

Judicial Review of Shareholder Derivative Suits: Directors' Diminishing Control of Corporate Litigation

I. INTRODUCTION

When the two top officers of Financial Corporation of America resigned under pressure during a severe liquidity crisis at the company,¹ they were reportedly paid severance settlements totalling \$3,000,000. One month later, a shareholder filed a derivative lawsuit² seeking the return of the money to the corporation and alleging that the payments were a waste of corporate assets.³ The defendants undoubtedly will raise the business judgment rule⁴ as a defense by arguing that the decision to make the payments was a good faith business decision and consequently not subject to judicial review.

This case is typical of the increasing use of the shareholder derivative suit as a means for shareholders to make the officers and directors of a corporation accountable for misconduct in the management of corporate affairs. The business judgment rule traditionally has protected corporate directors from liability when business decisions have been made in good faith and in the absence of any breach of the directors' fiduciary duty to the corporation.⁵ However, recent court decisions have eroded the protections of the business judgment rule as a defense in derivative litigation.⁶ On one side of the controversy are those who believe that the increased use of derivative suits and the corresponding decline of the business judgment rule represent a long overdue check on management activities such as those reported in the Financial Corporation of America case. Others argue that the increased accountability of directors paralyzes boards of directors by making them unwilling to take legitimate risks in managing the corporation for fear of being held personally liable for the consequences.⁷

¹*Financial Corp. of America is Sued Over Severance Outlay*, Wall St. J., Sept. 28, 1984, at 2, col. 4.

²See *infra* text accompanying notes 18-38.

³Wall St. J., Sept. 28, 1984, at 2, col. 4.

⁴See *infra* text accompanying notes 54-64.

⁵*United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Briggs v. Spaulding*, 141 U.S. 132 (1891).

⁶*E.g.*, *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795 (E.D. Va. 1982); *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311 (S.D. Iowa 1981); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). Many cases have upheld the business judgment rule. *E.g.*, *Gaines v. Haughton*, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

⁷See *Business-Judgment Rule Draws Criticism As More Firms Take Anti-Takeover Steps*, Wall St. J., Aug. 10, 1984, at 21, col. 4.

Several articles⁸ have discussed the business judgment rule, derivative actions, and the demand requirement.⁹ This area of law received considerable attention after the landmark decision in *Zapata Corp. v. Maldonado*¹⁰ created a higher level of judicial scrutiny of motions to dismiss excused demand derivative suits.¹¹ Nevertheless, an assessment of recent developments is appropriate, particularly after a recent Delaware decision which elaborates on the *Zapata* ruling and defines the limits of the demand requirement.¹²

This Note will analyze recent developments in two aspects of shareholder derivative suits: the demand requirement and corporations' motions to dismiss these suits. This Note will provide an overview of the shareholder derivative suit,¹³ the development of the special litigation committee,¹⁴ and the business judgment rule.¹⁵ Additionally, the methods used by courts to evaluate the demand requirement and dismissal motions will be examined.¹⁶ The conclusion will suggest a standard for evaluating both the demand issue and dismissal motions that promotes the interests of the shareholders while preserving the essence of the business judgment rule.¹⁷

II. BACKGROUND

A. Shareholder Derivative Actions

Shareholders may initiate a suit to enforce a right that the corporation could have asserted directly but has failed to pursue.¹⁸ The derivative

⁸Block, Prussin & Wachtel, *Dismissal of Derivative Actions Under the Business Judgment Rule: Zapata One Year Later*, 38 BUS. LAW. 401 (1983); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW.U.L. REV. 96 (1980); Stellingwerf, *Involuntary Dismissals of Shareholder's Derivative Suits*, 10 SEC. REG. L.J. 246 (1982); Note, *The Business Judgment Rule and the Litigation Committee: The End of a Clear Trend in Corporate Law*, 14 IND. L. REV. 617 (1981); Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168 (1976); Comment, *Limits On The Power of Directors To Terminate Shareholder Litigation: The Revival of The Derivative Suit*, 50 U. CIN. L. REV. 786 (1981); Comment, *Zapata Corp. v. Maldonado: Restricting the Power of Special Litigation Committees to Terminate Derivative Suits*, 68 VA. L. REV. 1197 (1982); Comment, *Directors' Business Judgment In Terminating Derivative Suits Subject To Judicial Review*, 59 WASH. U.L.Q. 1425 (1982).

⁹A shareholder, before filing a derivative action, must make a demand on the board of directors that the board pursue the claim on behalf of the corporation. See *infra* text accompanying notes 25-33.

¹⁰430 A.2d 779 (Del. 1981).

¹¹See *infra* text accompanying notes 27-29.

¹²Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

¹³See *infra* notes 18-38 and accompanying text.

¹⁴See *infra* notes 39-53 and accompanying text.

¹⁵See *infra* notes 54-64 and accompanying text.

¹⁶See *infra* notes 65-196 and accompanying text.

¹⁷See *infra* notes 202-211 and accompanying text.

¹⁸8 FEDERAL PROCEDURAL FORMS § 22:5 (L. Ed. 1976). The complaint must contain specific allegations, including the basis for the claims, the status of the shareholder at

action is a procedural device under which the substantive right of action arises from state law.¹⁹ The plaintiff shareholder is a nominal plaintiff; the real party in interest is the corporation.²⁰ Typical defendants include other shareholders, directors and officers of the corporation, and third parties from whom relief is sought.²¹ The corporation, as a necessary and indispensable party, is also joined as a defendant.²²

In a derivative suit, the complaint should allege that the transaction was beyond the board's authority, that the action was fraudulent and resulted in severe detriment to the corporation, or that a majority of shareholders was illegally acting in the name of the corporation in violation of the rights of the other shareholders.²³ A derivative suit alleges a breach of duty to the corporation and seeks to compel the directors to pursue the claim for the benefit of the corporation. As such, the derivative suit is distinct from an individual shareholder's action against the corporation for a breach of the shareholder's membership contract with the corporation.²⁴

Before filing a derivative action, the shareholder must make a demand on the board to pursue the claim for the benefit of the corporation.²⁵ This procedure gives the corporation the opportunity to enforce the claim or remedy the alleged wrongdoing on its own and to avoid the involvement of the courts.²⁶ The demand may be excused if the complaining shareholder can demonstrate that demand would be futile²⁷ because of the directors' adverse interests or their participation in the alleged wrong-

the time of the questioned action, the efforts made by the plaintiffs to obtain the desired action from the directors, the reasons for the failure to obtain that action or the reasons why no demand was made, and the adequacy of the plaintiff's representation of the interests of the shareholders. *Id.* § 22:14. The plaintiff must fairly and adequately represent the interests of shareholders similarly situated, although the defendant bears the burden of proving inadequate representation. *Id.* § 22:7.

Before a derivative action may be dismissed or compromised, the parties must obtain approval from the court. *Id.* § 22:12. The shareholders must receive notice of the proposed compromise or dismissal. *Id.* If there is no fraud or collusion, a settlement of a derivative action has the res judicata effect of a final judgment. *Id.*

¹⁹*Id.* § 22:13.

²⁰*Id.* § 22:9.

²¹18 C.J.S. CORPORATIONS § 570 (1939).

²²*Id.*

²³*Hawes v. Oakland*, 104 U.S. 450, 460 (1881).

²⁴H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 360, at 755-61 (2d ed. 1970). The membership contract refers to the rights and duties that define the shareholder's relationship with the corporation. Examples of actions for breach of a membership contract include compelling payment of dividends and enforcing the right to examine the corporate books. *Id.* at 757.

²⁵FED. R. CIV. P. 23.1 provides in part: "[T]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff, to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort."

²⁶Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 171 (1976).

²⁷FED. R. CIV. P. 23.1.

doing.²⁸ The shareholder has the burden of showing why demand would be pointless and must allege these facts with particularity.²⁹ The court addresses the demand issue when the corporation, in response to the plaintiff shareholder's complaint, moves for dismissal for failure to make the requisite demand on the board of directors.³⁰

The board may refuse a demand to pursue a claim if it determines that pursuit of the action would not be in the corporation's best interests.³¹ In this way the directors can dispose of strike suits, meritless litigation, or even valid claims that would cost the corporation more to pursue than could be recovered.³²

After the refusal of a demand or if a demand is excused, the shareholder may file the derivative suit. The board of directors then decides whether or not to pursue the claim and assume control of the litigation. If it is determined that continuing the litigation would not be in the corporation's best interests, the directors will move for dismissal.³³

A collateral issue in shareholder derivative suits concerns the choice of law in a particular case. Many derivative actions are brought in federal courts because the claims arise under federal securities law. The United States Supreme Court has ruled that state law will govern the disposition of a derivative suit even if the cause of action is based on a federal statute.³⁴ If state law permits disinterested directors to terminate a suit, the court must inquire whether such state law is consistent with the policies inherent in the federal statutes.³⁵ Likewise, state law controls in diversity suits in federal courts.³⁶ Because of the prevalence of Delaware incorporation, Delaware law governs many of these derivative actions.³⁷

²⁸*Stepak v. Dean*, 434 A.2d 388, 390 (Del. Ch. 1981) (citing *Sohland v. Baker*, 15 Del. Ch. 431, 141 A. 277, 281-82 (1927)). See also *Rogers v. Lafayette Agricultural Works*, 52 Ind. 296 (1875); *Cole Real Estate Corp. v. Peoples Bank & Trust Co.*, 160 Ind. App. 88, 310 N.E.2d 275 (1974); *Marcovich v. O'Brien*, 63 Ind. App. 101, 114 N.E. 100 (1916).

