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Director Dismissal Of Derivative Suits After Zapata Corp. V. Maldonado

DIRECTOR DISMISSAL OF DERIVATIVE SUITS AFTER *ZAPATA CORP. v. MALDONADO*

Corporate stockholders bring derivative suits on behalf of a corporation to enforce corporate rights.[1] Derivative suits enable stockholders to remedy or prevent injury to the corporation when directors fail to sue, or wrongfully refuse to sue.[2] Although the plaintiff stockholder names the corporation as a nominal defendant, the corporation, and not the

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[1] Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949); Meyer v. Fleming, 327 U.S. 161, 167 (1946); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 96 n.1 (1980) [hereinafter cited as Dent]; Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 168 (1976) [hereinafter cited as *Demand and Standing*]. *See generally* 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5939 (rev. perm. ed. 1980) [hereinafter cited as FLETCHER].

[2] *See* Ross v. Bernhard, 396 U.S. 531, 534 (1970) (derivative suit is equitable remedy to enforce corporate cause of action when directors will not); United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Dodge v. Woolsey, 59 U.S. (18 How.) 331, 345 (1856) (first United States Supreme Court case recognizing derivative action). In *United Copper*, the Supreme Court stated the rationale of judicial reluctance to interfere with directors' decisions. 244 U.S. at 263-64. Comparing a decision not to enforce a corporate cause of action to any other business decision, the Court disdained judicial involvement in intracorporate affairs unless the directors had breached their fiduciary duty to corporate shareholders. *Id. See generally* Dent, *supra* note 1, at 96 n.1; Prunty, *The Shareholders' Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. REV. 980 (1957) [hereinafter cited as Prunty]. A corporation's shareholders may institute a derivative suit against corporate officers, directors, or any other party that allegedly has harmed the corporation. Ross v. Bernhard, 396 U.S. 531, 534-35 (1970). *See also* notes 6-7 *infra* (procedural prerequisites for derivative actions). The corporation keeps any recovery the shareholder earns because to allow the shareholder to recover directly might defraud corporate creditors by enabling the shareholder to convert corporate assets to personal assets regardless of the corporation's solvency. *See* Prunty, *supra*, at 989; Note, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110 U. PA. L. REV. 1147, 1147 (1962) [hereinafter cited as *Shareholder Suits*]. Suits alleging direct harm by the corporation or its employees do not come within the recognized category of derivative suits even if brought by a shareholder. *See Demand and Standing*, *supra* note 1, at 168 n.2. *See generally*, *Shareholder Suits*, *supra*. Because the derivatively suing shareholder alternatively seeks to compel the corporation to sue or to enforce the corporation's rights, courts and commentators perceive the derivative suit as a dual cause of action. *See, e.g.*, Ross v. Bernhard, 396 U.S. 531, 538 (corporate claim and derivative shareholder claim combined in derivative suit); Maldonado v. Flynn, 413 A.2d 1251, 1261-62 (Del. Ch. 1980) (recognized dual aspect of shareholder derivative suit), *rev'd on other grounds sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); *cf.* 13 FLETCHER, *supra* note 1, § 5946 (both aspects of derivative action essential to balance corporation's and shareholders' interests); Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 603 (1980) [hereinafter cited as *Business Judgment Rule*] (suit against corporate directors for refusal to sue and suit against wrongdoer); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 748 (1960) (shareholder must establish claim that directors wrongfully refused to sue before court will allow maintenance of action against wrongdoer); Comment, *Offensive Application of the Business Judgment Rule to Terminate*

stockholder, recovers any judgment from the derivative suit.[3] Because minority shareholders allegedly have abused the power to sue derivatively,[4] courts and legislatures have created impediments to the right to sue derivatively.[5] To institute a derivative suit, a shareholder must meet demand and standing requirements.[6] To meet the demand requirement, the shareholder must demand that the corporation's directors sue on behalf of the corporation, or prove that demand would be futile.[7] A shareholder satisfies the demand requirement if after receiv-

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Nonfrivolous Derivative Actions: Should the Courts Guard the Guards?, 12 TEX. TECH. L. REV. 635, 637 (1981) [hereinafter cited as *Court Guards*] (derivative action contains two suits)..

[3] 13 FLETCHER, *supra* note 1, § 5953, at 387; Prunty, *supra* note 2, at 989.

[4] *See* Dent, *supra* note 1, at 137-40; Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 75-77 (1967) [hereinafter cited as Dykstra]; *Demand and Standing*, *supra* note 1, at 168. Abuses may occur if a shareholder institutes a nuisance or "strike" suit solely for a private settlement, or if an attorney brings a derivative action primarily to collect attorney's fees. *See* Dent, *supra* note 1, at 138 & nn.211-12; note 5 *infra*.

[5] *See* Buxbaum, *Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CALIF. L. REV. 1122, 1132 & nn.54-56 (1980) [hereinafter cited as Buxbaum] (citing authorities who evaluate validity of "strike suit" charges); Dent, *supra* note 1, at 137-40 (requirement of court approval of settlements and discretion to assess costs against plaintiff); Dykstra, *supra* note 4, at 75-82 (impediments include security for expenses, contemporaneous ownership, and demands on directors and shareholders); *Demand and Standing*, *supra* note 1, at 168 (impediments include requirement that shareholders exhaust intracorporate remedies); notes 6-7 and accompanying text *infra*. Because shareholders may institute "strike suits," which are derivative suits brought solely for the suits' settlement value to the particular stockholder, courts and legislatures have limited the availability of derivative suits. *See* notes 6-7 *infra*. The Federal Rules of Civil Procedure now require court approval to settle derivative suits, thereby virtually eliminating the danger of strike suits. FED. R. CIV. P. 23.1; *see* Dent, *supra* note 1, at 138. Courts do not approve of settlements in strike suit situations, and instead require the plaintiff shareholder to prove the merits of his case, if any, at trial. Dent, *supra* note 1, at 138.

[6] *See* notes 7-9 and accompanying text *infra*. Some legislatures have enacted procedural barriers other than showing demand or standing. *See, e.g.*, FED. R. CIV. P. 23.1 (requiring court approval of derivative suit settlements); N.Y. BUS. CORP. LAW § 627 (Consol. Supp. 1979) (requiring shareholder to post security for corporation's expenses); WIS. STAT. ANN. § 180.405 (West 1957) (ownership of shares contemporaneous with alleged wrong necessary).

[7] *See, e.g.*, Hawes v. Oakland, 104 U.S. 450, 460-61 (1882) (original judicial creation of demand requirement in American derivative suits); FED. R. CIV. P. 23.1; 13 FLETCHER, *supra* note 1, §§ 5963, 5965. *See generally* Buxbaum, *supra* note 5; Note, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CALIF. L. REV. 885 (1981) [hereinafter cited as *Derivative Suits*]; *Demand and Standing*, *supra* note 1. Besides acting as a procedural limitation on shareholder derivative suits, the demand requirement is a condition precedent to shareholder suits to enforce corporate rights that serves some constructive purposes. *See Demand and Standing*, *supra* note 1, at 171-72. The demand requirement prevents judicial interference in intracorporate disputes until the shareholder exhausts all available intracorporate remedies. *Id.* at 171. In addition, the demand serves to notify the corporation's directors of a remediable harm or right that the directors may have overlooked, thereby allowing the directors the opportunity to enforce corporate rights. *Id.* The directors normally supervise corporate litigation as part of their managerial function. *Id.*

Practical reasons favor allowing directors rather than shareholders to litigate a cor-

ing the shareholder's demand, the directors refuse to sue or fail to act.[8] To establish standing, a shareholder must show that the directors' inaction or refusal constitutes a "wrongful refusal" not to sue.[9]

Directors may attempt to terminate a derivative suit by challenging the shareholder's standing to sue derivatively.[10] If the shareholder fails to show "wrongful refusal," the court will grant the directors' motion to dismiss for lack of standing.[11] Courts uniformly have granted directors'

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porate cause of action. *Id.* First, directors generally have greater access to the facts underlying the proposed suit. *Id.* Directors can better evaluate the business justifications for and against pursuing the cause of action, both because of their business expertise and fiduciary obligations to do so. *Id.* at 171-72. Finally, allowing the directors to pursue the litigation themselves places the vast corporate assets behind the litigation. *Id.* at 172.

[8] Maldonado v. Flynn, 413 A.2d 1251, 1262 (Del. Ch. 1980), *rev'd on other grounds sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). *See generally Demand and Standing, supra* note 2, at 170-82.

[9] *See* 13 FLETCHER, *supra* note 1, § 5969; *Demand and Standing, supra* note 1, at 193. The standing requirement rests on the common-law doctrine that minority shareholders may not maintain a suit on the corporation's behalf contrary to the directors' decision because the directors manage the corporation's business affairs. *See Demand and Standing, supra* note 1, at 169. A derivatively suing shareholder must demonstrate the wrongfulness of the directors' decision not to sue in order to establish standing. *Id.* at 191. A shareholder may prove wrongfulness, for example, by showing self-dealing, a board controlled by the wrongdoer, or proving that the corporation has a clear cause of action. *Id.* at 193-98.

