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"What's in a Name?": The Business Judgment Rule after *Zapata Corp. v. Maldonado*

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"WHAT'S IN A NAME?"*: THE BUSINESS JUDGMENT RULE AFTER *ZAPATA CORP. V. MALDONADO*

Special litigation committees are groups of "disinterested" directors assigned the task of deciding whether a shareholder derivative suit is in a corporation's best interests. When a committee seeks to terminate derivative litigation determined not to be in the corporation's best interests, courts are often called upon to review the decision. This Note maintains that director decisions to terminate derivative suits must be scrutinized like any other "business" decision by applying the traditional business judgment rule. The Note concludes that, as in other contexts, the business judgment rule should be viewed as a dynamic test, with courts manipulating burdens or standards of proof to reach higher levels of scrutiny when indicia of director conflict of interest or bad faith surface.

INTRODUCTION

SHAREHOLDER derivative suits traditionally have served the business world as "corporate policemen."[1] In form, a derivative suit is an action brought on behalf of the corporation by a shareholder.[2] A problem arises, however, when the corporation elects not to pursue the derivative litigation or seeks to dismiss it.[3]

* "That which we call a rose / By any other name would smell as sweet." W. Shakespeare, *Romeo and Juliet*, act 2, sc. 2, line 43, in 1 THE PLAYS OF SHAKESPEARE 153, 174 (H. Staunton ed. 1858–61).

1. *See* Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 77–82 (1967); *see also* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949). Justice Jackson described the derivative suit's origin in *Cohen*:

> Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. . . . This remedy, born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

337 U.S. at 548.

2. Ross v. Bernhard, 396 U.S. 531, 534–35, 538–39 (1970); *see also* Comment, *Offensive Application of the Business Judgment Rule to Terminate Nonfrivolous Derivative Actions: Should the Courts Guard the Guards?*, 12 TEX. TECH. L. REV. 636, 636–38 (1981) (shareholder is nominal plaintiff; corporation is real party in interest).

3. This usually occurs on a motion for summary judgment or a pretrial motion to dismiss. Payson, Goldman & Inskip, *After* Maldonado—*The Role of the Special Litigation Committee in the Investigation and Dismissal of Derivative Suits*, 37 BUS. LAW. 1199, 1209 (1982). *But see* Gall v. Exxon Corp., 418 F. Supp. 508, 520 (S.D.N.Y. 1976) (issues presented when special litigation committee (SLC) seeks dismissal of shareholder derivative suit "are particulary inappropriate for summary disposition"). Under the Federal

The resulting conflict is grounded in the dual nature of a derivative suit.[4] A derivative suit consists of two segments: an initial proceeding in equity[5] compelling the directors to pursue the corporate claim,[6] followed by a proceeding seeking relief for the corporation.[7]

Rules of Civil Procedure, the corporation, as the moving party, must "show that there is no genuine issue as to any material fact and that [it is] entitled to a judgment as a matter of law." FED. R. CIV. P. 56(c). State rules contain similar standards. *See, e.g.*, WEST'S ANN. C.C.P. § 437(c); DEL. CT. C.P.R. 56(c); OHIO R. CIV. P. 56(C).

4. 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5946 (rev. perm. ed. 1980), states:

> The cause of action when a stockholder sues is dual in composition, consisting of the basic cause of action, which pertains to the corporation and on which it might have sued, and the derivative cause of action, pertaining to the stockholder, consisting in the fact that [the] corporation will not . . . sue for its own protection.

See also Hawes v. Oakland, 104 U.S. 450, 452- 53 (1881) (stockholder "has two causes of action entitling him to equitable relief . . . namely, one against his own company . . . for refusing to do what he has requested them to do; and the other against the party which contests the matter in controversy with that corporation"); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 99 (1980) (establishing dual nature of derivative suit in context of demand requirement); Note, *Judicially Exercised Business Judgments in Shareholder Derivative Suit Dismissals: Implementing* Zapata Corp. v. Maldonado, 46 ALB. L. REV. 980, 983 (1982) (same) [hereinafter cited as Note, *Implementing* Zapata]; Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 603 (1980) ("derivative suit is, in effect, two causes of action asserted by a shareholder"); Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 168 n.2 (1976) (emphasizing that shareholders cannot sue in "personal capacity" for injury to corporation's asset pool, despite "pecuniary loss caused by a decline in the value of their stock").

5. Ross v. Bernhard, 396 U.S. 531, 534–35, 538–39 (1970); *see also* Hawes v. Oakland, 104 U.S. 450, 452–53 (1881). It is important to recognize that by filing a derivative suit a shareholder, either implicitly or explicitly, is suing the directors who decided against pursuing the corporate claim. A challenge to such a decision must be viewed in the same manner as any other "business" decision. *See infra* notes 24–29 and accompanying text.

6. Generally, a shareholder must satisfy very strict procedural requirements before he will be permitted to pursue the derivative suit. *See infra* notes 55–66 and accompanying text. The most significant hurdle is the demand requirement. An example of this requirement is set out in Rule 23.1 of the Federal Rules of Civil Procedure:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . the corporation . . . having failed to enforce a right which may be properly asserted by it, the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

FED. RULE CIV. P. 23.1. *See generally* Comment, *supra* note 4, at 169–82 (exhaustive review of issues and collection of cases on demand requirement).

7. The underlying corporate claim may be for injuries caused by third parties or by directors or officers. No distinction exists between injuries caused by either group of possible defendants. *See* 13 W. FLETCHER, *supra* note 4, § 5850 (rev. perm. ed. 1980).

Most, if not all of the cases analyzed in this Note involve some form of director misconduct. Some commentators have argued that corporate decisions not to pursue claims against director defendants should be analyzed differently than other types of corporate

A significant controversy has developed within the conceptual ambit of the proceeding to compel action on the corporate claim. Corporations, desiring to "affect the path of litigation ostensibly brought on [their] behalf,"[8] conceived the concept of special litigation committees (SLC's). These groups of "disinterested"[9] directors are charged with determining whether the suit is in the corporation's best interests. Two major cases, decided within a relatively short time span,[10] have validated SLC's and circumscribed their powers. *Burks v. Lasker*[11] *and Zapata Corp. v. Maldonado*[12] are both pivotal, yet somewhat elusive decisions in a nascent area of corporate law.[13] These decisions have already produced a substantial body of critical commentary.[14]

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decisions. *See, e.g.*, Dent, *supra* note 4, at 110–34. The former situations, however, also may be resolved through more traditional modes of analysis. *See infra* notes 24–39 and accompanying text.

8. Aronoff & Freeman, *Shareholder Derivative Actions—A Continuing Balancing Effort*, Nat'l L. J., Nov. 16, 1981, at 28, col. 1.

9. The significance of the "interest" or "disinterest" of committee members is grounded in the inherent judicial limitations on the business judgment rule. *See infra* notes 41–49 and accompanying text. Because one of those limitations is that "the directors making the decision [not to sue] be independent—that they have nothing to gain or lose personally as a result of the decision made," Note, *Disinterested Director Committees and the Shareholder Derivative Suit*, 70 KY. L.J. 831, 833 (1982), the use of SLC's with newly appointed directors has proliferated. This has occurred because plaintiffs probably named all of the preexisting directors as defendants. Although such procedural maneuvering cannot, of its own accord, create "interest" in the litigation, Weiss v. Temporary Inv. Fund, Inc., 516 F.Supp. 665, 672–73 (D. Del. 1981); *see infra* note 47 and accompanying text, courts generally recognize that "where the directors, themselves, are subject to personal liability in the action [they] cannot be expected to determine impartially whether [the suit] is warranted." Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

10. When one considers that the Supreme Court recognized derivative suit principles almost 130 years ago, *see* Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855), the rapid recognition and proscription of SLC's between 1979 and 1981 is remarkable.

11. 441 U.S. 471 (1979); *see infra* notes 79–86 and accompanying text.

12. 430 A.2d 779 (Del. 1981); *see infra* notes 121- 47 and accompanying text.

13. *See supra* note 10. Even the *Zapata* court "implicitly recognized that any answers in this novel field of law must be partly provisional . . . in advance of *the practical experience provided by future cases.*" Payson, Goldman & Inskip, *supra* note 3, at 1212 (emphasis added); *see, e.g.*, Joy v. North, 692 F.2d 880, 891–92 (2d Cir. 1982) (attempting to establish general guidelines for judicial scrutiny of SLC decisions because task is difficult and rule is unclear), *cert. denied*, 103 S. Ct. 1498 (1983); Recent Development, 8 J. CORP. L. 145, 165 (1982) ("As derivative litigation moved into the area of director malfeasance, the practice of deferring the board recommendations for dismissal remained without adequate safeguards.") This Note seeks to highlight the "practical experience" provided by post-*Zapata* decisons. *See infra* notes 148–81 and accompanying text.

