Hasan v. Clevetrust Realty Investors: The Business Judgement Rule and Procedural Review of the Special Litigation Committee

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The business judgment rule insulates corporate directors from legal liability arising from decisions they make in their capacity as directors.1 The rule is based on the notion that directors, in the course of performing duties on behalf of a corporation, take risks and make mistakes for which they should not be held legally accountable.2 This protection is lost only when a shareholder proves that the director’s decision was the result of serious wrongdo-

1. See 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039, at 37 (rev. perm. ed. 1975). The rule has been a part of corporate law for at least 150 years. For early expressions, see Godbold v. Branch Bank, 11 Ala. 191 (1847), where the Alabama Supreme Court applied the business judgment rule to a directors’ misunderstanding of the law. The court excused the directors’ authorization of paying extra compensation to a fellow director for services the latter provided, even though the employment of directors in this manner was unlawful. Id. at 201. The court reasoned that directors, by necessity, must be granted wide discretion to make decisions. Id. at 199. In Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829), the Louisiana Supreme Court absolved bank directors from liability for losses resulting from the embezzlement of funds by the bank’s president and cashier. The court attributed the directors’ failure to detect the scheme of the president and cashier as an error in judgment for which the court refused to hold them responsible. Id. at 76-80. The use of the rule to protect directors’ decisions coincided with the industrial growth of the latter nineteenth century. For evidence of the parallel development of the rule and the economic policy of laissez-faire, see Briggs v. Spaulding, 141 U.S. 132 (1891); Witters v. Sowles, 31 F. 1 (C.C.D. Vt. 1887); Spering’s Appeal, 71 Pa. 11 (1872); Hodges v. New England Screw Co., 1 R.I. 312 (1850).

2. The rule tends to encourage entrepreneurial risk-taking. See Coffee & Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 COLUM. L. REV. 261, 281 (1981). The authors observed that "normal business judgments are often made under time pressure and uncertainty, which preclude studied reflection or textbook-style decisionmaking. Time is money, and excessive prudence can be more a vice than a virtue. The business judgment rule properly recognizes and tolerates these factors, in order to encourage entrepreneurial risktaking." Id. However, the authors draw a distinction between ordinary business judgments and decisions not to bring shareholder suits because there is more time for investigation and less uncertainty about the facts in question in a decision not to sue. Id.
ing or corruption rather than the result of an error in judgment.  

The decision of a board of directors to terminate a shareholder derivative suit is protected by the rule. However, courts have not allowed the rule to preclude shareholder derivative suits when a majority of the directors making the decision were involved in the alleged wrongdoing. In such cases, courts have permitted the shareholder to bring the derivative action.

To circumvent these suits, corporations have appointed to the board new directors with no connections to the transaction the shareholder is challenging. The new directors are placed on a "special litigation committee" charged with considering the merits of the shareholder suit and recom-

3. See 3A W. Fletcher, supra note 1. The author noted 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." Id. at 37. The burden of proving lack of good faith or due care traditionally falls on the plaintiff-shareholder Ash v. International Business Mach., Inc., 353 F.2d 491, 493 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966). In Ash, the Third Circuit held that the directors' decision not to allow a shareholder derivative action to address a wrong to the corporation would be respected unless the shareholder alleged and proved that the directors of the corporation were personally involved or interested in the alleged wrongdoing in a way calculated to impair the exercise of business judgment on behalf of the corporation, or that their refusal to sue reflected bad faith or breach of trust in some other way.

4. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917). In United Copper, the United States Supreme Court held that the directors' decision to enforce or not to enforce a derivative action should be interfered with by the courts only when misconduct is apparent. Id. See infra notes 119-21 and accompanying text.

Shareholders bring a derivative action 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 and can only be brought when the corporation does not assert the corporate cause of action itself. H. Henn, Handbook of the Law of Corporations and Other Business Enterprises § 360, at 756 (2d ed. 1970). For a discussion on the origin of the shareholder derivative suit, see Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?, 75 Nw. U.L. Rev. 96, 96 nn.1-2 (1980).


6. See United Copper Sec. Co., 244 U.S. at 264; Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 461 (1903); Hawes, 104 U.S. at 460.

7. Such a committee usually is comprised of a handful of directors recently appointed to the board and invested with the board's full authority to make a decision on terminating or maintaining the derivative action. See infra notes 128-34 and accompanying text. State statutes permit corporations to appoint such 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 1981-82); Model Bus. Corp. Act Ann. 2d § 42 para. 1 (1971). Corporations have used varying names to refer to such committees, including "independent investigation committee" and "special review committee." See Dent, supra note 4, at 97 n.10.
mending its maintenance or termination. Because a special litigation committee is not implicated in the alleged wrongdoing, it has enjoyed business judgment protection for its recommendation regarding the shareholder suit. Carrying the rule’s shield, these committees have frustrated many shareholder attempts to challenge corporate transactions.

The courts in most jurisdictions have sanctioned the power of a special litigation committee to terminate a shareholder suit. However, critics of the business judgment rule have expressed concern about the continuing frustration of derivative actions by special litigation committees. They have stressed the need for the courts to balance the interest of the corporation in discouraging frivolous litigation with the policy of preserving the derivative suit as an effective policeman of corporate governance. In an attempt to accommodate these interests, courts have divided on the degree of deference a court should afford a special litigation committee asserting its business judgment to forego a suit.

The approaches taken by the courts in Delaware and New York exemplify

8. For examples of situations in which corporations have appointed special litigation committees, see Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817 (S.D.N.Y. 1979).

9. The ostensible disinterestedness of the committee arose from the use of the term “interested director” only when the director had a financial interest in the outcome of the transaction, see DEL. CODE ANN. tit. 8, § 144(a) (1974), and from the court’s determining “disinterestedness” by considering only whether the director was involved in the challenged transaction. See Gall v. Exxon, 418 F. Supp. 508, 519-21 (S.D.N.Y. 1976).

10. Corporations have persuaded federal and state courts to dismiss shareholder derivative actions if a special litigation committee recommended termination even if a majority of the board of directors was involved in the challenged transaction. For cases where a majority of the board was charged in the wrongdoing but where courts have allowed the board to delegate decisionmaking authority to a special litigation committee, see Lewis v. Anderson, 615 F.2d at 778; Abbey v. Control Data Corp., 603 F.2d at 724; Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259 (3d Cir. 1979), cert. denied, 439 U.S. 1129 (1979); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. at 817; Gall v. Exxon, 418 F. Supp. 508 (S.D.N.Y. 1976); Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), rev'd sub nom. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).


12. For citations to cases and commentaries on the need to preserve derivative suits, see Dent, supra note 4, at 96 n.3.

this division in the law. In Delaware, the judiciary has employed a two-
pronged test. Initially, the court requires the corporation to establish the
independence and good faith of the committee.\textsuperscript{14} Once this has been proven, the
court will exercise its own business judgment on the committee’s recom-
mendation to determine whether the suit should be maintained.\textsuperscript{15} In New
York, the approach has been more deferential to the committee’s recom-
mendation once the independence and good faith of the committee have been
established. New York courts have held that the business judgment rule
operates to shield the decision of the special litigation committee from judi-
cial evaluation.\textsuperscript{16} These courts thus reject the Delaware requirement that
the court subject the committee’s substantive recommendations to its own
business judgment.\textsuperscript{17}

The current boom in mergers and acquisitions has heightened the contro-
versy over the appropriate amount of judicial deference to afford corporate
decisions.\textsuperscript{18} In the course of these transactions, corporate management has
been able to thwart shareholder derivative suits challenging a corporate ma-
neuver to avert a takeover by relying on the business judgment rule.\textsuperscript{19}

\begin{itemize}
\item \textsuperscript{14} Zapata Corp. v. Maldonado, 430 A.2d at 788-89.
\item \textsuperscript{15} Id.
\item \textsuperscript{16} See, e.g., Auerbach v. Bennett, 47 N.Y.2d at 633-34, 393 N.E.2d at 1002, 419
N.Y.S.2d at 929.
\item \textsuperscript{17} Id.
\item \textsuperscript{18} According to W.T. Grimm & Co., a merger consultant and statistical firm, the total
sum spent on mergers in the first half of 1984 was $80.6 billion, which was 157% over the total
for the first half of 1983. This half-year total was $2 billion less than the annual record of
$82.6 billion set in 1981. Included in these figures are two oil mergers completed in 1984: the
$13.3 billion acquisition of Gulf Oil by Standard Oil of California and the $10.1 billion acquisition
\item Recent acquisitions include Bendix' tender offer for Martin Marietta in August 1982, and
Allied's acquisition of Bendix for $1.8 billion; General Cinema's increase in stock holdings in
Hublein to 18.9% in May 1982, and R.J. Reynolds' purchase of Hublein for $1.4 billion; and
Newell's increase in stock holdings in Binney & Smith to 6.5% in March 1984, as well as
Hallmark Card's acquisition of Binney & Smith for $204 million. Some recent friendlier take-
overs include: the purchase of Stokely-Van Camp by Quaker Oats for $238 million in 1982;
Beatrice's acquisition of Esmark for $2.8 billion in August 1984; and Taubman Holdings' ac-
quision of Woodward & Lothrop for $220 million in 1984. Fisher, \textit{Oops! My Company is on
\item \textsuperscript{19} The rule has protected directoral decisions in even brash maneuvers to avoid a take-
over. In April 1984, when Limited, Inc. attempted a $1.1 billion acquisition of Carter Hawley
Hale Stores, Inc., Carter Hawley responded by buying 51% of its own stock for $470 million
and selling a 37.5% interest in itself to a "white knight," General Cinema Corporation. It also
granted an option for the sale of its most valuable subsidiary, Walden Books Company. Limited
sued to block the transactions on the grounds that Carter Hawley directors breached a
fiduciary duty to shareholders. The federal court in a preliminary ruling held that the maneu-
vers were "protected by the business judgment rule as an exercise of 'reasonable judgment by
prudent businessmen.'" Wall St. J., Aug. 10, 1984, at 27, col. 4. A separate SEC request to

ics of the rule in Congress have questioned whether it should protect such maneuvers that may really be efforts to preserve incumbent management, rather than actions taken in the best interest of the corporation and its shareholders. With this question in mind, recent decisions of the circuit courts have chipped away at the rule's broad protections. Additionally, corporate law practitioners, in a study sponsored by the American Law Institute (ALI), have proposed changes for the application of the business judgment rule. Under the ALI model, the rule would protect directors' decisions only when the directors meet formalized standards of care. Similarly, officials at the Securities and Exchange Commission have called for limitations.

20. Sparked by the Carter Hawley decisions, see supra note 19, Representative Timothy Wirth (D-Colo.), Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance, introduced on May 22, 1984, a package of legislation to regulate corporations' defensive tactics. H.R. 5695, 98th Cong., 2d Sess., 130 Cong. Rec. 4360 (1984). The package included a proposal to modify the business judgment rule. Under the Wirth proposal, directors and management would escape liability if they could show that their decisions were made using the best available information, were approved by a majority of the corporation's board, and were in the corporation's best interests. These requirements were incorporated into a "prudent and fair to shareholders" test. The business judgment provisions were not included in the bill reported by the House Energy and Commerce Committee on September 17, 1984, H.R. 5693, 98th Cong., 2d Sess. 130 Cong. Rec. 9642 (1984), but are expected to be reintroduced in 1985. (The Telecommunications Subcommittee is conducting hearings on takeover issues in the 99th Congress.)

21. Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255 (2d Cir. 1984). Norlin Corporation, a New York musical instrument and printing concern, issued 49% of its outstanding shares of stock to a Panamanian subsidiary and to an employee stock plan in order to block a takeover by Piezo Electronic Products, Inc. In June, the United States Court of Appeals for the Second Circuit upheld the district court's injunction barring the voting of those shares. Id. at 269. The court ruled that Norlin's tactics were a blatant effort to protect management's control of the company. The court ruled that the burden of proof under the business judgment rule rested with Norlin. Id. at 264. Recent decisions of the Delaware Supreme Court have limited the use of the business judgment rule to shield directors from liability. See, e.g., Smith v. Van Gorkom, No. 255 (Del. Jan. 29, 1985).

22. The American Law Institute is an association of law practitioners including judges and law professors. The four-year-old corporate governance project arose out of concern for the need to redefine and clarify existing principles of corporate behavior. The draft proposals recommend both mandatory legal controls and voluntary guidelines for management and directors to ensure that companies act responsibly to their shareholders and to the public. When completed (the slated completion date could be later than 1987), the project will serve as a model for the courts, state legislatures, Congress and federal regulatory agencies. Drafts of the proposals are available from the Institute's executive offices at 4025 Chestnut Street, Philadelphia, Pa. 19104.

23. Principles of Corporate Governance and Structure: Restatement and Recommendations § 4.01, at 140-41 (Tent. Draft No. 1, 1982) [hereinafter cited as ALI Draft]. A corporate director or officer would not be subject to liability if his business judgment was made after reasonable inquiry, in good faith, without a disabling conflict of interest, and with a rational basis for the judgment. Id. § 4.01(d).
on the situations in which the rule's protections may be invoked. Throughout the business community, the business judgment rule has generated heated debate.

The recent trend to reevaluate the business judgment rule was reflected in the decision of the United States Court of Appeals for the Sixth Circuit in *Hasan v. CleveTrust Realty Investors*. In *Hasan*, a shareholder in a Massachusetts real estate investment company brought a derivative suit alleging that the directors of the company had wasted corporate assets through various stock purchases undertaken to avert a takeover. The shareholder alleged that, through these transactions, the directors caused direct and intentional harm to CleveTrust for the purpose of protecting their positions. The shareholder named all but one member of the board in his suit. Soon thereafter, the board appointed a special litigation committee consisting only of this one member, Galvin, to investigate the transactions and to determine whether the derivative suit was in the corporation's best interests. In his report on the investigation, Galvin concluded that the suit was not in the corporation's best interests.

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24. Address by John J. Huber, SEC. REG. & L. REP. (BNA) No. 15, at 639-40 (April 13, 1984). Huber, Director of the Division of Corporation Finance of the SEC, urged a new approach to the business judgment rule at the 9th annual meeting of the American Bar Association's Section of Corporation, Banking and Business Law on April 7. According to Huber, state law rulings on the business judgment rule ignore the structural conflict of interest that boards of directors face when addressing hostile takeover issues. Huber urged the courts to alter the business judgment rule so that incumbent management is no longer afforded a presumption that actions taken in the face of takeover are in the best interests of the corporation.

In addition, the SEC's Advisory Committee on Tender Offers in its July 8, 1983 Report of Recommendations discusses the role of the business judgment rule in hostile takeover situations. In some cases, the committee recommends preemption of the rule.


26. *Id.* at 373. CleveTrust is a Massachusetts real estate investment trust. Its principal place of business is Ohio. When CleveTrust's stock prices declined to the point that they were less than the appraised value of the stocks' investment properties, CleveTrust became attractive to companies seeking takeover. Tulip and Champion, two such aggressors, each acquired 22.4% of CleveTrust's outstanding stock and sought to purchase a controlling block of shares. In the event of a takeover, CleveTrust's directors (the "trustees") would forfeit their positions.

The CleveTrust directors arranged a repurchase of the stock with corporate funds at a price exceeding the fair market value. They made an arrangement with Merchant Navy Officers Pension Fund Trustee, Ltd. to sell the fund 30% of CleveTrust's outstanding shares at two-thirds their appraised value. In exchange, Merchant Fund agreed to support the CleveTrust directors, to refrain from selling any stock for five years, and to give the directors of CleveTrust the first option to repurchase the entire block of CleveTrust stock. CleveTrust used the proceeds from this sale to prepay debts that would not mature for two years. *Id.*

27. *Id.* Shareholder Hasan held a significant amount of CleveTrust stock. *Id.*

28. *Id.* Galvin, a real estate broker, was not named as a defendant because he was appointed to the board after the challenged transactions had occurred. *Id.*

29. *Id.* at 373-74.

30. *Id.* at 374.
The United States District Court for the Northern District of Ohio held that under the applicable Massachusetts version of the business judgment rule, Galvin's report was controlling. Despite Galvin's business associations with two members of the CleveTrust board, the district court found that the plaintiff-shareholder failed to rebut the presumption of good faith afforded to Galvin under the business judgment rule.

The Sixth Circuit, on appeal, ruled that the district court erred in presuming Galvin's good faith. The court determined that Massachusetts courts would require the corporation to prove Galvin's good faith, at least with respect to the independence of the special litigation committee and the reasonableness of its investigation. In support of this conclusion, the court relied upon the convergence of opinion between the Delaware and New York approaches on these issues. In so doing, the court demonstrated a way to curb abuses of the business judgment rule through closer scrutiny of

31. Id.

32. Galvin's report acknowledged that Galvin owned 25% of a firm that had received fees from a company managed by the Chairman of the CleveTrust board, James Carney. The report also revealed that Galvin held a 2% interest with another defendant in an investment partnership. Galvin concluded in his report that "his own business associations with these named defendants did not compromise the disinterestedness of his investigation and recommendation." Id.

33. Id. The district court found that Hasan had failed through discovery to introduce any affirmative evidence of the committee's bias. Id.

34. Id. at 377.

35. Because CleveTrust is a Massachusetts corporation, Massachusetts law controls. The search for the applicable state law in a diversity jurisdiction context follows the guidelines established by the Supreme Court:

[T]he State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State.

In this respect, it may be said to be, in effect, sitting as a state court.

Commissioner of Internal Revenue v. Estate of Bosch, 387 U.S. 456, 465 (1967) (quoting Bernhardt v. Polygraphic Co., 350 U.S 198 (1956)). Accordingly, the circuit court in Hasan reviewed Massachusetts corporate law. The court found that "[i]n cases in which the directors of a corporation are charged with self-dealing, the Massachusetts courts have not applied the business judgment rule." Hasan, 729 F.2d at 377 (citing American Discount Corp. v. Kaitz, 348 Mass. 706, 206 N.E.2d 156 (1965)). Furthermore, the Massachusetts courts have been skeptical about the ability of directors to engage in an independent inquiry over the misconduct of their peers. Pupecki v. James Madison Corp., 376 Mass. 212, 218-19, 382 N.E.2d 1030, 1034 (1978). In addition, the United States Court of Appeals for the First Circuit inferred the likelihood of bias from the very fact of a decision by a director to forego litigation in support of a colleague. In re Kauffman Mutual Fund Actions, 479 F.2d 257, 265 (1st Cir. 1973). Thus the Hasan court found that the First Circuit and the Massachusetts courts have "articulated a firm willingness to allow judicial scrutiny of corporate abuses and to place upon corporate decisionmakers the burden of proving their disinterestedness." Hasan, 729 F.2d at 378.


37. Id. at 376. See infra notes 150-72 and accompanying text.
the structural and procedural aspects of the special litigation committee. At the same time, it suggested that courts can narrow the protection provided to the committee under the business judgment rule without violating the rule's basic policies.

Before discussing the significance of Hasan's policy of strict procedural review, this Note will outline the historical reasons for providing directors' decisions protection under the business judgment rule. It will also explain the standards directors must meet to qualify for this protection and the situations in which courts will refuse to apply the rule. In addition, this Note will trace the application of the rule to the decision of a special litigation committee to terminate a shareholder derivative action and the split in the courts over the degree of judicial deference to be extended to these committees under the rule. Finally, this Note will describe how the court's policy in Hasan both follows and deviates from the rule's traditional interpretations. Further, it will suggest how Hasan's policy serves as a moderate measure of reform among more radical proposals to redefine the rule, and how it provides courts with a workable approach to reviewing special litigation committee decisions.

I. THE BUSINESS JUDGMENT RULE: ITS PHILOSOPHY AND OPERATION

A. Accommodating Human Error, Risky Business and Judicial Economy

Corporate directors may invoke the business judgment rule to defend against a challenge to their decisions. Such challenges appear most often in the form of a derivative suit commenced by a shareholder to enjoin a proposed corporate transaction, such as the issuance of stock, or to recover damages as a consequence of a completed act, such as a questionable payment made by the corporation to a foreign government. Directors can dismiss these challenges if, in their business judgment, they believe that the

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38. The way in which strict scrutiny of the structure and investigative process of the special litigation committee demands adherence to the duties of care and loyalty and to the basic principles of the business judgment rule is developed later in this article. See infra notes 254-62, 274-82 and accompanying text.

39. Because the authority to manage a corporation rests with the board of directors, before commencing a derivative action, a shareholder must ask the board to bring a suit seeking redress for the alleged wrong. Hawes v. City of Oakland, 104 U.S. 450, 460-61 (1882); DiFani v. Riverside County Oil Co., 201 Cal. 210, 215, 256 P. 210, 213 (1927). If the alleged wrongdoers include a majority of the board or control the board through ownership of voting stock, the demand generally is excused on the theory that those who control the corporation would not be expected to sue themselves. See Meltzer v. Atlantic Research Corp., 330 F.2d 946 (4th Cir.), cert. denied sub nom. Scurlock v. Meltzer, 379 U.S. 841 (1964); Craftsman Finance & Mortgage Co. v. Brown, 64 F. Supp. 168, 174-75 (S.D.N.Y. 1945).


41. See Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979);
suits are inimical to the corporation's best interests. Courts generally will not interfere with the directors' decisions.42

This judicial deference is supported by the policy argument that humans are fallible and that business involves risk.43 In one of the earliest expressions of the business judgment rule, Godbold v. Branch Bank,44 the Alabama Supreme Court articulated these underlying policy considerations. In Godbold, a bank's board of directors had appointed a fellow director as an agent of the bank to collect money for the bank and to handle certain bank affairs.45 As compensation for this special service, the board agreed to pay the director an additional $500 per year.46 The employment of a fellow director was subsequently found to be unlawful under an Alabama statute, and a shareholder sued the directors who authorized the compensation to recover the amount of the unlawful payments.47 The court absolved the directors of liability, citing their misunderstanding of the law.48 The court maintained that the fallibility of directors in their decision-making was ac-


42. There are certain situations, however, in which the courts will overturn directors' decisions. See United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917) (directors may dismiss derivative suits, and courts will not interfere with such a decision except when directors are acting in bad faith); Hawes v. City of Oakland, 104 U.S. 450 (1881) (directors may dismiss derivative suits, and the business judgment rule insulates the decision when neither fraud nor bad faith is alleged); Mercantile Trading Co. v. Rosenbaum Grain Corp., 17 Del. Ch. 325, 334-35, 154 A. 457, 461 (1931) (fraud or ultra vires misconduct must be proven to justify judicial interference in business judgment matters).

43. See Arshs, The Business Judgment Rule Revisited, 8 HOFSTRA L. REV. 93, 97 (1979). Arshs explains that the business judgment rule developed from judicial concern that the threat to directors that they would be liable for an honest error of judgment would discourage "persons of reason, intellect and integrity" from serving as directors. Id. The threat is increased by the fact that directors are expected to take the same kind of chances a man would take in his own business. See also 3A W. FLETCHER, supra note 1.

