

Notes

The Business Judgment Rule and the Litigation Committee: The End of a Clear Trend in Corporate Law

I. INTRODUCTION

The time-honored business judgment rule has foiled many shareholder challenges to their directors' business decisions.¹ However, if self-dealing, bad faith, or lack of due care tainted the directors' decision, the shareholder could summon the courts' aid.² A board's refusal to pursue a corporate cause of action historically would not block a shareholder's derivative suit naming a majority of the board as wrongdoers.³ Recently, however, corporations have persuaded federal courts to dismiss shareholder derivative actions if a committee composed of ostensibly disinterested directors decides, in its good faith business judgment, to terminate the suit.⁴

¹The business judgment rule's origin coincided with the industrial growth of the latter portion of the nineteenth century. See *Briggs v. Spaulding*, 141 U.S. 132 (1891); *Witters v. Sowles*, 31 F. 1 (C.C.D. Vt. 1887); *Spring's Appeal*, 71 Pa. 11 (1872); *Hodges v. New England Screw Co.*, 1 R.I. 312 (1850); Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562, 565-66 (1967) (finding the rule parallel to the economic policy of laissez-faire).

²See *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980); *Issner v. Aldrich*, 254 F. Supp. 696 (D. Del. 1966); *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952); *Guth v. Loft*, 5 A.2d 503 (Del. 1939); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980). See also text accompanying notes 55-70 *infra*.

³*United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 264 (1917); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 461 (1903); *Hawes v. City of Oakland*, 104 U.S. 450, 460 (1881); *Galef v. Alexander*, 615 F.2d 51, 61-62 (2d Cir. 1980); *Ash v. International Bus. Mach., Inc.*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Swanson v. Traer*, 249 F.2d 854, 858 (7th Cir. 1957); *Nussbacher v. Chase Manhattan Bank*, 444 F. Supp. 973, 977 (S.D.N.Y. 1977); *Issner v. Aldrich*, 254 F. Supp. 696, 701 (D. Del. 1966).

⁴*Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980); *Seigal v. Merrick*, No. 74-2475 (S.D.N.Y. Dec. 20, 1979); *Rosengarten v. International Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *Parkoff v. General Tel. & Elec. Corp.*, 425 N.Y.S.2d 599 (App. Div. 1980); *Falkenberg v. Baldwin*, N.Y.L.J., Mar. 3, 1980, at 12, col. 6 (Sup. Ct. 1980); *Wallenstein v. Warner*, N.Y.L.J., May 9, 1978, at 11, col. 6 (Sup. Ct. 1978); *Auerbach v. Aldrich*, N.Y.L.J., Dec. 23, 1977, at 13, col. 5 (Sup. Ct. 1977); *Levy v. Sterling Drug, Inc.*, N.Y.L.J., Nov. 23, 1977, at 10, col. 2 (Sup. Ct. 1977). *Contra*, *Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980). See also text accompanying notes 74-143 *infra*.

This Note will review the traditional application of the business judgment rule as a defense for inexpedient business decisions and the rule's counterpart, the intrinsic fairness test.⁵ An examination of the "special litigation committee"⁶ cases will also be made, in light of the disparate results reached in three suits against Zapata Corporation.⁷ Finally, this Note will discuss the ramifications of the litigation committee cases and the Zapata decisions.

II. THE BACKGROUND OF THE BUSINESS JUDGMENT RULE

Corporation law places the management of corporate affairs under the direction of the board of directors.⁸ The courts recognized the necessity of an unfettered decision-making environment and developed the business judgment rule to effectuate the directors' exercise of discretion in management.⁹ Broadly stated, the business judgment rule provides that "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."¹⁰

Some commentators perceive the business judgment rule to be incorporated into the statement of director duties posited by section 35 of the Model Business Corporation Act.¹¹ Section 35 provides:

⁵See text accompanying notes 55-70 *infra*.

⁶*Id.* The committees are designated with various titles. For convenience, the general description "litigation committee" will be used.

⁷*Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980). Zapata is a Delaware corporation.

⁸DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1980); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1980-1981). See generally ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 35 (Supp. 1977); N. LATTIN, *THE LAW OF CORPORATIONS* § 69 (2d ed. 1971).

⁹See, e.g., *Galef v. Alexander*, 615 F.2d 51, 57 (2d Cir. 1980); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); 3A W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS*, § 1039, at 37-38 (perm. ed. 1975); ABA, *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1604 (1978) [hereinafter cited as ABA].

¹⁰3A W. FLETCHER, *supra* note 9, at 37; see H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 242, at 482 (2d ed. 1970); N. LATTIN, *supra* note 8, § 78, at 272-73; ABA, *supra* note 9, at 1604; Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562, 562-63 (1967); Comment, *The Business Judgment Rule: A Guide to Corporate Directors' Liability*, 7 ST. LOUIS U.L.J. 151 (1962).

¹¹ABA, *supra* note 9, at 1632; Arsh, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 662 (1979). See also Veasey, *Directors' Standard of Care Under Section 35 of the Model Business Corporation Act*, 4 DEL. J. CORP. L. 665 (1979).

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.¹²

In other words, as long as the director remains within the boundaries of conduct traced by the section 35 standard, the business judgment rule will be available as a defense to charges of liability for injuries sustained by the corporation and its shareholders.¹³

In addition to exercising good faith and due care, a director must fulfill a fiduciary duty before he comes within the protection of the business judgment umbrella.¹⁴ The Delaware Supreme Court provided a universally recognized definition of that fiduciary duty in *Guth v. Loft*:¹⁵

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests

¹²ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 35 (Supp. 1977).

¹³ABA, *supra* note 9, at 1632; Arsht, *supra* note 11, at 660.

¹⁴*United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903); *Hawes v. City of Oakland*, 104 U.S. 450 (1881); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *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); *Nussbacher v. Chase Manhattan Bank*, 444 F. Supp. 973 (S.D.N.Y. 1977); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976); *Bernstein v. Mediobanca Banca di Credito Finanziario-Societa Per Azioni*, 69 F.R.D. 592 (S.D.N.Y. 1974); *Klotz v. Consolidated Edison Co.*, 386 F. Supp. 577 (S.D.N.Y. 1974); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Warshaw v. Calhoun*, 221 A.2d 487 (Del. 1966); *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952); *Bodell v. General Gas & Elec. Corp.*, 140 A. 264 (Del. 1927); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980). W. FLETCHER, *supra* note 9, at 38; H. HENN, *supra* note 10, at 483; N. LATTIN, *supra* note 8, § 78, at 272-73. See generally *Guth v. Loft*, 5 A.2d 503 (Del. 1939); *Gottlieb v. McKee*, 34 Del. Ch. 537, 107 A.2d 240 (1954); Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157, 160-61 (1970).

¹⁵5 A.2d 503 (Del. 1939).

of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.¹⁶

Hence, "[b]usiness judgment . . . , by definition, presupposes an honest, unbiased judgment (compliance with fiduciary duty) reasonably exercised (due care), and compliance with other applicable requirements."¹⁷ As a defensive rule, the business judgment doctrine insulates the directors from personal liability unless the complaining shareholder is able to rebut the presumption that the directors have fulfilled all of their duties.¹⁸

The business judgment rule has also been characterized as a standard for judicial review.¹⁹ As a judicial guidepost, the "rule will be applied only when an objective evaluation of the context surrounding a decision indicates that forces influencing the judgment of the decision-makers uniformly tended to motivate a decision for the benefit of all shareholders."²⁰ However framed, the rule provides directors with a sanctuary where they may exercise uninhibited corporate discretion unless self-dealing, bad faith, or lack of due care²¹ breach the rule's presidio.²²

A. *Public Policy Considerations*

The protection afforded by the business judgment rule is well supported by several policy arguments. First, the courts, especially

¹⁶*Id.* at 510.

¹⁷H. HENN, *supra* note 10, at 483.

¹⁸*See, e.g.,* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Warshaw v. Calhoun, 221 A.2d 487, 493 (Del. 1966); ABA, *supra* note 9, at 1604. *See generally* cases cited note 2 *supra*; text accompanying notes 27-53 *infra*.

¹⁹Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562 (1967).

²⁰*Id.* at 564. The author based his view on Judge Shientag's statement: "The 'business judgment rule' . . . yields to the rule of undivided loyalty." Bayer v. Beran, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

²¹Although due care implies a negligence standard, the courts rarely hold directors liable for mere negligence. *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."). *See, e.g.,* Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966).