[10] *See, e.g.*, Burks v. Lasker, 441 U.S. 471, 474 (1979) (directors asserted that their decision not to sue was not wrongful because litigation was not in corporation's best interests); Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979) (special litigation committee maintained that continuation of suit would harm corporation), *cert. denied*, 444 U.S. 1017 (1980); Genzer v. Cunningham, 498 F. Supp. 682, 684 (E.D. Mich. 1980) (directors urged that pursuit of claim was detrimental to corporation); Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713, 715 (E.D. Va. 1980) (committee concluded that costs outweighed benefits of lawsuit); Maher v. Zapata Corp., 490 F. Supp. 348, 350 (S.D. Tex. 1980) (litigation committee urged dismissal because the shareholder's claim lacked merit, costs outweighed benefits, litigation would waste management's time, and would generate adverse publicity); Maldonado v. Flynn, 485 F. Supp. 274, 278 (S.D.N.Y. 1980) (decision to dismiss not wrongful for reasons stated in *Maher* v. *Zapata Corp.*), *rev'd per curiam*, 671 F.2d 729 (2d Cir. 1982) (remanded to allow trial court to determine whether in court's business judgment suit would not benefit Zapata); Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981) (same reasons for dismissal as in *Maher v. Zapata Corp.*); note 23 *infra* (defining "special litigation committee").

[11] *See* note 10 *supra*. Only a few courts deny the special litigation committee's right to compel dismissal. *See* Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713, 718 n.1 (E.D. Va. 1980) (Virginia law does not permit directors to dismiss derivative actions); Maher v. Zapata Corp., 490 F. Supp. 348, 354 (S.D. Tex. 1980). Furthermore, if the Southern District of Texas reheard *Maher*, the court might reach a different result because of the Delaware Supreme Court's subsequent decision in *Zapata Corp.* v. *Maldonado*. *See* note 50 *infra*.

[12] *See, e.g.*, Hawes v. Oakland, 104 U.S. 450, 461-62 (1882) (derivative suit against city seeking payment for water supplied dismissed because directors' decision not to charge city was reasonable business judgment); Ash v. International Business Mach., Inc., 353 F.2d 491, 492-93 (3d Cir. 1965) (directors' refusal to sue competitor for possible antitrust violation deemed proper), *cert. denied*, 384 U.S. 927 (1966); Klotz v. Consolidated Edison Co., 386 F. Supp. 577, 581-83 (S.D.N.Y. 1974) (directors' avoidance of challenge to allegedly confiscatory rate-making policy proper); Bernstein v. Mediobanca Banca di Credito Finanziario-Societa

motions to dismiss for lack of standing when shareholders attempt to sue unaffiliated third parties derivatively.[12] Courts have reached conflicting results, however, when presented with the question whether directors may terminate shareholder derivative actions alleging wrongs by the directors themselves.[13] Some courts have held that a director's financial or other interest in the outcome of the derivative suit precludes a rational decision by the director on whether to dismiss.[14] Consequently, these courts have held that when a shareholder charges the majority of the board with wrongdoing, the directors can never dismiss the action.[15] Most courts have reviewed the directors' decision to dismiss using the business judgment rule, which precludes judicial scrutiny of directors' actions unless the shareholder shows fraud, self-dealing, or unreasonableness in the decision.[16] Because of the difficulty of showing impropriety in a director's motivation,[17] these courts generally have granted the directors' motion to dismiss.[18] Thus, the issue remains whether directors may terminate shareholder derivative suits brought against corporate board members.[19] Additionally, if courts allow director termination of at least some derivative suits, a second issue arises concerning the proper standard of review a court should apply before allowing termination.[20]

In *Burks v. Lasker*,[21] the United States Supreme Court tacitly sanc-

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Per Azioni, 69 F.R.D. 592, 595-97 (S.D.N.Y. 1974) (directors properly refused to bring suit for alleged impropriety in third parties' stock purchases); Issner v. Aldrich, 254 F. Supp. 696, 699-700 (D. Del. 1966) (court deferred to directors' decision not to sue parent corporation for alleged adhesion contract).

[13] *Compare* Maldonado v. Flynn, 485 F. Supp. 274, 287 (S.D.N.Y. 1980) (allowing director dismissal), *rev'd per curiam*, 671 F.2d 729 (2d Cir. 1982), *with* Maher v. Zapata Corp., 490 F. Supp. 348, 354 (S.D. Tex. 1980) (not permitting director dismissal).

[14] *See* Abella v. Universal Leaf Tobacco Co., 395 F. Supp. 713, 717 (E.D. Va. 1980) (director interest negated necessity of demand and precluded judicial deference to directors' business judgment that suit would not benefit corporation); Maher v. Zapata Corp., 490 F. Supp. 348, 354 (S.D. Tex. 1980) (court called the interested directors' decision not to sue "unreasonable" implying directors' unfitness to make that decision).

[15] *See* Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713, 718 (E.D. Va. 1980); Maher v. Zapata Corp., 490 F. Supp. 348, 354 (S.D. Tex. 1980).

[16] *See, e.g.*, Galef v. Alexander, 615 F.2d 51, 60 (2d Cir. 1980); Abbey v. Control Data Corp., 603 F.2d 724, 729-30 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Genzer v. Cunningham, 498 F. Supp. 682, 687 (E.D. Mich. 1980); Auerbach v. Bennett, 47 N.Y.2d 619, 629-32, 393 N.E.2d 994, 1000-01, 419 N.Y.S.2d 920, 926-27 (1979); Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111-12 (1979) [hereinafter cited as Arsht] (distilling business judgment rule from early cases). *See* notes 85-90 and accompanying text *infra*.

[17] *See* note 65 *infra* (structural bias may be unconscious and consequently difficult or impossible for plaintiffs to prove).

[18] *See* Galef v. Alexander, 615 F.2d 51, 62 (2d Cir. 1980) (court remanded to determine if dismissal was appropriate); Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Genzer v. Cunningham, 498 F. Supp. 682, 689 (E.D. Mich. 1980); Auerbach v. Bennett, 47 N.Y.2d 619, 636, 393 N.E.2d 994, 1004, 419 N.Y.S.2d 920, 930 (1979).

[19] *See* notes 60-76 and accompanying text *infra*.

[20] *See* notes 85-108 and accompanying text *infra*.

[21] 441 U.S. 471 (1979).

tioned director termination of shareholder derivative suits brought against board members.[22] In *Burks*, the Supreme Court determined whether a special litigation committee[23] created by a corporation's board to investigate the shareholder's allegation could terminate a derivative suit against fellow directors.[24] The *Burks* special litigation committee had full authority to investigate whether the shareholder's claim

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[22] *See id.* at 485.

[23] *Id.* at 474. The procedure corporate directors use to terminate shareholder derivative suits brought against board members centers around the special litigation committee. *See generally* Dent, *supra* note 1, at 608-15. Normally, a corporation confronted with a derivative suit implicating its directors will create a committee composed of allegedly disinterested and independent directors. *See, e.g.*, Burks v. Lasker, 441 U.S. at 474 (special litigation committee composed of five board members who were neither defendants, directors at time of alleged wrong, nor affiliated with co-defendant, and were disinterested within meaning of Investment Company Act of 1940); Lewis v. Anderson, 615 F.2d 778, 780 (9th Cir. 1980) (special litigation committee composed of two outside directors appointed to board subsequent to allegedly illegal transactions plus one director named as defendant but who allegedly did not receive any gain); Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979) (special litigation committee was composed of seven outside non-defendant directors who allegedly had no knowledge of challenged transactions). The corporation next delegates to the special litigation committee the power to investigate the stockholder's complaint, and advise the corporation whether to pursue the alleged cause of action. In most cases, the committee will advise the board of directors to oppose the suit. *See* Dent, *supra* note 1, at 109. Different special litigation committees generally cite similar reasons for opposing the derivative suit. *Id.* The committee usually maintains that no genuine cause of action exists, the corporation probably will not prevail, the litigation costs outweigh any potential gain, the negative publicity will harm the corporation's business, and the action will disrupt corporate affairs and reduce morale. *See* Galef v. Alexander, 615 F.2d 51, 56 (2d Cir. 1980); Genzer v. Cunningham, 498 F. Supp. 682, 686 (E.D. Mich. 1980); Gall v. Exxon Corp., 418 F. Supp. 508, 512-14 (S.D.N.Y. 1976); Auerbach v. Bennett, 47 N.Y.2d 619, 625-26, 393 N.E.2d 994, 997, 419 N.Y.S.2d 920, 923 (1979).

