee's investigative methods.\(^{48}\) Looking at the submissions made by the defendants in support of their motions for summary judgment, the court found nothing in the record to indicate a triable issue of fact concerning the committee's procedures or the committee's good faith in carrying out those procedures.\(^{49}\) Wallenstein suggested that a triable issue could only be raised if he were permitted discovery.\(^{50}\) The court refused to permit discovery.

\(^{43}\) 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. Judge Jones cautioned that the court may not trespass in the "domain of business judgment" under the guise of determining the adequacy and appropriateness of the committee's investigative procedures. Id. at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929.

\(^{44}\) Id. at 634, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929. The court did not elaborate as to how one establishes good faith in pursuing an investigation. See notes 60-71 and accompanying text infra.

\(^{45}\) 47 N.Y.2d at 634, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929.

\(^{46}\) Id.

\(^{47}\) Id. at 634-35, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929. The court did not specify how one can demonstrate a shallow investigation without being able to obtain and scrutinize the committee's findings and deliberations. See notes 64-66 and accompanying text infra.

\(^{48}\) See 47 N.Y.2d at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929.

\(^{49}\) Id. at 635-36, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929-30. The committee engaged former Chief Judge Desmond of the New York Court of Appeals as special counsel to "guide its deliberations." 64 A.D.2d at 102, 408 N.Y.S.2d at 87. The specific procedures used by the committee were as follows:

The committee reviewed the prior work of the audit committee, testing its completeness, accuracy and thoroughness by interviewing representatives of Wilmer, Cutler & Pickering, [the audit committee's special counsel from Washington, D.C.], reviewing transcripts of the testimony of 10 corporate officers and employees before the Securities and Exchange Commission, and studying documents collected by and work papers of the Washington law firm.

47 N.Y.2d at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929-30. Also, the committee conducted individual interviews with the defendant directors and with representatives of Arthur Andersen & Co., and questionnaires were solicited from each nonmanagement director of the corporation. Id. at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 930.

\(^{50}\) 47 N.Y.2d at 636, 393 N.E.2d at 1003-04, 419 N.Y.S.2d at 930.
reasoning that 1) Auerbach had not asked for discovery at the trial court level; 2) there were no opposing affidavits (to summary judgment) indicating to the court that essential facts might exist which could be obtained by discovery; and 3) neither Wallenstein’s brief nor oral argument identified particulars as to which he desired discovery regarding the disinterested independence of the committee or its methodology in pursuing its investigation. 51

In his dissenting opinion, Chief Judge Cooke took the position that summary judgment should be postponed pending discovery. 52 He recognized that continuation of the suit depended upon the motives and actions of the defendants and the committee, and that knowledge of such matters was “peculiarly in the possession of the defendants themselves.” 53 The dissent reasoned that Wallenstein was placed in a “Catch-22” situation by the majority which denied him discovery because he had not produced facts which, by their very nature, were discernable only after discovery. 54 Chief Judge Cooke concluded by suggesting that the majority’s decision “may render corporate directors largely unaccountable to the shareholders whose business they are elected to govern.” 55

51. Id., 393 N.E.2d at 1004, 419 N.Y.S.2d at 930. The court noted that the disclosure proposed . . . by Wallenstein . . . would go only to particulars as to the results of the committee’s investigation and work, the factors bearing on its substantive decision not to prosecute the derivative actions and the factual aspects of the underlying [allegedly illegal] activities of defendants—all matters falling within the ambit of the business judgment doctrine.

52. Id. at 636-38, 393 N.E.2d at 1004-05, 419 N.Y.S.2d at 930-31 (Cooke, C.J., dissenting). Chief Judge Cooke reasoned that this was not a typical business judgment rule case because the directors were the alleged wrongdoers. Id. at 637, 393 N.E.2d at 1004, 419 N.Y.S.2d at 930 (Cooke, C.J., dissenting). Therefore, the Chief Judge concluded that “since certain defendants as well as the members of the special litigation committee have the sole knowledge of the facts upon which [the business judgment rule’s] applicability turns, summary judgment should be withheld pending disclosure proceedings.” Id.

