1982

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CORPORATIONS—THE COURT'S INDEPENDENT BUSINESS JUDGMENT WILL BE APPLIED TO A DECISION OF A COMMITTEE OF DISINTERESTED DIRECTORS TO DISMISS A DERIVATIVE SUIT ALLEGING A BREACH OF FIDUCIARY DUTY BY A MAJORITY OF THE CORPORATION'S DIRECTORS

Zapata Corp. v. Maldonado (Del. 1981)

In 1975 William Maldonado, a shareholder of the Zapata Corporation (Zapata), brought a derivative action on behalf of Zapata in the Court of Chancery of Delaware. Maldonado alleged that all members of Zapata’s board of directors breached their fiduciary duties in approving

1. Zapata Corp. v. Maldonado, 430 A.2d 779, 780 (Del. 1981). In addition to the Delaware action, Maldonado commenced an action in the United States District Court for the Southern District of New York in 1977 against the same defendants, excepting one, asserting claims under § 10(b), § 14(a) and § 7 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78n(a), 78g (1976), as well as the same common law claim raised in the Delaware action. Maldonado v. Flynn, 448 F. Supp. 1032 (S.D.N.Y. 1978), aff’d in part, rev’d in part, 579 F.2d 789 (2d Cir. 1979), 477 F. Supp. 1007 (S.D.N.Y. 1979), sum. judgment granted, 485 F. Supp. 274 (S.D.N.Y. 1980), rev’d in part, 671 F.2d 729 (2d Cir. 1982). Zapata’s motion to stay the federal action pending the outcome in the Delaware courts was denied. Maldonado v. Flynn, 477 F. Supp. 1007 (S.D.N.Y. 1979). Maldonado amended his complaint to eliminate the common law claim then being pursued in Delaware and proceeded in the district court with the alleged proxy rule violations. Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980). Following the Delaware Supreme Court’s decision in Zapata Corp. v. Maldonado, the Second Circuit reversed in part and remanded the action to the district court with instructions that the court should apply its own independent business judgment to determine whether Zapata’s motion to terminate the suit should be granted, provided the district court found that the suit was not barred by res judicata as a result of the settlement in a Texas derivative suit. Maldonado v. Flynn, 671 F.2d 729, 731 (2d Cir. 1982), citing Maher v. Zapata, No. H-79-234 (S.D. Tex. June 12, 1981).


2. Zapata Corp. v. Maldonado, 430 A.2d 779, 780 (Del. 1981). Named as defendants in the suit were all eight directors of Zapata, four of whom were officers, and two non-director officers. Maldonado v. Flynn, 448 F. Supp. 1032, 1035 (S.D.N.Y. 1978); Maldonado v. Flynn, 413 A.2d 1251, 1254 (Del. Ch. 1980). In 1971, the shareholders of Zapata ratified a stock option plan granting the senior officers of the corporation an option to purchase shares of Zapata at $12.15 a share, exercisable in five annual installments, the last date being July 14, 1974. Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980). In June of 1974, when the market price of Zapata stock was between $18.00 and $19.00, the board of directors decided that the corporation should make a tender offer on the open market for its own shares at a price between $25.00 and $30.00. Id. On July 2, 1974, the management requested that the New York Stock Exchange suspend trading in Zapata stock pending an important
ing an acceleration of stock purchase options held by senior officers of the company \(^3\) and accordingly that demand on the corporation to institute suit was futile.\(^4\) In 1979, the board of directors of Zapata created an "Independent Investigation Committee" (Committee)\(^5\) consisting of two outside directors who were appointed after the activities challenged by Maldonado had taken place.\(^6\) The Committee was to determine whether the continuation of several derivative suits on behalf of Zapata was inimical to the corporation's best interests.\(^7\) Based upon the Committee's conclusion that continued maintenance of the actions was not in Zapata's best interest, Zapata moved alternatively for dismissal of Maldonado's suit or summary judgment.\(^8\)

3. Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980), rev'd, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). The options were exercised on the accelerated date by the six officers, four of whom were also directors of Zapata. Maldonado v. Flynn, 448 F. Supp. 1032, 1035 (S.D.N.Y. 1978). The board approved a tender offer for its own stock on July 8; the offer was announced on July 8 and trading in Zapata stock resumed; on July 14, the original exercise date, the price of Zapata stock was $24.50 a share. \(^{413}\) A.2d at 1254-55. The acceleration of the option's exercise date resulted in a lower federal income tax liability for the officers, since taxable income resulting from the exercise of these options was measured by the difference between the option price and the market price at the time the option was exercised. \(^{Id}\). See also I.R.C. § 83 (1976). Maldonado alleged that this lower federal income tax liability for the officers resulted in a correspondingly lower deduction to Zapata, with a loss to Zapata of a $430,000 net federal income tax benefit. Maldonado v. Flynn, 448 F. Supp. at 1035-36.

4. 430 A.2d at 780. Maldonado alleged in his complaint that prior demand on the board was excused. \(^{430}\) A.2d at 780. For a discussion of the demand requirement, see notes 27 & 28 and accompanying text infra.

5. \(^{430}\) A.2d at 781. The board of directors of a Delaware corporation is empowered to delegate its authority to manage the corporation to a committee. See Del. Code Ann. tit. 8, § 141(c) (1974). The Zapata committee was created subsequent to a decision of the New York Court of Appeals shielding special litigation committee decisions from judicial scrutiny. See Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). For a discussion of Auerbach, see notes 37-40 and accompanying text infra.

6. Maldonado v. Flynn, 485 F. Supp. 274, 278 (S.D.N.Y. 1980). The two outside directors were F. Arnold Daum, a partner in the law firm retained as special counsel to the Committee, and George A. Lorenz, a businessman who had been a shareholder and director of a firm acquired by Zapata in 1972. \(^{Id}\). at 283. In 1979, when the Committee was created, four of the defendant directors were no longer on the board. Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981).

7. Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980). For a discussion of the various suits brought derivatively on behalf of Zapata, see note 1 supra.

8. 430 A.2d at 781. Zapata also moved for dismissal or summary judgment in the two derivative suits that were being pursued in federal court. \(^{Id}\).
Rejecting Zapata’s claim that the Committee’s conclusions were shielded by the business judgment rule,\(^9\) the Court of Chancery of Delaware denied Zapata’s alternative motions, finding that the business judgment rule did not empower a committee of the board of directors to compel a termination of a derivative suit and that, once the corporation has refused to act, a stockholder has an independent right to bring suit on behalf of the corporation to remedy a breach of fiduciary duty by the directors.\(^10\) On an interlocutory appeal \(^11\) by Zapata, the Supreme Court of Delaware reversed, holding that a court, faced with a motion to dismiss a properly instituted derivative suit, should apply its own independent business judgment in reviewing the decision of an independent committee to dismiss the action. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

In *Maldonado v. Flynn*, the District Court for the Southern District of New York granted the motion, holding that under Delaware law the Committee’s decision was “insulated from shareholder challenge and judicial scrutiny” by the “business judgment rule.” 485 F. Supp. 274, 278-79, 284, 285. The Second Circuit stayed the appeal, pending the Delaware Supreme Court’s determination of the issue of Delaware law. See 430 A.2d at 781. Finding that under Delaware law the business judgment rule is purely defensive, the United States District Court for the Southern District of Texas denied Zapata’s motion. *Maher v. Zapata*, 490 F. Supp. 348, 353 (S.D. Tex. 1980).