[24] 441 U.S. at 473. The plaintiffs in *Burks* were two shareholders of Fundamental Investors, Inc. (Fundamental), an investment company incorporated in Delaware and registered under the Investment Company Act of 1940 (the ICA). *Id.*; see 15 U.S.C. §§ 80a-1 to 80a-52 (1976) (current version of ICA). The plaintiffs brought a derivative suit against Anchor Corp., Fundamental's registered investment advisor under the Investment Advisors Act of 1940 (the IAA), and certain former and present directors of Fundamental. 441 U.S. at 473; *see* 15 U.S.C. §§ 80b-1 to 80b-21 (1976). Fundamental purchased $20,000,000 face amount of Penn Central 270-day commercial notes on Anchor's recommendation. 441 U.S. at 473-74. Penn Central filed for reorganization under § 77 of the Bankruptcy Act seven months after Fundamental purchased the notes. *Id.* at 474 n.3; *see* 11 U.S.C. § 77 (1976). Penn Central did not meet the payments due on the notes at maturity. Lasker v. Burks, 567 F.2d 1208, 1209 (2d Cir. 1978), *rev'd on other grounds*, 441 U.S. 471 (1979). The plaintiffs' complaint alleged that Fundamental purchased the Penn Central notes exclusively on the recommendation of Goldman, Sachs & Co., and that neither Fundamental nor Anchor undertook an independent investigation into Penn Central's financial condition. 441 U.S. at 473. The complaint charged that by foregoing an independent inquiry into the quality of the Penn Central notes, Anchor breached its responsibility as Fundamental's investment advisor. *Id.* Moreover, the plaintiffs alleged that Fundamental's directors knew of Anchor's failure to investigate and failed to object to the purchase, thereby breaching their fiduciary duties to Fundamental's shareholders. *Id.* The complaint charged that Fundamental thus violated § 36 and § 13(a)(3) of the ICA by not properly investigating Penn Central's financial condition before investing

merited further action.[25] Furthermore, the board only appointed to the litigation committee disinterested directors who had no financial stake in the outcome of the lawsuit.[26] The Supreme Court held that disinterested directors could terminate a derivative suit in federal court provided the applicable state law allows termination,[27] and that termination of the suit does not frustrate federal policy.[28] The two-pronged *Burks* test requires a federal court to determine first whether directors have the power to dismiss derivative suits against fellow directors.[29] When the Supreme Court decided *Burks*, however, many state supreme courts

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in Penn Central bonds, and by buying over 10% of Penn Central's securities. Lasker v. Burks, 404 F. Supp. 1172, 1174-75 (S.D.N.Y. 1975), *aff'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd on other grounds*, 441 U.S. 471 (1979); *see* 15 U.S.C. § 80a-35 (1976) (as amended) (cause of action exists for gross abuse of trust); 15 U.S.C. § 80a-13(a)(3) (1976) (by its registration statement Fundamental could not hold more than 10% of any single issuer's securities). The complaint further alleged that Anchor violated § 206 of the IAA. 404 F. Supp. at 1174; see 15 U.S.C. § 80b-6 (1976) (antifraud provision). Finally, the complaint alleged that because the fund's directors failed to notice Penn Central's deteriorating condition, did not attempt to sell the notes, and because Anchor failed to advise the fund to sell the notes, all defendants violated their common-law fiduciary duty. 404 F. Supp. at 1175.

Fundamental created a five-man special litigation committee to investigate the shareholders' complaint and advise the board what to do about the suit. 404 F. Supp. at 1175. None of the five directors was on Fundamental's board at the time of Fundamental's purchase of Penn Central securities, or was named as a defendant. *See* Lasker v. Burks, 567 F.2d at 1209, 1210 n.5. Thus, the directors on the committee were disinterested within the meaning of the ICA. *See* 15 U.S.C. § 80a-2(a)(19) (1976); Note, *Director Dismissal of Shareholder Derivative Suits Under the Investment Company Act*: Burks v. Lasker, 11 LOY. CHI. L. REV. 519, 528 n.52 (1980) [hereinafter cited as *Director Dismissal*]. The committee retained as special counsel former New York Court of Appeals Chief Judge Stanley H. Fuld, who presented three proposals to the committee. 404 F. Supp. at 1175. Judge Fuld advised the committee that they could move to dismiss, allow the suit to proceed, or attempt to gain control of the suit. *Id.* Fundamental moved to dismiss the action based on the special litigation committee's business judgment that the suit was not in Fundamental's best interests. *Id.* at 1176; *see Director Dismissal*, *supra*, at 529 n.55. The Southern District of New York initially held that it would not substitute the court's judgment for that of a truly disinterested and independent board. 404 F. Supp. at 1180. The court, therefore, denied without prejudice the directors' motion to dismiss and remanded the case to enable the plaintiffs the opportunity to conduct discovery on the issue of the committee's disinterestedness. *Id.* On rehearing, the court granted the directors' motion to dismiss. 426 F. Supp. at 852-53. The court held that the plaintiffs did not meet the burden of establishing that the directors lacked independence, and consequently that the business judgment rule shielded from judicial scrutiny the directors' decision to dismiss. *Id.*

[25] 441 U.S. at 474.

[26] *Id.*

[27] *See id.* at 480. In a derivative suit against directors for breach of fiduciary duty, the law of the state of corporate domicile applies. Shaffer v. Heitner, 433 U.S. 186, 215 n.44 (1977); Coleman v. Taub, 638 F.2d 628, 629 n.1 (3d Cir. 1981); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 309 (1971); *see* Koster v. (American) Lumbermens Mut. Cas. Co., 330 U.S. 518, 527-28 (1947) (court assumed that law of corporate domicile governed intracorporate affairs).

[28] *See* 441 U.S. at 480.

[29] *See id.*

had not addressed the issue whether directors had the power to dismiss shareholder derivative suits brought against board members.

A series of three cases construing Delaware corporate law illustrates the different results courts may reach when deciding whether state law allows director dismissal of derivative suits and the proper standard by which to review termination decisions.[30] *Maldonado v. Flynn*,[31] *Maher v. Zapata Corp.*,[32] and *Zapata Corp. v. Maldonado*[33] arose when shareholders of Zapata Corporation (Zapata), a Delaware corporation, brought derivative suits against Zapata's directors in federal district court in New York and Texas, and in Delaware state court. Although *Burks* required federal courts to apply Delaware state law to determine whether Zapata's directors had authority to dismiss the derivative actions,[34] the Delaware Supreme Court did not resolve the issue until after the federal courts had considered the question.[35]

In the first Zapata suit, *Maldonado v. Flynn*,[36] the plaintiff shareholder charged Zapata's directors with violations of the proxy disclosure standards of the Securities Exchange Act of 1934 ('34 Act).[37] The District Court for the Southern District of New York applied the two-tiered *Burks* test to determine whether to dismiss the action after a special litigation committee of disinterested Zapata directors recommended termination.[38] In the absence of a Delaware court decision on the

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[30] *See* notes 36-52 and accompanying text *infra*.

[31] Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) (decided Jan. 24, 1980), *rev'd per curiam*, 671 F.2d 729 (2d Cir. 1982).

[32] 490 F. Supp. 348 (S.D. Tex. 1980) (decided May 27, 1980).

[33] 430 A.2d 779 (Del. 1981) (decided May 13, 1981).

[34] *See* text accompanying notes 27-28 *supra*.

[35] *See* Zapata Corp. v. Maldonado (Madonado-Del.), 430 A.2d 779, 780-81 (Del. 1981) (citing but not following two previously decided cases involving *Maldonado-Del.* facts); text accompanying notes 47-52 *infra*. The plaintiff shareholders' complaints in all three Zapata actions concerned the directors' amendment to Zapata's stock option plan. Maldonado v. Flynn, 413 A.2d 1251, 1254 (Del. Ch. 1980) (decided March 18, 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). Zapata planned a tender offer for some of its outstanding stock while some of the options granted directors remained unexercisable. *Id.* Zapata's directors realized that the offer would increase the market price for Zapata shares. *Id.* Presumably wishing to limit the gain recognized on exercise of the options, the directors accelerated the exercise date so that they could exercise their options before the tender offer announcement. *Id.* This scheme enabled the directors to limit the gain they would recognize on exercise, but also reduced the deduction Zapata could take against taxable income. *Id.* The shareholders sued derivatively to recover the value of the pro forma tax deduction to Zapata. *Id.* at 1255.

[36] Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980), *rev'd per curiam*, 671 F.2d 729 (2nd Cir. 1982).

[37] Maldonado v. Flynn, 485 F. Supp. 274, 277 (alleging violation of 15 U.S.C. § 78n (1976) (regulating proxy statements)), *rev'd per curiam on other grounds*, 671 F.2d 729 (2d Cir. 1982).

[38] *See id.* at 278-82; text accompanying notes 27-28 *supra* (*Burks* test). Zapata's special litigation committee consisted of two directors appointed to Zapata's board four years after the board first received notice of Maldonado's complaint. *See* Maldonado v. Flynn, 413 A.2d

issue,[39] the district court relied on an Eighth Circuit opinion which had construed Delaware law.[40] The Eighth Circuit held that Delaware law allowed director termination of derivative suits brought against directors.[41] The Eighth Circuit applied the business judgment rule to review the propriety of the directors' decision to dismiss.[42] Following the Eighth Circuit, the Southern District court held that under Delaware law, courts should accord the utmost consideration to a special litigation committee's decision not to sue, and allowed director termination of the derivative suit.[43]

1251, 1255 (Del. Ch. 1980). The two outside directors had no direct interest in the *Maldonado* suit because they were not board members at the time of the decision that Maldonado attacked as improper. *See id.* The Southern District of New York investigated thoroughly the plaintiff's allegation charging the special litigation committee with a lack of independence but found no bias. *See* 485 F. Supp. at 282-84. The court found that the board delegated full power to decide whether to dismiss the derivative suit to the litigation committee. *Id.* at 283. The two committee members had no significant contacts with board members before their appointment to the board. *Id.* Even the fact that the defendant board picked the committee members did not sway the court's finding of independence. *Id.* at 283-84. *But see* note 54 *infra* (directors may favor those who appointed them).

[39] *See* Maldonado v. Flynn, 485 F. Supp. 274, 278 (S.D.N.Y. 1980), *rev'd per curiam*, 671 F.2d 729 (2d Cir. 1982). The Southern District of New York decided *Maldonado v. Flynn* before the Delaware Chancery court decided whether directors could dismiss derivative suits brought against directors under Delaware state law. *Compare id.* (decided Jan. 24, 1980), *with* Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980) (decided Mar. 18, 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[40] 485 F. Supp. at 278 (citing Abbey v. Control Data Corp., 603 F.2d 724, 728-30 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980)).