²⁹*Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), cert. denied, 414 U.S. 857 (1973).

³⁰18 C.J.S CORPORATIONS § 575 (1939).

³¹*Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), cert. denied, 439 U.S. 1129 (1979).

³²*Id.*

³³*Abbey v. Control Data Corp.*, 603 F.2d 724, 730 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980). See also *Gaines v. Haughton*, 645 F.2d 761, 772 (9th Cir.), cert. denied, 454 U.S. 1145 (1981); *Lewis v. Anderson*, 615 F.2d 778, 782 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980).

³⁴*Burks v. Lasker*, 441 U.S. 471, 478-79 (1979).

³⁵*Id.* at 479.

³⁶*Swanson v. Traer*, 354 U.S. 114, 116 (1957).

³⁷Cases in many jurisdictions have been governed by Delaware law. *E.g.*, *Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983); *Abramowitz v. Posner*, 672 F.2d 1025 (2d Cir. 1982); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980); *Mills v. Esmark, Inc.*, 573 F. Supp. 169 (N.D. Ill. 1983); *In re Continental Illinois Securities Litigation*, 572 F. Supp. 928 (N.D. Ill. 1983); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y.

Delaware law is also quite influential in those cases where another state's law applies when that state's law is relatively undeveloped in the area.³⁸

B. *The Special Litigation Committee*

When members of the board of directors are implicated in a challenged activity or named as defendants in a suit, the board may appoint a special litigation committee (SLC) and grant it the authority to investigate the allegations and decide whether or not to continue the litigation.³⁹ A tainted board may delegate its authority over the litigation to a committee of disinterested directors.⁴⁰ Usually the SLC consists of outside directors appointed to the board since the alleged wrongdoing.⁴¹ The SLC typically hires outside legal counsel to conduct an investigation of the claims.⁴² The SLC then produces a report of its findings and recommends whether or not to pursue the litigation.⁴³

The board of directors frequently delegates to the SLC the power to move for dismissal of the action if the committee determines that the proposed suit is not in the corporation's best interests.⁴⁴ Among the

1980).

The Delaware state courts have heard many of the important cases in this area of law. *E.g.*, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *Abbey v. Computer & Communications Technology Corp.*, 457 A.2d 368 (Del. Ch. 1983); *Bergstein v. Texas Int'l, Co.*, 453 A.2d 467 (Del. Ch. 1982); *Stepak v. Dean*, 434 A.2d 388 (Del. Ch. 1981); *Sohland v. Baker*, 15 Del. Ch. 431, 141 A. 277 (1927).

³⁸*E.g.*, *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372 (6th Cir. 1984) (Massachusetts law); *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983) (Connecticut law); *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982) (California law); *Watts v. Des Moines Register and Tribune*, 525 F. Supp. 1311 (S.D. Iowa 1981) (Iowa law).

³⁹*Lewis v. Anderson*, 615 F.2d 778, 782-83 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981).

⁴⁰430 A.2d at 786.

⁴¹*E.g.*, *Gaines v. Haughton*, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); *Mills v. Esmark, Inc.*, 91 F.R.D. 70 (N.D. Ill. 1981); *Zapata Corp. v. Maldonado*, 430 A.2d at 781.

⁴²*E.g.*, *Gaines v. Haughton*, 645 F.2d 761, 768-69 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 71-72 (N.D. Ill. 1981).

⁴³A typical special litigation committee (SLC) report contains an extensive factual review of the allegations, includes witness interviews, and an examination of corporate records. The report evaluates the merits of the claims and the probable costs and benefits of continuing the litigation. *See generally* *Gaines v. Haughton*, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); *Mills v. Esmark, Inc.*, 573 F. Supp. 169 (N.D. Ill. 1983).

⁴⁴*See, e.g.*, *Gaines v. Haughton*, 645 F.2d 761, 770-71 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); *Abbey v. Control Data Corp.*, 603 F.2d 724, 730 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Zapata Corp. v. Maldonado*, 430 A.2d at 785. *But see* *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372 (6th Cir. 1984); *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983) (SLC in both cases recommended that the board move for dismissal).

reasons given for not pursuing a claim are that such a suit would not be in the shareholders' best interests,⁴⁵ that the claim is not in the corporation's best interests,⁴⁶ that "legal action against the defendants could significantly impair their ability to manage corporate affairs,"⁴⁷ that pursuit of the claims would have an adverse effect on morale and impose heavy costs on the corporation,⁴⁸ and that there was little chance of success on the merits.⁴⁹ Occasionally, the SLC will decide to proceed with the shareholder's claims.⁵⁰

Finally, the court decides whether or not to grant the motion to dismiss after examining the good faith and autonomy of the SLC and the thoroughness of its investigation.⁵¹ In the past, the business judgment rule precluded the courts from reviewing the merits of a decision reached by an independent board or SLC.⁵² Nonetheless, recent developments in the law have eroded this rule.⁵³

C. *The Business Judgment Rule*

The business judgment rule developed as a means of limiting the liability of a corporation's officers and directors for mistakes made while performing their corporate responsibilities. As early as 1855, directors were not held accountable unless guilty of misconduct amounting to a breach of trust or fraud on the corporation,⁵⁴ but members of the board of directors were expected to exercise the standard of care of ordinary,

⁴⁵Gaines v. Haughton, 645 F.2d 761, 768 (9th Cir.), cert. denied, 454 U.S. 1145 (1981).

⁴⁶Zapata Corp. v. Maldonado, 430 A.2d at 781.

⁴⁷Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979).

⁴⁸Mills v. Esmark, Inc., 573 F. Supp. 169, 172 n.2 (N.D. Ill. 1983).

⁴⁹Joy v. North, 692 F.2d 880, 884 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983); Mills v. Esmark, Inc., 573 F. Supp. 169, 172 n.2 (N.D. Ill. 1983).

⁵⁰Seafirst Corporation appointed an SLC to investigate shareholders' claims stemming from losses incurred in the company's energy loan portfolio. After an investigation, the SLC decided to pursue the litigation against some former officers and the corporation's outside auditors after finding that there were "viable claims." *BankAmerica's Seafirst Unit to Pursue Claims Against Former Head, Audit Firm*, Wall St. J., Aug. 21, 1984, at 4, col. 2.

⁵¹E.g., Gaines v. Haughton, 645 F.2d 761, 772 (9th Cir.), cert. denied, 454 U.S. 1145 (1981); Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 623-24, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979). As these cases demonstrate, courts consider an SLC independent if its members were appointed to the board after the alleged wrongdoing occurred and if the SLC members do not have business or personal connections with the implicated directors. See also Hasan v. CleveTrust Realty Investors, 729 F.2d 372 (6th Cir. 1984).

⁵²United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724, 729 (8th Cir. 1979); Auerbach v. Bennett, 47 N.Y.2d 619, 623, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979).

⁵³See *infra* text accompanying notes 137-196.

⁵⁴Briggs v. Spaulding, 141 U.S. 132, 149 (1890); Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855).

prudent, and diligent men.⁵⁵ In 1917, Justice Brandeis explained the scope of the business judgment rule: "Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, where they stand in a dual relation which prevents an unprejudiced exercise of judgment"⁵⁶ Therefore, absent serious wrongdoing, the directors could operate without fear of personal liability.

The justifications for the rule include the need for corporations to attract qualified individuals as directors and the desire to promote judicial and business economy.⁵⁷ If directors were subjected to personal liability for mistakes of judgment or for the ordinary fluctuations of business conditions, corporations would be unable to retain competent directors. The rule promotes judicial economy by giving corporations the latitude to settle most disputes without court involvement. Business economy is likewise promoted because most business decisions and disputes are handled expeditiously by internal corporate mechanisms, such as voting unsatisfactory directors out of office and exerting pressure on the directors through shareholder meetings and proxy votes. Furthermore, the rule defers to the directors' expertise at managing a business enterprise.⁵⁸

Courts still adhere to the idea of the business judgment rule.⁵⁹ A recent Delaware decision characterized the rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."⁶⁰ The decision of a board of directors will not be disturbed if the court can find a rational business purpose behind the action.⁶¹ Anyone challenging the presumption that directors have used their best business judgment has the burden of production of evidence to the contrary.⁶²

Application of the business judgment rule occurs frequently in derivative suits in which shareholders challenge the corporation's business

⁵⁵Briggs v. Spaulding, 141 U.S. 132, 152 (1890).