9. *Maldonado v. Flynn*, 413 A.2d 1251, 1255, 1257 (Del. Ch. 1980). Zapata argued that absent self-dealing or the failure to exercise due care, the decisions of corporate directors are accorded a presumption of propriety by the operation of the business judgment rule. *Id.* at 1255. For a discussion of the business judgment rule, see notes 16-21 and accompanying text infra.

10. *Maldonado v. Flynn*, 413 A.2d 1251, 1262-63 (Del. Ch. 1980). Having determined that the business judgment rule merely provides a presumption of regularity that attaches to decisions made by directors absent allegations of self-dealing, lack of good faith, or failure to exercise due care, the Vice Chancellor concluded that the business judgment rule “is irrelevant to the issue of whether the stockholders have an independent right to bring an action on behalf of the corporation to rectify a breach of fiduciary duty where the corporation itself refuses to act . . . .” *Id.* at 1263. Accord *Abella v. Universal Leaf Tobacco, Inc.*, 495 F. Supp. 713, 717 (E.D. Va. 1980) (business judgment rule irrelevant where plaintiff challenged directors’ decision to resist takeover and not committee’s recommendation to dismiss suit).

11. 430 A.2d at 780. The purpose for allowing an appeal from an interlocutory order is to advance the termination of litigation by resolving a threshold question. Del. Sup. Cr. R. 42 (committee commentary). During the pendency of an interlocutory appeal, proceedings in the trial court are not automatically stayed. Del. Sup. Cr. R. 42(d). Between the time that the interlocutory appeal was filed and the time that it was accepted by the Supreme Court of Delaware, the Chancery Court dismissed Maldonado’s suit “based on principles of *res judicata*, expressly conditioned upon the Second Circuit affirming the . . . New York District Court’s decision [in Maldonado v. Flynn, 448 F. Supp. 1032 (S.D.N.Y. 1978)].” 430 A.2d at 781. The appeal in the Second Circuit was stayed pending the Delaware Supreme Court’s resolution of the question of Delaware law. *Id.* This resulted in Zapata being placed in a “procedural gridlock.” *Id.* For a discussion of the New York action, see note 1 and accompanying text supra. For a discussion of the Delaware Supreme Court’s recognition of Zapata’s predicament, see note 48 infra.
It is a basic principle of corporate law that the board of directors, and not the shareholders, is empowered to manage the business affairs of the corporation. Corporate directors, as fiduciaries, owe the corporation duties of loyalty and due care. Generally, a court will not


A corporation is a fictitious legal entity created by the sovereign. H. Henn, supra, at 12. Corporate attributes include the power to hold and convey property; the power to sue and be sued; centralized management; transferability of interest; perpetual existence; and limited liability. Id. at 109. While the directors are elected by the shareholders, they do not derive their powers from them; directors receive their authority directly from the state through the act of incorporation. 2 W. Fletcher, supra, § 507 at 531. The authority of the directors extends only to the "ordinary and regular" business of the corporation, excluding any power to change its character or to wind-up the corporation. Id. § 505 at 517.

13. See H. Henn, supra note 12, at 415. Corporate directors are fiduciaries whose duties run primarily to the corporation. Id. at 415-16.

14. See Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?, 75 Nw. U. L. Rev. 96, 101 nn.26-27 (1980). A director's duty of loyalty requires that there be "no conflict between duty and self-interest" which may result in the director's use of his position of trust to further his own interests. Guth v. Loft, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Sup. Ct. 1939). When an action is brought to challenge actions of a director, the plaintiff bears the burden of showing that the defendant-director breached his duty to the corporation by acting in his own self-interest. See Arsht, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93, 116 (1979). Once a breach of the duty of loyalty has been demonstrated the defense of the business judgment rule is no longer available to the director, who then bears the burden of showing the intrinsic fairness of the transaction. See, e.g., Singer v. Magnavox, 980 A.2d 969, 979, 980 (Del. 1977) ("it is within the responsibility of an equity court to scrutinize a corporate act when it is alleged that its purpose violates the fiduciary duty owed to minority stockholders"); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (shareholder ratification of interested director transaction merely means that the defendant-director breached his duty to the corporation by acting in his own self-interest. See Arsht, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93, 116 (1979). Once a breach of the duty of loyalty has been demonstrated the defense of the business judgment rule is no longer available to the director, who then bears the burden of showing the intrinsic fairness of the transaction. See, e.g., Singer v. Magnavox, 980 A.2d 969, 979, 980 (Del. 1977) ("it is within the responsibility of an equity court to scrutinize a corporate act when it is alleged that its purpose violates the fiduciary duty owed to minority stockholders"); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (shareholder ratification of interested director transaction merely means that the director cannot be voided solely because of such interest; the court retains the power to scrutinize the fairness of the transaction); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Sup. Ct. 1952) (interested directors bear the burden of showing the entire fairness of the transaction); Tanzer v. International Gen. Indus., Inc., 402 A.2d 382, 386 (Del. Ch. 1979) (even where the majority has a bona fide business purpose for its action, it bears the burden of proving "entire fairness" to the minority). Compare Puma v. Mariott, 283 A.2d 695 (Del. Ch. 1971) (where interested directors were not on both sides of the transaction the decision was protected by the business judgment rule). Under a Delaware statutory provision, transactions involving interested directors will not be voided solely because of the taint of self-interest, if such self-interest is disclosed to the board, a committee of the board, or the shareholders, and the transaction is approved by the board, the committee, or the shareholders; or if the transaction is fair to the corporation and is authorized or ratified by the board or the shareholders. See Del. Code Ann. tit. 8, § 144 (1974).

15. See Dent, supra note 14, at 101 nn.26-27. The duty of due care, requiring that a director act with ordinary prudence, is judged by negligence
examine management decisions made by directors on the ground that "the substitution of someone else's business judgment for that of the directors 'is no business for any court to follow.'" The protection of this "business judgment rule" extends to decisions made in good faith and in the best interests of the corporation and includes the decision standards. See, e.g., Hun v. Carey, 82 N.Y. 65 (1880) (due to precarious financial condition of bank, expenditure for new building was found to be reckless and unreasonable). See also Model Bus. Corp. Act, § 35 (1971); N.Y. Bus. Corp. Law § 717 (McKinney Supp. 1981-82). Commentators have criticized any requirement of a finding of gross negligence for the imposition of liability. See Arsh, supra note 14, at 101-08; Dent, supra note 14, at 101 n.26. Once a lack of reasonable diligence in the making of a business decision has been demonstrated the business judgment rule defense becomes inapplicable. See, e.g., Warshaw v. Calhoun, 43 Del. Ch. 148, 157-58, 221 A.2d 487, 492-93 (Sup. Ct. 1966); Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944). See also Arsh, supra note 14, at 130.


In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts. . . . The acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation, and a . . . stockholder who challenges their bona fides of purpose has the burden of proof.

Id. at 157-58, 221 A.2d at 492-93.

The underlying purpose of the business judgment rule is to encourage qualified persons to serve as directors by protecting them from liability for mere mistakes of judgment when they have acted as prudent persons would have in the same situation. Arsh, supra note 14, at 97, quoting Percy v. Millaudon, 8 Mart. (n.s.) 68, 77-78 (La. 1829). See also Dent, supra note 14, at 135.

17. A good faith decision is one made with loyalty to the corporation and with due care. See H. HENN, supra note 12, at 433; Dent, supra note 14, at 101. For discussions of the directors' duties of loyalty and due care, see notes 14 & 15 supra.