14. *See* Block, Prussin & Wachtel, *Dismissal of Derivative Actions Under the Business Judgment Rule:* Zapata *One Year Later*, 38 BUS. LAW. 401 (1983) [hereinafter cited as *One Year Later*]; Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva* Zapata?, 37 BUS. LAW. 27 (1981) [hereinafter cited as *Viva* Zapata?]; Coffee &

This Note examines the "business judgment rule" in the context[15] of corporate decisions to terminate derivative suits. It suggests that far from being a novel "offensive"[16] use of a "defensive" rule, the use of the term "business judgment" often represents a shorthand description of the differing degrees of judicial scrutiny applied to a director's conformity with his performance obligations.[17] The Note first analyzes the "traditional" business judgment rule[18] and reveals its limitations as well as the reasoning that underlaid its development.[19] Second, the Note examines the cases decided between *Burks* and *Zapata*.[20] Third, it explores the post-*Zapata* decisions,[21] establishing that each can be fully explained by traditional business judgment analysis. The Note concludes that future courts will, and should, continue to apply traditional business judgment analysis to corporate decisions to terminate derivative suits.[22] The nature of previous court decisions and state policies behind corporation statutes[23] supports this conclusion.

I. THE TRADITIONAL BUSINESS JUDGMENT RULE

Courts use the term "business judgment rule" in a wide variety

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Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Dent, *supra* note 4; Comment, *Off the Bench and into the Boardroom: Judicial Business Judgment After* Zapata, 70 GEO. L.J. 1025 (1982) [hereinafter cited as Comment, *Off the Bench*]; Comment, Zapata Corp. v. Maldonado: *Restricting the Power of Special Litigation Committees to Terminate Derivative Suits*, 68 VA. L. REV. 1197 (1982) [hereinafter cited as Comment, *Restricting the Power*].

15. "In analyzing the application of the business judgment rule, the approach to judicial review in one context . . . may differ from that involved in another. . . ." Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions—An Analytical Framework for Litigation Strategy and Counselling Directors*, 37 BUS. LAW. 1247, 1249 (1982). Veasey cogently posed several questions which need to be answered by the post-*Zapata* decisions. These questions include: "Is there more than one standard of judicial review? Is it feasible to articulate a cohesive statement of the business judgment rule so that it will be applicable to various [types of "business" decisions]? Is [such a cohesive statement] applicable to the termination of derivative suits upon motion of an [SLC]?" *Id.* This Note answers each of these questions in the affirmative. *See supra* note 7; *infra* notes 24–49 and accompanying text.

16. Offensive in the sense that it may be used as a weapon to compel termination of derivative suits. *See* Veasey, *supra* note 15, at 1260; Comment, *supra* note 2, at 653–59.

17. *See infra* notes 30–31 and accompanying text.

18. *See infra* notes 24–39 and accompanying text.

19. *See infra* notes 41–49 and accompanying text.

20. *See infra* notes 50–147 and accompanying text.

21. *See infra* notes 148–81 and accompanying text.

22. *See infra* notes 182–85 and accompanying text.

23. This Note focuses on the corporate statutory schemes of California, Delaware, and Ohio, as well as that of the Model Business Corporation Act ("MBCA"). *See infra* notes 25 & 85 and accompanying text.

of cases and factual patterns. What is often overlooked, however, is the inherent congruence among the various applications of the rule. The rule's underlying rationale, as well as its limitations, permit its use in many seemingly divergent situations.

A. *Rationale for Its Development*

Corporations may be engaged in several "asset projects" at one time.[24] While managing these ongoing projects,[25] corporate directors must conform to judicially enforced performance obligations.[26] The types of director decisions vary within the broad range of permissible corporate transactions. All types of future-looking[27] decisions, grounded in the need for value maximiza-

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24. Corporations have a wide latitude in carrying on their business. *See, e.g.*, CAL. CORP. CODE § 206 (West Supp. 1984) ("any corporation other than a corporation subject to the Banking Law . . . may engage in any business"); DEL. CODE ANN. tit. 8, § 101(b) (1975) (corporations may "conduct or promote any lawful business or purposes"); OHIO REV. CODE ANN. § 1701.03 (Page 1978) ("A corporation may be formed for any purpose or purposes."); MODEL BUSINESS CORP. ACT § 54(c) (1982) (corporations may be organized to transact "any or all lawful business for which corporations may be incorporated").

25. State corporation statutes apparently favor centralized corporate governance. *See, e.g.*, CAL. CORP. CODE § 300(a) (West 1977) ("business and affairs . . . and *all* corporate powers shall be exercised by or under the direction of the board") (emphasis added); DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1982) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors"); OHIO REV. CODE ANN. § 1701.59 (Page Supp. 1983) ("all the authority of a corporation shall be exercised by or under the direction of its directors"); MODEL BUSINESS CORP. ACT § 35 1982) (normative description of such centralization).

26. "Directors and other officers must exercise the utmost good faith in all transactions touching their duties to the corporation and its property . . . ." 3 W. FLETCHER, *supra* note 4, § 850 (rev. perm. ed. 1975); *see, e.g.*, United States v. Byrum, 408 U.S. 125, 137–38 n.11 (1972) (performance obligation includes acting with "good faith, and with an eye single to the best interests of the corporation"); Herald Co. v. Seawell, 472 F.2d 1081, 1094 (10th Cir. 1972) ("directors and officers must manage corporate affairs in good faith . . . and give the corporation the benefit of their best judgment and care").

In many states, this obligation to perform reasonably and single-mindedly in the best interest of the corporation has been codified. The MBCA's version provides:

> A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

MODEL BUSINESS CORP. ACT § 35 (1982). The codifications directly follow court decisions predating the general corporation laws. *See, e.g.*, Thomas v. Matthews, 94 Ohio St. 32, 113 N.E. 669 (1916) (directors must manage corporate business with view solely to common interest, and cannot directly or indirectly derive personal profit or advantage because of their position); *In re* Mansfield Ry., Light & Power Co., 3 Ohio App. 253 (1914) (stockholders of corporation are entitled to have corporation managed by directors whose sole consideration is corporation's best interests.

27. "It is recognized that plans must often be made for a long future, for expected competition, for continuing as well as an immediately profitable venture." Dodge v. Ford

tion,[28] involve "risk evaluation, assumption, or avoidance."[29]

Several distinguished corporate law scholars have focused on limited liability as the purpose of the business judgment rule.[30] This analysis, however, approaches the business judgment rule's underlying rationale from an improper perspective. Rather, this judicially created rule is based on the wide latitude the courts have given directors.[31] The rule thus represents a summary of judicial decisions focusing largely on the appropriate level of scrutiny to be applied to director decisionmaking.

Judicial deference to the business decisions of corporate directors arose for several different but certainly related reasons. One reason is that engrained in the equitable of doctrine "exhaustion of remedies"[32] is the goal of resolving corporate disputes within the corporate structure.[33] Another reason is that the business

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Motor Co., 204 Mich. 459, 508, 170 N.W. 668, 684 (1919). A decision to seek dismissal of a derivative suit should not be viewed differently, even though there may be some "structural bias" in derivative suits alleging director misconduct. Structural bias, in contrast to the actual bias of a particular director against a particular derivative suit, is a board of directors' inherent prejudice against any derivative suit. Note, *Derivative Suits*, *supra* note 4, at 601 n.14. One commentator has argued that courts often "display insensitivity" towards structural bias. *Id.* at 601. This concern, however, can and indeed is being dealt with by varying degrees of judicial scrutiny of directors' conformity with their performance obligations. *See infra* notes 41–49 and accompanying text.

28. Every business has one or more real asset projects aimed at maximizing the return on the owners' investment. Some might suggest that decisions involving the pursuit of corporate claims against third parties or directors differ in kind from other business decisions since derivative plaintiffs bear the litigation costs. Yet, this should be just another factor to consider, like any other cost or benefit, in a value-maximazation decision.

29. Veasey, *supra* note 15, at 1250.

30. *See, e.g.*, Dent, *supra* note 4, at 135 (purpose of business judgment rule is to "insulate from liability directors who have made mistaken decisions resulting in corporate losses, notwithstanding their good faith and exercise of due care"). *But see* Note, *Derivative Suits*, *supra* note 4, at 631 (business judgment rule's purpose is to "protect the board's authority to manage the corporation, not to insulate directors from liability").

31. 3A W. FLETCHER, *supra* note 4, § 1039, at 38 (rev. perm. ed. 1975).

32. *See, e.g.*, Ross v. Bernhard, 396 U.S. 531, 534, 538 (1970). *See generally* Comment, *supra* note 4, at 169-91 (discussing demand requirement in derivative suits as reflection of exhaustion doctrine).

33. Ashwander v. TVA, 297 U.S. 288, 318 (1936); Hawes v. Oakland, 104 U.S. 450, 460–61 (1881); Galef v. Alexander, 615 F.2d 51, 59 (2d Cir. 1980); *cf.* Lewis v. Graves, 701 F.2d 245 (2d Cir. 1983). The *Lewis* court saw "numerous practical advantages" to the demand requirement, thereby allowing corporations the opportunity to regain control of derivative suits:

> Corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation. Deference to directors' judgments may also result in the termination of meritless actions brought solely for their settlement or harassment value. Moreover, where litigation is appropriate, the derivative corporation will often be in a better position to bring or assume the suit because of superior financial resources and knowledge of the challenged transactions.

judgment rule represents judicial awareness of the statutory grant of power to corporations[34] and of the state policies supporting corporate power. The final and most significant reason is that the rule represents judicial cognizance of the uniqueness of business decisionmaking.[35] Judicial deference to the decisions of corporate directors is not due to a belief that directors are blessed with a special business acumen.[36] Rather, it manifests the courts' recognition of the realities of any ex ante decision. Such a decision, based on a probabilities analysis, needs to be respected (absent bad faith[37] or conflict of interest[38]) to foster proper and efficient

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Id. at 247–48 (citations ommitted); *see also* Aronson v. Lewis, No. 203, slip op. at 11–12 (Del. Sup. Ct. March 1, 1984). In *Aronson*, the court recognized that

> [b]y its very nature the derivative action impinges on the managerial freedom of directors. Hence, the demand requirement of Chancery Rule 23.1 exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits. Thus, by promoting this form of alternate dispute resolution, rather than immediate recourse to litigation, *the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations.*

Id. (emphasis added).

