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THE BUSINESS JUDGMENT RULE AND
SHAREHOLDER DERIVATIVE SUITS: A
VIEW FROM THE INSIDE

RICHARD W. DUESENBERG*

I. Introduction

The term "business judgment rule" is one of those legal abstractions which take on fresh meaning in new and different situations. While the rule reaches back many years in American legal history, it has assumed a new role in the twilight decades of the twentieth century. These are the years that have witnessed the spate of foreign payments incidents out of which stemmed not only a series of lawsuits seeking to recover the value of such payments for corporations, but also stirrings in Congress, in regulatory bodies such as the Securities and Exchange Commission, and elsewhere. Their common focus was upon the quality of corporate governance in America.

In the foreign payments lawsuits, the business judgment rule underwent an ingenious and innovative adaptation. Those corporations that

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4. The American Bar Association, Section of Corporation, Banking and Business Law, was at the leading edge of constructive reform of corporate practices when it published its Corporate Director's Guidebook at 32 BUS. LAW. 5 (1976). This was followed by the prestigious Business Roundtable's position paper adopted early in 1978. See The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation—Statement of the Business Roundtable, 33 BUS. LAW. 2083 (1978).
had officers or directors targeted in lawsuits for return of funds allegedly wrongfully paid out established special committees drawn from the board of directors to study whether or not the best interests of the corporation mandated a stockowners' derivative action against such parties. Typically referred to as special litigation committees, they were composed of nondefendant directors who along with special counsel would study the lawsuit, examine papers, documents, and interview persons, and, after careful scrutiny, commonly conclude that the case was not in the interest of the corporation and should be dismissed. The success of this process in a number of celebrated cases\(^5\) moved the business judgment rule to center stage in the corporate law arena.

This Article offers a defense of the rule in its more expansive application. Some may feel, as did Kierkegaard, that in defending the faith it is sometimes betrayed, but the pragmatism of this uniquely common-law creation is impressive.

**II. The Historical Setting**

**A. Original Contours**

The history of the business judgment rule has been examined before in a number of comprehensive presentations,\(^6\) and it is unnecessary to restate this material in these pages. Nonetheless, some reference to its background is essential for a perspective on the current debate.

The rule's traditional incantation runs something to this effect: In an action seeking to impose personal liability on officers and/or directors

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5. The first big case associated with questionable payments and involving a litigation committee was Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976). The derivative action sought recovery by the corporation of $59 million from the directors for illegal payments made to Italian political parties and politicians from 1963 to 1974. The first state high court decision in this area was Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

for business decisions, their good faith will be presumed. If in fact their action is found to have been made in good faith and with due care, a court will not probe the wisdom or merits of the business judgment that was made, and no personal liability will be imposed.

Underlying this rule is the wisdom of the courts in recognizing that the administration of a business enterprise necessarily involves making many business decisions, not all of which will prove successful. Some should be expected to turn into unmitigated disasters; it does not take a great deal of searching to come up with instances of corporate business judgments gone bad. New ventures that never turn profitable, mature ones that are upset by intervening technologies, and loans and extensions of credit that are never repaid, are familiar fare of business reports. As these words are written, banks around the Western World, the United States included, are shaken by the prospects of default on billions of dollars or other currency extended in the form of loans to an internally troubled East European nation, which in retrospect should never have been made. One purpose of the business judgment rule is to protect against personal liability for the losses suffered in such misadventures.

7. Several recent cases challenging board action in resisting unwanted tender offers dramatically evidence the power of this presumption. In Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981), the court wrote that the business judgment rule validates certain situations that otherwise would involve a conflict of interest for the ordinary fiduciary. The rule achieves this purpose by postulating that if actions are arguably taken for the benefit of the corporation, then the directors are presumed to have been exercising their sound business judgment rather than responding to any personal motivations.

Id. at 292.

8. There are many judicial expressions of the rule, a leading one of which is found in Warshaw v. Calhoun, 43 Del. Ch. 148, 157-58, 221 A.2d 487, 492-93 (Del. 1966), which provides:

In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts. . . . The acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation, and a minority stockholder who challenges their bona fides of purpose has the burden of proof.

Id. (citations omitted).


10. An able corporate practitioner has observed:

Even its worst detractors would, I suppose, admit that the fundamental premises underlying the business judgment rule are salutary. Those premises are simply that, as human beings, directors are not infallible and are not able to please all of the stockholders all of the time. The first premise recognizes human nature, the second the need to foster both business and judicial economy by not allowing every corporate transaction to be subject to judicial review at the request of a disagreeing stockholder.
Were courts, with perfect retrospective vision, to second-guess the judgment of officers and directors in their decisionmaking function, they would be injecting themselves into a management role for which they were neither trained nor competent. Such judicial action would also be taking a step to discourage others from performing these desired and essential societal activities. One pragmatic objective of the business judgment rule, then, is to keep courts out of a role they are ill-equipped to perform. Another is to encourage others to assume entrepreneurial and risk-taking activities by protecting them against personal liability when they have performed in good faith and with due care, however unfortunate the consequence. Both are of monumental social utility.

One decision that managers and directors of corporations frequently have to make is whether to pursue certain rights which the corporation may have against third parties. These may be rights arising under contract, arising as a result of some wrong done to the corporation, or on some other basis. Not all claims that may be made are pursued. A myriad of considerations is relevant to a decision whether or not to press a cause of action against another party, including the probability of success, probability of recovery and satisfaction of a judgment, cost of prosecution, effect on continued relations with the other party, and similar concerns. When a cause against another is not pursued, it


11. Percey v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829), is often credited as the earliest American judicial expression of the rule. In this case, the court wrote that to reject the rule would presuppose "the possession, and require the exercise of perfect wisdom in fallible human beings. No man would undertake to render a service to another on such severe conditions." Id. at 77. See generally Veasey & Manning, supra note 6.

12. As one court stated:

It appears to us that the business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments. The authority and responsibilities vested in corporate directors both by statute and decisional law proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise. Even if that were not the case, by definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility.


13. See notes 10-11 supra and accompanying text.

14. See, e.g., Gall v. Exxon Corp., 418 F. Supp. 508, 514 n.13 (S.D.N.Y. 1976), where the court noted the reasons of the special litigation committee for recommending dismissal. These
may be that the shareholders of the corporation will themselves be able to complain, seeking to enforce the right not on their individual behalf, but rather derivatively, for the benefit of the corporation. An invention of courts of equity, this derivative action has as its real beneficiary the corporation, and not the shareowners. The corporation's rights are the same as if the corporation itself had maintained the action.\textsuperscript{15}

What happens, then, if a shareowner takes issue with a decision of the corporation not to pursue a claim it has against another party? That question, and its general answer, have long existed.

The majority of courts has concluded that the business judgment rule protects a determination of management not to sue, with the result being that if appropriate procedures are followed, a stockholder's derivative action pursuing a claim of the corporation will be dismissed.\textsuperscript{16} This conclusion follows from the principle that the directors of the corporation are statutorily charged with managing its affairs, and if the directors determine that prosecution of a claim against another is not within the corporate interest, that decision is accorded the protection of the business judgment rule, which operates to abort the shareowner derivative action. Perhaps the most frequently quoted articulation of this principle is the passage by Justice Brandeis in a case concerning the enforcement of an antitrust action against competitors, where it was written:

Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of

\textsuperscript{15} Liken v. Shaffer, 64 F. Supp. 432, 441 (N.D. Iowa 1946).

\textsuperscript{16} One of the procedures required of stockholders before they can acquire standing to challenge the board decision not to sue is to make demand on them that the claim be pursued. This is designed to afford the board an opportunity to determine what its decision should be. Failing such a demand, a shareowner may have no derivative action. See Hawes v. City of Oakland, 104 U.S. 450 (1882); Continental Securities Co. v. Belmong, 206 N.Y. 7, 99 N.E. 138 (1912). The requirement of a demand for standing has some important exceptions, one of which is that it need not be made if the result is predetermined, as where all directors are implicated in the alleged wrong. This topic is beyond the scope of this Article. For a discussion of the requirement, see Comment, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. Chi. L. Rev. 168 (1976). See also Fed. R. Civ. P. 23.1.
internal management and is left to the discretion of the directors, in the absence of instruction by a vote of the stockholders. Courts interfere seldom to control such discretion intra vires the corporation...\\footnote{17}

Justice Brandeis further explained that the situations in which judicial interference will occur are “where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment...\\footnote{18}

The question of what constitutes an instance of misconduct equivalent to a breach of trust or standing in a dual relation, such that the derivative action could go forward even against dissent, has been, predictably, a matter of much dispute. Usually, these have been either instances of self-dealing\\footnote{19} or situations in which failure to prosecute or defend has been regarded as an ultra vires giving away of corporate assets.\\footnote{20} Aside from these rather narrow factual patterns,\\footnote{21} however,

\\footnote{17} United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917). \textit{See also} Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903), where the court wrote that “[t]he directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right.” \textit{Id.} at 463. In Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957), the court wrote that “an individual stockholder has no more right to challenge by a derivative suit a decision by the board of directors not to sue than to so challenge any other decision by the board.” \textit{Id.} at 859.

