

# THE BUSINESS JUDGMENT RULE IN THE CONTEXT OF TERMINATION OF DERIVATIVE SUITS BY INDEPENDENT COMMITTEES

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Cox: The issue presented by the recent success of the special litigation committee in causing the dismissal of derivative suits raises a concern for the role of the courts in responding to a committee's recommendation that is analogous to a problem recently addressed by Judge Seitz in *Lewis v. Curtis*.<sup>1</sup> The defendants in the derivative suit sought a ruling that would require the plaintiff to make a demand upon the board as a condition to continuing the derivative suit. Judge Seitz reasoned that the answer to the question whether a demand should be required depends on whether the court believes the directors have sufficient detachment to render an impartial response.<sup>2</sup> It is a determination the court should make based on all the facts raised by the individual case and should not be rigidly determined by the nature of the allegations in the complaint.<sup>3</sup>

The impartiality of the special litigation committee is another issue that requires consideration of a range of factors before a court should accept the committee's recommendation to dismiss a derivative suit. *Auerbach v. Bennett*,<sup>4</sup> the leading case in this area, holds that a committee's recommendation is to be examined under conventional applications of the business judgment rule; the recommendation is presumed valid and dismissal of the derivative suit should occur unless the plaintiff can establish that the committee was not independent or acted in bad faith.<sup>5</sup> Two important aspects of *Auerbach* are the court's determination that the burden of proof is on the plaintiff and the court's loose definition of independence and good faith.

Independence has generally been satisfied when the special litigation committee members are not defendants in the suit.<sup>6</sup> The Ninth Circuit, how-

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1. 671 F.2d 779 (3rd Cir. 1982).

2. *See id.* at 786.

3. *See id.* at 786-87.

4. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (Ct. App. N.Y. 1979).

5. *Id.* at 630-31, 393 N.E.2d at 100-01, 419 N.Y.S.2d at 926-27.

6. *See, e.g.,* *Gaines v. Haughton*, 645 F.2d 761 (9th Cir.), *cert. denied*, 102 S. Ct. 1006 (1981); *Control Data Corp.*, 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Cramer v. G.T.E.*, 582 F.2d 259 (3rd Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

ever, in *Lewis v. Anderson*,<sup>7</sup> used an even less demanding interpretation of independence. The court held that even though one of the three committee members was named in the suit, the director would nevertheless be considered independent if he was not directly involved in the alleged wrongdoing that was the gravamen of the complaint.<sup>8</sup> With one exception, lack of independence has not caused any recommendation of a special litigation committee to be rejected.

The one exception is the North Carolina case of *Swenson v. Thibaut*,<sup>9</sup> in which the issue of independence was raised by the court on its own. The basis for finding that the committee lacked sufficient independence was that at the board of directors meeting in which the second item on the agenda was the creation of a special litigation committee, the first item was a vote on whether the suit had merit. All the directors, including those later appointed to the committee, voted against the suit. The court held that the committee members, because they had already indicated prejudgment of the matter, lacked sufficient independence.<sup>10</sup> The recommendation of the special litigation committee was therefore ignored.

Independence, I submit, has generally been a very empty standard. I also submit that regardless of who has the burden of proof, the standard is one that favors the defendants, and leads to dismissal of the action, unless other standards lead to a more searching inquiry.

The second requirement for the business judgment rule to apply is that the committee must have acted in good faith. Good faith appears to require that the committee was guided by the hand of able counsel.<sup>11</sup> Every committee that has ever been formulated has hired counsel to guide it in its investigation and to prepare the tentative conclusions for the committee. A second aspect of good faith pertains to the committee's diligence in reviewing the evidence.<sup>12</sup> Was it familiar with the investigative report prepared by counsel or others? Has it asked searching and probing questions? Did the committee prepare a report articulating its conclusions?

The problem presented by the special litigation committee is unique because it presents a concern of "structural bias" on the part of the committee members.<sup>13</sup> The presence of this bias is unlikely to be detected solely by an inquiry into the committee's relationship to the defendant and the lawsuit or by its relative diligence in reviewing the case. Structural bias refers to a predisposition toward the defendant because the members who serve on the spe-

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7. 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

8. *See id.* at 780.

