ARTICLE: CORPORATE GOVERNANCE — THE ROLE OF SPECIAL LITIGATION COMMITTEES.

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BIO:

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SUMMARY:

... The recent furor over executive compensation has brought to light an even more fundamental concern — the issue of corporate governance. ... The 1980s have seen the development of several phenomena that markedly impact corporate governance — the spectacular rise in executive compensation, the takeover movement, the market for corporate control and insider trading, and the focus of this Article, the development of the special litigation committee as a means to shield director wrongdoing from judicial scrutiny. ... For example, in the executive compensation area, the SEC has reviewed and revised its long-standing policy that this issue is a managerial one which is not a proper subject for shareholder action. ... In such a case, the directors will file a report with the court and, under the Proposed Final Draft, the court, in reviewing the report, will generally follow an Auerbach standard in duty of care cases and a Zapata standard in duty of loyalty cases. ... In fact, during the course of the hearing (investigation), the hearing body and the defendant have worked side by side on board of director and committee matters. ...

HIGHLIGHT: Abstract: In reviewing decisions of a special litigation committee, courts have generally applied the business judgment rule to the "second-tier" decision by the committee when it moves to dismiss litigation challenging alleged "first-tier" wrongdoing. While all courts inquire into the independence and good faith of the committee, and the adequacy of its procedures, a judicial split exists as to whether the court can inquire into the substantive reasons why the committee believes the litigation should be dismissed. This Article analyzes the nature of structural bias and contrasts the procedural rights which a plaintiff possesses in a judicial proceeding with the lack of such rights in the special litigation committee context. It concludes that Auerbach should never be the standard of review, that Zapata is the appropriate standard where the "first-tier" wrong implicates the duty of care, and that no deference should be given to the committee when the underlying wrong involves a breach of the duty of loyalty.

TEXT:

[80] I. INTRODUCTION

The recent furor over executive compensation has brought to light an even more fundamental concern — the issue of corporate governance. Both the reality and the theory of corporate governance have undergone radical change in this century. At the turn of the century, ownership and management were related. Powerful men both owned and exercised
control over major corporations. n1 Later, Berle and [*81] Means identified a separation of ownership and control. n2 Corporations were now managed by professional managers with little significant stock ownership in the firms they managed. If professional managers perpetuated themselves because fragmented shareholders could not practically exercise effective power, then how could management be held accountable? The response of institutional shareholders to bad management was to "vote with their feet" -- that is, to sell rather than fight. n3 Then, in the 1970s, spurred at least in part by the concern of the Securities and Exchange Commission (SEC) n4 and the American Law Institute project on corporate governance, n5 the concept of the independent director was seized upon as the instrument that would hold corporate managers responsible. Inextricably intertwined with the increased use of independent or outside directors is the development and expansion of the committee structure of the board of directors.

The 1980s have seen the development of several phenomena that markedly impact corporate governance -- the spectacular rise in executive compensation, n6 the takeover movement, n7 the market for corporate [*82] control and insider trading, n8 and the focus of this Article, the development of the special litigation committee as a means to shield director wrongdoing from judicial scrutiny. These phenomena are related in the following respects: the first three involve transactions which may or may not involve harm to the corporation and may possibly implicate wrongful conduct; the fourth involves process issues of who shall determine whether harm exists or whether wrongful conduct is implicated.

The last two years have dramatized the fact that there is little correlation between executive compensation and executive performance. n9 The issue has become increasingly visible because it comes at a time when the rest of the work force is suffering from the effects of a recession. This has raised the query "why?" and called into question the effectiveness of the board of directors. Why have these so-called independent directors failed to exercise greater control and failed to require enhanced corporate performance for increased compensation? The answer lies in the fact that there is substantial mutuality of interest between all directors of a corporation -- both inside (management) and outside (independent). As the Economist recently noted, "two-thirds of outside directors in America are themselves chief executives of other companies." n10

Although the system has not worked well with one set of transactions, executive compensation, that does not mean the system should be junked or that radical responses are necessary. It does mean, however, that the system should be analyzed and that underlying assumptions should be reviewed for their current validity. For example, in the executive compensation area, the SEC has reviewed and revised its long-standing policy that this issue is a managerial one which is not a proper subject for shareholder action. The SEC now recognizes that this issue does involve policy considerations. n11

[*83] Even more fundamentally, it is necessary to review the concept of the board of directors and the role of independent directors. How does accountability work? What expertise do directors, particularly the so-called outside or independent directors, bring with them to the corporate boardroom? What, if any, is the role of the courts in corporate governance issues?

In the last decade or so, the answer of many courts and commentators to the last question has been basically "none." The mechanism by which courts have generally reviewed the acts of corporate managers has been the shareholder derivative suit. This device has always been subject to mixed reviews. Some view it as a mechanism by which a shareholder with a modest holding, often at the behest of an attorney, can file a "strike suit." n12 The corporation is then spurred by the suit's nuisance value to pay a modest sum to rid itself of the unfounded litigation rather than expend time and money to fight it in court. Others view the device much more positively, seeing it as a necessary final check on potential managerial misconduct. n13 Traditionally, if director [*84] misconduct is alleged, a plaintiff need not make demand on the board of directors but may file a suit alleging the reasons why demand was not made. n14 If substantiated, the court would then determine the merits of the case.

However, the development of the special litigation committee, and the expansion of situations in which demand must be made upon the boards of directors, have had a dramatically chilling effect upon shareholder derivative suits. If demand must be made on the board and the board refuses to sue, one view holds that the only recourse for the shareholder is then to sue the directors for wrongful refusal. But if the existing board, or the committee to which the matter was referred, was not involved in the challenged transaction, the decision not to sue would be protected by the business judgment rule which effectively insulates directors against an adverse ruling. n15

If demand need not be made and suit is filed, as will generally be the case when the directors who were involved in the challenged decision still sit on the board, the typical response in recent years has been for the directors to appoint to the board two or three new ("independent") directors who constitute a special litigation committee with the task of
determining whether the litigation against their fellow directors should go forward. Invariably the committee moves to
dismiss the litigation. This Article will address the issue of what deference, if any, [*85] courts should give to such
motions to dismiss. If the court defers to the committee, the court will have effectively abdicated any role in overseeing
corporate governance.

To understand the process by which courts have been ceding their authority to the board of directors, it is necessary
to understand the historical distinctions between two fiduciary duties, the duty of care and the duty of loyalty, and the
effect of the business judgment rule on judicial oversight. The duty of care requires directors to exercise some degree of
care n16 when managing the assets which shareholders have contributed. The duty of loyalty precludes directors from
using their position to enrich themselves at the expense of the shareholders. Courts, in dealing with duty of care issues,
have developed the business judgment rule, whereby courts generally will not second-guess managerial decisions. n17
A plaintiff, in a duty of care case, has the burden of proof and is confronted by the presumption arising from the
business judgment rule that managers exercised proper care. Contrariwise, in a duty of loyalty case, the burden is on the
defendant to justify his or her self-dealing actions.

In recent shareholder derivative suit litigation involving special litigation committees, courts have analyzed the
issues by recognizing two tiers of corporate decision making. n18 The first tier involves the acts of directors which
give rise to the alleged wrongful conduct. The second tier is the decision of the special litigation committee to
determine whether the litigation based upon the first tier actions ought to be dismissed. Courts thus far have focused
strictly upon the second-tier decision. In one line of cases, if the directors making the second-tier decision whether to
continue litigation against their fellow directors are themselves not implicated in the first-tier alleged wrongdoing,
absolute deference is given to the second-tier decision on the basis of the business judgment rule. n19 Another line of
cases would permit the court some latitude in reviewing the substantive merits of the second-tier decision. n20

The thrust of this Article is to challenge the existing analysis and to argue that the deference, if any, accorded the
second-tier decision cannot be determined without reference to the nature of the first-tier alleged wrongdoing -- that is,
whether the alleged wrongdoing implicates the duty of care or the duty of loyalty. This position results from [*86]
examining the relative competence of directors and courts and from recognizing that directors, when passing judgment
upon those with whom they serve, are subject to structural bias, a fact well demonstrated by the executive compensation
uproar. It is proper for courts to accord some deference to independent directors who evaluated the business judgments
which are challenged in duty of care cases. However, courts, and not directors, have experience in assessing the type of
wrongdoing which is challenged in duty of loyalty cases. Thus, deference -- and certainly not abdication -- is not
appropriate where the alleged first-tier wrongdoing implicates the duty of loyalty.

This Article first traces the evolution of the committee concept and the two primary existing lines of authority
regarding judicial deference to special litigation committees. It then develops the duty of care/duty of loyalty
distinction and analyzes the bases for the existence of structural bias. It concludes by challenging the use of the special
litigation committee concept in the closely held corporation situation where the board of directors is generally a non-
functioning entity.

II. THE DEVELOPMENT OF THE COMMITTEE STRUCTURE

During the 1970s, as a result of renewed interest in and concern about corporate governance, n21 the use of
committees by boards of directors expanded substantially. Prior to this time, the most prominently used committee was
the executive committee. This committee very early received statutory acknowledgement, n22 with the first extensive
provisions regarding this committee appearing in section 38 of the Illinois Business Corporation Act of 1933 n23 which formed the basis for the Model Business Corporation Act. n24

In the 1960s and 1970s, other committees came into use, in part as a result of developments in other areas of law.
For example, the use of a compensation committee, at least insofar as it had jurisdiction over stock options, was sparked
by the introduction of qualified stock options into the Internal Revenue Code of 1954 n25 and by the concern about
avoiding short-swing profit liability under section 16(b) of the 1934 Securities Exchange Act. n26 The regulations
under the Code [*87] allowed the board of directors or some other group to have authority to select particular
employees from the group eligible under the plan to be awarded options. n27 If a committee composed of disinterested
directors had such authority, the acquisition of a stock option would be exempt from section 16(b) of the 1934 Act.

By 1970, audit and nominating committees, as well as compensation committees, had come into use, sometimes
with specific statutory authorization and sometimes pursuant to the general power of the board of directors to delegate
of the corporation. n31

The development of these committees in the publicly held corporation n32 has been viewed very positively by
commentators on corporate governance. n33 This is, at least in part, because committee development has proceeded
side-by-side with the practice of adding nonmanagement [*88] "outside" directors to the board of directors. As
nonmanagement directors are added to the board, the size of the board will increase and efficiency dictates that the
board should be broken down into committees. According to the Business Roundtable, the use of committees
compensates for the fact that outside directors can only function part-time, permits a better focus on particular problems and
a more intensive exploration of those problems, and permits development and utilization of specialized knowledge
and experience. n34

In addition to these standing committees, other ad hoc committees also have been used. For example, in conflict of
interest situations, section 144 of Delaware's General Corporation Law provides that transactions involving an
interested director are not voidable solely for that reason if, inter alia, the transactions were approved by a committee of
disinterested directors. n35 Building upon the general statutory authorization for committees, another ad hoc
committee -- the special litigation committee -- developed in the 1970s and became prominent in the 1980s. n36

The origin of special litigation committees appears to have been in the ancillary relief that the Securities and
Exchange Commission has sought in its enforcement litigation. n37 The real impetus for their establishment came out of
the "improper foreign payments" cases of the 1970s. n38 Litigation in this area was triggered when a shareholder
filed a derivative suit, generally against the inside directors who had authorized the questionable payments (sometimes
amounting to millions of dollars), and sought, on behalf of the corporation, to recover the amount of the payments from
the inside directors. n39 The corporation would respond by appointing a committee of disinterested directors who
would investigate the merits of the litigation and, almost invariably, recommend dismissal of the litigation. n40

[*89] During the 1980s, a split of authority arose over what weight the recommendation of a special litigation
committee should be accorded and what the standard for judicial review of the committee's decision should be.
Concern was also raised about the structural bias that exists in the decisions of such a committee. While these issues
were addressed, if not resolved, in the 1980s, two other critical issues will draw the attention of the courts in the 1990s:
whether courts should defer to special litigation committee recommendations when the underlying litigation alleges
breach of the duty of loyalty rather than the duty of care, and whether such a committee ought to be recognized at all in
disputes involving closely held corporations where the board of directors has traditionally been little more than a
formality.

III. DIFFERING JUDICIAL APPROACHES TO SPECIAL LITIGATION COMMITTEES

The highest courts of six states have considered the power of a special litigation committee to terminate derivative
suits against board members. n41 The two earliest cases, which take opposing viewpoints and which are the most
frequently cited, are Auerbach v. Bennett n42 and Zapata Corp. v. Maldonado. n43 Auerbach held that a court may
review the independence and good faith of the committee and the sufficiency of its investigation, but may not inquire
into the merits of the recommendation -- a one-step approach. Zapata, however, employed a two-step approach: after
making the Auerbach review, the court may apply its own independent business judgment as to whether the committee's
motion should be granted. Massachusetts, n44 North Carolina, n45 and Alabama n46 have substantially followed or
evén broadened the Zapata formula for judicial review, while Iowa has held that interested directors do not have the
power to confer upon a committee the power to terminate a derivative action. n47 In addition, intermediate [*90]
appellate courts in California, n48 Colorado, n49 Florida, n50 Illinois, n51 and Minnesota n52 have dealt with
issues involving special litigation committees.

A. Auerbach v. Bennett: Expansion of the Business Judgment Rule

Auerbach v. Bennett n53 is arguably an unwarranted extension of the business judgment rule which can only be
understood in light of its facts. Auerbach was a "questionable payments" case -- the corporation had paid bribes and
kickbacks to foreigners totaling more than eleven million dollars. n54 The company initiated an internal investigation
and reported its results in its proxy statement to shareholders in 1976. n55 Almost immediately, Auerbach filed a derivative suit against the corporation's directors and auditors. n56 Four members of the board of directors were named as defendants and served, thirteen other members were named but not served. n57 The three directors comprising the special litigation committee had joined the board after the challenged transactions had taken place and were vested with full authority to act for the board with respect to the derivative action. n58

The committee, after a six-month investigation, concluded that none of the defendants had profited personally, that the suit was without merit, that senior management would be distracted by the continuance of the suit, that continued publicity would be damaging to the company's business, that litigation costs would be extremely high, and that there was only a remote likelihood of success. n59 The committee [*91] directed the corporation's general counsel to take that position in present and pending litigation. n60

The question, as the court saw it, was whether the first-tier bribes and kickbacks could be insulated from judicial scrutiny by the second-tier corporate action in reviewing them. n61 The court concluded that the special litigation committee's finding that the best interests of the corporation would not be served by continuing the action against the defendant directors should stand. n62 According to the court, the validity of the second-tier decision to terminate the derivative litigation turned upon "the proper application of the business judgment doctrine . . . to a decision . . . of disinterested directors."