²²ABA, *supra* note 9, at 1604; Arshnt, *supra* note 11, at 660; Lewis, *supra* note 14, at 172. *See also* text accompanying notes 27-53 *infra*.

when deluded by hindsight, are often "ill equipped" to pass judgment on complex business decisions.²³ Second, imposition of liability for honest errors in judgment might stifle entrepreneurial risk-taking and chill board meetings.²⁴ Third, the directors do not hold themselves out as insurers of the corporation's success; consequently, it would be unfair to impose liability upon directors for set-backs when the directors have fulfilled their duties to the corporation.²⁵ Finally, state law puts the responsibility of management upon the board of directors elected by the shareholders and not upon a judicial system which is wholly unaccountable to the corporation and its shareholders.²⁶ To effectuate corporate goals, the corporate policy-making atmosphere must be free from judicial and shareholder interference. Shareholders, however, must be able to seek the courts' assistance when directors act in derogation of the best interests of the corporation and its shareholders.

B. *The Burden of Proof*

Most courts place upon the plaintiff-shareholder the burden of proving that a director's decision does not warrant the protection of the business judgment rule defense.²⁷ In *Ash v. International*

²³*Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 274-75 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); ABA, *supra* note 9, at 1604; *See Lewis, supra* note 14, at 171-72.

²⁴*Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944); ABA, *supra* note 9, at 1603-04; *Dyson, The Director's Liability for Negligence*, 40 IND. L.J. 341, 367 (1965); *Ward, Fiduciary Standards Applicable to Officers and Directors and the Business Judgment Rule Under Delaware Law*, 3 DEL. J. CORP. L. 244, 245 (1978); *Note, supra* note 1, at 565.

²⁵*See H. HENN, supra* note 10, at 482-83; *N. LATTIN, supra* note 8.

²⁶*Lewis, supra* note 14, at 158, 171-72. *See generally* statutes cited note 8 *supra*.

²⁷*United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Ash v. International Bus. Mach., Inc.*, 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976); *Bernstein v. Mediobanca Banca di Credito Finanziario-Societa Pre Azioni*, 69 F.R.D. 592 (S.D.N.Y. 1974); *Klotz v. Consolidated Edison Co.*, 386 F. Supp. 577 (S.D.N.Y. 1974); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Wolfensohn v. Madison Fund, Inc.*, 253 A.2d 72 (Del. 1969); *Warshaw v. Calhoun*, 221 A.2d 487 (Del. 1966); *Marks v. Wolfson*, 188 A.2d 680 (Del. 1963); *Bodell v. General Gas & Elec. Corp.*, 140 A. 264 (Del. 1927); *Gimbel v. Signal Co.*, 316 A.2d 599 (Del. Ch. 1974); *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971); *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427 (Del. Ch. 1968); *Davis v. Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 142 A. 654 (1928). *See Arsht, supra* note 11, at 661-62; *Lewis, supra* note 14, at 172; *Ward, supra* note 24, at 245; *Note, supra* note 1, at 562. *See generally* ABA, *supra* note 9, at 1604.

Business Machines, Inc.,²⁸ the United States Court of Appeals for the Third Circuit held that

[a] stockholder's derivative action . . . can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way.²⁹

The Delaware courts use such language as "fraud or gross overreaching,"³⁰ "bad faith or abuse of discretion,"³¹ "fraud, misconduct, or abuse of discretion,"³² "profited at the expense of the corporation,"³³ and "improper motive . . . or a reckless indifference to or a deliberate disregard of the stockholders"³⁴ to describe what the plaintiff must allege and show to overcome the business judgment defense. Finding this language overbroad,³⁵ one commentator, after reviewing the Delaware decisions holding the business judgment rule inapplicable, found that the shareholder could circumvent the defense by showing:

(1) that the directors did not exercise due care to ascertain the relevance of the available facts before voting to authorize the transaction; or (2) that the directors voted to authorize the transaction even though they could not have reasonably believed the transaction to be for the best interest of the corporation; or (3) that in some other way the directors' authorization of the transaction was not in good faith.³⁶

Not surprisingly, these conditions encompass the directors' duties imposed by section 35 of the Model Business Corporation Act.³⁷

²⁸353 F.2d 491 (3d Cir. 1965).

²⁹*Id.* at 493. See also *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903); *Klotz v. Consolidated Edison Co.*, 386 F. Supp. 577 (S.D.N.Y. 1974).

³⁰*Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971).

³¹*Warshaw v. Calhoun*, 221 A.2d 487, 493 (Del. 1966).

³²*Kors v. Carey*, 39 Del. Ch. 47, 54, 158 A.2d 136, 140 (1960).

³³*Maldonado v. Flynn*, 413 A.2d 1251, 1256 (Del. Ch. 1980). See also *Issner v. Aldrich*, 254 F. Supp. 696, 700 (D. Del. 1966) ("helping themselves financially at the expense of the corporation").

³⁴*Allaun v. Consolidated Oil Co.*, 16 Del. Ch. 318, 325, 147 A. 257, 261 (1929).

³⁵*Arsht*, *supra* note 11, at 655.

³⁶*Id.* at 660. See also *Lewis*, *supra* note 14, at 172.

³⁷*Arsht* argues that Delaware's business judgment rule is incorporated into section 35. *Arsht*, *supra* note 11, at 662. *Arsht* reasons that "the key issue is whether the directors, officers or controlling stockholders have complied with the legal standards

Exactly what facts the shareholder must bring forth to pierce the rule's shield is not always clearly articulated by the courts.³⁸ Illustrative of the shareholder's predicament is the Delaware decision in *Chasin v. Gluck*.³⁹ *Chasin* involved a parent-subsi- diary relationship in which the defendant, Gluck, by stock ownership, dominated the entire board of the parent, Grayson.⁴⁰ Gluck used his position to control eight⁴¹ of the twelve directors of the subsidiary, Beck.⁴² Beck rented space in Grayson stores in return for a percentage of Beck's sales.⁴³ The terms of the lease provided for Grayson employees to sell the Beck products, to commingle Beck receipts with Grayson receipts, and to remit Beck's portion of the receipts on a monthly basis.⁴⁴ Beck allowed Grayson's indebtedness to accumulate to \$233,856.76 over eight months because of Grayson's financial difficulties.⁴⁵ After Grayson went into bankruptcy, shareholder Chasin brought a derivative suit claiming that the directors breached their fiduciary duty to Beck by not demanding timely debt payments when their dual capacities as directors in both firms should have given them knowledge of Grayson's precarious financial state.⁴⁶ Defendant claimed that he merely used good business judgment to help Grayson through its financial trauma and thus secure Grayson's equity in Beck.⁴⁷ Evidence showed that Gluck had personally guaranteed a \$4,200,000 loan to the faltering Grayson company and had full knowledge of Grayson's financial crisis.⁴⁸

Conceding that "Gluck could no doubt have hoped to be personally benefited as a result of the transactions complained of through reduction of his personal liability on his guarantees of Grayson debts . . .,"⁴⁹ the court found no direct evidence of Gluck's culpability despite his domination of both boards, his personal

which the courts apply to determine whether directors have properly performed their duties. If they have met those standards, the court will not enjoin the transaction or hold them liable." *Id.* at 660 (footnotes omitted).

³⁸See *Issner v. Aldrich*, 254 F. Supp. 696 (D. Del. 1966); *Findley v. Garrett*, 109 Cal. App. 2d 166, 240 P.2d 421 (1952); *Chasin v. Gluck*, 282 A.2d 188 (Del. Ch. 1971). See generally text accompanying notes 39-53 *infra*.

³⁹282 A.2d 188 (Del. Ch. 1971).

⁴⁰*Id.* at 189.

⁴¹Seven of the Beck directors were also Grayson directors. *Id.*

⁴²*Id.*

⁴³*Id.* at 190.

⁴⁴*Id.*

⁴⁵*Id.*

⁴⁶*Id.*

⁴⁷*Id.* at 191.

⁴⁸*Id.*

⁴⁹*Id.* at 192.

knowledge of the financial problems, and his guarantee of Grayson loans.⁵⁰ The court held:

[T]he mere fact that interlocking directors are involved in an intercorporate transaction does not of itself cause the higher burden of proof called for under such rule to shift to the party sought to be charged with accountability. In other words, self-dealing on the part of a dominant fiduciary must first be established in order for the intrinsic fairness rule to be successfully invoked⁵¹

Not only did the court find the shareholder's evidence inadequate to show self-dealing,⁵² but the evidence was also deemed insufficient to show "bad faith, negligence, or gross abuse of discretion, the type of conduct looked for when a non-self-dealing fiduciary is sought to be charged with responsibility for corporate losses injurious to minority stockholders."⁵³

C. *The Intrinsic Fairness Test*

If a shareholder's challenge survives the burden and pleading pitfalls⁵⁴ surrounding the business judgment rule defense, the counterpart of the business judgment rule, the intrinsic fairness test, may be invoked by the courts.⁵⁵ This test is invoked because

⁵⁰See text accompanying notes 40-41, 48 *supra*.

