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NOTES

ZAPATA CORP. V. MALDONADO: A MIDDLE GROUND WHEN APPLYING THE BUSINESS JUDGMENT RULE TO THE TERMINATION OF DERIVATIVE SUITS

The judicially created business judgment rule\(^1\) shields officers and directors of a corporation from personal liability in the exercise of their corporate duties.\(^2\) Under the business judgment rule, directors will not be held liable for honest errors or mistakes of judgment, unless it can be shown that the directors acted in bad faith or with corrupt motive.\(^3\)

This rule serves several purposes: First, it encourages qualified persons to become directors by assuring them that they will not be held to a higher

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1. See 3A W. Fletcher, Cyclopedia of the Law of Private Corporations § 1039 (rev. perm. ed. 1980) ("[T]he law will not hold directors liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith."). In addition to imposing a standard of care for directors, the business judgment rule traditionally imposes the burden of proving lack of good faith or due care on the plaintiff shareholder. Gall v. Exxon Corp., 418 F. Supp. 508, 516 (S.D.N.Y. 1976). Although the business judgment rule may be raised as a defense to any business decision in which directors exercise discretion, this Note will focus primarily on the directors’ decision not to pursue a corporate cause of action. For further discussion of the rule, see infra notes 30-41 and accompanying text.

2. The officers and directors of a corporation are empowered, by state statute and by corporation bylaws, to act on behalf of the corporation and its shareholders. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1980); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1981-82); MODEL BUSINESS CORP. ACT ANN. 2d § 35 ¶ 4.01 (1971). Although the business judgment rule generally protects executive officers of a corporation from personal liability, W. Fletcher, supra note 1, § 1039, this Note will focus on directors’ liability.

3. In the seminal case of Guth v. Loft, 5 A.2d 503 (Del. Ch. 1939), the Delaware court asserted that although officers and directors are technically not trustees, they must show "undivided and unselfish loyalty to the corporation." Id. at 510. The court stated that this rule flows from both a long-standing public policy and profound knowledge of human characteristics. Id. In applying the determinations of honesty, good faith and undivided loyalty, the court recognized that no hard and fast rule could be formulated. In Delaware, the standard to which directors are held is still determined by case law. However, 20 states have now codified a standard of care, eight of which have followed, in some respect, the Model Business Corporation Act § 35. Veasey & Manning, Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law, 35 BUS. LAW. 919, 920-21 (1980). See infra note 34.
standard of care than that expected of them in the exercise of their own business affairs. Second, the rule promotes business economy by discouraging individual shareholders from bringing suit every time a decision with which they disagree is made. Third, it fosters judicial economy by foreclosing inquiry into the everyday decisions of a corporation.

The business judgment rule has been used traditionally as a defensive shield to protect directors from personal liability when their decisions have been attacked by dissatisfied shareholders. In addition to protecting directors from personal liability in their business judgments, the rule may also serve as a barrier to the maintenance of shareholder derivative suits. A decision by the board of directors not to bring a suit against a third party is ordinarily respected as a legitimate exercise of business judgment. The rule, however, was not meant to preclude shareholder derivative suits when the directors' refusal to bring suit against a third party was in breach of trust or when a majority of the directors were involved in the alleged


5. Arsh, supra note 4, at 95. In addition to discouraging litigious shareholders, the rule encourages entrepreneurial risk-taking. Johnson & Osborne, The Role of The Business Judgment Rule in a Litigious Society, 15 Val. U.L. Rev. 49, 54 (1980). See also Coffee & Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261, 281 (1981). ("[N]ormal business judgments are often made under time pressure and uncertainty, which preclude studied reflection or textbook style decision-making." However, the authors distinguish ordinary business judgments from a decision not to bring suit because the elements of time pressure and uncertainty are not as prevalent in the decision not to sue. Id).

6. Arsh, supra note 4, at 95; see also Ashwander v. TVA, 297 U.S. 288, 343 (1935) (Brandeis, J., concurring) ("If a stockholder could compel the officers to enforce every legal right, courts, instead of chosen officers, would be the arbiters of the corporation's fate."). In Auerbach v. Bennett, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979), the court stated that the business judgment rule is also grounded on the recognition of the peculiar qualifications that directors of the corporation possess: "[C]ourts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments." Id.


8. A shareholder derivative suit is a cause of action brought by shareholders to redress a harm to the corporation. The suit is "derivative" in that it is brought on behalf of and for the direct benefit of the corporation. Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?, 75 Nw. U.L. Rev. 96 n.1 (1980). The derivative suit can only be brought "[w]hen the corporate cause of action is for some reason not asserted by the corporation itself." H. Henn, Handbook of the Law of Corporations and Other Business Enterprises § 360, at 756 (2d ed. 1970).

wrongdoing.\textsuperscript{10} In such a case, a shareholder, on behalf of the corporation, could bring a derivative suit to redress the wrong.\textsuperscript{11}

Recently, corporations have attempted to use the business judgment rule offensively by blocking derivative suits, even when a majority of directors are alleged to be wrongdoers or are deemed "interested."\textsuperscript{12} Once a shareholder suit is initiated, the board may appoint a special "disinterested" litigation committee\textsuperscript{13} which is given authority to investigate the shareholder's claim and to determine whether the suit is in the best interests of the corporation. In all reported cases, these committees have either moved to dismiss or requested summary judgment, on the grounds that the suit is not in the best interests of the corporation.\textsuperscript{14}

Courts are split as to the propriety of this offensive use\textsuperscript{15} of the business judgment rule. Most courts that have addressed the issue have approved of such use and have limited their inquiry to the issues of the good faith and

\textsuperscript{10} See Ashwander v. TVA, 297 U.S. 288, 319 (1936); 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 (1882); Ash v. IBM, 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966); Rogers v. American Can Co., 305 F.2d 297 (3d Cir. 1962). See also 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5822 (rev. perm. ed. 1980); Dent, supra note 8, at 102.

\textsuperscript{11} As "managers" of the corporation, directors are first given the opportunity to maintain the derivative suit in the corporation's name. If they refuse to pursue the litigation, the business judgment rule is triggered. The directors' decision will be respected unless either bad faith is shown or a majority of the directors are implicated in the alleged wrongdoing. See infra notes 46-59 and accompanying text.

\textsuperscript{12} The term "interested director" is most commonly employed when the director has a financial interest in the outcome of a transaction. See Del. Code Ann. tit. 8, § 144(a) (1974). More generally, the Model Business Corp. Act Ann. 2d § 41 12 comment (1971) states that a "conflict of interest exists in every situation where a director's personal interest conflicts with his duty to the corporation."

