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THE POWER OF DIRECTORS TO TERMINATE SHAREHOLDER LITIGATION: THE DEATH OF THE DERIVATIVE SUIT?

George W. Dent, Jr. *

Shareholders' derivative suits1 have long played2 a crucial role in assuring a modicum of integrity and competence in the management of corporations.3 Nonetheless, real or imagined abuses4 of the derivative

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1 A shareholders' derivative suit is a suit brought by shareholders on behalf of and for the direct benefit of the corporation to redress harm to the corporation. The derivative suit permits a shareholder to assert a corporate claim "[w]hen the corporate cause of action is for some reason not asserted by the corporation itself...." H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 360, at 756 (2d ed. 1970). The derivative suit has also been called a shareholder's or stockholder's suit, and a minority shareholder's suit. See id; W. CARY, CASES AND MATERIALS ON CORPORATIONS 868-69 (4th ed. 1969); Prunty, The Shareholders' Derivative Suit: Notes On Its Derivation, 32 N.Y.U.L. REV. 980, 980 (1957); Stickells, Derivative Suits—The Requirement of Demand Upon the Stockholders, 33 B.U.L. REV. 433, 433 (1953). The derivative suit is to be distinguished from the representative suit, in which the shareholder complains of an injury not to the corporation but directly to himself and other shareholders. Haudek, The Settlement and Dismissal of Stockholders' Actions—Part I, 22 SW. L.J. 767, 768 (1968).

2 The shareholders' derivative suit is often said to have originated with Foss v. Harbottle, 67 Eng. Rep. 189 (Ch. 1843). The right of minority shareholders to secure relief for managerial excesses, however, was recognized in America as early as Robinson v. Smith, 3 Paige Ch. 222 (N.Y. 1832), and in England as early as Hichens v. Congreve, 38 Eng. Rep. 917 (Ch. 1828), 39 Eng. Rep. 58 (Ch. 1829). See generally Ross v. Bernard, 403 F.2d 909, 912 (2d Cir. 1968), rev'd on other grounds, 396 U.S. 531 (1970). The derivative suit has been authorized in nearly all states. E.g., DEL CODE ANN tit. 8, § 327 (1975); N.Y. BUS. CORP. LAW § 626 (McKinney 1963); Berger, "Disregarding the Corporate Entity" for Stockholders' Benefit, 55 COLUM. L. REV. 808, 816 n.60 (1955); Prunty, supra note 1, at 980.

suit process have prompted courts and state legislatures to erect many obstacles to the bringing of these suits. Many of these obstacles seem designed more to thwart all derivative suits, including those that are meritorious, than to prevent alleged abuses.

One such obstacle is the rule adopted in many cases that the board of directors' refusal to sue or its active opposition to the derivative suit will, under some circumstances, warrant dismissal of the suit. Although this rule is by no means new, the courts have begun to use it with increasing frequency. The rule generally has been held not to apply if a majority of the board is implicated in the alleged wrong. Several recent cases, however, have held that if a duly appointed committee of directors (sometimes called a "special litigation committee") not implicated in the alleged wrong decides not to sue, that decision will, under some circumstances, warrant dismissal of the suit. Al-

For a discussion of the alleged abuses, see text accompanying notes 203-22 infra.

These obstacles include the following requirements: ownership of stock at the commencement and during the pendency of the suit; ownership of stock at the time of the alleged wrong, known as the contemporaneous ownership requirement; allegation with particularity of the facts constituting the corporate cause of action, often interpreted to require the plaintiff in effect to plead evidence; demands on the board and the shareholders to take action with respect to the alleged wrong or a showing that such demands would be futile; fair representation of the shareholders by the plaintiff; provision by plaintiff of security for expenses, including attorneys' fees, of the corporation; indemnification of corporate personnel for litigation expenses; bringing of suit within the period of a short statute of limitations for certain actions against directors, officers, and shareholders; and reimbursement of defendants' expenses. See generally H. HENN, supra note 1, §§ 359, 361-367, 372, 378; N. LATTIN, supra note 3, §§ 105-106.

A. CONARD, CORPORATIONS IN PERSPECTIVE § 252, at 399-400 (1976); Dykstra, supra note 3, at 75; Hornstein, New Aspects of Stockholders' Derivative Suits, 47 COLUM. L. REV. 1, 2-3 (1947).

Notwithstanding these obstacles, derivative suits have managed to survive and perhaps even to thrive. See Dykstra, supra note 3, at 74-75 (finding a 50% increase in derivative suits noted in West's Seventh Decennial Digest for 1956-1966 over the number reported for the prior decade). Cf. Note, Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience, 4 COLUM. J.L. & SOC. PROB. 50, 65-66 (1968) (concluding that security-for-expenses statutes are not "a significant deterrent to derivative litigation").

The courts have not distinguished between the board's active opposition to a derivative suit and its mere refusal to sue. There are, however, factors that would warrant the board's refusal to sue but not dismissal of a derivative suit. See text accompanying notes 112 & 162-65 infra.

The rule is at least as old as Hawes v. City of Oakland, 104 U.S. 450 (1882).

See note 31 infra.

A derivative suit generally may be brought only when the board has refused to sue. Thus, a rule permitting the board to terminate derivative suits which, by hypothesis, it refuses to bring itself could mean the death of the derivative suit. A decision by the board or some of its members to terminate litigation against directors entails potential conflicts of interest too serious to ignore. If the board is disabled completely from terminating derivative suits, however, the corporation could be saddled with expensive, frivolous, vexatious litigation. This article will analyze the problems raised by the board's attempt to terminate shareholder suits and will advance proposals to deal with those problems.

THE CURRENT STATE OF THE LAW

Modern corporation laws generally provide that the business of a corporation shall be managed by or under the supervision of a board of directors. 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. When the alleged wrongdoers are not affiliated with the corporation, the board can be expected to weigh dispassionately the benefits and detriments of litigation. Where the directors themselves are alleged to have wronged the corporation, however, a decision by the directors whether to sue themselves obviously would block even a derivative suit against a majority of the directors.

See text accompanying notes 51-69 infra.

Until recently, it could safely be said that a derivative action also could be brought where the board obviously would refuse to sue, as where the alleged wrongdoers constituted a majority of the board or otherwise dominated the corporation. See notes 17-20 and accompanying text infra. If, however, as some courts have recently held, a committee of nonimplicated directors may decide whether such suits should be brought, see text accompanying notes 51-69 infra, plaintiff may not be able to proceed on the theory that in such cases the board obviously would refuse to sue. See Seigal v. Merrick, No. 74-2475, slip op. at 14 (S.D.N.Y. Dec. 20, 1979) (complaint dismissed for plaintiff's failure to make demand on board where board had established a litigation committee).


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ously will not be dispassionate. It is largely to handle such situations that the law permits shareholder suits on behalf of a corporation.

Because the power to manage the corporation resides initially with the board, before commencing a derivative action a shareholder generally must make a demand on the board that it bring a suit seeking redress for the alleged wrong. Where, however, the alleged wrongdoers include a majority of the board or otherwise control the corporation or the board, as through ownership of a majority of the voting stock, the demand is generally excused on the theory that the demand would be futile because those who control the corporation cannot be expected to sue themselves.

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15 Dispassion also may be absent where the alleged wrongdoers are officers or major shareholders who are not also directors. See notes 147 & 153 and accompanying text infra.

16 Although state statutes do not limit derivative suits to actions against officers and directors, most derivative suits take this form. See Conard, supra note 6, § 252, at 401. See Hornstein, The Counsel Fee in Stockholder's Derivative Suits, 39 Colum. L. Rev. 784, 797 (1939) (finding that in nearly all of the 54 successful derivative suits surveyed, "the defendants included one or more directors of the corporation"); Rostow, supra note 3, at 48-49.

17 Hawes v. City of Oakland, 104 U.S. 450, 460-61 (1882); DiFani v. Riverside County Oil Co., 201 Cal. 210, 215, 256 P. 210, 213 (1927); Fleer v. Frank H. Fleer Corp., 14 Del. Ch. 277, 283, 125 A. 411, 414 (1924); Continental Sec. Co. v. Belmont, 206 N.Y. 7, 19, 99 N.E. 138, 142 (1912). See 13 W. Fletcher, supra note 14, § 5963; H. Henn, supra note 1, § 365. See generally Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746 (1960) (hereinafter cited as HARVARD NOTE); Chicago Comment, note 3 supra. Rule 23.1 of the Federal Rules of Civil Procedure requires the plaintiff to "allege with particularity the efforts, if any, 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." Fed. R. Civ. P. 23.1. Many state statutes and court rules are modeled on federal rule 23.1. See, e.g., CAL. Corp. Code § 800(b)(2) (West 1977); N.J. Civ. Prac. R. 432-5; N.Y. Bus. Corp. Law § 626(c) (McKinney 1963).

The purpose of requiring a demand on the board has been stated variously as giving the directors the opportunity to take over the suit, Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975); Lasker v. Burks, 404 F. Supp. 1172, 1178 (S.D.N.Y. 1975), rev'd on other grounds, 567 F.2d 1208 (2d Cir. 1978), rev'd, 99 S. Ct. 1831 (1979); H. Henn, supra note 1, § 364, at 770; giving the board the opportunity to settle the dispute without litigation, thus promoting judicial economy, Winter v. Farmers Educ. & Coop. Union of America, 259 Minn. 257, 262, 107 N.W.2d 226, 233 (1961); Barr v. Wackman, 36 N.Y.2d 371, 379, 329 N.E.2d 180, 186, 368 N.Y.S.2d 497, 505 (1975); and preventing interference in corporate affairs until intracorporate remedies have been exhausted, Chicago Comment, supra note 3, at 171. See also HARVARD NOTE, supra, at 748-49.

18 Meltzer v. Atlantic Research Corp., 330 F.2d 946 (4th Cir.), cert. denied, 379 U.S. 841 (1964) (applying Virginia law); Orlando Orange Groves Co. v. Hale, 107 Fla. 304, 316, 144 So. 674, 678 (1932); Robb v. Eastgate Hotel Inc., 347 Ill. App. 261, 279, 106 N.E.2d 848, 856 (1952); Eston v. Argus, 328 Mich. 554, 556, 44 N.W.2d 154, 155 (1950); Caldwell v. Ebanks, 326 Mo. 185, 192, 30 S.W.2d 976, 979 (1930); Barr v. Wackman, 36 N.Y.2d 371, 379, 329 N.E.2d 180, 186, 368 N.Y.S.2d 497, 505 (1975); H. Henn, supra note 1, § 365; N. Lattin, supra note 3, § 105, at 417.


20 See 13 W. Fletcher, supra note 14, § 5965 and authorities cited therein; H. Henn, supra note 1, § 365; HARVARD NOTE, supra note 17, at 753. Trial courts are afforded considerable discretion in determining whether the demand should be excused. 13 W. Fletcher, supra note 14, § 5965, at 370 & 374 n.2. Federal courts generally have been liberal in excusing demand under
Whether the derivative suit may proceed in the face of the board’s opposition to it is unclear. Most courts have held that the board’s opposition will warrant termination of a derivative suit in some circumstances. These courts disagree, however, as to what the applicable standard is and how that standard should be applied.

The positions taken by the courts in the many cases dealing with the effect of a refusal to sue\(^{21}\) fall into a relatively few categories. A few courts have simply stated, usually in dictum, that the shareholder is automatically entitled to sue derivatively if the board refuses to sue.\(^{22}\) Several courts have held that the board’s refusal to sue on a particular kind of claim (or, in a few cases, on any valid claim) constitutes a breach of trust; therefore, if a shareholder’s complaint states such a claim, the board’s refusal to sue will not bar the derivative suit.\(^{23}\) Most courts have held, however, that the board’s refusal to sue falls within the business judgment rule\(^{24}\) and blocks the derivative suit unless the plaintiff shows some defect in the board’s action.\(^{25}\)

\(^{21}\) Although this article will mention over 50 such cases, it is surprising that so many derivative suits have proceeded without discussing this issue. Since a derivative suit generally may proceed only if the corporation has declined to sue after receiving a shareholder’s demand that it sue, see notes 12 & 17 supra, one would imagine that nearly every derivative suit would follow the board’s refusal to sue and would thus face the question of the effect of that refusal. In cases not raising this question, perhaps defense attorneys either viewed a defense based on the refusal as hopeless because a majority of the board was implicated in the alleged wrong or simply overlooked the defense.


The business judgment rule provides that directors shall not be liable for harm to the corporation resulting from their decisions if those decisions lie within the powers of the corporation and the authority of management and were reasonably made in good faith and with loyalty and due care;\(^{26}\) that is, directors are not to be held liable if they have fulfilled all their duties to the corporation.\(^{27}\) In many cases, the courts have overlooked or ignored these requirements of the rule.\(^{28}\) Techni-


It is widely agreed that the business judgment rule requires due care, which generally imports a negligence standard. Briggs v. Spaulding, 141 U.S. 132, 151-52 (1891); Miller v. American Tel. & Tel. Co., 507 F.2d 759, 762 (3d Cir. 1974); Hun v. Cary, 82 N.Y. 65, 72-74 (1880); Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944); 3A W. FLETCHER, supra note 14, § 1039, at 38, 42 n.9, § 1040, at 44, 45 n.1; H. HENN, supra note 1, § 234, § 242, at 483; N. LATTIN, supra note 3, § 78, at 274. Thus, the rule is consistent with statutes adopted in many states requiring directors to act with due care or ordinary prudence. See, e.g., N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1979-1980). Some courts have held the standard of care to be one of gross negligence. 3A W. FLETCHER, supra note 14, § 1029, at 12 N. LATTIN, supra note 3, § 78, at 274 & nn.12 & 13. This test has been criticized and generally is not followed, 3A W. FLETCHER, supra note 14, § 1029, at 12, § 1040, at 44, 45 n.5; N. LATTIN, supra note 3, § 78, at 274, although courts have tended to define negligence narrowly. See note 37 infra.

The duty of due care requires not only good faith and a modicum of effort, but also proper skill and a reasonable basis for any judgment reached. Hun v. Cary, 82 N.Y. 65, 74 (1880); 3A W. FLETCHER, supra note 14, § 1040, at 44, 45 n.1 & 2, § 1055, at 65 & n.2, § 1061, at 74; H. HENN, supra note 1, § 242, at 482-83. Thus, "a director is chargeable with the knowledge actually possessed or which he might have possessed had he diligently discharged his functions." 3A W. FLETCHER, supra note 14, § 1029, at 12. Accord, id., § 1059, at 68, 69 n.1; H. HENN, supra note 1, § 234, at 453.

\(^{27}\) See H. HENN, supra note 1, § 242, at 483 ("Business judgment thus, by definition, presupposes an honest, unbiased judgment (compliance with fiduciary duty) reasonably exercised (due care), and compliance with other applicable requirements."). The rule does not bar inquiry into the directors' independence. Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927 (1979). It is often stated that the rule frees directors from liability for errors of judgment, but the rule is unnecessary for that purpose because none of the directors' duties imposes such liability in any case.

