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The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits

MARC I. STEINBERG*

A corporation's board of directors will frequently appoint a special litigation committee when faced with a shareholders' derivative action against fellow directors. Committee dismissal of such actions is the subject of increasing scrutiny by the courts. The author addresses this particular issue by analyzing the relevant federal and state court decisions and by focusing on special procedures that should be employed to ensure that the decision reached by the special litigation committee serves the best interests of the corporation and its shareholders. The author concludes that the principle of corporate accountability should determine the extent to which such committees may exercise their business judgment to bar such shareholder derivative suits.

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I. INTRODUCTION

What may be viewed as a fairly new defensive strategy in response to shareholders' derivative suits against corporate directors is the appointment of a special litigation committee by the defendant corporation's board of directors. The committee, usually composed of nondefendant directors, retains outside counsel of unimpeachable integrity. After calling witnesses, examining documentary evidence, and issuing a detailed report, the committee, with the concurrence of the special counsel, concludes that the suit is contrary to the corporation's best interests because of the litigation's improbability of success, its high costs, the disruption to the company's business, and the adverse impact on employee morale. Relying on the special litigation committee's report, the corporation seeks to dismiss the complaint.¹

The extent to which a special litigation committee appointed by a corporation's board of directors can exercise its business judgment to cause the dismissal of such a shareholders' derivative suit remains somewhat unsettled.² This article will address that issue in the context of the applicable federal and state law, analyze the discerning trends in the case law, and focus on the use of procedures that may help protect the best interests of the corporation and its shareholders.

Perhaps the most important decision in this context is the Supreme Court's opinion in Burks v. Lasker.³ Also significant are the post-Burks lower federal court holdings that scrutinize crucial issues not raised before the Supreme Court. Moreover, state court decisions must be fully digested, particularly in light of the recent decision by the Delaware Chancery Court in Maldonado v. Flynn.⁴


4. 413 A.2d 1251, subsequently dismissed on res judicata grounds, 417 A.2d 378 (Del.
Currently on appeal to the Delaware Supreme Court, the lower court decision in Maldonado held that under Delaware law the independent directors are precluded from compelling the dismissal of a shareholder's derivative action which seeks redress against fellow directors for breach of fiduciary duty.

II. THE BUSINESS JUDGMENT RULE AND Burks v. Lasker

As a general proposition, modern corporation laws vest responsibility for the management of a corporation in the board of directors, which stands in a fiduciary relationship to both the shareholders and the corporation. These fiduciary responsibilities require directors to act in good faith and in the corporation's best interests. The business judgment rule complements this standard of care by generally providing that directors, absent self-dealing or other personal interest, shall be insulated from liability for injury 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." In other words, under the business judgment rule,
directors are not liable for mere errors in judgment not constituting breaches of their fiduciary duty.\textsuperscript{10}

Included within the authority to manage the corporation is the directors' determination of whether the corporation shall bring suit for redress of wrongs it allegedly has suffered.\textsuperscript{11} Invocation of the business. Because they are given this wide latitude, the law will not hold directors liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the head of honest mistakes. And that is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs. The rule is commonly referred to as the "business judgment rule," which generally applies to decisions of executive officers as well as those of directors. The basis of this rule is the wide latitude that directors of a corporation are given in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.

3A W. FLETCHER, Cyclopedia of the Law of Private Corporations § 1039 at 37-38 (rev. perm. ed. 1975). Recently, one commentator has proffered the following definition of the business judgment rule:

A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damages, unless:

1. the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or

2. the directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or

3. in some other way the directors' authorization of the transaction was not in good faith.


10. See authorities cited notes 7-9 supra. In Auerbach v. Bennett, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979), the New York Court of Appeals gave its rationale for the applicability of the business judgment doctrine:

It appears to us that the business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments. The authority and responsibilities vested in corporate directors both by statute and decisional law proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise. Even if that were not the case, by definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility. Thus, absent evidence of bad faith or fraud (of which there is none here) the courts must and properly should respect their determinations.

11. See United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917).
business judgment rule as a ground for the directors’ refusal to bring suit or their active opposition to a derivative action will warrant, under some circumstances, dismissal of the action.\textsuperscript{12} Until recently, this principle was primarily applied when the alleged wrongdoers were not affiliated with the corporation. Under such circumstances, directors could be expected to judge impartially the benefits and detriments of bringing suit.\textsuperscript{13} For example, Mr. Justice Brandeis, addressing the decision by the board of directors of a corporation not to bring an antitrust action against a third party, remarked:

Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the shareholders. Courts interfere seldom to control such discretion \textit{intra vires} the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment . . . .\textsuperscript{14}

As Mr. Justice Brandeis implied, the rule generally has not been invoked if the directors are implicated in the alleged wrong.\textsuperscript{15} Re-


\textsuperscript{13} See Dent, \textit{supra} note 9, at 98.

\textsuperscript{14} United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. at 263-64 (emphasis added).


As an analogy, before commencing suit, a shareholder must make a demand on the board of directors that it bring suit to seek redress, unless such a demand would be futile. \textit{See} Fed. R. Cvr. P. 23.1:

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

\textit{Such a demand on the board has been held to be futile if the alleged wrongdoers constitute}
cently, however, several courts have applied the rule when a duly
appointed special litigation committee composed of directors not
involved in the alleged wrong has elected not to bring suit.18 The
starting point in this analysis is the Supreme Court's fairly recent
decision in *Burks v. Lasker.*17

The issue in *Burks* was whether a quorum of four statutorily
disinterested directors within the meaning of the Investment Com-
pany Act18 could terminate a shareholders' derivative suit against
fellow directors on the basis that, in the exercise of their good faith
business judgment, the continuation of the litigation was not in the
company's best interests.19 Rather than directly answering this in-
quiry, the Supreme Court promulgated a two-prong test: (1) whether
the applicable state law allows the disinterested directors
to terminate a shareholders' derivative suit, and (2) whether such a
state rule is consistent with the policies underlying the federal se-
curities laws.20


When a majority of the directors have engaged in fraud or self-dealing, such
as appropriating a corporate opportunity, courts have generally not required de-
mand. But when a majority of the directors are accused of approving or pas-
sively acquiescing in an allegedly injurious transaction, courts are split on
whether demand should be required.

See also text accompanying note 57 infra.


19. 441 U.S. at 473-74. The disinterested directors were appointed by the board of di-
rectors of the defendant fund and were not named as defendants.

20. Id. at 480, 486. Although the Court's decision promulgated this standard within
the context of the Investment Company Act, subsequent lower court decisions have applied it
irrespective of the federal securities act alleged to have been violated. See cases cited note 1
supra. Unlike the other securities acts, however, the Investment Company Act requires that
at least forty percent of the directors of such companies be "independent." See 15 U.S.C. §§
80a-2(a)(19), -10 (1976); 441 U.S. at 482. As noted by the *Burks* Court: "Congress' purpose
in structuring the Act as it did is clear. It was 'designed to place the unaffiliated directors in
the role of "independent watchdogs."' " Id. at 484 (quoting Tannenbaum v. Zeller, 552 F.2d
402, 406 (2d Cir.), cert. denied, 434 U.S. 934 (1977)). Nevertheless, the Second Circuit in
The Court's opinion, however, left unresolved a number of issues. For example, what constitutes, for purposes other than the Investment Company Act, a "disinterested" director? Will courts inquire into the "reasonableness" of the directors' determination to bar a shareholders' derivative suit? May less than a quorum of directors properly act for the corporate entity for these purposes?