18. See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (where parent received nothing from subsidiary to exclusion of subsidiary's minority shareholders there is no self-dealing and business judgment rule protects directors' decision to declare dividend from judicial review); Warshaw v. Calhoun, 43 Del. Ch. 148, 157-58, 221 A.2d 487, 492-93 (Sup. Ct. 1966) (interlocking directors of personal holding company and its subsidiary exercised reasonable business judgment in selling holding company's stock subscription rights in its subsidiary rather than passing them on to holding company stockholders); Bodell v. General Gas & Elec. Corp., 15 Del. Ch. 420, 426, 140 A. 264, 267 (Sup. Ct. 1927) (court would not interfere with board of directors' authority to set the price of unissued stock absent a showing of selfish motive on the part of the directors; honest mistake of judgment not reviewable); Pollitz v. Wabash R. R. Co., 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912) (directors' "honest and unselfish" management decisions may not be questioned even where they prove to be "unwise or inexpedient"); Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944) (a court will not interfere with decisions reached as a result of reasonable diligence and the exercise of honest, unbiased
of whether to pursue a corporate cause of action. The rule, however, will not shield decisions where it appears that the directors have not acted with scrupulous loyalty to the corporation; these decisions, unprotected by the business judgment rule, may be scrutinized by a court.

When a stockholder wishes to challenge decisions made by the directors as being in breach of their fiduciary duties, his recourse is to judgment. See also 2 W. Fletcher, supra note 12, § 505 at 516-17; H. Henn, supra note 12, at 482-83; Arsht, supra note 14, at 111-12.

19. See, e.g., United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903); Hawes v. Oakland, 104 U.S. 450 (1881); Ash v. International Business Machs. Inc., 353 F.2d 491 (9d Cir. 1965), cert. denied, 384 U.S. 927 (1966); Gall v. Exxon, 418 F. Supp. 508 (S.D.N.Y. 1976); Koral v. Savory, Inc., 276 N.Y. 215, 11 N.E.2d 883 (1937). See also Dent, supra note 14, at 98 n.14 ("The power to manage corporate business usually includes the power to determine whether the corporation shall sue for redress of a wrong it is alleged to have suffered."); Comment, The Demand and Standing Requirements in Stockholders Derivative Actions, 44 U. Ch. L. REV. 168, 171 (1976) (decision to bring an action on behalf of the corporation is a management decision which arises in controlling the business affairs of the corporation and is entrusted to the board of directors).

In Ash v. International Business Machs. Inc., the plaintiff-stockholder attempted to pursue his corporation's antitrust claim under the Clayton Act by enjoining a competitor from acquiring another corporation, where the result of the acquisition was alleged to be a lessening of competition. 353 F.2d at 492. See 15 U.S.C. §§ 25, 26 (1976). The directors refused to bring suit and the court denied plaintiff's claim of standing to sue finding that "nothing [was] pleaded or even suggested to indicate that the refusal of the directors to sue was . . . anything worse than unsound business judgment honestly exercised in the corporate interest." Id.

The protection of the business judgment rule extends to the settlement of derivative suits by directors, although such settlements require the approval of the court. See Del. Ch. Ct. R. 23.1. Where the directors have exercised honest business discretion, they will not be held responsible for mistakes in judgment and the court will not interfere with the settlement. Perrine v. Pennroad, 28 Del. Ch. 342, 43 A.2d 721 (Ch. 1945); aff'd, 29 Del. Ch. 351, 47 A.2d 479 (Sup. Ct. 1947), cert. denied, 329 U.S. 808 (1947). However, "[i]n determining whether or not to approve a proposed settlement of a derivative stockholder's action [when directors are on both sides of the transaction], the Court of Chancery is called upon to exercise its own business judgment." Neponsit Inv. Co. v. Abramson, 405 A.2d 97, 100 (Del. 1979). Cf. Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 110 (Sup. Ct. 1952) (where parent and subsidiary have interlocking directors, merger of the corporations will be scrutinized by the court for entire fairness).

20. See, e.g., Guth v. Loft, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Sup. Ct. 1939) (director's diversion of a corporate opportunity to his own benefit found to be breach of duty of loyalty); Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918) (contract between two corporations with common director voidable where director, seeking to benefit himself, did not disclose the unfairness of the contract to one of the corporations).

bring suit derivatively on behalf of the corporation. Under Delaware law, a stockholder is permitted to conduct derivative litigation when "material corporate rights would not otherwise be protected." A derivative action may be brought either to enforce a claim of the corporation against a third party or to hold the directors liable to the corporation for an injury allegedly caused by them.

22. Sohland v. Baker, 15 Del. Ch. 431, 441, 141 A. 277, 281-82 (Sup. Ct. 1927). The derivative suit is a means developed in equity of preventing abuse by corporate management; it allows shareholders to enforce managerial responsibility without questioning the underlying managerial power. Prunty, The Shareholder's Derivative Suit: Notes on its Derivation, 32 N.Y.U. L. Rev. 980, 992-93 (1957). The derivative suit redresses two wrongs to the corporation: the failure of the directors to bring suit and the injury to the corporation committed by those allegedly liable to it. See H. Henn, supra note 12, at 756 n.1. See also Cantor v. Sachs, 18 Del. Ch. 359, 365, 162 A. 78, 76 (Ch. 1932); E. Folk, The Delaware General Corporation Law 484 (1972); Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746, 748 (1960). Since the cause of action belongs to the corporation, any recovery obtained as a result of a derivative action likewise belongs to the corporation. See Keenan v. Eshleman, 23 Del. Ch. 344, 355-54, 2 A.2d 904, 912-15 (Sup. Ct. 1938); Taormina v. Taormina Corp., 32 Del. Ch. 18, 25, 78 A.2d 473, 476 (Ch. 1951); Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 89 N.E. 193 (1909), aff'd, 225 U.S. 111 (1912). But see Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955) (minority shareholder plaintiff allowed pro rata recovery where majority shareholder would have been unjustly enriched by a corporate recovery).

23. Sohland v. Baker, 15 Del. Ch. 431, 442, 141 A. 277, 282 (Sup. Ct. 1927). In Sohland the plaintiff's demand on the board was refused, but because the directors had taken part in the challenged issuance of stock, the court questioned whether the directors could be expected to institute suit, or, if they did, whether they would be the proper parties to conduct the suit. The court indicated that if demand had not been made, this would have been a proper case for its excuse. Id. at 442-43, 141 A. at 282. Accordingly, the Delaware Supreme Court affirmed the lower court's denial of the individual defendant's motion to dismiss. Id. at 454, 141 A. at 287.

24. See, e.g., United Copper Sec. v. Amalgamated Copper Co., 244 U.S. 261 (1917) (directors refused to sue a third party for damages under the Sherman Antitrust Act); Hawes v. Oakland, 104 U.S. 450 (1881) (derivative suit used in attempt to invoke diversity jurisdiction of federal courts to enjoin City of Oakland from free use of corporation's water supply); Miller v. American Tel. & Tel. Co., 507 F.2d 759 (5d Cir. 1974) (corporation's failure to sue Democratic National Committee for a debt would have resulted in an illegal campaign contribution); Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277 (Sup. Ct. 1927) (interested majority of directors refused to institute suit to compel cancellation of stock issued to former director).

