Special Litigation Committees and the Judicial Business Judgment Morass - Joy v. North

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SPECIAL LITIGATION COMMITTEES AND THE JUDICIAL BUSINESS JUDGMENT MORASS—JOY V. NORTH

In recent years, there has been a widespread call for increased controls on business activity. Revelations of corporate corruption at home and abroad have fueled suspicions of the commercial world. The very fact that small groups of businessmen manage vast sums of other people’s money seems to present dangerous opportunities for fraud and scandal.

Although government was initially reluctant to interfere in business affairs, it has now become deeply involved in regulating commerce. The courts have contributed to the fight against corporate abuse by enforcing these legislative mandates.


2. See Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. REV. 1099, 1101-02 (1977) (media reports of corporate misconduct read like baseball box scores) [hereinafter cited as Coffee, Corporate Misconduct]; Ross, How Lawless Are Big Companies?, FORTUNE, Dec. 1, 1980, at 56 (listing numerous examples of corporate scandals); see also Vagts, Directors: Myth and Reality, 31 BUS. L. 1227, 1227 (1976) (society has always been somewhat suspicious of businessmen); Russo & Wolfson, Why Must Boards Change?, N.Y. Times, Jan. 21, 1979, at F16, col. 3 (corporate corruption is no greater today, yet government justifies increased regulation by giving “anecdotal accounts of occasional corporate misbehavior”). Most recently, the discovery that American corporations had been paying substantial amounts to foreign governments and political groups to secure favorable treatment seemed to confirm the reports of increasing “white collar” corruption. See generally Herlihy & Levine, Corporate Crisis: The Overseas Payment Problem, 8 L. & POL’Y INT’L BUS. 547 (1976).

3. In 1932, Berle and Means dramatized the growing separation of ownership from control in American business. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968). These commentators interpreted this phenomenon to mean that with little or no financial stake in the corporation, directors had little incentive to serve the shareholders. Id. at xxxv.

4. See, e.g., Note, The Continuing Viability of the Business Judgment Rule, 35 GEO. WASH. L. REV. 562, 565-66 (1966) (regulation of business was viewed with suspicion as being economically disruptive, to be tolerated only as a necessary evil) [hereinafter cited as Note, Continuity Viability].

5. For instance, corporations are subject to antitrust laws, federal securities laws, and state corporation laws. They must also comply with federal regulations governing employment opportunity, labor relations, minimum wage and maximum hour requirements, and laws covering employee benefit plans. In addition, the federal government regulates corporate conduct with respect to the environment, product safety, consumer warranties and credit, and advertising. The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation—Statement of the Business Roundtable, 33 BUS. LAW. 2083, 2090-91 (1978) [hereinafter cited as Business Roundtable].

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checks and by allowing private individuals to seek redress for corporate wrongs. One such judicial remedy is the shareholder's derivative suit. In a derivative suit, shareholders may sue for the enforcement of corporate claims against third parties or against the corporate directors themselves. Not surprisingly, the business community has protested that excessive restraints on managerial discretion, including increased derivative litigation, have diluted corporate strength and are contrary to society's best interests.

Business has fought back. In an effort to dispose of costly derivative suits, many corporate boards have appointed special litigation committees comprised of outside directors to decide whether a shareholder's suit serves the company's best interests. Skeptics regard this practice as a corporate ploy to obscure misconduct and subvert derivative litigation. Management, however, views the committee as an effective tool for eliminating suits which ultimately do more harm than good for the corporation.

The courts are sharply divided on how to deal with special litigation committees.

6. The shareholder has three legal remedies against corporate misconduct. If the stockholder has been injured as an individual, he may file an individual action against the alleged wrongdoers. See 13 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 5911, 5915 (rev. perm. ed. 1980). When the injury is suffered primarily by the corporation, however, the shareholder may file either a pure class action or derivative suit. Id. § 5908. For an overview of these three remedies, see Comment, Special Litigation Committees: An Unwelcome Solution to Shareholder Demands, 1981 U. Ill. L. Rev. 485, 485-88.