\textsuperscript{13} State statutes generally provide for the appointment of committees as outlined in the corporation's bylaws, articles of incorporation, or certificate of incorporation. Del. Code Ann. tit. 8 § 141(c) (1974); N.Y. Bus. Corp. Law § 712 (McKinney Supp. 1981-82); Model Business Corp. Act Ann. 2d § 42 11 (1971).

\textsuperscript{14} Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 Cornell L. Rev. 600, 602 (1980). For examples of factors the litigation committee considers in reaching its decision to terminate the suit, see Gaines v. Haughton, 645 F.2d 771, 767 n.11 (9th Cir. 1981) (possibility of recovery, cost of litigation, reputation and standing in business community, effect on morale of employees, etc.; Auerbach v. Bennett, 47 N.Y.2d 619, 625, 393 N.E.2d 994, 997, 419 N.Y.S.2d 920, 923 (1979) (whether the action was meritorious, the waste of the time and talent of management, unlikelihood of success, and whether the reputation of the company would be damaged).

\textsuperscript{15} The use is "offensive" in that the litigation committee invokes the business judgment rule as authority for terminating the shareholder's suit. As a result, the original business decision that gave rise to the shareholder suit is never examined by the courts. Rather, the judicial inquiry is limited to whether the litigation committee's decision not to sue is a valid exercise of business judgment.
independence of the committee and the reasonableness of the investigation. A vocal minority of courts, however, rejects the offensive use of the business judgment rule and has denied committees' motions to dismiss. These courts conclude that the business judgment rule is not an independent source of power by which a committee may seek dismissal of a shareholder derivative suit. Nevertheless, because a majority of courts grants the committees' motions to dismiss, several commentators have forecasted the demise of the shareholder derivative suit unless some judicial action is taken to check the automatic application of the business judgment rule.

16. In upholding the offensive use of the business judgment rule, the courts have varied in the level of deference shown to the committee's decision to terminate the litigation. For examples of the most deferential inquiries, see Gaines v. Haughton, 645 F.2d 761, 772 (9th Cir. 1981) (construing California law) (remand unnecessary; record establishes beyond question the independence of the committee); Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980) (construing Delaware law) (“the rule apparently applies to any reasonable good faith determination”) (emphasis added); Lewis v. Anderson, 615 F.2d 778, 782-83 (9th Cir. 1979) (construing California law) (following Abbey and stating that good faith determination “is immune to attack by shareholders or the courts”); Abramowitz v. Posner, 513 F. Supp. 120, 133 (S.D.N.Y. 1981) (construing Delaware law) (no discovery of independence and good faith of committee was sought by plaintiff, and no evidentiary proof was raised as to these issues; dismissal granted); Maldonado v. Flynn, 485 F. Supp. 274, 278-79 (S.D.N.Y. 1980) (construing Delaware law) (rule is “highly deferential” and committee's decision is “insulated from shareholder challenge and judicial scrutiny”).

For those opinions showing less deference to the litigation committee, see Rosengarten v. ITT, 466 F. Supp. 817, 823 (S.D.N.Y. 1979) (decision on motion for summary judgment was postponed pending deposition of the committee members by the plaintiff shareholders); Auerbach v. Bennett, 47 N.Y.2d 619, 637, 393 N.E.2d 994, 1004, 419 N.Y.S.2d 920, 931 (1979) (Cooke, C.J., dissenting) (since knowledge of motives and actions of committee members and defendants is peculiarly within the defendants' knowledge, summary judgment is improper prior to disclosure proceedings); Gall v. Exxon Corp., 418 F. Supp. 508, 520 (S.D.N.Y. 1976) (“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.”).

17. The minority position rejects the relevancy of the business judgment rule to a committee's motion to terminate a shareholder suit. In Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. Ch. 1980), rev'd, Zapata v. Maldonado, 430 A.2d 779 (Del. 1981), the court's analysis of the dual nature led it to conclude that once a properly initiated shareholder derivative suit is brought (see infra notes 44-60 and accompanying text for a discussion of a properly initiated suit), the shareholder then possesses an independent right to maintain the suit, and the corporation no longer has control. Id. See also Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713 (E.D. Va. 1980); Maher v. Zapata, 490 F. Supp. 348 (S.D. Tex. 1980). For further discussion of the minority position, see infra notes 99-105 and accompanying text.

18. See, e.g., Dent, supra note 8, at 110-17 (proposing a “per se rule” that bars a minority of board members from terminating suits against a majority of directors); Note, supra note 14, at 633 (advocating use of the business judgment rule only as a defense to the alleged violation at a trial on the merits); Black & Smith, Business Judgment, 13 Rev. Sec. Reg. 935, 938 (1980) (requiring a limited inquiry on the merits in all cases involving dismissal of derivative suits on the basis of the business judgment rule). Two recent articles have advocated
Recognizing the ramifications of this trend, the Delaware Supreme Court, in *Zapata v. Maldonado*, attempt to establish a balancing point between bona fide stockholder power to bring corporate causes of action and a corporation's power to insulate itself from frivolous litigation. The court, in a case of first impression, examined when, and under what circumstances, an independent committee of the board of directors could successfully dismiss a stockholder's derivative suit under Delaware law.

In 1975, Maldonado, a shareholder of Zapata Corporation, brought a stockholder's derivative suit against Zapata and individual defendants who were members of the board of directors. The complaint, filed in the Court of Chancery of Delaware, alleged breach of fiduciary duty in connection with the board's decision to accelerate the date for the exercise of stock options in 1974.

Four years later, in 1979, Zapata's directors appointed an independent investigative committee, comprised of two newly appointed directors. The committee was authorized to investigate the claims asserted against Zapata and the individual defendants and to take appropriate action. Based on its findings, the committee concluded that the litigation was not in the best interests of the corporation, and Zapata moved to dismiss in all the pending suits.

The Court of Chancery of Delaware denied Zapata's motion to dismiss. The lower court reasoned that while the business judgment rule protects directors from liability, it does not give them an independent right to dismiss derivative suits. Rather, when directors refuse to institute legal proceedings for breach of fiduciary duty, the stockholder possesses an "in-
dependent right to redress the wrong."\textsuperscript{25}

Zapata filed an interlocutory appeal with the Delaware Supreme Court shortly after its motion was denied.\textsuperscript{26} The court reversed the interlocutory order and remanded for further proceedings in accordance with its new two-step approach.