44. 11 Ala. 191 (1847).
45. Id. at 194.
46. Id.
47. Id. at 192-93.
48. Id. at 199-200. In support of its holding, the court remarked that the fact:

The directory did not know it was unlawful to employ one of their number as an agent of the bank, and give him a compensation in addition to his salary as a director, for the performance of extraordinary services, is no impeachment of their knowledge as mercantile men; nor does it by any means demonstrate the want of that skill which would be necessary to qualify them for the station they filled. Indeed, it merely proves they were not skillful lawyers, as well as merchants, and although the act was not lawful, and the director receiving such additional compensation may be compelled to refund it, it is not, if done in good faith, and with the honest purpose to collect and preserve the assets of the bank, an act which would expose the directory to a personal responsibility.

Id.
commodated by the business judgment rule. The court explained that directors, by assuming the supervision of the institution committed to their care, do not represent that they possess such a perfect knowledge of the matters coming under their authority that they cannot make mistakes. Moreover, a policy that would demand extreme accuracy from directors charged with a great deal of entrepreneurial discretion would discourage persons from accepting such positions.

Another reason underlying the judicial deference to directors' decisions is the desire to promote judicial economy. Because courts will interfere in directorial decisions only in cases of wrongdoing or corruption, not every corporate transaction will be subject to judicial review at the request of a disgruntled shareholder. The rule operates to prevent courts from stepping in to resolve disagreements between directors and shareholders over the propriety of a board action. The limitation on judicial involvement in the affairs of the business sector is a policy the courts have respected. Courts have agreed that the judiciary is to leave questions of corporate management to directors by accepting board decisions as final unless shown to be corrupt.

49. See id. at 199-200.
50. Id. at 199.
51. Id. The fear that the imposition of liability on directors for errors of judgment would inhibit risk-taking and chill board meetings is also expressed in more recent cases. See, e.g., 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). See also Dyson, The Director's Liability for Negligence, 40 IND. L.J. 341, 367 (1965).
52. See supra note 3 and accompanying text.
54. In Karasik, 21 Del. Ch. at 97, 180 A. at 611, the Delaware Chancery Court explained how the rule prevented courts from interfering when directors made business mistakes:

Mere mistakes in the manner in which [the directors] honestly act in such matters does not justify judicial interference nor the substitution of the court's opinion for theirs. If it were not so, courts would be clogged with the pure business problems of corporations concerning which individual stockholders were in disagreement with the officers and directors chosen by the majority to think and decide for the corporate creature.

Id.
55. See supra note 53 and accompanying text.
56. Davis, 16 Del. Ch. at 169, 142 A.2d at 659 (1928). With reference to a derivative action, the court noted:

We have then a conflict in view between the responsible managers of a corporation and an overwhelming majority of its stockholders on the one hand and a dissenting minority on the other—a conflict touching matters of business policy, such as has occasioned innumerable applications to courts to intervene and determine which of
B. The Standard of Care for Protection under the Business Judgment Rule

While courts generally have accepted a policy of judicial noninterference in business affairs, they expect directors to adhere to a certain standard of care and diligence. In a majority of jurisdictions, this standard requires that directors make decisions in good faith, in what they believe to be the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances.

Early on, courts construed the words "ordinarily prudent person" to mean that directors must possess only a competent knowledge of the duties of the directorship assumed by them. Unless certain skills or expertise the two conflicting views should prevail. The response which courts make to such an application is that it is not their function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final.

Id. See infra notes 89-109 and accompanying text.


58. MODEL BUSINESS CORP. ACT ANN. 2d § 35 (Supp. 1977). Section 35 states:

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.

Id.

States that have adopted § 35 of the Model Act include: Connecticut, Florida, Hawaii, Idaho, Indiana, Iowa, and Maryland. Additional states that have enacted specific statutory provisions comparable to the § 35 standard include: California, Georgia, Louisiana, Maine, Massachusetts, Michigan, Minnesota, New Jersey, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Carolina, and Tennessee. In other states, the common law is the source of the duty of care standard. In nine of these states, the courts have not addressed the issue.

In the commentary to § 35, the business judgment rule is incorporated into the standard of care:

By combining the requirement of good faith with the statement that a director must act 'with such care as an ordinarily prudent person in a like position would use under similar circumstances,' section 35 incorporates the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment. A director attempting to create profits for his corporation will frequently make decisions involving risk for the enterprise. No personal liability should be imposed upon him in the event his good faith decision, in the exercise of business judgment, later seems to have been erroneous.


59. Godbold v. Branch Bank, 11 Ala. 191, 199 (1847). See also Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829) ("The test of responsibility therefore should be not the certainty of wisdom . . . but the possession of ordinary knowledge.") The same standard of knowledge is embodied in the ALI DRAFT, supra note 23. The Institute comments that an ordinarily prudent person is a "generalist who has the basic intelligence appropriate to the task at hand."
were required for appointment to the board, directors have not been required to demonstrate extraordinary qualifications.60 The degree of competence for directors under the rule was the capacity to understand the transaction of ordinary business.61 However, courts have required directors to make a reasonable inquiry into the circumstances surrounding a transaction before exercising business judgment.62 They have placed upon directors a continuing obligation to keep informed about the activities of the corporation and to take a reasonable amount of time to acquire the relevant facts before deliberation.63

In Francis v. United Jersey Bank,64 the New Jersey Supreme Court enforced the policy that directors receive business judgment protection only for informed decisions. In that case, Mrs. Charles Pritchard was the largest single shareholder in a reinsurance broker corporation65 founded by her late husband. Her sons, Charles, Jr., and William, were officers and shareholders, and with their mother constituted the board after the father’s death in 1973.66 Mrs. Pritchard was not involved in the business and knew little of its corporate affairs. She visited the firm’s offices on only one occasion and never obtained a copy of the firm’s annual financial statements. “She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to

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60. In the case where special expertise was a prerequisite to board membership (e.g., as controller or general counsel), or where the director represents that he has special skills or expertise, that director will be held to the standard appropriate to his representation. RESTATEMENT (SECOND) OF TORTS § 299A (1965).

61. Hodges v. New England Screw Co., 1 R.I. 312, 326 (1850). The court observed that: “Ignorance does excuse unless it be that palpable ignorance which shows an incapacity for the transaction of ordinary business.” Id.


64. 87 N.J. 15, 432 A.2d 814 (1981).

65. Id. at 20, 432 A.2d at 816. “Reinsurance involves a contract under which one insurer agrees to indemnify another for loss sustained under latter’s policy of insurance.” Id. When the face amount of an insurance policy is great, a company may ask one or more insurers to share in the risk. The company that sells the insurance is called a “ceding company,” while the entity that assumes the obligation is designated as the “reinsurer.” The person who arranges the contract between the ceding company and the reinsurer is called the “reinsurance broker.” Id. at 20, 432 A.2d at 817.

66. Id. at 23, 432 A.2d at 818.
the withdrawal of funds, complied with industry custom or relevant law." 67

Beginning in 1970, Charles, Jr. and William began appropriating for themselves increasing sums from the corporation in the form of loans. By 1975 when the company filed for voluntary bankruptcy, the loans totaled more than $12 million. 68 The trustees in bankruptcy brought suit against Mrs. Pritchard 69 to recover the funds paid by the corporation to her sons. The court held Mrs. Pritchard personally liable as a director for having no knowledge of the embezzlement and for not trying to prevent the misappropriation of corporate funds. 70 The court admonished the directors to acquire "at least a rudimentary understanding" of the corporation's business 71 and generally to monitor corporate affairs and finances. 72 In some situations, the court warned, directors would be required to seek the advice of counsel. 73 But whatever the transaction, directors were not to close their eyes to wrongdoing and then argue that they were under no duty to see it. 74

After making a reasonable inquiry into a proposed transaction, a director must allow the best interests of the corporation to dominate over his interest in any personal advantage he might derive from it. 75 In Guth v. Loft, Inc., 76

67. Id. at 26-27, 432 A.2d at 819.
68. Id. at 24, 432 A.2d at 816.
69. Because Mrs. Pritchard died after commencement of the suit but before the trial, her executrix was substituted as defendant.
70. Id. at 39, 432 A.2d at 829.
71. Id. at 31, 432 A.2d at 821.
72. Id. at 32, 432 A.2d at 822.
73. Id. at 33, 432 A.2d at 823. See also Williams v. McKay, 46 N.J. Eq. 25, 60, 18 A. 824, 837 (1889) on the duty of a bank director to obtain legal advice because there was doubt about the provisions of the bank's charter.
74. Francis, 87 N.J. at 31, 432 A.2d at 822 (quoting Wilkinson v. Dodd, 42 N.J. Eq. 234, 245 (1886), aff'd, 42 N.J. Eq. 647, 9 A. 685 (E & A 1887)) ("The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect."). The obligation of directors to make reasonable inquiry into corporate transactions is embodied in the American Law Institute's Corporate Governance Project, ALI DRAFT, supra note 23, § 4.01(b), at 141. The Institute notes that directors should be under an obligation to make reasonable inquiry that would lead to questions about the ramifications of any corporate action before it is approved. Directors may also be required to participate in discussions with attorneys, auditors, and other experts depending on the circumstances. In addition, directors should inquire about the activities of subordinates and employees and about the effectiveness of monitoring programs aimed at providing financial controls. Id. at 174-83.
75. ABA, Corporate Director's Guidebook, 33 Bus. Law. 1595 (1978).
76. 23 Del. Ch. 255, 5 A.2d 503 (1939).
the Delaware Supreme Court articulated the requirement that there be no conflict between a director's duty of loyalty to the corporation and his own self-interest. Guth was the president and dominant board member of Loft, Incorporated, which manufactured and sold candies, syrups and beverages. Guth organized his own company for the purpose of obtaining the formula and trademark of Pepsi-Cola and of replacing Coca-Cola with Pepsi in Loft stores. In his venture to manufacture the Pepsi syrup, Guth used Loft's plant, facilities, materials, executives, and credit without reimbursing Loft for the considerable expense he incurred and the resulting loss of profits.

The Delaware Supreme Court found that Guth made millions of dollars from the Pepsi enterprise by commandeering the resources of Loft. He also appropriated an opportunity to manufacture Pepsi that belonged to Loft because the opportunity was clearly within Loft's line of business. The court found that Guth had acted contrary to the corporation's best interests in this venture and had breached his fiduciary duty. As the court explained, Guth had violated a longstanding rule that demands of a corporate director "the most scrupulous observance of his duty" of loyalty to the corporation and its shareholders. This fiduciary obligation requires a director not only to act affirmatively to further the corporation's interests, but also to refrain from causing it harm or depriving it of profit.