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. Thus, absent evidence of bad faith or fraud (of which there is none here) the courts must and properly should respect their determinations. n64

The court then concluded that "derivative claims against corporate directors belong to the corporation itself. As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation's board of directors." n65

[*92] The court viewed the action of the committee as comprising two components: the selection of procedures and the ultimate substantive decision. With respect to the substantive decision, the court held that

[i]nquiry 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. Its substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach. n66

However, with respect to procedures, judicial inquiry was not foreclosed because courts are well equipped by long and continuing experience and practice to make [such] 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. n67

The committee in Auerbach also had the burden of demonstrating that the investigation was carried out in "good faith." n68 While the relative weight to be accorded the facts uncovered by the investigation is beyond judicial review, [p]roof . . . that the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or halfhearted as to constitute a pretext or sham . . . would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine. n69

B. Zapata v. Maldonado: A Two-Step Approach

Zapata Corp. v. Maldonado, n70 on the other hand, dealt with a situation that was clearly within the competence of a court to resolve. Zapata involved a board of directors action which accelerated the exercise date of stock options so that they became exercisable immediately before a self-tender at a premium. n71 This action saved the executives substantial taxes but, at the same time, cost the corporation deductions which, from a tax standpoint, would have saved
it several [*93] hundred thousand dollars. n72 The court viewed this as a "demand-excused" case in which demand would have been futile. n73

At the outset, the Zapata court recognized that power to control litigation, even derivative litigation, remains in the board even though the board is tainted by self-interest. "The problem is one of member disqualification, not the absence of power in the board." n74 Accordingly, the board could delegate its power to an independent committee composed of disinterested board members. n75 According to the court, the problem then became, on the one hand, that of determining the proper balance between the power of the board to rid the corporation of meritless or harmful litigation and strike suits, and, on the other, preventing untrammeled board power to wrest bona fide derivative actions away from the courts with the result that such a suit would lose "much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors." n76

The Zapata court did not see strict adherence to the business judgment rule as striking the proper balance. Not only should courts recognize that the suit was properly brought in the first instance, since demand was excused, but courts should also be aware that, when directors pass judgment upon fellow directors, a "there but for the grace of God go I" empathy might play a role. n77 In addition, since directors tend to be cut from the same bolt of cloth, n78 there is a possibility of "subconscious abuse." n79

In Zapata, the corporation had moved alternatively to dismiss the suit or for summary judgment. n80 According to the court, this reflected the fact that a motion in this context fit into no "ready pigeonhole" but was a hybrid between the two motions. n81 The court also saw parallels to judicial approval of a settlement and the situation where a plaintiff seeks dismissal of its suit after an answer has been filed. n82 Accordingly, the Zapata court chose "a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to [*94] unbridled plaintiff stockholder control." n83 The balance was achieved by applying a two-step test to the committee determination:

(i) the first step involved the Auerbach test in which the corporation has the burden of proving the independence and good faith of the committee and the reasonableness of its investigation; and

(ii) the second step involved the court applying "its own independent business judgment" as to whether the motion should be granted. n84

The purpose of the second step is "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." n85 In making such a determination, the court should "give special consideration to matters of law and public policy," as well as the corporation's best interests. n86

C. Can a Court Exercise Business Judgment?

The Zapata court has been criticized for suggesting that a court can exercise its own "business judgment." n87 On the other hand, a distinguished member of the Delaware corporate bar has recognized that "[i]f . . . all judicial review of the merits of the committee's decision is foreclosed, there will be very few cases where a committee, once formed and put to work judging their peers, will conclude that the litigation should proceed." n88

The basic purpose of the business judgment rule is a defensive one -- to protect directors against litigation premised upon their making business decisions. What this has meant in the past is that, when the duty of care exercised by an officer or director has been challenged, the presumption is in favor of the action taken by the officer or director and the burden of proof is placed upon the plaintiff. While directors are spoken of as having a duty of care, this has never meant that they are liable for mere negligence. In practice, they have only been held liable for conduct that amounts to gross negligence or worse. n89 Subsequent [*95] to Zapata, the Delaware Supreme Court expressly articulated the gross negligence standard in Smith v. Van Gorkom. n90

Courts seek to use the business judgment rule affirmatively in the special litigation committee context. In Auerbach, the result was to deflect focus from the first-tier transgression and focus inquiry upon the second-tier decision of the board of directors to dismiss the first-tier litigation against their fellow directors. While the result in Auerbach -- dismissal of the litigation -- may have been proper, the rationale is faulty. Courts are entitled to review the substantive decision of a special litigation committee -- not to substitute their judgment, but to ensure that the decision of the special litigation committee was not a whitewash of grossly negligent conduct. The Auerbach court itself recognized that a court could scrutinize the investigation to insure that it has not been so "shallow . . . pro forma or
halfhearted” as to evidence bad faith.  What Auerbach failed to recognize is that judicial scrutiny of the conclusion is necessary to insure that it is not shallow or pro forma.

This is, in effect, what the court in Zapata was proposing. Zapata recognized that a special litigation committee could follow extensive procedures, such as hiring a major law firm to interview 140 people and produce reams of paper, and yet come to an unwarranted conclusion. The Zapata court unfortunately used a term implying commercial competence -- exercising its own "business judgment" -- to review the conclusions of the special litigation committee rather than using the more appropriate judicial language -- "manifestly unreasonable" or "unsupported by the evidence" -- that a court uses when reviewing the decision of another body.

Auerbach, to the extent it can be read as precluding any review of the substantive decision of the special litigation committee, is simply bad law. Were the special litigation committee to be sued for failing to pursue the litigation against the directors in the first-tier transgression, the business judgment rule, used defensively, would protect them from liability. It is inappropriate, however, to use the business judgment rule offensively to preclude judicial review of the merits when directors engage in palpably grossly negligent conduct.

Zapata, on the other hand, is an appropriate standard of review to use when the challenged first-tier conduct involves a breach of the duty of care. If an independent and disinterested committee of the board reviews an operating decision by other directors and concludes that such decision or conduct did not involve self-dealing by the defendants and was rationally justified, and if a court, in a proceeding akin to summary judgment, concludes that the recommendation by the special litigation committee is supported by the record, then the litigation should be terminated.

While the Zapata approach can be justified when the underlying cause of action is predicated upon a breach of the duty of care, it cannot be justified when the defendant directors are charged with breaching their duty of loyalty to the corporation. There is absolutely no reason to defer to the board of directors when the underlying first-tier violation involves a breach of the duty of loyalty, or self-dealing. As the following section will discuss, in duty of loyalty cases as opposed to duty of care cases, it is the courts, not boards of directors, that have the relevant expertise. Thus, the controlling issue in determining whether to defer to the recommendation of a special litigation committee ought to be whether the duty of care or the duty of loyalty is implicated.

IV. DUTY OF CARE V. DUTY OF LOYALTY

A. Factual Distinctions Between Auerbach and Zapata

Perhaps the differing approaches in Auerbach and Zapata can be rationalized on the basis that the underlying litigation in Auerbach involved a breach of the duty of care, whereas the allegations in Zapata charged self-dealing. In Auerbach, the problem was one of questionable payments made by the corporation in connection with its overseas activities. There was no self-enrichment by the defendant directors, and even various cabinet departments of our government differed over the wrongfulness of the challenged acts.

[*97] On the other hand, in Zapata, the day before the board approved a self-tender at $ 25, the board, in a special meeting, accelerated the exercise date of outstanding stock options to the current date when the stock was trading at $18.50. Then, the six senior officers purchased 151,200 shares pursuant to the accelerated options. Because the spread between the fair market value at the date of exercise (either $18.50 or $25 depending upon whether the exercise date was accelerated) and the exercise price of $12.15 was taxable to the officer at ordinary income rates but was also deductible by the corporation, the effect of the acceleration was to deprive the corporation of a $1 million tax deduction. The special litigation committee, in determining that continuation of the litigation was not in the best interest of the corporation, set forth some boilerplate reasoning that was not supported by the facts.

The reasoning of the committee certainly did not reflect such insight which only a businessman, and not a court, would possess. The situation was clear: the defendants took corporate action which resulted in an effective transfer of approximately $400,000 from the corporation to themselves. Depending upon the relative tax rates of the corporation and the executives, the corporation probably lost substantially more than the executives gained.

B. Relative Competence Between Directors and Courts

Compensation decisions, such as those in Zapata, involve a clear conflict of interest. Critics of Zapata, downplaying the ability of a court to use its own independent business judgment in evaluating a committee recommendation, have stated that "[t]he very concept that courts have independent business judgment is, in fact, a
contradiction of over 250 years of legal development.” n102 This statement is correct if a fact pattern involving disinterested director judgment with respect to business operations is at issue.

On the other hand, judicial abdication of oversight of fiduciaries in situations involving self-dealing would be a contradiction of over 500 years of legal development. n103 For centuries, courts have been reviewing and enforcing the fiduciary duties of trustees, partners, agents, officers, and directors. There is nothing to indicate that directors, interested or disinterested, are any more astute in recognizing conflicts of interest or other breaches of fiduciary duty than are the courts.

In fact, the evidence is to the contrary. There are hundreds of reported cases in which directors have been charged with conflicts of interest. n104 Thus, in these cases, the board of directors either did not recognize the problem or crassly ignored it. Although directors have sometimes been terminated by their fellow directors for conflicts of interest n105 or improprieties, n106 this does not establish that directors are more astute than courts in recognizing and dealing with this problem. In fact, the Delaware Supreme Court recently charged the board of [*99] Macmillan, Inc. with being "torpid, if not supine” n107 for failing to recognize a conflict of interest problem.

This negative data does not implicate directors in general. It does suggest, however, that directors are not automatically cloaked with expertise on conflicts of interest. Directors are predominantly business executives. n108 Their experience should provide them with judgment on business matters, certainly more than can be expected of judges. However, business experience provides no particular insight into fiduciary responsibilities, whereas courts deal with this issue continuously. Accordingly, the pattern reflected by the Auerbach and Zapata cases is out of phase. Deference to a second-tier special litigation committee decision on whether the corporation should pursue a first-tier claim against other directors that is predicated upon the duty of care is appropriate. But deference does not mean abdication. Auerbach represents judicial abstention; Zapata represents judicial deference.

There are relatively few cases involving the duty of care in the last quarter century in which directors have been held liable. n109 The most famous of these is Smith v. Van Gorkom where the board authorized the sale of a company after listening to a twenty minute unsupported oral presentation by the CEO and authorized the execution of a merger agreement which had been seen by neither the board nor the CEO. n110 The documents, which had been drafted in a three-day period by the attorney for the buyer, were executed on the evening of the board meeting at the Lyric Opera. n111

The Van Gorkom case, which never would have seen the light of day if a special litigation committee had had the opportunity to dismiss it, had two beneficial effects. First, and more obviously, the corporation was given a remedy against the directors for their abject failure to engage in an appropriately deliberative process. The board foreclosed the possibility of a better price from the current bidder or a new bidder by allowing itself to be intimidated into a precipitate decision. n112 The [*100] Delaware Supreme Court later suggested that, when a company is to be sold, it should be put up for bid n113 unless the sale is part of a thoroughly deliberated business plan, n114 which the situation in Van Gorkom certainly was not.

More importantly, Van Gorkom sensitized the business community to the fact that boards of directors do have deliberative responsibilities. It generated a plethora of law review and business journal articles. n115 The fiascoes in the savings and loan crisis certainly demonstrate that boards needed to be reawakened to their responsibilities. In a perfect world, shareholder derivative suits to keep management on its toes would not be necessary. But again, the savings and loan crisis demonstrates that we do not live in a perfect world.

While Zapata is an appropriate approach when the first-tier activity implicates the duty of care, even Zapata is inappropriate where the challenged transaction involves director self-dealing or other duty of loyalty violations. As discussed above, directors have no particular expertise with duty of loyalty issues. n116 Indeed, as the next section will discuss, n117 directors, because of structural bias, are ill-equipped to pass judgment on their fellow directors.

The dismissal of litigation is essentially a judicial function. Circumscribing the normal functioning of the courts ought to be done with caution. In duty of care cases, courts have recognized the limitations of their competence and authority vis-à-vis the competence of business decision makers to address the operational aspects of a business -- thus, the business judgment rule. No such disparity of competence exists in the duty of loyalty area. As the Maine Supreme Court has stated:

[the business judgment rule does not, however, protect business decisions that result from fraud or bad faith. The policy reasons for keeping a court from evaluating after the fact the wisdom of a particular business [*101] decision do not apply when the issue is whether a party to that decision acted fraudulently or in bad faith. The assessment of fraud
or bad faith is a function courts are accustomed to perform, and in performing it the courts do not intrude upon the process of business decisionmaking beyond assuring that those decisions are not improperly motivated. n118

C. Policy Reasons to Distinguish Duty of Care from Duty of Loyalty Cases

Strong policy reasons exist for differentiating between litigation involving the duty of care and that involving the duty of loyalty. n119 If a court did not decide cases involving the duty of loyalty, there would be no external mechanism holding fiduciaries accountable. In the duty of care area, presumably any substantial deviation from sound business judgment will ultimately impact the bottom line and market forces will hold the managers accountable.

While the same argument could be made with respect to violations of the duty of loyalty, the director who has abused his position of trust through self-dealing has already received a benefit that will probably outweigh any discipline the market may impose. For example, in the Zapata case, the action of the directors in advantaging themselves deprived the corporation of the cash flow that the deduction would have produced for the corporation, but did not impact the earnings of the corporation. n120 In fact, their action enhanced the earnings by reducing expenses, but also reduced corporate cash flow. Will the market make such a fine distinction? Even if it does, all shareholders will pay the price of a market decline, whereas the benefit will accrue to a handful of inside directors.

Another reason to distinguish between the two types of litigation is that almost any corporate transaction can be challenged on duty of care grounds. With respect to any particular decision of the board, it may be very difficult to distinguish "bad decisions" from "bad luck." n121 Duty of loyalty litigation is much more precise. There must be a transaction with or advantage to a director. Although the specter of injunctive relief in an operating transaction could be horrendous because of the disruption to operations, the potential negative impact on the corporation is much more circumscribed when the basis for the [*102] litigation is an improper benefit to a director. In this latter situation, the corporation could receive adverse publicity or management could be subject to the inconvenience of discovery, but this hardly brings operations to a halt.

The final policy reason involves the integrity of the system. In the duty of care area, investors necessarily take risks regarding the success of the investment. The price that they pay is a function of those risks. But a breach of trust is not a risk for which they bargain. In this area, judicial oversight is necessary to preserve confidence in the system, particularly when structural bias is a real concern. If directors are the guardians of corporate integrity, sed quis custodiet ipsos custodes? -- who will watch the watchmen?

V. STRUCTURAL BIAS

A. Judicial Recognition of Structural Bias

The decisions which have rejected the Auerbach deference to the business judgment of the members of a special litigation committee have done so predicated, at least in part, upon a concern for structural bias. Since structural bias exists irrespective of whether the underlying issue is a duty of care or a duty of loyalty problem, it is reasonable to inquire why the existence of structural bias supports distinguishing between duty of care and duty of loyalty cases in terms of the power of a special litigation committee to dismiss a derivative suit. The basic response to this inquiry is that caution must be taken before ousting the courts from jurisdiction over an alleged wrong in an area -- duty of loyalty -- in which they have been historically involved, in favor of a body -- the special litigation committee -- which has neither the competence nor the independence and disinterestedness of the courts in evaluating the alleged duty of loyalty violation.