\(^{28}\) Many courts have dismissed derivative suits on the ground that the directors' refusal to sue was sacrosanct under the business judgment rule, even though the courts made no real inquiry as to whether the decision not to sue (and to oppose the derivative suit) was reached with due care (including a reasonable investigation) and skill, without any conflict of interest, and had a reasonable basis. For example, the business judgment rule does not warrant dismissal of a complaint on a motion for summary judgment—unless plaintiff admits that the directors have satisfied the rule—because such a motion raises issues of fact regarding the directors' due care and loyalty. Nonetheless, many suits have been dismissed on summary judgment on the basis of the business judgment rule. See, e.g., Ash v. International Bus. Mach., Inc., 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966); Stadin v. Union Elec. Co., 309 F.2d 912 (8th Cir. 1962), cert. denied, 373 U.S. 915 (1963); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).
cally, the rule would seem irrelevant as to the effect that a refusal to sue has on a derivative suit, since the derivative suit seeks neither to hold the directors liable for their refusal to sue nor to compel the corporation to sue. 

Nevertheless, the derivative suit is usually barred unless the plaintiff can demonstrate that the board's decision not to sue was *ultra vires*, or made fraudulently, in bad faith, in breach of trust, or the like. The board's involvement or collusion in the alleged wrongdoing and inexcusable neglect have also been cited as grounds for allowing the derivative suit to proceed despite a refusal to sue. A few cases cited in note 25 supra.

29 See cases cited in note 25 supra.


The board's refusal to sue generally will not thwart the suit where a majority of directors is involved in the alleged wrong. See Hawes v. City of Oakland, 104 U.S. 450, 460 (1882) (plaintiff may sue if he alleges that a majority of the directors "are acting for their own interest"); Galef v. Alexander, No. 79-7166, slip op. at 5905 (2d Cir. Jan. 22, 1980) (court may dismiss where a disinterested board majority opposes the suit); Ash v. International Bus. Mach., Inc., 353 F.2d 491, 493 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966) (plaintiff must allege "that the directors of the corporation are personally involved or interested in the alleged wrongdoing"); Swanson v. Traer, 240 F.2d 854, 858 (7th Cir. 1957) (suit dismissed where a majority of directors was "admittedly honest" and "not involved in the alleged wrong"); Nussbacher v. Chase Manhattan Bank (N.A.), 444 F. Supp. 973, 977 (S.D.N.Y. 1977) (summary judgment denied where the board "participated in and allegedly approved the transaction under attack"); Issner v. Aldrich, 254 F. Supp. 696, 699, 701 (D. Del. 1966) (suit dismissed where majority of directors is not "guilty of any particular wrongdoing . . . or improper self interest" in the challenged transactions).

courts have added that the court may inquire into the reasonableness of the board's refusal to sue.\(^\text{33}\)

Moreover, the defects in board action cited by courts as sufficient to permit a derivative suit are largely dicta, bearing little relation to the facts.\(^\text{34}\) This increases the difficulty of determining where the courts stand on many questions. For example, although only a few courts have stated that a derivative suit may proceed if the board's refusal to sue is alleged to be unreasonable, no court has expressly stated that such an allegation is insufficient to permit the plaintiff to proceed. Usually, the court gives only a general list of defects that does not include the unreasonableness of the directors' decision.\(^\text{35}\) Moreover, since plaintiffs rarely allege that the board's refusal was unreasonable, the courts have seldom ruled on such an allegation. Thus, the applicability and scope of the business judgment rule in the context of refusals to sue remain unsettled.

The duties of loyalty and due care, which the business judgment rule incorporates, are themselves of uncertain scope. Although due care is usually said, often in statutes, to import a "prudent man" or negligence standard,\(^\text{36}\) it is clear that in practice courts rarely hold directors liable for negligence alone.\(^\text{37}\) Where a conflict of interest is involved, however, courts scrutinize directors' acts much more carefully. This has led some to state that the business judgment rule does not apply to


\(^{34}\) See, e.g., Hawes v. City of Oakland, 104 U.S. 450, 460 (1882), where the Court cited ultra vires acts, fraud, illegal and oppressive acts or self-dealing by the majority as acts sufficient to permit a derivative suit to proceed. Since the complaint in Hawes alleged no such acts, however, the list is of limited value.

\(^{35}\) See notes 25-27 and accompanying text supra.

\(^{36}\) See, e.g., N.Y. Bus. Corp. Law § 717 (McKinney Supp. 1979-1980) ("that degree of care which an ordinarily prudent person in a like position would use under similar circumstances"). See generally H. Henn, supra note 1, § 234. See also note 26 supra.

\(^{37}\) See Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L.J. 1078, 1099 (1968) ("The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.").
acts entailing conflicts of interest. The statement is unnecessary, though, because the rule requires compliance with the duty of loyalty and thus, if applicable, requires the same careful scrutiny that courts otherwise give to conflicts of interest.

A further problem is that the courts have rarely spelled out what facts plaintiff must allege to make a sufficient pleading of the directors' bad faith, lack of independence, or involvement or collusion in the wrong, nor have the courts indicated to what extent plaintiffs are entitled to discovery and a trial to unearth and prove the necessary facts. No court has expressly denied that allegations of bias, collusion, bad faith, or unreasonableness raise questions of fact. Yet, while a few courts have stated that these allegations can be resolved only after discovery or only at trial, others have dismissed complaints containing such allegations for want of sufficient particularity.

In short, one can rarely predict what standard a court will apply and how it will apply that standard to the question whether the board's opposition warrants dismissal of a derivative suit against corporate insiders. One point is settled, however: even where a plaintiff's claims are based on federal law, the effect of the board's refusal to sue generally will be determined by reference to state law. In *Burks v. Lasker*, the Supreme Court held that the Investment Company Act of 1940 and the Investment Advisers Act of 1940 "did not require that States, 38 Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L REV. 562, 564 (1967).

39 It is not clear what facts plaintiff must allege to plead either acquiescence by the board in the wrong or domination of the board by the wrongdoers. Apparently, a bare claim of acquiescence will not suffice. See *Findley v. Garrett*, 109 Cal. App. 2d 166, 240 P.2d 421 (1952). Compare *Koral v. Savory*, Inc., 276 N.Y. 215, 220, 11 N.E.2d 883, 886 (1937) (domination of corporate receiver sufficiently pleaded by allegations that he was a clerk in the office of the attorneys of the alleged wrongdoers) with *Issner v. Aldrich*, 254 F. Supp. 696, 701 (D. Del. 1966) (domination of board not sufficiently pleaded by allegations that alleged wrongdoer, itself a corporation, was the corporation's largest shareholder, with more than 12% of its stock, and had three of its employees on the corporation's 17-member board). See also *Barr v. Wackman*, 36 N.Y.2d 371, 379, 329 N.E.2d 180, 186, 368 N.Y.S.2d 497, 506 (1975) (allegations of acquiescence held sufficient where "based on formal action of the board in which the individual directors were participants"). See also notes 226-27 infra.

40 Bernstein v. Mediobanca Banca di Credito Finanziario-Società per Azioni, 69 F.R.D. 592, 598 (S.D.N.Y. 1974) (permitting discovery only of matters "relating to the business judgment defense").


45 Id. §§ 80b-1 to 80b-21.
or federal courts, absolutely forbid director termination of all nonfrivo­
lous [derivative] actions.\textsuperscript{46} Although the Court technically left open
on remand the question whether in this particular case federal law for­
bade such termination under state law, Justice Brennan's majority
opinion suggests that it does not.\textsuperscript{47} If the Court finds the state law con­
sistent with the Investment Company and Investment Advisers Acts,
which were intended to deal with the especially difficult problems of
conflicts of interest of investment advisers and directors of investment
companies,\textsuperscript{48} probably it will also find the state law to be consistent
with most or all federal law,\textsuperscript{49} except federal laws expressly providing
for derivative suits.\textsuperscript{50}

\textbf{The Special Litigation Committee}

Although the courts generally have held that the board's refusal to
sue will not block a derivative suit naming a majority of the directors as
defendants,\textsuperscript{51} a few corporations facing such actions recently have estab­
liッシュed committees of allegedly independent directors to investigate
the allegations of shareholders' complaints and have argued that the
decisions of such committees not to sue warrant dismissal of the deriva­
tive suits. Nearly all of these "special litigation committee" cases have
involved attacks on questionable payments. Such cases raise several
unusual issues, and thus may be of limited precedential value to other
kinds of derivative suits.\textsuperscript{52} Nevertheless, acceptance of the corpora­

\textsuperscript{46} 99 S. Ct. at 1841.
\textsuperscript{47} The Court stated that "Congress consciously chose to address the conflict of interest prob­
lem through the Act's independent directors section, rather than through more drastic remedies,"
and that "when Congress did intend to prevent board action from cutting off derivative suits, it
said so expressly." \textit{Id.} at 1840. Justices Stewart and Powell, concurring, saw no "danger that state
law will conflict with federal policy," \textit{id.} at 1842, although Justice Blackmun, concurring, stated
that such conflicts "could very well exist. . . ." \textit{Id.} at 1841.
\textsuperscript{48} \textit{Id.} at 1838-39.
\textsuperscript{49} See \textit{Lewis v. Anderson, Fed. Sec. L. Rep. (CCH) \textsuperscript{\textregistered} 97,153} (9th Cir. 1979) (holding state law
permitting board termination of derivative suits consistent with rule 10b-5); \textit{Maldonado v. Flynn,
No. 77-3180, slip. op. at 8-13} (S.D.N.Y. Jan. 24, 1980) (finding board termination consistent with
Securities Exchange Act \textsuperscript{\$} 14(a)); \textit{Abbey v. Control Data Corp., 460 F. Supp. 1242, 1244-45} (D.
Minn. 1978) (distinguishing the Court of Appeals decision in \textit{Lasker} and holding that the Securi­
ties Exchange Act of 1934 does not preclude use of the business judgment rule to block a deriva­
Alexander, No. 79-7166, slip. op. at 5920-21} (2d Cir. Jan. 22, 1980) (finding board termination
inconsistent with Securities Exchange Act \textsuperscript{\$} 14(a) where all directors were defendants).
\textsuperscript{50} For example, state procedural obstacles to derivative suits (such as contemporaneous own­
ership and posting of security for expenses) often are held inapplicable to suits under \textsuperscript{\$} 16(b) of
Thus, courts will probably hold that the power of the board to terminate a \textsuperscript{\$} 16(b) suit is governed
by federal law.
\textsuperscript{51} See note 31 \textit{supra}.
\textsuperscript{52} See notes 169-74 and accompanying text \textit{infra}.
tions' arguments has disturbing implications.

One of the first cases to consider this argument, *Gall v. Exxon Corp.*, is typical. In 1975 Exxon’s board of directors established a Special Committee on Litigation to investigate allegations by Gall and others regarding questionable payments made by Exxon's Italian subsidiary and to determine whether the corporation should sue any of its own or its subsidiary's officers or directors regarding such payments. The committee concluded that the president of the subsidiary had made substantial unauthorized payments and that several directors of Exxon named as defendants in *Gall* knew of the payments at the time they were made. The committee concluded, however, that it would be detrimental to Exxon and its shareholders for Exxon, or anyone on its behalf, to sue any Exxon director or officer, and the committee therefore authorized Exxon’s officers and general counsel to oppose all derivative suits relating to the payments. The committee cited as reasons for its decision the poor prospects for success of the litigation, the cost of conducting the litigation, the interruption of corporate affairs, and the undermining of personnel morale.

Despite the committee's conclusions, several shareholders continued the suit against several Exxon directors. The defendants moved to dismiss the complaint in reliance on the committee's decision. Although the court initially denied the motion, the denial was a pyrrhic victory for plaintiffs. The court, holding that the matter was governed by the business judgment rule, rejected all plaintiffs' arguments that the use of the special committee was inherently defective and denied defendants' motion only for the purpose of permitting plaintiffs to conduct discovery to determine whether the committee members had acted in bad faith or were involved or interested in the alleged wrongs. After plaintiffs had conducted this limited discovery, the court granted the

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54 Id. at 510-11.
55 Id. at 511. The committee found that the unauthorized payments totaled at least $29 million, plus $27.9 million in contributions to Italian political parties. The president of the subsidiary maintained secret bank accounts to facilitate these payments.
56 Id. at 512.
57 Id. at 514.
58 Id. at 514 n.13.
59 Plaintiffs had argued that, since the full board of Exxon remained free to override the committee's resolution, the decision not to sue was in effect the decision of the full board, which was dominated by the defendants, and that the refusal to sue amounted to an impermissible ratification of illegal acts. Id. at 516-17. See notes 123-26 and accompanying text infra. Moreover, the court found "not a scintilla of evidence" that the Italian payments were in any way illegal. 418 F. Supp. at 518-19. In light of the latter finding, the result in *Gall* may be correct, although the court's path to that result is objectionable.
60 418 F. Supp. at 519-21. The court also spoke of determining whether the committee members were "independent" but the court's opinion makes it clear that by independence the court meant nothing more than an absence of involvement in the questionable payments. The court's
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renewed motion for summary judgment dismissing the complaints. In Auerbach v. Bennett, the most important case on point to date, the New York Court of Appeals ordered dismissal of a derivative suit on the ground that a special litigation committee of disinterested directors had decided to terminate the suit and that the business judgment rule placed this decision beyond judicial scrutiny so long as the committee had used appropriate “investigative methods.” The unusual procedural setting of the case leaves some doubt, however, as to the scope of the court’s holding.

In other cases involving special litigation committees the courts generally have followed Gall and Auerbach, holding that judicial scrutiny of the board’s refusal to sue is limited by the business judgment rule. They have divided, however, on whether to permit discovery or to dismiss without permitting even the limited discovery granted in Gall. Dismissal often has been premised on the plaintiff’s failure to plead the bad faith or lack of independence of the committee. After opinion followed this definition of independence. Gall v. Exxon Corp., No. 75-3682, slip op. at 4-5 (S.D.N.Y. Jan. 17, 1977).

63 Id. at 636, 393 N.E.2d at 1003, 419 N.Y.S.2d at 930.
64 The plaintiff did not appeal dismissal by the trial court. Another shareholder then intervened and prosecuted the appeal. The intervenor, however, was saddled with Auerbach’s complaint, the allegations of which were weak on the issues of the committee’s lack of independence and the inadequacy of the committee’s investigation.


though the courts seem to agree that such a pleading entitles the plaintiff to at least limited discovery, several courts have adopted, without much consideration, a narrow concept of what constitutes a lack of independence, most indicating that only active involvement in the alleged wrongs negates independence.67 Except in Auerbach, there has been little discussion of what constitutes an adequate investigation by the noninterested directors;68 nor have the courts discussed the burden of proof as to independence, although it seems that the burden has


67 See Lewis v. Anderson, Fed. Sec. L. Rep. (CCH) ¶ 97,153 (9th Cir. 1979) (court approved presence on committee of one director, even though he was named as a defendant for having acquiesced in the transaction in question, because he did not profit therefrom); Maldonado v. Flynn, No. 77-3180, slip. op. at 13-16 (S.D.N.Y. Jan. 24, 1980) (committee member held independent although he was a partner with committee’s special counsel); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 825 (S.D.N.Y. 1979) (court held two outside directors disinterested as to suit challenging questionable payments, even though one was a defendant and the other a potential defendant in their capacities as directors for other corporations that had made questionable payments); Auerbach v. Aldrich, N.Y.L.J., Dec. 23, 1977, at 13, col. 5 (Sup. Ct. 1977). Cf. Gall v. Exxon Corp., No. 75-3682, slip op. at 4-7 (S.D.N.Y. Jan. 17, 1977) (plaintiff must show directors "were either personally involved . . . or at least sufficiently interested in" the alleged wrongs); Auerbach v. Bennett, 47 N.Y.2d 619, 632, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927 (1979) (no triable issue as to independence of directors who were not on board and had no affiliation with corporation at time of alleged wrongs). But cf. Wallenstein v. Warner, N.Y.L.J., May 9, 1978, at 11, col. 6 (Sup. Ct. 1978) (possible knowledge of wrongdoing by committee member raised question as to his independence). See also Abbey v. Control Data Corp., 460 F. Supp. 1242, 1244 (D. Minn. 1978), aff’d, 603 F.2d 724 (8th Cir. 1979), cert. denied, 100 S. Ct. 670 (1979) (plaintiff conceded committee’s independence).