Both Francis and Guth demonstrate that directors must meet certain standards before invoking protection under the business judgment rule for their business decisions. First, directors must acquire knowledge of the corporation's activities, although the standard for this knowledge will be commensurate with, not greater than, the degree of care they would exercise in their own business affairs. Secondly, directors may not use their decision-mak-

77. Id. at 270, 5 A.2d at 510.
78. Id. at 258-60, 5 A.2d at 505-06. National Pepsi-Cola Co. was in bankruptcy at the time when Guth and the former controlling stockholder of Pepsi, Megargel, planned to acquire the formula and trademark for the manufacture of the soft drink from the trustee in bankruptcy. Id.
79. Id. at 261, 5 A.2d at 506.
80. Id. at 282, 5 A.2d at 515.
81. Id. at 279-83, 5 A.2d at 513. Under the corporate opportunity doctrine, corporate directors and officers are precluded from diverting to themselves opportunities in which the corporation has a right, property interest, or expectancy, or which in justice should belong to the corporation, unless the corporation clearly rejects the opportunity. The critical question is whether the opportunity is one within the legitimate line of the corporation's business. H. Henn, supra note 4, § 237, at 462 (2d ed. 1970).
82. Guth, 23 Del. Ch. at 280-81, 5 A.2d at 515.
83. Id. at 270, 5 A.2d at 510.
84. Id.
85. See supra notes 59-74 and accompanying text.
ing power to their personal advantage or to the corporation's detriment.86

C. Violation of the Standard of Care and the Consequent Loss of Protection under the Business Judgment Rule

In making a decision in the best interest of the corporation, courts have required that a director act “reasonably.”87 Reasonableness implies that ordinary negligence constitutes a violation of the duty of care. The majority of courts and commentators that have discussed this issue adhere to this rationale.88 However, it is the rare case in which ordinary negligence, absent an indication of self-dealing on the part of directors, has been found to be a sufficient basis for the finding that the duty of care has been violated.89 Loss of protection under the business judgment rule is triggered by behavior more extreme than ordinary negligence.90

In the earliest formulation of the business judgment rule, courts defined the standard of culpability for loss of business judgment protection as “an

86. See supra notes 75-84 and accompanying text.
87. See supra note 58 and accompanying text. A director is to act in a manner he reasonably believes to be in the best interests of the corporation.
88. The following commentators and many of the cases they cite support the proposition that, as a general rule, a finding of ordinary negligence, rather than gross negligence, constitutes a duty-of-care violation. See 3A W. FLETCHER, supra note 1, § 1029, at 12; H. HENN, supra note 4, § 234, at 453-55; Arsh & Hinsey, Codified Standard—Same Harbor But Charted Channel: A Response, 25 BUS. LAW. ix, xii-xiii (1980); H. BALLANTINE, LAW OF CORPORATIONS § 163, at 158-59 (rev. ed. 1946).
89. See Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1099 (1968). In this survey of duty of care cases, the author remarked:

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. Few are the cases in which the stockholders do not allege conflict of interest.

Id. Bishop found only “four specimens” of cases where directors of industrial corporations were held potentially liable for negligence uncomplicated by self-dealing: Selheimer v. Mangene Corp., 423 Pa. 563, 224 A.2d 634 (1966); Syracuse Television, Inc. v. Channel 9, Syracuse, Inc., 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966); New York Credit Men’s Adjustment Bureau v. Weiss, 305 N.Y. 1, 110 N.E.2d 397 (1953); Clayton v. Farish, 191 Misc. 136, 73 N.Y.S.2d 727 (Sup. Ct. 1947). Bishop concluded, after further analysis, that “none of these cases carries any real conviction.” Bishop, supra, at 1099. He continued: “all in all, I remain very skeptical of the proposition that directors of industrial corporations run any substantial risk of liability for ordinary negligence.” Bishop, supra, at 1101.

90. Bishop, supra note 89, found few cases of ordinary negligence violating the duty of care standard even among financial institutions and banks, despite the fact that their directors are assumed to owe a higher standard of care than do directors of other institutions. More modern cases and commentaries reject the standard of care distinction between financial and industrial corporations as anachronistic. See Bishop, supra note 89, at 1098-99; H. BALLANTINE, supra note 88, at § 63a.
error of the grossest kind”\textsuperscript{91} or a “willful and fraudulent” excess of power that “will forfeit the charter to the public.”\textsuperscript{92} Later, most courts advanced the policy of noninterference with business decisions unless serious wrongdoing existed.\textsuperscript{93} Decisions of the Delaware Supreme Court illustrate this approach. In \textit{Bodell v. General Gas \\& Electric Corp.},\textsuperscript{94} the court, under the business judgment rule, upheld the decision of utility company directors to permit a sale of the same stock at different prices to Class A and Class B holders.\textsuperscript{95} The directors contended that issuing no par common stock to Class A shareholders at $25 per share, and to all other shareholders at $45 per share, would stimulate public demand for Class A stock and enable the corporation to acquire large amounts of cash.\textsuperscript{96} The plaintiff-shareholders argued, however, that the directors were exercising their right to issue stock for the “exclusive benefit” of the Class A shareholders to the detriment of the Class B holders.\textsuperscript{97} Despite the apparent unfairness of the transactions, the court refused to set aside the directors’ decision.\textsuperscript{98} The court found no ground for interference with the board’s judgment because there was no suggestion of fraud, improper motive, or personal gain on the part of the directors, nor was there evidence that the board had deliberately disregarded the interests of the corporation.\textsuperscript{99}

Two years later, the same court in \textit{Allaun v. Consolidated Oil Co.}\textsuperscript{100} upheld a decision on the part of the directors of Consolidated Oil to sell corporate assets in the face of shareholder allegations that the sale was fraudulent; that the price charged for the assets was “grossly inadequate”; and that the controlling directors as majority shareholders would profit from the way the sale was structured.\textsuperscript{101} The court held that the disparity between the price set for the assets and their actual value was not a sufficient reason to deny the directors business judgment protection for their decision.\textsuperscript{102}

\textsuperscript{91} Godbold v. Branch Bank, 11 Ala. 191, 200 (1847).
\textsuperscript{92} Hodges v. New England Screw Co., 1 R.I. at 326.
\textsuperscript{93} See infra notes 94-109 and accompanying text. For a discussion of and citations to authorities concerning the confusion over the culpability standard, see Arsht \& Hinsey, supra note 88.
\textsuperscript{94} 15 Del. Ch. 420, 140 A. 264 (1927).
\textsuperscript{95} Id. at 430, 140 A. at 268.
\textsuperscript{96} Id. at 425, 140 A. at 266.
\textsuperscript{97} Id. at 424, 140 A. at 266.
\textsuperscript{98} Id. at 429-30, 140 A. at 268.
\textsuperscript{99} Id. at 427, 140 A. at 267. “[W]e think the discretion of a board of directors in the sale of its par value stock should not be interfered with, except for fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders.” Id.

\textsuperscript{100} 16 Del. Ch. 318, 147 A. 257 (1929).
\textsuperscript{101} Id. at 320, 147 A. at 259.
\textsuperscript{102} Id. at 325, 147 A. at 261.
considered intervention appropriate only if the directors had agreed to the sale with "reckless indifference" toward the interests and rights of the shareholders. 103

Similarly, in Sinclair Oil Corp. v. Levien, 104 the Delaware Supreme Court exercised judicial restraint in the absence of serious wrongdoing. Sinclair Corporation caused its subsidiary, Sinven, to pay out a large amount of dividends to its parent, Sinclair, at a time when Sinclair required cash for its expansion program. 105 The drain on Sinven's funds prevented Sinven's industrial developments, and a Sinven shareholder brought a derivative action against Sinclair. 106 The court held that the decision to siphon off Sinven's funds was protected by the business judgment rule 107 because there was no proof of self-dealing on the part of Sinclair's directors. 108 Absent "fraud or gross overreaching," the decision of the Sinclair directors to achieve expansion at the expense of Sinven was upheld. 109 As in Bodell and Allaun, the

103. Id. The court remarked:

It is not every disparity between price and value that will be allowed to upset a proposed sale. The disparity must be sufficiently great to indicate that it arises not so much from an honest mistake in judgment concerning the value of the assets, as from either improper motives underlying the judgment of those in whom the right to judge is vested or a reckless indifference to or a deliberate disregard of the interests of the whole body of stockholders including of course the minority.

104. 280 A.2d 717 (Del. 1971).

105. Id. at 720-21. Sinclair was a holding company that owned about 97% of the stock of Sinclair Venezuelan Oil Company (Sinven). Sinven's primary business was its petroleum operation in Venezuela. Id. at 719. In a six-year period, Sinclair caused Sinven to pay out $108,000,000 in dividends, which was $38,000,000 more than Sinven's earnings during these years. As found by the Chancery Court, the period in which Sinclair required Sinven to pay these dividends coincided with the time in which Sinclair needed large amounts of cash. Id. at 721.

106. Id. at 719.

107. Id. at 722-23.

108. Id. at 722. The court held that the siphoning off of Sinven dividends by Sinclair as Sinven's majority shareholder did not constitute self-dealing by Sinclair's directors because the minority shareholders of Sinven received a proportionate share of the money. "Sinclair received nothing from Sinven to the exclusion of its minority shareholders." Id. at 721-22.

109. Id. at 722. The court concluded:

Since there is no proof of self-dealing on the part of Sinclair, it follows that the expansion policy of Sinclair and the methods used to achieve the desired result must, as far as Sinclair's treatment of Sinven is concerned, be tested by the standards of the business judgment rule. Accordingly, Sinclair's decision, absent fraud or gross overreaching, to achieve expansion, through the medium of its subsidiaries, other than Sinven, must be upheld.

10. For examples of other cases that have used the gross and palpable overreaching standard, see Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967). Arsh, supra note 43, at 104-07, argues that the gross and palpable overreaching standard should not be considered the business judgment rule's
Delaware Supreme Court in *Sinclair* maintained that only serious wrongdoing involving gross negligence, fraud, or self-gain on the part of directors would deny them the rule's protection.

**II. APPLYING THE BUSINESS JUDGMENT RULE TO THE SPECIAL LITIGATION COMMITTEE**

**A. Shareholder Standing and the Birth of the Special Litigation Committee**

When a shareholder alleges a wrong to a corporation, and the corporation does not assert a cause of action, the shareholder may bring suit derivatively to redress the wrong on the corporation's behalf. A plaintiff-shareholder must first make a demand on the directors to initiate the suit because the derivative suit is an action asserting a right belonging to the corporation and not an individual right of the shareholder. A court may not require such a demand, however, if it would be futile, as in the case where a majority of the board members are alleged to be wrongdoers, or where the defendants control the board through stock ownership. Courts recognize that directors who are alleged wrongdoers cannot be expected to sue themselves.

If the board agrees to the shareholder's demand to initiate a corporation action, the shareholder's part in the lawsuit is ended. However, if the board refuses to sue, or if demand is excused as futile, the shareholder must then establish that he has standing to sue.

In 1881, the Supreme Court first enunciated the situations in which a shareholder has standing to enforce a right of a corporation or of an unincorporated 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.

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110. H. HENN, supra note 4, § 360, at 756.
111. FED. R. CIV. P. 23.1. The shareholder must make a demand on the directors, or if necessary, the shareholders, to bring the suit. The rule states:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated 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.

Id.

112. H. HENN, supra note 4, § 360, at 756.
114. Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 HARV. L. REV. 746, 753 (1960).
115. H. HENN, supra note 4, § 366, at 772.
116. The standing requirement in shareholder derivative suits is not equivalent to the requirement in administrative actions that the plaintiff have a stake in the action to warrant
the rights of a corporation. The shareholder must allege that the corporation acted beyond its charter; that a fraudulent transaction by the corporation is potentially harmful to the interests of the corporation or its shareholders; that a majority of the board is acting in its own self-interest to commit such a harm; or that the majority of the board is pursuing an oppressive and illegal course of action in the name of the corporation which violates shareholder rights and which only a court of equity could enjoin.

Thirty years later, in United Copper Securities Co. v. Amalgamated Copper Co., the Supreme Court again reviewed the requirement of shareholder standing. It held that courts should not allow a shareholder to assert a corporate cause of action against third parties when the board has refused to initiate the suit unless the directors are guilty of serving their own self-interest. The Supreme Court maintained that the board’s refusal to bring suit is a decision protected by the business judgment rule and is to be respected by the courts unless the shareholder can prove it was wrongful.