In establishing a middle ground between the rights of individual shareholders and the concerns of corporate economy, the court held that a properly initiated derivative suit could not be terminated by an independent committee unless: (1) the corporation proved the good faith and independence of the committee and demonstrated that the committee had made a reasonable investigation;\textsuperscript{27} and (2) the reviewing court, if it chose to exercise its discretion, agreed in its independent business judgment that the suit should be dismissed.\textsuperscript{28} This two-step approach radically departs from recent decisions concerning the business judgment rule in shareholder derivative actions,\textsuperscript{29} by shifting the burden of proof to the committee to establish its good faith and independence and by providing an opportunity for a court to exercise its independent business judgment as to whether or not the derivative suit should be terminated.

This Note will examine the two-step approach delineated in Zapata and discuss how it departs from the recent trend concerning the business judgment rule in derivative suits. It will analyze whether the Delaware Supreme Court has provided sufficient guidance for courts in considering the decision of an independent committee to dismiss a derivative suit and will discuss the possible impact of the decision on the future of shareholder derivative suits.

\textsuperscript{25} Id. at 1262.

\textsuperscript{26} The appeal was accepted on June 5, 1980. However, on May 29, 1980, Maldonado's complaint in the Delaware court was dismissed on the grounds of res judicata because of the January 24, 1980 decision of the District Court for the Southern District of New York. The Vice Chancellor held that Maldonado had impermissibly split his cause of action because he could have litigated his common law claims in the New York court. Black & Smith, \textit{Business Judgment}, 13 REV. SEC. REG. 935, 936 (1980). The dismissal, however, was expressly conditioned upon the Second Circuit affirming the decision of the lower court. The Second Circuit appeal was then ordered stayed, pending the resolution of the appeal to the Delaware Supreme Court. 430 A.2d at 781.

\textsuperscript{27} 430 A.2d at 788.

\textsuperscript{28} Id. at 789.

\textsuperscript{29} \textit{See supra} note 16 and cases cited therein. The burden of proof is now on the corporation to prove good faith, independence and a reasonable investigation. While not going so far as to hold that a group of directors appointed by their peers could never be "independent," the Zapata decision recognizes the potential for subconscious abuse inherent when fellow directors are passing judgment on their peers. 430 A.2d at 787.
I. THE TRADITIONAL DEFENSIVE USE OF THE BUSINESS JUDGMENT RULE

The early application of the business judgment rule involved allegations of breach of fiduciary duties against directors. The earliest expression of the business judgment rule was in 1829 by the Louisiana Supreme Court in *Percy v. Millaudon*. The stockholders of Planters' Bank brought an action to obtain a settlement of accounts, alleging fraudulent and unfaithful conduct by the board of directors of the bank. In assessing the liability of the directors, the court stressed that directors must not be held responsible for a course of conduct if "the error was one into which a prudent man might have fallen." The court reasoned that to require a standard of care higher than that of the prudent man would be to presuppose perfect wisdom in fallible beings and severely discourage anyone from assuming the duties of director.

The traditional "defensive" use of the business judgment rule remains substantially unaltered today. Because directors stand in a fiduciary rela-

30. For the application of the business judgment rule in a shareholder's suit to compel a cause of action against a third party, see infra notes 55-59 and accompanying text.
31. 8 Mart. (n.s.) 68 (La. 1829).
32. *Id.* at 78.
33. *Id.* In another early case, Godbold v. Branch Bank, 11 Ala. 191 (1874), the Alabama Supreme Court applied the business judgment rule to a director's misunderstanding of law. A shareholder brought suit against a bank's director to recover unlawful payments to a board-appointed agent. The court reasoned that directors, by necessity, must enjoy wide discretion in both the wisdom and legality of the decisions made by them. *Id.* at 199. To require "perfect knowledge" from directors may discourage a course of action that should have been pursued, but was not, due to the deterrent of personal liability. *Id.*
34. Arsht, *supra* note 4, at 134 (while recognizing the varying judicial expressions of the rule, the author finds that a careful reading of the cases suggests the rule remains substantially unchanged).

Section 35 of the Model Business Corporation Act, which has become the generally accepted standard for directorial conduct, mirrors these early decisions. Section 35 reads:

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. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared by:

(a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,

(b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or

(c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which committee the director reasonably
tionship to the corporation and its shareholders, their decisions are judged according to whether the best interests of the corporation are served.\textsuperscript{35} The rule remains an effective shield against attacks on directors' decisions, unless the plaintiff establishes that the directors acted in bad faith or without due care. Plaintiffs can normally carry this burden if they establish that the director personally gained from a particular corporate transaction, i.e., self-dealing, or failed to evaluate viable alternatives that a prudent person would have evaluated.\textsuperscript{36}

The business judgment rule is frequently characterized as a factual presumption in favor of directors,\textsuperscript{37} placing the burden on the plaintiff to establish lack of due care or bad faith. Under the rule, courts generally will not inquire into the merits of a business judgment. Thus, courts avoid substituting their judgment as to what is or is not in the best interests of the corporation.\textsuperscript{38}

Yet, a court will inquire into the merits of a decision in so far as it is necessary to consider the allegations of lack of due care or bad faith. A recent Delaware case is illustrative. In \textit{Gimbel v. Signal Companies, Inc.},\textsuperscript{39} a stockholder sought to enjoin the sale of a subsidiary of the corporation for $480 million. The plaintiff charged that the fair market value of the property was $761 million.\textsuperscript{40} While recognizing the presumption of good faith and due care the directors' decision enjoys, the court granted the plaintiff's motion for a preliminary injunction barring the sale, because it had serious doubts about the reasonableness of the corporation's decision.\textsuperscript{41}

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\textsuperscript{35} See Guth v. Loft, 5 A.2d 503 (Del. Ch. 1939). See also supra note 3.

\textsuperscript{36} See Arsh, supra note 4, at 100; W. FLETCHER, supra note 1, § 1040 (the rule "does not apply where the loss is the result of failure to exercise proper care, skill and diligence.").

\textsuperscript{37} For a discussion of the parameters of this presumption and its procedural impact, see Arsh, supra note 4, at 130-33.


The latter, substantive decision falls squarely within the embrace of the business judgment doctrine, involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. To this extent the conclusion reached . . . is outside the scope of our review.

\textsuperscript{39} 316 A.2d 599 (Del. Ch.), aff'd, 316 A.2d 619 (Del. 1974).

\textsuperscript{40} \textit{Id.} at 604.

\textsuperscript{41} \textit{Id.} at 615.
The so-called "defensive" use of the business judgment rule also serves as a barrier to the maintenance of a shareholder derivative suit. As early as 1916, the United States Supreme Court, in United Copper Securities Co. v. Amalgamated Copper Co., held that a directorial decision to seek enforcement of a corporate cause of action against a third party is ordinarily within the directors' discretion.