\\footnote{18} United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917). \textit{See also} Ashwander v. TVA, 297 U.S. 288 (1936) where Justice Brandeis stated that: “Courts may not interfere with the management of the corporation, unless there is bad faith, disregard of the relative rights of its members, or other action seriously threatening their property rights.” \textit{Id.} at 343. After adding that this rule applies also where the claim is a wrongful failure to assert a cause of action against a third party, he continued: “If a stockholder could compel the officers to enforce every legal right, courts, instead of chosen officers, would be the arbiters of the corporation’s fate.” \textit{Id.}

\\footnote{19} \textit{See, e.g.,} Groel v. United Electric Co., 70 N.J. Eq. 616, 61 A. 1061 (1905).

\\footnote{20} A number of cases have considered failure of directors to press valid claims, or failure to defend against invalid claims, to amount to an ultra vires giving away of corporate assets. This view has been taken in cases involving payment of taxes which shareowners alleged were illegal. For example, in Dodge v. Woolsey, 59 U.S. 331 (1856), the directors of a bank, in refusing to take action to prevent collection of a tax regarded as unconstitutional, cited the obstacles of testing the laws in the relevant state courts as their reason for not resisting payment. \textit{See also} Brushaber v. Union Pacific Ry. Co., 240 U.S. 1 (1916) (federal tax); Cotting v. Kansas City Stock Yards Co., 183 U.S. 79 (1901) (illegal rate regulation); Pollock v. Farmers’ Loan & Trust Co., 157 U.S. 429 (1895) (federal tax). It should be noted that where the payments have not yet been made and the suit is to enjoin them, the action is distinguishable from those instances where the decision is made not to pursue a claim that has matured. Arguably, the injunction action is equivalent to an action to prevent performance of a wrongful act, as distinguished from the act’s having already occurred, and the directors’ then having decided not to seek redress of the wrong. The distinction is not without its significance, since it explains an important digression from the general rule of these cases that the directors’ decision is not challengeable by shareowners, unless it is made in bad faith or involves self-dealing. \textit{See cases cited supra.}
the power to abort the shareowner action to seek redress from third parties has been formidable.

B. Cases of the 1970s

The above concepts were fairly well in place as the foreign payments cases and others emerged in the 1970s. Instead of suits against extra-corporate parties, however, the complaints were aimed at officers and directors of the corporations on whose behalf the derivative actions were being instituted. Some courts saw this setting as a variation on the earlier theme, and concluded that the authority to dismiss the action against codirectors and officers was but a “natural extension” of the earlier established principle. Others saw it differently.

On the side of giving to the board authority to dismiss shareowner derivative claims against directors and officers is, among others, a trio of decisions that teach a good deal about the practice of using special litigation committees. These were Gall v. Exxon Corp.,23 Burks v. Lasker,24 and Auerbach v. Bennett.25

Taken together, this trilogy announced a series of rules to guide the disposition of shareowner derivative actions. In Gall,26 a foreign payment case, the court ruled that a special litigation committee consisting of one inside director and two outsiders, none of whom was a defendant in the shareowner action, had authority to dismiss the derivative action. In the absence of allegations of fraud, collusion, self-interest, or grossly unsound judgment, the court said that such a committee was

21. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957).
24. 441 U.S. 471 (1979) (action against directors). Plaintiffs alleged, among other things, that the corporation’s directors negligently acquiesced in the purchase of worthless Penn Central notes, and should therefore have been liable for the losses sustained.
26. In Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976), the shareholder sought recovery from directors of $59 million in payments made by a foreign subsidiary to Italian political parties and politicians. It was asserted that such payments amounted to a wasting of corporate assets and to mismanagement. The special litigation committee consisted of one inside director and two outside directors, none of whom were named as defendants or implicated in the alleged wrong, because they had joined the board after the complained of events. It was also claimed that failure to disclose these payments in proxy statements was a violation of the Securities Act of 1934. Id. at 509-14.
appropriate, and the only concession it made to the plaintiff was to deny summary judgment for the defendant until the plaintiff had the opportunity to probe the independence of the special committee through discovery processes.\textsuperscript{27} The court emphatically declined to examine the underlying actions complained of, stating that were a court to embark on such a path, "it would necessarily involve itself in the business decisions of every corporation, and be required to mediate between the judgment of the directors and the judgment of the shareholders with regard to particular corporate actions."\textsuperscript{28}

After Gall, but only a few weeks before Auerbach, the United States Supreme Court ruled, in Burks v. Lasker,\textsuperscript{29} that a two-step analysis is required in any case involving a federal statute.\textsuperscript{30} First, the court must look to state law to determine if the directors are empowered to dismiss a derivative action against codirectors or officers.\textsuperscript{31} If such authority is concluded to exist, the court next decides whether it should be suspended so as to avoid frustration of any federal policy involved in the action at hand.\textsuperscript{32} This was not the first Supreme Court opinion to declare that state law should be examined for identifying the requisite authority,\textsuperscript{33} but it is the opinion most responsible for a flurry of new cases seeking authoritative state law pronouncements.\textsuperscript{34}

Not long thereafter, the first opinion from a state's highest court came down on the question of whether directors should have authority to dismiss derivative actions against codirectors. The case was Auerbach v. Bennett,\textsuperscript{35} decided by the New York Court of Appeals.

\textsuperscript{27} 418 F. Supp. at 520. Plaintiff was given 60 days within which to conduct discovery into issues of the committee's intent, good faith, and motivation. \textit{Id.}
\textsuperscript{28} \textit{Id.} at 519.
\textsuperscript{29} 441 U.S. 471, 475-86 (1979).
\textsuperscript{30} \textit{Id.} at 480. \textit{See id.} at 478.
\textsuperscript{31} \textit{Id.} at 480. \textit{See id.} at 478.
\textsuperscript{32} \textit{Id.} at 480. \textit{See id.} at 478-79.
\textsuperscript{33} For an earlier decision, see Swanson v. Traer, 354 U.S. 114 (1957).
\textsuperscript{35} 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). This is one of several cases involving General Telephone and Electronics Corporation. The foreign payments problem came to light through an internal audit, following which the audit committee, assisted by distinguished outside counsel, conducted further investigations. The investigations uncovered evidence of over $11 million in payments. When the shareholder derivative action was commenced, the board created a litigation committee of three disinterested directors who had joined the board after the challenged transactions. The committee was vested with all of the authority of the board to deter-
The situation was paradigmatic, in the sense that it contained a variety of facts: foreign payments; a special litigation committee consisting of nondefendant directors; use of independent counsel to assist the committee; defendant directors; and a defendant third party. The court drew no distinction whatsoever between actions against directors and those in which third parties are the target. Rather, the court focused primarily on what it considered the major issues in the case under a two-tiered analysis.

The first tier focused on the plaintiff's allegation that the corporation's directors and officers had breached their trust by paying bribes and kickbacks to foreign governmental customers, as well as customers that were privately owned. The second tier focused on the issue of whether the examination and recommendation of the special litigation committee was thorough and made by members of the board who were independent and disinterested. Proceeding under this analysis, the court concluded "that the determination of the special litigation committee forecloses further judicial inquiry in this case." The court justified its reluctance to review the judgment of the committee by asserting that "courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments." Therefore, absent a showing of bad faith or fraudulent activity on the part of the committee (a showing which expressly was not made in this case), the court considered judgments of special litigation committees to be beyond review. The court took care to emphasize that this business judgment rule did not, however, prevent a court from inquiring as

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36. Id. at 624-25, 393 N.E.2d at 996-97, 419 N.Y.S.2d at 922-23.
37. The court throughout discussed the assertions of both the director defendants and the independent accountant-defendant without comment as to the fundamentally different role that each performed. The special litigation committee ultimately found that Arthur Andersen & Co. "conducted its examination of the corporation's affairs in accordance with generally accepted auditing standards and in good faith . . . ." Id. at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923.
38. Id. at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
39. Id., 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
40. Id., 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
41. Id., 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
42. Id., 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
43. Id. at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927.
44. Id. at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
to the "disinterested independence" of the board. Rather, the court predicated its deference to the committee's decision entirely on the ability of the committee members to arrive at an independent and disinterested judgment.

The Auerbach opinion had dramatic effect. Under the two-tier analysis, the decision of the litigation committee is subject to scrutiny only to the extent of the good faith and independence of its makers. The court never examines the good faith and due care of the officers and directors who knew or should have known of the foreign payments. Its shelter is the shelter given under the business judgment rule to the decision of the special litigation committee.