⁵¹282 A.2d at 192.

⁵²*Id.* at 193.

⁵³*Id.*

⁵⁴The complaining shareholder not only must convince the court that the directors have breached their duties to the corporation and its shareholders but also must produce evidence sufficient to show active self-dealing, bad faith, or lack of due care. See text accompanying notes 27-53 *supra*.

⁵⁵*Teren v. Howard*, 322 F.2d 949 (9th Cir. 1963) (stock options and waste) (deciding Delaware law); *Harriman v. E.I. DuPont de Nemours & Co.*, 411 F. Supp. 133 (D. Del. 1975); *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979) (stock option plan); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964) (perpetuation of control); *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107 (Del. 1952); *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952) (stock option); *Keenan v. Eshleman*, 2 A.2d 904 (Del. 1938); *Tanzer v. International Gen. Indus., Inc.*, 402 A.2d 382 (Del. Ch. 1979); *Schreiber v. Bryan*, 396 A.2d 512 (Del. Ch. 1978); *Kemp v. Angel*, 381 A.2d 241 (Del. Ch. 1977); *Palley v. McDonnell Co.*, 295 A.2d 762 (Del. Ch. 1972), *aff'd sub nom. McDonnell Douglas Corp. v. Palley*, 310 A.2d 635 (Del. 1973); *Theodora Holding Corp. v. Henderson*, 257 A.2d 398 (Del. Ch. 1969) (personal loan); *Bastian v. Bourns, Inc.*, 256 A.2d 680 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Del. 1970); *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427 (Del. Ch. 1968); *Porges v. Vadsco Sales Corp.*, 27 Del. Ch. 127, 32 A.2d 148 (1943). See generally *Nathan & Shapiro, Legal Standard of Fairness of Merger Terms Under Delaware*

"when the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are on both sides, then the presumption and deference to sound business judgment are no longer present. Intrinsic fairness, tested by all relevant standards, is then the criterion."⁵⁶ As described in *Chasin v. Gluck*,⁵⁷ if the shareholder can show self-dealing, "bad faith, negligence, or gross abuse of discretion,"⁵⁸ the burden of proof "shifts to the defendants to show the entire fairness of the transaction under the careful watch of the courts."⁵⁹

Most cases involving the intrinsic fairness test concern parent-subsubsidiary relationships such as mergers⁶⁰ or corporate opportunity.⁶¹ Before scrutinizing the transaction, however, the courts require the shareholder to show the parent's domination and self-dealing.⁶² Once these requirements are fulfilled, the directors may not avail themselves of the business judgment rule defense,⁶³ and they must shoulder the burden of showing the entire fairness of the transaction.⁶⁴ The standard used to gauge the fairness of parent-subsubsidiary transactions requires "that the transaction between the two be reached as though each had in fact exerted its bargaining power against the other at arm's length."⁶⁵

Of more interest are those cases involving stock option plans tainted by self-dealing. In *Gottlieb v. Heyden Chemical Corp.*,⁶⁶ the

Law, 2 DEL. J. CORP. L. 44 (1977) (describing the business judgment rule and intrinsic fairness test as mutually exclusive extremes on a continuum).

⁵⁶David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968).

See cases cited note 55 *supra*.

⁵⁷282 A.2d 188 (Del. Ch. 1971).

⁵⁸*Id.* at 193.

⁵⁹Schreiber v. Bryan, 396 A.2d 512, 519 (Del. Ch. 1978).

⁶⁰See, e.g., Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979); Tanzer v. International Gen. Indus., Inc., 402 A.2d 382 (Del. Ch. 1979); Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978); Bastian v. Bourns, Inc., 256 A.2d 680 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Del. 1970); Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148 (1943).

⁶¹See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970); Guth v. Loft, 5 A.2d 503 (Del. 1939); Gottlieb v. McKee, 34 Del. Ch. 537, 107 A.2d 240 (1954).

⁶²Harriman v. E.I. DuPont de Nemours & Co., 411 F. Supp. 133, 152 (D. Del. 1975); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970); Schreiber v. Bryan, 396 A.2d 512, 519 (Del. Ch. 1978); Chasin v. Gluck, 282 A.2d 188, 192 (Del. Ch. 1971); David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968).

⁶³David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968).

See generally cases cited note 62 *supra*.

⁶⁴Schreiber v. Bryan, 396 A.2d 512, 519 (Del. Ch. 1978). See generally cases cited note 62 *supra*; Arsht, *supra* note 11, at 663; Ward, *supra* note 24, at 245.

⁶⁵Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 886 (Del. 1970).

⁶⁶90 A.2d 660 (Del. 1952).

directors instituted a stock option plan where "key employees" and the directors themselves received valuable options for no consideration.⁶⁷ The Delaware Chancery Court held that

[w]here a majority of the directors representing the corporation are conferring benefits upon themselves out of assets of the corporation, we do not understand that rule [business judgment rule] to have any application whatever. Human nature being what it is, the law, in its wisdom, does not presume that directors will be competent judges of the fair treatment of their company where fairness must be at their own personal expense. In such a situation the burden is upon the directors to prove not only that the transaction was in good faith, but also that its intrinsic fairness will withstand the most searching and objective analysis.⁶⁸

The *Gottlieb* standard of fairness requires "the directors to prove that the bargain had in fact been at least as favorable to the corporation as they would have required if the deal had been made with strangers"⁶⁹ Thus, a situation involving self-dealing directors strips away the business judgment defense and exposes the director to the harsher "stranger" standard of the intrinsic fairness test.⁷⁰

In summary, the business judgment rule is traditionally used as a defense to liability arising from mistakes in good faith business judgment which result in harm to the corporation and its shareholders.⁷¹ The challenging shareholder must rebut the presumption that the directors have fulfilled all of their duties to the corporation and its shareholders before the courts will scrutinize the transaction.⁷² Once the business judgment defense is circumvented, however, the directors have the burden of showing the entire fairness of the undertaking.⁷³

⁶⁷*Id.* at 663.

⁶⁸*Id.*

⁶⁹*Id.*

⁷⁰*Cohen v. Ayers*, 596 F.2d 733 (7th Cir. 1979); *Teren v. Howard*, 322 F.2d 949 (9th Cir. 1963); *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979); *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952); *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106 (Del. 1948). See *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980). *Contra*, *Udoff v. Zipf*, 58 A.D.2d 533, 395 N.Y.S.2d 462 (Sup. Ct. 1977). See generally *Beard v. Elster*, 160 A.2d 731 (Del. 1960); *Kerbs v. California Eastern Airways, Inc.*, 32 Del. Ch. 219, 83 A.2d 473 (1951).

⁷¹See text accompanying notes 8-18 *supra* (this protection is available providing, of course, that the director has fulfilled all of his duties to the corporation and its shareholders); H. HENN, *supra* note 10, at 483.

⁷²See cases cited note 27 *supra*; text accompanying notes 27-53 *supra*.

⁷³See cases cited note 55 *supra*; text accompanying notes 55-70 *supra*.

III. THE LITIGATION COMMITTEE

A. *The Committee Technique*

Since 1976,⁷⁴ shareholders have encountered an even more formidable obstacle to their challenges of director impropriety than was presented by the traditional business judgment defense. Now when a shareholder brings a derivative action⁷⁵ in a federal court,⁷⁶ corporate directors are attempting to insulate themselves from personal liability by appointing a "special litigation committee"⁷⁷ ostensibly composed of disinterested directors.⁷⁸ The committee is empowered to determine, in its business judgment, whether the shareholder's derivative suit should proceed or be terminated. Federal courts have ruled that the business judgment rule removes the committee's determination from judicial interference and have dismissed the derivative actions unless the shareholders have been able to show that the committee lacked independence or conducted

⁷⁴*Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976). *Gall* seems to be the first federal decision involving the special litigation committee technique to insulate corporate directors from personal liability.

⁷⁵A shareholder's derivative action is a suit brought by a shareholder on behalf of the corporation. The corporation, not the individual shareholder, owns the cause of action. The board of directors, hence, properly control the suit, as a corporate right. The derivative action allows 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, *supra* note 10, § 360, at 756. Justice Jackson described the derivative suit as "the chief regulator of corporate management." *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949). See generally, FED. R. CIV. P. 23.1; Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168 (1976).