68 The court in Auerbach held that courts may inquire into the directors’ selection of investigative procedures, but may not, absent a showing of bad faith, inquire into the directors’ weighing of factors after the conclusion of the investigation. Since the complaint did not challenge the adequacy of the investigation, however, summary judgment was appropriate on this point. Auerbach v. Bennett, 47 N.Y.2d 619, 633-34, 393 N.E.2d 994, 1002-03, 419 N.Y.S.2d 920, 928-29 (1979). See also Maldonado v. Flynn, No. 77-3180, slip op. at 20-21 (S.D.N.Y. Jan. 24, 1980) (following Auerbach); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 824-26 (S.D.N.Y. 1979) (court found investigation adequate, though not without flaws); Abbey v. Control Data Corp., 460 F. Supp. 1242, 1244 (D. Minn. 1978), aff’d, 603 F.2d 724 (8th Cir. 1979), cert. denied, 100 S. Ct. 670 (1980) (plaintiff conceded adequacy of committee’s investigation).
Summary and Implications

The special litigation committee cases may presage the demise of the derivative suit. When faced with a derivative suit, defendant directors will invariably request an investigation and decision by some fellow directors as to whether the suit is in the best interests of the corporation. The defendants have nothing to lose in so doing—at worst, the nonimplicated directors will decide to take over the suit, or to take a neutral stance toward the suit, leaving the defendants no worse off than when they started. More important, the prospect of such a decision is minimal; almost invariably, the directors charged with the decision decide to oppose the suit. In most cases, this opposition will result in dismissal of the suit unless the deciding directors are shown to be directly implicated in the alleged wrong or are so clumsy as to be found to have acted in bad faith. Such opposition can even block plaintiff's discovery as to defendants' alleged misdeeds.

It is doubtful whether the shareholders' derivative suit deserves the sudden interment it is being given. At the very least, pronouncement of this death sentence by the courts constitutes unjustifiable judicial legislation. More shocking is that the courts have neither offered a rationale for condemning the derivative suit nor even acknowledged that they have condemned it. One hopes that the courts simply do not realize that they are endangering the derivative suit and that once they do realize it they will act quickly to reverse the trend by significantly restricting the board's power to terminate derivative suits.

Proposed Standards of Judicial Review

When, if ever, should the decision not to sue, made by the full board of directors or a special litigation committee of supposedly disinterested directors, serve to terminate a shareholders' derivative suit? Clearly, not every derivative suit should be allowed to proceed in the face of the board's opposition. Even a meritorious suit may produce significant litigation costs for the corporation, diversion of corporate employees, detriment to personnel morale, and adverse publicity far outweighing any benefit that might be derived from a judgment in behalf of the corporation. If the suit is groundless, the cost to the corpo-

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69 See note 18 infra.
70 Although there are no statistics available, there are many reported cases where the directors have refused to sue after receiving a demand. See, e.g., cases cited in notes 26-29 & 43-58 supra.
71 In no case known to the author have the directors agreed to sue.
72 See notes 25, 59, 62 & 65 and accompanying text supra.
73 See notes 60-61 & 66 and accompanying text supra.
74 See generally text accompanying notes 162-64 & 232-40 infra.
ration is incurred without any compensating benefit, and is often compounded by the necessary indemnification of the defendants for attorneys' fees.\textsuperscript{75}

Yet, the existence of some suits that should not be brought does not mean that directors should be able to terminate all derivative suits at will. The importance of derivative suits in protecting minority shareholders from abuses by corporate insiders has been well-documented.\textsuperscript{76} The courts have recognized that the very insiders accused of injuring the corporation cannot be expected to sue themselves, and thus have held that the refusal of the full board to sue a majority of its members does not bar a derivative suit.\textsuperscript{77} There are also good reasons for a court to be skeptical even where the refusal to sue is made by a committee of supposedly disinterested directors.

Both inside and outside directors and their counsel are subject to heavy pressures not to take steps adverse to their fellow directors.\textsuperscript{78} Even genuinely independent directors cannot be expected to investigate alleged wrongs by their colleagues with the zeal of a plaintiff's attorney motivated by the prospect of receiving a large fee if he is successful.\textsuperscript{79} Where the corporation may have been injured by persons unaffiliated with the corporation, however, the directors can be expected to weigh dispassionately the merits of a suit to seek redress. Accordingly, the board should be able to terminate suits against unaffiliated persons subject only to compliance with the business judgment rule, but the board should never be able to block a derivative suit in which a majority of the directors is implicated. Moreover, where any derivative suit implicates a minority of the directors or other insiders, board opposition to the suit should not lead to dismissal unless the court is satisfied after weighing several factors that dismissal is appropriate.

\textit{Suits Implicating a Majority of the Directors}

Where a majority of the directors is implicated in a wrong alleged in a derivative suit, a refusal to sue by either the full board or a committee established by the full board should never block the suit. Neither the directors nor outside counsel can be truly independent in such cases. Moreover, the shareholders have a right to something more than an objective investigation by disinterested persons.

\textsuperscript{75} Indemnity of a director or officer who defends a derivative suit with some success is often required or permitted by statute. \textit{See, e.g.,} \textsc{Del. Code Ann. tit. 8, \$\ 145} (1975); \textsc{N.Y. Bus. Corp. Law} \textsc{\$\$\ 721-727} (McKinney 1963 \& Supp. 1979-1980); \textsc{Henn, supra} note 1, \$\ 380. Corporate by-laws and charters and employment agreements often provide for indemnification where permitted by law. \textit{See id.} \$\ 379.

\textsuperscript{76} \textit{See note 3 supra.}

\textsuperscript{77} \textit{See note 31 supra.}

\textsuperscript{78} \textit{See text accompanying notes 80-115 infra.}

\textsuperscript{79} \textit{See text accompanying notes 116-29 infra.}
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Independence of the Directors.—When charges are leveled against a majority of the directors, the pressures on even nonimplicated directors are so great as to justify a conclusive presumption that they cannot independently investigate and weigh the facts and reach a conclusion that is in the best interest of the corporation. This presumption is supported both by scholarly analyses of directors’ behavior and by comparisons to other areas of the law where independence is required of those who sit in judgment of others.

Most apparent is the probable lack of independence of inside directors—those who are also officers of the corporation. If the defendants in the derivative suit include his superior officers, the inside director cannot be expected to act independently; the same officers whom he is to judge will determine his future salary, fringe benefits, and promotions.80 Even if the defendants are subordinates of the inside director, his investigation will not likely be dispassionate. Corporate officers cannot run a business effectively without the cooperation of lower level managers,81 and a decision to sue a subordinate could well undermine the cooperation of lower officers generally by instilling fear that upper management will not be loyal to them. Furthermore, an inside director’s decision to sue subordinate officers could raise embarrassing questions, and the prospect of liability, with respect to his selection and supervision of subordinates.82

The independence of outside directors also may be compromised in many ways. The selection of outside directors is usually controlled by the senior management of the corporation,83 which seeks to name


81 Indeed, it is sometimes posited that effective power in the corporation “is lodged deeply in the technical, planning and other specialized staff,” and that interference with the technocracy by higher management creates serious problems. J. GALBRAITH, THE NEW INDUSTRIAL STATE 69 (1967).

82 Officers and directors may be held liable for negligence in selecting or supervising corporate agents or employees. H. HENN, supra note 1, § 234, at 456. See generally 3A W. FLETCHER, supra note 14, §§ 1065-1100.

83 Often the chief executive officer nominates new outside directors. HEIDRICK & STRUGGLES, inc., THE CHANGING BOARD 8 (1977) (in 46.5% of 1,000 corporations surveyed, the chief executive officer is “the initial decisionmaker regarding a prospective director”). See also C. BROWN, PUTTING THE CORPORATE BOARD TO WORK 28 (1976); M. EISENBERG, supra note 80, at 146; M. MACE, supra note 80, at 94, 108; Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 Va. L. Rev. 1099, 1233-34 (1977); Leech & Mundheim, supra note 80, at 1830; Soderquist, Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors, 52 N.Y.U. L. Rev. 2441, 1330 (1977). Cf. Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 34 (1962) (independent directors of mutual funds are selected by the controlling management group). It is widely recognized that, absent exceptional circumstances, nomination is tantamount to election. C. BROWN, supra, at 23; Weiss & Schwartz, Disclosure Approach for Directors, 56
individuals who will not “rock the boat.” Most outside directors share similar social and professional backgrounds and general attitudes with their inside director colleagues. Most are themselves corporate executives, often with firms that do business with the corporation, and thus are unlikely to look favorably on shareholder interference with management generally, or on derivative suits seeking to foist liability on corporate directors. Outside directors are often friends of high executives in the corporation before becoming directors, and even if not, friendships among directors naturally grow during their tenures on the board. Furthermore, the outside director is indebted to his fellow directors for the income and prestige he derives from his position, and he depends on those same directors for the continued re-

Harv. Bus. Rev. 18, 24 (Jan.-Feb. 1978). Management control of nominations is reduced when, as is becoming more common, the nomination of new directors is handled by a committee of outside directors, but even in those cases the committee is likely to bow to management’s suggestions. Solomon, supra note 80, at 605-06. At the very least, the chief executive officer usually has a tacit veto power over new nominations. Coffee, supra, at 1233. But see “Independent” Panels of Corporate Boards to Top New Directors Are Proliferating, Wall St. J., Feb. 15, 1979, at 12, col. 2 (citing view that nominating committees will bring “a more objective approach to director selection, which will result in more independent directors and decisions”).

M. Eisenberg, supra note 80, at 146. Accord, M. Mace, supra note 80, at 99, 108; Leech & Mundheim, supra note 80, at 1826-27; Solomon, supra note 80, at 584-85. See also Nuit, A Study of Mutual Fund Independent Directors, 120 U. Pa. L. Rev. 179, 219 (1971) (“[A] reasonable man . . . will not join a board [of a mutual fund] if he knows that he cannot support the existing fund-adviser relationship . . .”).


J. Bacon, Corporate Directorship Practices: Membership and Committees of the Board 29, 39 (1973); M. Mace, supra note 80, at 87, 96-97, 106, Nuit, supra note 84, at 217; Soderquist, supra note 83, at 1350-51; Solomon, supra note 80, at 584 & n.13; Weiss & Schwartz, supra note 83, at 24.

Moscow, The Independent Director, 28 Bus. Law. 9, 11 (1972); Solomon, supra note 80, at 590. See Leech & Mundheim, supra note 80, at 1830; Cf. M. Eisenberg, supra note 80, at 146 (“approximately one-fifth to one-quarter of the outside directors . . . are lawyers or investment bankers,” most of whom “are suppliers of services to the corporation”). But see Lubin, Outsiders In: Firms Adding More Independent Directors But Finding Doing So Can Mean Headaches, Wall St. J., May 26, 1978, at 38, col. 1 (stating that recently fewer outside directors have been “quasi-insiders”).

See Solomon, supra note 80, at 584 & n.13. But cf. Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 825 (S.D.N.Y. 1979) (court held two outside directors disinterested as to suit challenging questionable payments even though one was a defendant and the other a potential defendant in their capacities as directors for other corporations that had made questionable payments).

M. Eisenberg, supra note 80, at 146; M. Mace, supra note 80, at 95, 97-100; Solomon, supra note 80, at 584-85. See J. Bacon, supra note 86, at 28 & Table 4. But cf. Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce, 94th Cong., 2d Sess. 140 (1976) (statement of Richard M. Cyert) (“[r]ecruitment [of new directors] is not a question of the president getting his friends on the board”) [hereinafter cited as Corporate Rights: Hearings]. See also Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978), rev’d on other grounds, 99 S. Ct. 1831 (1979).
Both inside and outside directors are discouraged from independence by pressures to conform, sometimes referred to as “group-think.” The pressure to conform is great enough in ordinary matters of corporate planning, where board rejection of a management proposal would produce nothing more than annoyance. The pressure is much more onerous when the directors are asked to subject a fellow director to a suit that could lead to major financial liability, loss of job, and public humiliation. When a minority of directors is asked to sue the majority, the pressure may be unbearable. Abstention by or recusal of the interested directors does not solve the problem.

90 Selection of outside directors by management inspires feelings of loyalty to management among the directors so selected. M. Eisenberg, supra note 80, at 146-47; Moscow, supra note 87, at 11. If feelings of loyalty are inadequate to the purpose, the chief executive officer’s power over renomination of incumbents may do the trick. M. Eisenberg, supra note 80, at 147; Leech & Mundheim, supra note 80, at 1830; Solomon, supra note 80, at 605-06. See also Heidrick & Struggles, Inc., Profile of the Board of Directors 11 (1971) (nearly 37% of corporations surveyed reported “firing” directors). But cf. M. Eisenberg, supra note 80, at 147 n.40 (noting ambiguity in this statistic).

91 See Coffee, supra note 83, at 1233-34. But see Corporate Rights Hearings, supra note 89, at 140. At the very least, the clubby atmosphere and traditional etiquette of the corporate boardroom undermine any inclination toward independence. M. Mace, supra note 80, at 52, 54; Soderquist, supra note 83, at 1361 n.120.

92 Outside directors who oppose management may be told that such behavior is “inappropriate” or may be asked to resign. M. Mace, supra note 80, at 80. Usually the board will not act until a problem has reached crisis proportions. Id. at 41; Solomon, supra note 80, at 583. See M. Eisenberg, supra note 80, at 140-41, 170; Solomon, supra note 80, at 584 n.13, 585; Weiss & Schwartz, supra note 83, at 24.

93 See Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978), rev’d on other grounds, 99 S. Ct. 1831 (1979), where the court of appeals said, “It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned.” See also Fogel v. Chestnutt, 533 F.2d 731, 750 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976).

Even where the issue is not a suit against directors but dissatisfaction with the chief executive officer, the directors usually keep silent or resign. M. Mace, supra note 80, at 33-36. See Weiss & Schwartz, supra note 83, at 24.

94 See Cohen v. Industrial Fin. Corp., 44 F. Supp. 491, 494 (S.D.N.Y. 1942), where the court stated:

The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority. Where we know that puppet directors would be involved only to go through the motions, are we barred from considering who would be manipulating the wires?