The result reached in Auerbach is clearly the correct one. Plaintiff made no claim that any officer or director personally benefited from the foreign payments; the payments were made in the interest of the corporation and its shareowners. Millions of dollars were involved. The end result of denying effect to the litigation committee's recommendation would very likely have been a long and costly trial, ultimately resulting in protection of the underlying decision via traditional judgment rule application. Whether a principled distinction should be made where self-interest on the part of directors or officers is charged in the underlying action is another question, the one which is presented in the forays with the Zapata Corporation.

Involved in the Zapata Corporation cases was an action by direc-

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45. Id., 393 N.E.2d at 1001, 419 N.Y.S.2d at 927.
46. Id. at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.
47. The court, emphasizing the scope of the business judgment rule, said that the substantive decision not to sue involved weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. Inquiry into such matters would go to the very core of the business judgment made by the committee. To permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee.
48. Id. at 633-34, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.
49. The Zapata corporate directors were named as defendants in derivative litigation in three states as a result of their approving a modification in 1974 to an existing stock option plan. The plan had been ratified by Zapata shareowners in 1971. As the time for the exercise of final options approached, the company was planning a tender for over 2 million of its shares, which action was anticipated to drive the price of the shares from the range of $18-$19 per share to near $25. Aware that if exercise occurred after the tender, the federal income tax liability of the optionees would be much greater, the directors amended the plan to accelerate the exercise date to less than a week before the tender offer. The complaining shareowners claimed that the company lost the benefit
tors, who were also officers, to amend the company's stock option plan by allowing acceleration of certain options. This acceleration benefited the directors at the expense of optimal tax treatment for the corporation. The company's proxies made no disclosure of this amendment, and several stockholders became perturbed by the alleged self-dealing of the directors. The derivative suits resulted. In the lower state court decision, the court wrote that at least where there is a breach of fiduciary duty, a shareowner's litigation right is subordinate to the corporation's litigation right "only for so long as the corporation has not decided to refuse to bring suit." The shareowner's right to bring a derivative action on a claim of breach of fiduciary duty matures as soon as the corporation refuses to assert the claim. In such a situation, the of a higher tax deduction, and sued the directors for this loss. Maldonado v. Flynn, 413 A.2d 1251, 1254-55 (Del. Ch. 1980), rev'd sub nom. Zapata Corp. v. Maldonado, 430 A.2d 779 (1981). One suit was brought in the Southern District of New York by shareowner Maldonado, Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980), aff'd in part and rev'd in part, [Current] FED. SEC. L. REP. (CCH) ¶ 98,457 (2d Cir. Feb. 9, 1982), and another by the same shareowner in the state courts of Delaware, Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980) rev'd sub nom. Zapata Corp. v. Maldonado, 430 A.2d 779 (1981). The other action was in the southern district of Texas, by shareowner John Maher, Maher v. Zapata Corp., 490 F. Supp. 348 (S.D. Tex. 1980). In the New York southern district action, the court said that Delaware law would only require a showing of independence and disinterest on the part of members of the litigation committee in order for the directors to initiate a dismissal of a derivative action. 485 F. Supp. at 278. Significantly, the court said that the committee did not have to conclude that the derivative action was without merit in order to recommend dismissal. The court noted that such a finding is not a prerequisite to the exercise of business judgment though of course it is a factor that may well be considered. To the contrary, the essence of the business judgment rule in this context is that directors may freely find that certain meritorious actions are not in the corporation's best interests to pursue.

Id. at 285.

In the Texas action, the court said that Delaware, which in its Supreme Court had not then had a business judgment rule case involving a derivative action, would follow the lower Delaware court to the effect that the rule is purely defensive in scope, and not a basis for dismissing a derivative action. 490 F. Supp. at 353. It is clear, therefore, that both the Southern District of New York and the Southern District of Texas were wide of the mark when writing about what the Delaware law would be.

50. Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. Ch. 1980), rev'd sub nom. Zapata Corp. v. Maldonado, 430 A.2d 779 (1981). At another place in the opinion, the court also wrote that once a stockholder, who asserts a proper cause, has made a demand on the corporation and has met with refusal, he may assert his individual right and the corporate right together in a derivative suit, and the corporation no longer controls the corporate right to which the plaintiff's individual right attaches.

Id. at 1262.

51. Id. at 1263.

52. Id. Obviously, this decision contrasted sharply with that of the Southern District of New York, where Judge Weinfeld rejected the idea of an individual right of action and predicated the right to initiate a dismissal on the fact that the cause of action belonged to the corporation and
shareowner's right to bring the derivative action is considered "primary and independent."\footnote{53} The court thus rejected the Auerbach court's position that protection of the second-tier decision not to sue under the business judgment rule precludes any consideration of the first-tier action that underlay the shareowner's complaint. Critical to its conclusion was the court's attitude that in derivative actions alleging self-dealing, "courts and not litigants should decide the merits of litigation."\footnote{54} The court stated that aggrieved shareowners were entitled to a decision by an impartial tribunal, rather than by a committee chosen by those accused of the wrongdoing.\footnote{55}

The concept, central to the court's ruling, of a primary and independent right in the shareholder was so far removed from the mainstream of American decisions,\footnote{56} that it did not stand long. On appeal, the Delaware Supreme Court reversed,\footnote{57} saying that although a shareowner might have the independent right to institute an action, that right does not include the right to maintain it.\footnote{58} "We see no inherent reason," the court wrote, "why the two phases of a derivative suit, the stockholder's suit to compel the corporation to sue and the corporation's suit . . . should automatically result in the placement in the hands of the litigating stockholder sole control of the corporate right throughout the litigation."\footnote{59} The court worried that such a rule would place undue weight on the interest of one protagonist "to the exclusion of all others within the corporate entity."\footnote{60}

The court then took what it characterized as a "middle course," seeking "to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the

\footnote{53} Id. at 1263.
\footnote{54} Id.
\footnote{55} Id.
\footnote{56} In theory, if the shareowner derivative action is substantively the right of the shareowner, then nothing that directors do should affect the right to bring the action. As with so many areas of the law, the distinction between procedural and substantive rights is blurred in these cases, and arguing the merits of competing opinions on the level of whether the derivative action is one or the other is not very productive.
\footnote{57} Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).
\footnote{58} Id. at 784-86.
\footnote{59} Id. at 784-85.
\footnote{60} Id. at 785.
board of directors, but the corporation can rid itself of detrimental litigation."\(^{61}\)

This "balancing point" was expressed in a totally new standard for the business judgment rule as applied to derivative actions against directors and officers. It comprised two steps, the first of which is fairly familiar to traditional articulations of the business judgment rule.\(^{62}\) The second step is another matter. While apparently applicable only in instances where demand on the board to bring suit is excused,\(^{63}\) the

\(^{61}\) *Id.* at 787. The court also said that if the board's determination is that a suit would be detrimental to the company, that determination stands. It prevails even when demand on the board is excused, if circumstances exist such that continuation of the litigation would not be in the corporation's best interest. *Id.* at 785.

\(^{62}\) 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.

\(^{63}\) The Delaware Supreme Court limited its two-step opinion to cases in which demand on a board to bring action is excused. "Consistent with the purpose of requiring a demand," it wrote, "a board decision to cause a derivative suit to be dismissed . . . will be respected unless it was wrongful. . . . Absent a wrongful refusal, the stockholder in such a situation simply lacks legal managerial power." 430 A.2d at 784. Where demand is excused because of board disqualification, the court said the situation then "presents a threshold issue." *Id.* at 784 n.10.

Already, this distinction has prompted judicial challenge. In Abramowitz v. Posner, [Current] Fed. Sec. L. Rep. ¶ 98,458 (2d Cir. Feb. 9, 1982) (2d Cir. 1982), aff'd 513 F. Supp. 120 (S.D.N.Y. 1981), demand was made and refused. The shareowner, joined in an amicus brief by the SEC, sought to get the court to treat a demand and refusal case as functionally equivalent to a futility case, but the court declined to go along. Saying that the lower court had correctly required that demand be made, it then wrote: "While we do not deny that Delaware has chosen a stricter test for futility cases, we believe that the SEC has misperceived our function as a reviewing court. We are not a legislative body free to rewrite Delaware law in order to advance federal policy." *Id.* at 92,695. In Abramowitz, only 5 of 17 directors were made defendants. Had all directors been made defendants, as in Maldonado, then the second-tier examination under the court's independent business judgment would have been in order. That was the result reached by the same court in the appeal of the New York Maldonado case, [Current] Fed. Sec. L. Rep. ¶ 98,457 (2d Cir. Feb. 9, 1982), aff'd in part and rev'd in part, 485 F. Supp. 274 (S.D.N.Y. 1979). *See also* Stein v. Bailey, [Current] Fed. Sec. L. Rep. ¶ 98,470 (S.D.N.Y. Feb. 4, 1982).