II. THE SHAREHOLDER DERIVATIVE SUIT

A. The Requirement of a Demand

The business judgment rule is inextricably intertwined with the shareholder derivative suit. Because the derivative suit is an action asserting a right belonging to the corporation, and not an individual right of its shareholders, a plaintiff-shareholder must overcome two barriers before being allowed to proceed with the lawsuit. The first barrier, almost procedural in nature, requires the shareholder to make a demand on the board of directors to initiate the suit.

The demand rule requires a shareholder to exhaust intracorporate remedies before bringing a suit to enforce a corporate right. The primary purpose of making a demand on the directors or comparable authority to bring the action the shareholder desires is to allow the directors to occupy their usual status as managers of the corporation's affairs. The board's refusal to bring suit, once demand is made upon it, is protected by the business judgment rule and will be respected, unless the shareholder can carry the burden of proof and show that the refusal was wrongful.

42. 244 U.S. 261 (1917).
43. Id. at 263.
44. See supra note 8.
45. Under FED. R. Civ. P. 23.1, the stockholder must make a demand on the directors or, if necessary, the shareholders, to bring the suit. The Rule states in part:

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.

(emphasis added).
47. See United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64
In some instances, however, demand may be futile and will be excused. If the shareholder does not make the demand, the complaint must state the reasons for failing to make the effort to have the board bring the suit.\(^4\) The most common situations in which a demand is futile are when a majority of the board are alleged to be wrongdoers or where the defendants otherwise control the board or corporation through ownership of the majority of voting stock. The rationale for excusing demand in these situations is that the alleged wrongdoers cannot be expected to sue themselves.\(^4\)

This exception was recognized in the leading Delaware case of *McKee v. Rogers*.\(^5\) In *McKee*, the shareholder sought to enforce the collection of a judgment previously entered in favor of the corporation, Standard Minerals Corporation, against the defendant Rogers.\(^6\) The bill alleged that Rogers controlled the board of directors of Standard Minerals Corporation. The court agreed that there was no certainty that the corporation would sue Rogers, or, if it did sue, that the prosecution of the suit would be entrusted to the proper hands.\(^7\) "[A] stockholder may sue . . . without prior demand upon the directors to sue, when it is apparent that a demand would be futile, that the officers are under an influence that sterilizes direction and could not be proper persons to conduct the litigation."\(^8\)

**B. The "Standing" Requirement**

If, after making demand on the board to pursue a corporate action, the board agrees to initiate the suit, the shareholders’ part in the lawsuit is ended. On the other hand, if the board refuses to sue after demand is made or demand is excused as futile, the shareholders must then overcome the second barrier to shareholder derivative suits by establishing that they have standing to sue.\(^9\)

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\(^5\) See Dent, supra note 8, at 98-99; Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746, 753 (1960).


\(^7\) See id. at 191-92.

\(^8\) See id. at 193.

\(^9\) Id. at 193.

54. "Standing" in shareholder derivative actions is a term of art arising from the early case of Hawes v. Oakland, 104 U.S. 450, 462 (1882). See also Coffee & Schwartz, supra note
In a number of early cases discussing a shareholder's standing to bring a cause of action against a third party on behalf of the corporation, the United States Supreme Court articulated the circumstances when a shareholder can enforce the rights of the corporation. In *Hawes v. Oakland*, the Court held that the shareholder must first allege one of the following: 1) some action or threatened action beyond the charter's authority; 2) a fraudulent transaction completed or contemplated that will seriously harm the best interests of the corporation or the shareholders; 3) self-interest on the part of a majority of the board which is harmful to corporate and shareholder interests; or 4) an oppressive and illegal course of action in the name of the corporation by a majority of the board which violates shareholders' rights and which is enjoinable only by a court of equity.

Over thirty years later, in 1916, the Supreme Court considered whether bringing a corporate cause of action against third parties is a matter for decision by the board of directors. *United Copper Securities Co. v. Amalgamated Copper Co.* was a derivative suit alleging antitrust violations of the company's competitors. Consistent with the principles of *Hawes*, the Court held that "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 stock holders." The Court recognized an exception to this rule when directors are guilty of a breach of trust or where they stand in a dual relationship which would interfere with an unbiased judgment.

This extension of the business judgment rule as a "standing" requirement for the maintenance of shareholder derivative suits against third parties was uniformly followed by courts throughout the first seventy years of this century. In the past ten years, however, corporations have sought

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5. at 262; Comment, supra note 46, at 191. The use of standing in derivative suits should be distinguished from its familiar use in administrative actions where the standing doctrine is used to ensure that the plaintiff has a sufficient stake in the outcome of the litigation to warrant judicial review. See generally L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 501-45 (1965).

55. 104 U.S. 450 (1882) In *Hawes*, the shareholder of a water works company challenged the board's refusal to comply with his demand to bring proceedings against the city of Oakland for an excess supply of free water.

56. See id. at 460.

57. 244 U.S. 261 (1917).

58. Id. at 263.

59. See id. at 264.

60. See, e.g., Ash v. IBM, 353 F.2d 491 (3d Cir. 1965). The plaintiff, stockholder of three corporations, sought to enjoin IBM from acquiring the assets of another corporation, alleging a violation of § 7 of the Clayton Act, 15 U.S.C. § 78g (1964). The court held that
further expansion of this barrier. This expansion typically has been sought when a majority of the board is implicated in a shareholder suit and, therefore, is unable to invoke business judgment protection. The board then appoints a special, disinterested committee which is given authority to investigate the suit. Invariably, after investigation, the committee moves to dismiss the suit as not in the best interests of the corporation. The majority of courts has respected the committees' decisions, applying the traditional defensive business judgment rule rationale to justify this offensive use of the rule.

III. "OFFENSIVE" USE OF THE BUSINESS JUDGMENT RULE

A. The Early Illegal Foreign Payments Cases

_Gall v. Exxon Corp._ was the first case in which a corporation used the business judgment rule to terminate a shareholder derivative action. Shareholders brought an action in United States district court against the corporation and its directors to recover allegedly illegal payments and bribes made to various Italian political parties and businesses between 1963 and 1974. The board appointed a special litigation committee to investigate the allegations and determine what action the corporation should take. After a four month investigation, the committee concluded that it would not be in the best interests of the corporation to maintain legal action against any present or former director of Exxon.