⁷⁶Shareholders are taking derivative suits to federal courts for several reasons. Primarily, shareholders perceive state court as too permissive of director misconduct. See, e.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (Delaware has "watered the rights of shareholders vis-a-vis management down to a thin gruel."). The Federal Rules of Civil Procedure provide the shareholder with more amenable discovery and other procedural rules. Furthermore, federal judges are perceived as being more sophisticated in understanding business transactions and as being free from favoritism for state-based industries. See Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 998-1001 & n.47 (1976).

⁷⁷See cases cited note 4 *supra*. The directors find the authority to create executive committees in the articles of incorporation, by-laws, or state corporation law. Generally, a majority of the board must designate certain of its own members to the committee. The committee may, with certain exceptions, exercise all of the authority of the full board. See, e.g., ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 42 (Supp. 1977).

⁷⁸A disinterested director is a member of the board who is not "involved in a transaction with his own company where that transaction is designed to benefit that director personally . . ." Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674, 674 (1979). Generally, the term "disinterested director" is used to

its investigation in bad faith.⁷⁹ This novel application of the business judgment rule has been seen as the harbinger of death for the shareholder derivative suit.⁸⁰

B. Stock Option Plans and Self-Dealing

Although most of the independent investigation committee cases concern challenges of questionable payments made to foreign officials,⁸¹ the cases involving self-dealing and stock option plans⁸² are of particular interest in light of the traditional disposition of such scenarios.⁸³ The decision of the United States Court of Appeals for the Ninth Circuit in *Lewis v. Anderson*⁸⁴ provides a typical application of the business judgment rule to a litigation committee's refusal to sue. In 1973 Walt Disney Productions established a stock option incentive program for key employees.⁸⁵ In the following year the board's stock option committee granted new options to its members and to other key employees.⁸⁶ Two shareholders initiated a

describe a director who is indifferent to the outcome of a committee's investigation into the conduct of fellow directors. *See* cases cited note 79 *infra*. *But see* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 110-17 (1980) (contending that neither inside nor outside directors can be truly disinterested).

⁷⁹*See* *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979); *Abbey v. Control Data Corp.*, 603 F.2d 724, 729 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980); *Gall v. Exxon Corp.*, 418 F. Supp. 508, 516 (S.D.N.Y. 1976); *Falkenberg v. Baldwin*, N.Y.L.J., Mar. 3, 1980, at 12, col. 6 (Sup. Ct. 1980). *But see* *Maldonado v. Flynn*, 413 A.2d 1251, 1263 (Del. Ch. 1980) (dictum) (defendants have burden to show good faith and independence of committee).

⁸⁰Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 109 (1980). Dent referred to the litigation committee cases as "unjustifiable judicial legislation." *Id.*

⁸¹*Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Rosengarten v. International Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *Parkoff v. General Tel. & Elecs. Corp.*, 425 N.Y.S.2d 599 (App. Div. 1980); *Wechsler v. Exxon Corp.*, 55 A.D.2d 875, 390 N.Y.S.2d 111 (1977); *Falkenberg v. Baldwin*, N.Y.L.J., Mar. 3, 1980, at 12, col. 6 (Sup. Ct. 1980); *Auerbach v. Aldrich*, N.Y.L.J., Dec. 23, 1977, at 13, col. 5 (Sup. Ct. 1977); *Levy v. Sterling Drugs, Inc.*, N.Y.L.J., Nov. 23, 1977, at 10, col. 3 (Sup. Ct. 1977).

⁸²*Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979); *Maher v. Zapata Corp.*, FED. SEC. L. REP. (CCH) ¶ 97,549 (S.D. Tex. May 27, 1980); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980).

⁸³*See* notes 66-70 and accompanying text *supra*.

⁸⁴615 F.2d 778 (9th Cir. 1979) (interpreting California law).

⁸⁵*Id.* at 780.

⁸⁶*Id.*

derivative action claiming that the 1974 options were more favorable to the directors and, hence, violated federal securities law.⁸⁷ In response to the shareholders' challenge, the directors formed a special litigation committee composed of two outside directors and a named defendant-director who did not personally gain from the 1974 options.⁸⁸ The committee concluded that it was not in Disney's best interests to pursue the litigation, and the committee's counsel moved for a summary judgment.⁸⁹ The trial court granted counsel's motion, holding that "if the committee exercised its business judgment in deciding to terminate the action, that decision could not be challenged derivatively"⁹⁰

Upholding the district court, the court of appeals in *Lewis* followed the two-step analysis previously prescribed by the United States Supreme Court in *Burks v. Lasker*.⁹¹ The first inquiry was whether the relevant state law permitted a litigation committee to terminate a shareholder's derivative suit; the second inquiry asked whether such state law was consistent with relevant federal law.⁹² To answer the first inquiry, the *Lewis* court applied a synergistic argument to find California authority permitting committees to terminate shareholder derivative suits implicating a majority of the board.⁹³ Although California law did not directly answer the first inquiry, the court found support for the application of the business judgment rule to the directors' good faith business decision to not pursue a cause of action.⁹⁴ The shareholders claimed that the rule did not apply when a majority of the directors were named defendants in the suit.⁹⁵

⁸⁷*Id.* The directors used inside information that the Disney stock price was low and options granted at that price would be profitable. *Id.* at 783 n.2.

⁸⁸*Id.* at 780.

⁸⁹*Id.*

⁹⁰*Id.* (emphasis in original).

⁹¹441 U.S. 471 (1979). Shareholders of an investment company alleged that the directors breached fiduciary duties under the Investment Company Act of 1940 and the Investment Advisor's Act of 1940 by purchasing \$20 million in Penn Central commercial paper from its investment advisor without independently investigating the paper's quality and safety.

⁹²*Id.* at 480.

⁹³615 F.2d at 781-83. The *Lewis* court made its argument by citing some California cases which involved the traditional application of the business judgment rule. The court based its extension of the business judgment rule to committee decisions on the federal decisions in *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), and *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980), neither of which construed California law. 615 F.2d at 782-83.

⁹⁴615 F.2d at 783.

⁹⁵*Id.* at 782.

Citing *Abbey v. Control Data Corp.*⁹⁶ and *Auerbach v. Bennett*⁹⁷ as reflecting a "clear trend in corporate law,"⁹⁸ the *Lewis* court held "that the good faith exercise of business judgment by a special litigation committee of disinterested directors is immune to attack by shareholders or the courts."⁹⁹ The decision was supported by the court's notation that the independent committee, not the defendants,¹⁰⁰ invoked the business judgment rule to protect its refusal to sue.¹⁰¹ Furthermore, policy considerations were held to favor the decision:

To allow one shareholder to incapacitate an entire board of directors merely by leveling changes against them gives too much leverage to dissident shareholders. There 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.¹⁰²

The *Lewis* opinion recognized that a court could probe the independence of the committee and examine its investigative procedures.¹⁰³ "The business judgment rule, as we interpret it, would not bar a derivative action when a special litigation committee of disinterested directors dismisses an action in bad faith."¹⁰⁴ The court skirted the independence issue by merely noting "that the independent committee members were appointed by interested directors is an 'inescapable' aspect of 'the corporation's predicament.'"¹⁰⁵ The *Lewis* court merely conceded that this situation "presents problems."¹⁰⁶

Finding that California law authorized a committee dismissal of a shareholder's derivative suit, the *Lewis* court tersely found this interpretation of state law consistent with the policies underlying federal securities laws.¹⁰⁷ Thus, the second inquiry mandated by

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

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

⁹⁸615 F.2d at 783.

⁹⁹*Id.*

¹⁰⁰The court was apparently not concerned that one member of the committee was named as a defendant. *Id.* at 782.

¹⁰¹*Id.* at 783.

¹⁰²*Id.*

¹⁰³*Id.*

¹⁰⁴*Id.* The court did not clearly articulate, however, who must show the committee's lack of independence or good faith. *See* note 79 and accompanying text *supra*.

¹⁰⁵*Id.* *See also* *Auerbach v. Bennett*, 47 N.Y.2d 619, 633-34, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979).

¹⁰⁶615 F.2d at 783.

¹⁰⁷*Id.* at 783-84.