The distinction the Delaware high court has drawn between demand and futility cases is confusing when demand is made and refused, but the facts are such that even if demand had not been made, the requirement would nevertheless have been excused. That was not the case in Abramowitz. Demand was made because the lower court required it, and the appellate court approved of that compulsion. Whether the two-step test of the Delaware Supreme Court could ever be applied to a demand case was a question explicitly raised but not answered in the Second
second step substitutes for the business judgment rule the court’s own independent assessment as to whether the action should go forward.\textsuperscript{64}

The court recognized that this independent assessment could well create situations where the reviewing court, despite its recognition of the committee’s good faith decision not to pursue the action, would deny the committee’s motion to dismiss.\textsuperscript{65} The court justified the second step by stating that its purpose was “to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation’s interest.”\textsuperscript{66} The court went on to emphasize that the Court of Chancery would have to determine the weight of the corporation’s interest in dismissal, paying particular attention to offsetting “matters of law and public policy” that might run counter to the sole question of the best interests of the corporation.\textsuperscript{67}

The exact or even general dimensions of this independent judicial business judgment are certainly not discernible from the court’s language. The language, however, is conceivably broad enough so as to supplant the traditional approach of the business judgment rule applied to the recommendation of a litigation committee.\textsuperscript{68}

Determination of the intended latitude of this decision will have to await future cases. Because the words are those of Delaware’s highest court, their import to American corporations is substantial. Furthermore, they can contrast markedly from the approach of the \textit{Auerbach} decision.

With this capsulization of the present tensions in American case law

\begin{footnotesize}
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\item \textsuperscript{64} 430 A.2d at 789.
\item \textsuperscript{65} \textit{Id.} For another case interpreting the business judgment rule as allowing directors to initiate a dismissal of a derivative action and permitting it in a context of self-dealing, see Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981), \textit{aff’d}, [Current] Fed. Sec. L. Rep. \textsuperscript{\textasciitilde} 98,458 (2d Cir. Feb. 9, 1982). In this case, the disinterest and independence of the litigation committee was defended, and it was noted that the recommendations of the committee included that of demanding of certain of the defendant directors a refund of personal gains made in breach of their obligations to the company. \textit{Id.} at 123, 133.
\item \textsuperscript{66} 430 A.2d at 789.
\item \textsuperscript{67} \textit{Id.}
\item \textsuperscript{68} See note 125 \textit{infra} and accompanying text.
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\end{footnotesize}
on the business judgment rule in derivative actions in mind, the author tenders a few observations from inside today's corporate environment.

III. THE DERIVATIVE SUIT AND BUSINESS JUDGMENT RULE IN CONTEMPORARY PERSPECTIVE

_Gall_, _Burks_, and _Auerbach_ on the one hand and _Maldonado_ in the Delaware Chancery Court on the other pull in opposite directions. Depending upon the scope to be given to the Delaware Supreme Court's independent judgment role in _Maldonado_, the tension between that opinion and _Auerbach_, in particular, can also be quite heavy. Either future decisional law or legislation must resolve this divergence and bring the later cases closer together. The former course has the important attribute of flexible evolution—the utilitarian facility to respond differently to varying circumstances in a highly fluid environment. Legislation tends to freeze responses based on the finiteness of circumstances as they are known or have been experienced. For either route, a pragmatic appreciation of the shareowner derivative action is instructive.

A. The Events Underlying Recent Derivative Actions

The cases of primary focus for this Article, _Gall_, _Burks_, _Auerbach_, and _Maldonado_, were all instances of suits against corporate officers and directors—individuals who were in a fiduciary capacity with their respective organizations. In some of them, third parties such as an outside corporate auditor^69_ were also targets. The plea of this Article, however, is for an extensive ability of corporate boards to bring to a close derivative actions against fiduciaries. What is said as to them will have no less relevance in the context of third party claims, and would also be equally true if the derivative action were against a lower level employee.

Many, perhaps the large majority, of the derivative actions that have helped shape this area of the law during the 1970s and the beginning years of the new decade involved foreign payments and dealings in a variety of corporate incentive plans, usually stock options. Both _Gall_ and _Auerbach_ were overseas payment cases, and _Maldonado_ arose out of a modification of a stock option program. In _Burks_, the complaint was that directors, because they were allegedly not paying due atten-

tion to their business, acquiesced in the purchase of worthless Penn Central obligations.

If the foreign payments cases are taken as a group, the reader will notice that in none of them were the directors implicated in any self-dealing or improper personal gain. One not unreasonable interpretation of the conduct of personnel who were familiar with the so-called overseas bribe activities is that the interests of shareowners were being pursued over-zealously. All of the bribes involved large sums of money, and in some it ran into tens of millions of dollars. The magnitude of these figures as potential liability on directors for allowing these payments afforded ample incentive for the judicial response uniformly reached, that is, the ability of board committees to initiate a dismissal of the derivative actions.

Perhaps the most significant driving force in all of these cases, however, was the high probability that if the complaint were sent to trial, protection of the officers and directors under traditional business judgment rule applications would have been forthcoming. Few examples exist under the business judgment rule when directors have been losers in a contest over alleged negligence. Even in the stock option cases, with their element of self-dealing, the business judgment rule would

70. In Gall v. Exxon, 418 F. Supp. 508 (S.D.N.Y. 1976), $59 million was involved. See notes 5 supra & 71 infra and accompanying text.


73. In addition to the Zapata group of cases, note 34 supra, see Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980) (action not dismissed, on basis of federal policy); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (action withdrawn, but substantial attorney's fee awarded), cert. denied, 449 U.S. 869 (1980).

74. Self-dealing is often said to obviate the availability of the business judgment rule. But this statement is too sweeping, for examples exist when although an element of self-dealing is alleged, the rule was applied because of a prevailing corporate purpose in the action taken. See
probably have afforded a safe harbor. Stock options are basically a form of compensation, and courts are reticent to journey into this preserve, leaving to compensation and development committees the responsibility to determine the corporate interest.75 The cases usually involved an option program that was amended in some manner to provide a greater benefit to participants, but at an added cost to the corporation because of a different but heavier tax treatment. Some dissident stockholder would call a "foul"76 and seek to recover from directors, particularly participating insiders, the increased cost to the corporation.

If targeted directors and officers are in the end expected to be successful in asserting a business judgment defense, rejecting the board's recommendation to dismiss and sending the case to trial achieves little. The time, expense, and other burdens of lengthy litigation prove counterproductive, clogging already overburdened court calendars and operating to discourage candidates from assuming directorial roles. The costs to the corporation, and indirectly to the shareowners as a whole, can be exorbitant because teams of defense counsel inevitably become involved. Each named defendant usually receives appropriate private counsel paid for by the corporation. Because current law holds that attorneys, even for a losing plaintiff-shareowner, may have a claim against the corporate treasury,77 the ultimate cost to the entire body of

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76. The argument usually is that the description of the option plan in the proxy statement was not complete if it did not provide for the type of amendment that was made. Then, if the amendment was not submitted to shareowners for approval, a violation of the disclosure rules is alleged. See, e.g., Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980), in which the directors of the corporation amended a plan to allow outstanding options to be turned in for new ones at a much lower price, with the result that on a subsequent rise in the market price of the company's shares, the optionees received a substantial benefit. The court adopted the Auerbach rationale enthusiastically, saying that

[to allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders. There is no reason to believe that a minority shareholder is more likely to act in the best interest of the corporation than are directors who are elected by a majority of the stockholders.
615 F.2d at 783.
77. Lewis v. Anderson, 509 F. Supp. 232 (C.D. Cal. 1981) (attorney for losing stockholder sought nearly $400,000 in fees, claiming that dismissed derivative action was catalyst for directors
stockholders may well outstrip whatever benefit is hoped to be gained in permitting a challenge to go to trial.

The panoply of malfeasance that derivative actions may attempt to redress is not, of course, limited to foreign payments and stock option machinations. As a hypothetical matter, the instances of misconduct can be much broader. A survey of cases occurring in the 1970s, the halycon days of the anticorporate activists, discloses other types of complaints, to be sure, but again in most of these the court confirmed the power of the board to terminate the action.\(^78\) When this did not occur, independent reasons usually existed to deny effect to a board recommendation, such as an involvement of the board decision makers that impaired their disinterest or independence.\(^79\) A few followed the reasoning of the Chancellor's decision in *Maldonado*,\(^80\) which, because of its subsequent reversal, casts those decisions in doubt. Judged by the cases, one can draw on very little to demonstrate any compelling need for this remedy against officers and directors to be loosed from the director authority under which it is currently controlled.\(^81\) Instances of egregious wrong are extremely rare in the cases,\(^82\) and when they have appeared, the requisite of disinterest or independence has proven suffi-

submitting an amendment of the stock option plan to stockholders for ratification). See also Neese v. Richer, _Ind. App._, 428 N.E.2d 36 (1981) (no pecuniary benefit to corporation derived from dismissed action, but attorney's fees awarded).


79. _E.g._, Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980) (undue influence of major shareholder, whose votes were necessary for director election), cert. denied, 450 U.S. 1029 (1981); Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980) (all directors named defendants, and court also employed federal policy); Watts v. Des Moines Register and Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981) (following Delaware Supreme Court opinion in *Maldonado* case in a corporate reorganization designed to discourage unfriendly tender offer).