9. 39 N.C. App. 77, 250 S.E.2d 279 (1978).

10. *Id.* at 106-08, 250 S.E.2d at 297-98.

11. *See, e.g.*, *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

12. *See, e.g.*, *Rosengarten v. I.T.T. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979).

13. *See generally* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. REV. 96 (1980); Comment, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CAL. L. REV. 885 (1981); Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600 (1980).

cial litigation committee have a common cultural bond with the defendants on whom they are passing judgment. They all serve as directors of a publicly held corporation. The Delaware Supreme Court recently summarized the committee members' feelings: "There but for the Grace of God go I."<sup>14</sup> There is also a feeling of collegiality among the directors, so that passing judgment on one's colleague is at best distasteful. An adverse judgment is unlikely, except under the most exceptional circumstances. There is also the problem of the defendants having the ability to select their own jury. With only one exception,<sup>15</sup> special litigation committees have been created after commencement of the derivative suit. There is a serious question of shopping for one's own jury.

A departure from *Auerbach's* uncritical review of a committee's recommendation was made in *Zapata Corp. v. Maldonado*,<sup>16</sup> decided by the Delaware Supreme Court. *Zapata* offers two levels of analysis. The first level is mandatory; the second discretionary. Under the first level of analysis, a hearing analogous to a motion for summary judgment is held.<sup>17</sup> The focus of this hearing is to review the record, findings, and recommendations of the committee.<sup>18</sup> *Zapata* responds to structural bias by placing the burden of proving the elements of the business judgment rule (i.e., independence, good faith, and reasonable basis) on the recommendation's proponents.<sup>19</sup> The independence factor is not altered by *Zapata*, which appears not to offer any different meaning for its definition. Independence is likely to continue to be judged by objective evidence regarding the committee members' relationship to the defendants and the misconduct underlying the suit.

Good faith is an easy standard to meet. To satisfy the good faith requirement one should be sure that the committee is guided by the hands of experts, legal or accounting depending on the nature of the case; that the committee keeps minutes; that the committee is systematic in its investigation; and that its record is cohesive and coherent.

The reasonable basis requirement was not clearly defined by the court. Some obvious confusion appears in an important message in *Zapata*:

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

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

15. *Falkenberg v. Baldwin*, N.Y.L.J. Mar. 3 1980 at 12, col. 6.

16. 430 A.2d 779 (Del. 1981).

17. *Id.* at 788.

18. *Id.*

19. *Id.*

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.<sup>20</sup>

From the above quotation, a good deal of imprecision is found in the court's holding. Does the court require only the reasonable basis standard of the business judgment rule, under which directors are free to choose from conflicting alternatives?<sup>21</sup> Or does the reference to reasonable bases merely require that the grounds advanced for the committee's recommendation are of a type that serves the corporate interest?<sup>22</sup> The court may envision that a reasonable investigation is synonymous with a committee having a reasonable basis for its recommendation. It is important to resolve the meaning of reasonable basis, because the level of scrutiny given to a committee's recommendation is directly dependent upon the reasonable basis criteria.

Crucial to conducting an adversarial hearing to review a committee's recommendation is the level of discovery a plaintiff is permitted before challenging a committee's recommendation. *Zapata* states that the reviewing court may extend discovery rights to the plaintiff.<sup>23</sup> In a footnote the court cited four cases.<sup>24</sup> All four of those, however, were decided under the *Auerbach* type standard. Three<sup>25</sup> of the four denied the plaintiff an opportunity to conduct discovery on matters germane to the suit's merits. Discovery was permitted only against the committee members to explore their good faith and independence. The fourth case<sup>26</sup> merely suggests the possibility of broader discovery by recognizing that the plaintiff had failed to seek *any* discovery. The only illumination to date on the discovery rights under *Zapata* is *Watts v. Des Moines Register and Tribune*.<sup>27</sup> In *Watts* the court held that the plaintiff shall have a right to discover the facts that were considered by the committee. The plaintiff, however, is expressly prohibited from discovering from the committee members the reasons for their consideration of those facts, their decision not to consider other facts, or their decision not to pursue other avenues of inquiry.<sup>28</sup> Of course, an important consideration here is the amount of time that has elapsed since the suit's initiation and the committee's recommendation. If the special litigation committee is created several years after the initia-

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20. *Id.* at 788-89 (emphasis added).