[41] *See* Abbey v. Control Data Corp., 603 F.2d 724, 729-30 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

[42] *See id.*

[43] 485 F. Supp. at 279, 286 (citing Beard v. Elster, 39 Del. Ch. 153, _____, 160 A.2d 731, 738-39 (Ch. 1960) (courts accord the utmost consideration to disinterested directors' decisions)).

The Southern District of New York first recognized that no Delaware court had addressed the issue whether directors had the power to dismiss derivative suits brought against directors. 485 F. Supp. at 278. Without guidance from Delaware courts, the New York federal court had to determine how the Delaware Supreme Court would decide the issue. *See id.* at 278-80. The *Maldonado v. Flynn* court reasoned that because the business judgment rule applied to directors' decisions about corporate litigation, and because Delaware courts also applied the business judgment rule to evaluate corporate litigation decisions, the business judgment rule applied in the instant situation. *Id.* at 279-80; *see* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 263-64 (1917) (business judgment rule applies to litigation decisions); Mayer v. Adams, 37 Del. Ch. 298, _____, 141 A.2d 458, 461 (Ch. 1958) (Delaware courts apply business judgment rule to evaluate litigation decisions).

The Second Circuit reversed the Southern District of New York on the latter court's holding that the business judgment rule allowed director termination of shareholder derivative suits brought against directors in all situations. Maldonado v. Flynn, 671 F.2d 729, 732 (2d Cir. 1982) (per curiam) (director termination appropriate only if directors act independently, in good faith, and if court independently decides that dismissal would benefit corporation). Under Delaware law, the business judgment rule applies to dismissal decisions only if the situation required the shareholders to demand that the directors institute suit on

Soon after the Southern District of New York decided *Maldonado v. Flynn*, the District Court for the Southern District of Texas decided *Maher v. Zapata Corp.*[44] In *Maher*, the plaintiff alleged not only the '34 Act proxy violation charged in *Maldonado v. Flynn*, but also alleged violations of the Texas Business Corporation Act and breach of common-law fiduciary duties.[45] Although the *Maher* court found that Zapata directors conducted a thorough, disinterested investigation, the court refused to grant the directors' motion for summary judgment. The court held that under Delaware law the business judgment rule did not give directors the power to dismiss derivative suits against directors.[46] Thus, two federal courts reached opposite conclusions regarding whether Delaware law allowed director termination of derivative suits brought against fellow board members.

In *Zapata Corp. v. Maldonado (Maldonado-Del.)*,[47] the third case in the Zapata series, the Delaware Supreme Court considered the issue of director termination of derivative suits brought against board members.[48] The *Maldonado-Del.* court held that a special litigation committee had the power to terminate shareholder derivative suits under Delaware corporate law,[49] although a committee had no power to dismiss under the judicially created business judgment rule.[50] The Delaware

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behalf of the corporation. *See id.* at 731; note 51 *infra*. If a court determines that demand on the directors would be futile and therefore exempts the shareholder from the demand requirement, then the court must review the directors' motion to dismiss using strict judicial scrutiny. *See id.*; note 7 and accompanying text *supra*; notes 51-59 and accompanying text *infra*.

[44] 490 F. Supp. 348 (S.D. Tex. 1980).

[45] *Id.* at 349-50 (plaintiff shareholder alleged violations of 15 U.S.C. §§ 78m(a), 78m(b)(2), 78n (1976 & Supp. III 1979) (require certain proxy statement disclosures), violation of TEX. BUS. CORP. ACT ANN. art. 2.02A(6) (Vernon 1980) (prohibits intracorporate loans to directors and officers), and breach of common-law fiduciary duties).

[46] *Id.* at 352-53. The Southern District of Texas court predicted that the Delaware Supreme Court would affirm *Maldonado* v. *Flynn*. *Id.* at 353. *But see* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (reversing *Maldonado* v. *Flynn*). In *Maher v. Zapata Corp.* the court correctly concluded that the business judgment rule did not give directors the power to dismiss shareholder derivative suits. 490 F. Supp. at 353; *see* Zapata Corp. v. Maldonado, 430 A.2d 779, 781-82 (Del. 1981). The business judgment rule does not grant directors any powers, which arise by statute or charter, but operates only to create a presumption of propriety in certain circumstances about a director's decision. 430 A.2d at 782; *see* Arsht, *supra* note 16, at 111-12 (detailing circumstances necessary to invoke business judgment rule); notes 85-90 and accompanying text *infra*. The *Maher* court overlooked Delaware corporate law, which did enable directors to dismiss derivative suits. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 782, 785 (Del. 1981) (directors may dismiss detrimental litigation under Delaware law).

[47] 430 A.2d 779 (Del. 1981).

[48] *Id.* at 781.

[49] *Id.* at 782 (construing DEL. CODE ANN. tit. 8, § 141(c) (1974 rev.)).

[50] *Id.* at 782; *see* text accompanying notes 85-90 *infra*. Because the Delaware Supreme Court held that directors had the power to dismiss shareholder derivative suits, the Southern District of Texas would have to reverse itself on that issue if it reheard *Maher* v.

Supreme Court held that the business judgment rule applied as a standard of review to disinterested board decisions, serving to insulate those decisions from strict judicial review.[51] The *Maldonado-Del.* court held that the business judgment rule did not apply to Zapata's special litigation committee's decision to dismiss because a disinterested board did not make the decision.[52] Because the *Maldonado-Del.* court found that directors could terminate suits brought against directors under Delaware corporate law, the court had to determine the proper standard of review.[53]

Balancing the directors' and shareholders' competing interests, the Delaware Supreme Court called for strict judicial review of the committee's decision to recommend dismissal whenever an interested majority of the board of directors appoints a disinterested special litigation committee.[54] After *Maldonado-Del.*, directors face a two step test before a

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Zapata Corp. In *Maher*, the absence at the time of a Delaware Supreme Court decision on whether directors had the power to dismiss derivative suits against fellow directors left the Texas court free to speculate on that issue. *See* Maher v. Zapata Corp., 490 F. Supp. 348, 351 (S.D. Tex. 1980). The Texas court erroneously predicted that the Delaware Supreme Court would prohibit disinterested director termination of derivative suits implicating fellow directors. *Id.* at 353. *Zapata Corp.* v. *Maldonado* forces federal courts presented with a director's motion to dismiss to recognize that under Delaware law, directors have a limited power to terminate shareholder derivative suits. *See* 430 A.2d at 782.

[51] 430 A.2d at 782. *But see* text accompanying notes 101-08 *infra* (court called for strict judicial review and did not apply traditional business judgment rule).

The Delaware Supreme Court distinguished between instances calling for demand on directors and situations when a court validly excuses demand because of its futility. 430 A.2d at 784 & n.10. When shareholders attack a board's refusal to bring suit against the alleged wrongdoer, the *Maldonado-Del.* strict judicial scrutiny test does not apply. *Id.*; *see* text accompanying notes 55-59 *infra* (strict judicial scrutiny test). *See also* Maldonado v. Flynn, 671 F.2d 729, 731 (2d Cir. 1982) (*Maldonado-Del.* makes sharp distinction between demand and no demand cases). Only when demand would be futile and the shareholder actually does not make a demand does the *Maldonado-Del.* strict judicial scrutiny standard of review apply. *See* 430 A.2d at 787-88. Under *Maldonado-Del.* the strict standard of review applies only where shareholders "properly commenced" the derivative suit. *Id.* at 788. The Delaware Supreme Court held that if the shareholder instituted suit after making demand and receiving a refusal, the shareholder would not have "properly commenced" the litigation. *See id.* at 787 (case properly initiated because demand was futile). The validity and value of the *Maldonado-Del.* court's distinction between board refusal cases and demand excused cases is suspect. *See* text accompanying notes 91-96 *infra* (courts should never apply business judgment rule to review directors' motions to dismiss derivative suits brought against directors).

[52] 430 A.2d at 787; *see* note 51 *supra.*

[53] 430 A.2d at 788-89; *see* text accompanying notes 101-08 *infra.* The *Maldonado-Del.* strict standard of review applies only when a court excuses a derivatively suing shareholder's failure to demand of the directors that the directors institute suit. *See* note 51 *supra.*

[54] 430 A. 2d at 788-89. The Delaware Supreme Court recognized that a special litigation committee appointed by a defendant majority of the board might have a predisposition to recommend dismissal. *Id.* at 787; *accord*, Maher v. Zapata Corp., 490 F. Supp. 348, 354 (S.D. Tex. 1980). Commentators label the tendency of directors to recommend dismissal of derivative suits against fellow directors as "structural bias." *See Business Judgment Rule,*

Delaware court will grant a motion to dismiss. First, the reviewing Delaware court[55] must find that the litigation committee acted independently and in good faith, and conducted a reasonable investigation of the shareholder's allegation.[56] After the complaining shareholder proves that demand was futile, the *Maldonado-Del.* test shifts the burden of persuasion to the directors, denying them the business judgment rule's presumption of propriety.[57] Second, the court must make an independent inquiry whether the derivative suit is in the corporation's best interests instead of blindly relying on the committee's judgment.[58] If the special litigation committee's dismissal recommendation fails to meet either part of the test, the court will not grant the directors' motion to dismiss.[59]

The *Maldonado-Del.* court balanced the legitimate and competing interests of the directors and shareholders to determine whether directors may dismiss derivative suits brought against directors and what standard of review applies to directors' motions to dismiss.[60] Several reasons