81. Reported case law is not necessarily a barometer for judging a need for law reform, but it is not irrelevant.

82. Perhaps one of the more focused self-dealing cases is Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981), aff'd [Current] Fed. Sec. L. Rep. ¶ 98,458 (2d Cir. Feb. 9, 1982). Here, the court gave effect to the special litigation committee's recommendation to dismiss, noting that it had also recommended certain repayments of improper personal gains. _Id._ at 123, 133. The case
ciently elastic to achieve the measure of judicial supervision desired. 83

If most or all cases, save for those few bordering on disabling self-interest, seem to be surviving the recommendation of a board or a board committee to dismiss a derivative suit, then what need is it that cries out for a change of direction through either judicial or legislative action? Little or none. It merits keeping in mind that the per share compensatory reward of most of these cases is of necessity extremely small. A recovery in the derivative action belongs not to the shareowner, but to the corporation, and, unlike in the formative days of the shareowners’ derivative suit, in today’s world the participant in such a challenge is likely to be a large publicly owned corporation. 84 Even a huge money recovery will prove inconsequential to most shareowners. 85 It may, indeed, be inadequate to cover the cost of such litigation. Lawyers for the shareowner plaintiffs are in effect lawyers for the corporation, since the derivative action belongs not to the shareowner but to his corporation. As the “client” of the shareowner’s counsel, the corporation is obligated for his fee, oftentimes win, lose, or draw. 86

Shareowners as a group may, when a derivative action survives the business judgment rule on the underlying claim, nonetheless foot the costs for losing officers or directors. For some years, corporations have commonly provided for indemnification of officers, employees, and directors for liabilities imposed on them as a result of the performance of their corporate obligations. The precise contours of these indemnification provisions, usually found in corporate bylaws approved by shareowners and often backed up by insurance, 87 vary from institution to

thus illustrates a positive use of this mechanism to achieve correction of abuses and at the same time avoid the diversions of adversarial litigation.

83. See cases cited note 54 supra. See also Zaub er v. Murray Sav. Assoc., 591 S.W.2d 932 (Tex. App. 1979).
84. The deep pockets of the large publicly owned corporations make them the targets of lawsuits. See Getting Into Those Deep Pockets, FORBES, Aug. 4, 1980, at 59.
85. The resources of most individuals would not permit satisfaction of a judgment which would on a per share basis be meaningful in most large publicly owned corporations.
87. The Monsanto Company bylaw on indemnification of employees, in effect on January 1, 1982, reads in part:
The Company may indemnify, to the full extent permitted by and in accordance with the laws of the State of Delaware as in effect either at the time of the act or acts complained of or at the time of indemnification, and shall so indemnify to the full extent required by and in accordance with such laws, any person (and the heirs and legal repro-
institution, and frequently refer to appropriate state law for the scope of available coverage. This means that two sets of costs conceivably can be borne by shareowners when derivative actions go forward. First, they may bear the heavy costs of defending the action on the part of multiple defendants, each with its team of costly counsel, and second, they may bear the funding of indemnification. It is unintelligent to respond by establishing laws denying the effectiveness of these indemnity obligations. In today's litigious environment, exacerbated as it indeed would be by any severe limitations on the business judgment doctrine in the derivative action setting, a potential corporate officer or director would be well nigh irresponsible and foolhardy to accept a board or senior officer appointment without this protection. The absence of indemnity would seriously threaten the pool of available director talent.

Shareowners' derivative actions are easily as much of interest to entrepreneurial lawyers as they are to shareowners, and probably more. If other virtues to derivative suits against officers and directors argue for their greater availability, then the fact that lawyers should profit from them is of little relevance. Reported decisions do not demonstrate the need, however, for greater availability.

88. No attempt is made here to describe the scope of indemnity which can be made either directly by the corporation or from insurance. Delaware distinguishes, in the case of negligence, between actions of third parties against officers and directors and derivative actions. In the latter category, indemnification is available only on approval of the court. Del. Code Ann. tit. 8, § 145(a)-(b) (1975). As to the availability of insurance protection that is broader than direct indemnity, see id. § 145 (g).

89. The funding may be by way of insurance, or part insurance and part self-insurance. Whether, in the case of indemnification for a stockholder derivative action judgment, public policy would preclude the protection is not here discussed. A search for case law on the topic was fruitless.

90. Once before in its history, the shareowners' derivative suit was in need of protection from abusive use. See Comment, Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience, 4 Colum. J.L. & Soc. Prob. 50 (1968). See also Hornstein, New Aspects of Shareholders' Derivative Suits, 47 Colum. L. Rev. 1 (1947).
B. *Derivative Suits and Management/Director Motivation*

Few would disagree with the observation that contemporary America is an overly litigious society. A well-known public opinion researcher and societal commentator observed not long ago that the propensity and ease with which Americans sue Americans is part of "the rot in our institutions and infrastructure" that must be faced. Strong words, these are, but they project a warning not to be ignored. Perhaps the chief victims of this propensity are American corporations along with their managers and directors.

Being on the downside of a litigious society's *casus belli* would not be objectionable or inappropriate were the position earned or a useful purpose served in enduring the agony or the threat thereof. It is often stated that the shareowners' derivative suit has "long played a crucial role in assuring a modicum of integrity and competence in the management of corporations," or that it is the "chief regulator of corporate management." In a competent and scholarly discourse of this subject, two academics have opined that "the organizing principle around which the derivative action should be reconstructed is a deterrent one: the derivative action should serve as the principal means by which to enforce the fiduciary duties of corporate officials and to penalize the violation thereof." In this observer's view, nothing is further off base or potentially more inimical to the interests of corporate governance and therefore to the welfare of shareowners than this view of the derivative action.

Lawyers and the legal profession often assign excessive credit to the

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91. Yankelovich, *Toward an Ethic of Commitment*, INDUSTRY WEEK, June 15, 1981, at 62. In an article published in 1975, Professor John Barton of the Stanford University Law School projected that in the year 2010 there would be a need for making one million federal appellate decisions. Reporting that number would require 5000 appellate judges in the federal court system alone. Because for each appellate case in federal courts, historically there have been ten new cases filed each year, simple projections led to the conclusion that in 2010, in the federal courts alone, 10 million new cases would be filed. Historically, in California the ratio of state to federal filings is 4 to 1, which means in one state of the 50, 40 million suits would be filed per year only one and a half generations in the future. See Barton, *Behind the Legal Explosion*, 27 STAN. L. REV. 567 (1975). It obviously would take an enormously wealthy nation to sustain and endure the expenditure of money and human resources this sort of litigation load would demand.


value of lawsuits or the threat of lawsuit in shaping the conduct of society. No empirical evidence suggests that lawsuits or their threat have any major impact in keeping others in line. Would lawyers, for example, concede that their conduct is determined in any meaningful measure by the threat of malpractice actions, as distinguished from a culturally derived attitude to perform in a respectable and professional manner? Do lawyers put the interests of clients foremost simply to avoid war with the law or the particular client? The view that shareowner derivative actions should be used as the "principal means" for enforcing managerial fiduciary responsibilities reflects either a cynical view of human action or an uninformed perspective of how management works.

Those who manage or guide the management of corporate enterprises are, except in the aberrant case, dominantly driven by the desire to perform effective and superior wealth-producing roles, and to perform these in a culturally acceptable manner. They are not motivated toward proper and effective leadership by the kind of adversarial relationship or climate that shareowner challenges, especially lawsuits, precipitate. This is not to say that the threat of potential liability has not swayed management or board room actions; it doubtless has. The norm of board and management conduct, however, is to take action without transgressions of morality and ethics because the ethos and culture of the participants so demand. To believe that boards and managers consciously skirt close to the margin of illegality or moral turpitude to achieve private aggrandizement or gain competitive advantage is to indulge in fantasy. The real world seldom orders itself in that manner. Directors and managers of American enterprises are products of the same culture as are other professionals, including lawyers, judges, and law professors, and their integrity and sense of justice and injustice are no less finely tuned, nor more flawed in execution.96

To the business manager, litigation is a nonproductive, highly expensive adversity to be suffered. Its cost is measured not only in dollars, but also in the injury it brings to organizational morale and the diversion it requires of management time and talent. In view of the discipline forfeited by American courts over the discovery process, it is an easy matter for opposing lawyers, through depositions, interrogatories, 

96. For a discussion of classical concepts of human action, see F. HAYEK, LAW, LEGISLATION AND LIBERTY (1973).
and subpoenas of documents, literally to tie in knots a target organization. What can be and is done through these tactics belies any rational justification. Filing lawsuits with little or no merit has become, it seems, a way of life with many lawyers, nurtured by a number of practices that managers see as pernicious in consequence. These include contingency fees, treble damage statutes, and discovery abuses. Another contributing factor, and perhaps the more significant, is the failure of our system to impose a penalty on claimants who are inspired by counsel to seek draconian relief when an appropriate remedy actually may be only a fraction of that prayed for, or nothing at all. The over-deposed, over-interrogated and over-discovered defendant, pursued by teams of lawyers, becomes victimized by the process, not by the effects of the allegedly wrongful conduct. Pragmatists as they are, managers reluctantly turn their attention to settlement, not to avoid adjudication of their alleged guilt, but to end the process and return their labors to the ongoing affairs of the entities they are charged to manage. Because the shareowner-plaintiff is not the recipient of what may be left in any such settlement after lawyers' fees, the real winner in these forays are not the shareowners, but the lawyers.