⁵⁶United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917).

⁵⁷Comment, *Limits On The Power of Directors To Terminate Shareholder Litigation: The Revival of The Derivative Suit*, 50 U. CIN. L. REV. 786, 787-88 (1981).

⁵⁸Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981).

⁵⁹E.g., Gaines v. Haughton, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

⁶⁰Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).

⁶¹Whittaker Corp. v. Edgar, 535 F. Supp. 933, 950 (N.D. Ill. 1982) (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

⁶²Panter v. Marshall Field & Co., 646 F.2d 271, 296 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

decisions.⁶³ However, where the corporate charter has delegated the authority to manage the corporation to directors, the shareholders have no right to challenge the board's judgment absent a showing of bad faith.⁶⁴ In other words, shareholders may not sue their directors merely because of a disagreement over the management of the company; there must be a showing of actual wrongdoing or a breach of trust in order to initiate litigation.

III. THE DEMAND REQUIREMENT: A LOWER THRESHOLD FOR INITIATING LITIGATION

A. Background

A shareholder seeking to institute a derivative action must first make a demand on the corporation. This demand is an essential preliminary step in any derivative action. If the complainant fails to demand that the corporation enforce the claim or fails to prove that demand would be futile, the court will dismiss the suit.⁶⁵ The criteria courts use to ascertain whether or not demand should be excused have become increasingly important after the *Zapata Corp. v. Maldonado*⁶⁶ ruling which introduced a higher degree of judicial scrutiny of dismissal motions made by a special litigation committee in demand excused cases.⁶⁷

The demand requirement originated as a means to avoid abuses of shareholder derivative suits and to prevent court intervention in the dispute until all intracorporate remedies have been exhausted.⁶⁸ Deference to the directors' decision allows prompt termination of meritless suits and elimination of unnecessary litigation expenses.⁶⁹ The demand requirement also affords corporations a procedure for disposing of suits brought to harass the company or to extract a favorable settlement for the named plaintiff or his attorney rather than to correct wrongs to the

⁶³In contrast to its application in derivative suits, the business judgment rule is criticized when used as a defense to charges of securities law violations during hostile takeover battles. In this instance, the Securities and Exchange Commission (SEC) or investors may sue the corporation on their own behalves. The drastic defenses used by corporations against these takeover attempts often incite allegations that the officers and directors were acting to further their own interests rather than to promote the best interests of the corporation. There has been a growing concern in both Congress and the courts that the business judgment defense should be used in takeover situations only when the directors were acting objectively and fairly on behalf of the corporation. See *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984); H.R. REP. No. 1028, 98th Cong., 2d Sess. 14-15 (1984).

⁶⁴*Dodge v. Woolsey*, 59 U.S. (18 How.) 331, 341 (1855).

⁶⁵FED. R. CIV. P. 23.1.

⁶⁶430 A.2d 779 (Del. 1981).

⁶⁷See *infra* text accompanying notes 136-46.

⁶⁸Comment, *supra* note 26, at 168-71.

⁶⁹*Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

corporation.⁷⁰ Moreover, where litigation is appropriate, the corporation is frequently in a better position to bring the suit because of its familiarity with the activity at issue and its greater financial resources.⁷¹

In many of the early cases in which the demand requirement was discussed, the primary rationale for excusing demand was that the procedure would be futile. The First Circuit Court of Appeals in *In re Kauffman Mutual Fund Actions*⁷² concluded that there must be specific allegations that the board was under the control and domination of the wrongdoers.⁷³ The fact that the named defendants were directors who participated in the challenged transaction was not sufficient to excuse demand.⁷⁴ This ruling created a substantial burden for plaintiffs seeking to prove that demand was unavailing.

In contrast, the Seventh Circuit Court of Appeals in *Nussbacher v. Continental Illinois National Bank & Trust Co.*,⁷⁵ in a situation similar to that in *Kauffman*, found that where the majority of outside directors approved of or participated in the alleged misconduct, demand would be excused.⁷⁶ Examination of allegations of futility focused on the extent to which members of the board of directors were implicated in the purported misconduct. If the complaint showed a genuine conflict of interest between the board's corporate responsibilities and board members' potential personal liability for wrongdoing, the demand requirement was waived.⁷⁷

Other cases illustrate how courts have analyzed the particular facts of the case and balanced concerns over conflicts of interest and domination of the board by the defendants against the right of the corporation to control the litigation. In *Cramer v. General Telephone & Electronics Corp.*,⁷⁸ the court, declining to excuse demand, decided that although four of the fourteen individuals on the board were defendants, there was no evidence that the remaining directors were involved in the allegedly fraudulent activity or under the control of the defendants.⁷⁹ Conversely, the fact that the complaint concerned a long course of conduct involving decisions made by the entire board, all but one of whom were named as defendants, persuaded the court in *Zilker v. Klein*⁸⁰ to excuse demand.

⁷⁰*Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

⁷¹*Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983).

⁷²479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

⁷³479 F.2d at 264.

⁷⁴*Id.*

⁷⁵518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976).

⁷⁶518 F.2d at 879.

⁷⁷Comment, *supra* note 26, at 174-75.

⁷⁸582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

⁷⁹582 F.2d at 276-77.

⁸⁰510 F. Supp. 1070 (N.D. Ill. 1981).

B. *Recent Trends—Increasing Judicial Scrutiny
of the Demand Requirement*

After the landmark *Zapata* decision in 1981,⁸¹ courts began to place greater emphasis on the demand requirement and the standards used for ascertaining whether or not demand was futile. In *Lewis v. Graves*,⁸² all of the directors were named in a derivative action alleging various violations of securities laws in connection with J. Ray McDermott & Co.'s acquisition of the Babcock and Wilcox Company and the issuance of McDermott stock to certain McDermott officers and directors. No demand was made prior to the filing of the complaint. The complaint maintained that demand was futile because all of the directors had "knowingly participated, assisted, aided and abetted in the wrongful acts."⁸³ The court reasoned that demand is futile when the directors are antagonistic or involved in the disputed transactions but upheld the district court's determination that, absent specific charges of bias or of self-dealing by the majority of the directors, demand was required.⁸⁴ Lacking sufficiently specific charges, the *Graves* court refused to excuse demand:

The fact that a corporation's directors have previously approved transactions subsequently challenged in a derivative suit does not inevitably lead to the conclusion that those directors, bound by their fiduciary obligations to the corporation, will refuse to take up the suit. . . . Rule 23.1 would be substantially diluted if prior board approval standing alone established futility. . . . Excusing demand on the mere basis of prior board acquiescence, therefore, would obviate the need for demand in practically every case.⁸⁵

The *Graves* court also expressed the concern that by merely naming all the directors as defendants the plaintiffs could circumvent the demand requirement.⁸⁶ The conclusion here represents a continuation of the relatively strict standard for excusing demand espoused by the *Kauffman* case.

Another group of cases illustrates the evaluation of the futility of demand by focusing on the percentage of the board that is implicated by the charges.⁸⁷ In *Abramowitz v. Posner*,⁸⁸ the Second Circuit Court of Appeals, applying Delaware law, decided that demand was not

⁸¹See *infra* text accompanying notes 137-47.

⁸²701 F.2d 245 (2d Cir. 1983).

⁸³*Id.* at 247 (quoting the complaint).

⁸⁴*Id.* at 248.

⁸⁵*Id.* (citation omitted). *Accord* *Kaster v. Modification Sys., Inc.*, 1983 FED. SEC. L. REP. (CCH) ¶ 99,184 (S.D.N.Y. April 26, 1983).

⁸⁶701 F.2d at 249.

⁸⁷See *Abramowitz v. Posner*, 672 F.2d 1025 (2d Cir. 1982); *Lewis v. Curtis*, 671 F.2d 779 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); *Vanderbilt v. Geo-Energy Ltd.*, 590 F. Supp. 999 (E.D. Pa. 1984); *Abbey v. Computer & Communications Technology Corp.*, 457 A.2d 368 (Del. Ch. 1983).

