1982

Zapata Corp. v. Maldonado

Mitchell A. Sabshon

Follow this and additional works at: http://scholarlycommons.law.hofstra.edu/hlr

Part of the Law Commons

Recommended Citation
Available at: http://scholarlycommons.law.hofstra.edu/hlr/vol10/iss3/11

This document is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in Hofstra Law Review by an authorized administrator of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.
ZAPATA CORP. v. MALDONADO

Corporations—Where a corporation seeks dismissal or summary judgment of a stockholder derivative suit alleging directorial wrongdoing upon the recommendation of a special litigation committee appointed by the corporation's board of directors, the corporation has the burden of proving the independence and good faith of the committee and the reasonableness of its conclusions; if the corporation meets this burden, then the court is to exercise its own independent business judgment as to whether the motion should be granted. 430 A.2d 779 (Del. 1981).

Traditionally, courts have held that a board of directors may properly choose not to litigate a particular corporate claim. These decisions are founded on the tenet that the determination of whether or not to pursue a claim, like all other corporate decisions, is within the sole authority of the board of directors. Stockholder challenge to the adequacy of the board's performance of this duty is the basis of the stockholder derivative suit.

In considering stockholder challenges to board decisions, it should be noted that there are, broadly, two categories of stockholder derivative suits. The first category consists of actions in which a stockholder seeks redress of wrongs to the corporation committed by third parties. The second is comprised of actions seeking redress of


3. Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 Harv. L. Rev. 746, 748 (1960); see Dykstra, The Revival of the Derivative Suit, 116 U. Pa. L. Rev. 74, 97 (1967).

4. See, e.g., Hawes v. Oakland, 104 U.S. 450 (1881); Ash v. I.B.M., 353 F.2d 491 (3d
wrongs to the corporation committed by the corporation's own directors. Before commencing the first type of derivative suit, a stockholder is required to make a demand upon the corporation, through its board of directors, to initiate the suit on behalf of the corporation. The purpose of the demand requirement is to assure that the board has an opportunity to determine whether the corporation ought to litigate the claim. Generally, board decisions not to pursue a claim against third parties have been respected by the courts and have precluded initiation of the derivative suit by the stockholder.

The basis for this judicial deference to board decisions is the business judgment rule. One commentator has defined the rule in the following manner:

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

1. the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction;
2. the directors voted to authorize the transaction even though they did not reasonably believe or could not have
reasonably believed the transaction to be for the best interest of the corporation; or

(3) in some other way the directors' authorization of the transaction was not in good faith.\(^9\)

A board decision not to pursue a corporate claim in response to a shareholder demand to do so is a transaction within the contemplation of the rule.\(^{10}\) Consequently, a stockholder challenge to the board's decision not to pursue a corporate claim against third parties will fail, save for a showing of personal interest, bad faith, or unreasonable investigation into the matter on the part of the directors.\(^{11}\)

This application of the business judgment rule has been extended to the other category of stockholder derivative suits in which the stockholder seeks redress of wrongs to the corporation allegedly committed by all or some of the corporation's directors.\(^{12}\) In such actions, the courts have understandably excused the demand requirement,\(^{13}\) since "demand would be futile [in] that the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation."\(^{14}\) Thus, in these cases, the courts have permitted the stockholder immediately to initiate the suit in his or her own name.\(^{15}\)

Several cases reveal a recent trend in board response to such stockholder-initiated derivative suits.\(^{16}\) The corporation law of vari-


\(^{11}\) United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Ash v. I.B.M., 353 F.2d 491, 493 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966).


\(^{13}\) See, e.g., Meltzer v. Atlantic Research Corp., 330 F.2d 946, 948 (4th Cir.), cert. denied, 379 U.S. 841 (1964); Ainscow v. Sanitary Co. of America, 21 Del. Ch. 35, 36-37, 180 A. 614, 615 (Ch. 1935); McKee v. Rogers, 18 Del. Ch. 81, 86, 156 A. 191, 193 (Ch. 1931); Barr v. Wackman, 36 N.Y.2d 371, 377, 329 N.E.2d 180, 185, 368 N.Y.S.2d 497, 504 (1975).