53. Id. at 637, 393 N.E.2d at 1004, 419 N.Y.S.2d at 931 (Cooke, C.J., dissenting), quoting Terranova v. Emil, 20 N.Y.2d 493, 496-97, 231 N.E.2d 753, 755, 285 N.Y.S.2d 51, 54 (1967). Chief Judge Cooke found the lower appellate court’s opinion extremely persuasive. 47 N.Y.2d at 636, 393 N.E.2d at 1004, 419 N.Y.S.2d at 930 (Cooke, C.J., dissenting). That lower court had suggested that “the depth and amplitude of the investigation and the emphasis placed by the committee on the various factors necessarily to be considered” were proper subjects for judicial scrutiny. 64 A.D.2d at 107, 408 N.Y.S.2d at 87-88. According to the lower court, the factors likely to be considered would include the reasons for the payments, the benefits to the corporation resulting from the payments, the personal gain by the defendant directors, and the loss of public confidence in the corporation which might be caused by the derivative suit. Id. Unlike the majority of the New York Court of Appeals, the lower court believed “the hesitancy which might arise in outside directors by their investigation of the activities of fellow directors, especially when personal liability is at stake, [to be] a consideration of moment.” Id. at 107, 408 N.Y.S.2d at 88 (footnote omitted).

54. 47 N.Y.2d at 637, 393 N.E.2d at 1004-05, 419 N.Y.S.2d at 931 (Cooke, C.J., dissenting).

55. Id. at 638, 393 N.E.2d at 1005, 419 N.Y.S.2d at 931 (Cooke, C.J., dissenting).
RECENT DEVELOPMENTS

It is submitted that, as a matter of judicial expediency, the notion that honest, disinterested, independent directors, acting in good faith, should be able to decide not to pursue a suit against the majority of the directors is not without merit. It is contended, however, that the Auerbach court's application of this principle suffers from two major inconsistencies. First, after noting that it is never foreclosed from inquiring into the disinterested independence of the committee members, the court failed to probe deeply into that very subject, apparently because it simply relied upon the reputations of the three new directors and the committee's special counsel. Second, it is submitted that the court practically avoided considering the good faith requirement of the business judgment rule—even after admitting that evidence of bad faith or fraud would be sufficient to overcome the business judgment justification.

With respect to the requirement of proving good faith, it is suggested that the Auerbach court contradicted itself in several respects. Significantly, the court noted that the adequacy and appropriateness of the committee's investigative procedures were proper subjects of inquiry, and that the committee may reasonably be required to prove that they pursued their chosen investigative methods in good faith and with reasonable completeness. Yet, it is submitted that the court proceeded to eliminate a potentially fruitful area of inquiry, stating that it was not permitted to consider the facts revealed by the committee's investigation or the relative weight accorded to them by the committee. While the court seemingly qualified

56. See text accompanying notes 34-36 supra. Concerning the dilemma which a court faces in considering a management group's refusal to sue, one commentator has suggested:

The usual ties between all members of a management group may and perhaps should induce a court to view [a decision not to sue] with a degree of skepticism and prompt scrutiny as to the true motives of the "independent" directors. [It is easy to appreciate the dilemma of courts faced with the choice, on the one hand, of a prophylactic rule that holds the erosion of moral precept, attending a fraudulent fiduciary's escape from liability, too high a price to pay for peace in any case, and on the other, of a rule that makes narrow corporate interest, primarily financial, as determined by the judgment of presumably independent directors, preeminent.


57. 47 N.Y.2d at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927. See text accompanying note 38 supra.

58. 47 N.Y.2d at 631-32, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927. See notes 4 & 49 and accompanying text supra.

59. 47 N.Y.2d at 631, 393 N.E.2d at 1000, 419 N.Y.S.2d at 927. See notes 37-40 & 44-47 and accompanying text supra; notes 60-66 and accompanying text infra.

60. See notes 61-66 and accompanying text infra.

61. 47 N.Y.2d at 633-34, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928-29. See notes 43-45 and accompanying text supra.

62. 47 N.Y.2d at 634, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929. See note 44 and accompanying text supra.