Of course, prior to the Court's opinion in Burks, a number of lower federal courts rendered decisions on this subject, generally holding that a good faith decision by a special litigation committee to bar a shareholders' derivative suit against fellow directors is permitted under the business judgment rule. Decisions reflecting this rationale include Rosengarten v. International Telephone & Telegraph Corp.21 and Gall v. Exxon Corp.22 In both of these decisions, it is interesting to note that the plaintiffs were granted limited discovery to test the bona fides and independence of the special litigation committee members.28 In subsequent cases, if the plaintiff has pleaded bad faith or lack of independence on the part of the members of the committee, a number of courts have similarly permitted limited discovery.24

Burks held that "disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties." Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978), rev'd, 441 U.S. 471 (1979).

For additional commentary on Burks, see Bishop, supra note 1, at 161-62; Block & Barton, supra note 7, at 102; Dent, supra note 9, at 104-05; Gammon, Derivative Suits, 12 Rev. Sec. Rtg. 887, 887-91 (1979). See generally Note, Mutual Fund Independent Directors: Putting a Leash on the Watchdogs, 47 Fordham L. Rev. 568 (1979).

22. 418 F. Supp. 508 (S.D.N.Y. 1976). As stated by the court in Gall:

It is clear that absent allegations of fraud, collusion, self-interest, dishonesty or other misconduct of a breach of trust nature, and absent allegations that the business judgment exercised was grossly unsound, the court should not at the instigation of a single shareholder interfere with the judgment of the Corporate officers.

Id. at 516. But see Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973, 977 (S.D.N.Y. 1977) ("It is inconceivable that directors who participated in and allegedly approved of the transaction under attack can be said to have exercised unbiased business judgment in declining suit based on that very transaction."); Swenson v. Thibaut, 39 N.C. App. 77, 250 S.E.2d 279 (1978) (court refused to apply business judgment rule to determination made by special litigation committee when defendant directors influenced members of the committee).

23. See 466 F. Supp. at 823; 418 F. Supp. at 520 ("Plaintiff must be given an opportunity to test the bona fides and independence of the Special Committee through discovery and, if necessary, at a plenary hearing.").

Although the result reached in cases like *Rosengarten* and *Gall* may well be the same after *Burks*, it is clear that *Burks*’ two-prong analysis must now be employed. One pre-*Burks* decision, however, may still remain good law. In *Miller v. American Telephone and Telegraph Co.*, the complaint in a shareholders’ derivative action alleged that the company had neglected to collect a $1.5 million debt owed by the Democratic National Committee. Holding that the business judgment rule was unavailable under New York law, the court rested its decision on the premise that, as alleged in the complaint, the failure of the directors to collect the debt may itself have constituted a continuing illegal act. Atypical of the *Burks* scenario was the presence in *Miller* of an allegation that the directors’ decision not to prosecute the claim was *itself* an illegal act.

III. *Burks*’ Progeny in the Federal and State Courts

The following discussion analyzes the relevant federal and state court decisions on the authority of special litigation committees to dismiss shareholder derivative suits against fellow directors. Note that the first prong of *Burks*’ two-prong analysis may require a federal court, in essence, to sit as a state court. Only if relevant state law permits director dismissal of the derivative suit will a federal court turn to the second prong. If, however, dismissal is sought in state court, the only inquiry is whether applicable state law authorizes such dismissal.

A. Federal Court Decisions

After *Burks*, a number of federal courts have considered the

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25. 507 F.2d 759 (3d Cir. 1974).
26. Id. at 761.
27. Id. at 762. The district courts in *Gall* and *Rosengarten* expressly distinguished *Miller* on this basis. See 466 F. Supp. at 824 n.8; 418 F. Supp. at 518.
28. E.g., Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979); see notes 72-75 and accompanying text infra.
29. See *Burks* v. Lasker, 441 U.S. at 480-81. *Burks* signified, as have other recent cases, that the degree of investor protection under the federal securities laws will depend in large part on state law. Thus, the Court remarked: “Congress has never indicated that the entire corpus of state corporate law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute.” Id. at 478. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977); *Cort v. Ash*, 422 U.S. 66, 84 (1975). See generally *Ferrara & Steinberg, A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. Pa. L. Rev. 263 (1980).
authority of special litigation committees to dismiss shareholder
derivative suits. For example, in Abbey v. Control Data Corp.,31
shareholders brought a derivative action to recover $1.3 million
from seven senior officers and directors after the corporation pled
guilty to making illegal payments to certain foreign entities. In
particular, the suit charged violations of sections 13(a) and 14(a)
of the Securities Exchange Act32 by the corporation's failure to
disclose the illegal payments.33 After conducting its investigation, a
special litigation committee composed of seven outside directors,
who were appointed by their fellow directors, concluded that the
derivative suit was not in the corporation's best interests.34 The
district court subsequently granted summary judgment for the cor-
poration.8

Employing Burks' two-prong analysis, the Eighth Circuit affirmed, concluding that Delaware law authorizes dismissal of
a shareholders' derivative suit if the determination by the outside
directors was reasonable and in good faith,35 and that, in this case,
the plaintiff's federal law claims were at best weak.36 In an accom-
panying footnote, however, the court implied that, in certain in-
stances, the strength of the federal policy involved may preclude
committee dismissal of the plaintiff's federal claims.37

Relying on both Burks and Abbey, the Ninth Circuit reached a
like result in Lewis v. Anderson,38 with the exception that the
Lewis court reserved for trial the issue whether the committee did,
in fact, exercise good faith business judgment.40 Interestingly, one
claim of the plaintiffs alleged that the defendants violated section

31. 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980).
33. 603 F.2d at 726.
34. Id. at 727.
35. Id.
36. "As a matter of Delaware law, we agree with the district court that the rule appar-
tently applies to any reasonable good faith determination by an independent board of direc-
tors that the derivative action is not in the best interests of the corporation." Id. at 730.
37. Id. at 731-32. The Abbey court observed that the plaintiff had failed to show
"transactional causation." See notes 59-62 and accompanying text infra.
38. See 603 F.2d at 728 n.4. See also Burks v. Lasker, 441 U.S. at 487 (Blackmun, J.,
concurring) ("[T]he reason that state law conflicts with federal policy is that the situation could very well exist where state law conflicts
(there may be cases in which a business judgment dismissal of claims that directors have
violated the proxy solicitation rules is not consistent with the policy of full disclosure which
is necessary for the ultimate goal of shareholder protection . . . ."). But see 441 U.S. at 487
(Stewart, J., concurring in the judgment) ("I cannot agree with the implications in the
Court's opinion that there is any danger that state law will conflict with federal
policy.").
39. 615 F.2d 778 (9th Cir. 1979), cert. denied, 101 S. Ct. 206 (1980).
40. Id. at 780.
10(b) of the Securities Exchange Act\(^41\) by trading on inside information.\(^43\) The court's dismissal of this claim raises important policy considerations. Even in light of the Supreme Court's restrictive decisions in the securities law area,\(^44\) including Chiarella v. United States,\(^44\) there can be little question that the proscription against trading on inside information by those who owe a fiduciary duty to


\(^{42}\) 615 F.2d at 783-84.