34. *See* Comment, *Off the Bench*, *supra* note 14, at 1028 ("The rule manifests judicial deference to the statutory grant of power to the board. . . ."); *see also supra* notes 24–25 (review of statutory schemes of California, Delaware, and Ohio).

35. *See supra* notes 27–29 and accompanying text.

36. Many decisions, however, seemed to base judicial deference on recognition of the managerial expertise of directors. *See* Mills v. Esmark, 544 F. Supp. 1275, 1282 n.3 (N.D. Ill. 1982) (business judgment rule "reflects the reality that corporate decisions are better left to those who are close to the facts and have the expertise to weigh the significance of those facts in an increasingly complex business environment"); Auerbach v. Bennett, 47 N.Y.2d 619, 629–31, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926–27 (1979) (courts respect director decisions because statute vests responsibility in directors, who have necessary experience and capabilities to discharge that responsibility); *see also* Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980) (basing its reasoning on *Auerbach*). *But see* Galef v. Alexander, 615 F.2d 51, 57 n.13 (2d Cir. 1980) (because directors are given wide latitude, they are not liable for honest errors made in good faith) (quoting 3A W. FLETCHER, *supra* note 4, § 1039)(rev. perm. ed. 1975)).

37. Courts generally will not interfere with the decisions of directors acting within their powers and in good faith. *See, e.g.*, Cooper v. Central Alloy Steel Corp., 43 Ohio App. 455, 183 N.E. 439 (1931); *see also* Goff v. Emde, 32 Ohio App. 216, 167 N.E. 699 (1928) (directors exercising reasonable care, diligence, and good faith not liable for losses resulting from mere error of judgment). Indeed, some writers have argued that courts usually hold that bad faith precludes application of the business judgment rule altogether. *See* Note, *Implementing* Zapata, *supra* note 4, at 984 n.18 (citing Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979)).

Derivative plaintiffs, however, encounter a tough burden when proving bad faith—they must face and surmount a double level presumption. First, directors are presumed to make their decisions in good faith. *See, e.g.*, Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903); Treadway Companies v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); Kors v. Carey, 39 Del. Ch. 47, 56, 158 A.2d 136, 142 (1960). Second, if good faith is presumed, directors also "enjoy a *presumption of sound business judgment* . . .

corporate management.[39]

From the perspective of a court scrutinizing a director's conformance to his performance obligations, the focus must be on the nature of the decisionmaking process, not on the competency of the director.[40]

B. *Limitations on Its Application*

Corporate law authorities suggest that the business judgment rule "yields to the rule of undivided loyalty."[41] Although this suggestion is largely correct, the presence of dangerous temptations of self-interest[42] does not require a separate rule to determine a director's conformity with his performance obligation.

Judicial deference to decisions by a board of directors is based

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which courts will not disturb if any rational business purpose can be attributed to their decisions." Panter v. Marshall Field & Co., 486 F. Supp. 1168, 1194 (N.D. Ill. 1980) (emphasis added), *aff'd*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). *But see* Hasan v. CleveTrust Realty Investors, [Current Binder] FED. SEC. L. REP. (CCH) ¶99,704 (6th Cir. Mar. 2, 1984). In *Hasan*, the Sixth Circuit reversed the district court's grant of summary judgment. The focus of the Sixth Circuit's disagreement was the district court's use of the good faith presumption. Judge Jones wrote that "[n]either the *Auerbach* nor *Zapata* approach allows a reviewing court to extend members of a special litigation committee the presumption of good faith and disinterestedness." *Id.* at 97,824.

38. "Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors . . . stand in a dual relation which prevents an unprejudiced exercise of judgment. . . ." United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); *see also* Miller v. American Tel. & Tel. Co., 507 F.2d 759, 762 (3d Cir. 1974) (courts avoid intervention when director decisions not influenced by personal considerations); Schreiber v. Pennzoil Co., 419 A.2d 952, 956 (Del. Ch. 1980) (appropriate business decision presumed absent facts showing some taint of conflict of interest); Goff v. Emde, 32 Ohio App. 216, 221, 167 N.E. 699, 701 (1928) (directors not liable where they have not personally profited from their acts). To avoid conflict of interest problems in the context of a derivative suit, corporations devised the SLC. *See infra* text accompanying notes 68-70.

39. The business judgment rule "provides directors with the discretion they need in formulating dynamic and effective company policy without fear of judicial second guessing . . . [as well as] encourag[es] competent individuals to assume directorships." *Viva* Zapata?, *supra* note 14, at 32; *see also* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978) ("The rationale for the rule is that in order for the corporation to be managed properly and efficiently, directors must be given wide latitude in their handling of corporate affairs."), *cert. denied*, 439 U.S. 1129 (1979).

40. *See* Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980).

41. 3A W. FLETCHER, *supra* note 4, § 1039, at 38 (rev. perm. ed. 1975).

42. *See, e.g.*, *In re* Ryan's Will, 291 N.Y. 376, 406, 52 N.E.2d 909, 923 (1943). Several writers have noted inherent director bias in the context of a corporation seeking termination of a derivative suit. *See* Dent, *supra* note 4, at 113 ("[B]oth inside and outside directors are discouraged from independence by pressures to conform . . . [which become] more onerous when [they] are asked to subject a fellow director to a suit that could lead to a major financial liability, loss of job, and public humiliation."); *see also* text accompanying notes 63-66 & 87-91 (dicussing conflict of interest in the context of derivative suits).

on a presumption that the decisions were honest, unbiased, and in compliance with fiduciary obligations.[43] The business judgment rule bars substantive review of board decisions as long as the presumption remains intact.[44] The rule does not, however, irrevocably shield directors' decisions from challenge. Rather, "the business judgment rule extends only as far as the reasons which justify its existence."[45]

The general level of judicial deference to board decisions decreases as indicia of conflict of interest or bad faith begin to surface.[46] To overcome the rule's presumptions, and thus challenge a board decision directly, a derivative plaintiff must first show facts which, if true, would remove the decision from absolute protection.[47] The plaintiff thus has the initial burden of demonstrating the presence of bad faith or conflict of interest.[48] Heightened judicial scrutiny of a director's performance will not be applied if this burden is not met.[49]

The level of scrutiny exercised by a court must be viewed along a continuum—rigid tests are not applied. Although the performance obligation of directors stays constant, courts nonetheless manipulate the other parts of the judicial review equation to reach a higher degree of scrutiny. For instance, a court may shift the burden of establishing good faith from one party to the other (an increased procedural burden). Or a court may demand a stronger showing of credible evidence on one or several issues (an increased substantive burden). The business judgment rule, therefore, must be viewed as a dynamic rather than a static test.

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43. *See, e.g.*, Evans v. Armour & Co., 241 F. Supp. 705, 713 (E.D. Pa. 1965) (interpreting Pennsylvania law and finding that business judgment rule presupposes good faith board decisions); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (presumption of sound business judgment); Prince v. Bensinger, 244 A.2d 89, 94 (Del. Ch. 1968) (directors presumed to have acted in good faith); Marblehead Bank Co. v. Raridon, 4 Ohio App. 468 (1915); *cf. supra* note 37 (derivative plaintiffs must overcome two tiered presumption of good faith and sound business judgment to prove directors' bad faith).

44. Comment, *supra* note 2, at 639; *see* Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926–27 (1979).

45. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

46. *See* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 753–54 (1960) (discussing conflict of interest as determinant of whether demand requirement excused); *infra* notes 87-100 and accompanying text.

47. Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980).

48. *Id.*

49. *See supra* note 37.

C. *Applicability to Shareholder Derivative Suits*

Eighty years ago, the Supreme Court recognized that if a board has the requisite power, a decision on whether to litigate a corporate claim is a management prerogative.[50] Fourteen years later, in *United Copper Securities Co. v. Amalgamated Copper Co.*,[51] Justice Brandeis emphasized:

> Whether 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. . . . Courts interfere seldom to control such discretion . . . except where the directors are guilty of misconduct . . . or . . . stand in a dual relation which prevents an unprejudiced exercise of judgment . . . .[52]

A director deciding whether to litigate a corporate claim encounters risks and confronts uncertainty, as he does when making any other business decision.[53] Accordingly, a decision not to pursue a corporate claim should be subject to the business judgment rule.

The derivative suit's dual nature[54] brings the business judgment issue to the forefront at the time the shareholder seeks to litigate the corporate claim. A "demand" on the board is usually required prior to filing suit,[55] because the shareholder is seeking to enforce a *corporate* rather than a *personal* claim.[56] The subsequently filed derivative suit conventionally alleges, in addition to

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50. *See* Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903) (directors may consider expense of litigation or furtherance of corporation's general business in determining whether to enforce corporate claim); *see also* Comment, *supra* note 4, at 196 & n.179 (directors should consider "likelihood of success" of litigation, "direct and indirect costs," and possible "impairment of friendly commercial relations").