21. For instances in which courts have deferred to the choice of the directors, even though an equally supported alternative was considered, *see, e.g.*, *Elfenbein v. American Fin. Corp.*, 487 F. Supp. 619 (S.D.N.Y. 1980), *aff'd*, 652 F.2d 53 (1981); *Muschel v. Western Union Corp.*, 310 A.2d 904, 908-09 (Del. Ch. 1973).

22. In *Zapata* the court states that the basis for a committee's request "is the best interests of the corporation." 430 A.2d at 788.

23. *Id.* at 788.

24. *Id.* at 788 n.16.

25. *Galef v. Alexander*, 615 F.2d 51, 56 (2d Cir. 1980); *Rosengarten*, 466 F. Supp. at 823; *Gall v. Exxon Corp.*, 418 F. Supp 508, 520 (S.D.N.Y. 1976).

26. *Maldonado v. Flynn*, 485 F. Supp. 274, 285-86 (S.D.N.Y. 1980).

27. 525 F. Supp. 1311 (S.D. Iowa 1981).

28. *Id.* at 1329-30.

tion of the derivative suit, as in *Zapata*, there is reason to believe that the plaintiff has been accorded sufficient discovery against the defendants to launch a vigorous attack on the committee's recommendation. But if the special litigation committee's recommendation is offered soon after the filing of derivative suit, the plaintiff may encounter serious difficulties in probing the committee's report if some discovery on the suit's merits is unauthorized.

A further point in *Watts* is the court's response to a disagreement between the committee and its counsel. Counsel reasoned that one of the asserted causes of action should be allowed to go forward because there was reason to expect that the claim served the corporation's interest. The committee's report viewed all the causes of action to be without merit and urged dismissal. Because the committee did not explain or otherwise support its decision to ignore its counsel, the court retained the case for further consideration. The court held that there must be a further hearing on the committee's justification for ignoring the advice of counsel,<sup>29</sup> even though the court was satisfied that the committee had established its good faith and independence.

The second level of analysis set forth in *Zapata* is discretionary and is to be applied only in nonfrivolous actions.<sup>30</sup> The court is to exercise its own independent judgment: the court is to "give special consideration to matters of law and public policy in addition to the corporation's best interests."<sup>31</sup>

To suggest, as *Zapata* does, that the committee's recommendation should be subordinated to established public policy, raises an important question concerning the purpose of the derivative suit. For example, assume a special litigation committee reports as follows: "We recognize the suit has merit and the recovery can be expected in the amount of \$300,000; however, the total cost of prosecuting the action is expected to exceed \$500,000 when considering the loss of employee time, morale problems, and the cost of litigation." *Zapata* contemplates that a court, even though satisfied that the committee is independent, acting solely in the corporation's interest, and is correct in its estimates of costs and benefits, could ignore the committee's recommendation if it believes public policy would be advanced by the action's continuance. In my opinion this conscripts the corporation to vindicate the public interest, even though it results in a net loss to the corporation.<sup>32</sup> It must not be overlooked that it is the shareholders of the corporation who will bear the loss.

Proponents of this result may argue that it was first offered by the United States Supreme Court in *Burks v. Lasker*.<sup>33</sup> The Supreme Court held that whenever there is litigation under a federal statute, the first issue is whether

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29. *Id.* at 1328-29.

30. 430 A.2d at 789.

31. *Id.*

32. In other areas, the courts have conditioned corporate actions upon there being a compensatory purpose served by the suit; mere deterrence of wrongdoing is insufficient. *See, e.g.*, *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703, 717 (1974); *Home Fire Ins. Co. v. Barber*, 67 Neb. 644, 673, 93 N.W. 1024, 1035 (1903); *Borden v. Cohen*, 231 N.Y.S.2d 902, 903 (1962).

