The Zapata Two-Step--Will Corporations March Out of Delaware?: Zapata Corp. v. Maldonado

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COMMENT

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The business decisions of corporate officials have long been protected from judicial review by the business judgment rule. Under this doctrine, courts typically abstain from questioning business decisions absent a showing of bad faith or fraud. Decisions by directoral special litigation committees to terminate shareholder derivative suits are within the ambit of the business judgment rule. Since litigation committees are subject to influence by

1 The business judgment rule can be traced back in American jurisprudence to Percy v. Millaudon, 8 Mart. (n.s.) 68, 77-78 (La. 1829); see Araht, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93 & n.1 (1979); Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 Cornell L. Rev. 600, 600 (1980) [hereinafter cited as Cornell Note]. The rule provides that a decision made by the managing body of a corporation may not serve as the basis of a judicial cause of action unless the challenger can demonstrate directoral fraud or bad faith. See, e.g., Briggs v. Spaulding, 141 U.S. 132, 145-47 (1891); Hawes v. Oakland, 104 U.S. (14 Otto) 450, 456-57 (1881); Wheeler v. Aiken County Loan & Sav. Bank, 75 F. 781, 785 (C.C.D.S. Ca. 1896); Percy v. Millaudon, 8 Mart. (n.s.) 68, 77-78 (La. 1829); 3A W. Fletcher, Cyclopedia of the Law of Private Corporations § 1039 (1975); H. Henne, Law of Corporations § 242 (2d ed. 1970). The business judgment rule presumes that corporate directors and officers may make mistakes, but so long as they are made in good faith, liability should not attach. Otherwise, few persons would be willing to serve as corporate managers. Stegemoeller, Derivative Actions and the Business Judgment Rule: Directorial Power to Compel Dismissal, 69 Ill. B.J. 333, 339 (1981).


defendant-directors, however, the ability of shareholders to challenge corporate mismanagement may be diminished. Recently, in *Zapata Corp. v. Maldonado*, the Supreme Court of Delaware, confronted with this dilemma, held that even absent a showing of bad faith on the part of a corporate litigation committee, the trial court may, in its discretion, substitute its own business judgment for that of the litigation committee.

*Zapata* involved a stockholder derivative action alleging breaches of fiduciary duties by the entire board of directors of the Zapata Corporation. After this action was instituted, four directors left Zapata Corporation's board, and two new directors were

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Corporation Act, 25 ALB. L. Rev. 93, 93 (1961). The section of the Delaware corporate law which permits such delegation is especially broad, and provides that as long as the certificate of incorporation so permits, a committee may be given complete authority over any item confronting the full board. Del. Code Ann. tit. 8, § 141(a) (1975). Special litigation committees created pursuant to such statutory authority are groups of disinterested directors authorized to determine whether pending derivative litigation is in the best interests of the corporation. See Cornell Note, supra note 1, at 608.

4. See Cornell Note, supra note 1, at 619-26; notes 36-44 and accompanying text infra.

5. See Note, The Business Judgment Rule, supra note 2, at 635. Shareholder derivative actions have been heralded as “the most important procedure the law has yet developed to police the internal affairs of corporations.” Rostow, To Whom and For What Ends is Corporate Management Responsible?, in The Corporation in Modern Society 48 (E. Mason ed. 1959). The significance of the procedure is weakened, however, by permitting a committee of ostensibly disinterested board members—the very persons who are to be policed—to pass upon the merits of pending litigation. Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit, 75 Nw. L. Rev. 96, 110 (1980) [hereinafter cited as Dent].