51. 244 U.S. 261 (1917).

52. *Id.* at 263–64 (emphasis added).

53. *See, e.g.*, Veasey, *supra* note 15, at 1250.

54. *See supra* note 4 and accompanying text.

55. *See supra* note 6; *see also* Comment, *supra* note 4, at 171 (demand requirement gives board opportunity to exercise management authority by taking control of litigation). *See generally* 13 W. FLETCHER, *supra* note 4, § 5963, at 398–99 (rev. perm. ed. 1980) (reviewing case law on general rule of demand on directors). In addition to requiring demand on the board of directors, some states require that demand also be made on the other shareholders. *See* Hawes v. Oakland, 104 U.S. 450, 461 (1881) (shareholder must show, if unable to get board action, "that he had made an honest effort to obtain action by the stockholders as a body"); Wolgin v. Simon, 722 F.2d 389, 392 (8th Cir. 1983) (interpreting Missouri law, Mo. R. CIV. P. 52.09, and finding that demand on all shareholders is required even if it "would have taken too long and cost too much"); Comment, *supra* note 4, at 182 (showing that many states have adopted requirement of demand on shareholders) (citing ARIZ. R. CIV. P. 23.1; MINN. R. CIV. P. 23.06).

56. *See supra* notes 2 & 4–7 and accompanying text.

the existence of a corporate claim, that the board wrongfully refused to prosecute the claim.[57] This allegation in the shareholder's complaint can be viewed, implicitly, as a separate cause of action,[58] triggering the business judgment rule. The board's decision not to litigate or seek dismissal of a corporate claim should be scrutinized according to the same dynamic analysis as that used to evaluate other business decisions.[59]

Applying the business judgment rule to a board's refusal to maintain the suit must not be confused with the demand requirement.[60] Demand is a requirement that shareholders exhaust intracorporate remedies before going to court with a derivative suit[61] and is generally strictly enforced.[62]

Demand on a board and its wrongful refusal are not always

57. *See, e.g.*, 13 W. FLETCHER, *supra* note 4, §§ 5954, 5961, 5963–70 (rev. perm. ed. 1980) ("the right to sue arises from the fact that the corporation itself refuses to sue," *id.* § 5954, and such refusal, express or implied, is condition precedent to derivative suit, *id.* § 5961); *see also* Ross v. Bernhard, 396 U.S. 531, 534–35 (1970) (corporate refusal to proceed after suitable demand is precondition for derivative suit).

58. Comment, *Off the Bench*, *supra* note 14, at 1032 n.41 (suggesting that this analysis is helpful "for the purpose of understanding the application of the business judgment rule" where demand is made and refused).

59. The application of different tests to termination decisions ignores the underlying rationale for the business judgment rule's development and the rule's inherent flexibility. *See supra* notes 24–39 and accompanying text. Such an approach would only breed confusion.

60. *See, e.g.*, Grossman v. Johnson, 674 F.2d 115 (1st Cir. 1982).

61. *See supra* notes 32–33 and accompanying text; *see also* Heit v. Baird, 567 F.2d 1157, 1162 n.6 (1st. Cir. 1977) (purpose of demand is to "require resort to the body legally charged with conduct of the company's affairs *before* licensing suit in the company's name by persons not so charged") (emphasis added); *In re* Kauffman Mutual Fund Actions, 479 F.2d 257, 263 (1st Cir. 1973) ("to be allowed, sua sponte, to place himself in charge without *first* affording the directors the opportunity to occupy their normal status, a shareholder must show that his case is exceptional") (emphasis added), *cert. denied*, 414 U.S. 857 (1973).

62. *See, e.g.*, Evangelist v. Fidelity Management & Research Co., 554 F. Supp. 87, 90 (D. Mass. 1982) (demand requirement is to be strictly enforced and excused "only in exceptional circumstances"); Roderick v. Canton Hog Ranch Co., 46 Ohio App. 475, 479–80, 189 N.E. 669, 671 (1933) (stockholder may not maintain suit without alleging prior demand on corporation, unless demand would have been futile). *But cf.* Daily Income Fund v. Fox, 104 S. Ct. 831 (1984). In *Fox*, the Supreme Court held that Rule 23.1's demand requirement did not apply to a security holder bringing suit under § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (1982). The Court had found that § 36(b) did not confer a right judicially enforceable by the investment company. This forced the Court to address the meaning of Rule 23.1's language and requirements:

> [H]owever desirable the encouragement of intracorporate remedies may be as matter of policy, it is not, standing alone, enough to make a suit that the corporation can neither initiate nor terminate a "derivative action" within the meaning of Rule 23.1. Such a suit does not come within the Rule's language as it is most naturally interpreted and as we have consistently understood it.

104 S. Ct. at 837 n.9.

prerequisites for initiating a derivative suit. Demand may be "excused" if the court determines that such a requirement, because of director "interest," would have been useless.[63] Trial courts determining a director's level of "interest" in the litigation have considerable discretion to excuse the demand requirement.[64] Courts typically have excused demand when, for example, a majority of directors are named as defendants, and thus have a clear adverse interest, or when a board clearly indicates that it would refuse demand.[65] Some courts have suggested that different standards of director "interestedness" should apply depending on whether no demand was made or whether demand was made and refused.[66] A number of recent cases, however, espouse a significantly broadened interpretation of the demand requirement.[67]

63. 13 W. FLETCHER, *supra* note 4, § 5965 (rev. perm. ed. 1980); *see, e.g.*, Brody v. Chemical Bank, 482 F.2d 1111, 1114 (2d Cir.) (per curiam) (demand on directors not required where it would be useless), *cert. denied*, 414 U.S. 1104 (1973); Sorin v. Shahmoon Indus., 36 Misc. 2d 35, 38, 231 N.Y.S.2d 956, 959 (Sup. Ct. 1962) (same).

64. *See* Fields v. Fidelity Gen. Ins. Co., 454 F.2d 682, 684-85 (7th Cir. 1971) (court has discretion to excuse demand requirement under Federal Rule of Civil Procedure 23.1); deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1228 (10th Cir. 1970) (same).

65. *See* Nussbacher v. Continental Ill. Nat'l Bank & Trust Co., 518 F.2d 873, 878-79 (7th Cir. 1975) (allowing suit to proceed without prior demand because defendants dominated board), *cert. denied*, 424 U.S. 928 (1976); *cf.* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 276 (3d Cir. 1978) (plaintiffs failed to establish that defendants so dominated board as to make demand futile), *cert. denied*, 439 U.S. 1129 (1979).

66. *See, e.g.*, Galef v. Alexander, 615 F.2d 51, 59 (2d Cir. 1980) (standard when no demand had been made is whether it would have been futile to have tried, whereas when demand was made and refused, standard is whether directors were disinterested enough to have been unprejudicial).

67. *See, e.g.*, Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983) ("absent specific allegations of self-dealing or bias on the part of a majority of the board, mere approval and acquiescence are insufficient to render the demand futile."). Following *Lewis*, there now exists a severe dislocation (at least from the derivative plaintiff's point of view) between the demand requirement and judicial review of board (or SLC) decisions not to pursue derivative actions. *Lewis*, when read in conjunction with Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982), creates a significant if not insurmountable barrier to review of the merits of a derivative plaintiff's case. *Abramowitz* requires a court, in a *demand-required* case, to "defer to the company's business judgment to forego litigation unless the shareholder can show that the directors acted wrongfully [in refusing plaintiff's demand]." *Id.* at 1031. This deferential standard is extremely difficult for a derivative plaintiff to satisfy. *See supra* note 37. Because *Lewis* has broadened the class of demand-required cases, *Abramowitz*'s deferential review of director decisions will be activated more frequently. While a broad demand requirement boasts certain benefits, *see supra* note 33 and accompanying text, the policy of permitting shareholders to redress wrongs done to the corporation is undercut by requiring demand in such a wide class of cases and at the same time giving extreme deference to board decisions not to sue.

But see Aronson v. Lewis, No. 203, Slip op. at 20-21 (Del. Sup. Ct. March 1, 1984) (plaintiff must "alleg[e] facts with particularity which, taken as true, support a *reasonable doubt* that the challenged transaction was the product of a valid exercise of business judgment." (emphasis added)). The court in *Aronson* was responding to the lower court opin-

II. *Burks* to *Zapata*: Validation and Circumscription

Corporate defendants conceived the concept of special litigation committee (SLC) to avoid problems of interestedness.[68] To deal with suits identifying a majority of directors as wrongdoers, boards have delegated their statutorily granted authority[69] to SLC's to decide whether the corporation should pursue the claim.[70] In 1979, the Supreme Court, in *Burks v. Lasker*,[71] established a two-part test to determine whether disinterested directors, whether or not comprising an SLC, could properly terminate shareholder derivative suits.