⁸⁸672 F.2d 1025, 1033 (2d Cir. 1982).

necessarily futile when five of the seventeen directors were named as defendants and those five had cooperated in a related SEC investigation. Furthermore, there was no evidence that a litigation committee's investigation into the charges was not conducted fairly and independently.⁸⁹

Conversely, courts have decided that demand was futile if a majority of the board was involved in the disputed activity.⁹⁰ These decisions tend to probe the realities of the particular situation to determine whether or not demand would be a meaningless formality. If a demand on the board of directors is unlikely to produce any action to enforce the corporation's claim, the requirement will be waived.⁹¹ For instance, where the claims involved self-dealing in the corporation's assets among the corporation's board and its two parent corporations and where the majority of the directors were also officers or board members of those parent companies, the court concluded that requiring demand would accomplish nothing except to delay the plaintiff shareholder's suit.⁹²

A recent Delaware case, *Abbey v. Computer & Communications Technology Corp.*,⁹³ illustrates this pragmatic approach to the demand requirement. The plaintiff shareholder filed the derivative suit shortly after making a demand on the directors. The board appointed a special litigation committee to investigate the charges. In ruling on the demand issue, the court held that the aggrieved shareholder must give the board a reasonable opportunity to respond to the demand before claiming that the demand was unavailing.⁹⁴ However, the court further declared that the board of directors, by appointing a litigation committee with binding authority to decide whether or not to pursue the action, had, in effect, admitted that the shareholder was justified in initiating the suit without demand.⁹⁵ By deciding to appoint a litigation committee to investigate the claims, the board conceded that it was not qualified to pursue the claims for the corporation.⁹⁶ Therefore, the shareholder could reasonably be excused from making a demand.⁹⁷ This case not only illustrates judicial willingness to excuse demand, but also demonstrates the unpredictable effects of any corporate response to a derivative suit. By appointing a

⁸⁹*Id.* at 1034.

⁹⁰*Lewis v. Curtis*, 671 F.2d 779, 784 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); *Vanderbilt v. Geo-Energy Ltd.*, 590 F. Supp. 999 (E.D. Pa. 1984); *Bergstein v. Texas Int'l Corp.*, 453 A.2d 467, 470-71 (Del. Ch. 1982) (citing *Dann v. Chrysler Corp.*, 174 A.2d 696 (Del. Ch. 1961)). *See also* *Stepak v. Dean*, 434 A.2d 388 (Del. Ch. 1981) (where a majority of directors were not named in the suit, demand was not excused on the theory directors would be asked to sue themselves).

⁹¹*Lewis v. Curtis*, 671 F.2d 779, 786 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982).

⁹²*Vanderbilt v. Geo-Energy Ltd.*, 590 F. Supp. 999 (E.D. Pa. 1984).

⁹³457 A.2d 368 (Del. Ch. 1983).

⁹⁴*Id.* at 371. *See also* *Smachlo v. Birkelo*, 576 F. Supp. 1439 (D. Del. 1983) (Plaintiff must make a serious demand that the corporation pursue the claim and allow a reasonable time for response before filing suit.).

⁹⁵457 A.2d 368, 372-73.

⁹⁶*Id.*

⁹⁷*Id.*

litigation committee in an attempt to frame an appropriate response to the demand, the board found itself, in effect, admitting that the shareholder was justified in omitting the demand.

A federal district court in Illinois provided another rationale for excusing demand. In *Mills v. Esmark, Inc.*,⁹⁸ the plaintiffs made a demand on the board but filed suit before the directors responded. The court dismissed the complaint and held that a dissident shareholder must make a sincere effort to obtain cooperation from the corporation before filing suit.⁹⁹ Through a litigation committee, the directors then proceeded to investigate the claims and concluded that continuation of the action was not in the corporation's best interests. The plaintiffs meanwhile filed an amended complaint which reasserted old claims and added new ones.¹⁰⁰ The court at that point excused demand because the directors had expressed their opposition to the litigation after the first investigation, even though there was no intimation that the board had acted in bad faith.¹⁰¹ Because another demand would only prolong the dispute, the court excused demand as a waste of time.¹⁰²

This fact-dependent approach enables courts to excuse demand more readily than under the rule that requires specific allegations of wrongdoing by the board. Furthermore, by excusing demand more frequently, these courts have been able to apply the closer degree of scrutiny to motions to dismiss derivative suits that the *Zapata* decision permits for demand excused cases.¹⁰³

C. Aronson v. Lewis - Delaware's Guidelines For Excusing Demand

These developments, while permitting courts to exercise their own discretion in enforcing the demand requirement, establish no guidelines either for the parties to the litigation or for the courts to follow in determining whether or not demand is superfluous.¹⁰⁴ The Delaware Supreme Court recently issued an opinion creating a test for assessing the futility of requiring demand.¹⁰⁵ In this case, the court accepted an interlocutory appeal from the Court of Chancery's ruling that excused demand and denied the defendant's dismissal motion. The lower court had found that the plaintiff's allegations raised a reasonable inference

⁹⁸91 F.R.D. 70 (N.D. Ill. 1981).

⁹⁹*Id.* at 73.

¹⁰⁰*Mills v. Esmark, Inc.*, 573 F. Supp. 169, 172 (N.D. Ill. 1983).

¹⁰¹*Id.* at 172 (citing *Mills v. Esmark, Inc.*, 544 F. Supp. 1275 (N.D. Ill. 1982)).

¹⁰²*Mills v. Esmark, Inc.*, 573 F. Supp. 169, 172 (N.D. Ill. 1983).

¹⁰³*E.g.*, *Lewis v. Curtis*, 671 F.2d 779 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); *Mills v. Esmark, Inc.*, 573 F. Supp. 169 (N.D. Ill. 1983); *Abbey v. Computer & Communications Corp.*, 457 A.2d 368 (Del. Ch. 1983).

¹⁰⁴*See Bergstein v. Texas Int'l Corp.*, 453 A.2d 467, 470 (Del. Ch. 1982) (discussing the fact that the Delaware Supreme Court had not offered any guidelines for evaluating the demand requirement).

¹⁰⁵*Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

that the directors' actions were not protected by the business judgment rule.¹⁰⁶ The dispute arose over an employment agreement with a director who owned forty-seven percent of the corporation's stock. The complaint alleged that the agreement had no valid business purpose and was a waste of corporate assets. In addition, the complaint maintained that demand was futile because all of the directors were named as defendants and that each had participated in the misconduct. The complaint also alleged that the defendant director dominated and controlled the board, and the directors would have to sue themselves if they assumed control of the action.¹⁰⁷

In overruling the Court of Chancery's decision, the high court formulated a two-part analysis to determine whether or not to waive demand.¹⁰⁸ The court decided that the allegations on which the trial court based its decision to excuse demand were conclusory. Drawing inferences from these allegations had the effect of eviscerating the demand requirement.¹⁰⁹ Instead, the supreme court proposed a different approach to determine demand futility:

[T]he Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof.¹¹⁰

In the first step of the inquiry, regarding the directors' objectivity and independence, the court reviews the factual background of the charges to see if there is a reasonable doubt that the directors are entitled to the protections of the business judgment rule.¹¹¹ However, it requires more than the threat of personal liability to challenge successfully the directors' independence and good faith;¹¹² there must be specific factual allegations of domination and control of the board by the wrongdoers.¹¹³ If the directors fail to pass this first step, demand is excused.

At the second level of inquiry, the court scrutinizes the substantive nature of the transaction in question against the factual background alleged by the plaintiff. While the court does not assume that the transaction is wrongful, the plaintiff need only allege facts which, if

¹⁰⁶Lewis v. Aronson, 466 A.2d 375, 381 (Del. Ch. 1983), *rev'd*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

¹⁰⁷Aronson v. Lewis, 473 A.2d 805, 808-09 (Del. 1984).

¹⁰⁸*Id.* at 814.

¹⁰⁹*Id.*

¹¹⁰*Id.*

¹¹¹*Id.*

¹¹²*Id.* at 815.

¹¹³*Id.* at 816.

true, raise a reasonable doubt that the challenged transaction resulted from a legitimate exercise of business judgment.¹¹⁴ If such a question is raised, the court will excuse demand. In the case before it, the court rejected the plaintiff's arguments that demand was futile and concluded that the plaintiff had failed to allege facts with enough particularity to raise a reasonable doubt concerning the applicability of the business judgment rule.¹¹⁵

The *Aronson* court's test incorporates techniques used previously by courts to analyze the demand procedure and adds a new twist, the application of the business judgment rule to determine the preliminary issue of futility of demand.¹¹⁶ First, the court requires the plaintiff to allege, with particularity, facts concerning the independence of the board and the nature of the challenged transaction. This requirement is analogous to the rule of *In re Kauffman Mutual Fund Actions*.¹¹⁷ However, the *Kauffman* rule concerned the question of directors' capability to perform their duties to the corporation;¹¹⁸ the *Aronson* rule extends this requirement of detailed allegations to the substantive nature of the activity in contention.¹¹⁹ Second, the *Aronson* court considered the entire review of the demand issue to be factual in nature.¹²⁰ This approach is comparable to that taken by the court in *Lewis v. Curtis*,¹²¹ where the decision to excuse demand involved a factual examination of the independence of the board of directors. Significantly, however, the *Aronson* analysis extends beyond the scrutiny of the conduct to the merits of the claim.¹²²

It is the application of the business judgment rule at this point in the litigation that presents a new facet of the demand issue. While it has been asserted that the same standard should be used to excuse demand as is used to allow assertion of the business judgment rule,¹²³ the typical analysis has reserved determination of whether the directors' activities were entitled to deference under the business judgment rule to later stages of the litigation.¹²⁴ Usually, application of the appropriateness of the business judgment rule occurs when the board of directors moves for dismissal of the derivative suit, either after refusal of demand or after review of the allegations in a demand excused situation. However,

¹¹⁴*Id.* at 814-15.