95 See Allegheny Corp. v. Kirby, 344 F.2d 571, 575 (2d Cir. 1965), cert. dismissed, 384 U.S. 28 (1966), where Judge Hays said in dissent: “No one who knows anything about the conduct of corporate enterprise considers that the major stockholders’ withdrawal from the room when a vote is taken amounts to anything more than an empty ceremonial.” See also Schoenbaum v. Firstbrook, 405 F.2d 200, 215 n.2 (2d Cir.) (Hays, J., dissenting), rev’d, 405 F.2d 215 (2d Cir. 1968) (en banc) (majority opinion by Hays, J.), cert. denied, 395 U.S. 906 (1969).
though most studies confronting the problem of lack of independence among corporate directors have recommended approaches to produce a more independent board, it has been questioned whether any of these recommendations can succeed. For present purposes, however, such recommendations are superfluous: if minority directors cannot dispassionately decide whether to sue the majority, the solution is to allow the derivative suit to proceed and let a court decide the case on its merits.

The inherent conflict of interest that arises when directors are asked to pass judgment on fellow directors has been tacitly recognized by statutes and case law regarding other aspects of derivative suits. For example, although most state statutes provide mechanisms for board resolution of matters in which some directors are interested, the courts have nonetheless relieved the shareholder of the burden of making a demand on the board before commencing a derivative suit implicating a majority of the board. The courts have recognized that such a demand would be pointless since no action by the independent directors could be considered determinative of whether the derivative suit should proceed. Similarly, in many derivative suits the courts have insisted that the corporation appear by independent counsel, or even

96 See C. Brown, supra note 83, at 33 (arguing that the chief executive officer should be the only inside director); M. Eisenberg, supra note 80, at 175-76 (suggesting a majority of independent directors who also control proxy machinery); Coffee, supra note 83, at 1234 (stressing independent nominating committee); Leech & Mundheim, supra note 80, at 1830 (emphasizing independent nominating committee); Moscow, supra note 87, at 11-12 (suggesting random selection from list of eligible directors); Weiss & Schwartz, Using Disclosure to Activate the Board of Directors, 41 Law & Contemp. Prob. 63, 99 (1977) (advocating greater disclosure of directors' backgrounds and activities).

97 See generally Solomon, note 80 supra.

98 The author's present purpose is not to question the efficacy of outside directors, although others have raised such questions. M. Eisenberg, supra note 80, at 140-41; Solomon, supra note 80, at 610 & n.123. Even if one concede that outside directors can often be effective, it is too much to expect them to be genuinely independent and disinterested in deciding whether their colleagues should be sued.

99 The mechanisms include delegation of board powers to a committee, see Note, Executive Committees—Creation, Procedures, and Authority, 1967 Wash. U.L.Q. 42, 42 n.4 (1967) (list of such state statutes), and empowering the noninterested directors to act for the board even if they do not otherwise constitute a quorum, see, e.g., Del. Code Ann. tit. 8, § 144 (1975); N.Y. Bus. Corp. Law § 713 (McKinney 1963).

100 See notes 18-20 and accompanying text supra.

101 Cf. Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22 (1st Cir. 1978) (possibility that interested directors might disqualify themselves did not justify requiring demand on board with two interested and two noninterested directors). It would create an awkward, if not anomalous, situation if, in a suit against a majority of the directors, the plaintiff did not have to make a demand on the board, but the noninterested minority directors could subsequently terminate the suit. If cases like Gall are to be followed, it would seem logical to require a demand on the board in all derivative suits. See Seigal v. Merrick, No. 74-2475, slip op. at 14 (S.D.N.Y. Dec. 20, 1979) (complaint dismissed for failure to make demand on board where board had established a litigation committee).
that the corporation take a neutral stand on the suit. Here again, the courts' decisions would make no sense if the board could simply establish an allegedly disinterested committee to determine which position counsel should take on a derivative suit. Where the suit involves transactions between a corporation and its insiders, the courts have insisted that even the approval of noninterested directors does not render careful judicial scrutiny of the fairness of the transactions unnecessary.

In considering whether a minority of directors can be sufficiently independent to weigh a suit against the majority, useful perspective may be gained from the standards of disinterestedness required of triers of law and fact in judicial and arbitral proceedings. Because bias is so hard to prove and because it is essential that the judicial resolution of disputes be fair not only in fact but also in appearance, the law often disqualifies from certain roles in the dispute resolution process anyone who has an apparent conflict of interest in the dispute, even though his integrity is unimpeachable. A judge must recuse himself sua sponte whenever his impartiality might be reasonably questioned, or on the

102 Although the corporation must be a nominal defendant in a derivative suit, the suit is nonetheless brought on its behalf and it stands to benefit from any judgment for plaintiff. The question arises whether the corporation may interpose defenses to the action. There is little helpful authority on this point. N. LATTIN, supra note 3, § 109, at 435. See generally Washington, Stockholders' Derivative Suits: The Company's Role, and a Suggestion, 25 CORNELL L.Q. 361 (1940). A few cases have held that the corporation may not interpose any defense. Meyers v. Smith, 190 Minn. 157, 159, 251 N.W. 20, 21 (1933) (per curiam); Groel v. United Elec. Co., 70 N.J. Eq. 616, 626, 61 A. 1061, 1064-65 (1905). Others have permitted the corporation to interpose defenses when its interests lie in resisting the suit. Otis & Co. v. Pennsylvania R.R., 57 F. Supp. 680, 682-83 (E.D. Pa. 1944), aff'd per curiam, 155 F.2d 522 (3d Cir. 1946); Godley v. Crandall & Godley Co., 181 A.D. 75, 78, 168 N.Y.S. 251, 254 (1917) (dictum), aff'd mem., 227 N.Y. 656, 126 N.E. 908 (1920). It has been suggested that the corporation be permitted to interpose defenses designed to protect the corporation, but not those designed to protect the alleged wrongdoers. 66 HARV. L. REV. 342 (1952). See 13 W. FLETCHER, supra note 14, § 5997. Of course, the line between the two types of defenses is very hazy.


103 See notes 127-29 and accompanying text infra.


105 28 U.S.C. § 455 (1976) requires the judge to recuse himself "in any proceeding in which his
motion of a party alleging facts suggesting partiality, even if the judge feels the suggestion is unwarranted.\textsuperscript{106} Even friendship with an interested nonparty has been held sufficient to mandate recusal.\textsuperscript{107} Similarly, a juror may be disqualified for cause if he has an interest in the case or has any substantial connection, such as an employment relationship, with any party.\textsuperscript{108} Comparable rules apply to arbitration\textsuperscript{109} and administrative proceedings.\textsuperscript{110}

impartiality might reasonably be questioned," or where he has a personal bias. \textit{Semble, ABA Code of Judicial Conduct, Canon 3(C)(i).} A judge must also recuse himself when he has even a small financial interest in the case, including ownership of stock in a party-corporation. \textit{In re Honolulu Consol. Oil Co., 243 F. 348 (9th Cir. 1917). Semble, ABA Code of Judicial Conduct, Canon 3(C)(i)(e).} By comparison, the impartiality of a committee member owning stock in the corporation is surely open to question; the committee member's compensation as a director usually exceeds his monetary interest as a stockholder, thus clearly suggesting bias in favor of the accused directors who control that compensation. And even though his interest as a stockholder might give the director an identity of interest with the plaintiff-shareholder, it should be noted that a judge must recuse himself for financial interest even if the presumably injured party does not request it.


Federal and state arbitration laws require modifying or vacating awards by biased arbitrators. 9 U.S.C. § 10 (1976); N.Y. CIV. PRAC. LAW § 7511(b)(1)(g) (McKinney 1963); WIS. STAT. ANN. § 298.10(1)(b) (West 1958).


\textsuperscript{110} The rules governing disqualification for bias and interest apply equally to courts and administrative agencies. See B. SCHWARTZ, \textit{Administrative Law} §§ 106-109 (1976). See generally K. DAVIS, \textit{Administrative Law Text} §§ 12.01-04, 12.06 (3d ed. 1972). Section 7(a) of the Administrative Procedure Act, 5 U.S.C. § 556(b) (1976), provides a disqualification procedure similar to that for federal judges discussed in notes 105 & 106 supra. See B. SCHWARTZ, supra, § 109. Even a fairly remote financial interest in the case will
A corporate board considering whether or not to bring suit is, conceded, in a somewhat different position than a judge, jury, arbitrator, or administrative tribunal resolving a dispute. The board must weigh not only the legal rights of the parties but also the total costs of the litigation to the corporation. Nonetheless, the fact and appearance of impartiality are important not only to the particular corporation but to the entire corporate governance system. To ensure both the fact and the appearance of impartiality, the nonimplicated minority of directors should be presumed to have a conflict of interest and should not be permitted to act as judge and jury in deciding whether a derivative suit should proceed against a majority of their fellow directors.

Perhaps nonimplicated directors should not even be asked to weigh a suit against their colleagues. Two problems are evident. First, if the nonimplicated directors believe the accused directors guilty of serious wrongs to the corporation, they are, as a practical matter, constrained to ask the accused directors to resign from all corporate posts, and the accused directors might feel it only honorable to acquiesce. This action may, as a practical matter, be irreversible, for even if the accused directors are ultimately vindicated in a derivative suit, it might be awkward to return them to their corporate positions. Therefore, since a suit against their colleagues is such a destructive weapon, nonimplicated directors might decline to use it absent overwhelming evidence of grave wrongdoing. Second, since outside directors are supposed to be watchdogs to management, using them to shield management from shareholder suits is of questionable propriety. These problems are easily solved by allowing a derivative suit to proceed. The nonimplicated directors could then await disposition of the suit to decide whether the accused directors should resign. This lesser weapon, the derivative suit, is not so destructive as to make its use unthinkable, so it also retains its deterrent value.

Independence of Special Counsel for the Minority Directors.—Minority directors often are nonlawyers who have other principal occupations and little regular staff support. Often, therefore, they have neither the time nor the resources to conduct a thorough investigation of the charges raised by a derivative suit. As a result, a key role in the investigation must be played by special outside counsel to the minority directors.

111 See text accompanying notes 232-40 infra.
113 Ordinarily, independent counsel means counsel other than the corporation’s house counsel or regular outside counsel, who are too financially dependent on the board to be disinterested. See Bishop, supra note 37 at 1080.
rectors. Yet, even outside counsel may not be truly disinterested and effective. For example, the directors may select counsel with a reputation for indulgence toward accused directors, a reputation gained through lax investigations that curry favor with directors and enhance the counsel's prospects of being retained for similar future assignments by the same and other corporations. In short, counsel's self-interest may color his investigation and lead him to recommend against suing any director.

The Shareholders' Perspective.—In addition to disinterested decisionmakers, the Anglo-American legal system features adversary proceedings in which key roles are played by persons who clearly are not disinterested—the parties to the dispute and their attorneys. It is believed that the truth is more likely to emerge if each party, aided by skilled counsel, is free to advance his own case and to attack his opponent's case vigorously. In theory, and to a large extent in practice, shareholders receive the benefits of an adversary proceeding in a derivative suit. Although the interest of the nominal plaintiff in the outcome is usually minimal, the interest of his attorney in receiving a generous court award of attorneys' fees, usually from the fund created by a settlement or judgment in favor of the corporation, generally assures shareholders of vigorous and competent representation.

115 Professor Bishop has stated well the problems of relying on theoretically independent counsel with respect to indemnification of directors and officers:

No one need question the honesty of these darlings of corporate draftsmen: the problem rather is that those who choose them are pretty sure to favor a lawyer who was acquired in the course of a corporate practice a sympathetic understanding of the problems of corporate management. It is not easy for even a lawyer of the most rugged integrity to be harsh to people who were responsible for his retainer. But in fact counsel may well be a regular associate and friend of the defendants: "independent" may turn out to mean nothing more than he is not an employee of the corporation.

Bishop, supra note 37, at 1080 (footnote omitted). On at least one occasion independent counsel failed to convey to the board information he had obtained regarding illegal payments. Robertson, The Directors Woke Up Too Late at Gulf, FORTUNE, June, 1976, at 124. See also Coffee, supra note 83, at 1127-28 (describing cases where outside counsel was lethargic in conducting investigations of reported wrongdoing).


117 F. JAMES & G. HAZARD, supra note 116, § 1.2, at 5; A. MORGAN, SOME PROBLEMS OF PROOF UNDER THE ANGLO-AMERICAN SYSTEM OF LITIGATION 1 (1956). The moral acceptability of decisions is also enhanced when judges are not involved in initiating and conducting the case. See F. JAMES & G. HAZARD, supra note 116, § 1.2, at 5.

118 The motivation for the suit is usually the hope of attorneys' fees. Smolowe v. Delendo
the power of the court to disapprove settlements and discontinuances helps ensure that plaintiff and his counsel will not agree to a disposition of the case that places their own interests ahead of those of the shareholders.

When a derivative suit is dismissed due to the opposition of the board of directors, the benefits of an adversary proceeding are lost to the shareholders. No plaintiff presents himself to press the interests of the shareholders; special counsel to the directors is charged not with advocating the shareholders' interests but with being fair and objective; and the special counsel's fee does not depend on, and therefore is not an incentive for, procuring a settlement or judgment in favor of the shareholders. Shareholders are entitled to be represented by one who has a strong incentive to ferret out all evidence of wrongdoing. Unfortunately, although plaintiff's attorney in a derivative suit has such an incentive, he may have little incentive to consider the cost to the corporation of protracted litigation. In other words, plaintiff's attorney has little reason to consider whether it is in the best interests of the corporation, and of its shareholders generally, to proceed with the derivative suit. On balance, however, this problem is less serious than the potential for a biased decision by minority directors to oppose the suit.

Shareholders may not fare much better where the decision not to sue is rendered by a special litigation committee created by the board. In many if not all states, the full board, which by hypothesis the alleged wrongdoers dominate, may dissolve or overrule the committee. The

\footnote{119}{As to the requirement of court approval of settlements and discontinuances, see notes 209-10 and accompanying text infra.}
\footnote{120}{See Wolf v. Barkes, 348 F.2d 994, 996 & n.2 (2d Cir.), cert. denied, 382 U.S. 941 (1965); Craftsman Fin. & Mort. Co. v. Brown, 64 F. Supp. 168, 178 (S.D.N.Y. 1945); H. Henn, supra note 1, § 375, at 790; Haudek, supra note 1, at 768-71. See also note 211 infra.}
\footnote{121}{Indeed, counsel is likely to have a strong interest in conducting the investigation in such a way that the directors will decide to oppose any derivative suit. See note 115 and accompanying text supra.}
\footnote{122}{See text accompanying notes 232-40 infra.}
\footnote{123}{Several states expressly provide that the committee shall serve at the pleasure of the board, N.Y. BUS. CORP. LAW § 712(c) (McKinney Supp. 1979-1980); OHIO REV. CODE ANN. § 1701.63(c) (Anderson 1978), or that a majority of the full board may "abolish any such committee at its pleasure," N.J. STAT. ANN. § 14A:6-9(2)(c) (West Supp. 1979-1980), or that the committee shall be subject to the direction and control of the board, MINN. STAT. ANN. § 301.28(4)(8) (West Supp. 1979). See also 7 F. White, NEW YORK CORPORATIONS ¶ 712.03 (13th ed. 1979); note 125 infra. Where statute does not grant and the full board has not expressly reserved such power, it is unclear whether the board may dissolve or overrule a committee. Several courts have held that,
alleged wrongdoers thus occupy an enviable position. If the committee decides against suit, the accused directors may raise that decision as grounds for dismissal of a subsequent derivative suit, but if the committee chooses to sue or appears to be leaning in that direction, the board can simply overrule or disband the committee. In *Gall v. Exxon Corp.*, 124 the court rejected plaintiff’s argument that, for these reasons, the litigation committee proceeding should not raise a valid defense. The court seemed to assume that the board could not dissolve or overrule the committee, although the court cited no authority for this other than Exxon’s by-laws and the wrong part of a New Jersey statute. 125

The danger is not purely hypothetical: in at least one case, a corporate board did dissolve a committee that seemed to be taking its job seriously. 126

The investigation conducted by theoretically disinterested directors has other shortcomings from the shareholders’ perspective—notably, the inability to compel testimony under oath or the production of documents pursuant to court-supervised discovery. Although information may be obtainable from employees of the corporation, such information may not be sufficient to determine whether to sue. 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.