\(^{14}\) McKee v. Rogers, 18 Del. Ch. 81, 86, 156 A. 191, 193 (Ch. 1931).

\(^{15}\) See infra text accompanying notes 38-47.

\(^{16}\) See, e.g., Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), cert. denied, 50 U.S.L.W. 3547 (U.S. Jan. 18, 1982)(No. 81-703); 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
ous states permits a board of directors to appoint a committee of its members, empowering it to discharge duties that the board itself is responsible for. Under this statutory authority, boards have appointed committees comprised, in theory, of directors independent of and disinterested in the allegations of directorial wrongdoing professed by the plaintiff-stockholder. These special litigation committees are charged with the responsibilities of investigating the shareholder's allegations and ultimately determining whether continuation of the stockholder-initiated derivative suit is in the best interests of the corporation. The committee has complete authority over such determinations, and its findings and recommendations are binding on the entire board of directors. Ideally, in the course of investigation, the committee will engage independent counsel, outside accountants and tax consultants, interview current and former employees, officers and directors, take depositions, and review pleadings and related materials. If, upon such investigation, the committee concludes that continuation of the litigation, though meritorious, would not be in the corporation's best interests, it will then recommend that the

17. See, e.g., CAL. CORP. CODE § 311 (West 1981); DEL. CODE ANN. tit. 8, § 141(c) (1980); N.Y. BUS. CORP. LAW § 712(a) (McKinney Supp. 1981-1982); MODEL BUSINESS CORP. ACT § 42 (1979). It should be noted that the New York statute precludes granting authority over certain matters to committees. These include submitting to shareholders specified actions that require shareholder approval, filling vacancies on the board of directors, fixing director compensation, and amending, repealing, or adopting by-laws, or specified board resolutions. N.Y. BUS. CORP. LAW § 712(a) (McKinney Supp. 1981-1982). None of these restrictions, however, are concerned with determining whether particular claims ought to be litigated.


20. Id. at 284.

21. Reasons often cited by special litigation committees as justification for recommending that the corporation seek dismissal of a meritorious derivative suit include the probability that litigation costs may outweigh any possible monetary recovery, the diversion of senior management from the performance of their corporate duties, which litigation would entail, and the effect of negative publicity upon employees, customers, and suppliers. Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 CORNELL L. REV. 600, 626-27 (1980); see, e.g., Maldonado v. Flynn, 485 F.Supp. 274, 284 n.35 (S.D.N.Y. 1980).
corporation’s counsel move for dismissal of the pending stockholder-initiated action. A majority of the courts faced with such a motion have relied on the business judgment rule as they have in the other category of stockholder derivative suits. Accordingly, absent a showing of committee bad faith, personal interest, or unreasonableness in its investigation, these courts have deferred to the committee’s business judgment, and have granted the motion to dismiss.

In Zapata Corp. v. Maldonado, however, the Delaware Supreme Court departed from the business judgment rule in determining whether a motion to dismiss a stockholder derivative suit alleging directorial wrongdoing, made on the recommendation of a special litigation committee, ought to be granted. The court acknowledged a potential for abuse inherent in the committee mechanism, and consequently promulgated an alternative, two-step test intended to thwart such abuse. The first step requires an inquiry into committee independence and the adequacy of its investigatory procedures. It also directs the court to analyze the reasonableness of the committee’s recommendation. In contrast to the traditional application of the business judgment rule, the Zapata test places the burden of proving independence, adequacy, and reasonableness on the corporation rather than on the plaintiff stockholder. The second step distinguishes the Zapata test from the business judgment rule by requiring the court to exercise its own independent business judgment in


24. See supra text accompanying notes 4-11.


27. Id. at 888-89.
determining whether continuation of the suit would be in the corporation's best interests. This comment discusses the necessity of and sound bases for the court's departure.