When a majority of the board allegedly is involved in the wrongdoing, courts have not extended protection under the rule to encompass the board’s decision to forego the shareholder suit. In recent years, corporations in these situations have employed special litigation committees to assess the merits of the proposed derivative action. These committees are comprised of directors who are “disinterested” parties by virtue of the fact that they are not implicated in the challenged transactions. The committees are charged with investigating the shareholder complaint and recommending maintenance or dismissal of the suit. In most cases, special litigation committees have determined that the proposed suit is not in the best inter-

117. Hawes, 104 U.S. at 462.
118. Id. at 460.
119. 244 U.S. 261 (1917).
120. Id. at 263-64. The court remarked: “[W]hether 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.” Id. at 263. For a summary of the demand requirement, see Note, Zapata Corp. v. Maldonado: A Middle Ground when Applying the Business Judgment Rule to the Termination of Derivative Suits, 31 CATH. U.L. REV. 539, 547-50 (1982).
121. See supra note 5 and accompanying text.
122. See supra note 7 and accompanying text.
123. See supra note 9 and accompanying text.
124. See supra note 7.
125. See supra note 7.
1985]
ests of the corporation. These decisions have been upheld by the courts as within the protection afforded by the business judgment rule.

The use of the special litigation committee as a "formalized" method employed by a corporation to defeat a derivative action was approved by the United States District Court for the Southern District of New York in Gall v. Exxon. In Gall, a shareholder alleged that Exxon executives had negligently failed to detect and report the use of corporate funds for political payments. Exxon's board of directors appointed a special litigation committee to investigate the shareholder's allegations and to determine whether the corporation should sue any of its executives regarding the payments. Comprised of three directors appointed to the board after the challenged payments had been made, the committee conducted a four-month investigation. During this time, the committee employed special counsel, interviewed 100 witnesses, and issued an 82-page report summarizing its findings and conclusions. The committee recommended dismissal of the suit as contrary to the interests of Exxon and its shareholders.

Relying on the early Supreme Court decisions, the court adhered to the

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126. See supra cases cited at note 10. See also Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 CORNELL L. REV. 600, 602 (1980). Some factors the special litigation committee has considered in reaching its decision to terminate a suit include the cost of the litigation, the reputation and standing of the corporation in the business community and the effect of the suit on employee morale. Gaines v. Haughton, 645 F.2d 761, 767 n.11 (9th Cir. 1981), cert. denied, 454 U.S. 1145 (1982).

127. See supra cases cited at note 10.

128. Coffee & Schwartz, supra note 2, at 272. The authors outlined the "formalized methodology" of the special litigation committee:

[Step one, the Board appoints litigation committee and delegates decision-making authority concerning the lawsuit to it; step two, the committee retains special distinguished special counsel, preferably a retired judge; step three, a lengthy study and report is prepared, which casts doubt on the strength of plaintiff's case; and step four, the committee reaches the final decision not to sue, based on the report and the opinion of special counsel that litigation would not be in the best interests of the corporation.


130. Id. at 509. The plaintiff-shareholder alleged that $59 million in corporate funds were paid by Exxon's directors as bribes to Italian political parties and others during an 11-year period. The payments allegedly were made to obtain special political favors and commitments. Id.

131. Id. at 510-11.

132. Id. at 511.

133. Id.

134. Id. at 514. In its report, the special litigation committee cited the following reasons for its decision to dismiss the suit: "the unfavorable prospects for success of the litigation, the cost of conducting the litigation, interruption of corporate business affairs and the undermining of personnel morale." Id. at 514 n.13.

135. See supra notes 117-19 and accompanying text.
policy that, without allegations of the committee's collusion with the board or evidence of the members' self-serving motives, it would be inappropriate for the judiciary to interfere with the judgment of the committee not to sue. Before granting the committee's motion to dismiss the suit, however, the court allowed the plaintiff-shareholder to test, through the discovery process, the committee's motives and its degree of independence from the board. The court implied that the shareholder would have to show that the committee members were personally involved in the foreign payments in order to establish the committee's bias. The shareholder was unable to meet this burden after limited discovery, and therefore the court granted the corporation's motion to dismiss the complaint.

The court in Gall further limited inquiry into the committee's independence by not exploring the committee as a mechanism for the board to maintain control over the decision to terminate the shareholder's suit. The plaintiff-shareholder had argued that because the board could disband the committee at any time or could ignore its recommendations, the decision to terminate the suit rested ultimately with the defendant directors. Therefore, the shareholder contended, the committee's decision was not made independently from the board and should not be afforded business judgment protection.

The court rejected this argument. It concluded that the decision to terminate the suit was not advisory, because the board had invested the committee with the authority to conduct an investigation and to make a decision to forego or to pursue the suit. The court refused to inquire beyond that decision to ascertain who wielded authority on other corporate issues, such as the appointment of directors to the board and to special committees. Such authority might have indirectly influenced the judgment of the special

136. Gall, 418 F. Supp. at 516. "[A]bsent allegations of fraud, collusion, self-interest, dishonesty or other misconduct of a breach of trust nature, and absent allegations that the business judgment exercised was grossly unsound, the court should not at the instigation of a single shareholder interfere with the judgment of the corporate officers." Id.

137. Id. at 520.

138. See id. at 519-20. The court's opinion makes it clear that by independence the court meant nothing more than an absence of involvement in the payments. The court's later opinion was consistent with the narrow definition of independence. Gall v. Exxon, No. 75-3682, slip op. at 4-5 (S.D.N.Y. Jan. 17, 1977).


140. Gall, 418 F. Supp. at 516-17.

141. Id.

142. Id. at 517.

143. Id. "The focus of the business judgment rule inquiry 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." Id.
litigation committee. Yet the court suggested that delegating authority to the special litigation committee to make a decision on the suit rendered that judgment free of the board's control.

In keeping with the trend set by *Gall*, courts have been fairly uniform in sanctioning the power of a special litigation committee to terminate a derivative suit. As long as a committee composed of directors not involved in the challenged transaction conducted an investigation and decided in good faith that the action was not in the corporation's best interest, the action could be dismissed. At the same time, however, courts continued to recognize the derivative action as a generally-accepted means of policing corporate directors.

**B. Zapata and Auerbach: Stricter Scrutiny of the Special Litigation Committee**

The need to balance the desire to encourage shareholders to bring bona fide corporate suits and the desire to allow corporations to rid themselves of detrimental litigation was recognized by the Supreme Court of Delaware in *Zapata Corp. v. Maldonado*. In 1974, a shareholder, William Maldonado, brought a derivative suit against Zapata Corporation's directors. He alleged that the directors had breached their fiduciary duty to the shareholders by

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144. In determining the committee's independence, the court did not take into account subtle pressure that might be exerted by the board and the defendant directors on the members of the committee. For instance, the court's test did not factor in influences stemming from professional associations between directors, as well as family and social affiliations. For a discussion of the potential for bias in a special litigation committee, see Dent, *supra* note 4, at 124-28.

145. The court did not explore the possibility that the committee was given only nominal authority to make a decision regarding the shareholder suit, and that, in reality, the committee was charged merely with providing the justifications for termination. *See* Dent, *supra* note 4, at 124-28.

146. *Gall* seems to be the first federal decision involving the use of the special litigation committee to insulate the decision to dismiss a derivative suit under the business judgment rule. For federal decisions permitting the use of these committees, see *supra* cases cited at note 10.

147. *See supra* note 10. Most of the decisions have been those of federal courts interpreting the substantive corporate law of the state of incorporation. In *Burks v. Lasker*, 441 U.S. 471 (1979), the Supreme Court ruled that the doctrine of business judgment termination of suits is a matter of state law unless a federal policy would be frustrated by the imposition of a business judgment not to sue. Commentators have indicated that *Burks* removes "any barriers to an expansive recognition" of the rule's protection for the decision to terminate. *Coffee & Schwartz, supra* note 2, at 263.


accelerating the date for the exercise of stock options.\textsuperscript{151} Four years later, Zapata's board of directors appointed a special litigation committee, comprised of two new directors, to investigate the suit and to recommend its termination or maintenance.\textsuperscript{152} The committee concluded that the suit was not in the corporation's best interests,\textsuperscript{153} but the Delaware Court of Chancery denied Zapata's motion to dismiss Maldonado's complaint.\textsuperscript{154} The court concluded that when directors refuse to bring suit for breach of fiduciary duty, the shareholder possesses an "independent right to redress the wrong."\textsuperscript{155}

On appeal,\textsuperscript{156} the Delaware Supreme Court refused to adopt this reasoning.\textsuperscript{157} It determined that, under the business judgment rule, an independent right to initiate an action exists only if the refusal of the board to maintain the suit is wrongful.\textsuperscript{158} The court, however, rejected the argument that this limitation accommodated both the desire to encourage the initiation of shareholder derivative suits and the need to discourage frivolous litigation.\textsuperscript{159}

Although the court acknowledged the logic of extending protection under the rule to a special litigation committee's decision, it opposed strict adherence to the rule because of the peculiar risks inherent in the committee mechanism.\textsuperscript{160} In the court's view, the risks lay in the structural bias of the committee. The court observed that directors on the committee pass judgment on fellow directors to whom they owe their board membership and

\begin{footnotes}
\item[152] Id. at 1255.
\item[153] Id.
\item[154] Id. at 1262.
\item[155] Id. The Chancery Court held that a shareholder, once demand is made and refused, possesses an individual right to maintain a derivative suit for breaches of fiduciary duty over objection by the corporation. Id. at 1262-63. For this interpretation of Delaware law, the court relied on Sohland v. Baker, 141 A. 277 (Del. Sup. 1927), which the Delaware Supreme Court later distinguished from the action in Zapata, 430 A.2d at 782-83.
\item[156] Zapata, 430 A.2d at 779.
\item[157] Id. at 782-83.
\item[158] Id. at 784 & n.10. The court admitted that an individual right to bring suit could exist without a wrongful board refusal if it were the case where demand on the board would be excused as futile. Id. at 784.
\item[159] Id. at 786-87.
\item[160] Id. at 787. The court explained:

We are not satisfied, however, that acceptance of the 'business judgment' rationale at this state of derivative litigation is a proper balancing point. While we admit an analogy with a normal case respecting board judgment, it seems to us that there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the theory of business judgment.

\end{footnotes}
committee position. The danger is that the directors on the committee will sympathize with their accused colleagues and be subconsciously lenient. Mindful of this potential for abuse, the Delaware Supreme Court refused to grant the committee business judgment protection unless the corporation could establish the committee's independence and good faith, and could demonstrate the reasonableness of the committee's investigation.