33. 441 U.S. 471 (1979).

the committee's recommendation would have caused dismissal under state law; the second issue is whether dismissal offends public policy.<sup>34</sup> But the situation in *Burks v. Lasker* was vastly different from that contemplated in *Zapata*. *Burks* appears to apply a public policy test only when suit is under a federal statute for which Congress has carefully tailored derivative suit procedures. Cases suggested by the Court were actions under section 16(b) of the Securities Exchange Act and 36(b) of the Investment Company Act. In those situations the Court held that the directors should not have a right to terminate a derivative suit because Congress had clearly expressed a policy that the directors' refusal to sue should not be an automatic ban to the suit.<sup>35</sup> That analysis is vastly different from the reasoning that the obvious public interest in clean air, clean water, and no bribery of public officials compels the corporation to extend its resources to punish the defendants, even though the net result is a loss to the corporation.

ROBINSON: Let me comment on the *Swenson v. Thibaut*<sup>36</sup> case. I think that it is a very important case for North Carolina lawyers, not because of what the court decided, but for what the court said by way of dictum. Although the court decided that good faith and independence did not exist, it nonetheless expounded on the role, function, and authority of a special litigation committee. Citing *Auerbach v. Bennett* (this was before *Zapata*), the court said that it should undertake only the first level of analysis.<sup>37</sup> The court should inquire only whether there is an independent litigation committee and whether it acted in good faith; it should make no inquiry into public policy. It is a very restrictive opinion that is bound to have some influence, at least on the lower courts, and my guess is that the North Carolina Supreme Court would probably follow this line of reasoning. Thus, the law in North Carolina is the more restrictive view of *Auerbach v. Bennett*.

COX: One case I did want to mention was *Stein v. Bailey*,<sup>38</sup> a case in which demand was not excused and which therefore involved a different fact pattern than *Zapata*. The *Stein* court departed from precedent and required the directors to establish their independence.<sup>39</sup> Rejection of the demand was made by a minority of the entire board. Because the court feared such a small number was not a critical mass to assure independence, the court placed the burden of proving independence on the committee. The plaintiff still had the burden of establishing either bad faith or lack of reasonable basis.

Finally, let me remark that I agree with the American Law Institute project in its view that one should not distinguish between cases in which demand is excused and those in which demand is made. The problems of collegiality, cultural bias, and jury shopping transcend both situations. The answer is for the courts to get more involved in a review of the directors' reasoning in sup-

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34. *Id.* at 480.

35. *Id.* at 483-86.

36. 39 N.C. App. 77, 250 S.E.2d 279 (1978).

37. *Id.* at 105-08, 250 S.E.2d at 297-98.

38. 531 F. Supp. 684 (S.D.N.Y. 1982).

39. *Id.* at 693.

port of their recommendation for dismissal or rejection of a demand that the corporation file suit. I believe that is the thrust of the ALI project.

SCHWARTZ: The concern about the future of the derivative suit really began with *Lewis v. Anderson*.<sup>40</sup> In that case the plaintiff challenged the propriety of stock options that had been awarded. A committee was appointed, which even included one of the defendants. Based upon its interpretation of California law, the court found that the committee was independent and could dismiss the derivative suit. The court cited such cases as *Burks* never pausing to note that this case, unlike the others, involved an allegation of breach of fiduciary duty through self-dealing. Because *Lewis* involved self-dealing, it was an impermissible extension of the business judgment rule to dismiss a derivative suit; it was beyond the scope set forth in *Burks* and *Gall*.