¹¹⁵*Id.* at 818.

¹¹⁶*Id.* at 814.

¹¹⁷479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

¹¹⁸479 F.2d at 263.

¹¹⁹473 A.2d at 814.

¹²⁰*Id.* at 815.

¹²¹671 F.2d 779 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982).

¹²²473 A.2d at 814.

¹²³671 F.2d at 785.

¹²⁴*E.g.*, *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Mills v. Esmark, Inc.*, 573 F. Supp. 169 (N.D. Ill. 1983).

instead of deciding the demand question by analyzing only whether the board is sufficiently independent to make an objective decision whether to pursue the litigation on its own, a court using the *Aronson* test must probe the substance of the claims before deciding this preliminary issue.¹²⁵

Under the *Aronson* test,¹²⁶ a dissident shareholder can obtain a preliminary review of the substance of his claims merely by pleading facts of enough specificity to raise only a reasonable doubt concerning the directors' exercise of valid business judgment.¹²⁷ As the court noted, the reasonable doubt standard places a heavier burden on the plaintiff than does the "reasonable inference" requirement of the trial court.¹²⁸ However, the reasonable doubt standard, which is analogous to the level of proof required of criminal defendants, is not particularly onerous, and any shareholder with a remotely plausible claim should be able to plead sufficient facts to raise a reasonable doubt that the directors were independent and the activity in question was a valid exercise of business judgment.

The Delaware Supreme Court applied the *Aronson* rule in a subsequent decision and declined to excuse demand.¹²⁹ In analyzing the facts contained in the complaint, the court concluded that the allegations were insufficient to raise a reasonable doubt about either the independence of the board or the exercise of business judgment in the challenged actions.¹³⁰ The court emphasized that the plaintiff had the burden of alleging specific facts that demonstrated improper conduct by the board.¹³¹ Along with the requirement that the plaintiff make specific allegations, the reasonable doubt standard was intended to strike a balance between avoiding abuses of the derivative action and compelling a complainant to plead evidence without conducting discovery.¹³² This case was submitted to the supreme court before the *Aronson* decision was announced: but in subsequent proceedings, plaintiff shareholders should have less difficulty framing complaints of sufficient specificity to raise the necessary reasonable doubt.

As a result of these rulings, if the defendants are not permitted to present any evidence to counter the allegations, the plaintiff shareholder will be virtually certain of obtaining a waiver of demand by filing a sufficiently detailed, but possibly self-serving, complaint. On the other hand, if the defendants are allowed to present evidence concerning substantive aspects of the claim, the procedure resembles a trial on the

¹²⁵473 A.2d at 814-15.

¹²⁶See *supra* text accompanying notes 104-22.

¹²⁷473 A.2d at 814.

¹²⁸*Id.*

¹²⁹*Pogostin v. Rice*, 480 A.2d 619 (Del. 1984). See also *Kaufman v. Belmont*, 479 A.2d 282 (Del. Ch. 1984) (application of *Aronson* test led to dismissal).

¹³⁰*Pogostin v. Rice*, 480 A.2d 619, 625-26 (Del. 1984).

¹³¹*Id.* at 627.

¹³²*Id.* at 625.

merits, which is an unnecessarily complex means to ascertain whether the appropriate methods have been used to initiate the suit.

While the *Aronson* court made a commendable attempt to create guidelines for determining demand futility, the probable result will be a further prolonging of derivative litigation. The addition of a court hearing on the substantive aspects of a case to determine if the preliminary procedural demand requirement should be waived unduly complicates a process that is already far from simple. Excusing demand is necessary in certain situations of blatant director misconduct, but analysis of the substantive basis of the complaint is more appropriate after demand has been made and refused and the board moves for dismissal or summary judgment. Consequently, the court may be required to engage in two factual examinations of a derivative suit before trial: one to determine if demand should be excused and another to evaluate the board's motion to dismiss after conducting an investigation of the allegations.

The decision regarding the excuse of demand and the grant of a board's motion to dismiss a derivative suit should be distinguished. The first involves a determination of the independence and good faith of the directors and whether they can be expected to pursue a legitimate shareholder claim on behalf of the corporation. The second involves a determination of whether or not the board or its litigation committee has conducted an honest and fair investigation into the claims and whether the court should grant the motion to dismiss or the motion for summary judgment. While the autonomy and good faith of the directors are crucial aspects of both issues, the more substantive scrutiny of the allegations belongs in the analysis of the second issue, consideration of a motion to dismiss.

IV. DIRECTORS' DECLINING CONTROL OF DECISIONS TO TERMINATE

A. Background

Although the demand requirement and dismissal motions are separate aspects of shareholder derivative actions, they have certain factors in common and are often procedurally intertwined. A court ruling on the demand requirement occurs when the defendants in a derivative suit move for dismissal because of the plaintiff's failure to make a demand before filing the complaint.¹³³ If demand is made and refused or if demand is excused, the directors or the litigation committee may move for dismissal or for summary judgment after an investigation of the

¹³³*E.g.*, *Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983); *Nussbacher v. Continental Illinois Bank & Trust Co.*, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Mills v. Esmark, Inc.*, 91 F.R.D. 70 (N.D. Ill. 1981); *Zilker v. Klein*, 510 F. Supp. 1070 (N.D. Ill. 1981); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

claims and a determination that the suit is not in the corporation's best interests.¹³⁴

When the board or an authorized special litigation committee seeks dismissal of a derivative suit because pursuit of the claims would not be in the corporation's best interests, the court first scrutinizes the board or litigation committee's independence and objectivity and examines the extent and method of the investigation conducted to reach this conclusion. Historically, if the court found that the decision to seek dismissal was reached in good faith, after a thorough investigation of the charges and without domination by those involved in the alleged wrongdoing, the court applied the business judgment rule and deferred to the corporation's determination that dismissal of the suit was appropriate.¹³⁵ Then, in 1981, the Delaware Supreme Court announced that its scrutiny of dismissal motions in demand excused cases would extend beyond the independence and good faith of the directors and would delve into the substance of the allegations by the exercise of the court's own business judgment.¹³⁶

B. *Zapata Corp. v. Maldonado*

In 1981, the Delaware Supreme Court announced the *Zapata Corp. v. Maldonado*¹³⁷ decision which created a new framework of review for dismissal motions in demand excused derivative suits and which had a profound effect on subsequent court rulings on dismissal motions. The *Zapata* litigation originated when a shareholder charged that the Zapata Corporation's directors had breached their fiduciary duties to the corporation by accelerating the exercise date of certain Zapata stock options. The Delaware Supreme Court reversed the Court of Chancery's holding that a shareholder has an independent, absolute right to pursue a derivative

¹³⁴*Hasan v. CleveTrust Realty Investors*, 729 F.2d 372 (6th Cir. 1984); *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *In re Continental Illinois Securities Litigation*, 572 F. Supp. 928 (N.D. Ill. 1983); *Abella v. Universal Leaf Tobacco Co., Inc.*, 546 F. Supp. 795 (E.D. Va. 1982); *Mills v. Esmark, Inc.*, 544 F. Supp. 1275 (N.D. Ill. 1982); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

¹³⁵*Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); *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); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

But see Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980). In *Galef*, a demand required case, the court remarked that if the directors approved or were implicated in the challenged transaction, the business judgment rule would not necessarily apply to a decision regarding the grant of a dismissal motion. Demand was required so that the directors would have an opportunity to pursue the claim, but not to refuse it. *Id.* at 59. The case was remanded for a determination of Ohio state law on the availability of a business judgment summary dismissal. *Id.* at 62.

¹³⁶*Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

¹³⁷*Id.*

claim and that the business judgment rule does not confer power to end a derivative suit on a board of directors.¹³⁸ The higher court ruled that the shareholder's right to pursue an action terminated and that the business judgment rule would apply where demand was required and refused, but that the right to sue existed where demand was excused.¹³⁹ "Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful."¹⁴⁰

It is in the demand excused situation that the *Zapata* court broke new ground. The court found that in that situation, the motion to dismiss should contain a thorough written record of the findings and recommendations and each side should have the opportunity to make a record on the motion.¹⁴¹ The court applied a two-step test to the dismissal motion:

First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under Rule 56 standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.

The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. . . . The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.¹⁴²

¹³⁸*Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

¹³⁹473 A.2d at 784.

¹⁴⁰*Id.* (footnote and citations omitted).

¹⁴¹*Id.* at 788.

¹⁴²*Id.* at 788-89 (footnotes omitted).