Three years earlier, the New York Court of Appeals had adopted the same approach. In *Auerbach v. Bennett*, the plaintiff-shareholder had alleged that the board of General Telephone & Electronics Corporation (GTE) had authorized illegal payments to public officials in foreign countries. When a special litigation committee appointed by GTE determined that the derivative suit would not be in the corporation's best interests, the lower court granted GTE's motion for summary judgment on the ground that the business judgment rule protected the committee's decision. The Appellate Division reversed. The court held that before

161. *Id.*
162. *Id.* The court remarked: "The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role." *Id.*
163. *Id.*
164. *Id.* at 788. The court noted that limited discovery may be ordered to facilitate the court's inquiry into the independence of the committee, the reasonable basis for its conclusion and other factors relating to the good faith of the investigative process. *Id.* The court's inquiry into these issues would be the application of the first step of the test announced in *Zapata* in response to the corporation's pretrial summary judgment motion to dismiss the suit. *Id.* at 788 & n.15.
166. *Id.* at 624-25, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. GTE's audit committee, working with Arthur Anderson & Co., filed a report with the SEC disclosing its findings that, during the period from 1971 through 1975, the corporation or its subsidiaries had made payments in and out of the United States. The payments appeared to be bribes and kickbacks of more than $11 million. Several of the individual directors had been involved personally in these payments. *Id.* at 624, 393 N.E.2d at 996-97, 419 N.Y.S.2d at 922-23. The plaintiff-shareholder instituted action against these directors, the corporation and Arthur Anderson. *Id.* at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923.
167. *Id.* at 626, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. The special litigation committee found that "Arthur Anderson had conducted its examination of the corporation's affairs in accordance with generally-accepted auditing standards and in good faith and concluded that no proper interest of the corporation or its shareholders would be served by the continued assertion of a claim against it." *Id.* at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923. Further, the committee concluded that none of the other directors had breached the statutory standard of care and that none had benefitted financially. The committee asserted that continuance of the suit would waste the time and talents of GTE's senior management on extended pretrial and trial proceedings, that the litigation would be unreasonably expensive in light of the small chance for success, and that publicity from the suit could be detrimental to the corporation's business. *Id.* at 625-26, 393 N.E.2d at 997, 419 N.Y.S.2d at 923.
168. *Id.* at 626, 393 N.E.2d at 998, 419 N.Y.S.2d at 924.
169. *Id.* at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
business judgment protection could be afforded to the committee's decision, the court should inquire into the independence of its members\(^\text{171}\) and the appropriateness and sufficiency of the investigative procedures the committee followed.\(^\text{172}\) Strict scrutiny of the procedural aspects of the committee, therefore, was accepted by both the New York and Delaware courts.

The New York and Delaware courts divided, however, on the appropriate judicial treatment to be given the committee's substantive findings. Zapata held that once the court was satisfied that the corporation had established the committee's independence and the investigation's reasonableness, the court should proceed to a second step.\(^\text{173}\) That step would require the court to apply its own business judgment to the committee's findings to determine independently whether or not the suit should proceed.\(^\text{174}\) In Auerbach, however, the court refused to require independent judicial scrutiny of the committee's decision.\(^\text{175}\) It held that the business judgment rule shielded the deliberations and conclusions of the committee's directors from review.\(^\text{176}\)

\(^{170}\) Id.

\(^{171}\) Id. at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927.

\(^{172}\) Id. at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929. The court noted that "those responsible for the procedures by which the business judgment is reached may reasonably be required to show that they have pursued their chosen investigative methods in good faith. What evidentiary proof may be required to this end will . . . depend on the nature of the particular investigation." Id. at 634, 393 N.E.2d at 1002-03, 419 N.Y.S.2d at 929. The committee would be "expected to show that the areas and subjects to be examined are reasonably complete and that there has been a good-faith pursuit of inquiry into such areas and subjects." Id. at 634, 393 N.E.2d at 1003; 419 N.Y.S.2d at 929. The court will not be concerned with what is uncovered nor the relative weight the committee accords what is uncovered in evaluating the derivative suit. Id. The court cautions, however, that proof that "the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or halfhearted as to constitute a pretext or sham" would raise questions of good faith and deny the committee business judgment protection. Id. at 634-35, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929.

\(^{173}\) Zapata, 430 A.2d at 789.

\(^{174}\) Id. The court explained that "[t]he 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 the corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest." Id. The court would have to weigh carefully the corporation's interest in dismissing a nonfrivolous lawsuit. The final judgment to maintain or dismiss the suit would be a balance of many factors—ethical, commercial, and promotional considerations, public relations, employee relations, and fiscal and legal issues. Id. at 788.

\(^{175}\) Auerbach, 47 N.Y.2d at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.

\(^{176}\) Id. at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court noted:

The latter, substantive decision [not to maintain the derivative action] 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 by the special litigation committee is outside the scope of our review.
The court maintained that "judicial probing" of substantive matters would violate the basic principle against judicial interference in business affairs underlying the business judgment rule.\footnote{Id. at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court maintained that courts should not inquire into the reasons for the challenged payments, "the advantages or disadvantages accruing to the corporation by reason of the transactions, the extent of the participation or profit" by the directors and the potential loss of public confidence in the corporation by these occurrences. Id. at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court cautioned: Inquiry into such matters would go to the very core of the business judgment made by the committee. To permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions of the special litigation committee. [The committee's] substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach. Id. at 633-34, 419 N.Y.S.2d at 928.} Thus, New York and Delaware courts agreed on the judicial treatment to be given the procedures followed by a special litigation committee but disagreed on the deference to be afforded its substantive findings.

III. THE ALI CORPORATE GOVERNANCE PROJECT: A MODERN APPROACH TO THE BUSINESS JUDGMENT RULE

The division in the law represented by \textit{Auerbach} and \textit{Zapata} has prompted the American Law Institute (ALI) to propose a set of principles governing the termination of shareholder derivative actions upon the recommendation of a corporation's directors.\footnote{ALI DRAFT, supra note 23, at xviii. The proposed procedures for termination of shareholder derivative actions on the basis of board action are included in § 7.03. These procedures were discussed by members of the ALI on May 18, 19, 20, and 21, 1982. They are expected to be revised.} As part of an attempt to redefine and clarify principles of corporate behavior,\footnote{See supra notes 22-23 and accompanying text.} ALI has enunciated standards for judicial review of special litigation committee decisions to dismiss shareholder suits.\footnote{Id. § 7.03 commentary, at 306-07. The ALI proposal stipulates that the guidelines included in § 7.03 apply only to actions brought by a shareholder against a corporate fiduciary, such as a director or officer. Id. at 304-05. The proposal maintains that equitable limitations on the power of a corporation to terminate an action commenced in its name are warranted in these situations. Id. at 303. This is because of the "potential conflict of interest and the possibility that those in control of the corporation might seek to justify dismissal based on self-serving reasons." Id. at 303-04. The proposal indicates that a decision to terminate a derivative action against a third party or a low-level corporate employee presents little potential for} By providing specific criteria for assessing the independence of these committees, the adequacy of their investigation, and their reasons for dismissal, the ALI proposal seeks to end confusion about what is "good corporate practice."\footnote{Id. § 7.03, at 295-303.}
In its recommendations, the ALI draft excludes from its definition of independent directors those directors named as defendants in the shareholder's suit,\textsuperscript{182} and directors having a significant relationship with the corporation's senior management.\textsuperscript{183} Such disqualification is intended to reduce the likelihood of partiality where the alleged wrongdoers elected the body that ultimately evaluated their conduct.\textsuperscript{184} It also reflects the position that those directors with economic or professional relationships with the corporation's senior executives will be unable to scrutinize management's performance objectively.\textsuperscript{185} In addition, the disqualification reduces the appearance of bias that might result in the absence of actual bias.\textsuperscript{186}

Special litigation committees chosen by qualified directors must consist of at least three members.\textsuperscript{187} This requirement is designed to "foster a collegial sense within the committee and better enable it to resist covert pressures or influence to which one or two individuals might easily succumb."\textsuperscript{188} Qualified directors also must appoint special counsel to coordinate and advise the committees' investigations.\textsuperscript{189} Attorneys who already have been consulted regarding some aspect of the transaction in question, or who have family or

\textsuperscript{1985}
other relationships with the management of the corporation, are disqualified from serving in this position.\textsuperscript{190}

The ALI draft contemplates that the committees will take testimony from relevant parties and preserve a transcribed record of such oral evidence.\textsuperscript{191} They should take affidavits or sworn depositions in cases where the truthfulness of individuals is in question.\textsuperscript{192} The draft suggests that special litigation committees should have "unrestricted access" to corporate records, memoranda, files, correspondence, and employees who are asked to be witnesses.\textsuperscript{193}

In addition, the ALI proposal anticipates that various components of the corporation, such as the auditing branch or the general counsel's office, conduct "parallel and contemporaneous investigations."\textsuperscript{194} These groups may share information with special litigation committees, but they may not shape or predetermine the committees' conclusions.\textsuperscript{195} To this end, committee deliberations must be conducted in private, and drafts of reports must be kept confidential.\textsuperscript{196}

The ALI proposal also sets standards for the special litigation committee report.\textsuperscript{197} The report must include "more than conclusory statements that the action is injurious to the corporation."\textsuperscript{198} It may not rely on other well-known, generalized rationales for maintaining that the suit would be detrimental to the corporation.\textsuperscript{199} The report "must provide a corroborated justification of the specific reasons" supporting the conclusion that continuation of the action would be harmful to the corporation's best interests.\textsuperscript{200} Most importantly, the report must quantify any harm resulting to the corporation.\textsuperscript{201} However, balancing the harm to the corporation against the merits of the action must be left to the court.\textsuperscript{202}
The ALI proposal for judicial review of the report requires courts to determine, initially, whether the committee's procedures evidence the committee's thoroughness and impartiality in its review of the challenged transaction. Courts are required to place special emphasis on "whether the committee interviewed relevant witnesses and took their statements, received expert appraisals on questions of valuation, and was adequately informed by counsel." Under certain circumstances, the ALI draft instructs courts not to accept the special litigation committee's decision to dismiss the shareholder derivative action. This is advised in a situation in which the challenged transaction involved self-dealing by persons having control over the corporation. Control relationships arise through the ownership of a requisite percentage of the corporation's stock. They also can arise through a "longstanding pattern of abdication" by directors who made the dismissal decision in favor of those directors against whom the suit was brought. In such cases, courts are instructed to allow the suit to proceed.

With respect to the substance of the committee's report, the ALI draft requires courts to adopt the Zapata approach. Courts are asked to consider whether the business reasons offered in the committee's report as justification for dismissal of the suit warrant the same conclusion by the courts. Courts will evaluate these reasons on a de novo basis, even if they appear sound and substantial. Courts are advised to obtain corroboration against the merits of the action," but that "the primary importance of the committee's report" is to identify and quantify the harm the suit will cause the corporation. Id. § 7.03 commentary, at 326. This section provides that the court find that the procedures regarding the selection of the committee's members, see supra notes 182-88 and accompanying text, the appointment of special counsel, see supra notes 189-90 and accompanying text, and the gathering of evidence, see supra notes 191-96 and accompanying text, were "substantially complied with, or [that] other procedures were justified under the circumstances and did not pose a material risk of compromising the independence or adequacy of the committee's deliberations and determination." Id. § 7.03(c)(i) at 299.

203. Id. § 7.03 commentary, at 326.
204. Id. § 7.03 commentary, at 326.
205. Id. § 7.03 commentary, at 326. According to the ALI draft, a person who holds the power to vote 25% or more of the corporation's outstanding stock is in control of the corporation. Id. § 1.04(2), at 2.
206. Id. § 7.03 commentary, at 326. Persons who exercise a controlling influence over the management or policies of the corporation through intermediary persons also are in control of the corporation. Id. § 1.04(1), at 2.
207. Id. § 7.03 commentary, at 326.
208. Id. § 7.03 commentary, at 326.
209. Id. § 7.03 commentary, at 327. See supra notes 173-74 and accompanying text.
210. Id. § 7.03 commentary, at 327-29.
211. See id. at 325-28.
of the predicted harm to the corporation from maintaining the suit.\textsuperscript{212} Courts are admonished to reject boilerplate justifications, such as the cost of the litigation or the likelihood of adverse publicity arising from the lawsuit. These are reasons that can be invoked in almost any case.\textsuperscript{213} Ultimately, courts are asked to judge the merits of the shareholder suit and balance them against the harm alleged by the committee's report.\textsuperscript{214} Courts, in the last analysis, must exercise their own judgment on the reasons provided for dismissal, even though the committee has complied perfectly with the procedural requirements.\textsuperscript{215}

In an effort to clarify and uphold principles of good corporate governance, the ALI project has narrowed the application of the business judgment rule. Under the draft proposals, directors must meet certain qualifications, follow certain procedures, and reach legitimate conclusions before the rule's protection will be afforded their decision to dismiss a shareholder suit. Courts are provided with criteria for evaluating both the procedural and substantive sides of this decision. By specifying the situations in which the rule will apply, the ALI draft attempts to modify its operation.