Burks v. Lasker,¹⁰⁸ whether the state law is consistent with the relevant federal laws, was answered affirmatively by the *Lewis* court.¹⁰⁹

IV. THE ZAPATA DECISIONS

Another stock option plan modification scenario triggered a trio of actions against the Zapata Corporation.¹¹⁰ These three cases may mark the end of the "clear trend in corporate law"¹¹¹ that allows director-appointed litigation committees to terminate shareholder derivative suits under the purported auspices of the business judgment rule when a majority of the board are accused of misconduct.¹¹² First, the New York District Court decision¹¹³ will be reviewed as a further extension of the *Lewis* trend. This discussion will be followed by a study of the impact on shareholders engendered by the litigation committee cases. Next, the precipitous end to the litigation committee trend portended by the subsequent resolutions of the companion Zapata actions¹¹⁴ will be examined. Finally, arguments for the future application of the business judgment rule will be presented.

A. *The Zapata Factual Background*

All three actions share the same factual background. In 1971 the Zapata board devised a stock option program under which directors and key officers could exercise options to buy Zapata common stock at \$12.15 per share in five installments ending July 14, 1974.¹¹⁵ Immediately prior to July 14, 1974, Zapata planned to announce a tender offer for 2,300,000 of its own shares.¹¹⁶ The announcement was predicted to raise the market price per share from \$18 to about \$25.¹¹⁷ Realizing that significant additional federal income tax liability would be incurred by a post-announcement option exercise,¹¹⁸ the

¹⁰⁸441 U.S. at 480.

¹⁰⁹615 F.2d at 783-84.

¹¹⁰*Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980) (decided Mar. 18, 1980). Zapata is a Delaware corporation. All three claims stem from the same misconduct, self-dealing and a stock option plan.

¹¹¹*Lewis v. Anderson*, 615 F.2d 778, 783 (9th Cir. 1979).

¹¹²See cases cited note 4 *supra*.

¹¹³*Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980).

¹¹⁴*Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980).

¹¹⁵*Maldonado v. Flynn*, 413 A.2d 1251, 1254 (Del. Ch. 1980).

¹¹⁶*Id.*

¹¹⁷*Id.*

¹¹⁸*Id.* The capital gain incurred after the tender offer announcement would be equal to the difference between \$25 per share, the market price after the announcement, and \$12.15 per share, the exercise price. If the directors exercised their options

director-optionees accelerated¹¹⁹ the exercise date to July 2, 1974 to avoid the capital gain consequences of a post-announcement exercise.¹²⁰ The directors exercised their options on July 2, 1974 and obtained a suspension in trading of Zapata shares until the announcement date.¹²¹ The tender offer was made on July 8, 1974, and the market price per share immediately rose to \$24.50.¹²² Thus, the directors avoided personal income tax liability at the expense of Zapata's federal tax deduction for the same amount.¹²³

In 1975 the shareholders filed the three actions against Zapata. Four years later, the directors created an "Independent Investigative Committee" composed of two newly appointed outside directors.¹²⁴ The committee was empowered to investigate the three claims and to dispose of them in a manner consistent with the committee's business judgment.¹²⁵ After a three month investigation, the committee determined that none of the three shareholder derivative suits were in Zapata's best interests and moved for a dismissal of all pending claims.¹²⁶ In support of its decision, the committee mustered the following twelve reasons:

- (1) the asserted claims appeared to be without merit;
- (2) costs of litigation, exacerbated by likelihood of indemnification;
- (3) wasted senior management time and talents on pursuing litigation;
- (4) damage to company from publicity;
- (5) that no material injury appeared to have been done to company;
- (6) impairment of current director-defendants' ability

at the market price of \$18 per share prevailing before the announcement, the capital gain would be reduced to the difference between \$18 per share and the exercise price of \$12.15 per share. In other words, the directors could reduce their taxable capital gain by \$7 per share, a 54% reduction.

¹¹⁹*Id.* The directors moved up the date upon or after which the options could be exercised from July 14, 1974 to July 2, 1974. This ploy enabled the directors to avoid the market's reaction to Zapata's tender offer.

¹²⁰413 A.2d at 1254. This scenario is similar to that in *Lewis* where the directors took advantage of inside information to formulate a stock option grant. *See* note 87 *supra*.

¹²¹413 A.2d at 1254-55.

¹²²*Id.* at 1255.

¹²³*Id.* Zapata could have offset its federal tax liability by an additional amount equal to the difference between the per share prices of \$24.50 and \$18.00 had the directors exercised their options on the original exercise date after the tender offer announcement.

¹²⁴*Id.* Both of the committee members were appointed to fill vacancies in the board. The committee was formed under the corporation's bylaws and Delaware law. *See* DEL. CODE ANN. tit. 8, § 141(c) (1974) ("such committee . . . may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation . . .").

¹²⁵413 A.2d at 1255.

¹²⁶*Id.*

to manage; (7) the slight possibility of recurrence of violations; (8) lack of personal benefit to current director-defendants from alleged conduct; (9) that certain alleged practices were continuing business practices, intended to be in company's best interests; (10) legal question whether the complaints stated a cause of action; (11) fear of undermining employee morale; (12) adverse effects on the company's relations with employees and suppliers and customers.¹²⁷

B. *The Clear Trend Continues in New York*

The first disposition of the three Zapata challenges, *Maldonado v. Flynn*,¹²⁸ was decided on January 25, 1980 by the United States District Court for the Southern District of New York. The New York derivative suit alleged that the directors' failure to disclose in election proxy materials their self-interest in the stock option plan modification violated section 14(a)¹²⁹ of the Securities and Exchange Act of 1934.¹³⁰ The shareholder sought to nullify the election of the directors stemming from the illegal proxy solicitations.¹³¹

In responding to the shareholder's allegations, the New York court adhered to the two step approach of *Burks v. Lasker*¹³² to decide whether an investigative committee of two disinterested directors could terminate a derivative suit which named all nine fellow directors as defendants under Delaware law.¹³³ Noting that Delaware courts had not addressed this issue, the New York court cited the opinion of the United States Court of Appeals for the Eighth Circuit in *Abbey v. Control Data Corp.*¹³⁴ as conclusively establishing that Delaware law would apply the business judgment rule to an investigative committee's refusal to sue when a majority of the board were defendants in a suit.¹³⁵ The *Abbey* court relied on

¹²⁷*Maldonado v. Flynn*, 485 F. Supp. 274, 284 n.35 (S.D.N.Y. 1980). See *Maher v. Zapata Corp.*, 490 F. Supp. 348, 350-51 (S.D. Tex. 1980).

¹²⁸485 F. Supp. 274 (S.D.N.Y. 1980).

¹²⁹Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1976). Section 14(a) was promulgated to "protect investors from promiscuous solicitation of their proxies, on the one hand, by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and on the other hand, by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts." S. REP. NO. 1455, 73d Cong., 2d Sess. 77 (1934). See also Orrick, *The Revised Proxy Rules of the Securities and Exchange Commission*, 11 BUS. LAW. 32 (1956).

¹³⁰*Maldonado v. Flynn*, 485 F. Supp. at 278.

¹³¹*Id.*

¹³²441 U.S. 471, 480 (1979).

¹³³485 F. Supp. at 278. Eleven directors constituted Zapata's board.

¹³⁴603 F.2d 724, 729 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

¹³⁵485 F. Supp. at 278.

the Delaware cases of *Puma v. Marriott*¹³⁶ and *Beard v. Elster*¹³⁷ for its pronouncement. The *Maldonado* court cited *Beard* for the proposition that a court may not substitute its "uninformed opinion for that of experienced business managers of a corporation who have no personal interest in the outcome and whose sole interest is the furtherance of the corporate enterprise."¹³⁸ Relying on *Puma*, the New York court found the business judgment rule to apply "even where some board members are disqualified from participating in the board's decision . . ."¹³⁹ Finding the power to direct litigation within the director's realm,¹⁴⁰ the New York court concluded:

Thus under Delaware law a committee of disinterested directors, properly vested with the power of the board may in the exercise of their business judgment require the termination of a derivative suit brought on the corporation's behalf even though other directors are disqualified from participating in such a decision because they are named as defendants in the suit.¹⁴¹

In a footnote,¹⁴² the court referred to the "clear trend in corporate law" recently recognized in *Lewis v. Anderson*¹⁴³ to further buttress the court's holding.

The second inquiry mandated by *Burks*¹⁴⁴ is whether the court's interpretation of Delaware's business judgment rule is consistent with section 14(a) of the Securities and Exchange Act of 1934.¹⁴⁵ Contending that the purpose of section 14(a) is to prevent management

¹³⁶283 A.2d 693, 695-96 (Del. Ch. 1971). The New York court also noted that section 144(a) of the Delaware General Corporation Law allows interested director transactions if approved by an informed vote of a majority of the disinterested directors. DEL. CODE ANN. tit. 8 § 144(a) (Supp. 1978).