7. Id. at 789.

8. Id. at 780-81. Since Zapata Corporation is a corporation organized under the laws of the state of Delaware, id. at 781, Delaware law is controlling concerning the question of whether directors have the power to dismiss a pending derivative cause of action. Burks v. Lasker, 441 U.S. 471, 477-80 (1979). The derivative action instituted on behalf of the Zapata Corporation by William Maldonado, a shareholder, alleged that the board of directors wrongfully accelerated the exercise date of an employee stock option plan to the detriment of the corporation. Maldonado v. Flynn, 413 A.2d 1251, 1254 (Del. Ch. 1980), rev’d on other grounds, 430 A.2d 779 (Del. 1981). Maldonado argued that in 1974 the director optionees had knowledge that the company was planning to announce a tender offer for a large amount of its own stock. Id. This announcement was to be made just prior to the original exercise date under the option and it was expected to trigger a substantial rise in the value of Zapata stock. Id. Had the exercise date fallen after the announcement of the tender offer, the optionees, including the defendant-directors, would have been liable for additional capital gains taxes due to the increase in the value of their shares. Id. Maldonado contended that while the acceleration avoided this additional taxation, thereby enuring to the defendant-directors’ benefit, it prevented the corporation from taking advantage of a tax deduction equivalent to the liability avoided by the defendants. Id. at 1255.
appointed. In addition to their other responsibilities, these new directors were designated sole members of a special litigation committee empowered to determine whether the corporation should terminate any or all litigation, including Maldonado’s action, pending against it. Following an inquiry, the committee concluded that all such pending actions should be terminated. Acting upon the committee’s recommendation, the Zapata Corporation moved for dismissal or, alternatively, for summary judgment. Denying these motions, the Delaware Court of Chancery held that, under the business judgment rule, directors do not possess authority, to dismiss derivative suits.

On appeal, the Supreme Court of Delaware refused to adopt this narrow interpretation of directoral authority. Writing for a unanimous panel, Judge Quillen observed that the policy advocated by the trial court would give shareholders an “absolute” right to pursue derivative actions. Reasoning that the control by one person of the decision whether to litigate improperly negates the rights of all other interested groups, the court held that a corporate board of directors must be permitted to terminate detrimental litigation. In addition, noting that a corporate board, under Delaware law, may delegate its decisionmaking authority to

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9 430 A.2d at 781.
10 Id.
11 Id.
12 Id.
13 Id.
14 Shortly after the Court of Chancery rendered its decision, Maldonado filed an interlocutory appeal to the Delaware Supreme Court. 430 A.2d at 781. See generally Del. Code Ann. Sup. Ct. R. 42. Maldonado also had brought an action in the Southern District of New York in which he alleged, inter alia, violations of the federal securities laws. Maldonado v. Flynn, 485 F. Supp. 274, 277 (S.D.N.Y. 1980). Motions for summary judgment, or alternatively, dismissal were filed in the New York action, however, and were granted by the court. Id. at 277. The district court reasoned that the law of Delaware conferred upon litigation committees the authority to terminate pending derivative actions. Id. at 279. The court’s determination was appealed to the Second Circuit Court of Appeals, but that court ordered the appeal stayed, pending a final resolution of the termination issue by the Delaware state courts. 430 A.2d 779, 781 (Del. 1981).
15 430 A.2d at 786-87.
16 Judges Duffy and Horsey joined in the unanimous decision.
17 430 A.2d at 782. The court found that any determination giving to shareholders an “individual right” to pursue causes of action would be unacceptable. Id. Indeed, although the Court of Chancery maintained that such a privilege was supported by Sohland v. Baker, 141 A. 277, 281-83 (Del. 1927), the Delaware Supreme Court explained that Sohland could not be read to support such a broad proposition. 430 A.2d at 783.
18 Id. at 785.
Judge Quillen concluded that a special litigation committee properly may move to terminate derivative actions. Turning to the standard of judicial review to be used when scrutinizing committee motions to terminate derivative actions, the court stated that judicial review should not be limited to determining whether a special litigation committee properly exercised its business judgment. Indeed, Judge Quillen observed that such a conventional business judgment standard fails to consider, inter alia, that committee members, "subconsciously" loyal to the board at large, might dismiss meritorious claims. The court, therefore, appended to the conventional rule a measure of judicial business judgment. The Delaware Court held that, before a judicial business judgment inquiry is warranted, the trial court must first determine whether the special litigation committee acted independently of the board and properly exercised its business judgment. Similarly, the court noted that the burden of proof with respect to these matters is on the corporation. The Supreme Court further held that even when the trial court is satisfied that the committee acted properly it may nonetheless apply its own