I think you can array derivative suits on a spectrum. One end of the spectrum would be claims against third parties on any number of things—for example, the corporation has a claim against some supplier of the company who either delivered the wrong kind of merchandise or overcharged the company, and the company decides for a whole host of reasons that it does not want to bring suit, but a shareholder brings a derivative suit. That is one extreme, when no insider of the corporation is involved, and when there is no self-inflicted wound on the corporation by its officers or directors. On the other end of the spectrum is the self-dealing transaction by the controlling person of the company. In between would be lesser charges against controlling persons who did not line their own pocket (for example, negligence actions) and breach of fiduciary duty by noncontrolling persons (for example, outside directors who may have seized a corporate opportunity). Those categories fall in between the extremes of self-dealing by the controlling person and claims against third parties. The early cases in which the committee device was used, *Gall* through *Abbey*, including *Auerbach* and even *Burks*, did not involve the most extreme cases on either side. They did not involve actions against third parties or breaches of fiduciary duty by controlling persons. Indeed, in most of those cases there was not even any alleged harm to the corporation.

The ALI project on Corporate Governance, Tentative Draft No. 1, which was presented to the Institute's meeting in May of this year, leaned toward the *Zapata* approach that the business judgment rule is not the appropriate way to analyze a decision to terminate derivative litigations, other than third party litigations. Claims against third parties, states the ALI project, ought to be judged in the courts in accordance with the business judgment rule, and I think there is no quarrel on that issue. But the ALI takes the position, which the courts have not accepted, that suits against controlling persons (a defined term in the ALI project) alleging self-dealing may not be terminated by any action of the corporation itself. Of course, the suit is subject to dismissal on grounds that the claim does not state a cause of action, but it cannot be dis-

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40. 615 F.2d 778 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980).

missed simply because the corporation determines that it is not a good idea to go ahead with the lawsuit. All other types of suits may be dismissed if certain procedures are followed and if the court makes certain findings. The findings must conclude that there was a business justification warranting dismissal.

To dismiss a derivative suit under the ALI rules, there must be an independent committee; that is, there must be three directors who are independent and who then appoint special counsel, who is also independent. The committee must conduct an investigation, come up with a written report, and have the authority to act. The committee must have been chosen by the independent members of the board and not by persons who are not independent. Independence is not precluded simply because a person is named as a defendant in the lawsuit for the sole purpose of making him nonindependent. In other words, a bootstrap action to render the board incapable of having an independent committee will not work. But even if the board cannot have an independent committee—if the conduct alleged legitimately challenges everybody on the board—the company is not without recourse to this dismissal route. The board can go to court and ask the court to name a special panel of three persons, which can do the same thing the independent committee would have done. If a special panel includes lawyers, it may not even need to retain independent special counsel because the panel itself has the ability to deal with the legal issues.

There are several very important aspects of the ALI proposal. First, it rejects the business judgment analysis because the burden is on the moving party to show that the suit ought to be dismissed. Second, it does not require demand on the board to press the derivative suit. *Zapata* held that if demand were required, the decision to dismiss would be assessed in accordance with the business judgment rule and the burden would be on the plaintiff to show that dismissal of the lawsuit was wrongful, which is a difficult thing to show. The ALI procedures are applicable regardless of whether demand was required, but if demand was made or was required under traditional rules, it is a factor that weighs in favor of the committee's determination not to proceed with the lawsuit. Third, there is some limited discovery that the court may allow the plaintiff. The proceedings are like a mini-trial—if the board wants to fight it out at this stage and advance reasons why the suit should not go ahead, then the plaintiff is entitled, within the discretion of the court, to take some discovery. Finally, the special counsel appointed by the committee enjoys a privileged relationship with respect to the committee so that communications between counsel and the committee are privileged. This is a limited reversal of *Garner v. Wolfenbarger*<sup>41</sup> in the context of the derivative suit. There was very little discussion and very little criticism of this part of the ALI project dealing with derivative suits.

I think the courts are going to have occasion to look at the ALI proposal and draw upon whatever wisdom they see in it. The proposal may creep into

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41. 430 F.2d 1093 (5th Cir. 1970), cert. denied, 401 U.S. 974 (1971).



the law even though it is not official at this point and may never become anything official. But it is a document that has been written by serious people and looked over by serious people. Whatever you may say of the ALI project, it is an exercise not of advocacy but of scholarship.

HAZEN: I think it is clear in light of the obvious confusion of the courts that the proposal is a document that cannot be ignored. It is something the courts are going to have to grapple with, at least until it is finally adopted or rejected.