Relying on early Supreme Court decisions dealing with third party litigation, the district court granted the committee's motion to dismiss. The court held that the committee's decision not to sue, "like any other business decision, must be made by the corporate directors in the exercise of their sound business judgment." 353 F.2d at 492. See also Swanson v. Traer, 249 F.2d 854, 858-60 (7th Cir. 1958); 13 W. FLETCHER, supra note 10, § 5822. 62.

The district court also rejected the plaintiff's argument that the decision
of the committee was, in effect, the decision of those accused of the wrongdoing. The court was not persuaded by the plaintiff's contention that the board could have caused the committee to act contrary to its determination; rather, the proper focus of the business judgment rule is "on those who actually wield the decision-making authority, not on those who might have possessed such authority at different times and under different circumstances."

Thus, with little or no discussion of this expanded application of the business judgment rule, Gall laid the foundation for other courts to decide accordingly. Three years later, the New York Court of Appeals entertained the question of an independent committee's power to terminate a shareholder's suit in Auerbach v. Bennett. Auerbach also involved illegal foreign payments, and the New York court reached a conclusion similar to that of the Southern District of New York. Moreover, the state court outlined its reasoning in more detail. The Auerbach court examined two separate corporate transactions; the first dealt with the allegations of illegal bribes and kickbacks made by the board of General Telephone & Electronics Corporation, and the second involved the committee's decision that a suit against the directors is not in the best interests of the corporation. The court stated that because the committee's decision not to sue is also entitled to the protection of the business judgment rule, the first corporate action is necessarily insulated from judicial inquiry.

While asserting that judicial inquiry into the committee's evaluation of the motion to dismiss the shareholder suit was inappropriate because of the business judgment protection, the New York court found it appropriate to review the methodologies and procedures the committee used to arrive at its conclusion. Nevertheless, the court found nothing in the record to challenge the good faith pursuit of the investigation by the committee and denied the plaintiff-shareholder's request for further disclosure.

68. Id. at 516-17.
69. E.g., Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979), aff'g 460 F. Supp. 1242, 1245-46 (D. Minn. 1978). See also discussion of Abbey, infra at text accompanying notes 83-90.
71. Id. at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
72. Id.
73. Id.
74. Id. at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929 ("As to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are well equipped by long and continuing experience and practice to make determinations.").
75. Id. at 636, 393 N.E.2d at 1003-04, 419 N.Y.S.2d at 930. However, in his dissenting opinion, Chief Judge Cooke argued that summary judgment should not have been granted prior to disclosure proceedings "because certain defendants and the members of the commit-
B. Burks v. Lasker: The Supreme Court's Implicit Approval

The Supreme Court implicitly approved the power of an independent committee to terminate a shareholder suit in *Burks v. Lasker*, when it remanded the case for a determination of state law. In *Burks*, the United States District Court for the Southern District of New York held that disinterested directors had the power to dismiss a derivative suit under the Federal Investment Company Act of 1940. In construing the federal statute, the Court of Appeals for the Second Circuit reversed, stating that to hold otherwise would violate the intent of Congress to protect the public interest.

The Supreme Court, addressing the issue whether federal or state law controlled, reversed, holding that "federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the . . . [federal law]." In dictum, the Court implicitly approved the Gall approach, stating that "[t]here may well be situations in which the independent directors could reasonably believe the best interests of the shareholders call for a decision not to sue. . . ." the Court continued, noting that in some situations "it would certainly be consistent with the Act to allow the independent directors to terminate a suit, even though not frivolous."

C. Post-Burks: The Recognition of a "Clear Trend" in Corporate Law

The *Burks* decision thus paved the way for lower courts to determine whether applicable state law permits the establishment of an independent committee to make a business decision that maintaining the suit is not in the best interests of the corporation. An affirmative determination can be made, even when the plaintiff-shareholder alleges violation of a federal statute and not just common law breach of fiduciary duties.

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76. 441 U.S. 471 (1979), rev'd 567 F.2d 1208 (2d Cir. 1978).
78. 567 F.2d 1208, 1212 (2d Cir. 1978).
79. *Id.* at 1210-11.
80. 441 U.S. at 486.
81. *Id.* at 485.
82. 441 U.S. at 478-79.
Shortly after the *Burks* decision, another illegal foreign payment case arose in which the United States Court of Appeals for the Eighth Circuit was presented with the issue of whether Delaware law permits an independent committee to dismiss a shareholder derivative suit. In *Abbey v. Control Data Corp.*, the shareholder brought suit alleging common law violations of corporate waste and mismanagement, along with violations of the Securities and Exchange Act of 1934 in regard to proxy solicitations and registration materials filed with the Securities and Exchange Commission.

In examining Delaware law, the Eighth Circuit relied heavily on *United Copper Securities Co. v. Amalgamated Copper Co.* for the proposition that a decision to bring suit is ordinarily a question for the directors of the corporation. As in *Gall*, the court failed to distinguish *United Copper Securities Co.*, a case involving a shareholder suit to compel a suit against a third party, from a shareholder suit against the directors for breach of fiduciary duties. Consequently, the Eighth Circuit rejected plaintiff's argument that "the applicability of the business judgment rule hinges on the nature of the plaintiff-shareholder's cause of action." The court concluded, moreover, that the special litigation committee's decision not to sue was protected by the business judgment rule, despite allegations of criminal misconduct.

Prior to the decision in *Maldonado v. Flynn*, the *Gall, Auerbach* and *Abbey* opinions appeared to have established a "clear trend" in corporate law. In *Gaines v. Haughton*, the United States Court of Appeals for the

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83. 603 F.2d 724 (8th Cir. 1979).
84. 15 U.S.C. §§ 78m, 78n (1976).
86. 244 U.S. 261 (1917).
87. See 603 F.2d at 729. See also notes 57-59 and accompanying text.
88. See Black & Prussin, *supra* note 18, at 47.
89. 603 F.2d at 729-30.
90. Id. at 730. The Eighth Circuit accepted the conclusion in *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976), that the rule "applies to any reasonable good faith determination by an independent board of directors that the derivative action suit is not in the best interests of the corporation." 603 F.2d at 730.
91. 413 A.2d 1251 (Del. Ch. 1980), rev'd, 430 A.2d 779 (Del. 1981). In *Maldonado*, the court concluded that the independent committee does not have the power to terminate a shareholder suit because the shareholder possesses an independent right to redress the wrong once the corporation refuses to institute legal proceedings. See infra notes 97-106 and accompanying text.
92. 645 F.2d 761 (9th Cir. 1981) (plaintiff-shareholder brought suit against the majority
Ninth Circuit predicted that the California state court would follow the trend reflected in these decisions. The Gaines court, in light of the number of decisions following the views expressed in Abbey and Auerbach, reaffirmed an earlier opinion upholding the power of an independent committee to terminate shareholder litigation and limited the judicial role “to determining the disinterested independence of the committee members and the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee.” The court refused the plaintiff’s request for remand to the lower court for further findings of fact relating to the investigatory procedures of the committee. Instead, it stated that the record “establishes beyond question” both the independence of the committee and the adequacy of the procedures.