\(^{43}\) See, e.g., Aaron v. SEC, 100 S. Ct. 1945 (1980) (scienter required in SEC injunctive actions under § 10(b) of Exchange Act, rule 10b-5 thereunder, and § 17(a)(1) of Securities Act); Chiarella v. United States, 100 S. Ct. 1108 (1980) (no duty to disclose under section 10(b) from mere possession of nonpublic market information); Transamerica Mortgage Advisers, Inc. v. Lewis, 100 S. Ct. 242 (1979) (no implied private right of action under § 206 of the Investment Advisers Act; limited implied private right of action under § 215); Touche Ross & Co. v. Redington, 99 S. Ct. 2479 (1979) (no implied private right of action under § 17(a) of the Exchange Act); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979) (interest in noncontributory, compulsory pension plan not “security” subject to regulation under Securities Acts); SEC v. Sloan, 436 U.S. 103, 111-12 (1978) (limiting SEC's right to suspend summarily trading in registered securities for successive 10-day periods); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-74 (1977) (breach of fiduciary duty, without manipulation or deception, not actionable under § 10(b) of Exchange Act and rule 10b-5); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 28 (1977) (defeated tender offeror has no standing to bring implied private right of action for damages under § 14(e) of Exchange Act); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (scienter required in private damage actions under § 10(b) and rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975) (only purchasers and sellers have standing to bring implied private cause of action for damages under § 10(b) and rule 10b-5).

\(^{44}\) See generally Lowenfels, Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings, 65 Geo. L.J. 891 (1977); Steinberg, Implied Private Rights of Action under Federal Law, 55 Notre Dame Law. 33 (1979). With respect to § 10(b), Justice Blackmun, dissenting in Chiarella stated: “The Court continues to pursue a course, chartered in certain recent decisions, designed to transform § 10(b) from an internationally elastic 'catchall' provision to one that catches relatively little of the misbehavior that all too often makes investment in securities a needlessly risky business for the uninformed investor.” 100 S. Ct. at 1123-24 (Blackmun, J., dissenting).

On occasions, however, the Court has departed from this restrictive approach. See, e.g., Steadman v. SEC, [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,878 (U.S. 1981) (SEC correctly employed preponderance of the evidence standard in administrative proceeding); Rubin v. United States, 101 S. Ct. 698 (1981) (pledge of stock as collateral for a loan is an “offer or sale” of a security under § 17(a) of the Securities Act); Aaron v. SEC, 100 S. Ct. 1945 (1980) (scienter not required in SEC injunctive actions under § 17(a)(2) or § 17(a)(3) of Securities Act); United States v. Naftalin, 441 U.S. 768 (1979) (reach of § 17(a) of Securities Act extends beyond actual purchasers and sellers and encompasses aftermarket trading frauds). See generally Cannon v. University of Chicago, 441 U.S. 677 (1979) (implication of private right of action under Title IX of the Education Amendments of 1972). For a discussion of the possible ramifications of Aaron, Naftalin, and Steadman, see Steinberg, SEC and Other Permanent Injunctions—Standards for Their Imposition, Modification, and Dissolution, 66 Cornell L. Rev. 27 (1980); Steinberg, Steadman v. SEC—Its Implications and Significance, 6 Del. J. Corp. L. 1 (1981); Steinberg, Section 17(a) of the Securities Act of 1933 After Naftalin and Redington, 68 Geo. L.J. 163 (1979).

\(^{44}\) 100 S. Ct. 1108 (1980).
shareholders and the corporation remains a fundamental tenet underlying the objectives of the federal securities acts of protecting the investing public and the integrity of the marketplace. To allow dismissal of such claims without permitting the opportunity for redress arguably runs contrary to these objectives.

45. The Chiarella Court recognized:

Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material nonpublic information.


46. Quoting approvingly from Cady, Roberts & Co., 40 S.E.C. 907 (1961), the Supreme Court in Chiarella stated that the obligation to disclose or abstain from trading derives from

[a]n affirmative duty to disclose material information[,] which has been traditionally imposed on corporate ‘insiders,’ particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.


Another important question is whether a special litigation committee may, consistently with federal policy, terminate a derivative action alleging violations of § 16(b) of the Securities Exchange Act. By its terms, § 16(b) authorizes shareholders, under certain circumstances, to sue derivatively to enforce the corporation's right to recover insiders' short-swing profits. 15 U.S.C. § 78p(b) (1976); see Genzer v. Cunningham, 498 F. Supp. 682, 689 (E.D. Mich. 1980) (In ordering dismissal under § 14(a), the court noted that “[t]his is in sharp contrast to § 16(b) . . . [which] specifically authorizes shareholder suits to be instituted if the board of directors fails or refuses to bring the suit . . . .”); Grynberg v. Farmer, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,683 (D. Colo. Oct. 8, 1980) (Federal district court rejected the special litigation committee's determination and denied a motion for summary judgment in a suit based on violations of § 16(b) on the grounds that the members of the committee were biased, that the committee failed to engage independent counsel, and that one member of the committee was counsel to a defendant-director).
Equally disconcerting is the Lewis court’s implicit approval of the special litigation committee’s composition, which consisted of two outside directors and one director who was a named defendant but who did not personally benefit from the challenged transaction.\textsuperscript{47} The potential danger of using named defendants to dismiss shareholder derivative suits is illustrated by the Second Circuit’s decision in Galef v. Alexander.\textsuperscript{48} In Galef, the derivative action alleged that all fifteen directors had violated the proxy prohibitions of the Securities Exchange Act. Those defendant directors who did not benefit from the transaction\textsuperscript{49} determined that the suit was not in the corporation’s best interests and sought dismissal. In holding that dismissal of the suit was inappropriate, the Second Circuit concluded that the defendant directors who sought dismissal stood in a “dual relation” which prevented an unbiased exercise of judgment.\textsuperscript{50} In reaching this conclusion, the court seemed to imply that “disinterested” within the “dual relation” context must signify, at a minimum, that the disinterested directors did not authorize or approve the challenged transaction and were not named as defendants in the lawsuit.\textsuperscript{51} Thus, the court asserted, one could not expect that directors who had participated in or approved of the transaction, or who were themselves subject to personal liability, would determine impartially whether the shareholders’ derivative suit was warranted.\textsuperscript{52}

Viewing Lewis and Galef in conjunction, one can reconcile the two decisions only on the basis that the defendant director in Lewis composed only a minority of the special litigation committee. Hence, dismissal of the derivative suit would have occurred regardless of the defendant director’s appointment to the committee. Whether this distinction between these two cases is viable remains to be seen. Unfortunately, the court in Lewis never focused

\begin{itemize}
\item \textsuperscript{47} 615 F.2d 778, 782 (9th Cir. 1979).
\item \textsuperscript{48} 615 F.2d 51 (2d Cir. 1980).
\item \textsuperscript{49} The complaint alleged that proxy statements, seeking shareholder approval of stock option plans benefitting various directors, failed to meet the disclosure requirements of § 14(a) of the Securities Exchange Act. Id. at 53.
\item \textsuperscript{50} Id. at 60 (quoting United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917)). Distinguishing United Copper from the case at bar, the Galef court noted that “[i]n each case, the court has indeed allowed directors to preclude pursuit of a corporate claim, but in each the directors who made such a determination were not alleged to have authorized or approved the challenged transaction, and they were not made defendants in the lawsuit.” 615 F.2d at 60.
\item \textsuperscript{51} 615 F.2d at 60, 61.
\item \textsuperscript{52} Id. at 61.
\end{itemize}
In *Galef*, the Second Circuit also relied on the strong federal policies underlying claims based on the federal proxy provisions and on the defendant directors' participation in the alleged proxy violation. Turning to this point, the court observed that management's role in adequately educating the shareholder to enable him to vote intelligently is unique. Because directors are fiduciaries, have the greatest access to factual corporate information, and are most knowledgeable about the corporation's long-range plans, shareholders naturally rely heavily on their representations. Because of such reliance, the objective of section 14(a), that communications from management be full and fair as to all material facts, is a crucial one. According to the court, the achievement of this goal:

would quite clearly be frustrated if a director who was made a defendant in a derivative action for providing inadequate information in connection with a proxy solicitation were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation. The very premises which give life to a derivative right of action to enforce § 14(a) must save it from a premature death. In short, we conclude that to the extent that a complaint states claims against directors under § 14(a) upon which relief may be granted, federal policy prevents the summary dismissal of those claims pursuant to the business judgment of those de-

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53. See 615 F.2d at 783.
54. 615 F.2d at 62-66.
56. Id. at 63-64; see J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964). See generally Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973), in which the Second Circuit spoke of management's responsibilities in the tender offer context:

By reason of the special relationship between them, shareholders are likely to rely heavily upon the representations of corporate insiders when the shareholders find themselves in the midst of a battle for control. Corporate insiders therefore have a special responsibility to be meticulous and precise in their representations to shareholders.