Reliance on a decision by supposedly disinterested directors also deprives shareholders of the opportunity to persuade a court to modify existing law and the right to appeal adverse decisions on questions of law. While the plaintiff in a derivative suit can argue that the court

notwithstanding the literal language of the relevant statutes, the board is limited in the powers it can delegate to a committee. See Hayes v. Canada, Atl. & Plant S.S. Co., 181 F. 289 (1st Cir. 1910); Note, Executive Committees—Creation, Procedures, and Authority, 1967 WASH. U.L.Q. 42, 59-63 (1967). One commentator has suggested that because the committee is created by the board to assist in management, “there should be no question that the board may control the executive committee.” Id. at 47.


125 418 F. Supp. at 516-17. The court quoted N.J. STAT. ANN. § 14A:6-9(1) (West 1969), which generally empowers corporate boards to delegate to a committee “all the authority of the board” with certain exceptions. The court overlooked or ignored subsection (2) of § 14A:6-9, which empowers the board to “(c) abolish any such committee at its pleasure; and (d) remove any director from membership on such committee at any time, with or without cause.” Thus, the Exxon board could have dissolved the committee before it reached any decision. See Maldonado v. Flynn, No. 77-3180, slip op. at 14a (S.D.N.Y. Jan. 24, 1980) (apparently concluding that committee’s decision was not subject to board review). As to whether the board could overrule a decision of the committee, see note 123 supra.

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should expand existing doctrines of liability to include the allegedly wrongful behavior of the defendants, the directors' investigation and decision will probably only consider existing law. Directors certainly cannot be expected to expand the scope of directors' (and thus their own) fiduciary duties. It also seems unreasonable to measure the directors' decision solely against the standard of good faith when the decision of a trial judge is subject to a much tougher standard of appellate review.

A useful analogy can be drawn from the treatment of "interested transactions" between a corporation and one or more of its officers or directors. The prevailing view is that even where such a transaction is approved by a majority of disinterested directors the court will subject the transaction "to rigid and careful scrutiny, and [will] invalidate the contract if it [is] found to be unfair to the corporation." Even where the statutory language read literally suggests that approval by a majority of disinterested directors or shareholders is sufficient by itself, courts and commentators have insisted that the court review the transaction for fairness. This approach reflects a sage recognition that directors are placed in an awkward position when asked to pass on the fairness of a transaction.

127 Marsh, Are Directors Trustees?: Conflict of Interest and Corporate Morality, 22 BUS. LAW. 35, 43 (1966). See Pepper v. Litton, 308 U.S. 295, 306 (1939) (rigorous scrutiny of director's claim against bankrupt corporation); Burt v. Irvine Co., 237 Cal. App. 2d 828, 854, 47 Cal. Rptr. 392, 406-07 (1965); Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 82, 88, 90 A.2d 660, 663 (1952); Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 282-83, 166 N.E.2d 793, 799-801 (1960); Ailes v. Adams Eng'r Co., 35 N.J. 411, 426-29, 173 A.2d 246, 255 (1961); Chelrob, Inc. v. Barrett, 293 N.Y. 442, 460-61, 57 N.E.2d 825, 834 (1944) (court reviewed transaction for fairness even though the directors' "good faith is established"); La Vin v. La Vin, 283 A.D. 809, 810, 128 N.Y.S.2d 518, 519, aff'd per curiam, 307 N.Y. 790, 121 N.E.2d 620 (1954); H. HENN, supra note 1, § 238, at 467; N. LATTIN, supra note 1, § 80, at 291. A few states still adhere to the old view that such a transaction is voidable even if fair and approved by a majority of disinterested directors. Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 87-88 (2d Cir. 1955) (applying Connecticut law); Landstreet v. Meyer, 201 Miss. 826, 833, 29 So. 2d 653, 655 (1947); H. HENN, supra note 1, § 238, at 466 & n.4; N. LATTIN, supra note 3, § 80, at 291 n.67. On the other hand, a few cases require plaintiff to show not only unfairness but also fraud or bad faith. H. HENN, supra note 1, § 238, at 466 & n.5. The transaction will receive especially careful scrutiny if the interested directors have substantial influence with the corporation. See note 149 infra.

of transactions from which their colleagues stand to profit, and that the courts must be prepared to step in and protect shareholders from unfair transactions. The director who must decide whether to sue his colleagues is placed in an even more awkward position. In such cases the courts should be even quicker to intervene to defend shareholders by subjecting the alleged wrongs to “rigid and careful scrutiny.” In sum, even where the nonimplicated directors and their counsel are genuinely disinterested, there are strong reasons for finding a directors’ decision to oppose a derivative suit inadequate to justify dismissal of the suit.

If the foregoing analysis is correct, the board should never be able to terminate a derivative suit against a majority of its members. One could argue alternatively that, in such a case, a court should conduct a preliminary hearing and, after weighing all relevant factors, decide whether continuation of the derivative suit will serve the interests of the corporation and of justice. On balance, however, this approach seems unwise. Such a hearing would add to the expense and delay of the suit. Moreover, the independence of the noninterested directors and their counsel—a key issue in any such hearing—is exceedingly difficult to prove or to disprove. Finally, termination of shareholder litigation at the behest of a minority of directors, even after a court hearing, would fuel cynicism among stockholders and the general public.

One could overlook these problems if there were a substantial probability that the hearing would terminate the suit. There is little likelihood, however, that minority directors could demonstrate the high degree of independence and care that would merit dismissal of the suit. Accordingly, a per se rule that bars a minority of board members from terminating suits against a majority of directors is preferable.

Suits Implicating a Minority of Directors

Although the board should never be able to terminate a derivative suit against a majority of its members, it should be able to terminate a

129 See Cumberland Coal & Iron Co. v. Parish, 42 Md. 598, 606 (1875) (“[T]he remaining directors are placed in the embarrassing and invidious position of having to pass upon, scrutinize and check the transactions and accounts of one of their own body, with whom they are associated on terms of equality in the general management of all the affairs of the corporation.”); Munson v. Syracuse, G. & C. Ry., 103 N.Y. 53, 74, 8 N.E. 355, 358 (1886) (“The law cannot accurately measure the influence of a trustee with his associates, nor will it enter into the inquiry . . . .”); Marsh, supra note 127, at 37-38. Cf. Greene v. Allen, 35 Del. Ch. 242, 249, 114 A.2d 916, 920 (1955), rev’d on other grounds sub nom. Johnston v. Greene, 35 Del. Ch. 479, 121 A.2d 919 (Sup. Ct. 1956) (court barred insider from seizing a business opportunity that the corporation had rejected because of difficulty of determining whether insider had influenced board to reject that opportunity).

130 See text accompanying notes 136-91 infra, proposing such an approach for suits against a minority of the directors.

131 See note 104 supra.

132 See note 243 infra.

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suit against a minority of directors or nondirector officers in some cases. The pressures on nonimplicated directors are not always as great in the latter cases, and certain factors may weigh in favor of termination.

One major factor weighing in favor of termination of the derivative suit is the harm the corporation may suffer from litigation ostensibly brought on its behalf. Although the corporation usually is not an active participant in shareholder litigation, it may incur substantial costs in complying with demands for documents and depositions. Moreover, the litigation may divert the attention of management and undermine the morale of corporate personnel. Even if the derivative suit produces a recovery for the corporation, it may be outweighed by these costs. These considerations suggest that in some cases the court should be able to curtail derivative suits because they are not in the best interests of the corporation.

The pressures against the independence of nonimplicated directors may be much weaker in some cases than in others. Consider, for purposes of illustration, a continuum of situations generating different degrees of pressure. At one end would be a suit for self-dealing against all directors, including the senior officers and controlling stockholders of the company, where the accused board selects two lower corporate officers as new members and places them on a committee to determine whether the suit should proceed. At the other end of the continuum would be a derivative suit against a single lower level officer and director for acting beyond the scope of his authority. In the first situation, the argument against allowing the committee to terminate the suit is overwhelming. In the second situation, however, a court might well give serious credence to the board’s conclusion that the suit was not in the best interests of the corporation.

A line is needed to distinguish cases warranting a \textit{per se} treatment from those in which board action may warrant dismissal. Although any line drawn for this purpose must be somewhat arbitrary, drawing the line between suits against a majority of directors and suits against a minority has much to recommend it. A majority can select a committee of members deemed likely to reach a favorable result, dissolve or overrule the committee, and threaten not to renominate directors who will not cooperate. A minority of directors may be unable to do any of these things. Fear of publicity adverse to the corporation may weigh

\footnotesize{133 See notes 162-64, 203-05, \& 232-36 and accompanying text \textit{infra}.}

\footnotesize{134 In the large public corporation a majority of the board can usually control the future composition of the board by controlling the proxy machinery. See W. Cary, supra note 1, at 229-31. It has been suggested that control lies or could lie with the nominating committee. See Coffee, supra note 83, at 1232-34. Generally, though, statutes permit the full board to dissolve or overrule a committee. See notes 123-26 and accompanying text supra. Also, the nominating committee often bows to the wishes of the chief executive officer. See notes 90-92 supra.}
less heavily on the nonimplicated directors when a smaller number of directors is involved in the suit. Outside counsel will have less reason to curry favor with or be intimidated by the alleged wrongdoers if they are only a minority of the board. Termination of a derivative suit is more likely to be accepted as fair by shareholders and the general public if effected by a noninterested majority of the board. Moreover, courts have long drawn a line at this point with respect to both the effect of a refusal to sue and the necessity of a demand on the board. Finally, distinguishing between suits against a majority and suits against a minority of the board creates a bright-line test that facilitates the planning of the parties and better avoids lengthy and costly preliminary skirmishing than a less easily applied test, such as one based on whether the alleged wrongdoers dominate the board or the corporation.

A Weighing-of-Factors Approach.—Although the dangers of bias are less when only a minority of directors or nondirector officers are named in a derivative suit, there are still substantial pressures placed on the nonimplicated directors and their special counsel, and there is good reason to question whether the investigation by the nonimplicated directors is adequate to justify dismissal of the derivative suit. Rather than apply a per se rule that, without any inquiry, either dismisses the derivative suit or allows it to proceed, the court should conduct a careful inquiry and dismiss the suit only if it is persuaded, after plaintiff has had sufficient opportunity to develop his case, that the nonimplicated directors are reasonably independent, have conducted an adequate investigation, and have articulated cogent reasons why the derivative suit should not proceed.

Independence.—Although the courts recognize that directors must be independent of the alleged wrongdoers if their refusal to sue is to thwart a derivative suit, the courts often have assumed that the directors are independent unless plaintiff presents clear evidence of bias. As previously discussed, this assumption is unwarranted. How then

135 See notes 18, 19, & 31 supra.
136 See notes 147-49 and accompanying text infra.
137 See note 31 supra.
138 See Maldonado v. Flynn, 597 F.2d 789, 793 (2d Cir. 1979) ("disinterest" is defined as lack of any financial stake... in the transaction"); Issner v. Aldrich, 254 F. Supp. 696 (D. Del. 1966) (domination of board not sufficiently pleaded by allegations that alleged wrongdoer was the corporation's largest shareholder, owning more than 12% of its stock, and had three of its employees on the corporation's 17-member board); Coffee, supra note 83, at 1229-30. In cases involving special litigation committees, several courts have adopted narrow concepts of what constitutes a lack of independence, see note 67 supra, and seem to have placed the burden of proof as to independence on the plaintiff, see note 184 infra.
139 See text accompanying notes 80-112 supra.
should a court determine in a particular case whether nonimplicated directors are reasonably independent?

To be considered independent, a director must not be named as a defendant in the derivative suit or implicated in the alleged wrong. These are the minimum requisites of independence. A court may also consider whether each director's past performance on corporate boards has shown evidence of real independence. Evidence that a director who opposed suing a fellow director had often voted against that director on other matters would support a claim of independence. On the other hand, where a director has no history of opposing fellow directors, even on matters where their personal finances were not at stake, some courts have held it unrealistic to expect him to act independently in a matter that might result in serious liability for his fellow directors.140

Although outside as well as inside directors are subject to pressures on their independence, the pressures on inside directors are greater,141 and courts should be especially skeptical of their claims of independence. Even directors who are not corporate officers, and thus not inside directors, may be so closely connected to management that their independence should be doubted. Family ties, business or professional dealings with the corporation,142 or a web of interlocking directorates143 can seriously compromise a director's independence. It has been suggested that such directors be deemed "affiliated."144 Courts

140 De Haas v. Empire Petroleum Co., 286 F. Supp. 809, 814 (D. Colo. 1968), modified on other grounds, 435 F.2d 1223 (10th Cir. 1970). See also Ripley v. International Rys. of Cent. America, 8 A.D.2d 310, 316-17, 188 N.Y.S.2d 62, 71-72 (1959) (board found not independent where it was advised by officer of dominant shareholder and "[h]is advice was uniformly followed"), aff'd, 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1960). It might be argued that it is unreasonable to ask whether a director has dissented on prior board votes because nearly all board resolutions are adopted unanimously. This argument, however, only tends to underscore the lack of independence of most directors.

141 See notes 80-96 and accompanying text supra.

142 "Family ties, business or other professional arrangements may not disqualify one from serving as a director, but such an individual cannot be held out as an 'outside director.'" Report of the Fifty-Second American Assembly, The Ethics of Corporate Conduct 5 (Harriman, N.Y.) (Apr. 14-17, 1977). See also Leech & Mundheim, supra note 80, at 1830-31. It is not unusual for a board to include relatives of officers, retired executives of the corporation, outside counsel for the corporation, or investment bankers, commercial bankers, or suppliers who do business with the corporation. See note 87 supra. But see Maldonado v. Flynn, 597 F.2d 789, 794-95 (2d Cir. 1979) (partner for corporation's regular outside counsel held a legally disinterested director as to transaction in which he had no direct financial interest).

143 See Leech & Mundheim, supra note 80, at 1831.

144 Professors Weiss and Schwartz would label a director "affiliated" if he has recently engaged in or proposes to engage in material transactions with the corporation, if he has close family ties with a corporate officer, or if any officer of the corporation sits on the board of a corporation of which the director is an officer. Weiss & Schwartz, supra note 83, at 20. The SEC dropped a proposed amendment of Schedule 14A that would have required labeling many such directors as "affiliated non-management," but, in a note to Item 6(b) of the Schedule, stated that any attempt
should be equally skeptical regarding claims of independence by both affiliated directors and inside directors.

If a committee is established to investigate charges against directors, it should be composed exclusively of nonaffiliated, nonimplicated directors, and should, if possible, be selected solely by nonaffiliated nonimplicated directors so as to reduce the possibility that the accuser directors will fill the committee with directors from whom they expect the greatest leniency.