THE DECISION

In June 1975, plaintiff-stockholder Maldonado initiated a stockholder derivative suit in Delaware against several directors and officers of Zapata Corporation (Zapata), alleging various breaches of their fiduciary duty. Maldonado initiated the suit without making a prior demand on the board to do so.\(^\text{28}\) Thereafter, Maldonado initiated a second suit in the United States District Court for the Southern District of New York, alleging certain federal securities law violations in addition to the same claims raised in the Delaware action.\(^\text{29}\)

By June 1979, however, the composition of Zapata's board of directors had changed. Four of the ten defendants had departed from the board, and those remaining had appointed two new outside directors.\(^\text{30}\) Shortly thereafter, the board, by resolution, established an "Independent Investigation Committee," naming the two new outside directors as its sole members.\(^\text{31}\) The function of the committee was to investigate the pending actions\(^\text{32}\) and to determine whether maintenance of the litigation was in Zapata's best interests. By its resolution, the full board agreed to be bound by the committee's determination.\(^\text{33}\)

Subsequent to its investigation, the special committee determined that continuation of the actions would be detrimental to the interests of the corporation, and consequently recommended that Zapata's counsel seek termination of all pending litigation.\(^\text{34}\) Accordingly, the corporation moved for dismissal, or in the alternative summary judgment, in the pending actions.\(^\text{35}\)

In January 1980, the district court granted Zapata's motion for

\(^{28}\) Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980).
\(^{30}\) Id. at 278.
\(^{31}\) Id.
\(^{32}\) In addition to the two suits brought by Maldonado, another Zapata stockholder had initiated a third derivative suit alleging the same claims. Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980).
\(^{34}\) Id.
\(^{35}\) Id.
summary judgment,36 holding that under the business judgment rule
a committee of disinterested directors, properly vested with the
power of the board, may in the exercise of their business judgment
require the termination of a derivative suit brought on the corpo-
ration's behalf even though other directors are disqualified from par-
ticipating in such a decision because they are named as defendants
in the suit.37

In March 1980, the Delaware Court of Chancery denied Zapata's
similar motion,38 holding that "under well settled Delaware law, the
directors cannot compel the dismissal of a pending stockholder's de-
rivitive suit which seeks redress for an apparent breach of fiduciary
duty, by merely reviewing the suit and making a business judgment
that it is not in the best interests of the corporation."39 The court
reasoned that directors have no right to compel dismissal of a stock-
holder derivative suit alleging directorial breach of fiduciary duty af-
fter they have refused to initiate the suit, because under these cir-
cumstances the complaining stockholder possesses an independent
right to maintain the action.40 The court further held that the "busi-
ness judgment rule is merely a presumption of propriety accorded
decisions of corporate directors. . . . [N]othing in it grants any in-
dependent power to a corporate board of directors to terminate a
derivative suit."41 In response to this decision, Zapata filed an inter-
locutory appeal with the Delaware Supreme Court.

Faced with the task of reconciling these conflicting decisions,
the Delaware Supreme Court, in Zapata Corp. v. Maldonado,42 held
that under Delaware law a board of directors generally has the
power to pursue or refrain from pursuing litigation,43 and that such
power is delegable to a committee of independent directors.44 The
court then distinguished a stockholder derivative suit in which the
alleged wrongdoer is a third party from one in which some or all of
the directors are named defendants.45 As previously noted, in the

37. Id. at 279-80 (footnote omitted).
39. Id. at 1257.
40. Id. at 1262.
41. Id. at 1257 (citations omitted).
43. The court held that DEL. CODE ANN. tit. 8, § 141(a) was the statutory source of this
directorial power. 430 A.2d at 782.
44. 430 A.2d at 785.
45. Id. at 787.
former, the stockholder must make a demand upon the corporation to initiate the suit; 46 in the latter, the demand requirement is properly excused. 47 The court acknowledged that the business judgment rule is applicable to a suit in which demand is required. 48 In response to a shareholder demand, a refusal by the board or its committee to initiate a corporate action against a third party, unless shown to be wrongful, 49 will be respected by the court and will preclude initiation of the suit by the stockholder. 50 Conversely, the court observed that in a suit in which demand is excused, “the stockholder does possess the ability to initiate the action on his corporation’s behalf.” 51 Stockholder initiation, however, does not absolutely displace the corporation’s power to exercise ultimate control over the litigation, 52 for “excusing demand in certain instances, does not strip the board of its corporate power. . . . [T]he board entity remains empowered . . . to make decisions regarding corporate litigation.” 53