At first glance, it may appear that the court's rationale in *Galef* extends to any shareholders' derivative suit alleging section 14(a) violations by defendant directors. In other words, the federal policies in favor of disclosure are so vital that any state rule that allows dismissal in such circumstances necessarily conflicts with such policies. An important limitation in the court's language, however, is that a claim under section 14(a) must be one "upon which relief may be granted." As interpreted by the courts, "transactional causation" is an essential element of a section 14(a) cause of action, signifying that "[t]he harm to plaintiff-shareholders must have resulted from the corporate transactions which were authorized as a result of the false or misleading proxy solicitations." As applied to the facts in *Galef*, the defendant directors allegedly failed to disclose material facts when securing shareholder approval of stock option plans that inured to the direct benefit of certain recipient-directors, and when subsequently seeking the election of those directors. In this context, *Galef* may stand for the proposition that when there is a direct link between the alleged nondisclosures and the shareholder vote, the federal policies embodied in section 14(a) preclude dismissal of the deriva-

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57. 615 F.2d at 63-64. In making this statement, the court pointed out that its holding did not mean that a plaintiff could evade an otherwise available business judgment dismissal merely by asserting claims against all of the directors under § 14(a). The court opined that, depending on the facts of each particular case, a motion to dismiss under Fed. R. Civ. P. 12(b)(6) or a motion for summary judgment under id. 56, would be appropriate. 615 F.2d at 66.

The *Galef* court also analogized to the demand requirement, noting that the type of cases "in which the plaintiff stockholder has made a demand on the directors which has been rejected, are structurally closer to the case at hand, because the business decision not to have the corporation's claim pursued has been made and is known, and the question is whether that decision will be treated as definitive." *Id.* at 60. For a discussion of this analogy, see Dent, *supra* note 9, at 114-17; Brodsky, *Business Judgment Rule*, N.Y.L.J., Feb. 20, 1980, at 1. *See generally* notes 7-15 and accompanying text *supra*.

58. *See* 615 F.2d at 63, 64.

59. *Id.* at 64; *see* note 57 *supra*.


61. Abbey v. Control Data Corp., 603 F.2d at 732; *accord*, cases cited note 60 *supra*.

62. *See* 615 F.2d at 63-64. In *Galef*, the shareholders also sought to void the 1974-1976 election of directors, alleging inadequate disclosure of certain directors' remuneration from the stock option grants. Because the suit sought, *inter alia*, to set aside the elections on
tive suit by defendant directors.

In Galef, the Second Circuit left unresolved the question whether it would contravene federal policy for (1) nondefendant directors or (2) a committee composed of disinterested nondirectors to authorize, if state law allowed, the termination of a shareholders' derivative suit alleging violations of the proxy provisions.\textsuperscript{63} The federal district court's opinion in Maldonado v. Flynn\textsuperscript{64} sheds some light on the question. In that case, the plaintiff alleged that the proxy materials used to secure the election of Zapata Corporation's board of directors were false and misleading in failing to disclose the circumstances surrounding modification of a stock option plan.\textsuperscript{65} In response to this suit and two related actions, Zapata's board formed an "independent investigation committee" composed of two nondefendant directors who were appointed to the board after the derivative suits had commenced. After retaining special counsel to assist it, the committee conducted a three-month investigation, which included examining thousands of documents and conducting numerous interviews. In its report, the committee ultimately determined that the three actions were not in the corporation's best interest, for twelve specified reasons. Zapata thereupon moved to dismiss Maldonado's complaint.\textsuperscript{66}

Applying Burks, the district court held that an independent

account of the alleged nondisclosures, the court deemed the causation requirement satisfied. \textit{Id.} at 65-66 (relying on Weisberg v. Coastal States Gas Corp., 609 F.2d 650 (2d Cir. 1979), \textit{cert. denied}, 100 S. Ct. 1600 (1980)).

\textsuperscript{63} 615 F.2d at 64 n.20.
\textsuperscript{64} 485 F. Supp. 274 (S.D.N.Y. 1980).

The first Maldonado case, Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979), also a shareholder's derivative suit, involved allegations that §§ 10(b) and 14(a) of the Securities Exchange Act were violated in the administration of the corporation's stock option plan for key employees of Zapata and its subsidiaries. The Second Circuit found the claim under § 10(b) to be without merit, reasoning that "[s]ince the amendments [modifying the stock option plan] were thus validly enacted by a vote of disinterested board members who had been fully informed of all material facts, their knowledge was attributable to the Corporation and no 'deception' occurred within the meaning of Rule 10b-5." \textit{Id.} at 795. For a more extensive discussion on this aspect of Maldonado, see Ferrara & Steinberg, \textit{supra} note 29. With respect to the section 14(a) claim, which alleged that the proxy statements soliciting votes for the election of Zapata's directors were materially false and misleading, the Second Circuit remanded, reasoning that a reasonable shareholder could have considered the information important. 597 F.2d at 796-98. Thereafter, the corporation formed a special litigation committee consisting of two newly appointed directors who, after conducting an investigation, recommended that the derivative action be terminated. 485 F. Supp. at 278.

\textsuperscript{66} \textit{See} authorities cited note 65 \textit{supra}.
committee of disinterested nondefendant directors could foreclose the bringing of a shareholder's derivative suit against corporate directors based on federal proxy claims if the applicable state law permitted such termination and if such dismissal was not inconsistent with the policies underlying the federal proxy provisions.\textsuperscript{67} Answering both questions in the affirmative, the court concluded that "if a committee of independent, personally disinterested directors of Zapata has determined in good faith that in its business judgment the continuation of this action is not in the best interests of the corporation, the action must be dismissed."\textsuperscript{68}

It is significant that the district court reached its decision notwithstanding that the directors comprising the special investigation committee (1) were not elected by the shareholders, but were appointed by the defendant directors, (2) were appointed for the sole purpose of serving on the committee, i.e., to exercise their business judgment about the derivative litigation, and (3) had some prior, although not substantial, contacts with certain of the defendant directors. In sum, the logic of the court's decision may well have been based on such factors as the thorough investigative and procedural record developed by the committee, the apparent disinterestedness of the committee's members in the activities they investigated, and the board's delegation of binding authority (not subject to the board's review) to the committee to investigate and ultimately to determine whether the litigation was in the corporation's best interests.\textsuperscript{69}