25. See, e.g., Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980) (directors accused of proxy violations for failure to disclose change made in employee stock option plans); Gall v. Exxon, 418 F. Supp. 508 (S.D.N.Y. 1976) (claim that illegal foreign payments were approved by the directors); Taormina v. Taormina Corp., 32 Del. Ch. 18, 78 A.2d 473 (Ch. 1951) (directors alleged to have illegally diverted corporate profits); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) (charge that directors breached their fiduciary duties by the payment of bribes). Most derivative suits are brought against directors, officers or controlling persons. A. Conard, Corporations in Perspective 401 (1976).
The danger that frivolous derivative suits may be brought has prompted legislatures to impose certain restrictions on instituting shareholders' actions. One of these restrictions requires that a stockholder bringing suit on the corporation's behalf must first make a demand upon the board of directors to initiate the action. If demand is refused, a stockholder may proceed with the action only upon a showing that the refusal was wrongful. However, the requirement of making a demand

26. See H. Henn, supra note 12, at 752-55. See also Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 546 (1949) (derivative suit brought not to benefit the corporation but to benefit the plaintiff's attorney by the award of a fee is a nuisance action or "strike suit"). The restrictions upon the initiation of derivative suits include the requirement that the plaintiff must have been the owner of shares of the corporation at the time of the alleged wrongdoing. See, e.g., Fed. R. Civ. P. 23.1; Del. Ch. Ct. R. 23.1; Del. Code Ann. tit. 8, § 327 (1974); N.Y. Bus. Corp. Law § 626 (McKinney 1963). See also Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co., 417 U.S. 703 (1974). In addition, the stockholder plaintiff is required to make demand upon the board of directors to bring suit or give reasons why such demand was not made. See, e.g., Del. Ch. Ct. R. 23.1; N.Y. Bus. Corp. Law § 626 (McKinney 1963). For a discussion of the demand requirement, see note 27 and accompanying text infra. Some jurisdictions require the plaintiff to post security for the expenses the corporation will incur during the litigation; the corporation's entitlement to the fund is determined by the court. See, e.g., Cal. Gen. Corp. Law § 800 (West 1977); N.Y. Bus. Corp. Law § 627 (McKinney Supp. 1981-82); Pa. Stat. Ann. tit. 15, § 433 (Purdon 1967). See also A. Conard, supra note 25, at 400. Delaware does not have a security for costs requirement. See H. Henn, supra note 12, at 781 n.1. Despite the potential for "strike suits," it is acknowledged that in the corporate system, where ownership and control are separated, the derivative suit remains an important method by which stockholders can prevent abuses of managerial authority. Dykstra, supra note 12, at 81-82.

27. See, e.g., Hawes v. Oakland, 104 U.S. 450, 460-61 (1881); Fed. R. Civ. P. 23.1; Cal. Gen. Corp. Law § 800(b)(2) (West 1977); Del. Ch. Ct. R. 23.1; N.Y. Bus. Corp. Law § 626(c) (McKinney 1963). The shareholder's complaint must state "the efforts . . . made by the plaintiff to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort." Del. Ch. Ct. R. 23.1. The purpose of the demand requirement is to allow the board of directors to assess the situation, to decide whether litigation is appropriate, and, if it is, to conduct the litigation. See Comment, supra note 19, at 171-72. By ensuring that intracorporate remedies are exhausted first, the courts can avoid the burden of unnecessary litigation and the corporation may be able to rid itself of nuisance litigation. Id. See also H. Henn, supra note 12, at 770; Kim, The Demand on Directors Requirement and the Business Judgment Rule in the Shareholder Derivative Suit: An Alternative Framework, 6 J. Corp. L. 511, 512 (1981). For a discussion of nuisance actions, see note 26 and accompanying text supra.

28. See Comment, supra note 19, at 193-98 and cases cited therein. The directors' refusal may be wrongful when the directors are controlled by the alleged wrongdoer, are interested in the challenged transaction, have participated in an injurious or illegal transaction, or have refused to assert a cause of action where the refusal itself amounts to negligence or is an illegal act. Id. See also Dent, supra note 14, at 102. Where the board of director's refusal is not wrongful the derivative action will be dismissed. See, e.g., Cramer v. Gen. Tel. & Elec. Corp., 582 F.2d 296, 275 (3d Cir. 1978), cert. denied, 440 U.S. 1129 (1979); Ash v. International Business Machs., Inc., 553 F.2d 491, 495 (3d Cir. 1977), cert. denied, 384 U.S.
may be excused as futile where a majority of the directors are accused of the wrongdoing.29

927 (1966); Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957), on remand from, 354 U.S. 114 (1957); Issner v. Aldrich, 254 F. Supp. 696 (D. Del. 1966).

In Swanson, "several" members of the board were charged with fraudulent conspiracy, however, the court found that the plaintiff had not shown that at the time demand was made a majority of the board was either under the control of the wrongdoers or had engaged in any misconduct themselves. 249 F.2d at 856 & n.1. As a result, the board, which had rejected plaintiff's demand to bring suit, was allowed to terminate the litigation. Id. at 858.


In McKee v. Rogers, where a stockholder sought the collection of a judgment obtained in an earlier suit brought to redress breaches of fiduciary duty by the corporation's former president, the court stated that:

[A] stockholder may sue in equity in his derivative right to assert a cause of action in behalf of the corporation, without prior demand upon the directors to sue, when it is apparent that a demand would be futile, that the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation. 18 Del. Ch. at 86, 156 A. at 193. See also E. Folk, supra note 22, at 489.

Where the majority of directors have merely acquiesced in the challenged decision and only a minority of the defendant directors were actually self-interested, demand may not be excused. See In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir. 1973), cert. denied, 414 U.S. 857 (1973). In Kauffman, a shareholder in four mutual funds brought a derivative suit against the directors and investment advisors of the funds alleging a conspiracy to set excessive management fees. 479 F.2d at 261. Since fewer than a majority of the funds' directors were affiliated with the investment advisors, the court held that mere approval of the challenged action, absent self-interest, was insufficient to excuse demand. Id. at 265. However, the court went on to note that:

If a director goes along with a colleague in an act on its face advantageous only to that colleague and not to the corporation, this in itself is a circumstance ... supporting the claim that he is under that colleague's control. It may be assumed that he would remain so when the directorate votes on plaintiff's demand. ...

Id.

In contrast with Kauffman, the New York Court of Appeals held that demand was excused where disinterested directors approved transactions benefiting self-dealing directors. Barr v. Wackman, 36 N.Y.2d 371, 379-81, 329 N.E.2d 180, 187-88, 368 N.Y.S.2d 497, 506-08 (1975). The plaintiff in Barr, a shareholder of a company which was a takeover target, accused the self-dealing directors of, inter alia, approving a tender offer for personal gain, approving improvident employment contracts of fellow directors, and changing the terms of a merger proposal to the detriment of the corporation. Id. at 375-76, 329 N.E.2d at 184, 368 N.Y.S.2d at 502-03. However, in light of New York's adoption of the committee dismissal technique in Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) it is questionable whether any excuse for not making a demand on the directors now exists in that jurisdiction. For a discussion of Auerbach v. Bennett, see notes 37-40 and
In order to invoke the protection of the business judgment rule when a majority of the directors are implicated in the wrongdoing, a technique has been developed where the accused majority of the board appoints a committee of "disinterested" directors who will decide whether it is in the best interests of the corporation to pursue the derivative action against the accused directors. Statutes enacted in several states permit the board of directors to delegate its decision making authority to a committee. The courts have extended the protection accompanying text infra. See also Note, The Business Judgment Rule Shields the Good Faith Decision of Disinterested Directors to Terminate a Derivative Suit Against the Corporation's Directors, 25 Vill. L. Rev. 551, 564 (1980).