The Gall, Burks, Auerbach lineup offers an effective alternative to costly and disruptive litigation. In no way do these decisions raise the specter of an "effectively unrestrained corporate management." By their own standards they impose a severe limitation: the appropriateness of the process by which a decision is reached. Although Auerbach, the most extreme articulation of the power, suggests a clean demarcation between a court's examination of the process and its scrutiny of the underlying alleged misconduct, it also decrees that the authority to terminate a suit may only be exercised in the lawful and legitimate furtherance of the corporate purposes. The more egregious the wrong, the less likely is the prospect for success of a board litigation

97. See Coffee & Schwartz, supra note 6, at 265.
98. The power to shut off a derivative action must be exercised under the same guides that the business judgment rule erected for its defensive use: due care, good faith, and an absence of gross abuse of discretion. This exercise must be by directors who meet standards of independence and disinterest. The exact dimensions of these guides may as yet be undetermined, and they may shift in the course of time, but as measures for judging the independence and objectivity of the process by which a decision not to sue is made, they have and should continue to have substantial restraining effect and vitality.
committee’s recommendation to terminate, even, it may be anticipated, under Auerbach.

Beyond these constraints on the process itself, a plethora of other constraints circumscribes corporate management. Almost no decision of any consequence, from hiring to firing, from embarking on new ventures to exiting old ones, from building new plants to tearing old ones down, can be made in the executive suite of today’s major enterprises without an in-depth examination of wide-ranging regulations, contract rights, and business and social pressures, many of which impact or sometimes totally control the decisionmaking outcome. Shareowner actions that are representative rather than derivative are also in the background, so that in no manner does enhancement of the board power to abort derivative actions remove the shareowner as a potential

100. To talk in terms of unrestrained management is simply unrealistic in today’s environment, if it ever was. One need only reflect a moment on the regulatory activities of the SEC, Department of Labor, Department of Commerce, and the FTC, and such laws as antitrust, OSHA, Toxic Substances Act, ERISA, and EPA, to mention but a small number, to begin to get an idea of how hemmed in the business decision-making process has become. Many of these get repeated at the state and local level.

101. One court stated:

This does not mean, however, that directors may engage in illegal activity with impunity, relying on the prospect that a disinterested committee will seek dismissal on their behalf. To the contrary, when unlawful acts have been committed, there are other mechanisms available to the public or shareholders to enforce any rights infringed as a result of illegal corporate activities. The government may either prosecute alleged wrongdoers, which serves the public interest by punishing illegal conduct, or a shareholder may bring a direct action, which enables those personally harmed by the conduct to seek redress. These suits are not subject to dismissal at the instance of directors. As such they provide adequate safeguards against directors who attempt to ratify conduct not capable of ratification.

Joy v. North, 519 F. Supp. 1312, 1321 (D. Conn. 1981). A similar position was stated in the New York Maldonado suit, where the court said it is incorrect to imply that derivative actions are the sole private means of redressing violations of section 14(a) [of the 1934 Act] and enforcing the Congressional policy of protecting investors. The cause of action implied under section 14(a), however, can also be asserted by an individual shareholder in his own behalf or as a class action on behalf of all affected shareholders and therefore the business judgment rule cannot be said to preclude private enforcement of the proxy rules.


Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981), and Panter v. Marshall Field & Co., 486 F. Supp. 1168 (N.D. Ill. 1980), aff'd, 646 F.2d 271 (7th Cir), cert. denied, 102 S. Ct. 658 (1981), are examples of the business judgment rule as applied in shareholder representative actions. One of the most effective direct actions in the securities area was SEC v. Texas Gulf Sulphur Co., 401 F.2d 83 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), in which liability for nondisclosure of material information was at issue. Also to be borne in mind is the possibility of criminal actions, as for example, under antitrust proceedings, e.g., United States v. Foley, 598 F.2d 1323 (4th Cir. 1979), cert. denied, 944 U.S. 1043 (1980), under various environ-
plaintiff. Rather, it tends more to eliminate the nuisance threat of the entrepreneurial lawyer than the threat of a claim that validly reflects an injury directly sustained by shareowners.

Lodging extensive authority in directors to dispose of derivative actions against officers and other directors is an inherently principled common law development, serving as it does a central corporate need: maximum opportunity for effective management of corporate resources. Its enhancement also aids the societal objective of controlling the litigation explosion, without unduly jeopardizing the protection to which one of its segments is entitled. Managers and directors, and not courts, best understand a corporation’s need to nurture its business plans and the best interests of the corporation’s diverse constituencies, most significantly, all of its shareowners and employees.102

C. Compatibility with Corporate Governance

Initially, one might think that assigning the business judgment rule a role of closing off shareowner derivative actions would run counter to contemporary currents for corporate governance practices. Certainly, several commentators have expressed this view, and a few have even interpreted recent extensions of the rule as sounding the death knell of the derivative suit.103 If, as is the case with some of these writers, the derivative action is as esteemed as the mechanism by which corporate management is kept in tow,104 then its potential decline or demise would appear to be an event to be regretted.105

It seems, however, that one can make a persuasive case that the business judgment rule as a device for termination of derivative actions goes hand in hand with more responsible corporate governance.

mental laws. The potential for criminal actions against business officials has increased substantially in recent years.

102. See Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903), where the court wrote: “It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs.” Id. at 463.

103. See, e.g., Dent, supra note 6, at 98.

104. Whether made by competent scholars, e.g., Rostow, To Whom and For What Ends Is Corporate Management Responsible?, in The Corporation in Modern Society 46 (E. Mason ed. 1961), or iterated from the bench, e.g., Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949), the mere assertion that the shareowners’ derivative action is what keeps corporate boards and management in line does not make it so. For views on the value of lawsuits in management conduct, see notes 95-97 supra and accompanying text.

105. See Coffee & Schwartz, supra note 6, at 263; Dent, supra note 6, at 109.
In an earlier portion of this Article, which traced some of the history of the business judgment rule, the author noted that since its early application in the protection of officers and directors from judicial second-guessing, the elements of good faith, due care, and an absence of gross abuse of discretion had to be satisfied in order for this defensive shield to withstand challenge. These requisites also carried over to instances of board decisions not to pursue claims against third parties or against officers and directors.

More recently, however, especially in cases involving derivative actions against officers and directors, the qualities of independence and disinterest have emerged as pivotal. In this context, the business judgment rule has not been used as a defensive shield, but instead as an offensive weapon for avoiding attack on the underlying decision.

The logic of employing the business judgment rule in derivative suits against third parties was, and remains, the judgment that the decision not to sue is a matter of corporate interest. As such, the decision is one for management or the board to make in the light of corporate concerns as the board perceives them, and is therefore no more challengeable by a shareowner than any other management decision. Whether this logic has equal relevance to derivative actions against officers and directors is another question. As a distinguished jurist once observed, law and logic do not always coincide, but rather often are driven apart by the logic of experience. This undoubtedly underlay the wariness of the lower Delaware court in the subsequently reversed Maldonado decision, when it wrote that "under our system of law, courts and not

108. See cases cited at notes 5 & 71 supra. In Joy v. North, 519 F. Supp. 1312 (D. Conn. 1981), the court wrote:
   However, once an independent committee has been appointed, the fate of the derivative suit is no longer in the hands of the defendant directors charged with wrongdoing, but rather is under the exclusive control of a disinterested committee. The focus thus shifts from those accused of breach of trust over to the committee members. So long as the committee consists of directors who are not personally responsible for the breach of trust, or otherwise involved in the alleged illegality, they have the power, properly exercised, to absolve those directors claimed to have breached their fiduciary duties.
   Id. at 1319.
109. Swanson v. Traer, 249 F.2d 854, 859 (7th Cir. 1957) ("an individual stockholder has no more right to challenge by a derivative suit a decision by the board of directors not to sue than to so challenge any other decision by the board").
litigants should decide the merits of litigation." \footnote{111}{Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. Ch. 1980).} 

Logic and experience, however, may well be on the same course in allowing the business judgment rule to be used to insulate a first-tier management or board decision from shareowner challenge. With the elements of due care and good faith firmly intact, and with the importance of the condition of independence and disinterest on the part of board litigation committee members equally established, the rule applied in this context is a catalyst for improved governance practices.