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supra note 2, at 619-25. *See also* Dent, *supra* note 1, at 110-17; Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits*, 35 U. MIAMI L. REV. 1, 24 & n.117 (1980) [hereinafter cited as Steinberg]; *Derivative Suits*, *supra* note 2, at 602, 619-26; Note, *Mutual Fund Independent Directors: Putting a Leash on the Watchdogs*, 47 FORDHAM L. REV. 568, 580-81 (1979) [hereinafter cited as *Independent Directors*]; Note, *The Business Judgment Rule and the Litigation Committee: The End of a Clear Trend in Corporate Law*, 14 IND. L. REV. 617, 636-37 (1981) [hereinafter cited as *Clear Trend*]; *Director Dismissal*, *supra* note 24, at 537 n.112, 538; *Court Guards*, *supra* note 2, at 658. Four factors contribute to "structural bias." *Business Judgment Rule*, *supra* note 2, at 619-22. These factors are selection for predisposition, threats against the director, economic self-interest, and other personal interests. *Id.* First, the chief executive officer effectively selects new directors to the board, and the interested majority implicated by the derivative suit appoints disinterested directors to the special litigation committee. *Id.* at 619, 622. Both of these situations present opportunities to create a committee fundamentally opposed to recommending any suit against directors. *Id.* Second, once selected, committee members face implied threats of dismissal, loss of friendship, and revenge for failure to dismiss. *Id.* at 620-21. Third, board salaries and other financial ties to the corporation and its executives may impair a committee member's judgment. *Id.* Finally, committee members may view their directorships as status symbols requiring preservation, or may feel compassion for fellow directors facing a possibly enormous adverse judgment. *Id.* at 620, 622. One commentator claims that over 90% of the directors of the 200 largest industrial corporations have personal ties to each other and the chief executive officer, even though the majority are outside directors. *See* R. NADER, M. GREEN & J. SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS, 127-31 (1976).

[55] *See* note 27 *supra* (Delaware law applies to shareholder derivative suits brought against directors if corporate domicile is Delaware).

[56] 430 A.2d at 788.

[57] *See id.*

[58] *See id.* at 789.

[59] *Id.*

[60] *See id.* at 786-88. The Delaware Supreme Court sought a test that would enable the corporation to avoid detrimental litigation, but would not give directors absolute discretion over derivative suits. *Id.* The court's compromise should please commentators who criticized previous decisions because the courts incorrectly had favored either the corporation or the

favor authorizing directors to dismiss shareholder suits instituted against fellow board members. First, directors can best determine the economic merits of the lawsuit.[61] Second, directors have better access than shareholders to information inside the corporation concerning the shareholder's allegations.[62] Third, the directors can conduct a more thorough investigation with less disruptive effect than shareholder discovery.[63] Finally, allowing director dismissal guards against shareholder abuses of derivative suits for personal gain.[64]

Some commentators argue against allowing directors to dismiss derivative suits implicating corporate directors because a special litigation committee may have a predisposition to recommend dismissal.[65] The *Maldonado-Del.* test compensates for this inherent bias by requiring an independent judicial balancing of the benefits of going forward with the litigation and the benefits of dismissal.[66] Only if a court finds adequate and reasonable reasons supporting a motion to dismiss will the court terminate a derivative suit.

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minority shareholder. *See* Dent, *supra* note 1, at 118-19; Steinberg, Maldonado *in Delaware: Special Litigation Committees—An Unsafe Haven*, 9 SEC. REG. L.J. 381, 388-89 (1982) [hereinafter cited as Steinberg, *Unsafe Haven*]; *Business Judgment Rule*, *supra* note 2, at 632.

[61] *See Demand and Standing*, *supra* note 1, at 171-72. Directors consider the economic merits of a claim by weighing the potential recovery against the costs of that recovery. *See Court Guards*, *supra* note 2, at 653. Besides court costs and attorney fees, corporations may incur opportunity costs for lost management time, disruption of production activities, damaged public image, reduced morale, and lost goodwill. *See id.* at 654. The directors are best suited to make business decisions, but should not be the final arbiter of the legal merits of claims. *See* Zapata Corp. v. Maldonado, 430 A.2d at 789 n.18. "[C]ourts and not litigants should decide the [legal] merits of litigation." *Id.* (citing Maldonado v. Flynn, 413 A.2d at 1263).

Besides having the business expertise to evaluate the expected net return of corporate litigation, directors have other practical advantages over shareholders in redressing corporate wrongs, including efficiency in handling corporate litigation and access to the corporation's generally greater financial, legal, and business resources. *See* Brooks v. American Export Indus., Inc., 68 F.R.D. 506, 510 (S.D.N.Y. 1975); Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361, 369 (N.D. Ill. 1974); Tasner v. Billera, 379 F. Supp. 815, 826 (N.D. Ill. 1974); *Demand and Standing*, *supra* note 1, at 171-72. Directors also have greater incentives than shareholders to redress corporate wrongs. Directors have a fiduciary obligation to the corporation not to waste corporate assets, including corporate claims. *See* Tasner v. Billera, 379 F. Supp. 815, 826 (N.D. Ill. 1974). Directors have a substantial indirect financial interest in pursuing claims with a probable positive net recovery. *Id.* Shareholders have a much more indirect and substantially smaller motivation because they personally do not recover any damages. *See id.*

[62] *See Clear Trend*, *supra* note 54, at 643; *Demand and Standing*, *supra* note 1, at 171-72.

[63] *See Clear Trend*, *supra* note 54, at 643; *Demand and Standing*, *supra* note 1, at 171-72.

[64] *See* text accompanying note 5 *supra* (allowing dismissal would reduce incidence of strike suits).

[65] *See Derivative Suits*, *supra* note 7, at 886-87; *Court Guards*, *supra* note 2, at 656-59; note 54 *supra* (defining structural bias).

[66] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981).

A second drawback to allowing director dismissal is that the committee does not have judicial sanctions to force employees to cooperate with an investigation.[67] Board sanctions provide a workable substitute, however, and can ensure that the special litigation committee has the power to obtain complete assistance from corporate employees.[68] The *Maldonado-Del.* test diminishes the problem of incomplete or cursory committee investigations by granting the minority shareholder limited discovery to uncover the unreasonableness of the committee investigation.[69] The trial court will refuse to grant the directors' motion to dismiss if the court finds that the committee did not investigate the shareholder's allegations adequately.[70] Moreover, under the *Maldonado-Del.* strict judicial scrutiny standard of review, the court may deny the directors' motion for any reason relating to the adequacy of the committee's investigation.[71] Furthermore, the court will allow the derivative suit to proceed to trial if continuation would benefit the corporation, regardless of the adequacy and reasonableness of the directors' investigation.[72]

Finally, the possibility exists that the defendant board majority will overrule or abolish the committee if the committee recommends continuation of the derivative action.[73] This possibility calls for judicial scrutiny of the majority's bad faith but should not absolutely prevent disinterested minority directors from terminating shareholder derivative suits not in the corporation's best interests.[74] Neither

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[67] *See Derivative Suits*, *supra* note 7, at 900.

[68] *See id.* at 894, 900. Although board sanctions could compel low-level employees to cooperate with the litigation committee's investigation, those sanctions would not alleviate the committee's lack of judicial sanctions against directors. *See id.* at 900.

[69] *See* 430 A.2d at 788 & n.16.

[70] *See id.* at 788-89.

[71] *See id.* at 789.

[72] *See id.*

[73] *See* Dent, *supra* note 1, at 119-20. *But see* Joy v. North, 519 F. Supp. 1312, 1315 (D. Conn. 1981). In *Joy*, the special litigation committee appointed to investigate a shareholder's allegations of breach of fiduciary duties and violations of the National Banks Act, 12 U.S.C. §§ 21-215b (1976), decided not to recommend dismissal of some claims. 519 F. Supp. at 1315. The interested majority of the board did not move to withdraw the committee's authority, but accepted the committee's recommendation to institute suit against seven directors. *See* 519 F. Supp. at 1315. Thus, in certain instances directors act with the corporation's interests in mind even when structural bias and self-interest might tempt them to act otherwise. *See id.*

[74] *See* Zapata Corp. v. Maldonado, 430 A.2d at 788-89. *See generally* Dent, *supra* note 1, at 119-20. *See also* Gall v. Exxon Corp., 418 F. Supp. 508, 516 (S.D.N.Y. 1976) (court rejected plaintiff's claim that because board could disband committee, committee had no authority to seek dismissal). In deciding whether to dismiss a derivative suit, the ultimate question must be whether the derivative suit is in the corporation's best interests. *See* note 109 *infra*. Under *Maldonado-Del.*, the corporation's board or a special litigation committee makes the decision, subject to judicial review. *See* text accompanying notes 53-59 *supra*.

[75] *See* 430 A.2d at 785; DEL. CODE ANN. tit. 8, § 141(c) (1974 rev.) (enabling shareholders to enact charter provision giving directors power to create special committees, but remaining silent on directors' ability to disband those committees).

Maldonado-Del. nor Delaware corporate law addresses the possibility of board annulment of special litigation committees.[75] If the directors attempt to disband a special litigation committee about to decide whether to pursue the complainant shareholder's claim, the court should prohibit director termination of the lawsuit.[76]

The *Maldonado-Del.* director dismissal test employs strict judicial scrutiny to remedy a special litigation committee's inherent bias, and the reviewing court's power to require a trial compensates for a committee's lack of judicial sanctions to compel testimony.[77] Furthermore, courts may include an automatic trial provision to control defendant board majorities that abolish unfavorable litigation committees.[78] Finally, the *Maldonado-Del.* test avoids the extremes of always granting directors' motions to dismiss[79] or of always allowing derivative suits against directors to proceed to trial on the merits.[80] For these reasons, courts should allow directors to dismiss derivative suits but should apply *Maldonado-Del.* strict judicial scrutiny to review the directors' motions to dismiss.