¹³⁷160 A.2d 731, 738-39 (Del. 1960).

¹³⁸485 F. Supp. at 279 (quoting *Beard v. Elster*, 160 A.2d 731, 738-39 (Del. 1960)).

¹³⁹485 F. Supp. at 279.

¹⁴⁰*Id.* The court quoted *United Copper Sec. Co. v. Amalgamated Copper Co.*:

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 stockholders. Courts interfere seldom to control such discretion, *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 relationship which prevents an unprejudiced exercise of judgment.

244 U.S. 261, 263-64 (1917).

¹⁴¹485 F. Supp. at 279-80.

¹⁴²*Id.* at 280 n.16.

¹⁴³615 F.2d 778 (9th Cir. 1979).

¹⁴⁴441 U.S. at 480.

¹⁴⁵Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1976).

from obtaining authority for corporate action through deceptive proxy materials,¹⁴⁶ the shareholder claimed that allowing "the very violators of the statute to control exercise of this right of action renders federal law meaningless."¹⁴⁷ The New York court concluded that section 14(a) and the business judgment rule were consistent by citing similar rulings in *Abbey v. Control Data Corp.*¹⁴⁸ and *Burks v. Lasker*.¹⁴⁹ The *Maldonado* court also noted that although derivative suits could be terminated by the board, the business judgment rule did not totally preclude enforcement of section 14(a) claims. A shareholder could always bring an individual action or a class action on behalf of all shareholders.¹⁵⁰

C. *The Impact of the Litigation Committee Cases*

The litigation committee cases demonstrate the erosion of a shareholder's ability to derivatively protect the corporation and its shareholders from the ravages of director malversation. Allowing a board to interpose an "independent" committee's decision to not pursue the derivative action, thereby compelling dismissal of a derivative suit, leaves the shareholder uncertain of the substantive effect of the business judgment rule and of his ability to redress injuries to the corporation and its shareholders.

The most devastating impact on the shareholder results from the allocation of the burden of proof dictated by the litigation committee cases. Under the conventional application of the business judgment rule as a director's defense, the burden fell on the shareholder to impugn the rule's shield by showing fraud, self-dealing, bad faith, or lack of due care.¹⁵¹ Once the shareholder made an adequate showing of impropriety or nonfulfillment of duties, the burden shifted to the director-defendant to exhibit the entire fairness of the transaction under the court's careful scrutiny.¹⁵² Now, however, with the bastardized application of the business judgment rule, the burden falls on the shareholder to rebut the independence or good faith of the litigation committee even though a majority of

¹⁴⁶See also note 13 *supra*.

¹⁴⁷485 F. Supp. at 281.

¹⁴⁸603 F.2d 724, 731-32 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

¹⁴⁹441 U.S. at 485 (finding Investment Company Act and Investment Advisors Act consistent with state law permitting independent directors to terminate a nonfrivolous derivative suit).

¹⁵⁰485 F. Supp. at 281. The court did not consider the expense and burden such alternatives would place on the shareholder. See generally FED. R. CIV. P. 23(c)(2).

¹⁵¹See text accompanying notes 30-37 *supra*.

¹⁵²See text accompanying notes 55-70 *supra*.

the board are accused of wrongdoing or suffer dismissal of the derivative suit.¹⁵³

Showing the committee's nonindependence is an onerous task¹⁵⁴ for the shareholder, especially when the courts find only actual participation in the tainted transaction sufficient to defeat the rule's protection of the committee's decision.¹⁵⁵ The New York action, *Maldonado v. Flynn*,¹⁵⁶ crystallizes the frustrations confronted by a shareholder challenging a committee's independence.

In *Maldonado* the shareholder attacked the committee's independence on three grounds. First, one committee member was a partner in the law firm employed by the corporation.¹⁵⁷ Second, one member was appointed to the board on the day the committee was formed, thereby implying that the member was appointed for the sole purpose of favorable committee membership.¹⁵⁸ Third, the entire committee membership was selected by the defendants.¹⁵⁹

Referring to these claims as "vigorous innuendo,"¹⁶⁰ the court stated that "the fact that the Committee's membership became directors by appointment does not itself indicate that they bore any special loyalty to the disqualified directors or that they were any less effectively divorced from dependence upon the board then [sic] would have been the case with elected directors."¹⁶¹ The opinion also noted that the committee members "owe the same fiduciary duty as any director to the corporation and its shareholders."¹⁶²

A shareholder's frustration with attempting to reveal the committee's lack of independence is exacerbated by the common-sense awareness of the many inherent pressures on directors to be interested. An inside director's decision not to sue a fellow director

¹⁵³See cases cited note 79 *supra*.

¹⁵⁴See *Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y. 1975) (excusing demand on ostensibly disinterested board because "tangible indications of bias on the part of the unaffiliated majority are rarely present"); *Johnston v. Greene*, 121 A.2d 919 (Del. 1956) (difficulty of showing bad faith).

¹⁵⁵See, e.g., *Lewis v. Anderson*, 615 F.2d 778, 780 (9th Cir. 1979) (court did not impugn committee's independence even though one member was a named defendant who had not gained from the transaction); *Maldonado v. Flynn*, 485 F. Supp. at 283 (committee found independent despite one member's partnership in law firm hired as committee's counsel).

¹⁵⁶485 F. Supp. 274 (S.D.N.Y. 1980).

¹⁵⁷*Id.* at 283.

¹⁵⁸*Id.*

¹⁵⁹*Id.* This situation was usually present in all of the litigation committee cases. Most courts only went as far as noting that this problem is inescapable. See *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

¹⁶⁰485 F. Supp. at 284.

¹⁶¹*Id.* at 283-84.

¹⁶²*Id.* at 283.

may be influenced by salary, promotion, fringe benefits, employee morale, and career considerations.¹⁶³ Outside directors are subject to conflicts arising from personal friendships, pressures to conform, gratitude for position, and responsibilities to other corporations.¹⁶⁴ By forcing the shareholder to challenge the independence of the litigation committee and by requiring more than a showing of inherent pressures in order to avoid dismissal under the business judgment rule, the courts have effectively pronounced the last rites for the shareholder's derivative suit.¹⁶⁵

The litigation committee cases compound the shareholders' miseries by clouding the substantive meaning of the business judgment rule. Following the traditional use of the defense, the court in *Gottlieb v. Heyden Chemical Corp.*¹⁶⁶ clearly made the business judgment defense unavailable if a majority of the corporation's directors were accused of self-dealing.¹⁶⁷ Similarly, the United States Supreme Court in *Hawes v. Oakland*¹⁶⁸ gave shareholders the right to bring a derivative suit when "the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of the corporation itself, or of the rights of the other shareholders."¹⁶⁹ Now, even though a majority of the board may be defendants, the litigation committee cases allow the committee of directors to erect the business judgment rule defense and to compel dismissal of a shareholder's derivative action.¹⁷⁰ Chief Judge Cooke of the New York Court of Appeals commented in his dissenting opinion to *Auerbach v. Bennett*¹⁷¹ that the application of the business judgment rule to a litigation committee decision to terminate a shareholder derivative suit naming a majority of the directors placed the shareholder in a "'Catch-22'"¹⁷² position. He also observed that the "result reached by the majority not only effectively dilutes the substantive rule of law at issue, but may also render corporate directors largely unaccountable to the shareholders whose business they are elected to govern."¹⁷³

¹⁶³See Dent, *supra* note 80, at 111, 113.

¹⁶⁴*Id.* at 111-13. See also 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).

¹⁶⁵See Dent, *supra* note 80, at 109.

¹⁶⁶90 A.2d 660 (Del. 1952).

¹⁶⁷*Id.* at 663. See also cases cited note 70 *supra*.

¹⁶⁸104 U.S. 450 (1881).

¹⁶⁹*Id.* at 460.

¹⁷⁰See cases cited note 4 *supra*; text accompanying notes 84-143 *supra*.

¹⁷¹47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) (dissenting opinion).

¹⁷²*Id.* at 619, 393 N.E.2d at 1004, 419 N.Y.S.2d at 931.