7. See infra text accompanying notes 41-76.


10. See, e.g., Business Roundtable, supra note 5, at 2091 ("[these restraints] impose excessive and unnecessary costs—costs borne ultimately by the consuming public").

11. See infra notes 64-69 and accompanying text.

12. Outside directors are board members who are not company officers and who do not participate in the corporation's daily management activities. Black's Law Dictionary 994 (5th ed. 1979). They are compensated only for their services as outside directors and have no other connection with corporate management. Cohen, The Outside Director—Selection, Responsibilities and Contribution to the Public Corporation, 34 Wash. & Lee L. Rev. 837, 837 (1977).

13. See infra notes 76-90.


15. Payson, supra note 14, at 522.
committees. Recently, in *Joy v. North*, the United States Court of Appeals for the Second Circuit seriously curtailed the ability of litigation committees to terminate derivative suits. In a two-to-one decision, the court refused to extend to these committees the full measure of discretion traditionally afforded directors under the business judgment rule. Instead, the majority opinion held that in cases in which shareholders are not required to demand that the board pursue a corporate claim, lower courts interpreting Connecticut law must render an independent business judgment of the corporate interest in continued litigation. More importantly, the Second Circuit outlined an elaborate procedure to assist the courts in making this assessment.

In many respects, *Joy v. North* is an ill-considered opinion. Grounded on a skeptical view of special litigation committees, the Second Circuit's decision ignores the uncontroverted evidence that these committees are in no way pawns of the defendant-directors. The *Joy* court also exaggerates the role of the derivative suit as a "watchdog" on management and undermines the historic function of the business judgment rule in corporate law. Moreover, in an effort to reach its result, the Second Circuit disregards important legal principles.

The significance of *Joy v. North* is that it is certain to cause problems for both courts and corporations. By requiring judges to deliberate over a number of sophisticated, elaborate, and somewhat obscure issues, this decision will greatly complicate derivative litigation. *Joy* will encourage this litigation by stifling the ability of Connecticut corporations to terminate vexatious suits. *Joy* also will result in the demise of the special litigation committee in that jurisdiction, despite its beneficial role in corporate law. Finally, the Second Circuit's opinion will place unwanted costs on the shareholders it purports to protect and, ultimately, on society as well.

This Note will discuss directorial liability, derivative suits, and special litigation committees. It will then review the case law on litigation committees and describe how the *Joy* case has expanded significantly on the concept of judicial business judgment as applied to these committees' decisions. Finally, the Note will analyze *Joy v. North*, discuss its impact, and conclude that the Second Circuit's opinion is a prime example of why courts should refrain from engaging in corporate decision making.

**THE BUSINESS JUDGMENT RULE**

The business judgment rule is a common law doctrine that protects corporate directors from liability for mistakes of judgment. While the rule

16. See infra notes 92-131 and accompanying text.
17. 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983).
18. Id. For a discussion of the business judgment rule, see text accompanying notes 22-40.
19. See infra note 61 and accompanying text.
20. 692 F.2d at 891; see infra text accompanying note 157.
21. 692 F.2d at 891-93; see infra notes 161-66 and accompanying text.
condones honest errors,23 it does not insulate directors who fail to exercise reasonable care24 or who act in bad faith.25 By demanding diligence and a high degree of loyalty,26 the business judgment rule reflects the notion that directors have fiduciary obligations to the stockholders whose money they control.27

Although it is not surprising that the business judgment rule arose in an era of laissez-faire philosophy,28 a variety of practical considerations explain its persistence. The rule is based on the historic role of the board of directors as the guiding force of the corporation.29 It recognizes that businessmen are not infallible30 and that they do not insure the success of the business.31

23. 3A W. Fletcher, supra note 6, § 1039, at 37.
24. Id. § 1040, at 44.
Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. They cannot excuse imprudence on the ground of their ignorance or inexperience, or the honesty of their intentions; and, if they commit an error of judgment through mere recklessness, or want of ordinary prudence and skill, the corporation may hold them responsible for the consequences.