31. See, e.g., Del. Code Ann. tit. 8, § 141(c) (1974) (a committee of the board may exercise the power and authority of the board of directors in the management of the business affairs of the corporation, excepting the power to amend the certificate of incorporation or the bylaws, adopting agreement of merger or sale of all or substantially all of the corporation's assets, or recommending dissolution). See also N.J. Stat. Ann. § 14A: 6-9 (West Supp. 1981-82); N.Y. Bus. Corp. Law § 712 (McKinney Supp. 1981-82).
of the business judgment rule to the decisions of these independent committees. For example, in *Gall v. Exxon,* the board established a special litigation committee composed of directors appointed to the board after the action challenged by the derivative suit had taken place. The plaintiff-stockholder claimed that payments approved by a majority of the directors and made to Italian political parties were a waste of corporate assets, and that failure to disclose the payments violated the proxy requirements of federal securities law. The District Court for the Southern District of New York concluded that the independent committee could terminate the derivative suit if it concluded that termination was in the corporation's best interest. Three years after *Gall,*

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33. 418 F. Supp. 508 (S.D.N.Y. 1976) (applying New Jersey law). See also *Lasker v. Burks*, 404 F. Supp. 1172 (S.D.N.Y. 1975), rev'd, 567 F.2d 1208 (2d Cir. 1977), rev'd, 441 U.S. 471 (1979). In *Lasker,* a majority of the directors were accused of negligent and fraudulent acts in connection with the corporation's purchase of Penn Central notes shortly before Penn Central filed a petition for reorganization under the Bankruptcy Act. 404 F. Supp. at 1174-75. The full board decided that since a quorum could be obtained, consisting of the non-defendant directors, those directors would determine what position to take on the derivative litigation. *Id.* at 1175 n.1. The District Court for the Southern District of New York held that if "the minority directors were truly disinterested and independent" their motion to dismiss the action would be granted. *Id.* at 1180. The Second Circuit reversed, holding that federal law governed the fiduciary duties of the directors of investment companies and that the decision of a disinterested minority of the board could not be used to terminate a nonfrivolous derivative suit. 567 F.2d at 1212. In reversing the Second Circuit's decision, the United States Supreme Court held that the power of independent directors to cause dismissal of a derivative suit is a question of state law. 441 U.S. at 480. The Supreme Court stated that where disinterested directors of a corporation seek the dismissal of derivative suits alleging violations of federal law, a court must first determine whether under the relevant state law the business judgment rule would protect the directors' decision from judicial scrutiny. *Id.* The Court reasoned that state law is controlling because corporations are created under state statutes and the powers of corporate management are determined under the same statutes. *Id.* at 478. A court must next determine whether dismissal is consistent with the underlying policy of the applicable federal law. *Id.* at 480. The *Lasker* Court held that dismissal was consistent with the Investment Company Act. *Id.* To determine the underlying policy of the law, the Court looked to the legislative history of the Act and concluded that "Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders" and that in doing so the directors could reasonably determine that it was not in the best interests of the corporation to sue. *Id.* at 485.

34. *Id.* at 510 n.2. See N.J. STAT. ANN. § 14A:6-9 (West Supp. 1981-82) (directorial authority may be delegated to a committee).

35. 418 F. Supp. at 509. The *Gall* defendants were alleged to have violated § 13(a) and § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(a), 78n(a) (1976). 418 F. Supp. at 509.

36. 418 F. Supp. at 516-19. The court stated: "Such a determination, like any other business decision, must be made by the corporate directors in the
the New York Court of Appeals, in *Auerbach v. Bennett*, held that a special litigation committee's good faith decision not to continue a derivative suit was shielded from judicial scrutiny by the business judgment doctrine. In applying New York law, the *Auerbach* court reasoned that “[t]o permit judicial probing” into the substance of the committee's decision “would . . . emasculate the business judgment doctrine.” However, the court held that an inquiry into the “disinterested independence” of the committee members and into the “adequacy and appropriateness of the committee's investigative procedures” was not foreclosed by the business judgment rule.

Subsequent to *Auerbach* and *Gall*, several federal courts, interpreting Delaware law, concluded that Delaware courts would hold that the business judgment rule protects from judicial scrutiny the decision of a committee of independent and disinterested directors to terminate exercise of their sound business judgment.” *Id.* at 518. The grant of the corporation's motion for summary judgment was withheld pending discovery as to the disinterestedness of the committee members. *Id.* at 519-20.

37. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), noted in 25 Vill. L. Rev. 551 (1980). The plaintiff-stockholder in *Auerbach* alleged that four members of the fifteen member board of General Telephone & Electronics Corporation (GTE) had breached their fiduciary duties by paying bribes and kickbacks totalling more than eleven million dollars to foreign officials. *Id.* at 625, 631, 393 N.E.2d at 997, 1001, 419 N.Y.S. at 923, 927. For a discussion of other cases dealing with questionable foreign payments as a breach of directorial duty, see note 64 infra.

38. 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The *Auerbach* decision has been followed by the Appellate Division of the Supreme Court of New York in a connected case. Parkoff v. General Tel. & Elec. Corp., 74 A.D.2d 762, 425 N.Y.S.2d 599 (1980) (stockholder alleged waste of corporate assets resulting from questionable payments made to foreign officials; business judgment rule barred judicial inquiry into special litigation committee's decision not to pursue derivative suits).

39. 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court reasoned that in arriving at its decision not to pursue the litigation the committee would have had to weigh and balance the “legal, ethical, commercial, promotional, public relations [and fiscal] factors familiar to the resolution of . . . most corporate problems . . . ; [i]nquiry into such matters would go to the very core of the business judgment made by the committee.” *Id.* at 633-34, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court opined that the protection of the business judgment doctrine exists because the courts are “ill equipped” to evaluate the kinds of business decisions that corporate directors are “peculiarly qualified” to make. *Id.* at 630-31, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926-27. For a discussion of the business judgment rule, see notes 16-21 and accompanying text supra.

40. *Id.* at 631, 634, 393 N.E.2d at 1001, 1002, 419 N.Y.S.2d at 928. The court stated that committee members would be required to show that they conducted a reasonably complete investigation in good faith. *Id.* at 634, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929. The *Auerbach* committee met this burden by engaging special counsel, reviewing the results of a preliminary investigation, and interviewing the implicated directors and the corporation's outside auditors. *Id.* at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929-30.
derivative litigation. In *Abbey v. Control Data Corporation*, the Eighth Circuit, relying upon prior Delaware cases, reasoned that the deference given business decisions of independent directors also protects the decision of an independent minority of the board to terminate litigation. Relying in part upon the Delaware statutes governing delegation of power to committees and transactions involving interested directors, the District Court for the Southern District of New York in


In *Siegal v. Merrick*, the District Court for the Southern District of New York, construing Delaware law, held that even though the defendant directors controlled the board, demand was not futile since the board could establish an independent committee of those directors who would be protected by the business judgment rule. 84 F.R.D. at 110, *citing* *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971).

The Ninth Circuit, construing California law, noted the similarity between the Delaware and California statutes authorizing board committees. *See Lewis v. Anderson*, 615 F.2d 778, 782 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980). *Compare Cal. Corp. Code § 811 (West 1977) with Del. Code Ann. tit. 8, § 141(c) (1974)*. In *Lewis*, the stockholder claimed that the board granted new stock options which allegedly benefited the defendant directors and that the manner of their issuance violated the federal security laws. 615 F.2d at 780. The court granted the corporation's motion to dismiss based upon the good faith determination of a special litigation committee that the suit was not in the corporation's best interest. *Id.* at 783, *citing* Abbey v. Control Data Corp., 603 F.2d 724, *cert. denied*, 444 U.S. 1017 (1980).*

For a discussion of the Delaware statute, see note 31 supra.