The *Maldonado-Del.* court desired to ensure that derivative suits, even if meritorious, do not cost the corporation more than the expected recovery.[81] Conversely, the court sought to allow all beneficial derivative actions to proceed to trial.[82] To satisfy both desires, the *Maldonado-Del.* court fashioned a strict judicial scrutiny standard to review motions to dismiss.[83] Strict judicial scrutiny represents a marked departure from past judicial involvement in the corporate decision-making process.[84]

Before *Maldonado-Del.*, some courts adopted the business judgment rule as the applicable standard of review of director decisions to seek dismissal of shareholder derivative suits.[85] The business judgment rule

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[76] *Cf.* Gall v. Exxon Corp., 418 F. Supp. 508, 516 (S.D.N.Y. 1976). The *Gall* court assumed that the board had no statutory authority to disband a special litigation committee. *Id.* If faced with an attempted disbandment, the *Gall* court presumably would allow the derivative suit to proceed. *See id.*

[77] *See* text accompanying notes 65-72 *supra.*

[78] *See* text accompanying notes 73-76 *supra.*

[79] *See* 430 A.2d at 788; cases cited at note 14 *supra* ; note 60 *supra.*

[80] *See* 430 A.2d at 788; cases cited at note 16 *supra* ; note 60 *supra.*

[81] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 786-87 (Del. 1981).

[82] *See id.* at 789.

[83] *See id.* at 788-89; text accompanying notes 53-59 *supra.*

[84] *See* Arsht, *supra* note 16, at 95 & n.10. To foster judicial economy, courts traditionally have avoided reviewing directors' decisions. *See, e.g.*, Karasik v. Pacific E. Corp., 21 Del. Ch. 81, 97, 180 A. 604, 611 (Ch. 1935) (honest mistake does not justify judicial interference); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (Ch. 1928) (not court's function to resolve questions of business management or policy); Greenbaum v. American Metal Climax, Inc., 27 A.D.2d 225, 231-32, 278 N.Y.S.2d 123, 130-31 (App. Div. 1967) (matters depending upon business judgment are not actionable). *See generally* Arsht, *supra* note 16, at 95-100.

[85] *See, e.g.*, Lewis v. Anderson, 615 F.2d 778, 781-83 (9th Cir. 1979) (court applied business judgment rule under California law), *cert. denied*, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979) (court applied business judgment rule

raises a presumption of propriety about directors' decisions and shields those decisions from judicial review.[86] Although the shareholder's claim concerns the appropriateness of a director decision made before the creation of a special litigation committee,[87] most courts consider only the appropriateness of the committee's decision to move to dismiss.[88] Consequently, under the business judgment rule if the plaintiff stockholder fails to prove either self-dealing or other personal interest, lack of due care, unreasonableness, or lack of good faith, the court will grant the directors' motion to dismiss.[89] If the shareholder proves one of these elements, thereby rebutting the business judgment rule's presumption of propriety, courts refuse to dismiss and therefore proceed to trial on the merits.[90]

Courts should not review directors' motions to dismiss derivative

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under Delaware law), *cert. denied*, 444 U.S. 1017 (1980); Maldonado v. Flynn, 485 F. Supp. 274, 279-80 (S.D.N.Y. 1980) (dismissal proper under Delaware business judgment rule), *rev'd per curiam*, 671 F.2d 729 (2d Cir. 1982); Auerbach v. Bennett, 47 N.Y.2d 619, 630-34, 393 N.E.2d 994, 1000-02, 419 N.Y.S.2d 920, 926-28 (1979) (application of business judgment rule to director dismissal cases proper in New York). *Abbey v. Control Data Corp.* illustrates the general approach of pre-*Maldonado-Del.* cases applying the business judgment rule to review directors' motions to dismiss derivative suits brought against directors. *See* 603 F.2d at 730-32. In *Abbey*, plaintiff-shareholder Abbey alleged corporate waste and mismanagement for making illegal foreign payments. *Id.* at 726-27. Abbey discovered the violations after Control Data Corp.'s (Control Data) guilty plea in an earlier criminal proceeding. *Id.* at 726. Control Data's board responded to the suit by creating a special litigation committee to investigate Abbey's charges and to determine whether to pursue the claims against the implicated directors. *Id.* at 727. The committee recommended dismissal because further litigation was not in the corporation's best interests. *Id.* The Eighth Circuit affirmed the lower court's finding that under the Delaware business judgment rule a court may not substitute its views for those of a disinterested board made in good faith. *Id.* at 730. The Eighth Circuit then determined that allowing dismissal was consistent with the second part of the *Burks* test because the dismissal would not frustrate federal policy. *Id.* at 731-32. Thus, the Eighth Circuit affirmed the lower court's determination that the special litigation committee properly dismissed the derivative action. *See id.* at 732.

[86] *See* Arsht, *supra* note 16, at 111-12. Contrary to some courts' beliefs, the business judgment rule does not give directors the power to dismiss. Zapata Corp. v. Maldonado, 430 A.2d at 782; *see* text accompanying notes 51-52 *supra* (business judgment rule is a standard of review, not a power).

[87] *See* Zapata Corp. v. Maldonado, 430 A.2d at 780 (shareholder alleged impropriety in board's original decision and did not attack special litigation committee's later decision to dismiss).

[88] *See id.* at 785-89; cases cited at note 16 *supra*. *But see* Abella v. Universal Leaf Tobacco Co., 495 F. Supp. 713, 717 (1980). The *Abella* court held that the committee's decision to seek dismissal was irrelevant to the issue of the propriety of the board's original decision because the plaintiff challenged only the original decision. *Id.* The *Abella* court in effect held that whenever demand on the directors is excused, the directors cannot dismiss the derivative suit without litigating the merits of the shareholder's claim. *Id.* at 717-18. *Abella* offers no safeguard against detrimental litigation, unlike *Maldonado-Del.* *See* 430 A.2d at 789 (court recognized need to prevent or stop detrimental litigation).

[89] *See* Arsht, *supra* note 16, at 112.

[90] *See* Zapata Corp. v. Maldonado, 430 A.2d at 788-89; cases cited at note 16 *supra*.

suits brought against directors under the business judgment rule.[91] Normally plaintiff shareholders may shift the burden of persuasion to the defendant directors by establishing that those directors had a personal interest that conflicted with the corporation's interests in the decision at issue.[92] Because shareholders rarely can prove the presence of structural bias, courts generally apply the business judgment rule to review an "independent" litigation committee's motion to dismiss.[93] Most courts accept the "disinterested" directors' judgment that the litigation would not benefit the corporation without any inquiry into the directors' basis for that belief.[94] Consequently, most courts grant the directors' motion to dismiss.[95] The possibility of structural bias warrants a stricter standard of review than the business judgment rule if derivative suits are to continue as "the chief regulator of corporate management."[96]

If a shareholder proves that a director had an interest in a decision

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[91] *See Derivative Suits*, *supra* note 7, at 886-87; *Business Judgment Rule*, *supra* note 2, at 631; *cf.* Dent, *supra* note 1, at 110. One commentator advocates separate and distinct treatments for derivative suits against third parties, against a minority of the board, and against a majority of the board. Dent, *supra* note 1, at 110. Courts only would apply the business judgment rule to review directors' decisions to dismiss derivative suits brought against third parties. *Id.* Directors could never dismiss complaints brought against a board majority. *Id.* The proposal calls for judicial scrutiny into the reasons for dismissal of derivative suits brought against a board minority. *Id.*

Although the directors and not courts or shareholders run the corporation's business affairs, including corporate litigation, courts will interfere in corporate affairs when equity demands judicial involvement. *See* Arsht, *supra* note 16, at 109-11.

[92] *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719-23 (Del. 1971) (defendant directors controlled Sinclair and subsidiary that dealt with Sinclair); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 886-87 (Del. 1970) (parent-subsidiary self-dealing); Schreiber v. Pennzoil Co., 419 A.2d 952, 956-59 (Del. Ch. 1980) (management fee collected from partially owned subsidiary); Tanzer v. International Gen. Indus., Inc., 402 A.2d 382, 386-87 (Del. Ch. 1979) (majority shareholder on both sides of freezeout merger); Trans World Airlines, Inc. v. Summa Corp., 374 A.2d 5, 13-14 (Del. Ch. 1977) (parent-subsidiary transaction involving interlocking directorates); Chasin v. Gluck, 282 A.2d 188, 192 (Del. Ch. 1971) (controlling shareholder dealing with corporation). Federal courts, applying Delaware law, also use the intrinsic fairness test to shift the burden of proof to the defendant. *See* Johnson v. Trueblood, 629 F.2d 287, 290-91 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); Harriman v. E.I. Du Pont De Nemours & Co., 411 F. Supp. 133, 151-53 (D. Del. 1975).

[93] *See* Dent, *supra* note 1, at 115 (structural bias is very difficult to prove); *cf. Business Judgment Rule*, *supra* note 2, at 625 (shareholders usually cannot prove director self-interest when corporation uses independent special litigation committee); *Clear Trend*, *supra* note 54, at 636 & n.154 (showing committee nonindependence is an onerous task).

[94] *See* note 85 *supra* (courts generally defer to directors' judgment without inquiry).