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19 Id. at 786; see note 3 supra.
20 Id. at 786-87.
21 Id. at 787.
22 Id.
23 Id. at 788-89.
24 Id. at 788.
25 Id. Placing the burden of proving a litigation committee's objectivity and reasonableness on the defendant-directors represents a departure from the traditional business judgment rule, for that doctrine had required the challenger of a corporate decision to demonstrate that the determination was in some way wrongful. See Starbird v. Lane, 203 Cal. App. 2d 247, 21 Cal. Rptr. 280, 285 (Dist. Ct. App. 1962); Warshaw v. Calhoun, 221 A.2d 487, 493 (Del. 1966); Marony v. Applegate, 266 App. Div. 412, 423, 42 N.Y.S.2d 768, 779-80 (1st Dep't 1943); Stegemoeller, supra note 1, at 339-40. Nonetheless, in an analogous situation involving an attack on the validity of a corporate transaction consummated by interested directors, Delaware already had placed the burden of proving fair dealing and good faith on the directors. Singer v. Magnavox Co., 380 A.2d 969, 976 (Del. 1977); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 110 (1952); Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 82, 90 A.2d 660, 663 (1952).

Some states have shifted to committee members the burden of showing that they conducted a good faith inquiry into the advantages of bringing suit against defendant-directors. See, e.g., Auerbach v. Bennett, 47 N.Y.2d 619, 635, 393 N.E.2d 994, 1002-03, 419 N.Y.S.2d 920, 929 (1979). But see Durfee v. Durfee & Canning, Inc., 323 Mass. 187, 80 N.E.2d 522, 531 (1948)(burden of proof on the plaintiff shareholder). For a general discussion of the burden of proof on directors and other corporate officers and agents, see 3 W. FLETCHER, supra note 1, § 921.
business judgment in determining whether the derivative action at issue should be dismissed. Such a two-step approach, reasoned the Supreme Court, would preserve shareholder actions which otherwise would have been dismissed contrary to the "spirit" of the conventional business judgment rule.

It is submitted that the two-step judicial inquiry into special litigation committee determinations adopted by the Zapata court, while preserving the corporate right to terminate detrimental litigation, is a commendable attempt to ensure that meritorious shareholder derivative actions are litigated. Clearly, it would be contrary to the fundamental theory underlying derivative actions to prohibit special litigation committees from terminating detrimental suits altogether. Since the corporation is the true plaintiff in interest in derivative actions, the corporation, by way of a litigation committee, should be permitted to terminate those proceedings detrimental to its best interests. Moreover, the ability to terminate derivative suits is one of the few mechanisms provided to a

26 430 A.2d at 789.
27 Id. Because the second phase of a Zapata investigation is left to the trial court's discretion, it is conceivable that the corporation could sustain its burden of showing the committee's reasonableness and good faith and still have its dismissal or summary judgment motions denied. Id.; see notes 51-56 and accompanying text infra.
28 Maldonado v. Flynn, 413 A.2d 1251, 1261 (Del. Ch. 1980), rev'd on other grounds, 430 A.2d 779 (Del. 1981); Harff v. Kerkorian, 324 A.2d 215, 218 (Del. Ch. 1974); Taormina v. Taormina Corp., 78 A.2d 473, 475 (Del. Ch. 1951); Fleer v. Frank H. Fleer Corp., 125 A. 411, 414 (Del. Ch. 1924). A derivative action may be brought by a shareholder "[w]hen the corporate cause of action is for some reason not asserted by the corporation itself." H. HENN, supra note 1, § 360 at 756. Because of the shareholder's ownership interest in the corporate entity, he is permitted to step into the shoes of the corporation for the purpose of pursuing the claim. See Kaplan v. Bennett, 465 F. Supp. 555, 560 (S.D.N.Y. 1979); Johnson v. American Gen. Ins. Co., 296 F. Supp. 802, 810 (D.D.C. 1969). The corporation, therefore, is the actual plaintiff in interest, even though it is named as a nominal defendant in order to obtain jurisdiction over it. Maldonado v. Flynn, 413 A.2d 1251, 1261 (Del. Ch. 1980), rev'd on other grounds, 430 A.2d 779 (Del. 1981). Nonetheless, although the corporate entity is considered an indispensable party, it wields no control over the action. Brink v. DaLesio, 453 F. Supp. 272, 279 (D. Md. 1978); Slutzker v. Rieber, 28 A.2d 528, 529 (N.J. Ch. 1942); 13 W. Fletcher, supra note 1, § 5997. Of course, the prosecuting shareholder possesses no greater rights with respect to the litigation than the corporation would have had if it had elected to assert the cause of action, for the shareholder brings the action on the corporation's behalf. See Klotz v. Consolidated Edison Co., 386 F. Supp. 577, 580-81 (S.D.N.Y. 1974); 13 W. Fletcher, supra note 1, § 5994.
29 The courts have recognized that it would be illogical to force a corporation to litigate an action brought on its own behalf if it is determined that the costs and other adverse effects of pursuing the claim far outweigh any potential benefit. See, e.g., Gaines v. Haughton, 645 F.2d 761, 772 (9th Cir. 1981); Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1000-01, 419 N.Y.S.2d 920, 927 (1979).
corporation to dismiss unnecessary litigation brought on its behalf. Absent such relief, corporations could be “locked in” to the continuance of undesirable actions and plagued by meritless suits instituted solely for their settlement value.