Structural bias, according to one court, means that supposedly independent members of special litigation committees nonetheless are not free from "personal, financial or moral influences which flow from the directors who appoint them." n122 As stated earlier in the discussion of Zapata, it is the "there but for the grace of God go I" syndrome which exists when directors pass judgment on their fellow directors. n123 Often the defendant directors will have been responsible for the committee members' initial appointment or election to the board and also for their appointment to the special litigation committee. It is rare [*103] that the chief executive officer is not one of the defendants and, even in corporations which have an independent nominating committee, the influence of the chief executive on the composition of the board of directors is substantial. n124

One of the more recent state supreme courts to consider the issue of deference to special litigation committees withdrew its earlier decision following Auerbach and instead adopted a modified Zapata approach. In so doing, the court stated:
We interpret the trend away from *Auerbach* among other jurisdictions as an indication of growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose institutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interest of plaintiffs forced to bring suit on behalf of the corporation. \[n125\]

On the other hand, the corporate bar views the idea of structural bias as a "relatively silly, but harmless, academic argument." \[n126\] The notion of structural bias is challenged with the following argument:

Those who are chosen as outside directors of publicly held corporations are generally persons who have distinguished themselves in some other capacity. Chief executive officers of other corporations seem to be especially prized as outside directors. Generally speaking, then, outside directors tend to be men and women who have considerable investments in reputation but who have invested most of their human capital elsewhere. The structural bias argument asks us to believe that outside directors generally are more willing to risk reputation and future income than they are to risk the social embarrassment of calling a colleague to account. \[n127\]

This argument misperceives the nature of structural bias. Structural bias is not concerned with conscious decision making processes, although one court has stated that "if the involved directors expected any result other than a recommendation of termination at least as to them, they would probably never establish the committee." \[n128\] The empirical data seem to support this cynical view since a special litigation committee, "once formed, has almost invariably recommended [*104] dismissal of the action against all defendants." \[n129\] While strike suits do exist, it is statistically improbable that all suits brought against directors are unfounded.

**B. Structural Bias as a Function of Predisposition**

The concept of structural bias primarily recognizes the unconscious elements of decision making. It proceeds on the basis that members of the committee are not evil but biased. Bias is not used here in a negative or pejorative sense; rather it is used in the sense of inclination or predisposition. Predisposition in turn derives from background or relationships. Consider the many law schools that have abandoned honor codes and turned instead to monitored exams because students would not report other students who were cheating. This does not mean that the silent students themselves would cheat, or that they condone cheating, or that they fail to realize that cheating in others disadvantages themselves competitively, or that they fail to realize that cheaters bring disrepute to the legal profession. But the ethic of the group is that you don't rat on your friends. \[n130\]

In general, the business community looks askance at derivative litigation. The overwhelming percentage of directors would meet the test of Caesar's wife. Yet all have a concern over being sued. \[n131\] And all have felt the impact of derivative litigation as premiums for directors' and officers' liability insurance increased slightly over 500% in 1986 \[n132\] and over 200% in 1987. \[n133\] Under these circumstances, it would be incredible if directors did not have a general bias against derivative litigation.

Directors, however, also have predispositions stemming from their general backgrounds and relationships with each other. Despite all the rhetoric about the importance of seeking people from a variety of backgrounds when selecting directors, \[n134\] directors are a very homogeneous group. In the latest Heidrick & Struggles survey, 92.2% of directors were white males and this number has been fairly constant over the years. \[n135\] Ninety-four percent are fifty or older. \[n136\] In a 1982 study, 93% were college graduates and 57% had advanced degrees. \[n137\] The "old-boy" network is still a significant factor in recruiting new directors, \[n138\] and the chief executive of a corporation has the key role in selecting board members. \[n139\] Many of whom will be chief executives of other companies. \[n140\] In choosing directors:

[An] overriding consideration is that the board nominee's personality should be compatible with that of the current directors. Indeed, the new board member is expected not only to work within the group's collective views of the corporate interest, but also to cooperate with other board members in reaching decisions by group consensus. Individuals who are quarrelsome, disagreeable, or rigid are disfavored: they fail to fit within the desired mold of "loyal independence" by which management is given the benefit of the doubt. \[n141\]

Similarly, in explaining why outside directors have been ineffectual in controlling the compensation of chief executive officers or in ensuring that there is a correlation between compensation and corporate performance, one former chief executive officer explained:

It's the dynamic within the meeting. If you are a CEO, you can co-opt the issues. There are, let's say, 5000 names of people in the Fortune 500 boards. It's a club. They either know each other or they know of each other, or they are
there because of a friendship, or somebody else recommended [*106] them. And you rarely tell the CEO that he is full of it. You don't rock the boat. It's like that on board after board. n142

Thus, from their background and the nature of the selection process, there is a strong tendency for directors to think alike.

In the normal business context, such like-thinking is not necessarily a problem. The collective wisdom of a group of directors, however, often will not approximate the value stance of other groups or the community at large. For example, in Zapata, the board advanced the exercise date for options by twelve days so that the management directors could exercise their options when the fair market value of the shares was $18.50, six days before the corporation announced a tender offer at $25. n143 This saved the executives almost $400,000 but cost the corporation an even larger amount. n144

This action could be rationalized on several bases. It could be viewed as additional compensation to the executives. One study reported that "CEO's who sit on each others' compensation committees tend to support each others' pay raises rather than take an objective or challenging stance." n145 It could also be rationalized on the basis that the directors could have postponed the self-tender for twelve days. However, if the market changed in the interim, the corporation might have been hurt. Thus, the directors were protecting the corporation against a market rise by accelerating the options rather than deferring the tender. But this begs the question: did they have the right in the first place to defer the tender for their own advantage?

What would be the response of a labor leader to any purported justification for the benefit given to the management directors? How would that labor leader respond to the argument that the corporation is doing well and the acceleration of the options is only a little extra bonus? The board does not tear up an existing three-year contract and prepare a new one at a higher wage rate for the employees when the economy picks up and the corporation's profits increase. The union leader would expect such a suggestion to be greeted with the response that "a contract is a contract." Were the union leader to be appointed to a special litigation committee, he or she might find the conduct of the directors in advantaging themselves at the expense of the corporation [*107] reprehensible. n146 Why, the union leader might ask, should the corporation lose a tax benefit so that management can pay less taxes? But there is no reasonable likelihood that either a union leader, or a person of similar persuasion, would be appointed to such a committee.

C. Structural Bias as a Function of Group Dynamics

Predisposition is only one facet of structural bias. In addition to the fact that directors may have a value stance not shared by the rest of the population, directors of any particular corporation also constitute a group, specifically, what social psychologists call a "small group." Whenever a "group" exists, a "bonding" process evolves, together with "in-group" bias and "out-group" prejudice. While corporate lawyers tend to view these notions as silly, all one need do is observe ten teenagers shooting free throws for the purpose of dividing themselves into two teams to understand this idea's legitimacy. The first five to make a free throw constitute a team. While they may have had no prior relationship, an immediate bonding occurs. Members of the team support each other as to whether or not one of them was fouled, or touched the ball before it went out of bounds. When the game is over, the losing five will console each other, often over a beverage, telling each other they would have won had the other team played fairly.

The social psychology research consistently demonstrates that "groups of people readily segregate themselves on meager pretexts and quickly develop loyalties and patterns of favoritism toward others with whom they are arbitrarily grouped." n147 Part of the explanation for this phenomenon is that:

[P]eople like to be right and . . . one's attitudinal certainty increases to the extent that one sees one's beliefs as shared by others. The tendency to perceive agreement and avoid discrepancy between oneself and other in-group members is strongest when the dimensions of comparison are important, when membership in the group is desirable or undeniable, or when one cannot easily leave the group or change the opinions of its members. n148

All these factors promoting bias are inherent in the special litigation committee context. Great antipathy exists between directors and [*108] derivative suit plaintiffs. n149 Although litigation against directors has somewhat dampened the enthusiasm for holding corporate directorship, nomination to a board of directors has, nonetheless, been characterized by the foremost authority on boards as "a little bit like being knighted." n150 Service on the board of another corporation can provide rich dividends for a corporate executive. In addition to the prospect of "enlightening glimpses of self-analysis and comparison with his peers," n151 other substantial benefits exist:
Through such service, executives gain broader insight into trends in finance, technology, marketing, and other fields of interest to their firm. Moreover, exposure to another firm's problems can provide advance warning of potential problem areas in their own firm, as well as insight into the strengths of contrasting management styles. Finally, association with other executives on the board provides a reassuring and informal environment for candid discussions about issues at the executive's own corporation. These discussions cannot always be carried out as openly or in as relaxed an environment with that executive's own directors or management team, as they can with associates on another corporation's board. n152

Finally, leaving the board, particularly for a director who has been appointed or elected to the board in order to serve on a special litigation committee, would be awkward at best, since it could be viewed as tantamount to finding culpability on the part of the defendants. In addition, given the homogeneity of the board, changing the group mind-set is unlikely. Directors who discover after a few attempts that their views are not favorably received by their colleagues either stop raising unpopular points of view or withdraw from the board. n153

[*109] The strength of in-group bonding is a function of the "familiarity" of the in-group members. "In the context of the shareholder suit, several forces are at work that cause the directors to identify themselves and the defendants as a discrete group and the plaintiff as a disfavored outgroup." n154 Both the defendant directors and the other directors will have worked with each other over a period of time, possibly years, on general board and committee matters. Even directors who were appointed after the derivative suit was filed will work with the defendant directors on non-derivative suit matters while the investigation is pending -- a period which may span many months. n155

D. The Corporate Bar's Mission to Repudiate Structural Bias

The argument has been made that there is no need to disqualify a director for structural bias because a court will be able to determine any actual bias in deciding whether the director is independent. n156 Members of the corporate bar show little concern for the possibility of bias that can not be clearly demonstrated. The proposed amendments to the Model Business Corporation Act would not even disqualify a director who voted in favor of a transaction from serving upon a special litigation committee to determine whether litigation challenging that transaction should be dismissed, so long as the director himself received no personal benefit from the transaction. n157

[*110] Thus, in Zapata, where the board accelerated the exercise date of options so that the senior officers gained, and the corporation lost, about $400,000, n158 the four outside directors voted in favor of the action and one of the four inside directors, who attended the meeting to provide a quorum, abstained. n159 But, under the Model Act proposal, the same four outside directors who voted for the transaction could be constituted as a special litigation committee and vote to dismiss the action. In such a case, the court would be required to dismiss the action, assuming the directors (i) in good faith (ii) conducted a reasonable inquiry (iii) from which they concluded that continuing the derivative suit was not in the best interests of the corporation. If these four outside directors were a majority of the board (for example, if the board were a seven person board instead of eight), under the Model Act proposal, the plaintiff would have had the burden of proving that one of the above three elements was not met.

The Model Act proposal places an almost insurmountable burden on the derivative plaintiff. The special litigation committee can always orchestrate a reasonable investigation. Since the questionable payments cases of the 1970s, serving as counsel for special litigation committees has become a sub-specialty for large corporate law firms. Inasmuch as they are paid by the hour, exhaustive interviews and voluminous paper is the order of the day. n160 And, somewhere in such a record, there will probably be some shred of evidence to justify the committee's conclusion, particularly when the costs of litigation are taken into account.

Thus, the issues under the Model Act proposal and under Auerbach become the good faith and independence, respectively, of the committee. While plaintiffs can challenge the good faith and independence of [*111] the committee members, "the subtle pressures directed towards these directors daily are hardly susceptible to quantification and proof. Loyalty, friendship, and obligation among the directors may exist, but it is impossible to show conclusively that these influences affected the [committee] . . . decision." n161 If the plaintiff has the burden of proof, demonstrating lack of independence, particularly a lack of independence stemming from structural bias, will be incredibly difficult, intrusive, and costly. It will be necessary to delve into a director's private relationships and personal history.

Thus, the plaintiff's last hope will be to challenge the good faith of the committee. n162 When respectable businessmen and businesswomen are appointed to the committee, however, courts will hesitate to challenge their good
faith. In effect, the wrong people are being brought to trial: the courts should be reviewing the conduct of the defendants, not the conduct of the members of the special litigation committee.

The impact of the lobbying efforts of the corporate bar and the Business Roundtable can be seen in the evolution of the American Law Institute's Corporate Governance Project. The Discussion Draft [112] promulgated in 1985, dealing with derivative suits, provided that a "court should have authority to dismiss a derivative action" against an officer or director if disinterested directors, after reasonable investigation and submission of a particularized report to the court, find that the report substantiates one of the following bases for dismissal:

1. The likelihood of a judgment in favor of the plaintiff is remote;
2. The value of the potential relief, discounted for the likelihood of success and determined with respect to each defendant separately, does not clearly exceed the corporation's probable out-of-pocket costs for continuing the action against that defendant; (3) Before the commencement of the action, the corporation had itself undertaken appropriate corrective or disciplinary action with respect to the subject matter of the action; or (4) The balance of corporate interests warrants dismissal of the action, regardless of its merits. n165

This does not appear to be a stridently pro-shareholder, anti-director provision, but rather an attempt at balance.