The Delaware Supreme Court, however, was not as deferential to the independent committee’s decision to terminate a shareholder suit in Zapata. Rather, the court formulated a two-step approach to follow when considering an independent committee’s motion to dismiss, which is likely to curb the “clear trend” referred to in Gaines.

IV. Zapata Corp. v. Maldonado: The Two-Step Approach and Rejection of the Traditional Business Judgment Rationale

In 1970, the Zapata board of directors adopted a stock option plan, to be exercised in five separate installments, which gave certain officers and directors the option to purchase Zapata common stock at $12.15 per share. The plan provided that the fifth installment was to be exercised on July 14, 1974. Zapata’s directors later accelerated this date to July 2, 1974. Maldonado claimed that the board (most of whom were entitled to purchase stock under the plan) advanced the exercise date from July 14 to July 2, 1974 in order to avoid additional, substantial federal income tax liability. A tender offer announcement was expected just prior to July 14, 1974, at which time the market price of Zapata stock would increase. Maldonado alleged that this acceleration resulted in the loss of a federal tax deduction to the corporation equal to the amount of the tax liability saved by the
In 1975, Maldonado filed a complaint in the Court of Chancery of Delaware, alleging that the directors breached their fiduciary duty to Zapata and its stockholders. Four years later, the directors appointed an independent investigative committee. After a three-month investigation, the committee concluded that the litigation was not in the best interests of the corporation and instructed Zapata’s counsel to move for dismissal.

The lower court denied Zapata’s motion. In a well reasoned opinion authored by Vice Chancellor Hartnett, the court held that the business judgment rule is irrelevant to the question of the power of an independent committee to terminate a shareholder derivative suit. The court distinguished the application of the business judgment rule in two situations. If the committee’s decision not to sue was attacked as improper, the rule would protect the committee members from personal liability, absent bad faith or lack of due care. The court contrasted this defensive use of the rule with its offensive use as an independent conferral of power to terminate a derivative suit.

In his suit, Maldonado was not attacking the committee’s decision to dismiss but, rather, the board’s decision to accelerate the stock option date in 1974 as a breach of fiduciary duty. Therefore, the court reasoned, the committee’s exercise of its business judgment to dismiss the suit, regardless of its propriety, is irrelevant to the question of whether the committee possesses the power to terminate derivative suits.

The court distinguished the early Supreme Court cases relied upon by the committee for support of its motion to dismiss as involving third party litigation where no breach of fiduciary duties or improper board conduct was alleged. Instead, the court looked beyond the business judgment

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97. The amount of capital gain for federal income tax purposes for the optionees would have been equal to the difference between the option price of $12.15 and the price on the date of the exercise: $18 to $19, if exercised before the tender announcement, and $25, if exercised immediately after the announcement.

98. The committee was composed of two newly-appointed, outside directors. Maldonado, 413 A.2d at 1255.

99. Id. at 1257.

100. Id.

101. Id.

102. See supra notes 55-59 and accompanying text.

103. 413 A.2d at 1259-60. Accord Dent, supra note 8, at 607; Coffee & Schwartz, supra note 5, at 265-66. In addition to arguing that the third party model is distinguishable from derivative suits brought against the directors for alleged self-dealing or breach of fiduciary duties, Coffee and Schwartz further limit these decisions on the basis of their historical context. Prior to 1880, federal courts had no federal question jurisdiction. Therefore, derivative
rule to the nature of the derivative suit.104

The court concluded that where a shareholder has alleged breach of fiduciary duties, and the corporation has refused to institute legal proceedings, the shareholder possesses an independent right to redress the wrong. This right, moreover, cannot be terminated by an independent committee of board members, since the corporation's right is secondary to that of the shareholder's by virtue of the corporation's refusal to bring suit.105 Accordingly, Zapata's motion to dismiss was denied.

Zapata immediately filed an interlocutory appeal with the Delaware Supreme Court. The court began its analysis by stating the lower court's assertion that "the business judgment rule is irrelevant to the question of whether the Committee has the authority to compel dismissal of this suit."106 While recognizing the contrary assertions of other courts,107 the supreme court agreed with the lower court since the business judgment rule is generally a defense to an attack on the soundness of a corporate decision. The rule creates a presumption of propriety of decisions made by corporate directors; it is based on a practical recognition of human fallibility and also on the need for judicial economy. Therefore, the rule does not come into play until after a decision to dismiss the litigation is attacked as improper.108

Unlike the lower court, however, the Delaware Supreme Court did not reach the conclusion that Delaware law gives a shareholder an independent right to continue litigation over the objections of the corporation.109

104. The court relied on a 1932 opinion of Chancellor Wolcott in Cantor v. Sachs, 162 A. 73, 76 (Del. Ch. 1932), for its discussion of the historical evolution of the derivative suit: "A bill filed by stockholders in their derivative right therefore has two phases—one is the equivalent of a suit to compel the corporation to sue, and the other is the suit by the stockholders in its behalf, against those liable to it." Id. at 76. In discussing the first phase of the derivative suit, Cantor referred to that phase as the "individual right" of the stockholder. Id. See also Ross v. Bernhard, 396 U.S. 531 (1970):

For the fact is that a shareholder's suit was not originally viewed in this country, or in England, as a suit to enforce a corporate cause of action. Rather, the shareholder's suit was initially permitted only against the managers of the corporation—not third parties—and it was conceived of as an equitable action to enforce the right of a beneficiary against his trustee. The shareholder was not, therefore, in court to enforce indirectly the corporate right of action, but to enforce directly his own equitable right of action against an unfaithful fiduciary.