Of course, once corporations are imbued with the discretionary authority to terminate derivative litigation, the potential for abuse of discretion arises and must be checked. Traditionally, however, judicial inquiry has been limited by the business judgment rule, whereby courts refrain from questioning the conduct of corporate decisionmakers. Indeed, judicial scrutiny is restricted, under the

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30 It is recognized that the demand requirement, see notes 40-42 and accompanying text infra, also provides the corporation with an opportunity to determine that a derivative suit is not in its best interests. A demand on the board of directors, however, is not always required. See id. Moreover, at least one commentator has suggested that there are better methods of eliminating frivolous litigation. See Cornell Note, supra note 1, at 632. One approach would be mandatory judicial review of settled derivative actions. Id. Another approach would be to grant summary judgment motions to defendant corporations whenever it becomes clear that derivative suits are not meritorious. Id. Furthermore, a number of jurisdictions require the plaintiff shareholders, in a derivative action, to post security for the reasonable expenses that may be incurred by the corporation in connection with the derivative suit. See, e.g., CAL. CORP. CODE § 800(d) (Deering 1977); N.J. STAT. ANN. § 14A: 3-6(3) (West Supp. 1981); N.Y. Bus. CORP. LAW § 627 (McKinney Supp. 1980-1981).

31 Cf. W. CARY & M. EISENBEEG, CASES AND MATERIALS ON CORPORATIONS 697 (5th ed. 1980) (prevention of detrimental litigation by requiring court approval of settlements). Were litigation committees to be barred from terminating detrimental cases, corporations would be required to litigate all such actions. Clearly, in some cases it would be more economical to offer a private settlement to the complaining shareholder than to expend corporate resources pursuing an action. See generally Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978), cert. denied, 439 U.S. 1129 (1979).

32 Given that in no published case did a special litigation committee not terminate pending litigation, it is conceivable that committee discretion might have been abused in some instances. See Cornell Note, supra note 1, at 602; Dent, supra note 5, at 109. The problem of potential abuse was recognized by the Zapata court which stated that “there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the theory of business judgment.” 430 A.2d at 787. In Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951), the court noted that it is doubtful that a disinterested quorum of directors would impartially decide whether or not to bring suit against their colleagues. Id. at 344.

33 See notes 1-2 and accompanying text supra. The permissible scope of inquiry under the business judgment rule is clearly defined in Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 984, 419 N.Y.S.2d 920 (1979), the leading case in New York applying that standard of review to special litigation committee determinations. In its opinion, the court explained that “[t]he business judgment rule does not foreclose inquiry by the courts into the disinterested independence of those members of the board chosen by it to make corporate decisions on its behalf—here the members of the special litigation committee.” Id. at 631, 393 N.E.2d at 901, 419 N.Y.S.2d at 927. Similarly, the court observed that “while [a] court may also properly inquire as to the adequacy and appropriateness of the committee’s investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment.” Id. at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d
rule, to determining whether corporate managers acted either fraudulently or in bad faith. Hence, critics of the business judgment doctrine contend that the rule is inappropriate when scrutinizing the decisions of special litigation committees formed to judge the merits of nondemand shareholder derivative claims. It is here that "structural bias," what the Zapata court termed "subconscious" loyalty of committee members to the board at large, lessens the likelihood of dispassionate committee action. Although several factors are responsible for "structural bias," perhaps the most obvious is the shift in director propensities necessarily occasioned by the shift from demand to nondemand litigation. Clearly, whether a shareholder first demands directors to institute proposed claims against other directors, or whether the shareholder is permitted to forego demand, some subset of the corporate board will be called upon to investigate the merits of litiga-

at 929 (citations omitted).