[95] *See* note 85 *supra*; Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 262 (1981) [hereinafter cited as Coffee] (business judgment rule gives directors veto power over derivative suits); *Business Judgment Rule*, *supra* note 2, at 600, 602 (business judgment rule immunizes decisions to terminate by barring judicial scrutiny); *Clear Trend*, *supra* note 54, at 643-44 (business judgment rule unfairly shields directors).

[96] Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949); *see* note 54 *supra* (structural bias defined).

adverse to the corporation, a Delaware court will apply the intrinsic fairness test, a strict standard of review of the director's decision.[97] Under the intrinsic fairness test, the director implicated by the derivative suit may escape liability by proving the fairness of the transaction to the corporation.[98] Courts applying the intrinsic fairness test strictly scrutinize the results of the director's decision.[99] If the director meets the difficult burden of establishing the questioned decision's intrinsic fairness, the court will absolve the director of liability for the decision's negative results.[100]

The *Maldonado-Del.* standard of review combines elements of the business judgment rule and the intrinsic fairness test.[101] The *Maldonado-Del.* test adopts the procedural prerequisites of the business judgment rule, requiring an independent, good faith director dismissal decision based on a reasonable investigation of the plaintiff shareholder's allega-

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[97] *See* cases cited at note 92 *supra*. The intrinsic fairness test represents judicial recognition that individual benefit and not corporate interests will govern decisions by directors on both sides of a transaction. *See* Arsht, *supra* note 16, at 115. Application of the intrinsic fairness test negates the business judgment rule's presumption of propriety and substitutes a presumption of impropriety which the director must overcome to avoid liability. *Id.* at 115-16.

[98] *See* Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Sup. Ct. 1952); Tanzer v. International Gen. Indus., Inc., 402 A.2d 382, 386 (Del Ch. 1979). The intrinsic fairness test shifts the burden of persuasion from complaining shareholder to defendant director. *See* Arsht, *supra* note 16, at 116. While the business judgment rule considers the reasonableness of corporate decisions as of the time the decisions are made, the intrinsic fairness test considers only the resulting fairness to the corporation. *Id.*

[99] *See* notes 92 & 98 *supra*.

[100] *See* DEL. CODE ANN. tit. 8, § 144(a) (1974 rev.) (director not liable for negative results of transaction which was fair in court's judgment).

[101] *See* 430 A.2d at 788-89; text accompanying notes 102-08 *infra*. Courts should apply the *Maldonado-Del.* test only with the Delaware Supreme Court's strict standard of review. *See* 430 A.2d at 788-89. Misinterpretation of the *Maldonado-Del.* holding could seriously impair the value of derivative suits in policing intracorporate affairs because review under the business judgment rule invariably results in termination of the litigation. *See* Coffee, *supra* note 95, at 262 (derivative suits threatened by judicial trend to allow director dismissal); Dent, *supra* note 1, at 109 (special litigation committee cases may presage demise of derivative suits); *Business Judgment Rule*, *supra* note 2, at 602 (continued existence of derivative suits as check on intracorporate abuses threatened by application of business judgment rule to dismiss suits implicating majority of board); *Clear Trend*, *supra* note 54, at 645 (allowing director dismissal of derivative suits effectively denies shareholder remedies for certain intracorporate wrongs); *Court Guards*, *supra* note 2, at 635 (increased use of special litigation committees erodes effectiveness of derivative actions). *But see* Nussbacher v. Chase Manhattan Bank (N.A.), 444 F. Supp. 973, 977, 980 (S.D.N.Y. 1977) (motion to dismiss under business judgment rule denied where director interest in derivative suit present). Other courts mistakenly may regard *Maldonado-Del.* as an indication that disinterested directors may conclusively terminate derivative suits against fellow directors. *See* Zapata Corp. v. Maldonado, 430 A.2d at 782, 788-89 (modifying standard of review of director termination of derivative suits). *But see* Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311, 1325-26.(S.D. Iowa 1981) (adopted *Maldonado-Del.* strict scrutiny test);

tions.[102] The court shifted the burden of persuasion on the prerequisites, however, from the plaintiff to the directors who move to dismiss.[103] The intrinsic fairness test likewise allocates the burden of persuasion to the defendants.[104] The *Maldonado-Del.* court also called for strict judicial scrutiny of the reasons for the directors' motion to dismiss.[105] A disinterested director's decision to recommend dismissal merely represents his business judgment that prosecuting the derivative suit would result in a negative net return to the corporation.[106] Ordinarily, courts review disinterested director decisions under the business judgment rule.[107] Recognizing the possibility of structural bias, however, the *Maldonado-Del.* court required the strict judicial review reserved for instances of self-dealing under the intrinsic fairness test.[108]

Because the *Maldonado-Del.* court's fundamental concern centered on the costs of litigation in comparison with the expected recovery of the derivative suit,[109] the court should have recognized the secondary nature

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Weiss v. Temporary Inv. Fund, Inc., 516 F. Supp. 665, 670 n.13 (1981) (recognized *Maldonado-Del.* test called for strict scrutiny). Although *Maldonado-Del.* requires federal courts applying Delaware law to recognize that directors may dismiss derivative suits, the federal court need not adopt the *Maldonado-Del.* standard of review. *See* Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938) (federal procedural rules apply in federal court). If a federal court allowed director dismissal under *Maldonado-Del.* but accorded the decision to dismiss the traditional deference given under the business judgment rule, the consequent decision possibly would signal the death knell of shareholder derivative suits. *See* Coffee, *supra* note 95, at 262 (call for legislative reform to keep derivative suit remedy viable). *Maldonado-Del.* suggests the means to prevent strict judicial scrutiny and thereby allow directors to shield themselves from liability for self-dealing. *See* 430 A.2d at 781 (i.e., by appointing disinterested directors to investigate "thoroughly" all derivative suit charges). Even if the derivative suit implicated all board members, if the corporate charter allows the directors to appoint new members to the board, the board could form a special litigation committee composed solely of the new directors, and wait for the anticipated recommendation to dismiss. *See* Maldonado v. Flynn, 485 F. Supp. 274, 278, 284-85 (S.D.N.Y. 1980), *rev'd per curiam*, 671 F.2d 729 (2d Cir. 1982); note 54 *supra* (structural bias would probably assure recommendation to dismiss from special litigation committee). The Delaware Supreme Court adopted a strict judicial scrutiny test solely because of the danger of structural bias in derivative suits brought against a board majority. *See* 430 A.2d at 787.

[102] *See* 430 A.2d at 788-89 (standard of review in derivative suits brought against board majority).

[103] *Id.*

[104] *See* text accompanying notes 97-100 *supra.*

[105] 430 A.2d at 789.

[106] *See* Maher v. Zapata Corp., 490 F. Supp. 348, 350-51 (S.D. Tex. 1980).

[107] *See* text accompanying notes 85-90 *supra.*

[108] 430 A.2d at 788-89; *see* notes 101-05 *supra. Maldonado-Del.* does not apply in any case when the court does not excuse the demand on directors requirement. 430 A.2d at 784 & n.10; *see* note 51 *supra.*

[109] 430 A.2d at 785, 789; *accord,* Burks v. Lasker, 441 U.S. 471, 485 (1979); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978); Dent, *supra* note 1, at 142-44 (ultimate issue is corporation's interests but costs rarely exceed probable recovery); *Derivative Suits, supra* note 7, at 906; *Business Judgment Rule, supra* note 2, at 626-27; *Court Guards, supra* note 2, at 654-55; *Demand and Standing, supra* note 1, at 168, 196.

of the impartiality of directors seeking to dismiss derivative actions.[110] If a court requires a derivative suit to proceed to trial because of director interest in the outcome, without first considering whether continuation of the suit will further corporate interests, the court has disregarded the policy behind the *Maldonado-Del.* test of dismissing meritorious but detrimental litigation.[111] The Delaware Supreme Court recognized that the ultimate question in derivative suits is whether the litigation furthers the corporation's best interests.[112] Courts should dismiss even meritorious derivative claims whenever the litigation costs outweigh the benefits that the corporation may gain by further pursuit of the claim[113] and whenever the shareholder has available a more economical means to redress the alleged wrong.[114] Although acknowledging the validity of this tenet,[115] the *Maldonado-Del.* court fashioned a test that precludes dismissal of suits not in the corporation's best interests if interested directors seek a dismissal.[116] The mere finding of director interest in the suit should not necessitate trial on the merits, because the trial could unduly burden the corporation's operations and financial resources.[117]

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[110] *See* Dent, *supra* note 1, at 123.

[111] *See* Zapata Corp. v. Maldonado, 430 A.2d at 787-88 (court balanced shareholders' desire to litigate and corporation's interest in avoiding detrimental litigation).

[112] *See id.* at 788.

[113] *See* cases cited at note 109 *supra.* If the directors pursued a claim not in the corporation's best interests, even if the claim had clear social or political value, the shareholders successfully could maintain an action for breach of fiduciary duty. *See* Dodge v. Ford Motor Co., 204 Mich. 459, _____, 170 N.W. 668, 684 (1919) (business corporation organized primarily for profits may not operate for noneconomic although altruistic reasons). *But see* Steinberg, *Unsafe Haven, supra* note 60, at 388 (considerations encompass shareholder welfare, public policy, and corporate accountability).

[114] *See* Abbey v. Control Data Corp., 460 F. Supp. 1242, 1243 (D. Minn. 1978), *aff'd,* 603 F.2d 724 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980). Remedies possibly more economical than derivative suits include compelling director compliance or voting noncomplying directors out of office, pursuing a private cause of action, or bringing criminal charges against the wrongdoers. *See Court Guards, supra* note 2, at 655.