In reaching this conclusion, the court emphasized the realities of a demand excused situation. Where circumstances are such that demand on the board would be futile, it is less likely that even an independent committee could be completely objective.¹⁴³ Consequently, the court should try to strike a balance between complete deference to the independent judgment of a litigation committee and total control of the litigation by a plaintiff shareholder.¹⁴⁴

The *Zapata* approach has been viewed as providing a balance between the corporation's desire to dispose of meritless, harmful, or costly suits and the shareholders' legitimate interest in making directors accountable for their wrongful conduct. However, the *Zapata* test gives courts broad discretion to analyze the merits of directors' actions and diminishes the effectiveness of the business judgment rule as a defense in demand excused cases. Under this approach, if an independent board or litigation committee reaches a good faith conclusion that the suit should be terminated, that decision is subject to a substantive review by the court.¹⁴⁵ As a result, the primary effect of the *Zapata* ruling has been a precipitous decline in the application of the business judgment rule in demand excused cases and a correspondingly sharp increase in the courts' exercise of their own business judgments to determine whether or not to grant a motion to dismiss a derivative suit.¹⁴⁶ Most of these subsequent cases have been excused demand situations,¹⁴⁷ where the courts have conducted extensive reviews of the good faith and disinterestedness of the directors as well as the substantive aspects of the decision to terminate the litigation. As a result, the procedure now resembles a trial on the merits rather than a determination that there are sufficient allegations and evidence to have a trial.¹⁴⁸

C. *The Aftermath of Zapata*

The Second Circuit Court of Appeals initially adhered to the distinction between demand required and demand excused cases and followed the *Zapata* ruling. In *Abramowitz v. Posner*,¹⁴⁹ demand was required and the court ruled that, under Delaware law, it must defer to the business judgment of the directors who had acted independently and in good faith. On the same day, the Second Circuit decided *Maldonado*

¹⁴³*Id.* at 787.

¹⁴⁴*Id.* at 788.

¹⁴⁵*Id.* at 788-89.

¹⁴⁶*See, e.g.,* Lewis v. Curtis, 671 F.2d 779 (3d Cir.), cert. denied, 103 S. Ct. 176 (1982); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982); Watts v. Des Moines Register and Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981); Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

¹⁴⁷*See supra* note 146.

¹⁴⁸Kaplan v. Wyatt, No. 6361, slip op. (Del. Ch. June 21, 1983) (criticizes *Zapata* for setting up litigation within litigation and imposing substantial burdens on the trial court hearing a derivative case, while not accelerating the course of the litigation).

¹⁴⁹672 F.2d 1025 (2d Cir. 1982).

v. Flynn,¹⁵⁰ a demand excused case, and again applied the *Zapata* test. Because demand was excused, the court had to exercise its own business judgment in reviewing a motion to dismiss. Subsequent rulings, however, have offered a variety of interpretations of the scope of the *Zapata* test.¹⁵¹

*Joy v. North*¹⁵² demonstrates the extent to which the judiciary has embraced the *Zapata* analysis. A shareholder brought suit on behalf of Citytrust Bancorp, Inc. for breach of trust and fiduciary duties. The defendants were a subsidiary of the corporation and various officers and directors. The charges involved a defaulted loan allegedly in excess of the size permitted by federal law.¹⁵³ Demand was made and refused in 1977. Subsequently, in 1979, the board appointed an independent special litigation committee to investigate the allegations. The committee, after investigation, recommended that the suit be discontinued against twenty-three outside defendants and that a settlement be considered with regard to seven defendants. Following this recommendation, the corporation filed a motion to dismiss the action against the twenty-three outside defendants.¹⁵⁴

The district court granted summary judgment for the defendants and held that the business judgment rule limited judicial examination of the corporation's recommendations to the independence, good faith, and thoroughness of the committee's investigation.¹⁵⁵ The appellate court disagreed and conducted an extensive review of the substance of the allegations before denying dismissal. The court dispensed with the demand requirement by ruling that, even though demand was made and refused, demand would not have been required because the directors were defendants.¹⁵⁶ The appointment of the litigation committee by defendant directors created a conflict of interest which made the business judgment rule inapplicable to the decisions of the board or its litigation committee.¹⁵⁷ The court, applying the *Zapata* test, not only analyzed the committee's autonomy, good faith, and the thoroughness of its investigation but also exercised the court's own business judgment concerning the recommendation to terminate the litigation.¹⁵⁸

¹⁵⁰671 F.2d 729 (2d Cir. 1982). This suit involved the same parties as *Zapata Corp. v. Maldonado*. The appellate court remanded the case to the district court on the basis of the *Zapata* ruling so that the district court could apply its own business judgment.

¹⁵¹*Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); *Mills v. Esmark, Inc.*, 573 F. Supp. 169 (N.D. Ill. 1983); *In re Continental Illinois Securities Litigation*, 572 F. Supp. 928 (N.D. Ill. 1983); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795 (E.D. Va. 1982).

¹⁵²692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

¹⁵³692 F.2d at 882.

¹⁵⁴*Id.* at 883-84.

¹⁵⁵*Id.* at 884.

¹⁵⁶*Id.* at 887-88 & 888 n.7.

¹⁵⁷*Id.* at 888.

¹⁵⁸*Id.* at 891.

The court made an attempt to limit the scope of this rule to those allegations involving economic injury to the corporation as a result of self-dealing, fraud, or mismanagement.¹⁵⁹ However, the limitation was so broad that it encompassed virtually the entire range of claims asserted in derivative actions; derivative suits typically involve allegations of self-dealing, fraud, mismanagement, or waste of corporate assets.¹⁶⁰

This ruling exemplifies the extent to which courts have interceded in the resolution of disputes between shareholders and directors. If the board is implicated in the suit by the allegations in the complaint, the corporation will have little control over the decision to terminate the suit even if a group of independent directors reaches that decision. For example, the *Zapata* court permitted a tainted board of directors to delegate its authority to an autonomous committee.¹⁶¹ Conversely, the *Joy v. North* court maintained that an implicated board could not eliminate its conflict of interest by appointing an independent committee to investigate the charges.¹⁶² This ruling, if widely followed, would essentially eliminate the use of the special litigation committee and thereby restrict the use of the business judgment rule to occasions in which the directors were not the subject of the allegations.¹⁶³

In contrast, in *Abella v. Universal Leaf Tobacco Co., Inc.*,¹⁶⁴ the court, in granting a motion to dismiss, engaged in its own business analysis but less extensively than in *Zapata Corp. v. Maldonado*¹⁶⁵ or *Joy v. North*.¹⁶⁶ There was no discussion of the demand requirement

¹⁵⁹*Id.*

¹⁶⁰*E.g.*, *In re Continental Illinois Securities Litigation*, 732 F.2d 1302 (7th Cir. 1984) (fraud); *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372 (6th Cir. 1984) (self-dealing); *Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983) (securities fraud and self-dealing); *Abramowitz v. Posner*, 672 F.2d 1025 (2d Cir. 1982) (fraud); *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982) (mismanagement and waste of corporate assets); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980) (self-dealing); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) (corporate waste and mismanagement); *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979) (mismanagement, waste of corporate assets, and fraud); *Mills v. Esmark, Inc.*, 573 F. Supp. 169 (N.D. Ill. 1983) (waste of corporate assets); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795 (E.D. Va. 1982) (fraud); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (mismanagement and waste of corporate assets); *Maldonado v. Flynn*, 417 A.2d 378 (Del. Ch. 1980), *rev'd sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (self-dealing).

¹⁶¹*Zapata Corp. v. Maldonado*, 430 A.2d 779, 786-87 (Del. 1981).

¹⁶²692 F.2d at 888.

¹⁶³*Cf. Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983). (court expressing a concern that by naming all the directors as defendants the plaintiff could avoid the demand requirement). *See supra* text accompanying note 86.

¹⁶⁴546 F. Supp. 795 (E.D. Va. 1982).

¹⁶⁵430 A.2d 779 (Del. 1981).

¹⁶⁶692 F.2d 880 (2d Cir. 1982).

before the application of the *Zapata* test.¹⁶⁷ The court reasoned that its exercise of business judgment should not be an invasion of the corporation's own business discretion. Rather, the court would apply its business judgment only to the extent needed to determine whether the suit would fail if continued.¹⁶⁸ By employing this type of scrutiny, the court tried to balance the danger of unwarranted litigation against the risk that the litigation committee would not pursue valid claims.¹⁶⁹

D. Recent Applications of the Zapata Standard

Two cases from the Northern District of Illinois illustrate the variety of approaches courts have taken since *Zapata*. In *Mills v. Esmark, Inc.*,¹⁷⁰ demand was excused for charges added in an amended complaint because the corporation had refused demand on a prior complaint in the same litigation.¹⁷¹ However, because demand had been excused, the court applied the *Zapata* test and examined the substantive allegations of the plaintiffs. After reviewing the merits, the court concluded that the defendants had met the burden of showing the good faith, independence, and thoroughness of the committee's investigation and that the plaintiffs had not demonstrated why deference to the committee's decision would violate the spirit of the business judgment rule.¹⁷²

This substantive review of the allegations in the complaint, while within the scope of the *Zapata* test, served only to complicate the *Mills* litigation. Application of the second step of the *Zapata* test is an option within the court's discretion and need not be applied in every demand excused situation.¹⁷³ In the *Mills* case, neither the court nor the plaintiffs challenged the independence and good faith of the litigation committee's report.¹⁷⁴ The plaintiffs challenged only the committee's recommendation.¹⁷⁵ When demand was excused only because it had already been refused once in the same case and when not even the plaintiff could impugn the good faith and thoroughness of the committee's investigation, a review of the defendant's substantive evaluation of the claims accomplished little. Furthermore, the court proceeded to find that the plaintiffs did not adequately represent the shareholders and remarked that it would

¹⁶⁷Because waiver of the demand requirement is a prerequisite to the application of the *Zapata* test, the court's analysis would have been more persuasive if it had mentioned the resolution of the demand issue. In an earlier ruling on the *Abella* case, the court noted that no demand had been made, but that its absence was not challenged. 495 F. Supp. 713, 717-18 (E.D. Va. 1980).