The comments in the 1985 Discussion Draft dealt gently with the structural bias issue, stating that "at a minimum, it must be recognized that the nature of a decision made by such a [special litigation] committee is unique and sensitive" and that "[t]o permit an otherwise well-pleaded action to be dismissed without substantive judicial review of the reasons for dismissal would seem strikingly at odds with the basic premises of our system of civil procedure." n166

However, in 1988, the balance began to shift. The concept of "universal demand" was introduced by the American Law Institute's Tentative Draft No. 8, requiring a plaintiff in a derivative suit to make demand on the board of directors even if all board members were interested in the questioned transaction, thereby eliminating the "futility" [113] exception. n167 This draft also provided that, in duty of care cases, the court "should accept any findings and conclusions [of the special litigation committee] as to business matters, unless the plaintiff establishes that such findings and conclusions are so clearly unreasonable as to fall outside the bounds of the directors' discretion." n168

Although the foregoing changes from the 1985 Discussion Draft reflected a shift in favor of defendant directors, from the perspective of at least some members of the corporate bar, the ALI reporters were still engaged in "reform" rather than restatement. In fact, the reporters were analogized to the Bellman in Lewis Carroll's poem, The Hunting of the Snark, because they allegedly asserted that the law is what they say it is. n169 However, the very article that takes the reporters to task is guilty of the same crime because its view of what is the "law" is in fact based, first, on Delaware law (as if Delaware law were the only law that mattered) and, second, upon an incomplete reading of Delaware law at that. n170

Nevertheless, the business campaign to circumscribe derivative litigation by empowering supposedly "disinterested" directors bore fruit in the Proposed Final Draft. n171 In the final draft, the concept of structural bias is substantially circumscribed and the burden required to establish it is extremely difficult. When fellow directors act to dismiss a derivative suit, usually through a special litigation committee, all the Proposed Final Draft requires is that any director who is a member of the committee not be "interested" and that the directors "as a group" be capable of objective judgment in the circumstances. n172 A director is interested if he or she (i) has a "business, financial, or familial relationship" with the defendant, other than service on the board of directors, (ii) which "would reasonably be expected to affect [the director's] judgment . . . in a manner adverse to the corporation." n173 Because the plaintiff, under the Proposed Final Draft, has the burden of proving interest, n174 and because the plaintiff also has the burden of particularized pleading n175 without benefit of discovery, n176 the burden on the plaintiff is indeed a heavy one. Moreover, according to the commentary, "[a] director may have a significant relationship with senior executives of a corporation and still be disinterested. . . ." n177

The Proposed Final Draft also imposes a specific "particularized" pleading requirement upon the plaintiff, thereby rejecting notice pleading. n178 In Delaware, a derivative plaintiff felt the sting of "particularized" pleading when the Delaware Supreme Court held that an allegation that a forty-seven percent shareholder in a public corporation, "having selected each director, controls and dominates every member of the board," was not sufficiently particularized. n179

[*115] The Proposed Final Draft also retained the universal demand requirement added in 1988 so that the board now can move to dismiss the derivative suit if the plaintiff does not first make demand. n180 But what if plaintiff makes a demand upon the board? According to the ALI Proposed Final Draft: once the board's timely response is made
or a decision to conduct a lengthier study is reached, the plaintiff is free to file the action. On the plaintiff’s filing of the action, however, the corporation may immediately move to dismiss under section 7.04 if the action fails to plead particularized facts that “raise a significant prospect” that the defendants violated the standards set forth in these principles, and it may seek a stay under section 7.06 of all discovery and related efforts to prosecute the action by the plaintiff. n181

The board can also move to dismiss the action “as contrary to the best interests of the corporation.” n182 In such a case, the directors will file a report with the court n183 and, under the Proposed Final Draft, the court, in reviewing the report, will generally follow an Auerbach standard in duty of care cases and a Zapata standard in duty of loyalty cases. n184

However, “[v]arious ALI members objected to the reporters’ proposal insofar as it required a court to undertake some level of review . . . regardless of the type of violation alleged.” n185 An amendment was offered which “would have provided that a plaintiff could challenge a board’s rejection of demand only if the plaintiff alleged facts raising ‘a significant prospect that a majority of the board which rejected the demand was interested’ in the conduct or transaction complained of.” n186 The intent of the amendment appears to be to impose effectively a burden of proof obligation at the pleading stage on top of a particularized pleading obligation, all without the benefit of discovery. A compromise was offered and adopted, which, like the amendment, is not presently available to the public, but which appears not to deviate much from the initial amendment. n187

However, even though the “final” proposal was adopted, there is not yet a final draft because details on the compromise amendment and commentary are unsettled. It seems clear, however, that the ALI [*116] work product will be much more acceptable to corporate counsel because of the lobbying efforts.

VI. WHEN ARE DIRECTORS INDEPENDENT?

Courts in various jurisdictions differ markedly in the degree to which they will scrutinize underlying facts to determine whether a director is truly independent in a particular situation. For example, while California, Illinois, and Massachusetts have closely scrutinized the question of directors’ independence when this criterion is an issue, n188 Delaware courts have shut their eyes to factors that would compromise independence in the minds of most people.

A. The Delaware Presumption of Director Independence

In Aronson v. Lewis, n189 a leading Delaware case on director independence, the defendant, who was seventy-five-years-old and owned 47% of the shares of each of two corporations, made a consulting agreement with each corporation for substantial compensation. n190 One corporation also made interest-free loans amounting to $225,000 to the defendant. n191 The court treated the situation as a demand required case, notwithstanding the allegation in the complaint that the defendant, “having selected each director, controls and dominates every member of the Board. . . .” n192 The court stated:

The causal link between Fink's control and approval of the employment agreement is alluded to, but nowhere specified. The director's approval, alone, does not establish control, even in the face of Fink's 47% stock ownership. The claim that Fink is unlikely to perform any services under the agreement, because of his age, and his conflicting consultant work with Prudential, adds nothing to the control claim. Therefore, we cannot conclude that the complaint factually particularizes any circumstances of control and domination to overcome the presumption of board independence, and thus render the demand futile. n193

It is almost beyond credibility to assert that a 47% shareholder of a publicly held corporation does not control the board of directors. For such control not to exist, over 90% of the public shareholders would need to attend the shareholders' meeting and unanimously vote against the 47% shareholder. It is common knowledge that it is [*117] almost impossible to obtain the presence of 90% of the public shareholders. That is why management, over time, has lobbied to reduce the vote for mergers and other organic changes from two-thirds to a mere majority and why quorum requirements for annual shareholder meetings can now be reduced to one-third in most states. Yet, Delaware treats a pleading which alleges control by a 47% shareholder as insufficient.

The following year, in Kaplan v. Wyatt, n194 the Delaware Supreme Court again considered the issue of director independence. In Kaplan, a derivative suit charging self-dealing was brought against Oscar S. Wyatt, Jr., the founder, chairman of the board, and chief executive officer of Coastal Corporation. n195 Marshall, a director on the special litigation committee which had moved to dismiss the suit, was, along with members of his family, a 16% owner of a
B. Other Jurisdictions Take a More Realistic View of When a Director Is Truly Independent

Other authorities are not so permissive as Delaware. The Illinois Supreme Court has held that a subordinate officer is not an independent [*118] director when passing on a transaction involving his superior, nor is the attorney for the corporation independent. n199 In a similar vein, the Committee on Corporate Laws has indicated that "an employee, director, agent, partner, close relative, or affiliate of the controlling shareholder" n200 is not independent when passing on transactions between the corporation and the controlling shareholder and that "commercial bankers, investment bankers, attorneys, and others who supply services or goods to the corporation” n201 may be affiliated directors.

In addition, Massachusetts courts appear far more skeptical of director independence than does Delaware. Whereas Aronson held that an allegation that the principal shareholder owned 47% of the shares and "personally selected" each director did not suffice to excuse demand on the basis that the directors were dominated by the shareholder, n202 a Massachusetts court excused demand on the basis that "[w]e think that it can be inferred from Fisher's control of the outstanding voting stock that the directors would have acted in a manner favorable to his interests.” n203

In contrast to the Kaplan case, where Delaware held that business arrangements with the corporation in question did not impinge upon a director's independence, n204 a federal court, applying Massachusetts law in Hasan v. CleveTrust Realty Investors, n205 looked at long-standing business contacts between Galvin, the director on the special litigation committee, and Carney, a defendant and chairman of the board, and [*119] held that 'Galvin's 'personal interests' and 'prior affiliation with the corporation' preclude any affirmative demonstration of disinterest.” n206

That the federal court correctly "read" Massachusetts law was confirmed recently by the Massachusetts Supreme Court's decision in Houle v. Low. n207 In Houle, the supreme court reversed the summary judgment entered by the lower court, even though the supreme court found no evidence that Dr. McKee, the director who constituted the special litigation committee, acted in less than good faith. n208 The plaintiff had challenged the independence of the director on the basis of "Dr. McKee's junior role . . . as the youngest of the participating physicians and stockholders. . . . her professional association with them, her business connections with them, and her dependency on them for future economic success.” n209 The supreme court responded:

Although typically there are relationships among directors that call for scrutiny of the independence of members of a litigation committee, Dr. McKee's position is particularly suspect. . . . The pressures on Dr. McKee to recommend dismissal of the action may have been strong. The possible consequences to her of a contrary recommendation call for further consideration of her independence. We cannot fairly say that, on this record, there is no dispute of material fact as to whether the committee was independent and unbiased. n210

A California court has also rejected Delaware's position, as reflected in the lower court's decision in Kaplan, that independence of a director is presumed in the special litigation context. Will v. Engebretson & [*120] Co., Inc. n211 held that a plaintiff "is entitled to a trial on the merits as opposed to a 'limited review' of the merits regarding the issue of the good faith and independence of the committee.” n212 At the hearing on the corporation's motion for summary judgment, the plaintiff submitted evidence that the so-called "'disinterested' directors were relatives of the Engebretsons or business clients with substantial financial interests managed by Engebretson.” n213 The Engebretson court stated that "[b]y conducting only a limited review of the merits on the theory the court should give deference to the business judgment of the committee, the court, in effect, lets the committee determine its own independence and good faith."
n214 Moreover, "a limited review of the merits will tend to hide the structural bias of the special litigation committee."

n215

C. Recognition of Director Bias by the Business World

Not only does the presumption of impartiality which Delaware appears to grant members of special litigation committees not accord with judicial thinking in other states, nor with everyday experience, nor with research into the functioning of small groups, it also does not comport with data coming from the corporate world itself.

Conference Board studies have documented the strong influence of senior management upon the outside directors on nominating and compensation committees. Most significantly, a recent study showed that less than one-half of the chief executive officers surveyed believed that special litigation committees could render independent and unbiased judgment of the merits of derivative litigation. n216 Finally, one of today's leading advocates for expansion of the powers of special litigation committees n217 earlier recognized that "[i]f . . . all judicial review of the merits of the committee's decision is foreclosed, there will be very few cases where a committee, once formed and put to work judging their peers, will conclude that the litigation should proceed." n218

[*121] VII. THE SIGNIFICANCE OF TRADITIONAL STATUTORY PROVISIONS AND COMMON LAW DOCTRINE UPON THE SCOPE OF SPECIAL LITIGATION COMMITTEES

Most of the discussion of special litigation committees, both in judicial decisions and in academic commentary, has focused on the business judgment rule -- a judge-made law. Inadequate consideration has been given to the significance of the work of legislatures, namely, what bearing statutory provisions have on the scope of special litigation committees. While all statutes do authorize generally the formation of committees, n219 these particular statutory provisions say little about the scope of special litigation committees. However, numerous states, including Delaware, though eschewing business judgment/duty of care provisions in their statutes, have enacted statutory provisions dealing with duty of loyalty issues, particularly with respect to situations involving conflicts of interest.

A. Conflict of Interest Statutes -- Background

One of the first statutory provisions dealing with conflicts of interest, and one which has been widely copied, is that of Delaware, enacted in 1967. The Delaware law provides that a conflict of interest transaction is not voidable, (1) if the conflict is disclosed and approved by disinterested directors, (2) if the conflict is disclosed and approved by shareholders, or (3) if fair. n220 The purpose of section 144 was to ameliorate the common law rule of "per se voidability for interested transactions." n221

However, statutes such as section 144 present some troubling problems of interpretation. Clauses (1) and (2) speak of approval by either disinterested directors or by the shareholders, while clause (3) speaks of fairness. Since all three clauses are in the disjunctive, does this mean that disinterested director or shareholder approval n222 can validate a transaction that is unfair? An affirmative answer to this query is suggested by the fact that, if director or shareholder approval also requires that the transaction be fair, then clause (3) would be superfluous. In addition, if validation by director or shareholder action also required fairness, then the conjunction before clause (3) should be the conjunctive "and" rather than the disjunctive "or."

Notwithstanding these textual arguments, the Delaware Supreme Court has held that "the statute cannot 'sanction unfairness'" n223 and reconciled the procedural/fairness issue by stating that the defendant director who seeks to uphold the conflict of interest transaction would have the burden of proof without disinterested director or shareholder approval whereas, with such approval, the plaintiff would have the burden of proof. n224 In other words, approval by a disinterested body removes the presumption against the interested director and leaves the plaintiff with the burden of proof, which is the normal incident in litigation.

Learning from the Delaware experience, Illinois, in enacting its 1983 Business Corporation Act, n225 adopted a new provision, section 8.60, dealing with conflict of interest transactions. n226 The new provision first provides that a conflict of interest transaction is not invalid if fair, n227 and then provides that, if specified disinterested directors or disinterested shareholders approve the transaction (having been informed of the conflict), the plaintiff has the burden of proof. n228 Thus, in Illinois, it is clear that the touchstone for validity is fairness and that the effect of procedural approvals is to change the burden of proof.
B. The Impact of a Conflict of Interest Statute upon the Authority of a Special Litigation Committee to Dismiss Litigation

What is the effect of these statutory provisions upon the power or authority of a special litigation committee to cause the dismissal of a shareholder's derivative suit predicated on a conflict of interest? Because the statutes provide that disinterested director approval only changes the burden of proof, dismissing a suit on the recommendation of a special litigation committee gives the directors' recommendation broader effect than the legislature intended. A statute that deals with the burden of proof contemplates a judicial determination at an evidentiary hearing. Dismissal on motion of the special litigation committee short circuits any factual finding by the judiciary on the alleged first-tier wrongdoing.

The Auerbach approach in the duty of loyalty area directly conflicts with statutes such as Delaware's section 144 and Illinois' section 8.60 [*124] since these statutes provide that the second-tier action -- approval by a committee of disinterested directors -- does not foreclose judicial review but rather only changes the burden of proof. Thus, for a judge to apply the Auerbach standard and decline to review the merits of the alleged first-tier breach of the duty of loyalty would amount to judicial repeal of the conflict of interest statute.

Even the Zapata approach is inconsistent with the conflict of interest statutes. While Zapata does permit the court to exercise its own business judgment in determining whether the motion by the special litigation committee should be granted, the flaw in the Zapata approach lies in the nature of the record before the court.

Under Zapata, which is a hybrid between a motion to dismiss and a motion for summary judgment, the record with which the plaintiff is constrained is that made by the special litigation committee, subject to plaintiff's limited right of discovery. n230 Under the conflict of interest statutes, however, the plaintiff, in the first instance, has the right to make her own record. While the plaintiff has the burden of proof if there is disinterested director approval, she has the right to call witnesses and examine them and can even call defendants as adverse witnesses and, in effect, cross-examine them. This is a far cry from being stuck with the record made by a special litigation committee, with its attendant problems of structural bias.

VIII. THE EFFECT OF DEREERENCE TO SPECIAL LITIGATION COMMITTEES FROM A PROCEDURAL PERSPECTIVE

In any contested matter, the resolution of the dispute is often a function of the presence or absence of a set of procedures that assures procedural fairness and, thus, a substantial likelihood that the "right" decision will in fact be made. This is taken for granted in judicial proceedings; however, even with respect to internal corporate matters such as removal of directors, courts have required procedures that embody at least a modicum of fundamental fairness. These minimum standards include "service of specific charges, adequate notice and full opportunity of meeting the accusation. . . . " n231 Although these are normally thought of as defendant's rights, in the special litigation committee context, the "power" roles are reversed and it is the plaintiff [*125] who needs protection, particularly the full opportunity of meeting the justifications that the committee will present to dismiss the litigation.

In seeking to get a sense of whether a hearing is basically fair, what factors should be examined? Essentially, one needs to know who composes the hearing body, what opportunity exists for each party to gather evidence, who is given the opportunity to present evidence, whether evidence presented can be challenged, who has the burden of proof, how the decision is made, by whom it is reviewable, and under what standard. For comparison purposes, consider a claim brought by a minority shareholder against a controlling shareholder, the president of the corporation, who has removed substantial assets from the corporation through excessive compensation or other self-dealing transactions. n232 If this claim were brought under traditional procedures, it would be filed in state court before a judge who had no relationship with either party. n233 Both the plaintiff and the defendant would have access to the discovery process, which, though subject to abuse, can also be judicially controlled: sanctions exist for making false statements or abusing the discovery process. n234 Each side has full opportunity to present evidence and to cross-examine the other party's witnesses. Rules exist to insure that the evidence introduced is relevant and reliable, and the decision must be based upon such evidence. [*126] The defendant president has the burden of proof n235 and the decision is made by the unbiased judge. If the judge requests suggested findings, either the request will be extended to both parties or the losing party will have the opportunity to challenge the findings submitted by the prevailing party.