396 U.S. at 545 (Stewart, J., dissenting) (citations omitted).

105. See Maldonado, 413 A.2d at 1263.

106. Zapata, 430 A.2d at 781-82.

107. See supra note 16.

108. See Zapata, 430 A.2d at 782.

109. Id.
Although the supreme court agreed with the Vice Chancellor that the business judgment rule does not grant an independent committee the authority to terminate a shareholder suit,\textsuperscript{110} it rejected the lower court's determination that in a derivative suit the shareholder's right takes priority over the corporation's right.\textsuperscript{111} The court argued that the rule of the lower court would permit the interest of one person or group to prevail over all others within the corporate entity.\textsuperscript{112}

Instead, the court looked to relevant statutory law\textsuperscript{113} and asserted that an independent committee does possess the corporate power to seek termination of a derivative suit.\textsuperscript{114} Title 8, section 141(c) of the Delaware Code permits a board of directors to designate committees and, absent any re-

\begin{itemize}
\item \textsuperscript{110} \textit{Id.}
\item \textsuperscript{111} \textit{Id.} at 784-85.
\item \textsuperscript{112} \textit{Id.} at 785.
\item \textsuperscript{113} The court examined 	extit{Del. Code Ann. tit. 8, §§ 141(a) and (c) (1974 & Supp. 1980)} to conclude that the corporation has the power to appoint an independent committee to decide whether or not to pursue litigation on behalf of the corporation. Subsection 141(a) states:

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

Subsection 141(c) states:

> The board of directors may by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. The board may designate 1 or more directors as alternative members of any committee, who may replace any absent or disqualified member at any meeting of the committee. The bylaws may provide that in the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it; but no such committee shall have the power or authority in reference to amending the certificate of incorporation, adopting an agreement of merger or consolidation, recommending to the stockholders the sale, lease or exchange of all or substantially all of the corporation's property and assets, recommending to the stockholders a dissolution of the corporation or a revocation of a dissolution, or amending the bylaws of the corporation; and, unless the resolution, bylaws, or certificate of incorporation expressly so provide, no such committee shall have the power or authority to declare a dividend or to authorize the issuance of stock.

\item \textsuperscript{114} Zapata, 430 A.2d at 785.
\end{itemize}
strictions or limitations in the corporation's by laws or articles of incorporation, provides that the committees shall have the same power in the management and affairs of the corporation as does the board of directors. Moreover, the court concluded that an independent committee would have the power to terminate a derivative suit if the full board would also have that power.

Although recognizing that, under the rule in *McKee v. Rogers*, a stockholder will not "be permitted . . . to invade the discretionary field committed to the judgment of the directors" when demand had been made and refused, the court pointed out two common exceptions to this rule: when, after demand has been made and refused, the shareholder proves the board's refusal to sue is wrongful, and when demand on the board would be futile. The court, again looking to title 8, section 141(c) of the Delaware Code, asserted that the board retains its managerial authority (which extends to controlling corporate litigation) even after a shareholder is permitted to bring suit because of a wrongful refusal to sue. The board still retains authority; the court will not respect wrongful use of that authority.

The second exception was directly at issue in *Zapata*. Since all of the directors were named as defendants in Maldonado's suit, a demand on the board was alleged to be futile. Even where demand has been excused, the board, or its committee, maintains managerial power over the corporation. According to the court, the problem with a futile demand is not the absence of power on the shareholder's part but rather the lack of disinterested board members. The court asserted that the recognition of a futile demand, under Rule 23.1 of the Federal Rules of Civil Procedure, does not strip the board of its power. Rather, it is designed to save a shareholder the time and expense of making a demand on a board tainted with self-interest.

Recognizing that the board retains the power to make decisions regarding corporate litigation, the court next considered under what circumstances a board may delegate its authority to a committee when the

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117. 156 A. 191 (Del. Ch. 1931).
118. *Id.* at 193.
119. *Zapata*, 430 A.2d at 784.
120. *Id.* at 786.
121. *Id.*
122. *Id.* at 780.
123. *Id.* at 786.
majority of board members are alleged wrongdoers. The court refuted the lower court's assertion that a shareholder has an independent right to litigate corporate rights since that would result in one shareholder controlling the destiny of the corporation. On the other hand, the court was concerned that a blanket grant of managerial discretion to terminate suits solely on the basis of the business judgment rationale would lessen the efficacy of derivative suits as instruments to police corporate actions.

Rather than adopting either of these extremes, the Delaware Supreme Court devised a two-step approach for lower courts to follow when faced with a motion by an independent committee to dismiss a suit. In entertaining the motion to dismiss by the corporation's committee, the court must first "inquire into the independence and good faith of the committee and the bases supporting its conclusions." Traditionally, this has been the only step employed by those courts recognizing application of the business judgment rule. Additionally, the corporation now has the burden of proof; a court will not presume that the corporation acted with good faith and independently or that it conducted a reasonable investigation. If the corporation fails to meet this burden, or if a court is otherwise dissatisfied with this process, the motion to dismiss will be denied and the suit will continue to a trial on the merits.

If, however, the court is satisfied that these standards are met, then, at its discretion, it may proceed to the next step and determine, using its own independent business judgment, whether or not the motion should be granted. In addition to considering the best interests of the corporation,

124. Id.
125. Id. at 784-85 (citing with approval Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980)).
126. 430 A.2d at 786.
127. Id. at 788-89. The court admitted that the independent committee's motion could not be easily "labeled" as a motion to dismiss for failure to state a cause of action or under a motion for summary judgment. Therefore, the court characterized the procedure as a "hybrid summary judgment motion for dismissal." The court analogized its "hybrid" motion to the court's role when there is a request to terminate litigation in favor of a proposed settlement. Id. at 787. In Neponsit Investment Co. v. Abramson, 405 A.2d 97, 100 (Del. 1979), the court held that it must exercise its own business judgment when considering whether to accept a settlement of a shareholder derivative suit. The Zapata court also considered the Delaware Court of Chancery Rule 41(a)(2) that applies when a plaintiff seeks dismissal after the defendant's answer. This rule provides that the action will be dismissed only "upon order of the Court and upon such terms and conditions as the Court deems proper." DEL. CH. R. 41(a)(2), quoted in Zapata, 430 A.2d at 488.
128. 430 A.2d at 788.
129. See supra note 94 and accompanying text.
130. See Zapata, 430 A.2d at 788-89.
131. See id. at 788.
132. See id. at 789.
the court may also consider matters of law and public policy. The court asserted that this step was essential "in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee."

V. ZAPATA: MIDDLE GROUND?

In an attempt to strike a middle ground between frivolous shareholder derivative suits and unchecked corporate power to dismiss derivative suits, the Delaware Supreme Court's opinion generates more confusion in this area of corporate law than had existed previously. In a decision based more on policy than legal considerations, the court rejects the traditional rationale of the business judgment rule in situations where the shareholder has brought a properly initiated suit. Although agreeing that Delaware law permits the establishment of a committee to make litigation decisions, the court will not defer to these committees when a demand on the board would be futile. The court will not presume the committee's independence but, instead, requires the committee to show affirmatively its independence and good faith. The court thus recognizes the potential of structural bias and subconscious abuse inherent in directors passing judgment on fellow directors.