A. Burks v. Lasker

Prior to *Burks*, lower federal courts had faced several cases involving SLC's seeking to terminate shareholder derivative suits.[72] In *Gall v. Exxon Corp.*,[73] for example, a shareholder derivative suit sought reimbursement for the corporation from those

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ion which utilized a "reasonable inference" standard. *Id.* at 18. Although somewhat stricter, the "reasonable doubt" standard will not pose an insurmountable barrier. This is particularly so in cases which involve director self-dealing. It is clear from *Aronson*, that absent such particularized charges, the protections of the business judgment rule's presumptions are still operative. The Delaware Supreme Court properly recognized that courts have become too lenient in excusing demand. They were mindful, however, "that the plaintiff need only allege specific facts; he need not plead evidence." *Id.* at 23. If derivative plaintiffs meet this simple, but particularized requirement, thereby excusing demand, the review standard of *Zapata* will be activated in a significant number of cases.

68. *See supra* notes 8-9 and accompanying text. Simply naming a director as a defendant is not necessarily enough to create interest in the litigation. *See supra* note 9; *see also* Auerbach v. Bennett, 47 N.Y.2d 619, 633, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979) (to so limit independence "would be to render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative suit"). *But see* Abbey v. Control Data Corp., 460 F. Supp. 1242, 1243-44 (D. Minn. 1978) (director properly named as defendant is necessarily "interested"), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

69. *See supra* notes 24-25 & *infra* note 85.

70. *But see* Miller v. Register & Tribune Syndicate, 336 N.W.2d 709, 718 (Iowa 1983) (directors "who are parties to the derivative action may not confer upon a special committee . . . the power to bind the corporation as to its conduct of the litigation").

71. 441 U.S. 471 (1979).

72. *See, e.g.*, Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817 (S.D.N.Y. 1979); Abbey v. Control Data Corp., 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); *cf.* Galef v. Alexander, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,758 (S.D.N.Y. Jan. 25, 1979) (termination decision by disinterested directors who constituted majority of board but did not comprise SLC), *rev'd*, 615 F.2d 51 (2d Cir. 1980).

73. 418 F. Supp. 508 (S.D.N.Y. 1976).

who had allegedly made improper foreign payments.[74]

An independent committee[75] had found that the suit would not have been in the corporation's best interests. The court held that absent some taint of conflict of interest or "allegations that the business judgment exercised was grossly unsound, the court should not at the instigation of a single shareholder interfere with the judgment of the corporate officers."[76]

Federal courts have created a potential conflict with policies embedded in existing federal law by sanctioning use of the business judgment rule to scrutinize directors' decisions.[77] As a result of the rule's presumptions, director decisions are less open to attack. Derivative actions, however, often represent the only effective method of enforcing violations of federal statutes.[78] With applicable federal statutory policy in view, the *Burks* Court sought to establish the proper standard for determining the availability of board or SLC dismissal.

The Court held that in determining the propriety of dismissing a derivative suit under the Investment Company Act of 1940[79] and the Investment Advisors Act of 1940,[80] the initial inquiry is whether the termination is permitted under applicable state law.[81] The second inquiry is whether the state law is consistent with fed-

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74. *Id.* at 509. Between 1963 and 1974, $59 million of corporate funds had been used as contributions to Italian political parties and as bribes to others.

75. The committee was composed of three disinterested directors. Two were nonemployee (outside) directors. The third was an Exxon senior vice president who had just left a post with the United States Treasury Department. None of the committee members was elected to the board until after the questioned payments had been made. *Id.* For an interesting discussion of how to choose independent directors to serve on SLC's, see Payson, Goldman & Inskip, *supra* note 3, at 1201–04.

76. 418 F. Supp. at 516.

77. This conflict does not arise when federal courts face the same issues in diversity cases. *Cf.* Erie R.R. v. Tompkins, 304 U.S. 64 (1938) (federal courts sitting in diversity must apply state law).

78. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 432- 33 (1964) (implied private right of action is available under § 14(a) of Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1982), as means of supplementing SEC's enforcement powers). For a discussion of the federal policies embodied in *J.I. Case* and how they impact on derivative suits, see Coffee & Schwartz, *supra* note 14, at 287–300.

79. 15 U.S.C. §§ 80a-1 to -52 (1982).

80. *Id.* §§ 80b-1 to -20 (1982).

81. 441 U.S. at 475–80. Neither the Investment Company Act nor the Investment Advisors Act requires that federal law, rather than state law, control the authority of directors, because the relevant federal policies do not demand that directors' powers be uniform among the states. *Id.* at 479 & n.6.

Despite the second part of the *Burks* test, which focuses on whether the state rule is compatible with federal policy, a real question arises whether, in the post-*Burks* decisions, the federal policy embodied in *J.I. Case* is being subverted by state law.

eral policy.[82] Most of the controversy seems to have centered on the stage of determining what state law permits or limits, which is when the courts have confronted the business judgment rule.[83]

The *Burks* decision, like the traditional rule, requires the board or SLC to have the power to act under state law.[84] Since most corporate statutes authorize a broad delegation of board powers to committees,[85] an SLC's statutory authority is seldom at issue.[86]

Another judicial concern is the possibility of conflicts of interest impinging on an SLC's ability to act independently.[87] Some courts, though, have held that a committee is independent when the plaintiff merely failed to allege sufficient evidence to the contrary.[88] At the other extreme, at least one court has doubted even the possibility of a corporate board creating an unbiased committee.[89] Cases involving the traditional disinterested business judgment defense, however, do provide some specific themes for determining whether a committee is truly unbiased. Courts have applied heightened scrutiny to director decisionmaking when the

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82. 441 U.S. at 480.

83. *See, e.g.*, Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980). *But see* Evangelist v. Fidelity Management & Research Co., 554 F. Supp. 87 (D. Mass. 1982) (court denied power of termination because federal policy behind Investment Company Act overrides power to seek termination under state law).

84. 441 U.S. at 480.

85. *See, e.g.*, CAL. CORP. CODE § 311 (West 1977) ("Any such committee [appointed by the board] . . . shall have all the authority of the board. . . ."); DEL. CODE ANN. tit. 8, § 141(c) (1975) (such committees "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation"); OHIO REV. CODE ANN. § 1701.63(a)-(f) (Page Supp. 1983) (directors "may authorize the delegation to any such committee of any of the authority of the directors . . . [and] an[y] act or authorization of an act by any such committee . . . shall be as effective . . . as the act or authorization of the directors"); MODEL BUSINESS CORP. ACT § 42 (1982) (committees appointed by board "shall have and may exercise all the authority of the board of directors").

86. The issue has not been dispositive in any of the recent cases. *See* cases cited *supra* note 83.

87. *See supra* notes 10 & 69–74 and accompanying text. *But cf.* Coffee & Schwartz, *supra* note 14, at 283 (not enough attention is given to problem of structural bias in board determinations); Dent, *supra* note 4, at 110–17 (same); Note, *Derivative Suits*, *supra* note 4, at 629 (same).

88. *See, e.g.*, Rosengarten v. International Tel. & Tel. Corp. 466 F. Supp. 817, 825 (S.D.N.Y. 1979).

89. *See* Maher v. Zapata Corp., 490 F. Supp. 348, 354 (S.D. Tex. 1980). *But see* Auerbach v. Bennett, 47 N.Y.2d 619, 633, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979) ("To accept [such] assertions . . . would be to render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative action.").

director or his family had a financial interest adverse to that of the corporation,[90] or when the director had authorized and/or benefitted from the underlying challenged transaction.[91]

Despite these concerns, various federal courts, with direction from the Supreme Court concerning the proper choice of law, "hastened to bless"[92] SLC termination decisions.[93] These cases fall into two general categories—suits alleging that directors or officers had made or authorized illegal foreign payments,[94] and suits alleging that they had breached their fiduciary duty and violated federal securities laws.[95]

B. *SLC Dismissals of Derivative Suits Alleging Improper Foreign Payments*

Many have sought reimbursement from directors or officers for improper payments made on the corporation's behalf. Courts traditionally have upheld payments made in this context.[96] In *Abbey v. Control Data Corp.*,[97] shareholders brought a derivative action against seven directors seeking repayment of civil and criminal penalties charged to the corporation.[98] The Eighth Circuit, following the Supreme Court's *Burks* test, interpreted Delaware law to determine whether the SLC could terminate the derivative action.[99] The court affirmed the district court's grant of summary judgment in favor of Control Data, stating: "As a matter of Delaware law, . . . the [business judgment] rule applies to any reasonable good faith determination by an [SLC] that the derivative action is not in the best interests of the corporation."[100]

Some writers have criticized the *Abbey* decision for relying on cases involving true business decisions to determine the board's

90. *See* Bastian v. Bourns, Inc., 256 A.2d 680, 681 (Del. Ch. 1969).

91. *See* Galef v. Alexander, 615 F.2d 51, 60–61 (2d Cir. 1980).

92. Aronoff & Freeman, *supra* note 8, at 28, col. 3.

93. *See, e.g.*, cases cited *supra* note 83; *see also* Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981) (interpreting Delaware law), *aff'd*, 672 F.2d 1025 (2d Cir. 1982); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) (interpreting Delaware law), *rev'd in part*, 671 F.2d 729 (2d Cir. 1982) (per curiam); *infra* notes 96–120 and accompanying text.

94. *See infra* notes 96–109 and accompanying text.

95. *See infra* notes 110–20 and accompanying text.

96. Coffee & Schwartz, *supra* note 14, at 271.

97. 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

98. The corporation had pled guilty to making illegal foreign payments between 1967 and 1976. As a result, almost $1.4 million in civil and criminal penalties were levied against and paid by the corporation. *Id.* at 726.