After reaching these conclusions, the court proceeded to reject the business judgment rule as a test for resolving disputes characterized by “a stockholder assertion that a derivative suit, properly instituted, should continue for the benefit of the corporation and a corporate assertion, properly made by a board committee acting with board authority, that the same derivative suit should be dismissed as inimical to the best interests of the corporation.” 54 Acknowledging that other courts faced with such a dispute have relied on the business judgment rule, 55 the Delaware court nevertheless refused to apply the rule to a suit in which the committee seeking dismissal was appointed by all or some of the director-defendants, 56 stating that there was “sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the the-

46. Id.; see supra text accompanying notes 4-11.
47. 430 A.2d at 785-87; see supra text accompanying notes 12-15.
48. 430 A.2d at 787.
49. Examples of a wrongful refusal to initiate a suit include situations where the directors are controlled by the alleged wrongdoer, have participated in the illegal transaction, were negligent in pursuing a clear cause of action, have failed to pursue a constitutional claim, and have refused to bring suit where such refusal is itself an illegal act. Comment, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. Chi. L. Rev. 168, 193-98 (1976).
50. 430 A.2d at 784.
51. Id. (emphasis added).
52. Id. at 785-86.
53. Id. at 786; see DEL. CODE ANN. tit. 8, § 141(a) (1980).
54. 430 A.2d at 786.
55. Id. at 787; see supra notes 9-11 and accompanying text.
56. 430 A.2d at 787.
ory of business judgment." The court held that a motion to dismiss, initiated on the recommendation of a special litigation committee, should include a written record of the committee's investigation, findings, and recommendations. Both parties should then be provided with an opportunity to make a record on the motion; and the burden of proof, as under all Rule 56 summary judgment motions, should be placed on the moving party to show that there is no genuine issue of material fact to be tried and that it is entitled to dismissal as a matter of law.

Furthermore, the court promulgated a two-step test in lieu of the business judgment rule to be applied in ruling on such motions. The first step involves an inquiry into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery is available to facilitate such inquiries. The court placed the burden of proof to establish the committee's independence, good faith, and reasonableness of conclusions on the corporation rather than on the plaintiff-shareholder who challenges the committee's decision. If the committee fails to carry this evidentiary burden, then its motion will be denied. If it succeeds, however, then the court must proceed to the second step of the test before granting the motion.

The second step requires the court to apply its own independent business judgment as to whether litigation or dismissal of the plaintiff-stockholder's claim is in the best interests of the corporation. The court "must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court . . . should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests." If the court, in its independent business judgment, concludes that litigation of the derivative claim, however meritorious, would not serve the best interests of the corporation, it

57. Id. (emphasis added).
58. Id. at 788.
59. Id.
60. Del. Ct. C.P.R. 56.
61. 430 A.2d at 788.
62. Id. at 788-89.
63. Id. at 788.
64. This is in stark contrast to the business judgment rule. See infra notes 75-76.
65. 430 A.2d at 788-89.
66. Id. at 789.
67. Id.
will then grant the committee’s motion.\(^{68}\)

**A LOGICAL COMPROMISE**

While the highest court in one other state\(^{69}\) and several federal courts\(^{70}\) have been confronted with the issue involved in *Zapata*,\(^{71}\) it was a case of first impression in the Delaware Supreme Court. The court stated:

> [T]he problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. . . . If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result.\(^{72}\)

By refusing to apply the business judgment rule in cases where demand is properly excused, and by promulgating the two-step test,\(^{73}\) the court sought to achieve a proper balance between these extreme alternatives.\(^{74}\)