It is probably no mere coincidence that at the same time the business judgment rule was taking on a new role in derivative actions, significant shifts in corporate board supervision were in motion. The decade of the 1970s brought pronounced moves to more independent outside board members, and their assignment to significant new oversight functions. As a result, today’s typical board of a large publicly owned corporation is predominantly an outside board. \footnote{112}{See Mruk & Giardina, Organization & Compensation of Boards of Directors (The Financial Executives Institute and Arthur Young & Co. 1981). The same pattern of recent development is identified in Heidrick & Struggles, Director Data (1981) and the Eighth Annual Board of Directors Survey, Korn/Ferry (1981).} The director committees created for specific working functions are now highly visible, and commonly include executive, audit, compensation, nominating, and, not infrequently, public issues committees. Of these, the audit committee is composed exclusively of outside members, and the nominating and compensation groups are heavily weighted in that direction.

These developments are highly compatible with extending the authority of boards to terminate shareowners’ derivative actions. The courts, however, have not failed to notice that an expansion of the authority to close out a derivative action carries within it the seeds of potential abuse. For that reason, the elements of independence and disinterest have assumed disproportionate significance. Commentators and courts alike have debated the issue aggressively. \footnote{113}{See, e.g., note 6 supra.}

\emph{Gall} and \emph{Auerbach} were both instances where the special litigation committee was made up of directors who were not on the board at the time of the alleged defalcation. Such individuals generally are accorded a presumption of independence and disinterest, unless special facts are pleaded that show a connection to the event or an interest in its resolution. In \emph{Auerbach}, plaintiffs made the argument that no direc-
tor, however detached from the corporation at the time of the event, can ever be expected to be fully independent because his working relationship with other directors amounts to a structural bias impacting on his judgment. The Auerbach court soundly rejected this contention. In Maldonado, the Federal District Court for the Southern District of New York labelled this contention a "cynical attitude" that would effectively render nugatory any actions undertaken by a board appointed independent committee.

These extracts demonstrate that expectations can and do run high as to the ability of board members to be independent and disinterested

114. This same skepticism has been expressed in other suits. See, e.g., Burks v. Lasker, 567 F.2d 1208 (2d Cir. 1978), rev'd, 441 U.S. 471 (1979).

115. To disqualify the entire board would be to render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative action. The possible risk of hesitancy on the part of the members of any committee, even if composed of outside, independent, disinterested directors, to investigate the activities of fellow members of the board where personal liability is at stake is an inherent, inescapable, given aspect of the corporation's predicament.

47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. The court added:

To assign responsibility of the dimension here involved to individuals wholly separate and apart from the board of directors would, except in the most extraordinary circumstances, itself be an act of default and breach of the nondelegable fiduciary duty owed by the members of the board to the corporation and to its shareholders, employees and creditors. For the courts to preside over such determinations would similarly work an ouster of the board's fundamental responsibility and authority for corporate management.

Id. In Joy v. North, 519 F. Supp. 1312 (D. Conn. 1981), when dealing with the structural bias issue, the court wrote:

No decision which plaintiff has cited to this Court has held that this unique relationship between defendant directors and the directors they chose to determine the fate of the derivative suit is grounds, standing alone, either to dissolve the Committee or invalidate its result. In fact, to take this position would compel this Court to find self-dealing by the directors even though they followed procedures prescribed by statute and corporate bylaws in appointing an independent Committee. Moreover, to find these procedures infirm and voidable under the statute would place in jeopardy the concept of a litigation committee at a time when such committees have become widely accepted, useful tools for disposing of detrimental derivative actions.


116. The court stated; "This cynical attitude would require a per se disqualification of any committee appointed by a board exercising its statutory authority no matter how far the independent committee may be removed from the transactions that are at the core of the litigation." 485 F. Supp. 274, 282 (S.D.N.Y. 1980), aff'd in part and rev'd in part, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,457 (2d Cir. Feb. 9, 1982). The shareowner in this case also applied the structural bias argument to the attorney retained to study the charges, the claim being that since fees would be paid for the service, an objective independent recommendation would not be forthcoming. The court dismissed this implication of infirmity as "quite simply, a non sequitur and hardly worthy of comment." Id. at 283.
when determining whether an action against their associates should be continued. The illustrations purposely were drawn from cases where the members of the litigation committee were chosen after the occurrence of the challenged activity. This effectively is the maximum disconnection that can be achieved. This is not to suggest, however, that directors who were on boards when the event complained of took place cannot satisfy the test of independence and disinterest. They have satisfied the test, as have directors who have been named as nominal defendants, but of whom no relief was demanded.

The interest in these judicial rejections of an inherent incapacity, resulting solely from board membership, is not so much what the courts stated as their reasons for the rejection, but what they failed to state. The courts left any satisfied conviction that the deciding board members were free of influence from their peers substantially unexpressed; instead, the conclusion was seen as inescapable if the business judgment rule were to have any vitality in the arena of derivative suits against board or management.

This silence, however, does not infer that these or other courts, in applying the business judgment rule to stop derivative actions against officers and directors, have a subliminal suspicion that freedom from the influence of peers is an inescapable concomitant of their relationship. The rule is predicated, as previously noted, on the judicial judgment that making this decision involves predominantly business considerations, the determination of which directors and not courts are eminently more suited to make. Moreover, board members typically


119. As between judging the wisdom of dismissing a shareowner derivative action and judging the merits of the process by which this decision was reached, courts have acknowledged that their expertise lies in the latter, not former area. In *Auerbach v. Bennett*, the court wrote:

As to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are well equipped by long and continuing experience and practice to make determinations. In fact they are better qualified in this regard than are corporate directors in general. Nor do the determinations to be made in the adoption of procedures partake of the nuances or special perceptions or comprehensions of business judgment or corporate activities or interests. The question is solely how appropriately to set about to gather the pertinent data.

47 N.Y.2d at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929. To the same effect is *Joy v. North*, 519 F. Supp. 1312 (D. Conn. 1981): “Although courts may be ill-equipped to evaluate whether a
are strong-willed individuals, not easily maneuvered, and quite capable of identifying when they have a bad situation on hand that requires unpleasant resolution.\textsuperscript{120} Most jurists, it can be presumed, appreciate this and therefore deem it a wise course to defer to the judgment of others more knowledgeable about managing the affairs of a business organization, so long as there are reasonably appropriate safeguards for the integrity of their decisions.

This debate over the independence and disinterest of board members identifies the process by which enhancement of the power to close out a derivative action comes together with improved corporate governance practices. Obviously, the authority and power to terminate a lawsuit is an exceedingly useful one, creating as it does a mechanism for avoiding the risk of potential liability resulting from the merits of the underlying claims. Far more important to the corporation, however, is the fact that the power is a helpful tool for preserving within the enterprise those conditions that are critical to effective, and hopefully profitable, leadership. Responsible management, recognizing these values, will take the lead by instituting practices that will improve its opportunity to invoke the rule, when and if ever needed.\textsuperscript{121} Outside board members and good oversight practices become important. These will reduce the probability of events occurring for which a special litigation committee might be needed, and will thereby improve the prospects for selecting members for such a committee who will withstand a challenge to their disinterest or independence. The two contribute to each other an improvement in corporate governance and the ultimate extension to

\textsuperscript{120} The structural bias argument relies heavily on the fact that directors are selected with a good deal of influence, if not total control, by a chief executive officer. The relationship created by this inhibits, the argument goes, any decision by "outside" directors which would be against the chief officer or his associates. It seems this argument overlooks the independent qualities that many directors have, as well as the need for a close relationship between the senior officer and the board. This relationship is likely to be the closest when the officer is performing well; when this condition changes, the relationship tends to break down. Thus, as a situation giving rise to shareowner derivative actions increases in severity or repetitiveness, the reasons for a maverick role increase and whatever structural bias in the officer's favor there may have been, will likely diminish. There is a very real limit to the structural bias argument, it seems, and that limit is reached quickly in difficult situations.

\textsuperscript{121} In the context of a representative shareholders' action, the appellate court in Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), cert. denied, 102 S. Ct. 658 (1981) wrote: "The presumption of good faith [that the business judgment rule affords is heightened when the majority of the board consists of independent outside directors." \textit{Id.} at 294.
shareowners of the benefits of providing management with an environment in which to manage effectively.122

IV. A FINALE: THE FUTURE

Appreciation of the business judgment rule as used in its "offensive" setting is an innovative response to dispute resolution. In this function, its utilitarian qualities become apparent. The courtroom is set aside as the arena where battle must take place, and in its stead is substituted a mechanism, albeit not flawless, which is calculated to achieve the optimum result for a diverse set of interests.