If a party believes the decision of the trier of fact is wrong, an appeal can be taken to what is usually a three judge reviewing court, and the standard of review is whether the judgment is against the weight of the evidence. n236 This standard of review is in opposition to the possibly more restrictive scope of review in administrative hearings, namely
whether there is any substantial evidence in the record to support the decision. n237 In either case, however, the review is of the entire record made before the trier of fact. n238

Contrast the fairness of the foregoing procedure with that which exists under both the Auerbach and Zapata approaches. First, the hearing body -- the special litigation committee -- rather than being unbiased in the judicial sense, is composed of persons chosen, directly or indirectly, by the defendant. n239 The hearing body often appoints [*127] investigators to assemble the facts for it. n240 Thus, the system is closer to an inquisitorial system than an adversary system. The fees for the investigation are paid for by the corporation, not the defendant, and there is often little incentive to limit the cost since the expenditure benefits those in control. n241 In one case, the cost of investigating a not unduly complicated charge of self-dealing amounted to $500,000. n242 While reducing litigation costs is often suggested as a rationale for using a special litigation committee, there are undoubtedly many attorneys who would be happy to try such a case to judgment for less than $500,000. n243 Moreover, overall litigation costs are very likely increased because the investigation involves an additional set of attorneys whose expenses will be paid by the corporation. Thus, under typical indemnification provisions, the corporation will pay not only the legal counsel for the defendants, but also the legal counsel for the special litigation committee.

The plaintiff may or may not have access to the hearing process, that is, be able to present evidence to the special litigation committee. Essentially, the "hearing" is an ex parte process with the investigators reporting to the committee. If discovery is available, it may be limited to the issues of whether the committee was unbiased and whether a reasonable investigation was conducted in good faith. Under Auerbach, the trial court cannot review the substantive decision so, correlatively, discovery could not inquire into such matters. The plaintiff has no right to challenge the probity or reliability of the evidence or to cross examine witnesses before the special litigation committee.

It is difficult to view this process from the perspective of who has the burden of proof. The "hearing" is not really a hearing process but rather a justification process. There is little incentive for the hearing body to find for the plaintiff. After the "hearing" is over, the hearing body will go back to work for, or with, the defendant. In fact, during [*128] the course of the hearing (investigation), the hearing body and the defendant have worked side by side on board of director and committee matters. n244 In addition, during the course of the "hearing," the defendant, through his control or influence on the nominating committee, may have determined whether the hearing body members would be retained as directors. n245

As discussed previously, the special litigation committee invariably moves to dismiss the litigation. n246 In effect, the trial court then becomes the reviewing court to determine whether the finding and recommendation should take effect. Under Auerbach, the special litigation committee's "evaluation of the problems posed and its judgment in their resolution are beyond [judicial review]." n247 Thus, only a limited portion of the "record" is before the reviewing body. While Zapata provides for some review of the substantive decision by enabling the court to exercise its "business judgment," this phraseology has subjected the Zapata approach to ridicule in the business world. n248 Zapata would be better received if the standard of review had been articulated in traditional terms. Moreover, as previously discussed, Zapata "liberality" has been drastically circumscribed by the subsequent expansion of the demand requirement in Delaware which precludes the plaintiff from getting to court in the first place. n249

The problem with entertaining a motion by a special litigation committee, even under a Zapata test, is illustrated by the decision in Houle v. Lowe. n250 Here, the Massachusetts Supreme Judicial Court recognized (i) that Massachusetts has always "vigorously scrutinize[d] the situation" where a director's loyalty to the corporation is in conflict with his or her own self-interest and (ii) that the "danger of 'structural bias'" is inherent in the use of a special litigation committee. n251 Accordingly, the court rejected the lower court's deference to the special litigation committee in granting summary judgment, adopted a Zapata type two-step approach, and remanded for an evidentiary hearing -- at least with respect to part of the "record," namely the committee's independence and good faith and the adequacy of its investigation. n252

[*129] But beyond the issues of independence, good faith, and adequacy of investigation, the supreme court also instructed the judge to determine "on the basis of the evidence presented, whether the committee reached a reasonable and principled decision." n253 The trial court's standard of review apparently should be whether "the committee's decision is contrary to the great weight of evidence." n254 Thus, as discussed above, even in a two-step Zapata type approach, the committee, in effect, is the trial court and the trial court becomes a reviewing court. n255

The crucial function of the trial judge in a non-jury case is to determine disputed issues of fact after hearing evidence and after having the opportunity to appraise the credibility of witnesses upon cross-examination. But, when the "hearing" is the report of the special litigation committee and the court's role is that of determining whether the committee's decision is "contrary to the great weight of evidence," n256 the factual determination is not made by the
trial court with its expertise in assessing reliability and credibility, but by the (arguably) structurally biased committee. This simply does not square with the fundamental precept that "[u]nder our system of law, courts and not litigants should decide the merits of litigation." n257

IX. SPECIAL LITIGATION COMMITTEES IN THE CONTEXT OF CLOSELY HELD CORPORATIONS

One of the most disturbing developments with respect to special litigation committees is that they are now being employed in connection with disputes among shareholders in closely held corporations. Quite [*130] often these disputes involve breaches of the duty of loyalty. n258 Although it is only recently that minority shareholders have realized effective remedies when majority shareholders act in a heavy-handed manner, n259 use of special litigation committees in the close corporation context carries with it the specter of destroying the derivative suit as a brake upon wrongful conduct by the majority.

A. The Nature of Litigation in Closely Held Corporations

Most litigation in the close corporation context is a battle over the spoils of success. Today, courts generally recognize close corporations as incorporated partnerships. n260 However, there are significant differences between the two forms of business organization. In a partnership, absent an agreement between the partners to the contrary, no partner is entitled to compensation for services n261 and, more importantly, any partner can dissolve the partnership, even in violation of the agreement, and thus obtain a return of capital. n262 Contrariwise, in the corporate context, salaries are established by majority rule of the board of directors, n263 sometimes protected by the business judgment rule. n264 Further, because corporations are usually formed for a perpetual existence, capital is locked-in -- subject to the possibility that a frozen-out minority shareholder may establish oppression or some other [*131] basis for involuntary judicial dissolution n265 and thereafter overcome the judicial fear that dissolution is a "drastic" remedy. n266

If the corporation is successful, the majority may take out excessive compensation, n267 thus reducing the profits available to the minority. The majority may also foreclose the minority from any participation in the profits, either by declaring no dividends if the minority shareholder is inactive, n268 or by firing a minority shareholder who had been employed. n269

The board of directors is often a de facto irrelevancy in the close corporation context. Often no meetings are held n270 or, if they are held, the board is composed of the majority shareholder, his or her spouse or accountant or attorney, and the minority shareholder. n271 Thus, meetings -- to the extent they are held -- are a mere formality because the board is dominated by the majority shareholder. If structural bias is a problem in the publicly held corporation where some of the disinfectant [*132] power of sunlight is available through the disclosure mechanisms of the federal securities laws, a fortiori it is a much more serious problem in the closely held corporation where both the players and their counsel have been less subject to the discipline of disclosure than their publicly traded corporation counterparts.

B. The Impact of Special Litigation Committees in Litigation Involving Closely Held Corporations

Two recent cases demonstrate the Cronyism that is very likely to infect the special litigation process in the context of a closely held corporation. In Will v. Engebretson & Co., Inc., n272 a 20% shareholder brought a shareholder's derivative suit against the 80% shareholder and his wife, charging they "had breached their fiduciary duty as directors by receiving excessive and unreasonable amounts from Company in the form of salaries, dividends and/or deferred compensation in excess of $ 4 million, and by failing to issue any dividends to minority shareholders." n273 This is not an atypical type of dispute in closely held corporations.

At the time the suit was filed, the wife had been replaced as a director by her brother. n274 A couple of months after the suit was filed, two additional members were added to the board -- both of whom, the plaintiff charged, were business clients or relatives of the defendant majority shareholder. n275 The brother and the two new directors were appointed as a compensation committee. n276 The committee met with counsel by a conference telephone call, reviewed a two-page analysis by an accounting firm, and recommended the suit be dropped. n277 The trial court viewed the corporation's summary judgment motion as a hybrid dismissal motion and conducted only a limited review on the merits to determine the committee's "good faith." n278 It found the committee to be disinterested and its decision to be in good faith. n279 However, the California appellate court determined that the plaintiff had submitted evidence that the special litigation committee was not independent and that it did not make a good faith investigation.
n280 The appellate court viewed the committee, not as disinterested in the [*133] legal sense, but rather disinterested in the sense of uninterested. n281 Accordingly, the plaintiff was entitled to a trial on the merits.

For the trial court to have deferred to a special litigation committee appointed by the majority shareholder, and consisting of two of his business associates who were appointed for the obvious purpose of approving his compensation, is akin to the ostrich putting its head in the sand. The average citizen would see through such a subterfuge in an instant. Yet judges sometimes repress their common sense and get caught up in formalities. It strains credibility to believe that the brother and the two business associates would ever combine to oppose action by the eighty percent shareholder. Empirically, it is likely that the new directors never personally attended another meeting.

The fact pattern in *Houle v. Low* n282 was even more egregious from the standpoint of the independence, or rather lack thereof, of the special litigation committee. Here the issue very likely went beyond structural bias to actual domination. The plaintiff was a minority shareholder in Eye Health, the corporate umbrella under which the plaintiff and defendants practiced ophthalmology. n283 The parties discussed forming a surgical center to provide outpatient operating services, after which the plaintiff visited such a facility in another state and submitted a written report to his fellow shareholders and directors. n284 The majority shareholders decided to launch the surgical center, but by forming another corporation from which plaintiff was excluded. n285 Litigation ensued, part of which was a derivative action against the defendants predicated on the corporate opportunity theory. n286

The directors appointed a junior physician, who was a director and shareholder of Eye Health but not a defendant, as a special litigation committee of one. n287 She determined that the derivative suit was not in the best interest of the corporation. n288 The plaintiff challenged her independence on the basis of the "closeness of her professional association" with the defendants, "her business connections with them, and her dependency on them for future economic success." n289 The Massachusetts Supreme Court found her position was "particularly suspect." n290 [*134] Accordingly, the court reversed the summary judgment because the material fact of whether the committee was independent and unbiased was in dispute. n291

To recognize the efficacy of a special litigation committee in the context of a closely held corporation where the board of directors is rarely a functioning entity is to exalt form over substance. Neither the brother nor the business associates in *Engebretson*, nor the young doctor in *Houle*, had any particular expertise in dealing with conflict of interest situations, nor the independence to make an impartial decision. As previously discussed, the issue raised in litigation involving closely held corporations often is whether the majority shareholder has appropriated property in which the minority shareholder has an interest -- either the profits of the business through salaries or other diversions, or business opportunities. This is an issue for judges to decide, not laymen who are hand-picked by the defendant.

X. CONCLUSION

The business judgment rule -- the focus of most cases dealing with issues involving special litigation committees -- should not be blindly applied. The rule is a practical recognition that there are some issues with which judges have no particular expertise. It is, however, more than that. It is also a recognition that judicial intrusion into the operating decisions of a business can work substantial mischief. MBA programs to the contrary notwithstanding, business is an art and not a science. Business decisions are multi-faceted and interwoven. Success and failure implicate good luck and bad luck, as well as good judgment and bad judgment. n292 In the present economic and political system, risk taking and entrepreneurship are encouraged. n293 There is no [*135] assurance that any particular business judgment will turn out for the better and some may even lead to the ruin of a particular business, n294 but, on the whole, the predominant belief is that society is the better where initiative and risk taking are encouraged. In general, judicial hindsight of operating business decisions, except in extreme circumstances, is antithetical to the present political and economic philosophy.

On the other hand, this system has always expected integrity of fiduciaries. Courts have been overseeing fiduciary obligations for centuries. Recent experience in the securities industry with its insider trading scandals, and in the savings and loan industry with its sweetheart deals and sham transactions, demonstrate that business experience provides no special insight into issues of integrity.

There is a simplistic logic in arguing that second-tier decisions by special litigation committees implicate business judgment and thus the nature of the first-tier alleged wrong -- whether it is a duty of care or a duty of loyalty type issue -- is irrelevant in determining the scope of judicial deference to the second-tier decision. However, such logic misses the underlying rationale for creating the business judgment rule in the first place: the limited competence of courts to
address certain issues. This rationale has no relevance, however, when the issue at hand is one with which the courts have traditionally dealt and with which the competence of the court matches or exceeds that of the board of directors.

A special litigation committee could not dismiss a criminal securities or antitrust indictment. The subjects of such indictments -- manipulating the price of a corporation's stock to forestall a hostile bidder, fixing prices to improve margins -- are a form of business decision and are acceptable in some countries. But we do not allow the board of directors to make such decisions, even if they receive no direct personal benefit.

Obviously, a criminal prosecution implicates interests outside the corporation -- those of the public -- which is why criminal actions are brought in the name of the people. In the duty of loyalty area, there are, in effect, outside interests as well. Investors take the risk of business decisions; they do not take the risk of divided loyalty by those to whom they entrust the operation of their business. Moreover, the confidence of the public in the system of centralized management to which investors entrust their capital is also at stake.

In the public corporation area, pro-business publications, such as Business Week, Fortune, and the Wall Street Journal, have been raising questions for the past year as to how well the board of directors is monitoring the compensation levels of top management, and whether there is any correlation between such compensation and corporate performance. One pay consultant has stated that "[i]f the board doesn't get ahold of executive pay very quickly, I think the federal government will. The directors are just not doing their job, and it's running out of control." In the public corporation area, excessive withdrawals by top management have only a minuscule effect upon the bottom line because the ratio of management compensation to net income is so small. In the close corporation, however, excessive withdrawals by one shareholder can markedly affect the value of another shareholder's interest.

Thus, particularly in the close corporation context, issues involving self-dealing and abuse of a fiduciary responsibility are for judges to decide, not laymen who are hand-picked by the defendants for the sole purpose of ridding those in control of inconvenient litigation. In the close corporation, no one is so naive as to suggest that the new directors (appointed by those in control to dismiss the litigation) will remain on the board of directors, nor that if they did they would manage it independently of the majority shareholder who theretofore dominated the board of directors -- if in fact the board functioned at all.