Id. (quoting Wangrow v. Wangrow, 211 A.D. 552, 556, 207 N.Y.S. 132, 136 (App. Div. 1924)). The generally accepted standard of care is that which a reasonably prudent man would have exercised under similar circumstances. See Briggs v. Spaulding, 141 U.S. 132, 152 (1891); Model Business Corp. Act § 35 (1979); N.Y. Bus. Corp. Law § 717 (McKinney Supp. 1982-1983). Bank directors, however, are normally held to a higher standard of accountability than directors of other corporations. See Lippitt v. Ashley, 89 Conn. 451, 462, 94 A. 995, 999 (1915) (issue is not what a reasonably prudent person would have done, but what a reasonably prudent banker would have done); Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940) (bank directors held to higher standard than ordinary corporate director); see also 3A W. Fletcher, supra note 6, § 1035, at 28.

25. See Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir.) (rule inapplicable in cases of fraud, bad faith, gross overreaching, and abuse of discretion), cert. denied, 454 U.S. 1092 (1981); Treadway Co. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) (directors called to account only for self-dealing, fraud, or bad faith); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978) (absent fraud or some other corrupt motive, directors are not ordinarily held liable for mistakes of law or fact). Questions of bad faith encompass conflict of interest situations in which the directors' loyalty to the corporation is in doubt. 3A W. Fletcher, supra note 6, § 1039, at 28.

26. Arsht, supra note 22, at 96 (limitations on rule's application place significant duties on directors).

27. See, e.g., Zapata Corp. v. Maldonado, 430 A.2d 779, 783 (Del. 1981) (directors owe a "well-established" fiduciary duty to the corporation).

28. Note, Continuity Viability, supra note 4, at 565 (rule based on notion that "the free play of human motives, all in themselves selfish and acquisitive, works out to promote the highest benefit to society").


30. Arsht, supra note 22, at 99-100.

31. 3A W. Fletcher, supra note 22, § 1035, at 28. The corollary to the notion that direc-
The business judgment rule encourages risk taking and entrepreneurship, and it presumes that holding directors to an unreasonably high standard of care would frustrate commerce and discourage competent people from assuming directorships. In addition, the rule acknowledges that the judicial system would be unable to handle a flood of litigation questioning the propriety of business decisions.

Consequently, under the business judgment rule, directors are entitled to a presumption that their actions were taken in good faith and for a rational business purpose. Courts will not second-guess their decisions unless the plaintiff can prove a breach of fiduciary duty. If the plaintiff sustains this burden of proof, the business judgment rule becomes inapplicable and the burden shifts to the directors to prove the transaction's "intrinsic fairness" to the corporation. Essentially, the business judgment rule guarantees limited
judicial review while placing a heavy burden on shareholders who challenge corporate transactions.40

THE SHAREHOLDERS DERIVATIVE SUIT

"[B]orn of stockholder helplessness," the derivative suit arose at equity as a device to prevent injustice to the shareholders.41 The derivative suit provides a remedy for mismanagement and abuse of corporate assets by allowing shareholders to represent the corporation in actions against directors or third parties.42 In effect, it functions as a dual cause of action: first, as a suit on behalf of the shareholders seeking to force management to bring a claim; and second, as a suit on behalf of the corporation against the alleged wrongdoers.43 Any recovery belongs to the corporation,44 except for corporate reimbursement of the plaintiff-shareholder's attorneys' fees.45 From a financial perspective, the shareholder is actually a nominal plaintiff because his financial stake in the suit's outcome—an appreciation in the value of his stock—is usually marginal.46 The incentive to litigate often lies with the plaintiff's attorney,47 who hopes to earn generous fees if the litigation confers

41. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949); see also id. (equity stepped in where common law was too lax and stockholders had no standing to sue at law); Prunty, The Shareholders' Derivative Suit: Notes on its Derivation, 32 N.Y.U. L. Rev. 980, 992 (1957) (suit arose as a response to wrongs for which legal procedures were inadequate).
42. See Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949) (equity came to the relief as a means of restitution); Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981) (shareholder's right to litigate corporate claims is intended to prevent injustice) (quoting Sohlund v. Baker, 15 Del. Ch. 431, 443, 141 A. 277, 282 (1927)). Providing the derivative suit as a remedy for wrongs to the corporation, and to the shareholders as a body, is considered the compensatory rationale. See infra note 76.
43. See 13 W. FLETCHER, supra note 6, § 5941.1, at 362-63.
45. 13 W. FLETCHER, supra note 6, § 5953, at 387.
46. Id. § 6045, at 626. The derivative suit is an exception to the "American rule," whereby a winning party is not entitled to attorneys' fees absent statutory authorization. Bailey v. Meister Brau, Inc., 535 F.2d 982, 994-95 (7th Cir. 1976). The rationale for requiring the corporation to reimburse the successful plaintiff for his attorneys' fees is two-fold. First, to allow other shareholders to benefit from the litigation without contributing to its expense would constitute unjust enrichment. Mills v. Electric Auto-Lite, 396 U.S. 375, 392 (1970). Second, reimbursement of attorneys' fees encourages beneficial derivative suits which shareholders would otherwise be unable to bring. Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983) (quoting W. CARY & M. EISENBERG, CORPORATIONS 938 (5th ed. 1980)).
49. Joy, 692 F.2d at 887. Derivative plaintiffs' attorneys often take litigation on a contingent fee basis. Dawson, Lawyers and Involuntary Clients in Public Interest Litigation, 88
Before a dissatisfied shareholder may bring a derivative suit, he must first demand that the directors pursue the action in the corporate name. This common law requirement, embodied in the Federal Rules of Civil Procedure, directs the plaintiff either to state specifically in his complaint his efforts to persuade the board to take such action, or to explain why a demand would have been futile. Like the business judgment rule, the demand requirement defers to the directors' authority to manage corporate affairs, including litigation. It also gives the board an opportunity to decide whether

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<td>Gallin v. Nat. City Bank</td>
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<td>Ripley v. Int'l Ry of Central Am.</td>
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See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 395 (1970) (noting a trend toward allowing attorneys' fees as long as the corporation receives a substantial benefit from the litigation—even if the benefit is nonpecuniary); Bailey v. Meister Brau, Inc., 535 F.2d 982, 995 (7th Cir. 1976) (substantial benefit rule is "well settled"); see also Lewis v. Anderson, 509 F. Supp. 232, 236 (C.D. Cal. 1981) (fees may be awarded even if defendants render case moot by bringing about beneficial changes); Neese v. Richer, Ind. App., 428 N.E.2d 36, 39 (1981) (fees awarded for compelling corporate accounting even though plaintiff lost on issues of mismanagement, fraud, and conversion); Duesenberg, supra note 48, at 327 (even a losing plaintiff-shareholder may have a claim against the corporate treasury).

See 13 W. FLETCHER, supra note 6, § 5963, at 398-99. In Hawes v. Oakland, 104 U.S. 450 (1881), the Supreme Court stated that before initiating a derivative action, the shareholder had to "make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court." Id. at 461. One commentator states that the original purpose of the demand requirement was to prevent judicial intervention in corporate affairs until all internal remedies were exhausted. Comment, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. CHI. L. REV. 168, 171 (1976) [hereinafter cited as Comment, Standing Requirements].

This rule also requires that demand be made on the shareholders "if necessary." Id. This requirement does not bear directly on the issue of the termination of derivative suits by litigation committees and therefore will not be discussed. For a review of the demand on shareholders requirement, see Comment, Standing Requirements, supra note 51, at 182-91. In most jurisdictions, however, demand on shareholders is required either rarely or not at all. 13 W. FLETCHER, supra note 6, § 5964, at 405.

Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978) (business judgment and demand requirement are "inextricably linked").

See Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975) (per curiam) (demand allows directors to occupy normal role as corporate managers); In re Kauffman Mut. Fund Actions, 479 F.2d 257, 263 (1st Cir.) (demand requires plaintiff to show why directors are incapable of doing their duty), cert. denied, 414 U.S. 857 (1973); Comment, Standing Requirements, supra note 51, at 171 (demand reflects the basic policy that corporate management is entrusted to directors).
or not litigation serves the corporation’s best interests. By requiring the plaintiff to exhaust his intracorporate remedies, the demand procedure treats the derivative suit as a final alternative.

If the board of directors refuses to bring suit in a good faith exercise of business judgment, the plaintiff’s claim will be dismissed. In order to maintain an action, the plaintiff must show that the board’s refusal to sue was wrongful. In United Copper Securities Co. v. Amalgamated Copper Co., Justice Brandeis described the circumstances in which a derivative suit would survive board refusal. When the directors are guilty of mismanagement constituting a breach of trust, or when they have a conflict of interest that prejudices their judgment, the plaintiff may pursue a cause of action despite the board’s refusal to litigate. Alternatively, if the court excuses demand as futile because the board would clearly oppose the suit, the plaintiff may maintain an action on his own behalf. Whether or not demand

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55. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917) (whether to enforce corporate claims is a business question left to directors’ discretion); see also Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903) (corporate interests are sometimes best served by waiving a legal right); Hawes v. Oakland, 104 U.S. 450, 456-57 (1881) (litigation is not always the answer to wrongs committed against the company); Comment, Standing Requirements, supra note 51, at 171-72 (directors are in a better position than shareholders to know whether a claim is worth pursuing).


58. 13 W. Fletcher, supra note 6, § 5969, at 423-24.

A Stockholder cannot sue where the refusal of the directors . . . is properly within their discretionary power with respect to the internal affairs of the corporation vested in them by the charter, where they act, not fraudulently, illegally or oppressively, but in good faith, in the exercise of their discretion, and for what they deem to be the best interests of the company.

Id. (footnotes omitted).

59. Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981); Comment, Standing Requirements, supra note 51, at 169.

60. 244 U.S. 261 (1917).

61. Id. at 263-64; see Joy, 692 F.2d at 887-88 (demand not required when there is a conflict of interest among the directors); Lasker v. Burks, 404 F. Supp. 1172, 1174 (S.D.N.Y. 1975) (no demand required when shareholder alleged directors’ actions were abuse of shareholder trust), rev’d, 567 F.2d 1208 (2d Cir. 1978), rev’d, 441 U.S. 471 (1979). Case law has interpreted these words to encompass situations in which the directors are either controlled by the alleged wrongdoer, interested in the transaction, or they actually participated in the actions attacked. Other authority supports the plaintiff’s standing to sue when the board failed to bring a constitutional claim or when refusal to sue was itself illegal. Comment, Standing Requirements, supra note 51, at 193-98.

62. 13 W. Fletcher, supra note 6, § 5965, at 410. Courts will excuse a plaintiff’s failure to make demand under various circumstances. Demand has been deemed futile when the alleged wrongdoer(s) constituted a majority of the board; when the directors had a conflict of interest predisposing them to dismiss the claim; when the alleged wrongdoer(s) dominated the board; and when the directors’ opposition to the suit was manifest. Comment, Standing Requirements, supra note 51, at 173-82; see also 13 W. Fletcher, supra note 6, § 5965, at 410-11. Shareholder
is required rests largely within the court's discretion. 63 The history of derivative litigation has been marked by controversy. Corporate directors often react with hostility to derivative suits against board members for a number of reasons. 64 First, between the cost of paying corporate counsel, wading through complex litigation, and funding the legal expenses of the successful party, derivative litigation can seriously drain corporate assets. 65 Second, the corporation suffers in terms of the paralysis of key personnel, lowered employee morale, and a tarnished corporate image. 66 Third, and perhaps most important, suits against directors represent a threat to the honor and business careers of people who may have been instrumental in building the company. 67 Furthermore, critics point to abuse of the action in the form of "strike litigation," derivative suits which are instigated

allegations of futility, when unsupported, will usually be insufficient to excuse demand. Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 277 n.23 (3d Cir. 1978); In re Kauffman Mut. Fund Actions, 479 F.2d 257, 264 (1st Cir.), cert. denied, 414 U.S. 857 (1973). In practice, the situations in which demand is considered futile and in which a board's refusal to sue is deemed wrongful are similar in nature. Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n.10 (Del. 1981).