B. State Court Decisions

Under the first prong of the \textit{Burks} standard, a federal court is to determine whether the applicable state law permits the disinterested directors to terminate a shareholder's derivative suit against

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\item \textsuperscript{67} 485 F. Supp. at 278.
\item \textsuperscript{68} Id. at 282.
\item \textsuperscript{69} Id. at 282-86. The law firm of one of the newly appointed directors was hired by the corporation as independent counsel for purposes of the investigation. The plaintiff argued that this appointment showed a lack of independence. The court disposed of this contention as "a non sequitur and hardly worthy of comment." Id. at 283. As pointed out later in this article, however, the meaning of independence should be fairly narrowly construed. Contrary to the court's holding, a plausible argument can be made that there exists, at the least, an appearance of impropriety when the newly appointed director, who is selected by the defendant directors, uses his law firm as independent counsel. The generation of fees induced by such business may prompt, albeit unintentionally, a disposition in favor of the defendants. Further, if the director and his law firm recommend termination, this may well prompt other corporate director defendants to seek their services. \textit{See} text accompanying notes 125-28 \textit{infra}.
\end{itemize}
their fellow directors. In many situations, however, the applicable state law may be unresolved, often because no decision of a high court of the state is squarely on point. In such instances, the federal court, in effect, will be "sitting as a state court." Assuming this role, both the federal district court in Maldonado and the Eighth Circuit in Abbey construed Delaware law to allow such dismissal. Furthermore, until the decision by the Delaware Court of Chancery in Maldonado v. Flynn, no federal court had decided that any state law precluded disinterested nondefendant directors from barring a shareholders' derivative action against fellow directors.

It is in this context that the decision by the Court of Chancery in Maldonado, currently on appeal to the Delaware Supreme Court, becomes so significant. Adoption of the rationale of the Court of Chancery by the Delaware Supreme Court and other state and federal tribunals would effectively preclude director dismissal of shareholder derivative suits against fellow directors.

The facts alleged in Maldonado showed that the Zapata Corporation's board of directors accelerated the exercise date of their stock options to avoid substantial additional federal income tax liability. This increased tax liability was due to an anticipated increase in the price of Zapata's stock after the announcement of an

70. See Burks v. Lasker, 441 U.S. at 480, 486; notes 19-20 and accompanying text supra.
71. See, e.g., Galef v. Alexander, 615 F.2d 51, 61 (2d Cir. 1980); Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979).
72. See Lewis v. Anderson, 615 F.2d at 781. See generally Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), in which the Court stated: [T]he State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the State. In this respect, it may be said to be in effect, sitting as a state court. Id. at 465. See also Berhardt v. Polygraphic Co. of America, 350 U.S. 198, 205 (1956).
73. See Abbey, 603 F.2d at 729; Maldonado, 485 F. Supp. at 278-80.
75. See, e.g., Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980) (result unclear under Ohio law); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (dismissal proper under California law); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979) (dismissal proper under Delaware law); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980) (dismissal proper under Michigan law).
76. 413 A.2d 1251 (Del. Ch. 1980); see Black & Smith, supra note 5, at 936.
77. Subsequent to the Delaware Court of Chancery's opinion in Maldonado, two federal cases have applied Maldonado's rationale to preclude dismissal under relevant state law. Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713 (E.D. Va. 1980) (Virginia law); Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980) (Delaware law); see notes 86-97 and accompanying text infra.
issuer tender offer. In a stockholder's derivative action, Maldonado alleged that the directors' conduct in moving up their option exercise dates constituted a breach of fiduciary duty and deprived Zapata of a federal tax deduction. After conducting an investigation and concluding that the suit was not in the corporation's best interests, the special litigation committee instructed Zapata's counsel to seek dismissal.

In denying Zapata's motion, the Court of Chancery concluded that, under well established Delaware law, the directors of a corporation cannot bar a pending shareholder's derivative action that requests relief for an apparent breach of fiduciary duty, by merely reviewing the action and rendering a business judgment that it is contrary to the corporation's best interests. According to the court, the cases cited by Zapata showed only that a shareholder may be denied standing to bring suit on behalf of the corporation if he has failed to make a proper demand, assuming one is necessary, or if he endeavors to declare a right not legally assertable by the corporation, or if the suit alleges a purely legal right of action against an extracorporate defendant without any claim that the directors have acted improperly. From prior Delaware cases, the Court of Chancery reasoned that the business judgment rule provides only a "shield" with which directors may protect their decisions from shareholder attack; nothing in the rule gives directors any independent power to bar a derivative suit against fellow directors to rectify an apparent breach of fiduciary duty. Contrary to Zapata's assertion that a shareholder's right to bring suit is always subordinate to that of the corporation and therefore subject to a corporate decision to bar its continuance, the court asserted

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78. 413 A.2d at 1254.
79. Id. at 1255; see Maldonado v. Flynn, 485 F. Supp. 274, 278 (S.D.N.Y. 1980).
80. 413 A.2d at 1257. As the court pointed out, Maldonado's complaint did not attack as improper the 1979 decision of the Committee to seek the dismissal of this litigation, which was probably an exercise of business judgment. Rather Maldonado is attacking the 1974 decision of the directors to accelerate the option dates as being in bad faith or in breach of the directors' fiduciary duties.
82. 413 A.2d at 1257. The court relied particularly on Sohland v. Baker, 141 A. 277, 281-82 (Del. Sup. Ct. 1927), concluding that "standing alone," Sohland was "probably sufficient ground to deny Zapata's motions." 413 A.2d at 1261.
that "[a]grieved shareholders of Delaware corporations ought to be able to expect that an impartial tribunal, and not a committee appointed by the alleged wrongdoers, will decide whether a stockholder's derivative suit alleging breach of fiduciary duty has any merit."83 In summary, the court concluded:

[A]n analysis of the business judgment rule shows that while it is a limitation on liability and ordinarily protects corporate directors when they, in good faith, decide not to pursue a remedy on behalf of the corporation, it is not an independent grant of authority to the directors to dismiss derivative suits. Under settled Delaware law the directors do not have the right to compel the dismissal of a derivative suit brought by a stockholder to rectify an apparent breach of fiduciary duty by the directors to the corporation and its stockholders after the directors have refused to institute legal proceedings, because the stockholder then possesses an independent right to redress the wrong.84

As a final caveat, the Delaware court commented that even if the business judgment rule were relevant to authorize such dismissal of shareholder derivative suits, principles of fairness and fiduciary duty require that the defendant directors who appointed the members of the investigative committee should bear the burden of proving the independence of the committee.85

83. 413 A.2d at 1263 (citing Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980)).
84. 413 A.2d at 1262. On this point, the court also stated:
The individual right of the stockholder to protect his interests and the interests of his corporation by bringing a derivative suit against the directors of the corporation for breach of fiduciary duty is not diminished because the suit may be commenced by the stockholder only if the corporation will not assert the right. The stockholder's right to litigate is secondary to the corporate right to bring suit only for so long as the corporation has not decided to refuse to bring suit. Once the corporation refuses, or impliedly refuses, to assert an apparently valid claim, involving a breach of fiduciary duty by the corporate directors, the stockholder is vested with a primary and independent right to redress the wrong by bringing a derivative suit.