34 See note 1 supra.

35 See Clark v. Lomas & Nettleton Financial Corp., 625 F.2d 49, 52-53 (5th Cir. 1980), cert. denied, 101 S. Ct. 1738 (1981); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 146 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 822-23 (S.D.N.Y. 1979). The potential for abuse of special litigation committees has led some to fear that the derivative cause of action will no longer deter directoral misconduct. Dent, supra note 5, at 109. Undoubtedly, the temptation exists for directors named as defendants in derivative actions to empower litigation committees to investigate the merits of derivative claims, since such committees rarely conclude that derivative litigation should be pursued. Id.; see note 32 supra. Professor Dent contends that the solution to this problem is to cut back the authority of directors to seek the dismissal of litigation. Id. This, however, already has been determined to be unacceptable. See notes 28-31 and accompanying text supra. What would most effectively establish the desired balance between shareholders and corporations is a change in the procedure used to review litigation committee determinations. See notes 45-50 and accompanying text infra. Such a procedure must provide an adequate means of protecting the shareholder's right to recover for injuries to the corporation, while not unduly shifting the corporate decisionmaking power away from the board of directors.

36 Cornell Note, supra note 1, at 619-26. This Note provides an excellent discussion of the potential for influence by implicated directors upon non-implicated committee members. These influences, whether actual or subconscious, may tend to taint the committee's determination not to pursue a potentially meritorious action. Id.

37 430 A.2d at 787.

38 Cornell Note, supra note 1, at 619-26. See note 52 and accompanying text infra.

39 See note 52 and accompanying text infra.

40 See 13 W. Fletcher, supra note 1, § 5963. "The very purpose of the 'demand' rule is to . . . allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975); Lasker v. Burks, 404 F. Supp. 1172, 1178 (S.D.N.Y. 1975). The demand requirement, therefore, allows the majority of non-implicated directors to choose whether to pursue proposed litigation. Halprin v. Babbitt, 303 F.2d 133, 141 (1st Cir. 1962).
tion. In both instances, the investigating directors presumably are disinterested in the outcome of the proposed or pending litigation.\(^4\) The ratio of disinterested investigating directors to interested non-investigating directors, however, is inverted. Thus, in the case of demand actions, the disinterested investigating subset is, by definition, a majority of the entire board, since demand otherwise would be excused.\(^4\) In the case of nondemand actions, however, the disinterested investigative subset, or special litigation committee, consists of a minority of the entire board.\(^4\) Under such

\(^4\) A demand on the directors is not required when the alleged wrongdoers represent a majority of the board of directors or are otherwise interested in the outcome of the litigation. 13 W. FLETCHER, supra note 1, § 5965; note 42 infra. Implicit in this statement is that when demand is required the majority of directors necessarily are disinterested. Various tests are used to determine whether a director is interested in pending litigation. The First Circuit has determined that the approval of allegedly “wrongful corporate action” does not brand a non-participating director “interested.” Heit v. Baird, 567 F.2d 1157, 1160 (1st Cir. 1977)(quoting In re Kauffman Mut. Fund Actions, 479 F.2d 257, 265 (1st Cir.), cert. denied, 414 U.S. 857 (1973)). Other jurisdictions have concluded that such support of the defendant-directors and even dominance by those individuals in unrelated matters may establish whether a director is interested. Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971); Papilsky v. Berndt, 59 F.R.D. 96, 97 (S.D.N.Y. 1973), appeal dismissed, 503 F.2d 554 (2d Cir.), cert. denied, 419 U.S. 1048 (1974); Lerman v. ITB Management Corp., 58 F.R.D. 153, 156-57 (D. Mass. 1973).