IV. \textit{HASAN v. CLEVE TRUST REALTY INVESTORS: STRICT PROCEDURAL REVIEW OF THE SPECIAL LITIGATION COMMITTEE}

In \textit{Hasan v. CleveTrust Realty Investors},\textsuperscript{216} the United States Court of Appeals for the Sixth Circuit confronted the issue of proper judicial treatment of a special litigation committee under the business judgment rule.\textsuperscript{217} \textit{Hasan} concerned a shareholder derivative action commenced on behalf of CleveTrust Realty Investors.\textsuperscript{218} The suit arose after CleveTrust's stock prices declined to the point that they were less than the appraised value of the stocks' investment properties, and the company invited takeover.\textsuperscript{219} Two aggressor companies\textsuperscript{220} each acquired 22.4\% of CleveTrust's outstanding stock and

\begin{itemize}
  \item \textsuperscript{212} \textit{Id.} at 329.
  \item \textsuperscript{213} \textit{Id.} at 328-29. The ALI draft maintains that the problem is not whether courts will overrule the special litigation committee's judgment "too capriciously, but whether they will defer to it too faithfully." Historically, the judiciary has accepted "general and vaguely phrased" reasons for terminating a suit. These reasons have included the unfavorable prospects of the litigation, its costs, and adverse publicity to the corporation. \textit{Id.} at 328.
  \item \textsuperscript{214} \textit{Id.} \S 7.03(c)(ii) at 299, \S 7.03 commentary, at 328.
  \item \textsuperscript{215} \textit{Id.} \S 7.03 commentary, at 307. The ALI draft comments further that "a corporate board is not an administrative agency, and the relaxed 'substantial evidence' standard of review of administrative law is not appropriate in derivative litigation." \textit{Id.} at 329.
  \item \textsuperscript{216} 729 F.2d 372 (6th Cir. 1984).
  \item \textsuperscript{217} \textit{Id.} at 375.
  \item \textsuperscript{218} \textit{Id.} at 373.
  \item \textsuperscript{219} \textit{Id.}
  \item \textsuperscript{220} \textit{Id.} See supra note 26.
\end{itemize}
sought to purchase a controlling block of shares. \footnote{Id.} Because CleveTrust’s directors would be forced to forfeit their positions in the event of a take-over, \footnote{Id.} the CleveTrust directors offered to sell 30% of the company’s outstanding shares of stock at two-thirds of its appraised value to a pension fund. \footnote{Id.} In exchange for the stock, the pension fund agreed to support CleveTrust’s present management, to refrain from selling the stock for five years, and to give the directors the first option to repurchase the entire block of CleveTrust stock. \footnote{Id.}

Shareholder Hasan brought a derivative action alleging that, through these transactions, the directors wasted CleveTrust’s assets in order to protect their own management positions. \footnote{Id.} He named all but one CleveTrust board member in his suit. \footnote{Id.} The only nondefendant board member was Peter Galvin, who had been appointed to the board after the challenged transactions had occurred. \footnote{Id.} The directors appointed a special committee, consisting only of Galvin, to investigate the challenged transactions and to recommend whether the suit should be maintained. \footnote{Id.}

In the course of conducting its investigation, the “special litigation committee” retained counsel and interviewed witnesses including the defendant directors. \footnote{Id.} The committee’s report stated that Galvin, as a real estate broker, was a 25% owner of a firm that had received fees from a company managed by the chairman of CleveTrust’s board. \footnote{Id.} It also revealed that Galvin had a 2% interest in an investment firm with another defendant who owned a 10% interest. \footnote{Id.} Galvin asserted, however, that his business affiliations with these defendants did not impair his ability to conduct an impartial investigation or to make appropriate recommendations. \footnote{Id.} In the committee
report, Galvin discounted Hasan’s allegations and found that the shareholder’s action was not in the corporation’s best interests.233 The United States District Court for the Northern District of Ohio granted the corporation’s motion for summary judgment.234 The court found that Galvin’s report was dispositive because Massachusetts law235 would afford the committee’s decision protection under the business judgment rule absent a showing of bad faith.236 Because the presumption of good faith was not rebutted by any affirmative evidence introduced by Hasan, the court upheld Galvin’s decision to terminate the suit.237

Reviewing the district court’s summary judgment order, the United States Court of Appeals for the Sixth Circuit held that the district court erred in presuming Galvin’s good faith.238 The court noted that the Zapata239 and Auerbach240 decisions supported its refusal to grant Galvin a good faith presumption on the procedural issues.241 As the court reasoned, neither the Delaware nor the New York approaches allowed the judiciary to presume that members of the committee were disinterested in the matters they were charged to consider.242 Moreover, in neither jurisdiction did the courts presume that the committee members were independent from their fellow board members, or that the investigation they conducted was impartial and thorough.243 The court explained that Delaware and New York courts have recognized that a committee handpicked by the members’ colleagues on the board is infused with “structural biases” that militate against an independent investigation and impartial recommendations concerning the misconduct of the members’ peers.244 Suspicious of a collegial bond between directors,245 both jurisdictions placed upon the corporation the burden of proving the

233. Id.
234. Id. The district court granted summary judgment and dismissed the complaint without prejudice. The court considered summary judgment proper because the relevant facts of the case “were not in dispute.” Id. That finding was based on the legal conclusion that a presumption of good faith attaches to the report and recommendations of the special litigation committee. Id. The appeals court rejected this conclusion. See infra notes 238-53 and accompanying text.
235. See supra note 35 and accompanying text.
236. Hasan, 729 F.2d at 374.
237. Id.
238. Id. at 377.
239. See supra notes 150-64 and accompanying text.
240. See supra notes 165-72 and accompanying text.
242. Id.
243. Id. See also supra notes 150-72 and accompanying text.
244. Hasan, 729 F.2d at 376-77. See also supra notes 160-63 and accompanying text.
245. Hasan, 729 F.2d at 378. The court refers to this bond among directors as “corporate collegiality.” Id.
committee's disinterestedness and thoroughness before business judgment protection for its decision could be invoked.\textsuperscript{246}

Based on the convergence of opinion between New York and Delaware on procedural issues, the \textit{Hasan} court required CleveTrust to demonstrate that Galvin was an independent decisionmaker who had conducted a complete investigation and had come to an unbiased conclusion to terminate the derivative action.\textsuperscript{247} According to the court, the corporation failed to make such an affirmative showing.\textsuperscript{248} Moreover, even if CleveTrust had offered evidence of the committee's impartiality, such evidence would have been insufficient to convince the court of the structural independence of the committee and the procedural adequacy of the investigation.\textsuperscript{249} As the court explained, Galvin's prior affiliations with the chairman of the CleveTrust board and another defendant, their continuing business associations, and Galvin's position as sole member of the litigation committee, precluded a showing of independence.\textsuperscript{250} In addition, Galvin had failed to interview representatives from the two aggressor companies that had acquired CleveTrust stock during the challenged transactions.\textsuperscript{251} The court noted that interviews with these representatives would have shed light on the CleveTrust directors' purpose for authorizing the challenged transactions, and whether such a purpose included any selfish motivation on their part.\textsuperscript{252} Because the decision to forego Hasan's suit was made by a committee structurally dependent on the board and procedurally infirm, the court refused to afford it business judgment protection.\textsuperscript{253}

V. \textit{Hasan}: Moderate Reform of the Business Judgment Rule

In its review of the independence and investigation of CleveTrust's special litigation committee, the \textit{Hasan} court employed the business judgment rule's traditional standards. The court's analysis consisted of the test enunciated in the early expressions of the rule.\textsuperscript{254} First, the court focused on factors

\textsuperscript{246} \textit{Id.} See also supra notes 150-72.

\textsuperscript{247} \textit{Hasan}, 729 F.2d at 378.

\textsuperscript{248} \textit{Id.} at 378-79.

\textsuperscript{249} \textit{Id.} at 380.

\textsuperscript{250} \textit{Id.} at 379. The court maintained that the burden of overcoming the evidence concerning Galvin's associations with the defendants, see supra notes 230-31 and accompanying text, and his failure to interview key witnesses, see infra notes 251-52 and accompanying text, was too great for the corporation to overcome. 729 F.2d at 380.

\textsuperscript{251} \textit{Hasan}, 729 F.2d at 379.

\textsuperscript{252} \textit{Id.}

\textsuperscript{253} \textit{Id.} at 379-80. The \textit{Hasan} court never decided if it would follow the Zapata approach on substantive issues and subject Galvin's reasons for dismissal to its own judgment because it rejected Galvin's report based on procedural issues.

\textsuperscript{254} See supra notes 57-86 and accompanying text.
that compromised Galvin’s objectivity.\textsuperscript{255} It determined that his prior business associations created conflicts between his personal motivations and the best interests of the corporation.\textsuperscript{256} In short, the court tested Galvin’s duty of loyalty and concluded that it had not been observed.\textsuperscript{257} Second, the court tested Galvin’s duty of care.\textsuperscript{258} It reviewed his investigation to determine if he had made a reasonably informed decision to terminate the shareholder’s suit.\textsuperscript{259} It found that his failure to conduct necessary interviews fell below the standard of knowledge that directors must attain before deliberation.\textsuperscript{260} Because of his failure to gather all relevant information, the court determined that Galvin breached his duty of care.\textsuperscript{261} Thus, the court’s decision to withhold business judgment protection from Galvin’s report was based on traditional standards of directoral conduct.\textsuperscript{262}

The \textit{Hasan} court departed from tradition, however, by placing the burden on the corporation to prove independence and a reasonable investigation.\textsuperscript{263}

\begin{itemize}
  \item \textsuperscript{255} See supra notes 247-50 and accompanying text. These factors included the bias inherent in special litigation committees, see supra note 244 and accompanying text, and the existence of only one member on the committee charged with making the termination decision, see supra note 244 and accompanying text.
  \item \textsuperscript{256} \textit{Hasan}, 729 F.2d at 379. See supra note 250 and accompanying text.
  \item \textsuperscript{257} See \textit{Hasan}, 729 F.2d at 379.
  \item \textsuperscript{258} The duty of care requires directors to make reasonable inquiry into the circumstances surrounding a transaction before exercising their business judgment and generally to monitor corporate activities. This duty was articulated in \textit{Francis}, 87 N.J. at 71-72, 432 A.2d at 821-22. In that case, a director was held liable for not detecting the embezzlement of corporate funds by her sons. See supra notes 59-74 and accompanying text.
  \item \textsuperscript{259} See \textit{Hasan}, 729 F.2d at 379.
  \item \textsuperscript{260} See supra notes 59-74 and accompanying text. By not obtaining statements from representatives of the companies threatening CleveTrust with takeover, Galvin failed to obtain the basic information an ordinarily prudent person would obtain in handling his own business affairs.
  \item \textsuperscript{261} The court asserted that Galvin’s failure to obtain relevant testimony deprived Galvin’s decision of its objectivity and meaningfulness. According to the court, Galvin’s investigation fell below the standard maintained in \textit{Auerbach}, 47 N.Y.2d at 634, 393 N.E.2d at 1003, 419 N.Y.S.2d at 930. In \textit{Auerbach}, the committee engaged special counsel, examined the prior work of an audit committee, took testimony from all relevant parties, and reviewed information gathered by the SEC. \textit{Hasan}, 729 F.2d at 379. In a case decided after \textit{Hasan}, the Delaware Supreme Court upheld the directoral duty of care as a prerequisite for business judgment protection. The court found that directors of Trans Union Corporation breached this duty when they agreed to sell the firm to Marmon Corporation in 1980. The court ruled that the directors had acted hastily without sufficient information. They had voted on the merger after only an oral presentation. They had had no prior knowledge of the proposal and had not been provided with a written summary of the merger’s terms or any documentation of the proposed price. Smith v. Van Gorkom, No. 255, slip op. at 3 (Del. Jan. 29, 1985).
  \item \textsuperscript{262} See supra notes 57-86 and accompanying text.
  \item \textsuperscript{263} Under the traditional business judgment rule, the plaintiff-shareholder had to show wrongdoing or self-interest before the court would review directoral decisionmaking. See supra notes 3, 89-109 and accompanying text.
\end{itemize}
By shifting the burden, the court modified the practice of earlier courts, which have presumed that directors make decisions in the corporation's best interests unless the plaintiff-shareholder proves other motivations. This modification of traditional interpretations of the business judgment rule was a prudent step for the *Hasan* court to take. Inherent structural biases in special litigation committees render such a presumption unreasonable. Thus, a realistic approach to the business judgment rule requires courts to refuse to take committees' objectivity and thoroughness for granted. The *Hasan* court demonstrated this modern interpretation of the rule.