The purpose of the derivative suit is to protect shareholders by insuring that a disinterested, independent, and competent body will be available to oversee the actions of those entrusted to manage the corporation. A case can be made for such oversight by a special litigation committee in the duty of care area, so long as there is some judicial review of the substantive decision as in Zapata. But there is no reason to oust courts from oversight in duty of loyalty cases. This is an area of traditional competence for the judiciary. A derivative plaintiff alleging a breach of the duty of loyalty by a fiduciary is entitled to a hearing before a judge, rather than before laymen with no particular qualifications or jurisdictional empowerment to decide matters of fiduciary responsibility. Absent compelling reasons to the contrary -- of which there are none in the duty of loyalty area -- "[u]nder our system of law, courts and not litigants should decide the merits of litigation." n299

FOOTNOTES:

n1 Prior to the turn of the century, big businesses were dominated by the Goulds, Vanderbilts, Morgans, Armours, Fisks, and Rockefellers. See generally PETER COLLIER & DAVID HOROWITZ, THE ROCKEFELLERS -- AN AMERICAN DYNASTY (1976). From 1900 to 1928, there was a striking increase in the number of shareholders of many major corporations. For example, the number of shareholders of DuPont Powder increased from 809 to 21,248; the shareholders of Proctor and Gamble increased from 1,098 to 37,000; and the shareholders of United Fruit increased from 971 to 26,219. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY app. H at 327 (1932). The dispersal of shareholdings developed from the expansion of investment banking activity. For example, Dillon, Read bought the Dodge Brothers Motor Company from the Dodge family, recapitalized it, and distributed the securities to the public. See MATTHEW JOSEPHSON, THE MONEY LORDS 19 (1972). The widespread dispersal of shareholdings led to the concentration of power in the hands of management.

n2 BERLE & MEANS, supra note 1. See, in particular, Chapter V, "The Evolution of Control," at 69-111.

n4 See SECURITIES & EXCH. COMMN., STAFF REPORT ON CORPORATE ACCOUNTABILITY 427-31 (1980) [hereinafter SEC STAFF REPORT].

n5 In May, 1978, the Council of the American Law Institute voted to undertake a study of corporate governance. Four national symposia were held in the late 1970s. See COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE -- THE ALI-ABA SYMPOSIUMS 1977-1978, at ix (Donald E. Schwartz ed., 1979). The project continues to date. See generally THE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, PROPOSED FINAL DRAFT (1992) [hereinafter A.L.I. PROPOSED FINAL DRAFT].


n8 Id.

n9 See supra note 6.

n10 Bosses' Pay: Worthy of His Hire?, supra note 6, at 20; see also Barbara Rose, The Ties That Bind -- Web of Connected CEOs Rules Boardrooms, CRAIN'S, Apr. 13, 1992, at 1.

n11 In view of the widespread public debate concerning executive and director compensation policies and practices, and the increasing recognition that these issues raise significant policy issues, it is the Division's view that proposals relating to senior executive compensation no longer can be considered matters relating to a registrant's ordinary business.

Shareholder derivative suits "could, if unconstrained, undermine the basic principle of corporate governance that the decisions of a corporation -- including the decision to initiate litigation -- should be made by the board of directors or the majority of shareholders." *Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 530 (1984).*

The American Law Institute has set forth a balanced appraisal of the derivative action: Since at least the middle of the 19th Century, it has been accepted in this country and in England that the law should permit shareholders to sue derivatively on their corporation's behalf under appropriate conditions. The problem has been to determine what these conditions should be. On the one hand, the availability of legal recourse is essential if management's fiduciary obligations to its shareholders are to constitute more than a precatory body of law. Some judicial mechanism for the enforcement of fiduciary duties must therefore exist that is external to the corporation. On the other hand, few intracorporate transactions are not susceptible to differences of opinion; nor are courts infallible. Thus, the corporate director might have reason to view his position as exposed and vulnerable if every transaction or alleged negligent omission subjected him to the prospect of significant liability at the behest of a single shareholder.

In striking a proper balance, it must be recognized that the derivative action is neither the initial nor primary protection for shareholders against managerial misconduct. A variety of social and market forces also operate to hold corporate fiduciaries accountable: the professional standards of managers, oversight by outside directors, the disciplinary power of the market, and shareholder voting -- all these mechanisms plus the regulatory authority of governmental agencies would constitute significant protections in the absence of private litigation. Even if dissatisfied shareholders had no other recourse than to sell their shares, such action, taken collectively, might also inhibit managerial overreaching, to the extent it depressed the value of the corporation's stock, which management typically also holds. Yet, no single technique of accountability (including market and legal remedies) is likely to be optimal under all circumstances. Each has its characteristic and well-known limitations, and, as a result, shareholders are best served by an overlapping system of protections. When properly structured, the derivative action should enhance the capabilities of these other mechanisms of accountability by (1) ensuring a measure of judicial oversight, (2) providing for a remedy that does not depend upon the ability of widely dispersed shareholders to take coordinated action, and (3) protecting the free functioning of the market for corporate control by subjecting to a measure of judicial review improper actions intended to prevent a change in control. In addition, the derivative action may offer the only effective remedy in those circumstances where a control group has the ability to engage in self-dealing transactions with the corporation.

AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 3-4 (Discussion Draft No. 1, 1985).

In recent litigation, Judge Easterbrook created a federal rule to require shareholder demand on the board of directors before any derivative action could be filed. *Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1342-43 (7th Cir. 1990).* However, the Supreme Court rejected such judicial creativity. *Kamen v. Kemper Fin. Servs., Inc., 111 S. Ct. 1711 (1991).* On remand, Judge Easterbrook opined that Maryland would follow Delaware, the "dominant corporate jurisdiction, [which] has emphatically rejected the proposition that an investor may forego demand whenever the directors participate in the transaction [plaintiffs] challenge." *Kamen v. Kemper Fin. Servs., Inc., 939 F.2d 458, 461 (7th Cir.), cert. denied, 112 S. Ct. 454 (1991).*

Requiring a shareholder to make demand on the board of directors before instituting suit is generally the death knell for a shareholder's derivative suit. "[O]nce a demand has been made, absent a wrongful refusal, the stockholders' ability to initiate a derivative suit is terminated." *Spiegel v. Buntrock, 571 A.2d 767, 775 (Del. 1990) (quoting Stotland v. GAF Corp., 469 A.2d 421, 422 (Del. 1983))." *"[W]hen a board refuses a demand, the only issues to be examined are the good faith and reasonableness of its investigation." Id. at 777.

See infra notes 89-90 and accompanying text.
n17 See infra note 64 and accompanying text.

n18 See infra notes 61-63 and accompanying text.

n19 See infra notes 53-69 and accompanying text.

n20 See infra notes 70-86 and accompanying text.

n21 See SEC STAFF REPORT, supra note 4, at 427-29.


n23 1933 Ill. Laws 310, 327.


n29 See MODEL BUSINESS CORP. ACT ANN. § 38, at 641-42 (1960).


n31 DEL. CODE ANN. tit. 8, § 141(c) (1991).

n32 While only 8% of the companies surveyed by the Conference Board had nominating committees before 1970, JEREMY BACON, CORPORATE DIRECTORSHIP PRACTICES: THE NOMINATING COMMITTEE AND THE DIRECTOR SELECTION PROCESS, CONFERENCE BOARD REPORT No. 812, at 7 (1981) [hereinafter THE NOMINATING COMMITTEE], the number had increased to about 30% by 1979. Id.; SEC STAFF REPORT, supra note 4, at 616. The increase in the use of audit committees during the 1970s was even more spectacular. In a 1961 study by the National Industrial Conference Board, it was found that only 15% of the responding companies had an audit committee, JOHN R. KINLEY, CORPORATE DIRECTORSHIP PRACTICES, STUDIES IN BUSINESS POLICY, No. 103, tbl. 29 at 129 (1962); by 1972, the number had
risen to 45%, and by 1978, 97% of the companies responding to a survey by the American Society of Corporate Secretaries reported they had an audit committee. JEREMY BACON, CORPORATE DIRECTORSHIP PRACTICES: THE AUDIT COMMITTEE, CONFERENCE BOARD REPORT No. 766, at 1 (1979). A study by the Securities and Exchange Commission in 1980 reported that 84% of all companies surveyed and 99% of New York Stock Exchange companies had audit committees. SEC STAFF REPORT, supra note 4, at 615.

n33 SEC STAFF REPORT, supra note 4, at 476-77 (and sources cited therein); ABA Committee on Corporate Laws, Corporate Director's Guidebook, 33 BUS. LAW. 1595, 1625-26 (1978).


n35 DEL. CODE ANN. tit. 8, § 144 (1991); see infra notes 220-24 and accompanying text.

n36 For a discussion of the inconsistency between the statutorily approved conflict of interest committees and special litigation committees, see infra notes 220-30 and accompanying text.


n39 See, e.g., Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (the corporation was alleged to have made "questionable payments" exceeding $11 million).


n41 See infra notes 42-47 and accompanying text.

n42 393 N.E.2d 994 (N.Y. 1979).

n43 430 A.2d 779 (Del. 1981).


n45 Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987) (state supreme court withdrew its earlier opinion following Auerbach and instead adopted a Zapata approach).
n46 Roberts v. Alabama Power Co., 404 So. 2d 629 (Ala. 1981). Roberts actually cited the chancery opinion in Zapata and adopted an approach which deviated from the chancery court's approach in a manner that mirrored the Delaware Supreme Court's modification of the chancery decision.

n47 Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709 (Iowa 1983) (structural bias precluded recognition of action by a special litigation committee which had been appointed by the defendant directors).


n49 Greenfield v. Hamilton Oil Corp., 760 P.2d 664 (Colo. Ct. App. 1988) (court declined to recognize recommendation of a special litigation committee which had been appointed by defendant directors and reported to them).

n50 DeMoya v. Fernandez, 559 So. 2d 644 (Fla. Dist. Ct. App. 1990) (reversed trial court's grant of motion by receiver of corporation to dismiss derivative suit on the basis that plaintiffs were entitled to sworn testimony and cross examination on issues of bias, conflict of interest, and objectivity and reasonableness of report).

n51 Axelrod v. Giambalvo, 472 N.E.2d 840 (Ill. App. Ct. 1984) (applied special litigation committee analogy to suit against predecessor managing trustees whose duty of care was challenged, e.g., predecessor trustees spent $15,000 on light bulbs for apartment building complex).


n54 Id. at 997.

n55 Id. at 996-97.

n56 Id. at 997.

n57 Id. at 997 n.2.

n58 Id. at 997.

n59 Id.

n60 Id.
n61 Id. at 1000.

n62 Id. at 1002.

n63 Id. at 1000.

n64 Id.

n65 Id. The court phrased the issue as being whether "the business judgement rule . . . applies in its full vigor to shield from judicial scrutiny the decision of a three-person minority committee of the board acting on behalf of the full board not to prosecute a shareholder's derivative action," and held that [t]he business judgment rule does not foreclose inquiry by the courts into the disinterested independence of . . . the members of the special litigation committee. Indeed the rule shields the deliberations and conclusions of the chosen representatives of the board only if they possess a disinterested independence and do not stand in a dual relation which prevents an unprejudicial exercise of judgment. Id. at 1001.

n66 Id. at 1002.

n67 Id.

n68 Id. at 1003.

n69 Id.

n70 430 A.2d 779 (Del. 1981).

n71 Maldonado v. Flynn, 413 A.2d 1251, 1254 (Del. Ch. 1980).

n72 Id. at 1255.

n73 Zapata, 430 A.2d at 784.

n74 Id. at 786.

n75 Id.

n76 Id. at 786-87.
n77 Id. at 787.

n78 See infra notes 134-42 and accompanying text.

n79 Zapata, 430 A.2d at 787.

n80 Id. at 780.

n81 Id. at 787.

n82 Id. at 788.

n83 Id.

n84 Id. at 788-89.

n85 Id. at 789.

n86 Id.


n89 In Selheimer v. Manganese Corp. of America, 224 A.2d 634 (Pa. 1966), the defendant inside directors raised funds by representing in a prospectus that the existing plant facilities were inadequate and that the corporation needed to move to specified modern facilities in another state. Instead, the directors continued to operate in the unsuitable existing location until the corporation became insolvent. Id. at 639. In Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981), the defendant director, a widow, stood by while her two sons looted the corporation, a reissuance broker, of almost $ 10 million which should have been escrowed for the insurance companies doing business through the corporation.

n90 488 A.2d 858 (Del. 1985). In Van Gorkom, the directors, who had not been informed of the purpose of the meeting, approved the sale of the company after a twenty-minute oral presentation by the CEO. Id.

n92 See infra note 160.

n93 In the cases previously addressed, see supra notes 89-90, should directors escape liability because a court, under the Auerbach approach, could not "peek" at the underlying transgression if a special litigation committee recommended dismissal? See infra notes 111-15 and accompanying text.

n94 Auerbach, 393 N.E.2d at 996-97.


n96 Maldonado v. Flynn, 597 F.2d 789, 792 (2d Cir. 1979), aff'd in part, rev'd in part, 671 F.2d 729 (2d Cir. 1982).

n97 Id.


n99 The conclusions of the committee with regard to the self-dealing of the directors was as follows:

(i) [T]he claims asserted appear to be without merit; (ii) litigation costs would be inordinately high in view of the unlikelihood of success and would be further exacerbated by the probable right of indemnification by the defendants from the Company if the defendants are successful; (iii) the time and talents of the Company's senior management would be wasted on lengthy pretrial and trial proceedings; (iv) continuing publicity about past events could be damaging to the Company’s ongoing and future business; (v) there does not appear to have been any material injury to the Company; (vi) further legal action against the present defendants (other than Messrs. Flynn, Naess or Wolcott) could significantly impair their ability to manage the Company's affairs; (vii) litigation is unnecessary as a policing action as the possibility of recurrence is slight in light of new internal controls and new top management; (viii) none of the present defendants obtained any improper personal benefit from the conduct alleged; (ix) certain of the practices alleged were a continuing business practice at the time and were intended to serve the business interests of the Company; (x) there is a serious legal question whether the New York and Texas Complaints state a cause of action under the federal securities laws and whether the Company has standing to assert such a claim; (xi) the continuation of these actions will undermine employee morale, as will any attempt to revoke options already granted and/or exercised or to call any loans currently outstanding; and (xii) the likely adverse effects on the relationship between the Company and the defendants, on the one hand, and the Company and its suppliers and customers, on the other, far outweigh any potential recovery. Mahler v. Zapata Corp., 490 F. Supp. 348, 350-51 (S.D. Tex. 1980).

n100 If the corporation were subject to a 46% rate, it lost $ 452,088 (46% X $ 6.50 X 151,200 shares), whereas the most likely maximum benefit to the executives, based upon the difference between the capital gains rate and the income rate, was $ 294,840 ((50% - 20%) X $ 6.50 X 151,200 shares).

n101 Committee on Corporate Laws, The Overview Committees of the Board of Directors, 35 BUS. LAW. 1335, 1347 (1980) ("The compensation of key executives is probably the most frequently recurring conflict-of-interest situation with which the board must deal.").
n102 Block & Prussin, supra note 87, at 63.


n104 A LEXIS search, States Library, Omni file, of "conflict w/3 interest w/25 director or officer w/25 corporate!" found 431 cases.


n108 HEIDRICK & STRUGGLES, DIRECTOR DATA 8 (1981); HEIDRICK & STRUGGLES, SELECTING CORPORATE DIRECTORS 4 (1966); Statement of the Business Roundtable, supra note 34, at 2105.