To attain the judicial deference and insulation from liability consequent to the business judgment rule, directors must have exercised good faith and reasonableness in their decisions and have been independent of the transaction in question.\(^{75}\) Inherent in the business judgment rule is a presumption that the directors have so acted, and the burden of proof falls on the plaintiff-stockholder to rebut this

---

68. *Id.*
72. *Id.* at 786 (citations omitted).
73. *See supra* text accompanying notes 62-68.
74. 430 A.2d at 787.
presumption by a preponderance of the evidence.76

In applying the rule to the decisions of special litigation committees to seek dismissal of properly initiated stockholder derivative suits, some courts have limited the scope of the plaintiff-stockholder's challenge of committee independence to a determination of whether the committee members were actively involved in the alleged wrongdoing that is the substantive basis of the suit.77 Yet restricting the definition of independence to such patent self-interest in dismissal fails to appreciate directorial realities and their contaminating effects on the committee's disinterestedness.

Regardless of their involvement in the alleged wrongdoing, corporate directors perform their duties under powerful pressures to conform.78 They are often nominated in expectation of their loyalty to management79 and receive benefits by the grace of the colleagues who nominated them.80 They typically will have had significant prior dealings with the corporation81 and conceivably will be anticipating future commercial transactions.82 Many may sit with the defendants on the boards of other corporations.83 Furthermore, the individuals nominated to board positions often have frequent social contact.84 Outside directors may be directors or officers of other corporations and therefore might oppose the maintenance of a stockholder derivative suit seeking to impose liability on fellow corporate directors.85 Moreover, members of special litigation committees are almost invariably appointed to the committee by some or all of the very defen-
dants whose fate they are to consider. In considering these points, it should be noted that there has been only one case involving a special litigation committee in which the committee determined that litigation of the substantive merits of the suit would be in the best interests of the corporation.

While the majority of courts have rejected consideration of these deterrents to directorial independence, at least one court has embraced the contrary view that directors, by virtue of their corporate predicament, can never be considered sufficiently independent to sit in judgment of their board colleagues. This extreme view, taken to its logical conclusion, would invariably preclude the corporation from ever ridding itself of such derivative litigation, regardless of the best interests of the corporation. This, in turn, would not only place the corporation at the mercy of a single dissatisfied shareholder alleging directorial wrongdoing, but would also permit a resurgence of the strike suit.

In light of these observations, per se disqualification of committee members is unacceptable, yet the presumption of and limited inquiry into committee independence are equally unwarranted. Thus, the Zapata court's placement of the burden of proof on the corporation to prove committee independence is a logical compromise. The

86. See supra text accompanying notes 16-20.
87. Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981). This decision is particularly noteworthy in that the court chose to apply the Zapata test in lieu of the traditional business judgment rule. Id. at 1325-26. Determining that discovery of the bases supporting the committee's decision had been insufficient, however, the court stayed the motion for summary judgment pending further discovery. Id. at 1329. Significantly, the special litigation committee's independent counsel had advised the committee to litigate two of the plaintiff-stockholder's eight causes of action. The first merely sought a declaratory judgment determining the legality of a voting trust. The second, however, sought monetary damages for corporate expenses incurred due to this trust. Id. at 1314. Nonetheless, in the face of such advice, the committee concluded that only litigation of the declaratory judgment would be in the best interests of the corporation. Id. at 1328-29. In no case reported to date has a special litigation committee determined that it would be in a corporation's best interests to litigate a claim seeking monetary damages against the corporation's directors.
88. Lasker & Burks, 567 F.2d 1208 (2d Cir. 1978), rev'd, 441 U.S. 471 (1979). "It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." Id. at 1212 (footnote omitted).
91. 430 A.2d at 788.
court analogized the circumstances of Zapata to those characterizing interested director transactions in which the burden of proof is on the directors to establish the fairness of the challenged transaction. This consistency in treatment evinces the court's appreciation of the subtle but indubitable influences that tend to destroy committee independence.