42. 603 F.2d 724, *cert. denied*, 444 U.S. 1017 (1980). In *Abbey*, plaintiffs sought to compel officers and directors of Control Data Corporation (CDC) to repay the corporation for criminal and civil penalties levied against CDC because of illegal foreign payments allegedly made under the direction of the individual defendants. 603 F.2d at 726. A special litigation committee composed of seven non-employee directors of CDC, none of whom were defendants, determined that legal action would not be in the best interest of the corporation. *Id.* at 727. At the direction of the committee, CDC's counsel moved for summary judgment. *Id.* The District Court for the District of Minnesota granted summary judgment. *Id.* at 726 n.1, 727. The United States Court of Appeals for the Eighth Circuit affirmed. *Id.* at 732.

43. 603 F.2d at 729, *citing* *Beard v. Elster*, 39 Del. Ch. 158, 160 A.2d 731 (Sup. Ct. 1960) (grant of stock options protected by business judgment rule where disinterested majority of the board concluded that the plan was in the corporation's best interest); *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971) (where the majority of the board was disinterested and not under control of the interested minority, the business judgment rule protected the board's decision to purchase stock in six corporations in exchange for its own stock).

44. Del. Code Ann. tit. 8, §§ 141(c), 144 (1974). For a discussion of the delegation of authority to committees of directors under corporate statutes, see note 31 supra. For a discussion of the interested director statute, see note 14 supra.
Abramowitz v. Posner, found that the disinterested directors were empowered to act for the corporation and concluded that to deny the independent directors the power to dismiss derivative litigation would be to hold "that a corporation is powerless to act, through independent members, whenever it has among its body an interested director." Against this background, the Supreme Court of Delaware addressed the issue of whether a committee of independent directors has the power to cause dismissal of litigation brought by a stockholder in a case where demand has properly been excused. Because the lower court had concluded that a stockholder has an independent right to maintain deriva-

45. 513 F. Supp. 120 (S.D.N.Y. 1981), aff'd, 672 F.2d 1025 (2d Cir. 1982). In Abramowitz, five of the seventeen board members of NVF Company (NVF), a Delaware corporation, were accused of misusing corporate funds to pay personal expenses and of not disclosing the misappropriations in reports filed with the Securities and Exchange Commission (SEC), the Internal Revenue Service, and the New York Stock Exchange. Id. at 121. Action taken by the SEC resulted in a consent judgment against the defendants for $600,000.00. Id. at 122. Pursuant to the terms of the consent judgment, two independent directors were appointed to the board. Id. at 128. An audit committee was formed composed of these two directors, and a third director who had been on NVF's board at the time of the alleged wrongdoing. Id. The committee recommended that the corporation seek reimbursement from the defendants for $1,021,445.00, in addition to the $600,000.00 judgment, but that the corporation take no legal action against the defendants unless they failed to reimburse NVF. Id. at 123. As a result of the committee's decision and the corporation's subsequent receipt of the reimbursement, the board of directors—with the defendants abstaining—voted to reject the plaintiff stockholder's demand that NVF bring suit. Id. at 124-25. The district court dismissed the suit. Id. at 129. On appeal to the Second Circuit, following the Delaware Supreme Court's decision in Zapata Corp. v. Maldonado, the decision of the district court was affirmed. Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982). The Second Circuit distinguished Abramowitz from Zapata in that the former was a case where demand was not excused, but was made and refused. Id. at 1030. The Abramowitz court deferred to the directors' business judgment and held that absent a showing of a wrongful refusal the stockholder was "simply without legal ability to initiate a derivative action." For a discussion of "wrongful refusal," see note 28 and accompanying text supra.

46. 513 F. Supp. at 127-129. For a discussion of the facts of Abramowitz, see note 45 supra.

47. 513 F. Supp. at 133. For a discussion of the general authority of directors, see notes 12-19 and accompanying text supra. For a discussion of interested director transactions, see notes 14 & 20 supra.

48. 430 A.2d at 782. The court found this question to be one of first impression in Delaware. Id. at 783. Before reaching the merits, Justice Quillen, writing for a unanimous court, acknowledged the court's responsibility to resolve the issue of Delaware law because of the "procedural gridlock" in which Zapata had been left by the dismissal of Maldonado's cause of action on res judicata principles. See Maldonado v. Flynn, 417 A.2d 378 (Del. Ch. 1980). The res judicata dismissal followed the Vice Chancellor's denial of Zapata's motion to dismiss on the basis of the special litigation committee's determination: dismissal was expressly conditioned upon the decision of the Second Circuit in Maldonado v. Flynn. However, Maldonado's appeal to the Second Circuit was stayed pending the decision of the Delaware Supreme Court in the instant case. 430 A.2d at 781. For a discussion of the Second Circuit action, see note 1 supra.
tive litigation, the *Zapata* court found that the power of a committee of
the board to cause derivative litigation to be dismissed, rather than the
application of the business judgment rule to the Committee's decision
to terminate the action, was the focus of the case. 49 The court deter-
determined that this focus required an analysis of three aspects of a corpo-
ration's motion to dismiss a derivative suit: the shareholder's right to
maintain a derivative action; the board's power to dismiss the action or
to delegate this authority to a committee of the board; and the role of
the trial court in resolving the conflict between the stockholder and the
directors. 50

Turning to the Vice Chancellor's determination that a stockholder
has an independent right to continue a derivative suit over the corpo-
rations' objection, the court distinguished the stockholder's right to in-
stitute a derivative action from the right to continue that suit. 51 The
court rejected the Vice Chancellor's determination, concluding that an
inflexible rule that placed sole control of the corporate action in the
hands of the litigating stockholders throughout the entire litigation
would serve the interests of only one person or group to the exclusion
of all others. 52

Having found that the stockholder does not have an absolute power
to continue the suit in the face of the corporation's desire to terminate,
the *Zapata* court concluded that the board's managerial power encom-
passes litigation decisions 68 and that this power can be delegated to a

49. 430 A.2d at 782. The Supreme Court agreed with the Vice Chancellor
that the business judgment rule is not a source of directorial power; the *Zapata*
court stated that the business judgment rule is a judicial creation which in-
sulates the directors from liability when they have exercised their statutory
authority. Id. For a discussion of the business judgment rule, see notes 16-21
and accompanying text supra.

50. 430 A.2d at 782.

51. Id. at 783-84. The Supreme Court found that *Sohland v. Baker*, relied
upon by the lower court, did not create a stockholder's right, where demand
is excused, to continue litigation after a corporation's decision to terminate,
but merely affirmed the right to initiate a derivative suit. Id. at 785, citing Sohland
v. Baker, 15 Del. Ch. 431, 141 A. 277 (Sup. Ct. 1927). In addition, while the
board in *Sohland* refused to assert the cause of action, it authorized payment of
the plaintiff's attorney's fees and it was not the board but the individual de-
fendant, a former board member, who challenged the plaintiff's right to bring
the suit. 430 A.2d at 783.

52. Id. at 784-85.

53. 430 A.2d 782. The *Zapata* court affirmed the general rule that "a
stockholder cannot be permitted . . . to invade the discretionary field com-
mitted to the judgment of the directors and sue in the corporation's behalf
when the managing body refuses." Id. at 783, quoting *McKee v. Rogers*, 18
Del. Ch. 81, 85-86, 156 A. 191, 193 (Ch. 1931).