Nonimplicated directors' claims of independence should also be greeted with skepticism where the derivative suit names dominant stockholders or officers as defendants. In such cases, a majority of the board may feel no more free to act independently than would a minority in a suit against a majority of the board. Such cases should therefore be treated like suits against a majority of the board. One problem with this is that it is often difficult to identify the controlling persons of large corporations. The percentage of stock owned is not always determinative of working control, for in a widely held company the holder of even a small percentage may have effective control. Furthermore, in many cases control is not absolutely lodged in a single person, institution, or cohesive group, but is divided among several. If the defendants in a derivative suit own a substantial amount of stock, the court should seek other indicia of control. Although no easy, fool-proof formula is available for determining control, numerous statutes and common law doctrines address the concept of corporate control, and the factors weighed by courts and administrative agencies in other matters involving determinations of corporate control should be useful by the issuer to label such directors "independent" might be materially misleading. See Securities Exchange Act Release No. 15,384 [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,766.

145 The reported opinions involving litigation committees generally have not indicated whether the committees have included inside directors. Although most probably have been composed solely of outside directors, in Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976), one committee member was a senior vice president of Exxon. Id. at 510 n.2.

146 It does not appear in the cases involving litigation committees that the accused directors have recused themselves from the selection of the committee.

147 The courts have recognized this by holding that a demand on the board is unnecessary and that the board's refusal to sue will not thwart a derivative suit if the defendants, though not comprising a majority of the board, otherwise dominate the board or the corporation. See note 19 infra.

148 W. CARY, supra note 1, at 230.

in derivative suits as well.\textsuperscript{150} The factors considered should include the amount of stock held by the persons in question, the number of their representatives on the board, their demonstrated influence, the corporate offices they hold, and their strategic position on executive and nominating committees.\textsuperscript{151} Power to direct the corporate proxy machinery should suffice to show control, but lack of such power should not necessarily prove an absence of control.\textsuperscript{152}

Even if the defendants do not dominate or control the corporation they may be able to influence the board if they are high-level officers, integral members of the management team. Such influence is especially likely when the board is composed largely of the defendants' fellow officers. If corporations adopt the suggestions of some commentators that insiders be virtually eliminated from the board,\textsuperscript{153} perhaps it will become unnecessary to assume some influence by insiders over the board, but until such time a court should consider such influence a strong possibility.

Only if the foregoing factors point strongly toward the independence of those directors who have decided not to sue should the court consider dismissing the derivative suit. Because bias is so difficult to prove or disprove, the inquiry will be a difficult one. Nevertheless, the inquiry is inescapable unless a \textit{per se} rule is to govern all such cases.

In investigating charges brought in a derivative suit, the nonimplicated directors will usually require the assistance of counsel.\textsuperscript{154} Although it is doubtful whether any counsel paid by the corporation can be truly disinterested,\textsuperscript{155} certain steps can be taken to assure some degree of independence. First, counsel should not be the corporation's house counsel or regular outside counsel: both have close and continuing ties with management that would subvert their independence.\textsuperscript{156} Second, to help ensure that counsel does not favor defendants in order to curry favor with management in the hope of receiving future business from the corporation, it should be agreed that counsel will not be retained again by the corporation for some substantial period of time. Third, to help ensure that counsel neither has nor tries to develop a reputation for leniency in such cases among other potential corporate

\textsuperscript{150} For example, the concept of control plays a key role in the statutes administered by the Securities and Exchange Commission. 2 L. Loss, \textit{supra} note 50, at 764-70.
\textsuperscript{151} \textit{Id.} at 778-83.
\textsuperscript{152} \textit{Id.} at 779.
\textsuperscript{153} For example, SEC Chairman Harold M. Williams has suggested that the chief executive officer should be the only inside director on the board. Speech by Harold Williams to the American Assembly 15 (Columbia University, Apr. 16, 1977). \textit{Accord,} C. \textit{Brown,} \textit{supra} note 83, at 33.
\textsuperscript{154} See note 114 and accompanying text \textit{supra}.
\textsuperscript{155} See text accompanying notes 113-15 \textit{supra}.
\textsuperscript{156} For this reason courts have often insisted that the corporation appear by independent counsel in a derivative suit. \textit{See} text accompanying note 102 \textit{supra}. 

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clients, it would be preferable to retain a reputable firm that often represents plaintiffs as well as defendants in derivative suits. Such counsel would be less concerned about its reputation among corporations and also more experienced in conducting the kind of aggressive inquiry that would be desirable. Finally, if special counsel is to be selected after a derivative suit has commenced, the nonimplicated directors should consult with plaintiffs as to the selection of counsel.

_Adequacy of the Investigation._—It would make a mockery of justice if supposedly disinterested directors could terminate a derivative suit after a sham investigation of the alleged wrongdoing. Clearly, a court must determine whether directors have conducted an adequate investigation.

To be consistent with the business judgment rule, the investigation must at least have been conducted with due care, that is, with the care and skill that a reasonably prudent and competent person would exercise under similar circumstances. The business judgment rule, however, is intended to apply to suits seeking to hold the directors liable for injury to the corporation, and perhaps to suits to compel or enjoin certain acts by the directors; the rule need not be applied to cases dealing with the effect of a refusal to sue on a derivative suit. Such cases demand a more stringent standard. Since the purpose of the derivative suit is to vindicate the rights of the corporation and, indirectly, of the shareholders, the court should permit the suit to proceed at least to the discovery stage if the directors failed to pursue any line of inquiry that probably would have led to material evidence incriminating the defendants. Any lesser standard would free the way for inadequate investigations and leave the corporation and its shareholders without remedy for a probable injury. Such a result cannot be justified by the policy underlying the business judgment rule—the absolution of directors from liability for mere errors of judgment—or by any other sound policy.

Failure to pursue a line of inquiry does not necessarily intimate any fault or negligence on the part of directors or their counsel. For example, the directors’ efforts may be frustrated by inability to compel the submission of evidence or to threaten punishment for perjury. If a due care standard were followed, an investigation could be deemed adequate despite the inability of the directors to compel submission of crucial evidence. The prospect of such a result argues further for the application of a more stringent test.

A standard requiring the directors to have pursued every probably material line of inquiry is somewhat vague, but no more so than other

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157 See note 115 and accompanying text _supra._
158 See text accompanying note 24 _supra._
159 See text accompanying notes 192-95 _infra._
standards applied by the courts or than a due care standard under the business judgment rule. More difficult than the vagueness problem is the problem of how the plaintiff can show that the investigation has overlooked a promising line of inquiry. This problem will be discussed below.\footnote{160}

Cogency of the Explanation.—One crucial issue is to what extent a court should review the reasons given by nonimplicated directors for opposing a derivative suit. Reasons tending to support a decision not to sue do not necessarily support a decision to oppose a derivative suit. For example, in \textit{Gall v. Exxon Corp.}\footnote{161} the reasons cited by the committee included “the unfavorable prospects for success of the litigation [and] the cost of conducting the litigation.”\footnote{162} Although these might be persuasive reasons for declining to sue, they would not justify opposing a derivative suit where the plaintiff-shareholder assumes the cost of litigation and the risk of an unfavorable decision. Similarly, the costs of the suit to the corporation should be irrelevant to the extent that the plaintiff is required to post security for the corporation’s expenses,\footnote{163} or where the corporation has waived the right to demand such security.

The directors should be required to describe with particularity the facts and assumptions underlying each reason for their decision to oppose the derivative suit. For example, a claim that the suit would interrupt corporate business affairs or undermine personnel morale\footnote{164} should not be taken at face value as sufficient grounds for stopping a derivative suit: lawsuits always interrupt the affairs of the parties and undermine the morale of those threatened with liability. The directors should be required to show that the interruption of business and the undermining of morale would be substantially greater than that which ordinarily attends involvement in litigation, and great enough to harm substantially the business of the corporation. The court should realize that large corporations are continually embroiled in litigation and that in most instances the costs of involvement in even a major suit are insignificant in comparison to the corporation’s assets and revenues. In

\footnote{160 See text accompanying notes 175-83 \textit{infra}.}
\footnote{161 418 F. Supp. 508 (S.D.N.Y. 1976).}
\footnote{162 \textit{Id.} at 514 n.13. See also \textit{Rosengarten v. International Tel. & Tel. Corp.}, 466 F. Supp. 817, 822 (S.D.N.Y. 1979); \textit{Auerbach v. Bennett}, 47 N.Y.2d 619, 626, 393 N.E.2d 994, 997, 419 N.Y.S.2d 920, 923 (1979).}
\footnote{163 See N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1979-1980). See generally H. HENN, \textit{supra} note 1, § 372. The expenses for which security must be posted include the expenses of other defendants indemnifiable by the corporation and, generally, include attorneys’ fees. \textit{Id.} at 782-83 & n.5.}
\footnote{164 See \textit{Gall v. Exxon Corp.}, 418 F. Supp. 508, 514 n.13 (S.D.N.Y. 1976), where the committee cited “interruption of corporate business affairs” as one reason for its decision. See also \textit{Galef v. Alexander}, No. 79-7166, slip op. at 5902 (2d Cir. Jan. 22, 1980), and \textit{Maldonado v. Flynn}, No. 77-3180, slip op. at 20 n.35 (S.D.N.Y. Jan. 24, 1980) (citing adverse effects on employee morale).}
general, since there can be no precise formula to weigh the cogency of the reasons for the directors' decision not to sue, a judgment as to the adequacy of these reasons will rest largely in the discretion of the trial judge, and the judge should not hesitate to require more than a cursory showing by the board.

Nature of the Alleged Wrong.—Since courts generally have not permitted the vote of a majority of shareholders to ratify a fraudulent, illegal, or *ultra vires* act, it should follow that directors, who presumably represent the shareholders, should not be permitted to decline to sue when the corporation is injured by such an act, for a refusal to sue has the same effect as a ratification: to shelter the act from judicial scrutiny. Nonetheless, it might be appropriate for the courts to consider the nature of the wrong in deciding whether the board should be able to thwart a derivative suit against a minority of the directors. Courts should be more reluctant to dismiss complaints of wrongs that would be nonratifiable. Perhaps more important, courts should be more reluctant to dismiss claims alleging self-dealing or some other breach of the duty of loyalty than to dismiss other kinds of claims.

The alleged wrongs in many of the recently decided cases involving litigation committees have concerned questionable payments, in

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166 See Coffee, supra note 83, at 1222-23.


many cases made exclusively in foreign countries. Defendants have usually argued successfully that such payments, even if unethical, violated no foreign or American laws. At the very least the courts in these cases may have been reluctant to hold defendants liable for acts that, when performed, were widely accepted in the business community and from which the defendants realized no personal gain, especially since the corporations in question had taken steps to prevent the recurrence of questionable payments. The unpopularity of recent federal legislation proscribing such payments and doubt as to the wisdom of attacking questionable payments by means of derivative suits may have been unarticulated reasons for judicial hostility to these suits. When more serious wrongs are alleged, however, courts should consider distinguishing dismissals of suits alleging nothing more serious than questionable payments.

The Stage of the Derivative Suit.—Several of the factors discussed above, including the independence of the nonimplicated directors and of special counsel, the adequacy of the investigation, and the reasons for the refusal to sue, entail issues of fact. The plaintiff, who often must commence his suit with little information, will not possess the relevant facts at the outset. Indeed, most of the relevant information will be in the hands of the defendants and of the corporation which, by hypothesis, opposes the suit. To what extent should plaintiff be entitled to discovery or a trial before the court decides a motion to dismiss based on the corporation’s refusal to sue? The cases are hopelessly inconsistent on this question, with some courts permitting full trials, some full discovery, some limited discovery, and some no discovery.
If the relevant test is whether the directors who refused to sue are not implicated in the suit and have conducted a reasonable investigation, little discovery by the plaintiff should be necessary. The plaintiff should be able to establish by simple depositions or interrogatories whether the directors have any connection with the suit, and the record of the investigation itself should indicate whether the directors conducted more than a sham investigation. If a court applies the business judgment rule, however, more substantial discovery—perhaps full discovery on all relevant issues—is appropriate, since it cannot be determined whether the nonimplicated directors have acted with due loyalty and care without some inquiry into the merits of the case. If the ultimate question is whether the nonimplicated directors have adequately protected the interests of the corporation and its shareholders, the plaintiff-shareholder generally should be permitted to conduct thorough discovery before the court will entertain a motion for summary judgment. Until the plaintiff has conducted such discovery it cannot be ascertained whether the directors have ferreted out all significant evidence of wrongdoing and whether there is factual support for the directors' decision not to sue.

To permit the plaintiff full discovery, however, may defeat the corporation's purpose in opposing the suit. Even if dismissal is granted after discovery and before trial, the corporation may suffer significant costs, disruption, and personnel morale problems attendant upon litigation during discovery. Nonetheless, to allow the plaintiff full discovery is the preferable approach. Many courts have held that summary judgment should rarely be granted against the plaintiff in a derivative suit before he has had an opportunity for discovery. To follow the approach in Gall v. Exxon Corp. of allowing plaintiff's discovery only for purposes of ascertaining the good faith and independence (apparently narrowly defined) of the litigation committee members may deny the corporation and its shareholders a remedy where the directors have not conducted a reasonably careful investigation. Even a reasonable care standard can leave the corporation remediless where evidence incriminating the defendants goes undetected because of limitations placed on the plaintiff's discovery. Such results cannot be countenanced.

If the directors' investigation has been conducted with reasonable skill, the additional costs, disruption, and personnel morale problems of the corporation resulting from plaintiff's discovery should not be excessive. Parties are limited to the discovery of relevant, nonprivileged matter, and protective orders can prevent the plaintiff from need-

lessly plowing the same ground already tilled by the nonimplicated directors. Thus, plaintiff's discovery can and should be limited to relevant matter overlooked by the nonimplicated directors. The burden of this additional discovery should not be unreasonable in light of the benefits of derivative suits and of the cynicism that would be bred if plaintiffs were not permitted to delve into charges of serious wrongs by corporate directors.

Once discovery has been completed, a hearing will usually be necessary to resolve questions of fact. It has been suggested that a separate trial be held on the corporation's motion to dismiss based on the directors' refusal to sue. On occasion such a separate trial may save the court and the parties time, trouble, and money, but in general it probably will not. To determine whether the nonimplicated directors are completely independent of the defendants and have conducted a thorough investigation exploring all probably fruitful lines of inquiry, it will be necessary to delve deeply into the same kinds of questions that constitute the merits of the case. To hold a separate trial as to the effect of the refusal to sue might save little time or money and would often waste much of both.

**Burdens of Proof.**—The courts have not paid much attention to the issue of who bears the burden of proof on such questions as the independence of the directors and the adequacy of their investigation, but they sometimes seem to imply that the plaintiff bears this burden. Perhaps this assumption is justified when directors are sued for a breach of duty; otherwise, a plaintiff

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179 See Fed. R. Civ. P. 26(c); F. James & G. Hazard, supra note 116, § 6.13, at 206-07. If the reluctance of courts to protect corporations from excessive, vexatious discovery in derivative suits makes such suits unreasonably expensive, reform efforts should deal directly with this reluctance rather than attempting to empower the directors, who cannot be completely disinterested, to terminate the suit.

180 Since the directors' investigation will not have been conducted under oath, it would be necessary to have witnesses swear to the accuracy of statements made to the directors.