In addition to requiring an inquiry into the independence of the committee, the first step of the Zapata test directs the court to scrutinize the committee's good faith. In this regard, the Zapata test is consistent with the business judgment rule as applied by other courts confronted with decisions by special litigation committees to seek dismissal of stockholder derivative suits. It requires the court to review the adequacy and appropriateness of the committee's investigatory procedures, and the burden of proving good faith, like that of proving independence, is on the committee. A finding "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." Such an investigation would fail to satisfy step one of the Zapata test or the requirements of the traditional business judgment rule. Consequently, a motion to dismiss founded on such an investigation would

---

92. Id. at 788 n.17; see, e.g., Johnston v. Greene, 35 Del. Ch. 479, 489, 121 A.2d 919, 925 (Sup. Ct. 1956); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Sup. Ct. 1952).

93. One commentator has suggested other justifications for placing the burden of proof to establish independence upon the committee: it has better access to the relevant information; the committee pleading the occurrence of the more unusual event (that in the face of the forces that tend to destroy independence, the committee has nonetheless remained independent) should have the burden of proving that event; the corporation has superior resources to bear the burden of proof; and since the plaintiff-stockholder bears the burden of proving the merits of the substantive action, the party moving to terminate judicial review of that action ought to bear the burden of proving that termination is warranted. Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?, 75 Nw. U.L. Rev. 96, 134 (1980).

94. 430 A.2d at 788.


96. Zapata, 430 A.2d at 788-89.

97. Id.


be denied regardless of the applicable standard. The limited discovery permitted by the Zapata court facilitates review of the investigatory process. Yet, the facts pertaining to the direction and extent of the inquiry are manifestly in the possession of the committee, and hence, more accessible to it. Thus, permissible discovery notwithstanding, the court logically and fairly placed the burden of proof on the committee to establish the good faith adequacy of its investigation.

Mere review of the committee's investigatory procedures, however, is insufficient to enable the court to determine whether the committee has exercised good faith. Such a limited inquiry could permit the perpetration of a sham upon the plaintiff-stockholder since it fails to address the danger that a committee, having conducted a proper investigation, might choose to make a decision that does not comport with the results of its investigation. It follows that review of the investigatory procedures is inextricably linked with the need to evaluate the substantive bases supporting the committee's conclusions.

Nonetheless, a number of courts applying the business judgment rule have held that "courts cannot inquire as to which factors were considered by [the] committee or the relative weight accorded them in reaching that substantive decision." These courts view such an intrusion into business decisions as overt judicial overreaching. This view stems from the assumption that the business judgment rule requires judicial deference to every directorial decision, absent a

100. 430 A.2d at 788.
101. Id.
103. The need for substantive review of the committee's conclusions has been recognized, albeit implicitly, by at least one court. See Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976). "[A]bsent allegations that the business judgment exercised was grossly unsound, the court should not . . . interfere with the judgment of the corporate officers." Id. at 516 (emphasis added).
104. Auerbach v. Bennett, 47 N.Y.2d 619, 633, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979); accord Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980): "The factors to be taken into account and their evaluation are for the Committee expressly appointed to consider . . . and are beyond the judicial reach." But see Arsht, supra note 9, at 125 (emphasis added): "[T]he rule does not preclude inquiry, but instead mandates inquiry into the facts and circumstances of a challenged transaction to such extent as may be necessary to enable the court to ascertain whether the director's decision was an exercise of informed, reasoned judgment or an arbitrary or reckless decision."
showing of self-interest, bad faith, or unreasonable investigation.\textsuperscript{108} This judicial deference, however, fails to recognize an underlying premise of the business judgment rule: "the need to foster both business and judicial economy by not allowing \textit{every} transaction to be subject to judicial review at the request of a disagreeing stockholder."\textsuperscript{107} To that end, the rule has been unquestionably successful. Its application averts the expenditure of corporate and judicial resources that would result if each directorial decision were subject to challenge.\textsuperscript{108}

By its terms, however, the rule provides that certain transactions will be scrutinized by the courts—those shown to be characterized by self-dealing, bad faith, or unreasonable investigation.\textsuperscript{109} Such transactions do not warrant judicial deference. Close scrutiny of such tainted transactions is required due to their potential for directorial abuse. But these types of transactions are not necessarily exclusive; others may present the same potential for abuse. If such transactions are challenged in court, the very logic that requires close scrutiny of the established exceptions to the business judgment rule demands that such scrutiny also be extended to these transactions.