The court found that there are two exceptions to the board's exercise of
this power. 1) In cases where demand has been made upon the board to
institute the litigation and the board has refused, the board's decision will not
be respected by the court if it is found to be wrongful and the stockholder
plaintiff may then initiate the action. 430 A.2d at 784. The court defined a
wrongful refusal as one which was itself a breach of fiduciary duty. Id. at 783.
committee formed pursuant to the Delaware statute.\(^{54}\)

Having concluded that a committee of disinterested directors could act for the corporation in moving to dismiss derivative litigation,\(^{55}\) the \textit{Zapata} court next addressed the role of a court in adjusting the conflicting claims of the stockholder and the board of directors.\(^{56}\) The court viewed its task as preserving the efficacy of the derivative suit as an "intra-corporate means of policing boards of directors"\(^{57}\) while not disabling the corporation from ridding itself of "meritless or harmful litigation and strike suits."\(^{58}\) The court rejected the use of the business judgment rule to restrict the court to an inquiry into only the independence and good faith of the committee members and the reasonableness of their investigation, while shielding the substance of the committee's decision from stockholder challenge and judicial scrutiny.\(^{59}\) The \textit{Zapata} court instead selected a "middle course" requiring the court to exercise its independent discretion in evaluating the litigation.\(^{60}\)

However, the court reasoned that even in these cases the board retains its power to conduct or terminate corporate litigation. \textit{Id.} at 786. The court opined that where the board's refusal has been found to be wrongful the board remains empowered to decide but its conclusion will not be respected. \textit{Id.}\(^{2}\)

Where demand has been excused the board retains its statutory powers but its members are disqualified from making the decision. \textit{Id.} Therefore, despite the fact that demand on the board was excused as futile, due to the presence of self-interested board members, the court concluded that Zapata's \textit{board} had the power to terminate the litigation although its members could not make the decision themselves. \textit{Id.} For a discussion of demand and refusal, see notes 27-29 and accompanying text \textit{supra}.

\(^{54}\). 430 A.2d at 785. The court based its conclusion upon the express, statutory power to delegate decision-making authority to a committee and by an analogy to the statutory authority of disinterested directors to act for the board in transactions in which some board members have an interest. \textit{Id.} at 785-86. \textit{See also DEL. CODE ANN. tit. 8, §§ 141(c), 144 (1974).} For discussion of these code sections, see notes 31 & 14 \textit{supra}.

\(^{55}\). 430 A.2d at 786.

\(^{56}\). \textit{Id.} For a discussion of the derivative suit as a policing mechanism, see notes 22 & 26 \textit{supra}.

\(^{57}\). \textit{Id.} For a discussion of “strike suits,” see note 26 \textit{supra}.

\(^{58}\). 430 A.2d at 786-87. For a discussion of “strike suits,” see note 26 \textit{supra}.

\(^{59}\). 430 A.2d at 787. The court opined that such a limited inquiry would not be sufficient to prevent abuse of the committee dismissal technique by directors who are called upon to judge their fellow directors. The court emphasized the fact that the committee mechanism requires directors to pass judgment on fellow directors who had appointed them to the board and that in such a situation empathy for the director-defendants would be natural. \textit{Id.} For a discussion of cases applying the business judgment rule to a committee's decision to cause dismissal of derivative litigation, see notes 30 & 32-47 and accompanying text \textit{supra}.

\(^{60}\). 430 A.2d at 788. Further, the court stated that the litigating stockholder is entitled to “strict court review” and should not be precluded from obtaining a decision on the merits because of a concern for practicality or judicial economy. \textit{The Zapata} court noted that review by the lower court of "ethical, commercial, promotional, public relations, employee relations, fiscal
The court concluded that when, on the advice of an independent committee of the board, the corporation moves to dismiss a derivative suit as detrimental to its best interests, the corporation bears the burden of proving the independence and good faith of the committee members and the adequacy of the bases supporting their conclusions. Limited discovery will be permitted for this inquiry and if this burden is not met, the court must deny the motion. Once independence and good faith are established, the court must proceed to apply its own independent business judgment to the decision to terminate the litigation, giving consideration to matters of law and public policy in addition to the best interests of the corporation, and should "weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit." It is submitted that the Supreme Court of Delaware's decision in Zapata preserves the derivative suit as an effective means of redressing breaches of fiduciary duty by corporate management. In looking be-

[and] legal" factors is not beyond its competence, as the Court of Chancery regularly "deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems." Id., quoting Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980). Compare Auerbach v. Bennett, 47 N.Y.2d at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926 (courts are "ill equipped" to evaluate business judgments). For a discussion of Auerbach, see notes 37-40 and accompanying text supra.

The court acknowledged that Zapata's alternative motion for dismissal or summary judgment was a hybrid and not easily characterized, but found that what the corporation sought was somewhat analogous to the settlement of derivative litigation wherein the court is called on to exercise its own business judgment in determining whether to approve a proposed settlement. 430 A.2d at 787. For a discussion of the trial court's role in the settlement of derivative litigation, see note 19 supra.

61. 430 A.2d at 788. The court stated: "The motion should include a thorough record of the investigation and its findings and recommendations." Id.

62. Id. at 788-89. Discovery would facilitate inquiry into the independence of the committee members and the adequacy of the bases for their conclusions. Id. at 788.

63. Id. The court explained that the application of the lower court's business judgment is intended to correct situations where, though the committee has been found to have been independent and to have conducted a reasonable investigation, the motion to dismiss would appear not to be in keeping with the "spirit" of those requirements. Id. Compare Auerbach v. Bennett, 47 N.Y.2d at 630, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928 (restriction of the court's inquiry to the independence of the directors and sufficiency of their investigation is a necessary corollary of the board's managerial authority). For a discussion of Auerbach, see notes 37-40 and accompanying text supra.

64. For a discussion of the purposes of the derivative suit, see Dent, supra note 14, at 109; note 22 supra. See generally Dykstra, supra note 12.

In Zapata the acceleration of the option exercise date resulted in a tax saving to the optionee-directors and a loss of the corresponding tax deduction to the corporation. See note 3 supra. This situation should be contrasted with the questionable foreign payments cases wherein the payments were not made to benefit the directors and were arguably made to further the corpora-
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hind the committee's decision, the Zapata court addressed the question of whether directors can use the power to delegate decision making authority to an "independent committee" to shield their own alleged acts of self-interest from shareholder challenge and judicial scrutiny. This question must be answered in the negative. It is necessary that the court apply its independent business judgment to a committee's decision to dismiss litigation in order to prevent the alleged wrongdoers from simply selecting their own judge and jury.

Further, it is submitted that, in concluding that an application of the business judgment rule to the committee's decision would not be sufficient to prevent the abuse of authority by corporate directors, the Zapata court's opinion is consistent with the spirit of prior Delaware case law. Even where statutory requirements have been complied with, the corporation's interests. See, e.g., Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980); Gall v. Exxon, 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 (1976). Two courts have granted committee generated motions to dismiss where the underlying wrongdoing was an alleged breach of duty of loyalty. See Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980); Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981), aff'd, 672 F.2d 1025 (2d Cir. 1982).

65. It is submitted that actions taken by directors to benefit their fellows at the expense of the corporation should be treated as breaches of the duty of loyalty just as are actions taken by the directors for their own benefit since in neither case is the good of the corporation the paramount concern. For a discussion of the duty of loyalty, see note 14 supra. While not reaching this issue, the Vice Chancellor noted that the acceleration of the option might not be entitled to the protection of the business judgment rule because of the directors' "personal interest" in the matter. Maldonado v. Flynn, 413 A.2d 1251, 1259 (Del. Ch. 1980). On the facts of Zapata it is clear that when three of the optionee directors did not attend the meeting at which the option acceleration was voted, the five attending directors became a quorum. The fourth optionee director abstained, so that the four non-optionee directors, who were a majority of the quorum, although not a majority of the full board, could approve the option acceleration. These actions on the part of the directors relieved the option holders from the necessity of voting for the option themselves while allowing them to benefit from the votes of their non-optionee fellows. See Maldonado v. Flynn, 448 F. Supp. 1032, 1305 (S.D.N.Y. 1978); notes 2 & 3 supra. For a discussion of the application of the business judgment rule, see notes 16-21 and accompanying text supra.