181 See text accompanying notes 241-44 infra.

182 See Chicago Comment, supra note 17, at 198-200.


could by bare allegations cast upon the directors the burden of proving the propriety of each of their acts. Where the issue is the soundness of a decision not to sue, however, all relevant considerations suggest that the corporation should bear the burden of proof. First, the burden of proof is often placed on the party having better access to the relevant facts, and the nonimplicated directors have access to the information relevant to proof of their independence, the independence of their special counsel, and the adequacy of their investigation. Second, the corporation has the burden of pleading the directors' refusal to sue as a defense and therefore usually would have the burden of proving that defense. Third, the burden should be placed on the corporation as the party contending "that the more unusual event has occurred," for, in light of the numerous studies showing the pressures on directors to conform and the general lack of independence among directors, it would be more unusual for the directors to be genuinely independent and to conduct a rigorous investigation than for the contrary to be true. Furthermore, the corporation has much greater resources than the plaintiff and thus can bear the burden more easily. Finally, since the question regarding the effect of the refusal to sue is only whether to dismiss or to permit plaintiff to proceed to a determination of the merits—a determination as to which the plaintiff ordinarily bears the burden of proof—it seems appropriate to cast the burden of proof on the corporation as movant so as to favor a full hearing on the merits.

ANALYSIS OF POSSIBLE OBJECTIONS TO THE PROPOSED STANDARDS

A number of criticisms may be leveled at the standards proposed

188 C. McCormick, supra note 186, § 337, at 787.
189 See notes 80-93 and accompanying text supra.
190 See C. McCormick, supra note 186, § 337, at 786 (burden of proof usually is allocated to the plaintiff, who seeks to change the status quo). Cf. H. Henn, supra note 1, § 234, at 457 & n.30 (burden is ordinarily on plaintiff to prove breach of duty of due care). Yet, the burden often has been placed on defendants to prove the fairness of interested transactions. See, e.g., Pepper v. Litton, 308 U.S. 295, 306 (1939); Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921); Perlman v. Feldmann, 219 F.2d 173, 177-78 (2d Cir.), cert. denied, 349 U.S. 952 (1955); notes 127-29 supra.
191 See C. McCormick, supra note 186, § 337, at 786, 789 (burden of proof is sometimes allocated to party making "a disfavored contention" or a disfavored defense). Because dismissal deprives plaintiff and the shareholders of a hearing on the merits, a defense based on the directors' refusal to sue could be deemed a disfavored defense.
above for determining the effect of the board's refusal to sue. Although some of these criticisms are well-founded, none is persuasive.

Disregard of the Business Judgment Rule

It may be argued that the decision whether it is in the best interests of the corporation to sue should be the province of those charged with managing the corporation, namely, the board of directors. It may be further argued that if such a decision is made in accordance with the business judgment rule, that is, in good faith and with due care, that decision should be conclusive. This argument ignores the purpose of the business judgment rule, which is not to ensure a correct result, but to insulate from liability directors who have made mistaken decisions resulting in corporate losses, notwithstanding their good faith and exercise of due care. Because the plaintiff in the derivative suit does not seek to impose liability on the directors for their decision not to sue, the business judgment rule is largely irrelevant in evaluating the directors' decision.192 Moreover, even to the extent that the business judgment rule is relevant, experience shows that courts tend to misuse the rule in derivative suits involving refusals to sue by applying it without sufficient inquiry.193 This is reason enough to be skeptical of the utility of the business judgment rule in this area.

The criticism that the proposed approach wrongfully disregards the business judgment rule may be placed in a more useful perspective, however, by considering the public policy underlying the rule and the public policy implications of permitting directors to stop a derivative suit. There are numerous salutary policy reasons for the rule. First, the directors are hired to manage the corporation to the best of their ability, not to insure the success of the corporation, and it would be unfair to treat them as insurers. Second, if directors were held liable for reasonable decisions that proved unsuccessful, competent persons would either refuse to be directors or would become inordinately cautious in managing the corporation so as to reduce the prospects of liability. Third, the rule leaves governance of the corporation primarily to the directors selected by the shareholders who own the corporation rather than to a judge not selected by them. Finally, the rule promotes judicial economy by relieving the courts from involvement in complicated business questions, unless the directors have breached a duty to the corporation.194 These policy reasons, however, do not generally war-

192 See text accompanying notes 29-30 supra.
193 See note 28 supra.
rant dismissing a derivative suit on the basis of the directors' refusal to sue, even when made with good faith and due care. Allowing the derivative suit to proceed despite the directors' opposition does not make insurers of the directors, causing them to resign or become unduly cautious, because the derivative suit does not threaten them with liability for refusing to sue. It also does not divide management and the board of directors because the corporation remains officially opposed to the suit. Last, it does not involve the courts in questions of business policy, as opposed to questions of wrongs to the corporation, because the corporation's policy remains undisturbed.

Even if permitting a derivative suit could be viewed as somehow infringing the principle of management by the directors, dismissing a meritorious derivative suit would seriously infringe the principle of policing observance of the directors' corporate duties. This latter principle should be deemed more important because, without it, the directors would be subject to no checks. In short, the business judgment rule is either entirely consistent with the standards proposed herein or should give way to the policies underlying those standards.

**The “Rudderless” Corporation Objection**

It has been objected that if nonimplicated directors cannot halt a suit against a majority of the directors, then, in such situations, the corporation is left “rudderless,” powerless to act on an important issue. This objection is largely specious. Within the proposed standards the corporation retains the power to investigate alleged wrongs, to decide whether to sue thereon, to join as a plaintiff and perhaps supersede the derivative plaintiff if it does decide to sue, to settle the dispute with the true defendants, to defend the suit actively if its interests are

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195 See text accompanying notes 196-202 infra.

196 See Maldonado v. Flynn, No. 77-3180, slip op. at 14a (S.D.N.Y. Jan. 24, 1980); Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979) (“To accept the assertions of the intervenor and to disqualify the entire board would be to render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative action.”). See also Brief for Appellants Bennett, et al. at 20-21, Reply Brief at 10-11, Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).


198 Wolf v. Barkes, 348 F.2d 994 (2d Cir.), cert. denied, 382 U.S. 941 (1965). The role of court approval of such settlements is unclear. In Wolf the court held that court approval was not required by Fed. R. Civ. P. 23(c) (now Fed. R. Civ. P. 23.1), but not all courts agree; in any case a court might insist on review of the settlement once it was pleaded as a defense in the derivative action. See generally Haudek, The Settlement and Dismissal of Stockholders' Actions—Part II: The Settlement, 23 Sw. L.J. 763, 813-16 (1969).
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threatened,199 and to advance the defendants their attorneys' fees pend­
ing disposition of the suit.200 The only thing the corporation cannot do is prevent a court from hearing charges of misconduct against its direc­
tors, except where a minority of the directors is charged and the court is satisfied after a careful weighing of all relevant factors that dismissal is appropriate.

Under the proposed standards, the corporation is no more rud­
derless than it is in a suit challenging interested transactions—transactions between the corporation and its officers or directors. In that situation, the courts will scrutinize the transactions for fairness even though approved by disinterested directors because of the inevitable pressure on disinterested directors to disregard the welfare of the cor­

199 See note 102 supra.
200 See H. Henn, supra note 1, § 379, at 803.
201 See notes 127-29 supra.
202 A suit challenging an interested transaction roils corporate planning by making it uncertain whether the transaction will be voided by the court. Most derivative suits seek damages for past acts and thus do not hinder corporate planning.
204 See H. Henn, supra note 1, § 358, at 752 n.22; Note, Extortionate Corporate Litigation: The Strike Suit, 34 Colum. L. Rev. 1308 (1934).
205 H. Ballantine, Corporations § 152, at 363 & n.4 (rev. ed. 1946); H. Henn, supra note 1, § 374, at 789.
206 See A. Conard, supra note 6, § 252, at 399-400; Hornstein, supra note 6, at 3-10.
lation, however, often seemed to go so far beyond what was necessary to curb the alleged abuses as to raise suspicions that its advocates wanted to discourage meritorious derivative suits as well as to eliminate the abuses.207 Professor Hornstein in particular argued persuasively that if the abuse was out-of-court settlements benefiting only the plaintiff's attorney, the remedy was simply to bar settlements without court approval; to burden derivative suits further would serve no legitimate purpose.208

The Federal Rules of Civil Procedure209 and most states210 now require court approval of settlements of derivative suits, thereby prohibiting private settlements.211 This requirement also helps to prevent strike suits, since a court would not approve the settlement of a groundless suit to the benefit of the plaintiff and the loss of the corporation.212 In a few jurisdictions statutes require the plaintiff to indemnify the corporation and the defendants for their expenses if the court finds that the action was brought without reasonable cause.213 Thus, the possible profit from strike suits may be far outweighed by the costs of bringing such suits.214 Certainly, the possibility of nuisance suits brought for their settlement value would seem to be greater in many nonderivative civil suits where plaintiff (and his attorney) keep the entire recovery and do not need court approval of a settlement. Moreover, if the corporation does encounter what it believes to be a groundless strike suit, there are many steps it can take to protect it-

\[207\] See note 6 supra.

\[208\] Hornstein, supra note 6, at 3.

\[209\] FED. R. CIV. P. 23.1 provides that "[t]he action shall not be dismissed or compromised without the approval of the court . . . ."

\[210\] Most states have followed federal rule 23.1. E.g., DEL. CH. CT. R. 23.1; MICH. GEN. CT. R. 208.5; N.J. CIV. PRAC. R. 4:32-4, -3; N.Y. CIV. PRAC. LAW 908 (McKinney 1976); N.Y. BUS. CORP. LAW § 626(d) (McKinney 1963). For a more complete list, see Haudek, supra note 1, at 767 n.3. See generally H. HENN, supra note 1, § 374.

\[211\] Moreover, if the plaintiff manages nonetheless to receive a secret settlement or to be bought off by the corporation, another shareholder may bring a second derivative action to recover the amount received by the plaintiff. See H. HENN, supra note 1, § 374, at 790-91; Haudek, supra note 198, at 816-19.

\[212\] For example, a court will not approve a dismissal conditioned on defendant's paying a fee to plaintiff's attorney but nothing to the corporation. Fistel v. Christman, 133 F. Supp. 300 (S.D.N.Y. 1955). Moreover, if the plaintiff is bought off with funds from the corporate treasury, the payment may be recovered from plaintiff for the corporation. Dabney v. Levy, 191 F.2d 201 (2d Cir.), cert. denied, 342 U.S. 887 (1951).

\[213\] See H. HENN, supra note 1, § 378. Many state statutes require plaintiffs to post security for the expenses of both the corporation and those indemnifiable by it. See note 163 supra. Although reimbursement or posting of security for expenses will rarely compensate the corporation for all the direct and indirect expenses it incurs, the prospect of such payments should deter frivolous derivative suits.

\[214\] See H. HENN, supra note 1, § 374, at 791 ("[T]here remains little opportunity to derive personal gain from a derivative action, thus seriously curbing 'strike-suits . . . .' ").
These factors have led some to question whether strike suits now exist to any significant degree. In practice it still may be possible for a plaintiff to profit from a nuisance suit, either because state indemnification laws or directors’ liability insurance may make it possible, or because a secret settlement may go undiscovered. The problems of indemnification and liability insurance might be remedied by revising relevant state laws. To the extent that strike suits remain a problem, they should be handled without permitting directors to halt derivative suits, except in accordance with the proposals in this article. The directors will tend to oppose both meritorious and nonmeritorious suits. Indeed, they may oppose meritorious suits more energetically because such suits pose greater threats of potential harm and embarrassment to the accused directors. It would be preferable to deter strike suits by requiring plaintiffs to pay the corporation’s and the defendants’ attorneys’ fees and other expenses where the action is found to have been brought without reasonable cause, by allowing suits for abuse of process against plaintiffs and directors’ attorneys. See notes 196-200 and accompanying text supra. See Note, Security for Expenses in Shareholders’ Derivative Suits: 23 Years’ Experience, 4 COLUM. J.L. & SOC. PROB. 50, 65 (1968) (quoting Abraham Pomerantz, a prominent plaintiffs’ attorney, as saying that the strike suit is a “false image,” as “epithet bereft of reality”). But see id. at 66-68 (stating that abuses of derivative litigation by plaintiffs’ attorneys continue). Some state statutes permit indemnification of directors for costs incurred in settlement of derivative suits, although they probably do not include amounts to be paid by the defendants to the corporation. See Bishop, supra note 37, at 1082-84. Thus, it may be in the short-term interest of the corporation to encourage the defendants to settle and then accept reimbursement for their attorneys’ fees rather than to force those defendants to engage in protracted litigation, after which the corporation may be required to pay a much larger indemnity. In the long run, however, the corporation’s interests are better served by vigorously opposing and thereby discouraging nuisance suits. If the defendants object to making payments out of their own pockets because they believe the suit is groundless, and if the corporation cannot directly indemnify them for amounts paid in settlement of the suit, the corporation might make a disguised indemnification through various forms of compensation to the defendants. As to directors’ and officers’ liability insurance, the insurer would have no incentive to pay a settlement out of its own pocket if, after litigating to a successful judgment, it could avoid payment because the corporation would either indemnify the defendant or reimburse the insurer for paying the defendant’s costs. The policy, however, may not provide for subrogation of the insurer to the defendant’s right of indemnification and, in any case, indemnification might be discretionary. Therefore, the insurer might be more willing to pay a small settlement than the larger costs of a successful, litigated defense. Thus, both indemnification and liability insurance may make it possible for a plaintiff to profit from a strike suit. The secret settlement could entail not only cash payments but also promises to retain plaintiff’s attorney for future services. Even if such retention became known, it might be hard to connect it to a secret settlement. Further, rules requiring court approval of settlements of derivative suits do not apply to suits threatened but not filed, Bishop, supra note 37, at 1081 n.11, so that one might profit by threatening without filing a nuisance suit. For example, indemnification by either the corporation or an insurer might be barred in cases of settlement or conditioned on court approval. Only a few jurisdictions currently provide for such reimbursement. See H. HENN, supra
attorneys who bring frivolous derivative suits, and by disciplinary actions against such attorneys.²²¹

Even if strike suits were completely eliminated, the corporation might still become embroiled in an expensive derivative suit that will yield no recovery for the corporation. Parties to all litigation face this danger, however, and the danger does not seem any greater in the field of derivative suits. As Professor Lattin has stated, "The cleansing effect of the threat of such suits would seem to an impartial observer to far outweigh the possible abuse through strike suits."²²² Permitting a director's colleagues on the board to stop a derivative suit against him would vitiate much of this "cleansing effect" and the other benefits of derivative suits.