\(^4\) 13 W. FLETCHER, supra note 1, §§ 5963, 5965; 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1831 (1972). See In re Kauffman Mut. Fund Actions, 479 F.2d 257, 264 (1st Cir.), cert. denied, 414 U.S. 857 (1973); Barr v. Wackman, 43 App. Div. 2d 689, 699, 350 N.Y.S.2d 428, 429 (1st Dep’t 1973), aff’d, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975). A demand may not be excused simply because the directors will not elect to bring suit, since one of the purposes of the demand requirement is to encourage intra-corporate resolution of disputes. Hawes v. Oakland, 104 U.S. (14 Otto) 450, 460-61 (1881); Weiss v. Sunasco, Inc., 316 F. Supp. 1197, 1206 (E.D. Pa. 1970). Because the principles of equity require that a corporation be given the opportunity to “vindicate its own right,” Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949), the shareholder demand requirement only may be waived when such a demand would be completely futile. See Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978), cert. denied, 439 U.S. 1129 (1979); 13 W. FLETCHER, supra note 1, § 5965; H. HENN, supra note 1, § 365; Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 HARV. L. REV. 746, 753 (1960). Shareholders have asserted that a demand is futile when the alleged wrongdoers dominate the disinterested members of the board. In re Kauffman Mut. Fund Actions, 479 F.2d 257, 264 (1st Cir.), cert. denied, 414 U.S. 857 (1973). Such an accusation of dominance may not be conclusory in form, but must be supported by specific facts. Cathedral Estates v. Taft Realty Corp., 288 F.2d 85, 88 (2d Cir. 1956); Lucking v. Delano, 117 F.2d 159, 160 (6th Cir. 1941); Baffino v. Bradford, 57 F.R.D. 79, 80 (D. Minn. 1972). In actuality, as noted by Professor Moore, “[t]here is no unanimity of opinion among the courts, and probably the most straightforward approach is to admit frankly that it lies within the sound discretion of the court to determine the necessity for a demand.” 3B J. MOORE’s FEDERAL PRACTICE ¶ 23.1.19, at 23.1-83 (2d ed. 1980).

\(^4\) The creation of a special litigation committee to evaluate the merits of a pending claim denotes that either no demand was required, because a majority of the board was
circumstances, the greater potential for "structural bias," whether in the form of subconscious loyalty or direct majoritarian influence, calls for a higher level of judicial scrutiny than the conventional business judgment rule affords.44

The Zapata two-step, by testing the reasonableness of litigation committee determinations,46 properly augments such scrutiny. Clearly, it is not unduly difficult for courts to test the reasonableness of a corporate decision to terminate pending litigation. Indeed, courts are required to make reasonableness determinations in appreciably more abstruse contexts. In passing upon the validity of corporate mergers, for example, courts are required to determine, inter alia, whether there is a reasonable probability that such mergers might substantially lessen competition.48 Surely,
therefore, a finding whether a special litigation committee acted reasonably in moving to quash pending litigation is not an overly burdensome task.

While the Zapata court should be praised for being so bold as to append a reasonableness test to the traditional business judgment doctrine, it is suggested that the court should also be commended for its restraint: permitting the reasonableness inquiry to stand as a second-tier, discretionary investigation.47 It is suggested that the threat of a judicial reasonableness investigation imposed by the Zapata court will stimulate corporate efforts to create truly independent litigation committees, thus minimizing the likelihood of "structural bias."48 Indeed, corporate decisionmakers after Zapata presumably will realize that the resources necessary to ensure committee independence are slight compared to those consumed in waging lengthy reasonableness investigations. Thus, it is submitted that a positive corporate reaction to the threatened use of judicial business judgment will result, mooting the need for such measures as mandatory judicial business judgment. Although a more strict approach might guarantee the reasonableness of litigation committee decisions, it is suggested that this benefit is outweighed by several costs: the "chilling" effect upon corporate decisionmaking;49 the greater potential that judicial business judgment inquiries will evolve into full trials on the merits;50 and, most certainly, a retrenchment from the worthy objective of judicial economy.

Notwithstanding that the discretionary use of judicial business judgment is supported, it is submitted that the Zapata court erred by failing to identify the criteria to ascertain when a reasonableness inquiry is proper.51 Such guidelines, which relate to the inde-

Walter Corp. v. FTC, 55 ST. JOHN'S L. REV. 312, 313 n.3 (1981).

47 430 A.2d at 789.
48 See note 36 supra.
49 See Note, The Business Judgment Rule, supra note 2, at 621.
50 To determine whether the expenses incurred in the pursuit of an action would be outweighed by any eventual recovery, the court validly may consider the issues of liability, causation and damages. See Gaines v. Haughton, 645 F.2d 761, 767 n.11 (9th Cir. 1981) (factors which were considered by the special litigation committee demonstrate that the application of judicial business judgment can result in the examination of issues usually explored at trial).
51 See 430 A.2d at 789. One commentator has stated:
One would think that if there is no issue of fact on the issue raised in the first part of the analysis, that the court would be required to proceed to the next step. If the court has discretion to refuse to do so, and therefore to direct that the litigation
pendence of the litigation committee, might include the ratio of interested to disinterested directors, the organizational rank and authority both of interested and disinterested directors, and the length of service of such directors.\textsuperscript{52} Clearly, since courts ultimately will have to determine whether to apply their judicial business judgment, they probably will rely on several of the aforementioned factors, in addition to other unnamed considerations.\textsuperscript{53} It is unlikely, however, that courts will be in accord as to the relative importance of such factors.\textsuperscript{54} To the extent of such disaccord, consistent judicial administration would be thwarted.\textsuperscript{55} Moreover, fairness dictates that the court formulate guidelines so that corporate boards, and their advising attorneys, can assess with confidence whether their litigation committees are fashioned properly.\textsuperscript{56}