¹⁷³*Id.*

The subsequent *Zapata* decisions may mark the return of the traditional application of the business judgment rule and an end to the "clear trend in corporate law"¹⁷⁴ that permits a committee of disinterested directors to compel dismissal of a shareholder's derivative suit in which a corporate board has been implicated.¹⁷⁵

D. *The Clear Trend Fades in Delaware*

On March 18, 1980, nearly two months after the New York case ended,¹⁷⁶ the Delaware Chancery Court rendered its decision in *Maldonado v. Flynn*.¹⁷⁷ In state court the shareholder alleged that *Zapata's* directors breached their fiduciary duty to the corporation and its shareholders by depriving *Zapata* of a federal tax deduction in an amount equal to the reduction in capital gain achieved by the optionees who exercised their options on the accelerated exercise date.¹⁷⁸ The defendant-directors contended that the business judgment rule permitted a disinterested committee to compel dismissal of a derivative suit determined to be contrary to the corporation's best interests.¹⁷⁹ They further asserted that the burden of proof should fall on the shareholder to dispel the presumption of the committee's independence and good faith.¹⁸⁰

The Delaware court denied *Zapata's* motion for dismissal¹⁸¹ after a thorough analysis of the business judgment rule and the history of the derivative suit.¹⁸² Beginning with a review of Delaware's application of the business judgment rule, the court's analysis revealed that

[i]ts character as a purely defensive rule has never been seriously challenged. The rule, however, is not of universal application, nor without exception. It does not irrevocably shield all corporate transactions It requires utmost loyalty to the corporation and its interests and does not protect fraudulent, illegal, or reckless decisions by the directors And, of course, the rule has no application where there is a showing that the directors have profited at the expense of the corporation.¹⁸³

¹⁷⁴*Lewis v. Anderson*, 615 F.2d at 783.

¹⁷⁵See cases cited note 4 *supra*.

¹⁷⁶*Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980).

¹⁷⁷413 A.2d 1251 (Del. Ch. 1980).

¹⁷⁸413 A.2d at 1255.

¹⁷⁹*Id.*

¹⁸⁰*Id.*

¹⁸¹*Id.* at 1262.

¹⁸²*Id.* at 1256-57, 1261-62.

¹⁸³*Id.* at 1256 (citations omitted).

Vice Chancellor Hartnett noted that the recent federal decisions pronouncing the business judgment rule as the authority for permitting a committee of impartial directors to stop a derivative suit against a majority of the board "correctly state the business judgment rule"¹⁸⁴ but erroneously assume state law compels dismissal of the suit under the rule.¹⁸⁵ Finding the issue unaddressed by case law or statute, the court held "that under well settled Delaware law, the directors cannot compel the dismissal of a pending stockholder's derivative suit which seeks redress for an apparent breach of fiduciary duty, by merely reviewing the suit and making a business judgment that it is not in the best interests of the corporation."¹⁸⁶

The Delaware court made the crucial distinction that the business judgment rule "provides a shield with which directors may oppose stockholders' attacks on the decisions made by them; but nothing in it grants any independent power to a corporate board of directors to terminate a derivative suit."¹⁸⁷ The Delaware court further developed the distinction by reasoning that

[w]hile the business judgment rule may protect the Committee of Independent Directors of Zapata from personal liability if they have made a good faith decision that this suit is not in the best interests of Zapata, and should be dismissed, an analysis of the character of a derivative suit shows that the business judgment rule is irrelevant to the question of whether the Committee has the authority to compel the dismissal of this suit.¹⁸⁸

The defendants claimed that the right to pursue a suit for a breach of fiduciary duty was primarily a corporate right, and a shareholder's derivative suit was subordinate to that right, notwithstanding the corporation's refusal to sue. Zapata rested its contentions upon *Hawes v. Oakland*,¹⁸⁹ *McKee v. Rogers*,¹⁹⁰ *Corbus v.*

¹⁸⁴*Id.* at 1257. The court cited *Lewis v. Anderson* and other cases for its contention. See text accompanying notes 84-109 *supra*.

¹⁸⁵413 A.2d at 1257.

¹⁸⁶*Id.* Vice Chancellor Hartnett's holding marks the first time that a Delaware court has addressed the issue of whether a committee may use the business judgment rule to compel dismissal of a shareholder's derivative suit naming a majority of the board. See *Abbey v. Control Data Corp.*, 603 F.2d 724, 730 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980). Cf. *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980) (finding no answer in Ohio law); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) (finding no California law on the issue).

¹⁸⁷413 A.2d at 1257.

¹⁸⁸*Id.*

¹⁸⁹104 U.S. 450 (1881).

¹⁹⁰187 U.S. 455 (1903).

Alaska Treadwell Gold Mining Co.,¹⁹¹ and *Ashwander v. Tennessee Valley Authority*.¹⁹²

In distinguishing these decisions, the Delaware tribunal stated:

[A] stockholder may be denied the right to assert on behalf of his corporation a corporate right of action when he has failed to make a proper demand; *Hawes v. Oakland*, *supra*; if, of course, one is necessary; *McKee v. Rogers*, *supra*; or where he seeks a right not legally assertable by his corporation, *Corbus v. Alaska Treadwell Gold Mining Co.*, *supra*; or where the purportedly derivative action asserts a purely legal cause of action against an extracorporate party without any allegation that the directors have acted improperly.¹⁹³

By relying on *Ashwander*, the court noted that Zapata "ignores the gravamen of Maldonado's suit."¹⁹⁴ The Vice Chancellor pointed out that Maldonado was not challenging the committee's decision to seek dismissal of the suit but was alleging a breach of fiduciary duty arising from the 1979 decision to accelerate the exercise date for the directors' personal gain at Zapata's expense.¹⁹⁵

After summarizing the history of the derivative suit and finding that the corporation no longer controlled the action once it refused a shareholder's demand,¹⁹⁶ 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.¹⁹⁷

Commenting upon the problem of committee independence left

¹⁹¹18 Del. Ch. 81, 156 A. 191 (1931).

¹⁹²297 U.S. 288 (1936).

¹⁹³413 A.2d at 1260 (citations omitted).

¹⁹⁴*Id.* at 1259.

¹⁹⁵*Id.*

¹⁹⁶*Id.* at 1262. See generally Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168 (1976).

¹⁹⁷413 A.2d at 1262.

unresolved by *Lewis v. Anderson*,¹⁹⁸ Vice Chancellor Hartnett noted:

Under our system of law, courts and not litigants should decide the merits of litigation. Aggrieved stockholders 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.¹⁹⁹

E. The Clear Trend Ends in Texas

Although the Delaware version of *Maldonado v. Flynn*²⁰⁰ discernibly faded the clear trend observed by the court in *Lewis v. Anderson*,²⁰¹ the United States District Court for the Southern District of Texas decision in the last of three Zapata actions may have reversed the trend completely. On May 27, 1980, *Maher v. Zapata*²⁰² became the first federal decision to hold that the business judgment rule did not grant directors the power to dismiss a shareholder derivative suit alleging a breach of fiduciary duty after the directors had refused the shareholder's demand.²⁰³

In the Texas suit, the directors were charged with violations of federal securities law²⁰⁴ and with a breach of fiduciary duty under Texas corporation law.²⁰⁵ As in the companion actions, the defendants claimed that the business judgment rule demanded dismissal of a derivative suit if an appointed committee of disinterested directors elected to forego a corporate cause of action alleging breach of duty.²⁰⁶ The court, relying upon the Delaware Chancery Court's interpretation of Delaware corporation law in *Maldonado v. Flynn*,²⁰⁷ denied the defendants' motion to dismiss.²⁰⁸

District Judge Black cut short the defendants' reliance upon the *Abbey*²⁰⁹ court interpretation of Delaware law. He answered the first

¹⁹⁸615 F.2d 778 (9th Cir. 1979).

¹⁹⁹413 A.2d at 1263.

²⁰⁰The Delaware court went further than any other case when it answered the first *Burks* inquiry negatively, but the end of the trend may need to await a favorable holding by the Delaware Supreme Court.

²⁰¹615 F.2d 778 (9th Cir. 1979).

²⁰²490 F. Supp. 348 (S.D. Tex. 1980).

²⁰³*Id.* at 353.

²⁰⁴Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n (1976); Rule 14a-9, 17 C.F.R. § 240.14a-9 (1980).

²⁰⁵TEX. BUS. CORP. ACT ANN. art. 2.02A(6) (Vernon 1980).

²⁰⁶490 F. Supp. at 351. See cases cited notes 113 & 179 *supra*.

²⁰⁷413 A.2d 1251 (Del. Ch. 1980).

²⁰⁸490 F. Supp. at 354.