Although the movement sustained occasional setbacks, the overwhelming direction of case law, until the Zapata decisions, was toward a continual aggrandizement of director authority to initiate dismissal of derivative actions. This, of course, did not occur without some important safeguards and qualifications, the most notable of which was emphasizing independence and disinterest on the part of the director decision makers. Two judicial dispositions fairly may be inferred from these decisions: first, that courts acknowledge the existence of conditions which require close scrutiny to afford reasonable assurance of the integrity of the process; and second, that rising above these conditions is a quality possessed by persons other than members of the bench. Critics of the Auerbach decision question this latter capability.123 Yet, board members are learning to disagree more agreeably, and the view that others cannot be trusted to exercise independent and detached judgments of their peers properly is criticized as a paralyzing perspective of human action.124 Expecting the same degree of objectivity as would be achieved by a court may be expecting too much, if indeed

122. "The continued willingness of the judiciary to accept its own concept, the business judgment rule, and to apply it to novel and stressful fact situations has to be a tribute to the gains that have been made in strengthening the role of outside directors." Estes, Corporate Governance in the Courts, 58 HARY. BUS. REV. 50, 60 (1968).
123. Dent, supra note 6, at 108-09.
124. Commenting on what amounts to disqualifying interest, the court in Joy v. North, 519 F. Supp. 1312 (D. Conn. 1981), wrote:

So long as directors serving on the Committee lack direct personal involvement in the subject matter of the suit, they satisfy the threshold test of independence. . . .

To qualify as interested, a Committee member must possess a direct personal stake in the subject matter being litigated. Personal involvement may take the form of authorizing the underlying transaction, . . . holding a financial interest in the conduct at the core of the litigation, . . . or otherwise reaping a tangible benefit from the challenged activity. Id., at 1326.
that is necessary. The goal is a decision in the interest of the entity, and
the greater understanding of its needs by those who manage it is a
healthy trade-off for the minimal impact that may flow from a "struc-
tural bias" labored under by a well-chosen body performing its assign-
ment thoroughly and in good faith.

Whether the Delaware Supreme Court's second-step criterion of a
court exercising its own business judgment will undermine this dispute-
resolution use of the business judgment rule is for future cases to deter-
mine. Opinions differ widely,\textsuperscript{125} and it is too soon to know how lower
courts will respond.\textsuperscript{126} It is not wholly beyond reason to hope, if not to

\textsuperscript{125} See Aronoff & Freeman, \textit{Shareholder Derivative Actions—A Continuing Balancing Effort},

\textit{NwUt. L. J.}, Nov. 16, 1981, at 28, col. 1:

[There is in our judgment no substantial difference between the Delaware Supreme
Court's ruling in \textit{Maldonado} and the 9th Circuit's decision \textit{in Gaines v. Haughton}, 645
F.2d 761 (9th Cir. 1981)].

\textit{Maldonado} makes clear that the motion to dismiss is "akin to proceedings on
summary judgment." The issue of the independence and good faith of the directors moving
to dismiss, whether or not it is expressly so stated, involves the court in some kind of
inquiry as to whether the wrong claimed to have been done is substantial or insubstan-
tial, or in the court's words whether the stockholder grievance is "deserving of further
consideration in the corporation's interest."

Thus, whether the court states that it is considering the merits of the lawsuit or not, its
decision as to the good faith and the independence of the directors' judgment will require
the court not only to examine the procedure of the independent committee but the nature
of that committee's consideration of the merits of the action and its reasoning as to why
the action should not be allowed to proceed further.

\textit{Id.} at 28, 30. \textit{Compare id. with} Block & Prussin, \textit{supra} note 6, at 28, where it is said that the
Delaware Supreme Court's two-stepped ruling will "have far-reaching effects on the way many
derivative actions are fought." These writers also comment:

The problem with the Zapata test is clear on its face: it is so open-ended, so compli-
cated, and so subject to judicial whimsy—which it seems to encourage—that such mo-
tions can never be the simple, inexpensive and straightforward proceedings which a
corporation needs if it is going to eliminate detrimental derivative litigation in a rational
way. \textit{Zapata} invites endless open-ended pretrial proceedings into such elusive issues as
whether the board's action satisfies the "spirit" of step 1; whether termination would be
"premature" because action is "deserving of further consideration"; whether the corpo-
rate interest is "compelling"; whether the derivative action is "nonfrivolous"; and
whether "matters of law and public policy" outweigh the corporate interest.

\textit{Id.} at 62.

\textsuperscript{126} The New York \textit{Maldonado} case was held up on appeal, pending a decision by the Dela-
ware Supreme Court. After that came down, the Second Circuit reversed in part and affirmed in
part the District Court's decision. Settlement of the parallel Texas shareholder action raised the
issue of res judicata, thus causing reversal. But on sending it back, the Second Circuit said that if
res judicata did not apply, then the lower court would have "to determine in its own independent
business judgment, whether Zapata's motion to terminate this action should be granted." \textit{Maldonado}
v. Flynn, (Current) \textit{Fed. Sec. L. Rep. (CCH)} ¶ 98,457, at 92,687 (2d Cir. 1982), aff'g \textit{in part and rev'g in part} 485 F. Supp. 274 (S.D.N.Y. 1980). It gave absolutely no guidance, however, on
how this was to be carried out—what, if any, hearings would be granted, what discovery would be
expect, that courts will recognize the utilitarian attributes of the rule and will be inclined to read the Delaware Supreme Court's choice of words as unfortunate and confusing. Courts instead should read these decisions to mean that the good faith, due care, and independent and disinterested standards required of the rule may be questioned by the irrationality of any decision that is reached. Methodology and result are, after all, never totally detached in any decisionmaking process.

What will be critical to the future viability of the business judgment rule as used to dismiss derivative actions is that courts do not so encumber the process as to destroy its vitality. Its attributes include the avoidance of costs in time and attention to business that litigation demands, combined with the speed with which a conclusion can be reached. The practices currently condoned and allowed when a challenge of the process is made easily cancel out these benefits. Endless discovery, shifting of burdens, and other techniques could make the process cumbersome and costly, and in turn invite claims and litigation in the expectation of settlement and resulting fees.

Such an error is being made by reporters for the American Law Institute in their first draft of a proposed restatement of Corporate Governance principles. Because this document has not yet surfaced in

permitted, who would have the burden of going forward with evidence, burden of proof, or any other matters.

In the only other case thus far employing the two-tier analysis of the Delaware Supreme Court, Watts v. Des Moines Register & Tribune Co., 525 F. Supp. 1311 (S.D. Iowa 1981), the court gave the shareholders a limited 30-day period to conduct discovery in order to challenge the recommendation of the litigation committee. Id. at 1330. It said the committee would have to bear the burden of the reasonableness of its decision, noting that the committee disregarded the suggestion of special counsel that one of the derivative claims should go forward. Id. at 1329. But the court withheld exercising its own business judgment until the discovery process extended to the stockholders was completed. Id. Thus the case was not instructive as to the substance of the second-step exercise of business judgment.

127. E.g., Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978), where the court wrote that "where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment." See also Gimbel v. Signal Co., Inc., 316 A.2d 599 (Del. Ch.) (involving injunctive action to prevent sale for $400 million of assets allegedly worth over $700 million), aff'd per curiam, 316 A.2d 619 (Del. 1974).

This position is developed in an article dealing with the scope of the two-step Delaware ruling to appear in the April, 1982 issue of The Business Lawyer, written by a leading Delaware corporate practitioner, Norman Veasey.

final form for its maiden presentation to an Institute plenary session, specific criticism is not appropriate. The draft has, however, caught the attention of various American Bar Association committees and of the Business Roundtable. The concerns expressed run deep, questioning even the wisdom of so prestigious a law organization attempting such a project. Why? Because of the prospects that it will etch in stone how corporations are to be managed, and the etching is being done by participants who are largely strangers to the task.

On the issue of the business judgment rule used to terminate shareowner derivative challenges, however, the message of the first draft is clear: derivative actions are a principal means for achieving responsible corporate governance and therefore barriers to their dismissal must be erected and raised high.129 The draft will not prevail without major debates. In its present mode it cannot and should not succeed. If it does, however, it will create another playground for lawyers, probably obstruct the steady drive for improved corporate governance,130 and effectively destroy the means that the genius of the common law created for putting in place an effective and equitable decisionmaking alternative to the adversarial environment of the courtroom.

Corporate governance practices have changed dramatically in the past decade. They continue to evolve, creating an institutional structure ever more compatible with the authority of directors to initiate dismissal of derivative actions. The hope is that legal theory will continue to be responsive and will avoid yet another area of confrontation that is destructive of the conditions needed for effective managerial leadership.

129. The ALI Statement imposes significant procedural burdens on corporations seeking to dismiss a derivative suit, and also makes the suits easier for shareowners to bring. The existing requirement that shareowners in certain cases post bond to cover the costs of the action to the corporation is eliminated, and the shareowner is given the right to discovery to acquire information to verify its complaint. As to the corporation's litigation committee, the elements of independence and disinterest are so altered from current requirements as to make it exceedingly difficult to establish such a unit from among existing "outside" directors. The authority of a court to dismiss an action on recommendation of a duly constituted board is also severely restricted. These provisions currently appear in Part VII of the proposed draft Statement.

130. See notes 103-22 supra and accompanying text.