continue, then what are the factors that must be used in exercising that discretion?


\textsuperscript{52} See Note, \textit{The Business Judgment Rule}, supra note 2, at 637. Some additional factors which might be considered by the court in its review of the committee's decision are directors' salaries and fringe benefits, personal friendships between implicated and nonimplicated directors, and gratitude for their appointment which nonimplicated directors might feel towards their fellow directors. \textit{Id.} One commentator has suggested that a mere "arithmetical analysis" of the ratio of interested to disinterested directors will not adequately reveal the presence of structural bias on the board. Cornell Note, supra note 1, at 608 n.43.

\textsuperscript{53} See Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 823 (S.D.N.Y. 1979); Zapata Corp. v. Maldonado, 430 A.2d 779, 788-89 (Del. 1981); Auerbach v. Bennett, 64 App. Div. 2d 98, 106-08, 408 N.Y.S.2d 83, 87-88 (2d Dep't 1978), \textit{modified}, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). In all these cases the courts examined a number of factors in deciding on the validity of a litigation committee's determination. Each court, however, examined a different set of factors. It is conceivable, therefore, that given equivalent factual situations, different courts applying their own unique criteria could reach different conclusions as to the validity of a litigation committee's decision.

\textsuperscript{54} See note 53 \textit{supra}. Clearly, the absence of guidelines for determining when to apply judicial business judgment results in unbridled judicial discretion. An English judge, Lord Camden, once wrote:

\begin{quote}
[T]he discretion of a judge is the law of tyrants; it is always unknown; it is different in different men; it is casual and depends upon constitution, temper and passion. In the best it is oftentimes caprice; in the worst, it is every vice, folly and passion to which human nature can be liable.
\end{quote}


\textsuperscript{56} Cf. \textit{Merger Guidelines of Department of Justice, reprinted in [1977] 1 Trade Reg.}
In addition to its failure to provide guidance for the use of judicial business judgment, it is submitted that the Zapata decision is to be faulted for implying, in dictum, that a reasonableness inquiry is unnecessary when reviewing dismissal of shareholder demand proposals. Surely, the potential for "structural bias," though perhaps less likely than in the nondemand situation, merits a degree of judicial scrutiny greater than that provided by the conventional business judgment rule. Indeed, it is not at all clear that the potential for abuse of shareholder rights is any less likely when demand is required than when demand is excused as futile.

Though the discretionary exercise of judicial business judgment in both demand and nondemand situations is advocated herein, it is recognized that this would be a radical development, one perhaps better attempted by state legislatures. Moreover, it is suggested that legislatures should consider alternatives to the use of judicial business judgment, for the approach does suffer several potential drawbacks. One such alternative would combine courts, arbitrators and screening panels. Under this plan, a judge would, upon petition to the court, request both the shareholder responsible for proposed or pending litigation and the corporate litigation committee which denied or wishes to terminate such litigation to consent to arbitration. The arbitrator, a person or group of per-

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Rptr. (CCH) ¶ 4510 (similar guidelines setting forth the factors used to assess the independence of litigation committees would be desirable). The merger guidelines of the Department of Justice are intended, inter alia, to "acquaint the business community" with factors used by the Department in assessing the validity of proposed mergers. Id.

See 430 A.2d at 784.

When demand is required, the board could make a business decision that the action would not benefit the corporation, and that determination would be protected by the business judgment rule. United Copper Secs. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); 13 W. Fletcher, supra note 1, § 5969.

See notes 49-50 and accompanying text supra.