66. See Maldonado v. Flynn, 415 A.2d 1251, 1263 (Del. Ch. 1980). The Delaware Supreme Court quoted the Vice Chancellor below with approval: "Under our system of law, courts and not litigants should decide the merits of litigation." 430 A.2d at 789 n.18, quoting Maldonado v. Flynn, 413 A.2d at 1263. See also note 59 supra.

67. See, e.g., Singer v. Magnavox, 380 A.2d 969 (Del. 1977) ("it is within the responsibility of an equity court to scrutinize a corporate act when it is alleged that its purpose violates the fiduciary duty owed to minority stockholders"); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (nothing in the interested director transaction statute sanctions unfairness or removes such a transaction from judicial scrutiny); Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277 (Sup. Ct. 1927) (a shareholder may conduct derivative litigation when "material corporate rights would not otherwise be protected"); McKee v. Rogers, 18 Del. Ch. 81, 156 A. 191 (Ch. 1931) (stockholder may sue on behalf
Delaware courts have inquired into the fairness of transactions between a corporation and those in control. This is analogous to the instant case, where, although the directors recommending dismissal constituted a committee authorized by statute and were found to be independent of the wrongdoers and to have conducted a reasonable investigation, the court retained the power to scrutinize the substance of the decision. *Zapata* is therefore consistent with cases such as *Singer v. Magnavox* and *Fliegler v. Lawrence* in its conclusion that it is well within the expertise of the courts to scrutinize actions taken by management in order to determine whether they are intrinsically fair to the corporation.

In essence, the import of *Zapata* is that the trial court, in applying its independent business judgment to determine whether it is in the best interests of the corporation and the public to terminate the litigation, will scrutinize the underlying allegedly wrongful actions of the directors to determine whether those actions are entitled to the protection of the business judgment rule. The court in *Singer* stated:

> [A] Delaware court will not be indifferent to the purpose of a merger when a freeze-out of minority stockholders . . . is alleged to be its sole purpose. In such a situation, if it alleged that the purpose is improper because of the fiduciary obligation owed to the minority, the court is duty bound to closely examine that allegation even when all of the relevant statutory forms have been satisfied. *See also Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976)* (compliance with interested director statute does not remove transaction from judicial scrutiny for fairness).

*68.* See, e.g., *Singer v. Magnavox, 380 A.2d 969, 979 (Del. 1977).* The court in *Singer* stated:


70. *Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).* For a discussion of *Fliegler v. Lawrence*, see notes 67 & 68 and accompanying text *supra*. *Compare Auerbach v. Bennett, 47 N.Y.2d at 630, 395 N.E.2d at 1000, 419 N.Y.S.2d at 926* (courts are "ill equipped" to evaluate business judgments). For a discussion of *Auerbach*, see notes 37-40 and accompanying text *supra*.

71. Where the challenged actions involve breaches of fiduciary duty, directors may not invoke the business judgment rule, therefore, the *Zapata* court's decision is simply a return to the way courts functioned prior to the development of the committee dismissal technique, when faced with derivative litigation brought to redress wrongs allegedly committed by management. For a discussion of the fiduciary duties of loyalty and due care, see notes 14 & 15 *supra*. Merely by the resignation of some of the alleged wrongdoers or by the
Further, as a result of the Zapata court's conclusion that the court's independent business judgment will be applied only in cases where demand has been excused, the characterization of demand as excusable becomes important. However, since the Zapata court's decision would require that a court begin its scrutiny of the substance of the committee's decision with a determination of whether there is merit in the plaintiff's allegation that a majority of the board members have breached their fiduciary duties to the corporation, the problem of "manufactured" pleadings against all or a majority of the directors for the purpose of having demand excused will be obviated.

expansion of the size of the board of directors and the filling of the resulting vacancies with "independent" directors to form a committee to decide the fate of the litigation, management should not relieve itself of the burden of showing the court that foregoing suit would benefit the corporation and not be detrimental to the public interest.

The Zapata court noted that "when 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 [not wrongful]." Id. at 784 n.10. For a discussion of wrongful refusal, see note 28 and accompanying text supra.

For a discussion of the grounds for excuse of demand, see note 29 supra. If the court finds that a majority of the directors were neither wrongdoers nor acted under the control of the wrongdoers the plaintiff must make demand on the board. See notes 27-29 and accompanying text supra. See also Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1980) (where fewer than a majority of the directors were accused of wrongdoing, demand was required). Once demand is found to be excused, it is suggested that the creation of an independent committee, either before or after the initiation of the suit, should not vitiate that excuse. Contra Seigal v. Merrick, 84 F.R.D. 106, 110 (S.D.N.Y. 1979) (demand is not excusable where the board can create an independent committee). The Auerbach decision, in effect, has eliminated any exceptions to the demand requirement in New York. See Note, supra note 29 at 564; notes 37-40 and accompanying text supra. This would not be consistent with the Zapata court's emphasis on the plaintiff's right to bring suit when the board itself is disqualified. Excusing demand "saves the plaintiff the expense and delay of making a futile demand resulting in a probable tainted exercise of . . . authority in a refusal by the board or in giving control of the litigation to the opposing side." 430 A.2d at 786. The creation of an independent investigation committee does not change the underlying disqualification of the board's majority on which the claim of excuse rests. Where, however, demand is required and is refused the plaintiff's burden will be to show that the refusal was wrongful. See note 28 and accompanying text supra. By alleging a wrongful refusal, the plaintiff will be able to invoke a judicial forum for the determination of the wrongfulness of the refusal. Therefore, it is submitted that even where demand is required, the board, merely by creating an independent investigation committee, will not be able to shield its activities from the court. Further, since the court has acknowledged its duty to consider questions of public policy in ruling on motions to dismiss derivative litigation where demand has been excused, it is suggested that the court may also be duty bound to consider public policy when the board has refused a demand to initiate the litigation. See note 75 and accompanying text infra.

See Dent, supra note 14, at 140-42. As expressed by Dent:

Courts may be justly reluctant to allow bare allegations to circumvent the requirement of a demand on the board because compliance with
The greatest impact of the instant decision is that the management of Delaware corporations will not be able to avoid judicial scrutiny of a shareholder's allegation that a majority of the board of directors breached their fiduciary duties to the corporation. Questions concerning public policy, legality and fiscal reality can only be answered by a careful study of the plaintiff's allegations and the committee's findings, making it necessary for a court to consider the merits of the case in order to properly evaluate the corporation's motion to dismiss. In light of these conclusions, it is suggested that if Delaware corporations continue to appoint independent investigative committees it will only be in an effort to assure the courts that management has conducted a proper investigation of the alleged wrongdoing.

Leah Levine Tompkins

The requirement is so easy, but the effect of a refusal to sue raises more serious problems. Although accepting at face value the plaintiff's allegations of dominion or of collusion, approval or acquiescence by the board may lead to abuses, this seems preferable to dismissing what may be meritorious claims, thereby negating important shareholder rights...

_id_. at 142.

75. See note 73 _supra_.

76. See note 60 _supra_.

77. See notes 61 & 62 _supra_. By allowing discovery the court will ensure that pertinent facts concerning the litigation will be uncovered. "Full discovery is vital to the development of any case against corporate directors, and the inability of disinterested directors to compel testimony or the production of documents raises a suspicion that their investigation may not adequately protect the interests of shareholders, even where the directors proceed energetically." Dent, _supra_ note 14, at 120.

78. See note 61 and accompanying text _supra_.

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