¹⁶⁸546 F. Supp. at 802.

¹⁶⁹*Id.* at 799.

¹⁷⁰573 F. Supp. 169, 172 (N.D. Ill. 1983).

¹⁷¹*Id.*; see also *supra* text accompanying notes 98-102.

¹⁷²573 F. Supp. at 175.

¹⁷³*Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981).

¹⁷⁴573 F. Supp. at 172-73.

¹⁷⁵*Id.* at 173.

have dismissed the suit even if the committee report had been wrongful.¹⁷⁶ Thus, the court could have dismissed the suit by applying only the first step of the *Zapata* test or by ruling on the representation issue. The application of the second step of the *Zapata* test was superfluous. Although the court ostensibly applied the second step of the *Zapata* test, its decision rested on a determination that Esmark had passed the first step, proving its independence in conducting a complete, unbiased investigation of the allegations. Thus, the *Zapata* test was reduced to a meaningless exercise.

*In re Continental Illinois Securities Litigation*¹⁷⁷ exhibits yet another interpretation of the *Zapata* approach to dismissal motions. The derivative claims arose from the substantial losses Continental Illinois National Bank incurred as a result of its relationship with Penn Square Bank of Oklahoma City.¹⁷⁸ Demand had been properly made and refused and a special litigation committee determined that pursuit of the litigation was not in Continental's best interests. The parties agreed that Delaware law applied and that *Zapata Corp. v. Maldonado*¹⁷⁹ was the controlling case. The parties disagreed over the appropriate level of inquiry the court should use in reviewing the committee's decision.¹⁸⁰ The district court broadly interpreted *Zapata* to apply to demand required cases as well as demand excused cases. Reasoning that the discussion of distinctions between excused demand and required demand was not pertinent to the issue in the *Continental* case, the court said:

The fact that there was no demand in *Zapata*, and that the court regarded the case as one where the demand was excused, is not a significant distinction, because in *Zapata*, as here, the question is what effect is to be given the corporate decision recommended by directors who are not alleged to have participated in the wrongdoing.¹⁸¹

The *Continental* court, relying on a passage in *Zapata*, questioned whether it was appropriate to accept the business judgment of a litigation committee " 'at this stage of derivative litigation.' " ¹⁸² The phrase was interpreted to refer to "the stage of legal development our society has reached."¹⁸³ However, the *Zapata* opinion had proceeded to emphasize that the context was a demand excused case: "We think some tribute must be paid to the fact that the lawsuit was properly initiated. It is not a board refusal case."¹⁸⁴ Even though the *Zapata* decision extended the scope of review of motions to dismiss derivative actions, that opinion,

¹⁷⁶*Id.*

¹⁷⁷572 F. Supp. 928 (N.D. Ill. 1983).

¹⁷⁸Wall St. J., July 11, 1984, at 8, col. 1.

¹⁷⁹430 A.2d 779 (Del. 1981).

¹⁸⁰572 F. Supp. at 929.

¹⁸¹*Id.* at 930.

¹⁸²*Id.* (quoting *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981)).

¹⁸³572 F. Supp. at 930.

¹⁸⁴430 A.2d at 787.

when read as a whole, does not expand this level of scrutiny to demand required situations.

The *Continental* court also interpreted *Zapata* to reject deference to the business judgment of a special litigation committee.¹⁸⁵ Under this interpretation, *Zapata* rejected the conclusions of other courts that the sole issue was the independence, good faith, and thoroughness of the committee's investigation.¹⁸⁶ However, the *Zapata* court was careful to explain that even a tainted board of directors could delegate to a special litigation committee all of the board's power to terminate a derivative suit.¹⁸⁷ The decision to terminate a derivative action where demand has been made would be respected unless it were wrongful.¹⁸⁸ The *Zapata* opinion went on to distinguish the demand excused case before it from the typical demand refused case and applied the two-stage analysis to the dismissal motion.¹⁸⁹ By deciding to apply both levels of the *Zapata* test, the *Continental* court failed to consider *Zapata's* interpretation of Delaware law that a board can delegate full authority to a litigation committee to terminate a derivative suit and that the court should respect a committee's decision to terminate such a suit where demand is made and refused unless the decision was wrongful.

The *Continental* court proceeded to apply the *Zapata* test to the committee's recommendations. The first step was an inquiry into the independence and good faith of the committee and the bases for its conclusions. The affidavit submitted by the committee described the procedures used but failed to disclose the facts revealed by the investigation. Because these facts were not disclosed, the court decided it could not adequately evaluate the committee's investigative procedures, denied the dismissal motion, and ruled that there should be a limited evidentiary hearing at which the defendants would present their case for dismissal.¹⁹⁰ The court intimated that after the defendants presented their evidence, it would decide whether any further discovery was needed by the plaintiffs.¹⁹¹ While this proceeding was intended to address only the issue of the independence of the litigation committee and the thoroughness of its investigation, such an open-ended evidentiary hearing resembles a trial on the merits of the claims.

Moreover, even if the defendants passed the first step of the inquiry, the court observed that it still had the discretion to apply the second step, its own business judgment.¹⁹² Presumably, application of this step would require another evidentiary hearing, further prolonging the pretrial process.

¹⁸⁵572 F. Supp. at 929-30.

¹⁸⁶*Id.* at 930.

¹⁸⁷430 A.2d at 785-86.

¹⁸⁸*Id.* at 785.

¹⁸⁹*Id.* at 787-89.

¹⁹⁰572 F. Supp. at 930-31.

¹⁹¹*Id.*

¹⁹²*Id.*

The *Continental* court's reading of *Zapata* is among the most expansive interpretations of that case and provoked a sharp dissent in an appeal on a collateral issue in the *Continental* litigation.¹⁹³ Circuit Judge Wilbur F. Pell, Jr., argued that the district court had misread *Zapata* and should have confined its review to the committee's independence and objectivity in reaching a good faith business decision not to pursue the action.¹⁹⁴ The judge interpreted *Zapata* to say:

that it was already firmly established in Delaware law that the business judgment prevailed in the demand case but that in the case in which the stockholders proceeded to file a derivative suit without making a demand first on the corporation to take action that a second step resting in the independent discretion of the judiciary was necessary.¹⁹⁵

If the district court had treated the issue as a demand required case, it would, according to Judge Pell, have found that the investigation was properly conducted by an independent committee and would have terminated the suit.¹⁹⁶ To date, the *Continental* district court's broad interpretation of *Zapata* has not been followed elsewhere, but the decision serves as an example of the extent to which an activist court can interject its substantive judgment into the preliminary stages of a shareholder derivative suit.

V. IMPLICATIONS OF THE EXERCISE OF JUDICIAL BUSINESS JUDGMENT

Objections to this weakening of the business judgment rule revolve around the issue of judicial ability to make competent business decisions. As Judge Cardamone stated in his dissent in *Joy v. North*,¹⁹⁷ "It is a truism that judges *really* are not equipped either by training or experience to make business judgments because such judgments are intuitive, geared

¹⁹³*In re Continental Illinois Securities Litigation*, 732 F.2d 1302 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part). The district court had ordered Continental to produce copies of the litigation committee's report for a hearing on the merits of the motion to dismiss. See 572 F. Supp. 928 (N.D. Ill. 1983) and the discussion accompanying *supra* notes 177-192. The order requiring production of the report expressly preserved claims of privilege and work product associated with the report. 732 F.2d at 1305 n.4. However, the report was discussed in court during the hearing on the dismissal motion. *Id.* at 1305-06. After Continental withdrew its motion to terminate claims against certain defendants in order to avoid a further review of the merits, reporters sought access to the committee's report. The district court judge ordered the release of the report to the press and Continental appealed. *Id.* The appellate court affirmed the decision on the issue of the effectiveness of the protective order and declined to consider the district court's interpretation of *Zapata*. Continental had failed to appeal the decision regarding the appropriate standard for ruling on the dismissal motion. *Id.* at 1309 & 1309 n.12.