n109 See supra notes 89-90.


n111 Id. at 869.

n112 In Van Gorkom, two other bidders tentatively entered the picture. One, GE Credit, was prepared to offer $2 to $5 more per share than Pritzker but was discouraged by the structure of the Pritzker deal, id. at 885, while the other, KKR, withdrew when Van Gorkom apparently dissuaded senior management from participating in a senior management/KKR proposed leveraged buyout, Id. at 884-85. In a later and equally famous Delaware case involving competing bidders, the negotiations opened at $40 and bidding finally closed at $57. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

n113 Revlon, Inc., 506 A.2d at 182 ("[W]hen the breakup of [a] company is inevitable . . . [t]he duty of the board . . . change[s] from the preservation of [the] corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.").

n114 Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) (In evaluating a bid, a company is entitled to evaluate long term versus short term investment goals.).

n115 A search of the Index to Legal Periodicals (on-line) for law review articles dealing with Smith v. Van Gorkom produced 29 articles. Similarly, a search of the Business Periodical Index dealing with corporate directors and liability in the period of 1985 to 1986 produced 13 articles dealing with Van Gorkom.
n116 See supra notes 103-08 and accompanying text.

n117 See infra notes 122-55 and accompanying text.


n119 See generally A.L.I. TENTATIVE DRAFT NO. 8, supra note 40, at 121-25.

n120 Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980).


n122 Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 716 (Iowa 1983).


n124 THE NOMINATING COMMITTEE, supra note 32, at 24-25, 28-29.


n126 Dooley & Veasey, supra note 121, at 535-36.

n127 Id. at 535 (footnote omitted).

n128 Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982).

n129 A.L.I TENTATIVE DRAFT NO. 8, supra note 40, at 161; see also Alford v. Shaw, 324 S.E.2d 878, 886 (N.C. Ct. App. 1985) ("[N]ot one committee, in all these instances, has decided to proceed with suit."); Cox, supra note 40, at 963.

n130 For a number of years, in teaching material about special litigation committees, I found that students generally regarded such committees positively and questioned the significance of structural bias. For the past couple of years, I have introduced the material with a hypothetical situation that a student was cheating on an examination question; I then poll my students as to who would inform me of the incident they had supposedly seen. As a result of this practice, two results are clear: (1) few students would turn in another student, and (2) almost all students now accept the concept of structural bias.
n131 HEIDRICK & STRUGGLES, supra note 106, at 1 (“[e]ight of nine participants [in the survey] would not serve on a board that did not offer D&O liability insurance”).


n133 HEIDRICK & STRUGGLES, supra note 106, at 1.

n134 THE NOMINATING COMMITTEE, supra note 32, at 21.

n135 HEIDRICK & STRUGGLES, supra note 105, at 3.

n136 Id. at 12.

n137 HEIDRICK & STRUGGLES, DIRECTOR DATA 8 (1982).

n138 HEIDRICK & STRUGGLES, supra note 106, at 15.

n139 THE NOMINATING COMMITTEE, supra note 32.

n140 Id. at 24. In the 1989 proxy statement of Ford Motor Co., eight of the nine outside directors were chief executive officers.

n141 James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, LAW & CONTEMP. PROBS., Summer 1985, at 83, 91 (footnotes omitted); see also sources cited therein; Stanley Schachter, Deviation, Rejection and Communication, 46 J. ABNORMAL & SOC. PSYCHOL. 190 (1951). As to the coziness that has existed on many boards of directors, see Bryan Burrough, Wimps in the Board Room, WALL ST. J., Mar. 12, 1992, at A10; Alison L. Cowan, The High-Energy Board Room, N.Y. TIMES, Oct. 28, 1992, at C1 (“[T]he awakening of the once sleepy G.M. board will redefine the cozy relationship that often exists between the nation's top executives and the hand-picked members of their boards.”).


n143 Maldonado v. Flynn, 413 A.2d 1251, 1254-55 (Del. Ch. 1980).

n144 See supra note 100.

n146 One labor leader has stated, "If there is a rationale for this [the rise in CEO pay] other than agreed, we are mystified as to what it is." John A. Byrne, The Flap Over Executive Pay, BUS. WK., May 6, 1991, at 90, 91.


n148 Id. (references omitted).

n149 See supra notes 131-33 and accompanying text.


n151 Cox & Munsinger, supra note 141, at 95.

n152 Id. at 95-96; see also JEREMY BACON & JAMES K. BROWN, CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD, CONFERENCE BOARD REPORT NO. 646, at 57-58 (1975).

n153 In the Bacon and Brown study, noted above, the authors state:

   One must take note of another strand in the complex and untidy fabric of directorial accountability. In many firms directors are, in a very real sense, accountable to management, even though the law and management theory have it the other way around. Management, first of all, effectively controls, or can effectively control, the selection of directors. Management also determines what the board will do -- the issues and questions that will come before it, the extent to which exploration and discussion of them will take place in the boardroom.

   And if a director seems to the chief executive to be deficient, the chief executive can ask for, and get, his resignation. It is the chief executive, moreover, who himself defines deficiency: whether it is poor attendance at meetings; failure to do homework between meetings; or a proclivity to ask tough, possibly embarrassing questions. Unless the board insists that it have a position of primacy in the selection and evaluation of individual directors, it will, in fact, be management that holds directors accountable. This is not to say that management should do this. But it is to say that, not uncommonly, managements do in fact do this. BACON & BROWN, supra note 152, at 10.

n154 Cox & Munsinger, supra note 141, at 103.

n155 In the leading analysis of the effect of familiarity in the corporate context, Cox and Munsinger conclude:

   Consequently, the judges and those to be judged associate on a regular basis in discharging their many tasks as corporate directors during the preliminary derivative suit skirmishes. In doing so, they share a mutual duty to serve the corporate interest, and they often adopt a common view of that corporate interest. Analogous studies suggest that the effect of these shared experiences is not only to bond the directors and the defendants together but also to form a basis upon which the directors can be expected to give greater weight to the defendant's values, attitudes, and perceptions than to those of outgroup members like the plaintiff. Indeed, the greater the
interaction between the defendants and directors, in terms of frequency and degree of task complexity, the stronger the favoritism the directors can be expected to express toward the defendants. *Id.* at 103-04 (footnotes omitted). This article was relied upon by the North Carolina Supreme Court in withdrawing an opinion following *Auerbach* and instead following a modified *Zapata* approach. *See supra* note 125 and accompanying text.


n157 *See id. at 550* (proposed MODEL BUSINESS CORP. ACT § 7.44(c)(3)).

n158 *See supra* note 100 and accompanying text.

n159 *Maldonado v. Flynn, 597 F.2d 789, 792 (2nd Cir. 1979).*

n160 *See, e.g., Kaplan v. Wyatt, 499 A.2d 1184, 1187 (Del. 1985):*

To help Holliday and Marshall with their investigation, Special Litigation Committee retained the firm of Brown, Wood, Ivey, Mitchell and Petty (Brown, Wood) as the Committee's counsel and Ernst and Whinney as independent outside accountants. Neither firm had prior dealings with Coastal.

In the course of their investigation, the Litigation Committee interviewed 140 people throughout the world, including 49 employees and 25 people who had no connection with Coastal. Coastal's officers and in-house counsel gathered some of the documents used in the investigation and were present at some of the interviews. At each of these interviews attorneys from Brown, Wood were present and took handwritten notes. Following the interviews, the handwritten notes were transcribed into typewritten memos, and then the handwritten notes were destroyed. Brown, Wood received in the vicinity of $500,000 for its efforts in fees and reimbursements. The committee moved to dismiss the litigation.


n162 *See, e.g., Peller v. The Southern Co., 707 F. Supp. 525, 529 (N.D. Ga. 1988).* In *Peller*, the committee had counsel conduct the interviews and then provide the committee with summaries. The committee then denied plaintiff access to the interviews on the basis that they were privileged. The court held that "by relying on counsel to outline and to conduct all interviews and then prepare interview summaries that contain 'privileged information,' the ILC has insulated its investigation from scrutiny by plaintiff. This is not good faith." *Id.*

n163 According to the chairman of the Lawyers Steering Committee Corporate Governance Task Force of the Business Roundtable, "[n]otwithstanding vigorous efforts by corporate counsel and many outside practitioners, the Project continues to contain provisions which would reduce the authority of directors to deal with important issues affecting the corporation and expose them to significantly greater risk of liability and litigation." Clifford L. Whitehill, *The American Law Institute Tentatively Approves Part VI of Its Corporate Governance Project, in THE AMERICAN LAW INSTITUTE CORPORATE GOVERNANCE PROJECT IN MID-PASSAGE -- WHAT WILL IT MEAN TO YOU? 113 (National Legal Center for the Public Interest, 1991).* The lobbying effort with respect to changes in control was summarized as follows:

On May 16 and 17, 1990 during its Annual Meeting, the membership of the American Law Institute again considered its Corporate Governance Project. The results represented a major victory for good corporate
governance. Part VI of the draft considered at the meeting, which relates to tender offers and transactions in control, was significantly changed. The board's power to deal with hostile takeovers was greatly enhanced. This improvement in the Draft was achieved as a result of the adoption of proposals made by members of CORPRO (The American Bar Association Business Section's official liaison with the ALI).

The ALI plays a major role in setting the course for future legal developments. Unfortunately, it operates on the town meeting principle, only those who turn out for the Annual Meetings are entitled to vote. Since only about two hundred fifty members normally attend the working sessions at the Annual Meetings out of a total membership of approximately three thousand, the votes are frequently not reflective of the views of the total membership. In 1990 CORPRO made a major effort to improve attendance. The results were gratifying -- more than one hundred additional members voted on key issues. Id. at 114 (footnote omitted). The lobbying efforts apparently continued with respect to director control over derivative litigation. See ALI Wraps Up Corporation Law Project, 60 U.S.L.W. 2727, 2728 (Gen. Law May 26, 1992).

n164 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.08, at 95 (Discussion Draft. No. 1, 1985) (emphasis added).

n165 Id. at 96. The proposal also would have permitted the court to consider countervailing evidence submitted by plaintiff and would preclude dismissal if dismissal would frustrate any legal rule that operates for the protection of shareholders. Id.

n166 Id. at 103; see also AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 113-14 (Tentative Draft No. 6, 1986). In Tentative Draft No. 6, the discretion of the court was circumscribed by changing the language "should have authority" (see emphasized language in text at note 164) simply to "should." Id. at 106.

n167 A.L.I. TENTATIVE DRAFT NO. 8, supra note 40, § 7.03, at 63-64, 70-71. Judge Easterbrook was recently reversed by the Supreme Court when he attempted to create a federal "universal demand" standard. See supra note 14.

n168 A.L.I. TENTATIVE DRAFT NO. 8, supra note 40, § 7.08(c), at 115-16 (emphasis added).

n169 Charles Hansen et al., The Role of Disinterested Directors in "Conflict" Transactions: The ALI Corporate Governance Project and Existing Law, 45 BUS. LAW. 2083, 2083-84 (1990). In defense of the reporters, the law was certainly not settled at this time (nor is it today) and the position taken by the reporters in the A.L.I. Discussion Draft No. 1 was probably closer to a restatement than the position taken by the corporate bar. See Joy v. North, 692 F.2d 880 (2d Cir. 1982).

n170 See Hansen et al, supra note 169, at 2090-97; see also Marciano v. Nakash, 535 A.2d 400 (Del. 1987) (which only provides that disinterested approvals change the burden of proof; they do not create a safe harbor); cf. infra notes 222-24 and accompanying text.

n171 A.L.I. PROPOSED FINAL DRAFT, supra note 5.

n172 Id. § 7.09(a)(1).
n173 Id. § 1.23.

n174 Id. §§ 4.01(d), 5.02(b).

n175 See infra notes 178-79 and accompanying text.

n176 See ALI Wraps Up Corporation Law Project, supra note 163, at 2728. An amendment providing that "the court may, for good cause, permit limited discovery concerning whether the directors who rejected the demand were disinterested" was rejected. The vote was 216 for and 297 against, which shows the value of the lobbying efforts to induce members sympathetic to the views of corporate counsel to attend the meeting. Id. The subject of limited discovery was discussed at length by the chancellor in Kaplan v. Wyatt, 484 A.2d 501, 510-11 (Del. Ch. 1984):

Also as a practical matter, experience shows (as it did here) that the plaintiff will attempt to seek all the discovery that he could possibly hope to obtain if he were seeking discovery on the merits of the allegations of the complaint. And why not? He certainly has nothing to lose by asking. And he has arguable justification. How can he test fully the reasonableness and good faith of the Committee's investigation unless he looks at each and every document reviewed by the Committee and unless he takes his own deposition of each person interviewed by the Committee so as to compare the Committee's findings with his own? And why should he not have access even to documents that were not examined by the Committee? Certainly, if he can turn up something of substance that was ignored by the Committee, it will support his argument that the recommendation of the Committee should not be honored. Of course, such all-encompassing discovery is not within the spirit of Zapata since its mandate contemplates only such discovery as fits the occasion in the view of the Court.

In any event, the "limited discovery" request of the plaintiff takes on particular significance since that which he gets -- which in all probability will be something less than all he wants -- will constitute the framework on which he must defend the motion initiated by the Special Litigation to have his derivative suit dismissed. Again, after assimilating a lengthy factual report, the Court must hear the parties on this issue and make the appropriate ruling.

n177 A.L.I. PROPOSED FINAL DRAFT, supra note 5, at 32. "Significant relationship" is defined in § 1.34.

n178 Id. § 7.04, at 669-70; cf. A.L.I. TENTATIVE DRAFT NO. 8, supra note 40, § 7.04, at 81-82.

n179 Aronson v. Lewis, 473 A.2d 805, 809, 816-17 (Del. 1984); see infra discussion at notes 189-93.

n180 A.L.I. PROPOSED FINAL DRAFT, supra note 5, § 7.05(a)(1), at 685; cf. A.L.I. TENTATIVE DRAFT NO. 8, supra note 40, § 7.05, at 93-94.

n181 A.L.I, PROPOSED FINAL DRAFT, supra note 5, at 659.

n182 Id. § 7.05(a)(3), at 685.
n183 Id. § 7.09(a)(4), at 708.

n184 Id. §§ 7.10(a)(1), (2), at 725-26.

n185 *ALI Wraps Up Corporation Law Project*, supra note 163, at 2727.

n186 Id. at 2727-28.

n187 Id. at 2728.

n188 See infra notes 200-15 and accompanying text.

n189 473 A.2d 805 (Del. 1984).


n191 Id. at 380.

n192 *Aronson*, 473 A.2d at 809.

n193 Id. at 816-17 (citation and footnote omitted).

n194 499 A.2d 1184 (Del. 1985).

n195 Id. at 1186.

n196 Id. at 1186-87.

n197 Id. at 1187.

n198 Id. at 1189 (citations omitted).

n199 Shlensky v. South Parkway Bldg. Corp., 166 N.E.2d 793, 805 (Ill. 1960); see also *Sarner v. Fox Hill, Inc.*, 199 A.2d 6 (Conn. 1964) (vote of the defendant director's attorney was considered to be the defendant's vote).
n200 Committee on Corporate Laws, Guidelines for the Unaffiliated Director of the Controlled Corporation, 45 BUS. LAW. 429, 434 (1989).

n201 ABA Committee on Corporate Laws, supra note 33, at 1620 (footnote omitted).


n203 Pupecki v. James Madison Corp., 382 N.E.2d 1030, 1034 (Mass. 1978). The two approaches might be distinguished on the basis that the defendant in Pupecki owned 90% of the shares while the defendant in Aronson owned 47%. Both the trial court and the state supreme court in Aronson several times characterized defendant Fink as a "less than a majority" shareholder. However, the Delaware Supreme Court stated that "even proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation." Aronson, 473 A.2d at 815. Moreover, it is sophistry to suggest that a shareholder who holds 47% of 1,245,745 shares does not control the directors when they vote him a compensation package that could pay him over $1 million but such "compensation was not to be affected by any inability to perform services. . . ." Id. at 809.

n204 Kaplan v. Wyatt, 499 A.2d 1184 (Del. 1985).

n205 729 F.2d 372 (6th Cir. 1984).

n206 Id. at 379. The business relationships that precluded disinterestedness were set forth by the court as follows:

In 1968, Galvin possessed a 1/7 interest in "Cragin, Lang," a leasing and management firm. Galvin's firm entered into a services agreement with Investment Plaza Company, of which Carney was a partner. By 1977, Galvin had become President of "Cragin, Lang" and Carney had become managing partner of Investment Plaza. The close business relationship between Carney and Galvin continued after Galvin left "Cragin, Lang." When, in 1979, Galvin became a founding principal and 25% owner of "Adler Galvin Rogers, Inc.," he brought with him Carney's account. At the same time, leasing contracts for properties included within Carney's investment company were transferred from "Cragin, Lang" to "Adler Galvin Rogers."