The business judgment rule is at least 150 years old.\textsuperscript{110} The first case dealing with the decision of a special litigation committee to seek termination of a derivative suit was decided in 1976.\textsuperscript{111} This innovative response to derivative litigation was uncontemplated by the early courts in which the business judgment rule evolved. The courts that have confronted the committee mechanism have recognized its inherent potential for abuse.\textsuperscript{112} It would be anachronistic to adhere to only the established exceptions to the business judgment rule. If the logic supporting close scrutiny of the transactions traditionally held to be unworthy of judicial deference is to retain its vitality, then the decisions of special litigation committees must also be subject to close scrutiny. The \textit{Zapata} court's appreciation of the potential for abuse inherent in the committee mechanism justifies inquiry into the reasonableness of the committee's conclusions. That

\begin{enumerate}
\item[106.] See supra text accompanying notes 9-11.
\item[107.] Arsht, supra note 9, at 95 (emphasis added).
\item[109.] See supra text accompanying notes 9-11.
\item[110.] See Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829).
\item[112.] See, e.g., \textit{Zapata}, 430 A.2d at 787; Auerbach v. Bennett, 47 N.Y.2d 619, 633, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979).
\end{enumerate}
inquiry does not constitute judicial overreaching; rather, it is in harmony with a premise on which the business judgment rule itself is founded—namely, that some, but not all, matters of business judgment are outside the scope of judicial review.

The second step of the Zapata test unequivocally distinguishes the decision from those of other courts applying the business judgment rule to the determinations of special litigation committees. As noted earlier, under this step, the court employs its own independent business judgment to determine whether dismissal of properly initiated derivative litigation is in the best interests of the corporation.\textsuperscript{113} The court considered this step to be “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.”\textsuperscript{114}

One critic of the decision, however, has characterized this step as inappropriate judicial second-guessing of business decisions.\textsuperscript{115} This characterization ensues from a most basic principle of corporate governance—that the board of directors is charged with sole responsibility and authority for the management of the corporation. State corporation law almost universally mandates that “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.”\textsuperscript{116} These statutes are the source of board power, including whether or not to litigate particular corporate claims.\textsuperscript{117} Interfaced with this mandate is the reality that shareholders, as owners of the corporation, select the board and entrust it with piloting the corporate vessel. Presumably, a board is elected based on the shareholders’ belief that each director possesses the requisite business judgment to successfully manage the corporation’s affairs. Consequently, the court’s exercise of independent business judgment, in juxtaposition to the board’s, would appear to be an improper infringement on the board’s decisionmaking franchise. While the Zapata court did acknowledge the importance of a

\textsuperscript{113} See supra text accompanying notes 66-68.

\textsuperscript{114} 430 A.2d at 789.

\textsuperscript{115} Hinsey & Dreizen, Delaware Court Addresses Business Judgment Rule, Legal Times of Wash., June 8, 1981, at 18, col. 4.


\textsuperscript{117} Zapata, 430 A.2d at 782; see supra text accompanying notes 1-2.
board’s decisionmaking function, it similarly recognized a potential for prejudice inherent in the committee mechanism. The court doubted whether inquiry into independence, good faith, and reasonableness of the committee’s investigation was sufficient to neutralize this potential for abuse. Accordingly, it promulgated the second step of the test.

In directing a court of equity to exercise its independent business judgment, the court recognized that “‘[t]he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors—ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal.’” Such a balancing of factors is otherwise properly within the board’s authority. Where there is a sufficient risk of directorial prejudice, however, exercise of that authority ought to be closely scrutinized, and if necessary, appropriated by the court. This is so, simply because no other party to the litigation is as objective.