Although the court states that one of its goals is to ensure the effectiveness of the derivative suit as a means of policing directors, the nebulous guidelines developed by the court do little to ensure that a shareholder's suit will be heard on its merits. The court grants broad discretion to the lower courts in assessing whether the committee's motion to dismiss should be denied. The motion to dismiss can be denied when the lower court determines that the committee is not independent or has not made a reasonable investigation, or when the lower court is "not satisfied for other reasons relating to the process." The court expressly states that these "other reasons" are not limited to the good faith of the committee, but it fails to define precisely what these "other reasons" or "the process" may be.

133. See id. The court provides no examples of public policies or special matters of law to be considered.
134. See id.
135. Id. at 785 n.13.
136. Id. at 786-87.
137. Id. at 785.
138. Id. at 789.
139. Id.
It is unlikely that a lower court will deny a committee's motion to dismiss on the basis of anything other than a lack of good faith, independence, or reasonable investigation. Courts have traditionally limited their inquiry to these three issues; it seems improbable that, with no direction as to the "other reasons relating to the process," a lower court will delve into the unknown. Step one, when stripped of its verbiage, is essentially an application of the business judgment rationale with the burden of proof shifted from the plaintiff-shareholder to the corporation.

Even with the burden of proof shifted to the corporation, it is arguable that the corporation will have little trouble in meeting that burden. Because the issues of good faith, independence, and a reasonable investigation are questions of fact, a lower court's determination that these facts have been established will be upheld, unless the appellate court finds them to be clearly erroneous. In addition, if the lower court grants the committee's motion to dismiss or motion for summary judgment, the motion will be reviewed on the basis of whether there is any material issue of fact raised as to the good faith, independence and reasonable investigation of the committee.

Although the Delaware Supreme Court might have been suspicious of the litigation committee of Zapata Corporation because it was appointed four years after the litigation had been initiated, previous situations involved committees composed of one or more members with impeccable credentials. In future cases, it is thus likely that a court will be more

140. See supra notes 76-95 and accompanying text.
141. Accord Coffee & Schwartz, supra note 5, at 329: "Rather, we suspect that courts, despite the new authority given them by Zapata, will continue to defer to the business judgment justifications that the board offers. Engrained traditions do not disappear overnight; rather, they persist in ways that have low visibility."
142. See also Gaines v. Haughton, 645 F.2d 761, 770 (9th Cir. 1981), for the "clearly erroneous" standard employed by a circuit court when reviewing a district court's interpretation of state law.
144. 430 A.2d at 787. See also Olson, Delaware Court Addresses Business Judgment Rule, Legal Times of Washington, June 8, 1981 at 18, col. 4. (suggesting that the Delaware Supreme Court's decision might have been different if the committee had been appointed immediately after the initiation of the suit).
145. For example, in Gall v. Exxon Corp., 418 F. Supp. 508, 514 n.12 (S.D.N.Y. 1976), the independent committee appointed Justice Joseph Weintraub, former Chief Justice of the New Jersey Supreme Court, as special counsel. In Lasker v. Burks, 404 F. Supp 1172, 1175 (S.D.N.Y. 1973), the disinterested directors retained the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to advise the board on whether they should proceed with a suit against the interested directors.
deferential to a committee's determination than the shifting of the burden of proof would lead one to believe.

Assuming that a committee meets its burden of proof regarding its good faith, independence, and reasonable investigation, a lower court can still exercise its discretion to proceed to the second step. Although the Delaware Supreme Court asserts that the exercise of the court's independent business judgment is the essential link in establishing the middle ground between frivolous derivative suits and unchecked committee power to terminate litigation, the court weakens this link by making this exercise discretionary rather than mandatory. In addition, even when the lower court chooses to exercise its independent business judgment, the court offers little guidance as to the exercise of that discretion. The court indicates that the second step is "intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest." Yet, the court does not articulate when an evaluation of these considerations is appropriate nor when it is appropriate for a lower court to consider matters of law and public policy in exercising its business judgment.

The only possible guidance to be gleaned from this statement of the "spirit" of the two-step approach is earlier in the opinion, where the Delaware Supreme Court adopts the lower court's assertion that the substantive judgment to dismiss a shareholder suit, even when involving ethical, promotional, commercial, public and employee relations, is within the scope of judicial review. Although aware of the danger of judicial overreaching into the affairs of the corporation, the court is persuaded that the danger is outweighed by the possibility of foreclosing a judicial determination on the merits. This discussion of a judicial determination on the merits is confusing in light of the discretionary power given to the lower court to exercise its independent business judgment. Unless the lower court chooses to proceed to this second step, there will be no judicial determination of the merits, since the first step is designed primarily to determine the good faith, independence, and reasonable investigation of the committee.

The court, in attempting to accommodate the interests of judicial economy, corporate control of its business affairs, and the effectiveness of shareholder suits as a control on corporate abuse, may succeed in creating

146. See also Coffee & Schwartz, supra note 5, at 330.
147. 430 A.2d at 789.
148. Id. at 788.
149. Id.
more confusion in this area rather than an effective middle ground. The impact of Zapata is likely to be significant in curbing the "clear trend" in corporate law where motions to dismiss are evaluated solely on the basis of the business judgment rationale, as a large number of shareholder suits arise under Delaware law.\textsuperscript{150} At least one commentator has predicted that the Zapata decision will become a model in other states, as well as in federal courts, applying Delaware and other state law.\textsuperscript{151}

VI. CONCLUSION

By departing from the rationale of the business judgment rule and calling for a judicial role in determining whether a motion to dismiss should be granted, the Delaware Supreme Court opens itself to the criticism that courts should seldom interfere with the internal affairs of corporations. Properly viewed, however, the court does not advocate judicial interference with business decisions; more accurately, the court is concerned with determining when and on what basis a motion to dismiss should be granted. In this respect, the court ensures that courts, and not litigants, decide the merits of litigation. Nevertheless, the success of the Delaware Supreme Court's effort to limit the power to terminate shareholder's derivative suits will depend largely on the lower courts' application of the two-step approach.

Joyce Murty

\textsuperscript{150} For a general discussion of the primacy of Delaware as the state of incorporation, see Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 \textit{Yale L.J.} 663 (1974).

\textsuperscript{151} See Olson, \textit{supra} note 144, at 19, col. 3.