99. *Id.* at 728.

100. *Id.* at 730.

authority to delegate its powers to the SLC.[101] A decision not to pursue a corporate claim, however, even when arising against directors or officers, is a business decision and the power to make the decision may be delegated to an SLC.[102]

An SLC had also recommended terminating a shareholder derivative suit in *Auerbach v. Bennett*,[103] in which the suit charged that four of General Telephone & Electronics Corporation's directors and its accounting firm were liable for approximately $ll million paid by the corporation in bribes and kickbacks. The New York Court of Appeals, with a very broad application of traditional business judgment analysis,[104] limited its inquiry to the independence of SLC members and the adequacy of their procedures.[105] The rule's presumptions, which serve to protect any *business* judgment, were operative in this case.[106] The majority held that courts "must and properly should respect the board's determination"[107] once satisfied with its independence and methodology because courts are "ill-equipped"[108] to evalute ex ante business decisions. The court, recognizing the impact of conflict of interest on judicial review of SLC decisions, did leave open the possibility that summary judgment may be withheld until broader discovery has been afforded a shareholder seeking specifics con-

101. *See, e.g.*, Note, *Derivative Suits*, *supra* note 4, at 618 (delegating authority to SLC's "is readily distinguishable from delegating authority to a committee for the purpose of approving transactions between the corporation and a majority of directors"). Although these two situations may be distinguishable, the dynamic traditional business judgment rule should still apply. *See supra* notes 27–28 & 59 and accompanying text.

102. *See supra* note 85 and accompanying text.

103. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

104. The court stated that all corporate actions "taken in good faith and in the exercise of honest judgment" deserve protection. *Id.* at 629, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.

105. *Id.* at 631, 393 N.E.2d at 1001, 419 N.Y.2d at 927.

106. The court found that "[n]otwithstanding the vigorous and imaginative hypothesizing and innuendo of counsel there [was] nothing in [the] record to raise a triable issue of fact as to the independence and disinterested status of [the SLC]." *Id.* at 632, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927. So even under the test set forth in what is arguably the most proshareholder decision of recent years, *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980), the derivative plaintiff failed to meet his burden of proof. *See supra* note 47 and accompanying text.

107. 47 N.Y.2d at 631, 393 N.E.2d at 1000, 419 N.Y.S.2d at 927.

108. *Id.* at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926. This degree of scrutiny of a board's decision to terminate a derivative suit is essentially the traditional test which applies to any business decision. *See supra* notes 24- 49 and accompanying text; *see also* Veasey, *supra* note 15, at 1262 (deference to the SLC determination "translates into the same refusal to review directors' decisions as is the case in the [traditional] . . . application of the business judgment rule").

cerning an SLC's disinterestedness.[109]

C. *Breach of Fiduciary Duty and Conflict of Interest—Increased Scrutiny of Corporate Decisions to Terminate Derivative Litigation*

In *Lewis v. Anderson*,[110] an SLC sought dismissal of a suit by minority shareholders against Walt Disney Productions and a majority of its board for violating federal securities laws[111] in connection with grants of stock options.[112] With no controlling California decision, the Ninth Circuit applied what it believed to be the relevant state law.[113] Following a quick review of the traditional business judgment rule and its application to SLC termination decisions,[114] the court noted that the relevant California statutes were "almost identical"[115] to those of Delaware. This similarity enabled the court to rely heavily on the *Abbey* decision, which had interpreted Delaware law.[116] That decision, as well as *Auerbach*, were seen by the *Lewis* court as "reflecting a *clear trend* in corporate law."[117]

109. 47 N.Y.2d at 636, 393 N.E.2d at 1004, 419 N.Y.S.2d at 930; *see also* Rosengarten v. International Tel. & Tel. Co., 466 F. Supp. 817, 823 (S.D.N.Y. 1979) (stay of summary judgment until there could be discovery of SLC members was granted "[o]ut of concern for the interest of shareholders in probing the motivation, good faith, and thoroughness of minority directors").

110. 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

111. The plaintiff asserted two claims based on alleged securities law violations. The first claim under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), alleged that the directors had inside information concerning the price of Disney stock which enabled them to issue options at a price that would ensure profits. The second claim, brought under § 14(a) of the Act, 15 U.S.C. § 78n(a) (1982), alleged that proxy statements sent to shareholders lacked full disclosure of the stock option plan. *Id.* at 783 n.2. *See generally* Block & Barton, *The Business Judgment Rule as Applied to Stockholder Proxy Derivative Suits Under the Securities Exchange Act*, 8 SEC. REG. L. J. 99, 106–10 (1980) (discussing federal securities law policies in context of derivative suit termination).

112. In November 1974, the corporation's "stock option committee" granted the defendant directors new options which allegedly were more favorable and in violation of federal securities laws. 615 F.2d at 780.

113. This is the first step of the *Burks* test. *See supra* text accompanying note 81. The Ninth Circuit also addressed the second step, *see supra* text accompanying note 82, finding no federal policy conflicting with the state law authorizing termination of the derivative suit. 615 F.2d at 783–84.

114. *Id.* at 781-82.

115. *Id.* at 782; *see supra* notes 25 & 85.

116. 615 F.2d at 782. The Ninth Circuit's reliance on *Abbey* must be reexamined in light of *Zapata*. *See infra* notes 121–47 and accompanying text. While the *Abbey* court's interpretation of Delaware law may still be valid in the context of illegal foreign payments, the strong conflict of interest overtones in *Lewis* indicate that the case falls within the *Zapata* zone of heightened judical scrutiny.

117. 615 F.2d at 783 (emphasis added).

There are two ways to approach the "clear trend" language in *Lewis*. First, the Ninth Circuit could have been focusing on the results in the cases[118] that had granted summary judgment to corporations or their SLC's seeking termination of derivative suits.[119] Second, and the better view of the trend, is that it represents an application of traditional business judgment rule concepts to termination decisions.

In its application of the business judgment rule, the *Lewis* court felt it necessary to analyze closely the facts surrounding the termination decision. This increased scrutiny was due to the court's concern over the possibility of director interest. The corporation's appointment of an SLC, however, enabled the court to give business judgment protection to the decision.[120]

D. Zapata Corp. v. Maldonado

1. *Facts and Procedural Complexities*

The lawsuit, originally *Maldonado v. Flynn*,[121] was based upon allegations of director self- dealing.[122] In 1979, the Zapata board formed an "independent investigative committee" consisting of two newly appointed outside directors. The committee decided that Maldonado's suit in the Delaware Chancery Court, as well as related suits in two federal district courts, were against the corporation's best interests and consequently recommended dismissal.[123] In January of 1980, the District Court for the Southern District of New York granted Zapata's motion for summary judg-

118. *See, e.g.*, cases cited *supra* notes 83 & 93.

119. In fact, there have been virtually no cases in which an SLC has recommended suit after a shareholder demand. *See* Dent, *supra* note 4, at 109 n.70.

120. 615 F.2d at 783. *But see* Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 489, 121 N.E. 378, 379–80 (1918) (Judge Cardozo noted that "[a] dominating influence may be exerted in other ways than by a vote . . . ."); *see also* Coffee & Schwartz, *supra* note 14, at 283 & n.124 (discussing reasons for domination of outside directors by corporate executives).

121. 413 A.2d 1251 (Del. Ch. 1980).

122. In 1970, a stock option plan adopted by Zapata's board granted certain officers and directors options to purchase common stock at $12.15 per share. The plan, to have been exercised in five installments, was to terminate on July 14, 1974. As that date drew near, the company planned to announce a tender offer for 2.3 million of its own shares, which would increase the price per share to about $25. If the options were exercised before the final date, the company would have lost a significant tax advantage while the directors would have received corresponding tax benefits. For this reason, Zapata's directors voted to accelerate the final option date to July 2, 1974, six days before the announcement of the tender offer. In 1975, Maldonado brought a derivative suit alleging that the directors had breached their fiduciary duty. *Id.* at 1254–55.

123. Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981).

ment.[124] Shortly thereafter, the Delaware Chancery Court, followed by the District Court for the Southern District of Texas, reached the opposite result and denied Zapata's motion.[125] Varying interpretations of Delaware law, particularly the conflict between the chancery court and federal courts applying Delaware law, spurred the Delaware Supreme Court to resolve the question of an SLC's authority to terminate a derivative suit.[126]

2. *The Decision*

The Delaware Supreme Court reversed the chancery court's holding that a shareholder has an independent right to prosecute a derivative suit.[127] The court acknowledged that a Delaware corporation's board has the power to delegate its authority, despite the taint of self-interest of a majority of its members.[128] Going further, though, the court added an arguably new step to the business judgment rule analysis. On remand, the chancery court was instructed to "apply its own independent business judgment"[129] in scrutinizing the committee's decision to seek summary judgment.[130]

3. *Apparent Significance*

A literal reading of *Zapata* suggests that it might well be limited to suits in which demand on directors is excused.[131] Several

124. Maldonado v. Flynn, 485 F. Supp. 274, 285–87 (S.D.N.Y. 1980), *rev'd*, 671 F.2d 729 (2d Cir. 1982) (remanding for district court review of *Zapata* criteria since district court's decision interpreting Delaware law was reached before Delaware Supreme Court's decision).