The Manufactured Pleadings Problem
The proposed approach could give a derivative plaintiff a strong incentive to name a majority of the directors as defendants, thereby both obviating a demand on the board and disabling the board from thwarting the suit. This sticky problem usually arises when the plaintiff alleges that certain persons have profited unfairly at the corporation's expense and that most of the directors, though not profiting themselves, have conspired in, approved, or knowingly or negligently acquiesced in the alleged transactions. On one hand, such allegations, if true, would not only make a demand futile and the board's opposition ineffective to stop a derivative suit, but would also render the majority liable for breach of the directors' duties of care and loyalty.²²³ On the other hand, to permit the plaintiff to circumvent a demand on the board and the effects of the board's refusal to sue simply by adding a few names to his complaint could deprive the board of any power to control corporate litigation. Furthermore, even though in theory directors may be liable for approving or acquiescing in transactions in which they have not profited, cases in which directors have been held so liable actually constitute "a very small number of needles in a very large haystack."²²⁴ Courts have feared, probably too much, that imposition of liability for "mere" negligence on directors, who usually receive small compensation and serve only part time, would deter the most qualified persons from becoming directors.²²⁵

²²² See Note, supra note 3, § 115, at 457. See also text accompanying notes 241-44 infra.
²²³ See generally H. HENN, supra note 1, §§ 218, 234-235; N. LATTIN, supra note 3, §§ 78-79.
²²⁴ See note 37 supra.
²²⁵ Thus, some courts have held that directors are liable only for gross negligence, but this test has been criticized. See note 26 supra.
Given these conflicting considerations, it is not surprising that the courts have dealt with the problem in widely divergent ways. One line of cases holds that allegations of board approval or acquiescence in the alleged wrongs or of domination of the board by the alleged wrongdoers must be supported by particular facts and that domination by the largest (albeit minority) shareholder will not be assumed.\(^{226}\) Another line of cases holds less specific allegations sufficient, or at least is more willing to assume domination of the board by a large shareholder.\(^{227}\)

A few steps can be taken to deal with the problem without dismissing the complaint. In some cases the naming of certain directors may be so patently frivolous that a court might dismiss the complaint as to them. For example, dismissal might be appropriate as to defendants who were not directors at the time of the alleged wrongs.\(^{228}\) On occasion it may be appropriate to approve discovery and a trial limited to the issue of domination of the board, or its knowledge or approval of or acquiescence in the alleged wrong.\(^{229}\) Separate claims of wrongdo-

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226 The case most often cited is *In re Kauffman Mut. Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), a suit charging antitrust and Investment Company Act violations by the investment advisors and minority, affiliated directors of four mutual funds. The court held that allegations of domination and control of the unaffiliated directors without supporting facts were not sufficiently particular to meet the requirements of Fed. R. Civ. P. 23.1 for excuse of a demand on the directors. In dictum the court said that even allegations of participation by the majority in wrongful acts are insufficient to excuse a demand unless they include allegations of "self-interest or other indication of bias." 479 F.2d at 265. See *also* Elfenbein v. Gulf & W. Indus., Inc., 590 F.2d 449 (2d Cir. 1978) (allegation of ownership of 27% of corporate stock and possession of two nominees on board insufficient to plead domination of board); Heit v. Baird, 567 F.2d 1157 (1st Cir. 1977); Meyers v. Keeler, 414 F. Supp. 935 (W.D. Okla. 1976); Phillips v. Bradford, 62 F.R.D. 681 (S.D.N.Y. 1974) (demand held not excused where unaffiliated directors named as defendants without allegations of domination); *Chicago Comment*, supra note 3, at 176-78.


229 See note 183 and accompanying text supra.
ing can be treated separately. Thus, if a few directors are charged with
looting the corporation and the majority are charged with acquiescing
in the looting, the former charge can be handled as a separate charge
not implicating a majority of the directors.

Courts may be justly reluctant to allow bare allegations to circum-
vent the requirement of a demand on the board because compliance
with 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 domination of or collusion, approval, or acqui-
escence by the board may lead to abuses, this seems preferable to
dismissing what may be meritorious claims, thereby negating important
shareholder rights, without full discovery and trial. Perhaps more im-
portant, given the numerous options open to the corporation to defend
itself against frivolous derivative suits and the strong incentive for
plaintiffs not to bring such suits, the prospect that the corporation
may occasionally become involved in a suit that proves frivolous
should not warrant flinging another major obstacle in the path of deriva-
tive plaintiffs.

Disregard of the Corporation’s Best Interests

Even a meritorious suit may be detrimental to the corporation. In
the decided cases, special litigation committees have often pointed to
the costs of litigation, the interruption of corporate business, and the
undermining of personnel morale as reasons for not bringing suit.
To some extent these reasons could justify opposing a derivative suit.
Although certain steps by the corporation, such as demanding security
for expenses or seeking a protective order from the court, can some-
times diminish these problems, they cannot always be eliminated.
Moreover, although the shareholder-plaintiff may have little incentive
to bring a groundless derivative suit, he may well have an incentive
to bring a meritorious suit even though it will be detrimental to the

230 See Chicago Comment, supra note 3, at 172-73.
231 See notes 196-202 and accompanying text supra. See also Fed. R. Civ. P. 11 (providing for
discipline of attorneys who falsely sign pleadings).
232 See Maldonado v. Flynn, No. 77-3180, slip op. at 19 (S.D.N.Y. Jan. 24, 1980) (committee
concerned about costs of litigation and indemnification); Gall v. Exxon Corp., 418 F. Supp. 508,
1980) (committee found “little likelihood of a recovery sufficient to justify the cost of maintaining
421, 428 (1952) (board may consider “cost in money, time and disruption” in deciding whether to
sue).
233 See notes 162 & 164 and accompanying text supra. See also Maldonado v. Flynn, No. 77-
3180, slip op. at 21 (S.D.N.Y. Jan. 24, 1980) (directors may decide to terminate even meritorious
suits).
234 See text accompanying notes 179 & 197-200 supra.
235 See text accompanying notes 209-14 supra.
corporation, since a court may not consider the costs and other detriments of the suit to the corporation in fixing plaintiff's attorneys' fees.\footnote{236} If the suit fails, the corporation not only incurs its own costs, but also may have to reimburse the individual defendants for their costs.\footnote{237}

The proposed approach would allow the court to weigh the costs of the suit to the corporation where a minority of the directors is sued,\footnote{238} but not where a majority is sued. It can be argued that the theoretically disinterested directors should be able to halt a derivative suit even if brought against a majority if they believe it will harm the corporation. Although this argument has considerable validity and is the strongest argument against the proposed approach, it is not ultimately compelling. First, derivative suits often do produce substantial monetary recoveries for the corporation.\footnote{239} Second, the cost of derivative litigation is rarely large in relation to the size of the corporation. Moreover, a substantial part of the cost of derivative litigation results from defendants' efforts to block plaintiff's attempt to reach a hearing on the merits. The high cost of shareholder suits would be better attacked by legislative or judicial reform sweeping away many of these obstacles (as well as dealing with excessive discovery by plaintiffs), rather than by permitting directors of dubious independence to terminate such suits.

\footnote{236} The author is not aware of any case where a court has explicitly taken such costs and detriments into account. There are, however, several cases where courts have denied plaintiffs attorneys' fees altogether because the plaintiff, though partly successful, conferred little benefit on the corporation. \textit{In re St. Clair Estate Co.}, 66 Cal. App. 2d 964, 153 P.2d 453 (1944); \textit{Bachelder v. Brentwood Lanes, Inc.}, 369 Mich. 155, 119 N.W.2d 630 (1963). That the costs of these suits to the corporation exceeded the benefits received may have been an unspoken reason for complete denial of attorneys' fees. Furthermore, in considering whether to approve proposed settlements, courts have often weighed the costs to the corporation of continued litigation, including adverse effects on the company's public relations and employee morale. \textit{Protective Comm. v. Anderson}, 390 U.S. 414, 434 (1968); \textit{In re Chicago Rapid Transit Co.}, 196 F.2d 484, 490-91 (7th Cir. 1952); \textit{Roman v. Master Indus., Inc.}, [1966-1967 Transfer Binder] \textit{Fed. Sec. L. Rep. (CCH)} ¶ 91,806 (S.D.N.Y. 1966); \textit{Berger v. Dyson}, 111 F. Supp. 533, 535-36 (D.R.I. 1953); \textit{Hoffman v. Dann}, 42 Del. Ch. 123, 139-40, 205 A.2d 343, 352-53 (Sup. Ct. 1964), \textit{cert. denied}, 380 U.S. 973 (1965); \textit{Heimann v. American Express Co.}, 53 Misc. 2d 749, 767, 279 N.Y.S.2d 867, 884 (Sup. Ct. 1967); \textit{Man v. Luke}, 82 N.Y.S.2d 725, 731-32 (Sup. Ct. 1948). Indeed, the corporation may settle the dispute with the true defendants, see note 198 \textit{supra}, and the court will consider the detriment of continued litigation to the corporation's public relations and employee morale in deciding whether to approve the settlement. See, e.g., \textit{Denicke v. Anglo Cal. Nat'l Bank}, 141 F.2d 285, 288 (9th Cir.), \textit{cert. denied}, 323 U.S. 739 (1944).

\footnote{237} See note 75 \textit{supra}. In many cases, especially where a defendant has settled or been only partially successful at trial, a corporation may indemnify the defendant but is not statutorily required to do so. See, e.g., \textit{Del. Code Ann. tit. 8, § 145(a) & (b)} (1975); \textit{N.Y. Bus. Corp. Law § 724(b)} (McKinney 1963). It is questionable whether such a voluntarily incurred cost should be a cause for the corporation to complain.

\footnote{238} See text accompanying notes 162-64 \textit{supra}.

On another level, many of the benefits and detriments of derivative suits are nonmonetary or nonquantifiable. On the detriment side, the costs of interruption of business and undermining of personnel morale are difficult to estimate. It might be argued that the undermining of personnel morale merits consideration apart from its financial impact on the corporation. Morale problems, however, will primarily affect those accused of misconduct. For them, the effect is perhaps unfortunate but necessary if they are guilty; if they are not guilty, successful defense of the suit and reimbursement of litigation costs from the corporation should be sufficient vindication.

On the benefit side, the monetary value to the corporation of injunctions procured on its behalf is also hard to estimate. More important is the deterrent value of shareholder suits. The broader implications of the deterrent effect of derivative suits are discussed below, but even considering only the single corporation in question, the deterrent value of derivative suits—though impossible to estimate—is undoubtedly very great.240

In sum, the quantifiable monetary costs to the corporation of a particular suit are unlikely to harm the corporation substantially, and in general these costs probably do not greatly exceed the quantifiable monetary benefits of derivative suits. Moreover, the total benefits of derivative suits far outweigh their detriments. Accordingly, the directors' decision that a derivative suit against their colleagues should be halted because its potential costs outweigh its potential benefits should only be considered as one relevant factor when a minority of directors is sued and should be disregarded when a majority is sued.

DETERRING CORPORATE ABUSES AND LEGITIMIZING CORPORATE GOVERNANCE

In addition to the immediate, perceptible benefits a corporation realizes from a successful derivative suit, derivative suits serve the additional, and perhaps more important, function of deterring corporate abuses and legitimizing the corporate governance system. The deterrent effect of derivative suits, though not quantifiable, has been recognized by courts and commentators.241 If directors and officers know that any charge of wrongdoing on their part will be weighed by their colleagues on the board and not by a court with the assistance of an aggressive attorney for plaintiffs, the temptation of directors and officers to line their pockets at the expense of the shareholders will be greatly increased, and some will succumb to the temptation.

240 See note 241 and accompanying text infra.
241 See Brendle v. Smith, 46 F. Supp. 522, 525-26 (S.D.N.Y. 1942); N. LATTIN, supra note 3, § 115, at 457; Bishop, supra note 37, at 1087 (“[T]he principal legal deterrent to the common varieties of self-dealing is probably fear of civil liability.”); Hornstein, supra note 6, at 31.
If corporate abuses increase, shareholders will not be the only losers. There has been growing criticism of, and even cynicism toward, the corporate governance system, and any judicially created rule that encourages corporate abuses by limiting derivative suits will breed more of the same. A review of the various proposals to improve corporate governance is beyond the scope of this article. It suffices to say that broad availability of derivative suits to disgruntled minority shareholders not only is consistent with these proposals but, as compared with them, has the advantage of requiring minimal governmental interference with corporate management and no additional legislation.

It is not surprising that corporate officers and directors should oppose derivative suits, but their opposition is shortsighted. If courts allow corporate miscreants to go free at the behest of the miscreants’ fellow directors, public resentment will force changes in corporate governance laws—changes that corporations almost certainly will find more onerous than derivative suits.

CONCLUSION

Recent decisions granting the board of directors broad powers to terminate derivative suits have created a grave danger that serious wrongs by corporate insiders may go unchallenged. The proposals set forth in this article would drastically reduce that danger without rendering the corporation defenseless against frivolous or unduly costly derivative suits. The question remains who will see that these proposals, or something like them, are put into effect.

The state legislatures are unlikely to do so. Most state legislation during the last forty years has been designed to limit derivative suits, not encourage them. Congress cannot act directly to amend laws relating to state-created derivative actions and is unlikely to authorize federal derivative actions dealing with abuses by corporate insiders generally, although it might deal with the problem by requiring federal chartering or minimum standards for state chartering. Also, Burks v. Lasker makes it likely that the federal courts will follow state law as

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242 See, e.g., Coffee, supra note 83, at 1104 & 1108 n.19 (the latter containing a brief list of proposals for reform).
243 See Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978), rev’d on other grounds, 99 S. Ct. 1831 (1979) ("[I]t cannot be expected that the public or the Fund’s stockholders would believe that . . . statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires.").
244 For example, Senator Metzenbaum is planning to introduce a bill to establish minimum federal standards for state chartering of certain corporations. SEC. REG. & L. REP. (BNA) A-1 (Dec. 12, 1979).
245 See notes 5-6 and accompanying text supra.
246 See note 244 supra.
to whether the board may terminate derivative suits. Therefore, relief must come from the state courts. Although the judicial record to date is not encouraging, a change of direction is quite possible.

First, the precedents will not bind too tightly a court that wants to impose meaningful limits on board termination of derivative suits. Most of the special litigation committee cases arose either in New York courts or in federal courts that tried to apply state law that was, except as to New York, almost nonexistent. Even in New York, the special facts of *Auerbach v. Bennett* make it easy to distinguish. Most other refusal-to-sue cases have also been decided by federal courts. Thus, there is firm authority for board termination of derivative suits in only a few states. Second, since most of the cases purport to apply the business judgment rule, a court could go far toward adopting the proposals contained herein by taking the reasonable view that the business judgment rule requires clear proof both of the directors' independence and of their reasonably prudent investigation of the facts. Finally, the recent Delaware cases on "going private" transactions show that state courts can act quickly to enforce fiduciary duties when they choose to do so, even though precedents suggest that they might not act at all.

In sum, the path is still open for state courts to remedy the dangers created by board termination of derivative suits, thereby preserving the derivative suit as an important tool to maintain the integrity of corporate officers and directors. To reject this path and to follow instead the path suggested by the cases to date will certainly mean the virtual death of the derivative suit.

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248 See notes 43-50 and accompanying text supra.
249 See generally text accompanying notes 51-69 supra.
251 See note 64 supra.
252 See note 25 supra.
254 Indeed, the Delaware courts may already have begun to act. In Maldonado v. Flynn, No. 4800 (Del. Ch. Mar. 18, 1980), decided while this article was going to press, the court held that the business judgment rule is irrelevant to an attempt by a supposedly independent board committee to terminate a derivative suit charging breach of fiduciary duty. The court therefore denied defendants' motion for summary judgment. This decision, together with Galef v. Alexander, No. 79-7166 (2d Cir. Jan. 22, 1980) (holding that the board may not terminate a derivative suit naming all the directors as defendants), may presage a split among the courts, prompting a thorough reconsideration of the path the courts have been taking.