85. 413 A.2d at 1263; see Genzer v. Cunningham, 498 F. Supp. 682, 693 (E.D. Mich. 1980) ("[t]he court must finally consider whether the defendants have established, as a matter of law, that the Special Litigation Committee acted independently and in good faith in recommending that the derivative claims be dismissed relative to all defendants."); Grynberg v. Farmer, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,683 at 98,586 (D. Colo. Oct. 8, 1980) (court left open whether such burden of proof "requires proof by a mere preponderance, by clear and convincing evidence, or by some other standard ... "). But
Maldonado's impact has already been felt. In another shareholders' derivative suit against Zapata Corporation, *Maher v. Zapata Corp.*, violations of both federal and state law were alleged. Relying on the opinion of the Court of Chancery, the federal district court held that under the first prong of *Burks*, Delaware law precludes directors or a committee thereof from dismissing shareholder derivative suits brought against fellow directors for alleged breaches of fiduciary duty. Although a federal case, *Maher* is important because its holding was predicated entirely on the application of state law. Equally significant is that even though not bound by the decision of the Court of Chancery, the *Maher* court was "convinced" that the Delaware Supreme Court would adopt the "thorough well-reasoned analysis" of the *Maldonado* court.

Although not ruling on the issue, the *Maher* court also expressed concern about whether the Zapata committee had made its determination that the suit was not in the corporation's best interests in good faith and within the bounds of reason. The court queried whether the committee had based its determination more on a "rationalization" than on an investigation, particularly because the alleged wrongdoers had appointed the committee. Acknowledging that, assuming the business judgment rule were applicable, it must respect the committee's decision if reasonable, the court nevertheless questioned the committee's balancing of the various factors involved in its decisionmaking process.

In another recent federal district court case, Judge Merhige,

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*see Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).*

In regard to *Maldonado*’s long-term effect on the business judgment rule, note that the Delaware Supreme Court has accepted an appeal from the Court of Chancery's initial landmark decision.

87. Id. at 349, 350.
88. Id. at 351-53.
89. "Since Delaware law does not permit independent directors to terminate a derivative action against other board members, this Court need not address whether the state law rule of dismissal is consistent with the policies of the federal securities act . . . ." Id. at 353.
90. See Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967) ("[U]nder some conditions, federal authority may not be bound even by an intermediate state appellate court ruling. . . ."). See also Bernhardt v. Polygraphic Co. of America, 350 U.S. 198, 205 (1956); note 72 and accompanying text supra.
91. 490 F. Supp. at 353.
92. Id. at 354.
93. Id.
94. Id. See also Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 n.21 (3d Cir. 1978).
relying directly on the *Maldonado* decision of the Delaware Court of Chancery, held that under Virginia law, the business judgment rule is "irrelevant" to a special litigation committee's determination that a shareholders' derivative suit against fellow directors should be barred. 96 Under Virginia law, Judge Merhige reasoned, a stockholder's independent right to institute suit on behalf of the corporation in such cases is conditioned only on a showing that a demand has been made upon the directors or that circumstances excuse such a demand from being made. 96 Thus, "Virginia law does not permit directors, interested or disinterested, to effect the dismissal of a derivative suit against a corporation and its directors, based simply on their business judgment that the suit is contrary to the corporation's best interests." 97

A New York Court of Appeals decision, *Auerbach v. Bennett*, 98 indicates that New York law apparently conflicts with the decision by the Delaware Court of Chancery in *Maldonado*. Decided before *Maldonado*, *Auerbach* recognizes the propriety of a committee composed of disinterested directors, appointed by the board, to exercise its business judgment in terminating a shareholders' derivative action seeking damages against fellow directors. 99 In such a situation, the court must confine its inquiry to assessing the "independence" of the members of the committee and the appropriateness and adequacy of the investigative procedures selected and pursued by the committee. 100 In so holding, the court concluded that the substantive aspects of the committee's decision to bar a shareholders' derivative suit "is beyond judicial inquiry under the business judgment doctrine." 101

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96. 495 F. Supp. at 717. In this case, the shareholder made no demand on the board prior to instituting suit because a majority of the current directors were named as defendants.


99. Id. at 630-34, 393 N.E.2d at 1000-02, 419 N.Y.S.2d at 926-28.

100. Id. at 634-35, 393 N.E.2d at 1002-03, 419 N.Y.S.2d at 929.

101. Id. at 623, 633, 393 N.E.2d at 926, 1002, 419 N.Y.S.2d at 922, 928. The court also expressly rejected the intervenor's contention that any committee appointed by the directors, some of whom were defendants, was legally infirm and thus had no authority to bar a derivative suit. The court stated:

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. The possible risk of
Two recent New York lower court decisions have applied Auerbach. In Falkenberg v. Baldwin, the Supreme Court of New York County held that a committee composed of outside directors of Uniroyal Corporation exercised its business judgment in recommending dismissal of a shareholders’ derivative suit alleging violations of Title VII of the Civil Rights Act of 1964 (discrimination against female employees) by corporate officers and directors. In so holding, the court placed the burden on the plaintiffs to show lack of independence or insufficient investigative procedures by the committee. The second case, Parkoff v. General Telephone and Electronics Corp., relying directly on Auerbach, held that a decision to terminate a shareholders’ derivative action against the defendant directors for alleged waste of corporate assets and breach of fiduciary duties in connection with questionable foreign payments lay within the business judgment of a special litigation committee composed of three outside directors, who were not directors at the time of the transactions at issue.

Although subsequently reversed by the New York Court of Appeals, the lower appellate court’s opinion in Auerbach may be deemed relevant by courts in other jurisdictions. In holding that the business judgment rule could not be invoked to allow summary dismissal of a shareholders’ derivative suit alleging breach of fiduciary duty, the lower court approved the propriety of inquiring

hesitancy on the part of the members of any committee, even if composed of outside, independent, disinterested directors, to investigate the activities of fellow members of the board where personal liability is at stake is an inherent, inescapable, given aspect of the corporation’s predicament. To assign responsibility of the dimension here involved to individuals wholly separate and apart from the board of directors would, except in the most extraordinary circumstances, itself be an act of default and breach of the non-delegable fiduciary duty owed by the members of the board to the corporation and to its shareholders, employees and creditors. For the courts to preside over such determinations would similarly work an ouster of the board’s fundamental responsibility and authority for corporate management.

Id. at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. But see Chief Judge Cooke’s dissent in Auerbach, where he asserted that "[s]ince the continuation of the suit is dependent, in large measure, upon the motives and actions of the defendants and the special litigation committee, and since knowledge of the matters 'is peculiarly in the possession of the defendants themselves', summary judgment should not be granted prior to disclosure proceedings." Id. at 637, 393 N.E.2d at 1004, 419 N.Y.S.2d at 931 (Cooke, C.J., dissenting) (citation omitted).

103. Id. (relying on Auerbach).
104. Id.
106. Id. at 764, 425 N.Y.S.2d at 601.
 Factors that such a committee must consider in an improper payments case, and which a court presumably must assess, include "the reasons for the payments, the advantages or disadvantages accruing to the corporation by reason of the transactions, the extent of the participation or profit by the respondent directors and the loss, if any, of public confidence in the corporation which might be incurred." In addition, the court emphasized that the hesitancy that outside directors may have in investigating the activities of their fellow directors, particularly when personal liability is at stake, "is a consideration of moment." As a final caveat, it should be mentioned that although both Auerbach and Maldonado contained allegations of breaches of fiduciary duty, Auerbach involved questionable foreign payments whereas Maldonado concerned a stock option plan. Thus distinguished, the decisions in Auerbach and Maldonado may be compatible. Unlike a number of shareholder derivative actions, including the Auerbach suit, the situation in Maldonado involved direct self-dealing on the part of the defendant directors. In such a situation, even assuming that the directors composing the special litigation committee do not "stand in a dual relation which prevents an unprejudiced exercise of judgment," the appearance of impropriety may be so great as to preclude the committee from terminating the shareholders' suit. On the other hand, it is possible that when the alleged actions by the defendant directors have not

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108. Id. at 106-08, 408 N.Y.S.2d at 87-88; see Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978); Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980). 109. 64 A.D.2d at 107, 408 N.Y.S.2d at 87-88. 110. Id. at 107, 408 N.Y.S.2d at 88. Speaking of the business judgment rule in this context, the court asserted:

The business judgment doctrine should not be interpreted to stifle legitimate scrutiny by stockholders of decisions of management which, concededly, require investigation by outside directors and present ostensible situations of conflict of interest. Nor should the report of the outside directors be immune from scrutiny by an interpretation of the doctrine which compels the acceptance of the findings of the report on their face. In particular, summary judgment which ends a derivative action at the threshold, before the plaintiff has been afforded the opportunity of pretrial discovery and examination before trial, should not be the means of foreclosing a nonfrivolous action.