125. *See* Maher v. Zapata Corp., 490 F. Supp. 348, 352–53 (S.D. Tex. 1980); Maldonado v. Flynn, 413 A.2d at 1262.

126. 430 A.2d at 781.

127. *Id.* at 782.

128. *Id.* at 786.

129. 430 A.2d at 789.

130. The court, believing that it was "striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an [SLC]," stated that this step shared "some of the same spirit and philosphy" as the chancery court decision. *Id.* at 789 & n.18 " 'Under our system of law, courts and not litigants should decide the merits of litigation.' " *Id.* (quoting Maldonado v. Flynn, 413 A.2d at 1263).

131. In a footnote, the court appeared to draw a distinction between derivative suits that have been properly initiated and those in which no demand had been made:

> [W]hen stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the "business judgment" rule and will be respected if the requirements of the rule are met. . . . That situation should be distinguished from the instant case, where demand was not made, and the *power* of the board to seek a dismissal, due to disqualification, presents a threshold issue.

writers, however, believe that the distinction between when demand is required and when it is excused should not be dispositive of the level of judicial scrutiny.[132] Despite these views, several post-*Zapata* decisions have focused on this dichotomy.[133] The distinction, in effect, places the burden of proving lack of good faith and independence on the shareholder when demand is required, but not when it is excused. The burden of proof is on the shareholder in demand required cases because of the presumption of good faith inherent in the traditional business judgment rule.[134] Thus, when demand is required, the *Zapata* test scrutinizes a corporation's refusal decision as it would any business decision.

When demand is excused, however, the burden of proving good faith and independence is shifted to the corporation.[135] This result can best be explained as a sub silentio[136] shifting of the conformity test[137] by the *Zapata* court. Sensing a high degree of self-interest, the court required the corporation to meet the usual standard for summary judgment.[138] It is as if the normally operative

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Id. at 784 n.10 (emphasis in orginal).

132. *See, e.g.*, Dent, *supra* note 4, at 105–07; *cf. One Year Later*, *supra* note 14, at 414 (recommending "making demand mandatory in all cases and fusing into one procedure the board's consideration of the demand with the motion to terminate"). *But see* Galef v. Alexander, 615 F.2d 51, 59 (2d Cir. 1980) (suggesting that there necessarily may be different standards for judicial scrutiny of these two separable parts of derivative suit process). Although these writers do not advocate the traditional mode of analysis, *see supra* notes 24–39 and accompanying text, the result they urge inevitably would amount to just that.

133. *See, e.g.*, Maldonado v. Flynn, 671 F.2d 729, 731 (2d Cir. 1982) ("We note only that the court drew a sharp distinction between cases in which demand is made on the corporation to sue on its own behalf and those in which such demand is excused due to futility."); Stein v. Bailey, 531 F. Supp. 684, 692 (S.D.N.Y. 1982) (when demand not excused, courts should only ask whether SLC's decision not to sue was wrongful); Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311, 1326 (S.D. Iowa 1981) (seeing *Zapata* as four-pronged test, with first prong being whether suit was properly initiated). *But see* Mills v. Esmark, Inc., 544 F. Supp. 1275, 1283 n.4 (N.D. Ill. 1982) ("Although the *Zapata* opinion does distinguish between demand and non-demand cases, we hesitate to draw the bright line advocated by the Second Circuit . . . . [D]emand on the board, although certainly relevant to the *level* of . . . review, does not itself bar all such review in this Court under Delaware law.") (emphasis in original).

134. *See supra* note 37; *see also* Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 130–33 (1979) (examining good faith presumption and strength of evidence needed in particular situations to overcome it).

135. *Zapata*, 430 A.2d at 788. Despite this shift in burden, the court still recognized the *power* of a corporation to seek dismissal through an SLC. *Id.*

136. *See, e.g.*, Coffee & Schwartz, *supra* note 14, at 270 (in cases where "the challenged transaction contains aspects of self-dealing, the court will *sub silentio* impose a higher standard of judicial review, *even* though the directors themselves were not dominated or controlled by the defendants." (emphasis added)).

137. *See supra* text following note 49.

138. *See supra* note 3.

presumptions were negated by the factors which had led to excusing demand.

In addition to shifting the burden of proof, the court explicitly indicated that the trial court, in its discretion, should exercise a "second step."[139] This second step implicitly changed the substance of the conformity test. The step involved the trial court's exercise of its own business judgment as to whether the action should proceed. Those who suggest that the corporation's burden of proof under the step will not be "particularly high"[140] are, in a sense, correct.

The content of the business judgment rule was subtly recast under *Zapata* to require the SLC to "show that its reasons for seeking termination are not only defensible, but persuasive."[141] The Delaware Supreme Court explicitly advised the trial court to take account of "matters of law and public policy in addition to the corporation's best interests."[142] Superficially, the court appeared to be "interposing . . . a completely new two-step test."[143] The two-step test, however, may be explained by traditional analysis.[144] The court seems merely to have explicated a bifurcated analysis which most courts have exercised "under one guise or another, . . . whether [admitted] or not."[145]

The Delaware Supreme Court's opinion demonstrated to other courts that judicial candor may represent the preferable approach to the many novel and difficult questions raised by corporate attempts to terminate derivative litigation. Despite the candor of the *Zapata* decision, many questions remain unanswered[146]—the

139. 430 A.2d at 789. There is real dispute over whether this second step is indeed discretionary. *See, e.g.*, Comment, *Restricting the Power*, *supra* note 14, at 1215 (future courts "generally will proceed to the second phase of the *Zapata* test"); *see also* Joy v. North, 692 F.2d 880, 897–99 (2d Cir. 1982) (Cardamone, J., dissenting) (criticizing majority for making second step of *Zapata* mandatory), *cert. denied*, 103 S. Ct. 1498 (1983).

140. *See, e.g.*, Comment, *Restricting the Power*, *supra* note 14, at 1214. The burden will not significantly increase because the second step merely explicates the analysis used in prior decisions. It is not a new burden in the sense of changing the normal dynamic business judgment test.

141. *Id.* at 1215. This "allows the court to scrutinize the SLC's recommendations for hints of subtle, perhaps even unconscious, bias." *Id.*

142. 430 A.2d at 789.

143. *One Year Later*, *supra* note 14, at 401.

144. The court, finding a conflict of interest, sought to impose a higher degree of scrutiny despite the use of an SLC. The dynamic view of the business judgment rule would account for such heightened scrutiny. *See supra* text following note 49.

145. Aronoff & Freeman, *supra* note 8, at 30, col. 1.

146. *See, e.g.*, Comment, *Restricting the Power*, *supra* note 16, at 1214–15.

gaps to be filled by the "practical experience"[147] of applying or refusing to apply *Zapata*'s principles in future cases.

III. THE PROGENY: APPLICATION OF *ZAPATA CORP. V. MALDONADO*

Motions to terminate derivative suits continue to be used by corporations seeking greater control over litigation involving *corporate* claims.[148] Some writers have argued that the major issues faced by the post-*Zapata* courts have been: (1) whether to adopt the *Zapata* or the *Auerbach* "test" when there is no controlling state decision; and (2) whether *Zapata* is applicable to demand-refused cases involving Delaware corporations.[149] The second issue is significant if the *Zapata* court indeed intended to create an explicit dichotomy in its curious footnote.[150] However, it is the first issue—the attempt to decide between allegedly different tests—that has continued the confusion over the proper standard for judicial scrutiny of directors' conformity with their performance obligations.

A derivative suit filed by minority shareholders, alleging breach of fiduciary duty and violations of securities laws, forced the federal district court in *Watts v. Des Moines Register & Tribune*[151] to predict the status of the business judgment rule in Iowa.[152] The court accepted the basic premise that a decision not to pursue a derivative suit is a business decision deserving some degree of judicial deference.[153] The *Watts* court also recognized the "current trend" of extending highly deferential business judgment protection to SLC decisions, represented by the *Burks-Abbey-Lewis* line of cases.[154] However, after considering several

147. Payson, Goldman & Inskip, *supra* note 3, at 1212.

148. Aronoff & Freeman, *supra* note 8, at 28; *see* Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982); Mills v. Esmark, Inc., 544 F. Supp. 1275 (N.D. Ill. 1982); Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981).

149. *One Year Later*, *supra* note 14, at 403.

150. *See supra* notes 131–33 and accompanying text.

151. 525 F. Supp. 1311 (S.D. Iowa 1981). The plaintiff alleged the violations in connection with voting trust and recapitalization plans designed to prevent takeover attempts. *Id.* at 1315–17.

152. *See supra* text accompanying note 81 (first part of *Burks* test).

153. 525 F. Supp. at 1324–25.

154. *Id.* at 1325; *see also supra* notes 25 & 85 (review of state corporate statutory schemes).