²⁰⁹603 F.2d 724, 729 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

Burks inquiry²¹⁰ negatively by finding that *Puma v. Marriott*²¹¹ and *Beard v. Elster*²¹² involved "the traditional application of the business judgment rule, that is, as a substantive defense on the merits of the case."²¹³ Quoting the Delaware *Maldonado* opinion²¹⁴ at length,²¹⁵ the Texas court stated:

This Court is convinced, however, that the Delaware Supreme Court would adopt the reasoning of the lower court, and the rule that the business judgment rule is a purely defensive rule, and not a basis for granting a motion to dismiss a stockholder derivative suit against a corporation and its directors alleging a breach of fiduciary duty when the corporate directors, or a committee thereof, in their collective business judgment, determined that the suit was not in the best interests of the corporation.²¹⁶

In addition the Texas court pursued the issue of the committee's independence and good faith further than the Delaware court's opinion. Finding authority to investigate the reasonableness of a committee's decision,²¹⁷ the court was "concerned whether the Committee's decision was in good faith within the bounds of reason."²¹⁸ On the issue of independence, Judge Black commented: "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."²¹⁹ The court also questioned the committee's balancing of the factors influencing the committee's decision²²⁰ and quoted: "'[T]he noninterference doctrine [the business judgment rule] should not be carried to the extreme of making an unreasonable reference of the board dispositive of the issue.'"²²¹

²¹⁰441 U.S. at 480 (whether state law permits a committee of disinterested directors to compel dismissal of a shareholder's derivative suit implicating a majority of the board under the business judgment rule).

²¹¹283 A.2d 693 (Del. Ch. 1971).

²¹²160 A.2d 731 (Del. 1960).

²¹³490 F. Supp. at 352.

²¹⁴*Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980).

²¹⁵490 F. Supp. at 352-53.

²¹⁶*Id.* at 353.

²¹⁷*Id.* (citing *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979)).

²¹⁸490 F. Supp. at 354.

²¹⁹*Id.*

²²⁰*Id.*

²²¹*Id.* (quoting *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 n.21 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979)).

Inevitably, the proper application of the business judgment rule will be litigated again in federal courts. The Delaware and Texas decisions, however, should at least give the courts cause to rethink their interpretations of Delaware's business judgment rule. Rather than obediently following clear trends, the courts should engage in more than a cursory analysis of the business judgment rule's history, and the oppressive consequences of the rule's distortion should be forefront in the courts' "proper regard"²²² of state law.

V. CONCLUSION

When the business judgment rule is used to defeat a shareholder's challenge to a transaction replete with conflicts of interest, the courts should consider plotting a new course for future trends in corporate law. The difficulties suffered by shareholders under the distorted application of the business judgment rule led Vice Chancellor Hartnett to express his concern:

[I]t would seem that, under current concepts of fairness and fiduciary duty, directors who are defendants in a stockholder's derivative suit, because they approved a transaction in which they had a self-interest, and who then seek a dismissal of the suit by appointing an Independent Committee to decide whether the suit should continue, should, at least, bear the burden of showing the independence of their Committee.²²³

Even if the business judgment rule is found irrelevant to the issue whether the shareholders have an independent right to derivatively rectify a breach of fiduciary duty when the corporation refuses to sue,²²⁴ several equities mitigate in favor of placing the burden of proof on the director-defendants. First, the corporation usually has superior access to the relevant information needed to pursue the lawsuit.²²⁵ Second, the corporation is able to muster more resources than the shareholder. Third, procedurally, the burden should fall on the directors when self-dealing is alleged in order to retain consistency with the intrinsic fairness rule.²²⁶ Some have even

²²²Lewis v. Anderson, 615 F.2d at 781 (quoting Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967)).

²²³Maldonado v. Flynn, 413 A.2d at 1263 (dictum). See also Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980).

²²⁴413 A.2d at 1255.

²²⁵See Auerbach v. Bennett, 47 N.Y.2d 619, 638, 393 N.E.2d 994, 1005, 419 N.Y.S.2d 920, 931 (1979) (dissenting opinion); C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE § 337, at 787 (2d ed. E. Cleary 1972); Dent, *supra* note 80, at 134.

²²⁶See text accompanying notes 55-70 *supra*.

proposed that when the majority of the board is charged with self-dealing, the unaffiliated minority should be presumed to have a conflict of interest because of the inherent, yet intangible, pressures to be dependent upon the majority.²²⁷

Abortion of the clear trend represented by the litigation committee cases is importuned by the resulting dilution of the business judgment rule's substantive meaning. Decisions like *Lewis v. Anderson*²²⁸ and New York's *Maldonado v. Flynn*²²⁹ make uncertain the breadth of the business judgment rule.²³⁰ The New York *Maldonado* outcome is totally inconsistent with a long line of Delaware decisions which have denied the directors the protection of the business judgment defense where self-dealing was alleged.²³¹ As late as 1979, the Delaware Supreme Court has said that "directors . . . are bound to act out of fidelity and honesty in their roles as fiduciaries And they may not, simply because of their position, 'by way of excessive salaries and other devices [stock options], oust the minority of a fair return upon its investment.'"²³² In a shareholder's derivative suit which implicated a majority of the board, the effect of permitting a committee of directors to compel dismissal of the suit by refusing to sue under the business judgment rule is to unfairly shield self-dealing directors from the rigorous burden imposed upon them by the intrinsic fairness test. Certainly the Zapata directors would have had their hands full demonstrating to the court the entire fairness of their stock option plan modification at the expense of the corporation.

Denial of a shareholder's derivative suit implicating a majority of the board in self-dealing is also inconsistent with both federal²³³ and state²³⁴ decisions. These decisions hold that a right to sue on behalf of the corporation inures to the shareholder challenging a transaction tainted by self-dealing once the corporation refuses to sue²³⁵ or if demand would be futile.²³⁶ Allowing a committee appointed by the defendants to decline suit would be inconsistent with decisions like *Galef v. Alexander*²³⁷ in which the court was "not

²²⁷Dent, *supra* note 80, at 110-22.

²²⁸615 F.2d 778 (9th Cir. 1979).

²²⁹485 F. Supp. 274 (S.D.N.Y. 1980).

²³⁰See text accompanying notes 170-73 *supra*.

²³¹See cases cited note 55 *supra*.

²³²*Michelson v. Duncan*, 407 A.2d 211, 217 (Del. 1979) (quoting *Baker v. Cohn*, 42 N.Y.S.2d 159, 166 (Sup. Ct. 1942)).

²³³See cases cited note 3 *supra*.

²³⁴*Sohland v. Baker*, 141 A. 277 (Del. 1927).

²³⁵See cases cited notes 3 & 234 *supra*.

²³⁶*McKee v. Rogers*, 18 Del. Ch. 81, 156 A. 191 (1931).

²³⁷615 F.2d 51 (2d Cir. 1980). See *Nussbacher v. Chase Manhattan Bank*, 444 F. Supp. 973 (S.D.N.Y. 1977).

aware of any case that has determined that directors against whom a claim has been asserted and who have determined that the claim against them should not be pursued, do *not* 'stand in a dual relation which prevents an unprejudiced exercise of judgment.'"²³⁸

By effectively denying the shareholder a remedy, the litigation committee cases place directors in a powerful position without accountability.²³⁹ The shareholder is denied the advantages of an adversary proceeding or full discovery when a committee insulates in the business judgment rule its refusal to sue.²⁴⁰ Presumably, a shareholder does not bargain for such rough treatment when he entrusts his investment to the board of directors' best business judgments.

The oppressive burden imposed upon the shareholders, the dilution of federal and state law, and the derivative suit's elegy each demand that the clear trend permitting a committee of directors to compel dismissal of a shareholder's derivative suit naming a majority of the board as defendants under the auspices of the business judgment rule must come to an abrupt end. The courts should heed the lessons taught by the Delaware disposition of *Maldonado v. Flynn*²⁴¹ and its federal companion, *Maher v. Zapata*.²⁴² The next clear trend in corporate law should be the return of the traditional interpretation of the business judgment rule as a defense to liability arising from mistakes in judgment. This defense should be available, however, only if the director has fulfilled all of his duties to the corporation and its shareholders.²⁴³ Otherwise, "*Sed quis custodiet ipsos custodes?*"²⁴⁴ will become an appropriate inquiry.

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²³⁸615 F.2d at 60 (referring to *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 264 (1917)).

²³⁹See text accompanying notes 171-73 *supra*.

²⁴⁰Dent, *supra* note 80, at 119-20.

²⁴¹413 A.2d 1251 (Del. Ch. 1980).

²⁴²490 F. Supp. 348 (S.D. Tex. 1980).

²⁴³See text accompanying notes 10-22 *supra*.

²⁴⁴"But who is to guard the guards themselves?" VI JUVENAL, SATIRES, 1.347. *But see* Gall v. Exxon Corp., 418 F. Supp. 508, 519 (S.D.N.Y. 1976) (forbidding this inquiry).