Id. at 107-08, 408 N.Y.S.2d at 88. 111. Compare 47 N.Y.2d at 623-25, 393 N.E.2d at 996-97, 419 N.Y.S.2d at 922-23, with 413 A.2d at 1254. 112. See, e.g., Lewis v. Anderson, 615 F.2d 778, 780 (9th Cir. 1979); Abbey v. Control Data Corp., 603 F.2d 724, 726-27 (8th Cir. 1979). 113. See 413 A.2d at 1254-55. 114. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917).
inured to their direct benefit or do not involve conflicts of interest or other dishonest or fraudulent conduct, courts will permit a special litigation committee to bar a shareholders’ derivative suit, under certain conditions.

IV. FURTHER REFLECTIONS ON THE USE OF SPECIAL LITIGATION COMMITTEES TO BAR SHAREHOLDER DERIVATIVE SUITS

To find a proper solution to this issue is a difficult proposition. As pointed out by the Ninth Circuit, to permit one stockholder to incapacitate an entire board of directors merely by alleging their having breached a fiduciary duty gives too much power to disdendent shareholders. Further, to disable the board from terminating derivative actions could well saddle the corporation with expensive and vexatious litigation. On the other hand, to allow directors to bar lawsuits against their fellow directors raises serious questions of conflicts of interest and ignores the inherent problem of “structural bias.” In this vein, there is certainly something to

115. See Lewis v. Anderson, 615 F.2d at 783. The court also stated that “[t]here is no reason to believe that a minority shareholder is more likely to act in the best interest of the corporation than are directors who are elected by a majority of the stockholders.” Id. Although this assertion is certainly true in the ordinary management of the corporation, it clearly is not when management is alleged to have engaged in conflicts of interest, self-dealing, or fraud.

116. See Dent, supra note 9, at 98.

117. “Structural bias” may be defined as “inherent prejudice against any derivative action resulting from the composition and character of the board of directors.” Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 CORNELL L. REV. 600, 601 n.14 (1980). In a recent decision, the Fifth Circuit recognized the problem of structural bias, holding that, because of conflicts of interest, a corporation’s board of directors was incompetent to compromise the plaintiff shareholders’ derivative claims. Clark v. Lomas & Nettleton Financial Corp., 625 F.2d 49 (5th Cir. 1980).

In an interesting and provocative article, one commentator argues that the courts have largely ignored the structural bias problem in shareholder derivative suits. In so doing, the commentator contends that courts have effectively insulated corporate malfeasants from liability. In conclusion, the commentator asserts:

Current judicial treatment of derivative actions against directors threatens to eliminate the utility of such suits. By applying the business judgment and demand rules originally designed for derivative suits against third parties to suits against directors, most courts have failed to recognize the inherent structural bias that corporate boards exhibit toward actions against directors. The use of special litigation committees has magnified the problem. Courts should only allow directors accused of wrongdoing to raise the business judgment rule as a defense to the alleged violation at a trial on the merits. They should retain the demand rule as a procedural requisite for derivative plaintiffs to give the corporation an opportunity to conduct the litigation. If the corporation declines that invitation, courts should allow the shareholder-plaintiff to pursue the claim.

Note, supra at 632-33.
be said for the Delaware Court of Chancery's observation that aggrieved shareholders, when suing directors of their corporation for alleged breaches of fiduciary duty, are entitled to receive judgment from an impartial tribunal rather than from a committee appointed by the alleged wrongdoers.118

As noted earlier, the appearance of impartiality may be as important as impartiality in fact. To the shareholder seeking redress on behalf of the corporation, judicial deference to a special litigation committee's decision to terminate the suit smacks of unfairness. To counteract this effect as much as practicable, yet retain the board's authority to bar such suits, a court in this situation should scrutinize the committee's composition and decision to assure that the committee is, in fact, independent and disinterested, and that its determination is reasonable under all of the circumstances.119

Some courts and commentators have concluded that assessing the "reasonableness" of the committee's judgment is outside the purview of the business judgment rule.120 Even assuming arguendo that such a position is technically correct, one should recognize that the use of special litigation committees to bar shareholder derivative suits against fellow directors is extraordinary. Indeed, three courts interpreting state law have placed this determination

118. Maldonado v. Flynn, 413 A.2d at 1262-63; see notes 80-85 and accompanying text supra. Note also that the issue remains whether a board of directors can validly delegate its authority to a special litigation committee, since a number of state statutes provide that committees serve "at the pleasure of the board." See, e.g., Cal. Corp. Code § 311 (West 1977); Mich. Comp. Laws Ann. § 460.1527 (1973); N.Y. Bus. Corp. Law § 712(c) (McKinney Supp. 1979). Such statutes raise questions about the validity of the board's delegation of "binding" authority to the special litigation committee. See Note, supra note 117, at 618, 619.

119. See generally Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259 (3d Cir. 1978): [W]e do not think that the business judgment of the directors should be totally insulated from judicial review. In order for the directors' judgment to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing. In addition, where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment.


outside the province of the business judgment rule. Even if viewed within the rule, such a determination nevertheless reflects different policies than those present in the ordinary corporate decision clearly protected by the doctrine. A relevant analogy can be drawn from derivative suits challenging "interested transactions" between a corporation and its officers or directors. In these situations, even if a majority of disinterested directors approve such a transaction, the prevailing view is that the transaction's fairness to the corporation will be rigorously scrutinized. The rationale for this approach equally applies to the issue of litigation termination: even if disinterested directors make that decision, the pressure to disregard the corporation's best interests is so great that only a court's careful scrutiny of the directors' conduct will ensure the protection of the entity's welfare.

In addition, the members who compose the special litigation committee should be both disinterested and independent. At the very least, "disinterested" should signify that the directors did not authorize or approve the challenged transaction and are not named as defendants in the law suit. Further, the term "independent" should signify that the members of the committee are not subject to the defendants' influence and can exercise independent judgment on behalf of the corporation. The "independence" of the members, particularly if selected by the defendants, should be subject to rigorous scrutiny. Any prior contacts or relationships between the members and the defendants should be examined with


122. See Genzer v. Cunningham, 498 F. Supp. 682, 689 (E.D. Mich. 1980) ("The court is aware that application of the business judgment rule to circumstances where a committee is charged with the responsibility of determining whether shareholder litigation should continue is an expansion of the traditional rule."). See also Maldonado v. Flynn, 413 A.2d at 1255-63.