Iowa decisions,[155] the court concluded:

> [U]pon consideration of the high standard of care to which corporate fiduciaries are subject in Iowa and the protective attitude displayed by the state's courts toward the rights of minority shareholders, . . . the Court is persuaded that the *Iowa Supreme Court would apply the more stringent version of the deferential business judgment rule expounded by the Delaware Supreme Court in Zapata* . . . .[156]

By its language, the court demonstrated a dynamic rather than static view of the business judgment rule.[157] The concerns raised in the *Watts* opinion are similar to those that traditionally have triggered heightened scrutiny of director decisionmaking.[158] The court implicitly recognized that blind deference to board recommendations of dismissal becomes increasingly less appropriate as derivative suits focus on director malfeasance.[159]

Faced with no controlling Virginia decision, Judge Merhige of the District Court for the Eastern District of Virginia adopted the *Zapata* test in *Abella v. Universal Leaf Tobacco Co.*[160] The court granted the corporation's motion for summary judgment even though it applied the more stringent judicial business judgment prong of the *Zapata* test.[161] Having excused demand,[162] the court compared Virginia corporate statutes[163] with those of Delaware,[164] which had been construed in *Zapata*. Finding the two to

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155. *See, e.g.*, First Nat'l Bank v. One Craig Place Ltd., 303 N.W.2d 688 (Iowa 1981); Rowen v. La Mars Mutual Ins. Co., 282 N.W.2d 639 (Iowa 1979).

156. 525 F. Supp. at 1325 (emphasis added) (citations ommitted).

157. *See supra* text following note 49.

158. *See supra* notes 41–49 and accompanying text.

159. Recent Development, 8 J. CORP. L. 145, 165 (1982). Even "[t]he issue of the independence and good faith of the directors moving to dismiss, whether or not it is expressly so stated, *involves the court in some kind of inquiry as to whether the wrong claimed . . . is substantial or insubstantial.*" Aronoff & Freeman, *supra* note 8, at 28, col.4 (emphasis added).

160. 546 F. Supp. 795 (E.D. Va. 1982). The district court previously had denied Universal's motion to dismiss. *See* Abella v. Universal Leaf Tpbacco Co., 495 F. Supp. 713 (E.D. Va. 1980) (relying heavily on "absolute right" theory of Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980)). Since *Zapata* reversed *Maldonado v. Flynn*, the court permitted Universal to renew its motion to dismiss. 546 F. Supp. at 797.

161. 546 F. Supp. at 805.

162. Although the defendants raised the demand requirement as an affirmative defense, none pressed this claim in the motion to dismiss. "For purposes of these motions, the Court [accepted] plaintiff's excuse that such a demand would have been futile, since a majority of the board took part in the transactions of which he complains." *Id.* at 798 n.2. Taking "considerable guidance" from *Watts*, *id.* at 799–800, the court used the excuse of demand to satisfy the first prong of the *Zapata* test.

163. *See* VA. CODE §§ 13.1–35, -40 (1978).

164. *See supra* note 25.

have substantially the same provisions, the court went on to apply the two-step *Zapata* test to the facts before it.

In applying the first step, the *Abella* court found that the corporation had carried its burden of proving the independence and good faith of the SLC, as well as the reasonableness of its investigation and basis of its conclusions.[165] Since the first step was satisfied, the court chose to go to the second step, which involved applying its own independent business judgment as to whether the suit should proceed.[166] At the outset of this step of the court's analysis, Judge Merhige made clear that the exercise of judicial business judgment is not a usurpation of director decisionmaking power.[167] Although apparently trying to limit the scope of *Zapata's* second step, the *Abella* court effectively granted the corporation summary judgment on the merits.[168] Exercise of judicial business judgment, according to the court, "involves only the sort of matter in which, not immodestly, the Court has a fair degree of expertise; *it has only to conclude . . . that a suit against the Directors was destined to fail*."[169]

The court's scrutiny of the directors' conformity with their performance obligations was apparently quite stringent.[170] Yet, the court specifically limited its basis for granting summary judgment to the fact that "plaintiff [had] not put forth evidence to support his claim."[171]

Thus, the significance of the *Zapata* test, as well as its content, remained generally undefined until the Second Circuit, in *Joy v. North*,[172] "flushed-out" some factors that courts should consider in exercising their independent business judgment. A divided panel[173] reversed the district court's dismissal of the derivative

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165. 546 F. Supp. at 800–01.

166. *Id.*

167. "The Court's exercise of its business judgment is not to be interpreted as an invasion of the right of trained business personnel to exercise their best business judgment." *Id.* at 802.

168. *See One Year Later*, *supra* note 14, at 407 (*Abella* court fundamentally misunderstood its task under second step of *Zapata* test).

169. 546 F. Supp. at 802 (emphasis added).

170. The court's inquiry into the merits of the plaintiff's claims amounted to almost a "mini-trial." *See* Aronoff & Freeman, *supra* note 8, at 28, col. 4; (second step of *Zapata* test involves 'mini-trial' on issues in litigation).

171. 546 F. Supp. at 801–02. In fact, the plaintiff was quite lax in conducting discovery; at the time of the summary judgment motion he had conducted only one two-hour deposition of one defense lawyer. *Id.* at 802.

172. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

173. Judges Oakes and Winter comprised the majority and Judge Cardamone dissented.

suit. Interpreting Connecticut law, the Second Circuit adopted a standard of review similar to that of *Zapata*.[174] The court recognized the difficulty of scrutinizing conformity of a director's decisionmaking with his performance obligations and thus sought to "establish some guidelines" to ease that task.[175]

The *Joy* court stressed that the guidelines only applied to situations of *direct economic injury* to a corporation's asset pool that diminish the value of shareholder investments.[176] The court applied "far more vigorous scruntiny . . . than occurs under the good faith, independence and throughness test,"[177] since the existence of a conflict of interest is "hardly eliminated by the creation of an [SLC]."[178] It thus shifted the burden to the corporation moving for dismissal or summary judgment "to demonstrate that the action is more likely than not to be against the interests of the corporation."[179]

The court described the mechanics of this judicial scrutiny:

> [T]he function of the court's review is to determine the balance of probabilities as to likely future benefit to the corporation, *not to render a decision on the merits*. . . . Where the court determines that the likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action, it should dismiss the case.[180]

174. Some writers have read *Joy* as offering a "new test." *See, e.g.*, *One Year Later*, *supra* note 14, at 404. Yet, no matter how the approach is described, all courts are simply trying to find "a balancing point where bona fide stockholder power . . . cannot be unfairly trampled on . . . but the corporation can rid itself of detrimental litigation." *Zapata* 430 A.2d at 777; *see supra* text following note 49 (describing judicial mechanics of arriving at "balancing point").

175. 692 F.2d at 891.

176. *Id.* Thus, *Joy* demonstrates how a court can determine whether to apply heightened scrutiny to director decisions. The court drew a nice distinction between "direct injury" cases and those involving ultra vires or illegal acts. *See supra* notes 96–109 (cases involving illegal or improper foreign payments).

177. 692 F.2d at 891.

178. *Id.* at 888.

179. *Id.* at 892. "This showing is to be based on the underlying data developed in the course of discovery and of the committee's investigation and the committee's reasoning, not simply its naked conclusions." *Id.* The weight of the evidence put forth by the SLC is to be determined by conventional analysis, involving considerations such as whether the testimony was under oath or subject to cross-examination. *Id.*

180. *Id.* The costs that may be considered in the court's review include attorney's fees and other out-of-pocket expenses related to the litigation, as well as the time spent by corporate personnel preparing for and participating in the trial. *Id.* It is noteworthy that over 80 years ago, the Supreme Court mentioned some of these factors as allowable considerations in a corporate decision whether to pursue a corporate claim. *See* Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903) (strangely not cited in *Joy*).

Scrutinizing the SLC recommendations with a dynamic analysis,[181] the *Joy* court was able to deny summary judgment within the bounds of traditional business judgment rule standards. The court not only altered burdens of proof, but also increased the degree of particularized showing necessary to sustain a motion to dismiss.

IV. CONCLUSION

As corporations have sought to regain some measure of control over the litigation of corporate claims, courts have been forced to develop appropriate standards to judge such corporate actions. This Note has demonstrated that, like other business decisions, a corporate decision to terminate a shareholder derivative suit must be scrutinized within established doctrine.

The dynamic business judgment equation, which has operated historically in this area, continues to apply to corporate acts challenged as improper or illegal.[182] Further, this equation is directly applicable to cases of alleged director malfeasance.[183] The judiciary has constantly searched for the appropriate degree of judicial review for board decisions. As one can see in both the pre-[184] and post-*Zapata*[185] decisions, the courts will closely analyze each factual nuance to establish an appropriate level at which to scrutinize a director's conformity with his performance obligations. Courts and commentators must recognize the dynamic nature of the business judgment rule. Only then can a reasonable sense of coherence be brought to judicial scrutiny (past and future) of board decisions to terminate shareholder derivative suits.

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Should the *Joy* analysis produce a finding of likely net return "not substantial in relation to shareholder equity," 692 F.2d at 892, the court may then consider two other items as costs: the impact of distraction of key personnel by continued litigation, and the lost profits that might result from trial publicity. *Id.* at 892-93. What will amount to a "substantial" net return will likely spark considerable debate. This part of the court's analysis is certainly favorable to the corporate movant. In large, publicly held corporations, it is difficult to imagine a derivative suit ever being able to generate a net return that is substantial in relation to shareholders' equity.

181. *See supra* text following note 49.

182. *See supra* notes 96–109 and accompanying text.

183. *See supra* notes 110–20 and accompanying text.

184. *See supra* notes 121–47 and accompanying text.

185. *See supra* notes 148–81 and accompanying text.