By shifting the burden to the corporation, *Hasan* lowered the threshold for judicial review. Traditionally, courts have not examined corporate decisions unless the plaintiff could show fraud, gross negligence, or self-interest. As demonstrated in *Gall*, special litigation committees escaped judicial scrutiny by refraining from participation in the alleged wrongdoing. In the absence of culpability, they enjoyed insulation from court review. By shifting the burden, the *Hasan* court rejected the high culpability standard that has served as a barrier to judicial inquiry. Because corporations must provide affirmative evidence of independence and of a reasonable investigation, such scrutiny will occur even if no wrongdoing exists. In dismissing shareholder suits, special litigation committees will be required to account to the court, if only on procedural issues.

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264. See supra note 3 and accompanying text.
265. For a discussion of the bias that is inherent in the structure of the special litigation committee, see supra notes 160-63 and accompanying text.
266. The court in *Hasan* asserted: "We do conclude . . . that the policies of the business judgment rule do not create a presumption in favor of the good faith of a special committee and that the realities of corporate life militate against any such presumption." *Hasan*, 729 F.2d at 377.
267. See supra notes 89-109 and accompanying text.
269. In *Gall*, the plaintiff-shareholder was unable to prove that the special litigation committee had been in collusion with the defendants or was involved in the challenged foreign payments. Because he could not prove the culpability required to rebut the corporation's presumption of good faith, the court dismissed the complaint. See supra notes 129-49 and accompanying text. The special litigation committee employed in *Gall* served as a formalized method by which corporations could defeat shareholder derivative actions. See supra note 128 and accompanying text.
270. See supra notes 136-39 and accompanying text.
271. Under the traditional business judgment rule, neither directors' decisions nor their decisionmaking process was reviewed by courts unless the plaintiff-shareholder proved gross negligence, fraud, or self-interest. See supra notes 89-109 and accompanying text.
272. Because of the presumption of good faith directors enjoyed, courts would investigate the disinterestedness and reasonableness of directors decisions only if the plaintiff-shareholder introduced affirmative evidence of directors' self-interest or serious wrongdoing. Thus, the lower court in *Hasan* granted the corporation's motion for summary judgment because no such evidence had been presented. The appeals court required the corporation to establish the
the burden, Hasan modifies the business judgment rule and chips away at
the insulation it has afforded special litigation committees.\textsuperscript{273}

The policy of procedural review with the burden of proof shifted to the
 corporation serves as a moderate proposal for reform of the business judgment
 rule. First, the policy respects the rule's prohibition against judicial
 intrusion into the business sector that was accepted by the early courts.\textsuperscript{274}
 By limiting the court's review to committees' independence and investiga-
 tions, it confines the court's role to evaluations of impartiality and factfind-
 ing, which are appropriate subjects for judicial consideration.\textsuperscript{275}  
 Second, by
 so limiting the court's role, procedural review avoids the tendency of other
 reform proposals\textsuperscript{276} to thrust the courts into matters of pure business judg-
 ment.\textsuperscript{277}  Unlike Zapata's policy of substantive review and the ALI guide-
 lines for administering it,\textsuperscript{278} the Hasan approach does not require courts, on
 a \textit{de novo} basis, to judge the soundness of special litigation committees' deci-
 sions to terminate suits.\textsuperscript{279} Courts are not charged with the onerous task of
 balancing the merits of the derivative action with the harm the litigation
 would cause to corporate resources and management.\textsuperscript{280} Third, procedural
 review does not stifle boardroom risk-taking. Courts will not pass on the
 prudence of committee decisions for shareholders, and directors will not be

committee's independence and good faith investigation, even though no evidence to the con-
 trary was submitted by the plaintiff. See supra notes 234-53 and accompanying text.

\textsuperscript{273} As a limitation on the rule's broad protections, the Hasan approach takes its place
 among other attempts to find a middle ground between frivolous shareholder derivative actions
 and unchecked corporate power to defeat shareholder suits. See supra notes 20, 150-77 and
 accompanying text. The Delaware Supreme Court has articulated the need for this middle
 ground: "It thus appears desirable to us to find a balancing point where bona fide stockholder
 power to bring corporate causes of action cannot be unfairly trampled on by the board of
 directors, but the corporation can rid itself of detrimental litigation." Zapata, 430 A.2d at 787.

\textsuperscript{274} See supra notes 52-56 and accompanying text.

\textsuperscript{275} Hasan, 729 F.2d at 376. The court asserted that the courts are particularly well-suited
 to evaluate these issues:
 As to the methodologies and procedures best suited to the conduct of an investiga-
 tion of facts and the determination of legal liability, the courts are well-equipped by
 long and continuing experience and practice to make determinations. In fact they
 are better qualified in this regard than are corporate directors in general.
 Id. (quoting Auerbach, 47 N.Y.2d at 634, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929).

\textsuperscript{276} See supra notes 20, 209-15 and accompanying text.

\textsuperscript{277} Auerbach, 47 N.Y.2d at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929. The New
 York Court of Appeals noted that evaluations of a committee's makeup and investigative pro-
 cess do not "partake of the nuances or special perceptions or comprehensions of business judg-
 ment or corporate activities or interests. The question is solely how appropriately to set about
 to gather pertinent data." Id.

\textsuperscript{278} See supra notes 173-77, 209-15 and accompanying text.

\textsuperscript{279} See supra notes 209-15 and accompanying text.

\textsuperscript{280} See supra notes 210-15 and accompanying text.
exposed to the increased risk of liability.\textsuperscript{281} Risk-taking and its importance to business enterprise was part of the rule's early rationale and continues to be recognized as necessary to corporate aggressiveness and competition.\textsuperscript{282}

In addition, through the recommendations of the ALI Corporate Governance Project, courts confronted with special litigation committee decisions would be provided with a framework for applying the policy of procedural review.\textsuperscript{283} Had the \textit{Hasan} court been provided with the ALI criteria for identifying independent directors\textsuperscript{284} and a thorough investigation,\textsuperscript{285} it would have employed clear standards for determining the degree of deference to afford CleveTrust's special litigation committee. The court's inquiry into Galvin's independence could have terminated with a finding that Galvin had violated the ALI guidelines requiring at least three persons to serve on the special litigation committee\textsuperscript{286} and requiring that none of the members of the committee have a significant relationship with the corporation's senior management.\textsuperscript{287} These violations would have presented conclusive evidence that extension of business judgment protection to Galvin's decision was improper. Had these violations not existed, however, and had Galvin passed the ALI independence test, the question of judicial deference could have been resolved without subjective evaluations. The reasonableness of Galvin's investigation, and the degree of judicial respect to which his findings were entitled, could have been measured by determining how closely Galvin's procedures resembled the ALI model for a thorough investigation.\textsuperscript{288} Using the ALI checklist, the court's review of Galvin's committee could have been imbued with a modicum of objectivity and certainty. Moreover, CleveTrust would have been presented with clear guidelines on how to satisfy its burden of proving Galvin's independence and reasonable investiga-

\begin{footnotesize}
\textsuperscript{281} See supra notes 1-2 and accompanying text.
\textsuperscript{282} Underlying the rule was the recognition of the need for directors to take risks and make mistakes for which they should not be held legally accountable, in the absence of wrongdoing. See supra notes 43-51 and accompanying text. The Business Roundtable, an association of leading business executives, has criticized substantive review of directorial business decisions as proposed by the ALI draft. The Roundtable asserts that the ALI regulations would inhibit risk-taking and make it harder for companies to attract and keep directors who feared liability for their decisions. Also, the Roundtable argued that substantive review will force companies "to maintain elaborate audit and paper trails" to justify their decisions to the courts. According to the group, management will be forced into defensive postures rather than into aggressive competition. ALI Project Will Increase Litigation, \textit{Daily Rep. for Exec.} (BNA) No. 213, at A-4 (Nov. 2, 1984).
\textsuperscript{283} See supra notes 178-208 and accompanying text.
\textsuperscript{284} See supra notes 182-86 and accompanying text.
\textsuperscript{285} See supra notes 191-202 and accompanying text.
\textsuperscript{286} See supra notes 187-88 and accompanying text.
\textsuperscript{287} See supra notes 183-86 and accompanying text.
\textsuperscript{288} See supra notes 191-96 and accompanying text.
\end{footnotesize}
tion, being forewarned that compliance with these criteria would be necessary to pass judicial muster.\textsuperscript{289} Equipped with the ALI proposals, courts confronted with special litigation committee decisions in the future would be able to administer the \textit{Hasan} policy with facility, and corporations would be able more readily to predict the parameters of judicial review.\textsuperscript{290}

\textbf{VI. CONCLUSION}

\textit{Hasan} is one response to calls for reform of the business judgment rule and its exploitation by special litigation committees seeking to defeat shareholder derivative actions. Subjecting these committees to close scrutiny, \textit{Hasan} conditions judicial deference to termination decisions upon compliance with certain standards. These standards incorporate the directoral duties of loyalty and care and are manifested in the committee's independence and investigation. The termination decision is afforded protection under the rule only when the corporation proves the existence of these procedural qualities.

As a limitation on the business judgment rule, \textit{Hasan}'s policy of strict procedural review provides courts with a moderate measure of reform. It does not advocate a solution to the problems of the rule by involving the courts in substantive business affairs. In contrast to other proposals, it avoids repudiation of the rule in the midst of controversy over its continued viability. Moreover, procedural review lends itself to the development of objective standards for application by the courts. Equipped with the ALI guidelines, the \textit{Hasan} policy provides courts with a workable approach to the treatment of special litigation committees and their decisions to terminate shareholder suits.

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\textsuperscript{289} Corporations can structure their special litigation committee and its investigation in conformance with judicial expectations of good corporate practice. \textit{See supra} notes 178-81 and accompanying text.

\textsuperscript{290} A framework for judicial treatment of special litigation committees will be helpful to courts in litigation arising from increased merger and takeover activity. \textit{See supra} note 18 and accompanying text.