[115] *See* Zapata Corp. v. Maldonado, 430 A.2d at 784-85 (court should dismiss suits detrimental to corporate interests or if corporation's rights otherwise are protected).

[116] *Id.* at 788-89. Under the first part of the *Maldonado-Del.* court's test, if the court finds that the special litigation committee lacked independence, acted in bad faith, or conducted an unreasonably shallow investigation, the reviewing court must deny the directors' motion to dismiss. *Id.* The special litigation committee's superficial investigation or bad faith should disqualify their recommendation to dismiss the derivative suit. *Id.* If the committee lacks the initiative properly to inquire into the shareholder's charge, the court should not bear the responsibility of investigating sua sponte the validity of the allegation. Mere interest in the transaction, however, should not preclude a director from participating in the dismissal decision. *See* text accompanying notes 106-11 *supra.*

[117] *Cf.* 430 A.2d at 784 (citing McKee v. Rogers, 18 Del. Ch. 81, _____, 156 A. 191, 193 (Ch. 1931)) (interested directors are not proper persons to conduct litigation); *Demand and Standing, supra* note 1, at 174-76 & n.60 (unreasonable to expect directors to sue themselves). Interested directors probably would not sue themselves wholeheartedly. Forbidding director dismissal of shareholder derivative suits on that basis makes a possibly unwarranted assumption, however, that the directors should be sued.

Attempted dismissal of derivative suits by interested directors presents many of the same considerations present in self-dealing director situations.[118] Both situations present potentially improper motivations in decisions purportedly made in the corporation's best interests.[119] The Delaware Interested Directors Statute[120] specifically provides that self-dealing transactions are neither void nor voidable per se because some director self-dealing benefits the corporation as well as the interested director.[121] Acknowledgment of an interested director's ability to make decisions beneficial to the corporation arguably applies to questions of director termination of shareholder derivative suits. Although an interested director improperly may urge dismissal based solely on his self-interest, the director also may set forth valid business reasons, irrespective of his personal financial interests, to recommend termination.[122] If the derivative suit actually would harm the corpora-

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[118] *See* note 54, *supra*. Because director termination of derivative suits brought against directors presents many of the issues present in any conflict of interest situation, the *Maldonado-Del.* court should not have distinguished between suits instituted against a board majority and suits instituted against a board minority. *See* Steinberg, *Unsafe Haven*, *supra* note 60, at 386 (inherent problems of structural bias remain whether shareholder implicates minority or majority of board); *Business Judgment Rule*, *supra* note 2, at 629 (naive to contend that structural bias disappears when plaintiff accuses fewer directors of wrongdoing). The *Maldonado-Del.* majority/minority distinction will encourage shareholders to charge a majority of the board. *See* Coffee, *supra* note 95, at 279 (plaintiffs might charge all board members to circumvent demand requirement). The distinction also will encourage shareholders to institute suit before making a demand, because once the shareholders demand that the directors bring an action against the wrongdoer, the business judgment rule applies to the directors' refusal to act. *See* Zapata Corp. v. Maldonado, 430 A.2d at 784 n.10 (dictum). Moreover, if shareholders began two or more derivative suits as in the Zapata series of cases, the directors' refusal to sue after demand in one case constitutes sufficient grounds to find demand unnecessary in the remaining actions. *See* Nussbacher v. Continental Ill. Bank & Trust Co., 518 F.2d 873, 879 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976). The *Maldonado-Del.* distinction encourages collusion between shareholders so directors will have to meet the *Maldonado-Del.* strict standard of review in at least one derivative action. *See Demand and Standing*, *supra* note 1, at 180-81.

[119] *See* Dent, *supra* note 1, at 121-22.

[120] DEL. CODE ANN. tit. 8, § 144(a) (1974 rev.).

[121] *See* Twin-Lick Oil Co. v. Marbury, 91 U.S. 587, 590 (1876) (holding loan from director/shareholder enforceable once creditor proved fairness of transaction to corporation). To hold all self-dealing transactions void or even voidable per se would deprive a corporation of aid from those most interested in the corporation's well-being. *Id.* at 589.

[122] *Cf.* note 54 *supra* (self-dealing director may provide valid reasons for dismissal of derivative suit against himself). No one reasonably expects an interested director to recommend pursuit of a claim against himself. *See* note 114 *supra*. Moreover, the director's interest would reduce his desire to litigate fully. *Id.* A logical though self-serving director will recommend dismissal regardless of the corporation's interests in going forward. *See* Dent, *supra* note 1, at 139; *cf.* Maher v. Zapata Corp., 490 F. Supp. 348, 354 (S.D. Tex. 1980) (committee might have rationalized a "foreordained" decision to dismiss). Therefore, the court should strictly review the interested director's rationale for recommending dismissal. *See* Zapata Corp. v. Maldonado, 430 A.2d at 788-89 (calling for strict court review even of allegedly disinterested directors' dismissal reasons).

tion,[123] the court should allow any director, disinterested or otherwise, to terminate the litigation.[124] The *Maldonado-Del.* test, however, requires the court to continue the litigation to the detriment of the corporation and shareholders alike if interested directors move to dismiss.[125]

Unless states radically change corporate law applicable to shareholder derivative suits,[126] individual states[127] should apply the standard of review developed in *Maldonado-Del.*[128] to determine whether to grant directors' motions to dismiss derivative suits brought against directors. Derivative suits may constitute the most effective deterrent to intracorporate abuses of managerial powers.[129] Unfortunately, some derivative suits merely may drain the corporation's resources.[130] Between these extreme classifications, courts should permit trial on the merits only of those derivative suits which potentially will further the corporation's interests.[131] Because the ultimate question does not hinge solely on the merits of the underlying claim, but also depends on the expected net return of the litigation to the corporation,[132] derivative suits should not go to trial on the merits automatically if the court finds interested directors demanding dismissal. Rather, the court should consider the directors' good faith and thoroughness of investigation when weighing the reasons put forth for dismissal.[133] Because the *Maldonado-Del.* test already requires strict judicial scrutiny,[134] extension of the test

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[123] *See* note 130 *infra* (litigation detrimental if costs exceed benefits thereby gained).

[124] *See* Dent, *supra* note 1, at 123.

[125] *See* 430 A.2d at 789 (trial must continue if court finds interest on part of petitioning directors).

[126] *See* Coffee, *supra* note 95, at 330-36 (recommending uniform change in state law to preserve shareholder derivative suits). Assessing costs against plaintiff and denying attorney fees probably would reduce the incidence of litigation having a negative net return to the corporation. *Id.*

[127] *See* Burks v. Lasker, 441 U.S. 471, 480 (1979) (state law determines whether directors may dismiss breach of fiduciary duty claims); note 27 *supra* (law of state of corporate domicile applies).

[128] *See* 430 A.2d at 788-89; text accompanying notes 95-108 *supra.*

[129] *See* Coffee, *supra* note 95, at 302-09.

[130] *See* Zapata Corp. v. Maldonado, 430 A.2d at 786-87; text accompanying notes 112-13 *supra.* The "costs" to the corporation include more than the direct litigation costs. *See* Maher v. Zapata Corp., 490 F. Supp. 348, 350-51 (S.D. Tex. 1980). In *Maher,* the litigation committee's assessment of costs of the derivative suit included the probable indemnification of defendants, business time lost, possible loss of goodwill, impairment of management abilities during trial, and the negative effect of a trial on employee morale. *Id.*

[131] *See* Dent, *supra* note 1, at 123; *Independent Directors, supra* note 54, at 579, 583.

[132] *See* Zapata Corp. v. Maldonado, 430 A.2d at 788 (permitting motion to dismiss based on corporation's best interests, not on underlying merits of claim).

[133] *See* Ferrara & Steinberg, *A Reappraisal of* Sante Fe; *Rule 10b-5 and the New Federalism,* 129 U. PA. L. REV. 263, 290 (1980) (crucial criterion should not be whether director is financially interested, but whether he can exercise independent judgment); *Director Dismissal, supra* note 24, at 537 (test is whether prudent, independent directors would move for termination under like circumstances).

[134] 430 A.2d at 788-89; *see* text accompanying notes 53-59 *supra.*

to instances of interested director dismissal should not unduly burden the courts. Objective judicial scrutiny should satisfy minority shareholders that their interests as shareholders would suffer if the court allowed the action to proceed to trial on the merits.[135] The *Maldonado-Del.* strict standard of review eliminates the danger posed by structural bias by placing an affirmative duty on the directors to prove the reasonableness of their motion to dismiss.[136] In addition, the *Maldonado-Del.* test, modified to allow interested directors to dismiss, would allow directors, whether disinterested or not, to continue generally unimpaired in managing the corporation's affairs.[137] The *Maldonado-Del.* dismissal test, modified to allow interested directors to participate in the investigation of shareholder allegations, ensures a thorough adjudication of the fundamental issue in every derivative action, whether the corporation's expected benefits will exceed the costs of recovery, without requiring a burdensome trial on the merits.

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[135] *See* Steinberg, *supra* note 54, at 25 (recommending strict judicial scrutiny to assure impartiality as well as appearance of impartiality).

[136] *See* text accompanying notes 103-05 & 108 *supra.*

[137] *See* Maher v. Zapata Corp., 490 F. Supp. 348, 350 (S.D. Tex. 1980) (allegation that time spent in litigating derivative suit detracted from time spent managing corporation).