In exercising its independent business judgment, the court is directed to consider whether the committee’s decision to terminate the suit satisfies the “spirit” of step one, or would “prematurely terminate a stockholder grievance deserving of further consideration in the corporation’s interest,” to determine “how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit,” and to consider “matters of law and public policy.” It is unlikely that the investigation of a litigation committee will encompass such matters. Yet, such considerations may warrant continuation of a derivative suit.

Litigation of stockholder derivative suits alleging directorial wrongdoing invariably entails adverse consequences to the corpora-
Special litigation committees consistently cite them in support of their decisions to seek termination of such suits. If repetition of these adverse consequences alone were held sufficient to justify termination of the suit, virtually all actions involving the committee mechanism would fail to receive substantive review. To avert this undesirable result, the court must be able to distinguish those actions in which the potential harm inherent in litigation is outweighed by the possible benefits. The second step of the test, directing the court to "consider and weigh how compelling the corporate interest in dismissal is when faced with a nonfrivolous lawsuit," provides for this balancing.

The court must consider the public policy ramifications of the decision to terminate the litigation. It has long been recognized that the benefit of stockholder derivative suits inures to society as well as to the corporation and its stockholders. Derivative suits provide a means by which directorial performance may be policed and wrongs redressed, so that stockholders may be assured that the directors of their corporation exercise the highest level of care and loyalty in discharging their fiduciary responsibilities. When a court grants a motion to dismiss a derivative suit, it terminates this policing process. The immediate effect is preclusion of the opportunity to substantiate and redress the alleged wrongdoing. If, however, courts fail to consider the particular nature of the wrongdoing, there may be a far more extensive effect: judicial absolution of all directorial mischief, no matter how egregious, so long as maintenance of the derivative suit is not in the best interests of the corporation. This result is diametrically opposed to the policy in favor of policing directorial performance, upon which the stockholder derivative suit is founded. Decisions heedless of this policy will inevitably deprive this form of action of its vital force and effect.

CONCLUSION

The practice of employing special litigation committees to deter-

125. See supra note 21.
127. Zapata, 430 A.2d at 789.
128. Id.
131. For a discussion of possible categories of wrongdoing that courts should hesitate to dismiss, see Dent, supra note 93, at 130-31.
mine whether a properly initiated stockholder derivative suit alleging
directorial wrongdoing should be litigated is fraught with substantial
risks. These committees have consistently concluded that continua-
tion of such suits is not in the best interests of the corporation and,
consequently, have sought their dismissal. 132 Continued judicial de-
ference to these determinations, founded on the application of the
business judgment rule, will do little more than ensure that direc-
torial wrongdoing will escape substantive scrutiny by the courts.

Cognizant that a potential for abuse inheres in the committee
mechanism, and doubtful that the business judgment rule is suffi-
ciently effective to prevent this abuse, the Delaware Supreme Court
in Zapata Corp. v. Maldonado promulgated an alternative ap-
proach. This two-step test, in stark contrast to the business judgment
rule, places the burden of proof to establish committee independence,
good faith, and reasonableness on the corporation rather than on the
complaining stockholder. 133 To determine whether the corporation
has met its burden, the court is permitted to scrutinize the substan-
tive bases upon which the committee's decision to terminate is
founded. 134 Equally distinctive is the test's requirement that the
court exercise its own independent business judgment to determine
whether dismissal is appropriate. These departures from the business
judgment rule evince judicial appreciation of the realities of corpo-
rate governance and committee operation. The two-tier inquiry
promulgated in Zapata is designed to prevent corporate debilitation
resulting from continuous derivative litigation, and at the same
time preserve this form of action as a means of ensuring proper directorial
performance. Only future application of this test, however, will es-
tablish its success or failure in balancing the competing interests in-
volved in this category of stockholder derivative suits.

Mitchell A. Sabshon

132. See supra note 87 and accompanying text.
133. See supra text accompanying note 64.
134. See supra text accompanying notes 101-02.