123. See, e.g., Pepper v. Litton, 308 U.S. 295, 306 (1939); Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 82, 88, 90 A.2d 660, 663 (1952); Abeles v. Adams Eng'r Co., 35 N.J. 411, 428-29, 173 A.2d 246, 255 (1961); Marsh, Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 Bus. Law. 35, 43 (1966). Additionally, it is important to emphasize that the business judgment rule does not apply in the scrutiny of such transactions. See notes 7-10 supra.

124. See Dent, supra note 9, at 121, 122, 137. Note that under this standard, the court scrutinizes the "reasonableness" of the special litigation committee's determination, avoiding the result that "almost any decision to terminate a derivative action will appear 'reasonable' to a 'reasonable' special litigation committee." Note, supra note 117, at 626.

care. Particularly if a member stands to gain financially or otherwise by determining that the derivative suit should be terminated, his "independent" status should be inherently suspect.\textsuperscript{128} Further, although some courts have placed the burden on the shareholders,\textsuperscript{127} such burden of establishing independence should be placed on the parties seeking dismissal. When the defendants have selected the committee members, the appearance of impropriety (indeed, perhaps the presence of it) can be remedied only if the persons who made that selection satisfy the court on the issue of independence.\textsuperscript{128}

Because the pleadings are usually inadequate for the court to assess the reasonableness of the special litigation committee's judgment, including such issues as whether the members were fully informed of the facts material to their decision\textsuperscript{129} and whether the particular members were in fact independent, it is appropriate for the court to permit limited discovery.\textsuperscript{130} Despite entailing some expense and inconvenience to the corporation, discovery is necessary for the court to rule in an informed manner on the defendants' motion to dismiss the complaint.\textsuperscript{131}

As a final comment, \textit{Maldonado} in Delaware and its progeny\textsuperscript{132} may well have as their benchmark the theme of corporate accountability. Although corporations are ordinarily managed under the direction of their directors,\textsuperscript{133} this line of cases indicates that at least some courts are showing less tolerance for self-dealing and conflicts of interest by directors that cause hardship to shareholders of publicly held corporations.\textsuperscript{134} Viewed from this perspec-

\begin{footnotes}
\footnote{126. See Galef v. Alexander, 615 F.2d at 60-61; Maher v. Zapata Corp., 490 F. Supp. 348, 353-54 (S.D. Tex. 1980); Maldonado v. Flynn, 413 A.2d at 1253-63; note 69 \textit{supra}.}
\footnote{128. "Plaintiffs' allegation that the Committee merely conducted a 'rationalization' of the claims instead of an investigation since the exculpation of Defendants' conduct was foreordained is not totally incomprehensible in view of the fact that the Committee was appointed by the alleged wrongdoers." Maher v. Zapata Corp., 490 F. Supp. at 354.}
\footnote{131. See Brief for the SEC, \textit{supra} note 129, at 16.}
\footnote{132. See authorities cited notes 76 & 77 \textit{supra}.}
\footnote{133. See authorities cited note 7 \textit{supra}.}
\footnote{134. The Goldberg v. Meridor line of rule 10b-5 cases provides further examples of this}
\end{footnotes}
tive, the decision of the Delaware Court of Chancery is refreshing. Regardless of whether other tribunals follow Maldonado's rationale on the applicability of the business judgment rule in this context, one can only hope that they will respect and heed its zealous concern for corporate accountability.

V. CONCLUSION

Although the complexities intertwined with director dismissal of shareholder derivative suits against fellow directors may sometimes appear incapable of resolution, certain criteria may be set forth to guide the conduct of special litigation committees. First, from decisions thus far, less than a quorum of directors can properly act for the corporation in seeking the termination of a shareholders' derivative action.138 Second, although the decisions arguably are conflicting,139 the wisest course of action would be to name only nondefendant, disinterested, and independent persons to the special litigation committee. Third, the board should delegate binding, nonreviewable authority to the committee to investigate and determine whether the suit is in the corporation's best interests.137 Fourth, the committee should employ thorough investigative procedures.138 Fifth, the board should inform committee members of all facts material to their decision to help ensure that the judgment reached is reasonable.139 And, as a final caveat, the special litigation committee should conduct itself so as to withstand strict judicial scrutiny.

Although the principles outlined above and throughout this article may not guarantee vindication of the shareholders' and corporation's grievances, they will help ensure, if diligently applied by the courts, increased accountability for directors' conduct. In a


135. See, e.g., Lewis v. Anderson, 615 F.2d at 782 n.1; Maldonado v. Flynn, 485 F. Supp. at 286.

136. Compare Lewis v. Anderson, 615 F.2d at 783, with Galef v. Alexander, 615 F.2d at 60-61, 63-64.


138. See, e.g., Auerbach v. Bennett, 47 N.Y.2d at 634-35, 393 N.E.2d at 1002-03, 419 N.Y.S.2d at 929.

139. See generally Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978); cases cited note 119 supra.
world where corporations fear “strike suits,” sometimes with good reason,\textsuperscript{140} and where the business judgment rule protects directors as the monitors of our corporations,\textsuperscript{141} perhaps this approach is most practicable. On the other hand, when directors’ alleged actions involve conflicts of interests, fraud, or self-dealing, which inure to their direct benefit, there is much to be said for the approach adopted by the Delaware Court of Chancery in \textit{Maldonado}.\textsuperscript{142} Whichever approach ultimately prevails, the courts should strive to implement the principle of corporate accountability and, in this manner, promote investor confidence in the integrity of the marketplace and the governance of our publicly held companies.

\footnotesize
140. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737-48 (1975). With regard to strike suits, the Supreme Court has stated:

\begin{quote}
[\textit{I}n the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.]
\end{quote}

\textit{Id.} at 740 (citations omitted). Arguably, however, the courts may combat the potential of vexatious litigation by measures such as requiring plaintiffs to post security for expenses, requiring judicial review of derivative settlements, and granting summary judgment motions. \textit{See Note, supra} note 117, at 632. A number of states now require the posting of security for expenses. \textit{See, e.g., Cal. Corp. Code § 800(d) (West 1976); N.J. Stat. Ann. § 14A:3-6(3) (West Supp. 1976); N.Y. Bus. Corp. Law § 627 (McKinney Supp. 1979); Model Bus. Corp. Act § 59, ¶ 2 (1976).} Recently, the Second Circuit held that, pursuant to New York law, the trial court properly dismissed a shareholder’s derivative suit for failure to post the required security. The court concluded that the shareholder’s acquisition of stock after the commencement of the action was not sufficient to obviate the security requirement. Hamburger v. Tobin, 626 F.2d 1101 (2d Cir. 1980).

141. \textit{See notes} 7-15 and accompanying text \textit{supra}.

142. \textit{See notes} 80-85, 111-14, and accompanying text \textit{supra}. \textit{See also Genzer v. Cunningham}, 498 F. Supp. 682, 688 (E.D. Mich. 1980) (“[U]nlike in \textit{Maldonado}, there is no allegation of personal gain by the directors . . . .”). Unlike certain commentaries, this article declines to draw a distinction between derivative suits naming a majority of directors as defendants and suits naming only a minority of directors. \textit{See, e.g., Dent, supra} note 9. To draw such a distinction would be to conclude that the impartiality of the special litigation committee depends on the number of directors named as defendants. Such a conclusion is unwarranted. The inherent problems of structural bias remain, regardless of whether the complaint accuses a majority or a minority of directors of wrongdoing. \textit{See Note, supra} note 117, at 629. \textit{See also Cohen v. Industrial Fin. Corp.}, 44 F. Supp. 491, 494-95 (S.D.N.Y. 1942).