Galvin, as a founding principal and 25% owner of a leasing and management company, also has a keen interest in attracting real estate developers. Defendant Carney is an active real estate developer in the Cleveland area. Furthermore, Galvin and defendant-trustee Alfred M. Rankin are partners in Bar Associates, a firm which owns a large apartment building in downtown Cleveland. Galvin owns a 2% interest in the building and Rankin owns a 10% interest.


n208 Id. at 58-59.

n209 Id. at 58.

n210 Id.

n212 Id. at 873.

n213 Id. at 870.

n214 Id. at 874.

n215 Id.

n216 HEIDRICK & STRUGGLES, supra note 106, at 15.

n217 See Dooley & Veasey, supra note 121 (E. Norman Veasey).

n218 Veasey, supra note 88, at 1273.

n219 The Annotated Model Act statutory comparison states: "All jurisdictions provide for committees of directors to be appointed by the board of directors. Two jurisdictions only refer specifically to an executive committee: the District of Columbia and South Dakota. The remaining fifty jurisdictions expressly refer to other committees as well." 2 MODEL BUSINESS CORP. ACT ANN. § 8.25 (Supp. 1992) (statutory comparison).

n220 DEL. CODE ANN. tit. 8, § 144 (1991), provides as follows:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

   (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

   (2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

   (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

n222 While clause (2) speaks only of shareholder approval, not "disinterested" shareholder approval, the Delaware Supreme Court held that shareholder approval which is not disinterested does not "freshen" the transaction. *Fliegler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976).

n223 *Marciano*, 535 A.2d at 404-05.

n224 *Id.* at 405 n.3.

n225 1983 Ill. Laws 6943.

n226 ILL. ANN. STAT. ch. 32, para. 8.60 (Smith-Hurd 1985), provides:

(a) If a transaction is fair to a corporation at the time it is authorized, approved, or ratified, the fact that a director of the corporation is directly or indirectly a party to the transaction is not grounds for invalidating the transaction.

(b) In a proceeding contesting the validity of a transaction described in subsection (a), the person asserting validity has the burden of proving fairness unless:

(1) the material facts of the transaction and the director's interest or relationship were disclosed or known to the board of directors or a committee of the board and the board or committee authorized, approved or ratified the transaction by the affirmative votes of a majority of disinterested directors, even though the disinterested directors be less than a quorum; or

(2) the material facts of the transaction and the director's interest or relationship were disclosed or known to the shareholders entitled to vote and they authorized, approved or ratified the transaction without counting the vote of any shareholder who is an interested director.

The presence of the director, who is directly or indirectly a party to the transaction described in subsection (a), or a director who is otherwise not disinterested, may be counted in determining whether a quorum is present but may not be counted when the board of directors or a committee of the board takes action on the transaction.

For purposes of this Section, a director is "indirectly" a party to a transaction if the other party to the transaction is an entity in which the director has a material financial interest or of which the director is an officer, director or general partner.

Illinois previously had its own misadventure in drafting a conflict of interest statute. A provision adopted in 1981, § 40a, eliminated voidability solely because of the conflict if the conflict is disclosed to either disinterested directors or disinterested shareholders and, nonetheless, approved. 1981 Ill. Laws 3377, 3379-80. However, the new provision said nothing about fairness and was thus open to the interpretation that a fair transaction could not be valid without disinterested director or shareholder approval. *Id.*

n227 ILL. ANN. STAT. ch. 32, para. 8.60(a) (Smith-Hurd 1985).

n228 *Id.* para. 8.60(b).


n230 *Id.* at 788; *Kaplan v. Wyatt*, 484 A.2d 501, 510 (Del. 1984).


n233 See, e.g., ILL. ANN. STAT. ch. 110, para. 2-1001(a)(2) (Smith-Hurd 1985) (providing for change of venue when the judge is prejudiced). In In re Marriage of Pussiales, 494 N.E.2d 541 (Ill. App. Ct. 1986), the court stated: "[t]he rationale for allowing a change of venue as a matter of right is that a litigant is entitled to an impartial hearing." Id. at 548; accord 28 U.S.C.A. § 144 (1968) ("whenever a party to any proceeding in a district court makes and files a timely and sufficient affidavit that the judge before whom the matter is pending has a personal bias or prejudice either against him or in favor of any adverse party, such judge shall proceed no further therein, but another judge shall be assigned to hear such proceeding").

n234 See, e.g., ILL. ANN. STAT. ch. 110, para. 2-611 (Smith-Hurd 1985) (which provides in part that: "[a]llegations and denials, made without reasonable cause and found to be untrue, shall subject the party pleading them to the payment of reasonable expenses, actually incurred by the other party by reason of the untrue pleading, together with a reasonable attorney's fee, to be summarily taxed by the court upon motion made within 30 days of the judgment or dismissal"); see also ILL. ANN. STAT. ch. 110A, para. 219(c) (Smith-Hurd 1985) (provision for a variety of sanctions, including contempt and entry of judgment on the issue in question, when there is abuse of the discovery process). The Illinois Supreme Court has stated that "[o]ur discovery procedures are meaningless unless a violation entails a penalty proportionate to the gravity of the violation. Discovery for all parties will not be effective unless trial courts do not countenance violations, and unhesitatingly impose sanctions proportionate to the circumstances." Buehler v. Whalen, 374 N.E.2d 460, 467 (Ill. 1977); cf. FED. R. CIV. P. 11, 26(c), 37.

n235 See supra notes 220-30 and accompanying text with respect to statutory provisions regarding the burden of proof in conflict of interest situations. The common law has always placed the burden of proof upon a fiduciary who is charged with self-dealing, irrespective of whether the alleged wrong is a conflict of interest or a usurpation of a corporate opportunity or other self-dealing situation, and courts have vigorously scrutinized the defendant's actions. See, e.g., Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 75 (Cal. Dist. Ct. App. 1952); Shlensky v. South Parkway Bldg. Corp., 166 N.E.2d 793, 800-02 (Ill. 1960); Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985). Even Delaware has generally recognized:

When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (citations omitted); see also Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987) (citing Weinberger).

n236 See, e.g., ILL. ANN. STAT. ch. 110A, para. 366(b)(1)(ii) (Smith-Hurd 1985) ("Any error of fact, in that the judgment or order appealed from is not sustained by the evidence or is against the weight of the evidence, may be brought up for review.").

n237 ILL. ANN. STAT. ch. 110, para. 3-110 (Smith-Hurd 1985) (providing, in part, that the "findings and conclusions of the administrative agency on questions of fact shall be held to be prima facie true and correct");
see also 5 U.S.C.A. § 706 (West 1977) (providing, in part, that a reviewing court shall set aside agency action that is "unsupported by substantial evidence").

n238 See, e.g., ILL. ANN. STAT. ch. 110, para. 3-110 (Smith-Hurd 1985) which provides, in part, that the "hearing and determination shall extend to all questions of law and of fact presented by the entire record before the court." § U.S.C.A. § 706 (West 1977) provides, in part, that with respect to contested rule making or adjudicatory proceedings, "the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error."

n239 See supra note 153 and text accompanying notes 138-42.

n240 See, e.g., Kaplan v. Wyatt, 499 A.2d 1184, 1187 (Del. 1985); see supra notes 160, 162 and accompanying text.

n241 The corporation pays the costs of the investigation whereas the defendants, who usually control the corporation, would pay any judgment entered. Since the court, under either Auerbach or Zapata, will look to the adequacy of the investigation, "spare no expense" will be the order of the day.

n242 Kaplan, 499 A.2d at 1187.

n243 The author was recently engaged as an expert witness in corporate litigation involving a breach of the duty of loyalty by corporate officers and directors. In discovery, thousands of pages of documents were produced and about two dozen depositions were taken. More than thirty witnesses testified in the trial extending over several weeks. Yet, the attorney fee submitted to the court was approximately $275,000, considerably less than the $500,000 fee for the law firm in Kaplan, id., for its "investigation" on behalf of the special litigation committee.

n244 See supra notes 154-55 and accompanying text.

n245 See BACON & BROWN, supra note 152, at 28-29; see also supra note 153.

n246 See supra note 40 and accompanying text.


n248 See supra note 126 and accompanying text.

n249 See supra notes 14-15 and accompanying text.

n251 Id. at 59 (citation omitted).

n252 Id. at 60.

n253 Id.

n254 Id. The court suggested the following mechanism:

This inquiry will allow the special litigation committee to point out to the judge on what factors it relied and why those factors support its decision. The test will also allow the derivative plaintiff to point out factors not considered by the committee or why those relied upon by the committee do not support its conclusion. Id.

n255 As discussed in the preceding section, see supra notes 220-30 and accompanying text, this is hardly what the legislature intended in enacting a statute which merely changed the burden of proof when a disinterested body approves the transaction. While a conflict of interest statute was not implicated in Houle since the alleged transaction fell under the rubric of corporate opportunity rather than conflict of interest, deferring to a special litigation committee recommendation is inappropriate in any situation in which the duty of loyalty is the basis for the litigation. Disinterested director approval should only change the burden of proof, not convert the trial court into an appellate court and thereby limit its ability to make a factual determination.

n256 Houle, 556 N.E.2d at 59.

n257 Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. 1980).


n259 For a general perspective on this area, see Charles W. Murdock, The Evolution of Effective Remedies for Minority Shareholders and Its Impact upon Valuation of Minority Shares, 65 NOTRE DAME L. REV. 425 (1990). The spectra of special litigation committees in minority shareholder litigation only arises in derivative actions such as those involving conflicts of interests, corporate opportunities, competing with the corporation, or waste of corporate assets. Other possible causes of action which may arise in the close corporation context, such as oppressive conduct justifying dissolution or breach of a majority shareholder’s fiduciary duty to the minority, are individual actions rather than derivative actions and thus do not implicate the use of special litigation committees.


n262 Id. § § 31(2), 38(c), 6 U.L.A. at 376, 456-57.
n263 See Corporate Director's Guidebook, 33 BUS. LAW. 1595, 1626 (1978); MODEL BUSINESS CORP. ACT § 35 (1969); ILL. ANN. STAT. ch. 32, para. 8.05(c) (Smith-Hurd 1985).

n264 See Arconson v. Lewis, 473 A.2d 805 (Del. 1984) (discussed supra at footnotes 189-93 and accompanying text); cf. Fields v. Sax, 462 N.E.2d 983 (Ill. App. Ct. 1984) (board approval of salary aggregating $643,072 over five-year period to the chairman of the board who was hospitalized for 251 days during that period and who was minimally involved in day-to-day activities was protected by business judgment rule).


n266 See Murdock, supra note 259, at 440-52.

n267 One valuation expert has stated:

In closely-held companies, it is common to find that compensation and perquisites to owners and managers may be based on the personal desires of owners and on the company's ability to pay rather than on the value of services performed for the company. How much the earning power base should be adjusted to reflect discrepancies between compensation paid and value of service performed depends on the purpose of the valuation.

Owners of successful closely-held businesses tend to take out what normally would be considered profits in the form of compensation and discretionary expenses. This may be an effort to avoid the double taxation that arises from paying a corporate income tax and then paying a personal income tax on what is left from that paid in the form of dividends. It is not uncommon to find an owner/manager of a successful company drawing $150,000 annual compensation, even though his services to the company could be replaced for $60,000 per year. The extreme cases go much, much further.

If the owner/manager described in the previous paragraph wants to sell his business and retire, the difference between his compensation and what it will cost to replace him will become available as a part of pretax profits, and the earning power base should be adjusted accordingly in establishing the selling price of the business.

SHANNON P. PRATT, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 172-73 (1981). One court has found the entire $93,813 salary of the inactive shareholder to be nonfunctional and $75,000 of the $250,000 salary of the active shareholder to be nonfunctional. Hendley v. Lee, 676 F. Supp. 1317, 1329 (D.S.C. 1987).


a closely held corporation, noted in passing that the trial court rejected a recommendation of a special litigation committee because all the members were not disinterested.


n273 Id. at 869.

n274 Id.

n275 Id. at 870.

n276 Id. at 869.

n277 Id.

n278 Id. at 870.

n279 Id.

n280 Id. at 874.

n281 See id.


n283 Id. at 52.

n284 Id.

n285 Id.

n286 Id.

n287 Id. at 53.

n288 Id.
n289 Id. at 58.

n290 Id.

n291 Id.

n292 See Dooley & Veasey, supra, note 121, at 530-31. As one federal court, in discussing the subject of special litigation committees, states:

[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982).


n294 In the early 1980s, Ford Motor Co., in effect, bet its future on the Ford Taurus by investing $3.2 billion in the new model. Ford teetered on the brink of disaster before the new models turned the company around. Had Ford guessed wrong on the success of its "jellybean" cars, the company would have been insolvent. RICHARD TANNER PASCALE, MANAGING ON THE EDGE 116-17 (1990). Compare the history of General Motors in the 1980s. See James B. Treece, GM -- The Board Revolt, BUS. WK., Apr. 20, 1992, at 30-34.


n296 Graef S. Crystal, Seeking the Sense in CEO Pay, FORTUNE, June 5, 1989, at 88; Byrne, supra note 146, at 90; Executive Pay, supra note 142; see also sources cited supra note 6.

n297 Byrne, supra note 146, at 91.

n298 See supra note 268; notes 273-75 and accompanying text.

n299 Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. 1980).