¹⁹⁴*In re Continental Illinois Securities Litigation*, 732 F.2d 1302, 1320 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part).

¹⁹⁵*Id.* at 1319.

¹⁹⁶*Id.* at 1317.

¹⁹⁷692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

to risk-taking and often reliant on shifting competitive and market criteria."¹⁹⁸ It is difficult for courts to formulate workable criteria for evaluating substantive business decisions which involve a multitude of factors encompassing risk balancing, changing market conditions, and intuition.¹⁹⁹ Determining which of the factors to consider and evaluating the weight to give each factor present serious problems for a court to overcome.

Similarly, judges do not have the training or experience necessary to make sound business judgments.²⁰⁰ Business decisions are entrepreneurial in nature and involve weighing the risks of loss against the potential for profit. Judicial decisions concern the application of legal principles to particular facts. Judicial participation in substantive business decisions leads to greater uncertainty for both the corporation and the aggrieved shareholders; neither side can predict on what basis the court will reach its decision and valuable resources are wasted in prolonged litigation.

These concerns are especially apparent in derivative suits where the factual issues are complex and a business judgment by one unfamiliar with the particular business has a high possibility of error. Thus, the potential benefits of an exercise of judicial business judgment to pretrial rulings on demand excusal and dismissal motions will seldom outweigh the problems that can result from a court's erroneous application of business judgment.

Nevertheless, dissident shareholders in meritorious derivative actions have significant, legitimate concerns. There is a tendency for a board of directors to develop an esprit de corps and a defensive attitude toward those who attack its judgment.²⁰¹ The judicial system can protect shareholders from this tendency by carefully scrutinizing the independence and good faith of the directors or litigation committee. The business judgment rule has consistently applied only to decisions made in good faith; if the directors acted wrongfully, they were not entitled to the rule's protections.

VI. AN ALTERNATIVE TO JUDICIAL BUSINESS JUDGMENT

Emphasis on the objectivity of the directors rather than the merits of the challenged transaction affects judicial decisions about both the

¹⁹⁸692 F.2d 880, 898 (Cardamone, C.J., concurring in part and dissenting in part) (citation omitted).

¹⁹⁹*Id.* (citing *Auerbach v. Bennett*, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979)).

²⁰⁰*See, e.g., In re Continental Illinois Securities Litigation*, 732 F.2d 1302, 1319-20 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part) (Pell questioned the judge's business judgment in reviewing the adequacy of the litigation committee's report. According to Judge Pell, the trial judge had stated that he "knew nothing about Price-Waterhouse other than what I have heard here.").

²⁰¹*Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 377 (6th Cir. 1984) (quoting *Coffee & Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 283 (1981)).

demand requirement and dismissal motions. If circumstances demonstrate that the board or litigation committee has acted in bad faith or has an inherent conflict of interest, demand will be excused as futile. Likewise, if the court perceives that, for any reason, the directors or litigation committee has not made a scrupulous, good faith investigation of the allegations before recommending dismissal, the litigation should not be terminated.

Before the *Zapata* decision and the trend toward increased judicial involvement in derivative suits, courts routinely deferred to the directors' decision to terminate these actions. Courts were reluctant to interfere with the directors' business judgment concerning the derivative claims unless there was a showing that the determination was wrongful. Because derivative suits were brought on behalf of the corporation, not the shareholders as individuals, the corporation, if acting in good faith, was permitted to control the course of the litigation. The corporation was the party most directly concerned with the results of such litigation and, therefore, in the best position to determine whether or not pursuit of the claims would further the corporation's interests.²⁰²

As shareholders became more willing to assert derivative claims, courts began scrutinizing more closely the directors' decisions to terminate these suits. The courts moved from examining the process by which the decision to terminate was reached to evaluating the substance of the decision itself. There was a legitimate concern that the directors be accountable to shareholders and the corporation when their conduct was wrongful or when the directors breached their fiduciary duties to the corporation.

However, holding directors accountable for a decision that is wrong, if based on good faith business judgment, cripples the board's ability to manage the corporation effectively and places the judiciary in the awkward position of ruling on corporate business decisions. This situation does not protect shareholders' interests in having the corporation managed competently and efficiently. Nevertheless, judicial scrutiny of the good faith and independence of the board of directors does further the shareholders' concern that the elected directors act in the best interests of the corporation, not for their own enrichment.

The Federal Rules of Civil Procedure require a demand on the board unless the challenger can show why demand would be futile.²⁰³ The burden of proof should fall on the party seeking to avoid demand to establish that demand would be futile. If the challenger fails to meet this burden, he must make a demand before proceeding with the suit; the plaintiff is not necessarily precluded from seeking a remedy even if the required demand is rejected by the corporation. If the directors refuse the shareholder's demand to pursue the claim, the shareholder can file the derivative suit which will proceed as would any litigation.

²⁰²See *supra* text accompanying notes 54-64.

²⁰³FED. R. CIV. P. 23.1.

Moreover, if the directors agree to assert the corporation's claims directly, the derivative litigation can be avoided entirely.²⁰⁴ Consequently, no benefit accrues from examining the merits of the suit at this preliminary proceeding.

The situation changes after demand is excused or made and subsequently refused. When the corporation moves for dismissal, it has the burden of proving that the litigation should not go to trial. The corporation must demonstrate that it acted independently and in good faith in deciding to terminate the suit.²⁰⁵ The burden on the corporation is more difficult to sustain when demand has previously been excused for futility than when demand has been made and refused. Where there has already been a finding that the directors were prejudiced enough to warrant waiving the demand requirement, any contention that that board or its duly appointed litigation committee has conducted a thorough and unbiased investigation must be viewed with skepticism. However, in both demand required and demand excused cases, if it is determined that a group of truly independent and objective directors based its decision to end the suit on a complete and fair examination of the allegations, a reexamination of the merits by the court accomplishes little except to prolong and complicate the litigation.

To permit judges to apply their own business judgment, especially when demand was not excused because the board or litigation committee was deemed independent and honest, reduces the vitality of the business judgment rule; in few instances will the courts defer to the corporation's business discretion. When demand is excused as futile, there is a compelling reason for the court to be wary of deferring too readily to the corporation's judgment. The concern about the objectivity of the directors may offset the concern about the competence of the court's business judgment. However, if it is determined that demand should not be waived, and that the board or litigation committee is independent and operating in good faith, no additional benefit accrues from another examination of the merits by the court.

VII. CONCLUSION

By exercising judicial business judgment on the merits of a derivative action, courts have attempted to balance the rights of shareholders to seek redress for corporate misconduct against the right of the corporation to conduct its legitimate business freely. The derivative action does provide shareholders a remedy when intracorporate procedures have failed. However, it is inescapable that many derivative suits are of questionable merit, brought for the purpose of obtaining quick settlements

²⁰⁴Kaufman v. Safeguard Scientifics, Inc., 587 F. Supp. 486 (E.D. Pa. 1984).

²⁰⁵Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 377 (6th Cir. 1984); Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982); Abramowitz v. Posner, 672 F.2d 1025, 1031 (2d Cir. 1982); Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

and hefty attorneys' fees.²⁰⁶ The business judgment rule affords directors the opportunity to dispose expeditiously of this meritless litigation.

The Delaware courts have interjected their own business judgment at two stages of the derivative suit. First, to decide whether or not to waive the demand requirement, the court examines the substantive aspect of the challenged transaction to determine if it resulted from the legitimate use of business discretion.²⁰⁷ Second, in demand excused situations, the court again employs its own business judgment to decide if it should grant a motion to dismiss.²⁰⁸ This trend toward application of judicial business judgment has resulted in a corresponding trend away from deference to corporate business judgment.

It has been long established in American law that shareholders have no right to challenge in court the good faith business judgment of the board of directors.²⁰⁹ By purchasing the corporation's stock, shareholders subject themselves to the normal risks of the business world. As the *Aronson v. Lewis*²¹⁰ and *Zapata Corp. v. Maldonado*²¹¹ decisions demonstrate, the courts have, in effect, assumed the right to challenge good faith business decisions in certain shareholder derivative suits. Continuation of this trend toward judicial review of corporate affairs places corporations at the mercy of any disgruntled shareholder who can convince a court the corporation exercised imperfect judgment. Nevertheless, shareholders certainly have a right to seek redress for corporate malfeasance. A stringent review by the courts of the objectivity and independence of the directors and the means used to evaluate the shareholders' claims will protect that right without compromising the corporation's autonomy.

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²⁰⁶*In re Continental Illinois Securities Litigation*, 732 F.2d 1302, 1317 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part); *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); *Mills v. Esmark, Inc.*, 573 F. Supp. 169, 176 (N.D. Ill. 1983).

²⁰⁷*Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

²⁰⁸*Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981).

²⁰⁹*Dodge v. Woolsey*, 59 U.S. (18 How.) 331, 341 (1855).

²¹⁰473 A.2d 805 (Del. 1984).

²¹¹430 A.2d 779 (Del. 1981).