63. 47 N.Y.2d at 634, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929. See note 46 and accompanying text supra. It is suggested that if the directors ignored very significant investigative results or began the investigation with a predetermined resolve that the damaging publicity factor would outweigh all else, a factfinder might justifiably infer bad faith. Moreover, it is submitted that the court's suggestion that bad faith can only be an element of the methodology of an investigation is unrealistic at best. A thorough investigation does not automatically guarantee that a decision was made in good faith. See notes 69-71 and accompanying text infra.
the latter statement by positing that proof of a "shallow" or "pro forma" investigation would raise questions of bad faith or even fraud,

64 the court failed to suggest how one could demonstrate a sham without considering the bases for the committee's decision.65 As a result, it is suggested that as long as a committee goes through the motions of a thorough investigation,66 there can never be proof of "shallowness" and the committee will not be accountable to anyone, even though its conclusions may be totally inappropriate in light of the information gained.

It is further suggested that the majority's refusal to allow discovery on the ground that Wallenstein had not produced evidence sufficient to raise a triable issue of fact concerning the committee's decision67 has created an almost impossible burden of proof for the complaining shareholder to meet.68 It is submitted that it is very difficult to challenge the "disinterestedness" of the committee members or to produce evidence of bad faith without being permitted to examine and use the substance and reasoning behind the committee's decision.69 By its very nature, this evidence can only be obtained through discovery.70 It is contended that the more reasonable view is that expressed by Justice Hopkins, who, while writing for the unanimous majority in the court below, suggested that discovery should be permitted, and, if the record then shows "that the disinterest of the directors was not refuted, the underlying facts were thoroughly investi-
gated and cogent reasons existed in support of the decision of the committee," the suit should be dismissed. 71

Finally, in response to the majority's argument that more extensive scrutiny of the committee's decision by the courts than that allowed in the instant case would usurp the board's "fundamental responsibility" to the corporation, 72 an additional point ought to be raised. It is submitted that courts should not consider themselves to be so tightly constrained by the business judgment rule in examining charges of wrongdoing leveled against a corporation's directors. 73 The mere fact that courts are willing to let "disinterested" directors decide the issue of whether to sue other directors does not mandate that the courts be precluded from using the substance of an investigation to test the good faith of those directors. 74 Indeed, the very question before the courts is whether directors are capable of exercising their "fundamental responsibility" to the corporation when close personal or business relationships may be involved. 75 Undoubtedly, the substance of the committee's work can be an enlightening source of evidence regarding this question.

Turning to the impact of this decision, it is submitted that the New York Court of Appeals, by giving the absolute power to the board of directors to terminate a derivative suit if it so chooses, has approved a method which will most assuredly reduce the number of such suits in New York. Moreover, if enough derivative suits against directors are quashed by committees of "disinterested" directors, truly meritorious causes of action may not be pursued because attorneys, very often the chief beneficiaries of a derivative action, will refuse to waste their time and effort on potentially fruitless lawsuits. 76

71. 64 A.D.2d at 108, 408 N.Y.S.2d at 88 (emphasis added). There is no intention to imply that "cogent reasons" did not exist in the instant case to support the committee's decision. Rather, it is suggested that the holding in this case creates a dangerous precedent by preempting judicial inquiry into the possibility that cogent reasons might not exist. See also Lasker v. Burks, 404 F. Supp. at 1181; note 31 supra.

72. See text accompanying note 41 supra.

73. See Auerbach v. Bennett, 64 A.D.2d at 107-08, 408 N.Y.S.2d at 88. The Appellate Division reasoned as follows:

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. . . .

In short, the business judgment rule should not be so rigorously applied as to cut short . . . apparently legitimate inquiry into a nonfrivolous claim of wrongdoing by directors . . . on the ground that a committee of disinterested directors . . . decided that the corporate interests will not be promoted by a derivative action.

Id. (citations and footnote omitted). The opinion of the Appellate Division was adopted by the dissent in the instant case. See 47 N.Y.2d at 636, 393 N.E.2d at 1004, 419 N.Y.S.2d at 930 (Cooke, C.J., dissenting).