Arbitration is a resolution procedure in which parties agree to allow a disinterested individual to decide a specific or future dispute. Because an individual is guaranteed the right to trial, arbitration may not be demanded, but must be agreed upon. Drake Bakeries Inc. v. Local 50, Am. Baking & Confectionary Workers' Int'l, 370 U.S. 254, 256 (1962). It has been held that as long as a party makes an informed choice to submit to arbitration, the use of that procedure may be enforced. See Madden v. Kaiser Found. Hosps., 17 Cal. 3d 699, 713-14, 552 P.2d 1178, 1186-88, 131 Cal. Rptr. 882, 890-92 (1977) ("take it or leave it" contract provision upheld). The decision rendered by the arbitrator or arbitration panel is final and is for all purposes the same as a court determination. See United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574 (1960); Bassis, Arbitration of Medical Malpractice Disputes—Some Problems, 676 Ins. L.J. 260, 263 (1979). Moreover, the use of arbitration as an alternative to judicial inquiry has gained widespread acceptance in certain types of cases. For instance, a number of states have formally codified arbitration procedures in medical
sons experienced in corporate decisionmaking, would evaluate the litigation committee’s recommendation and make a binding determination as to its accuracy. If one of the parties objected at the outset to the use of arbitration, an examination of the litigation committee’s judgment would be referred to a screening panel. Here, upon evaluating the conclusions of the litigation committee, a panel would submit to a judge a report containing both proposed rulings and a summation of the evidence upon which it relied. The judge, in turn, would review the report and rule on the advisability of dismissing proposed or pending litigation.

Although this adjudicatory paradigm may appear complicated at first glance, it is possessed of several overriding advantages. For instance, individuals qualified to exercise business judgment, and not the judiciary, would play a large role in determining whether pursuit of a shareholder derivative action would be in the best interests of the corporation. In addition, inquiries by arbitrators, screening panels, or judges would only address the reasonableness of a litigation committee’s desire to terminate litigation and would not result in unnecessary hearings on the underlying merits of shareholder claims. Finally, while the procedure would expedite the settlement of meritorious claims and prevent the prosecution of detrimental actions, the judicial attention required would be

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61 When individuals are selected to serve as arbitrators, it must be determined that they are not affiliated with the corporation involved in the action. Commonwealth Coatings Corp. v. Continental Cas. Co., 393 U.S. 145, 148-49 (1968).


63 One of the advantages of arbitration and screening panels is the expertise of the arbitrators or panelists. Note, Medical Malpractice Arbitration, supra note 60, at 457; Note, Classwide Arbitration: Efficient Adjudication or Procedural Quagmire?, 67 Va. L. Rev. 787, 794 (1981) [hereinafter cited as Note, Classwide Arbitration]. The arbitrators’ and panelists’ knowledge of the particular field of controversy lessens the need for expert testimony which often characterizes judicial review. Id. at 794 n.42. Moreover, the use of expert arbitrators and panelists is likely to lead to a more qualified determination of the accuracy of litigation committee decisions than judicial review could offer. See Desenberg, Medical Malpractice Arbitration: The New Michigan Statute, 31 Ariz. J. 36, 44 (1976).

64 Cf. Alexander, supra note 62, at 960 (discussing similarly structured panels in medi-
CONCLUSION

The Zapata court recognized that in order to protect shareholder rights some methodology had to be developed for examining the reasonableness of special litigation committee decisions. Although the court’s discretionary judicial reasonableness inquiry may lead commentators to exclaim that the demise of the business judgment rule is imminent, it is suggested that the Zapata test was not intended to destroy the defensive shield of business judgment, but merely to ensure that that shield would not be used offensively by corporations seeking to dismiss meritorious shareholder claims. Indeed, strong policy considerations speak against eliminating the business judgment rule in toto, because many persons, if expected to ensure the reasonableness of their decisions, would be reluctant to sit on corporate boards.

Notwithstanding the merits of the Zapata decision, the fact remains that Delaware courts may now subject litigation committee decisions to judicial reasonableness inquiries. Hence, an incentive has been created for businesses to incorporate outside the State of Delaware, where judicial review is limited by the business judgment rule. Of course, the Delaware legislature, reacting to this potentiality, might overturn the Zapata decision, thereby ensuring the continued attractiveness of Delaware to corporations. A preferable alternative, however, would be for Delaware’s sister states to take action similar to that taken by the Delaware Supreme Court, since the benefits of the traditional business judgment rule, as applied to special litigation committee decisions, clearly are suspect.

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