74. See note 71 and accompanying text supra.

75. See notes 53 & 73 supra.

76. Since it is the corporation which will recover in a derivative action, the individual shareholder usually will not stand to gain direct monetary benefits, but his lawyer may lay claim to substantial attorney's fees. See generally 2 G. Hornstein, Corporate Law and Practice
It is suggested that another noteworthy effect of Auerbach is that the New York Court of Appeals has effectively eliminated any exceptions to the requirement that demand be made on the board of directors. After Auerbach, as long as the bylaws of the corporation contain a provision for so-called “executive committees” to be created by the board, “interested” directors will be able to form a committee of “disinterested” directors having the power to terminate a derivative suit. Thus, it must be concluded that demand can never be futile since, even if the entire board of directors is accused of wrongdoing, only three directors need resign to allow substitution of enough disinterested committee members to require that demand be made.

It is submitted that if such is the case, directors will always be able to use this technique to attempt to quash a derivative suit and, in the majority of cases, they will prevail.

The decision of the litigation committee in the instant suit may very well have been proper and made in good faith. It is submitted, however, that the precedent established by this case does a disservice to the corporate system by rubber-stamping a technique which potentially allows directors’ decisions made in bad faith and totally contrary to investigative results to

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\[732\] (Supp. 1968); Dawson, Lawyers and Involuntary Clients in Public Interest Litigation, \[88\] HARV. L. REV. 849 (1975).

77. See notes 18-20 and accompanying text supra. As long as disinterested directorships can be created, it does not seem possible for a situation to arise in which it would be futile to make a demand. See notes 78-81 and accompanying text infra. It is submitted that the Auerbach decision makes the demand requirement exception of Barr v. Wackman, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975), an aberration easily avoidable by use of the technique employed in this case. See notes 21-23 and accompanying text supra.

78. Cf. note 29 supra.

79. See N.Y. BUS. CORP. LAW § 712(a) (McKinney Supp. 1979). New York authorizes such committees and empowers them to exercise “all the authority of the board.” Id.

80. See id. The New York Business Corporations Law requires at least three members to form a committee. Id.

81. Id. § 705(a). Section 705(a) provides in pertinent part:

Vacancies . . . may be filled by vote of the board. If the number of directors then in office is less than a quorum, such . . . vacancies may be filled by a vote of a majority of the directors then in office. Nothing in this paragraph shall affect any provision of the certificate of incorporation or the by-laws which provide that . . . vacancies shall be filled by vote of the shareholders.

Id. Strategically, directors would desire to avoid a bylaw provision requiring shareholders to fill vacancies on the board. This would eliminate the possibility that persons hostile to the present board members would fill the vacancies.

82. One possible situation might arise in which a derivative suit could not be terminated. At least one court has held that where the decision not to bring suit perpetuates an illegal act, the cause of action must be pursued. See Miller v. American Tel. & Tel. Co., 507 F.2d 759 (3d Cir. 1974) (failure to collect a debt constituted an unlawful campaign contribution); note 28 supra. If such a distinction is meritorious, it is submitted that Auerbach would be decided differently today on the basis of the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd 1-2 (Supp. 1979), which makes bribes illegal. Thus, a failure to sue by the board of directors to recover a “debt” owed by a foreign official would perpetuate an illegal act. However, if the directors did not accept kickbacks or bribes, but instead, were involved only in giving bribes, a decision not to sue the directors for the corporate asset would not seem to be illegal. In Miller, by forcing the directors to sue for the debt, the court prevented the illegal act (the contribution) from being consummated. 507 F.2d at 763. In a bribery situation, only suing the bribed official would truly rectify the illegality in a similar fashion by preventing the official from keeping the money.
hide behind the judicially constructed shield of the business judgment rule.\textsuperscript{83}

\textit{Jeff J. Friedman}

\textsuperscript{83} It is arguable that the availability of this technique could persuade corporations habitually troubled by frivolous suits to reincorporate in New York. An even more unfortunate result may be that other states will follow \textit{Auerbach} and insulate corporate directors in a similar fashion. Indeed, some federal courts have already followed the \textit{Auerbach} rationale in cases applying state law. See Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (applying California law); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979) (purportedly applying Delaware law), \textit{cert. denied}, 48 U.S.L.W. 3436 (1980); Maldonado v. Flynn, \textit{[1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,260} (S.D.N.Y. Jan. 24, 1980) (purportedly applying Delaware law). \textit{But see} Maldonado v. Flynn, No. 4800 (Del. Ch., Mar. 18, 1980) (shareholder has an absolute right to bring a derivative suit against directors).