63. 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.19, at 83 (2d ed. 1982); see, e.g., Abramowitz v. Posner, 672 F.2d 1025, 1033 (2d Cir. 1982) (trial court did not abuse discretion by requiring demand); Fields v. Fidelity Gen. Ins. Co., 454 F.2d 682, 684-85 (7th Cir. 1971) (demand procedure is within the sound discretion of the court).

64. Dykstra, supra note 9, at 75.

65. Block & Prussin, The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?, 37 BUS. LAW. 27, 29 (1981). If the plaintiff's suit is successful, the corporation is required to pay the plaintiff's litigation costs and attorneys' fees. D. VAGT'S, supra note 49, at 504. An unsuccessful plaintiff may also have a claim to these expenses under the "substantial benefit" rule. See supra note 49 and accompanying text. When the defendant-directors prevail, the corporation usually pays their attorneys' fees in addition to its own because all states either require or permit indemnification for litigation expenses. Block & Prussin, supra, at 29 n.4; see, e.g., CONN. GEN. STAT. ANN. § 33-320a(c) (West Supp. 1983) (mandatory); DEL. CODE ANN. tit. 8, § 145(b) (1974) (permissive); ILL. REV. STAT. ch. 32, § 157.42-12(b) (1981) (permissive); N.Y. BUS. CORP. LAW § 722(a) (McKinney Supp. 1982-1983) (permissive). The corporation also pays the attorneys' fees of all parties pursuant to a settlement agreement. Block & Prussin, supra, at 29 n.4.

In addition, some statutes permit corporate indemnification of directors against amounts paid in judgments and settlements if the court, in its discretion, deems it proper in light of attendant circumstances. See, e.g., CONN. GEN. STAT. ANN. § 33-320a(c) (West Supp. 1983); DEL. CODE ANN. tit. 8, § 145(b) (1974); ILL. REV. STAT. ch. 32, § 157.42-12(b) (1981). Because directors are routinely indemnified, many corporations insure themselves against these potential costs. See Conard, A Behavioral Analysis of Directors' Liability for Negligence, 1972 DUKE L.J. 895, 911 (1972) (indemnification of liability creates a circular effect by which the corporation returns amounts awarded in recovery and pays substantial legal fees as well); Johnston, Corporate Indemnification and Liability Insurance for Directors and Officers, 33 BUS. LAW. 1993, 2012-36 (1978) (discussing a variety of corporate insurance plans protecting directors against the heavy cost of litigation and liability that they otherwise would be unable to sustain).

66. See Block & Prussin, supra note 65, at 29 (suits "seriously disrupt" business and generate bad publicity); Duesenberg, supra note 48, at 332 (cost of derivative litigation includes injury to company morale and diversion of time and talent).

by attorneys for the sole purpose of claiming large fees from the corporate treasury. Consequently, corporate directors usually try to minimize losses by settling out of court or seeking prompt dismissal of the suit.

Despite charges of champerty and legislative threats on its life, the derivative suit continues to thrive, largely because of its acceptance as a "useful gadfly" that deters corporate corruption. Its proponents argue that by holding management more accountable to the shareholders, the suit has remedied many corporate wrongs, and even unsuccessful suits have called attention to questionable business practices. Moreover, it is said that the mere threat of derivative litigation has a cleansing effect on the business community. Within the past ten years, however, a new development has shattered all semblance of derivative tranquility.

68. H. Henn & J. Alexander, supra note 56, § 358, at 1039 n.22 (3d ed. 1983). See generally Note, Extortionate Corporate Litigation: The Strike Suit, 34 COLUM. L. REV. 1308 (1934) (discussing the practice of some derivative plaintiffs' attorneys to instigate potentially costly litigation that corporations will seek to avoid by settling out of court, effectively "paying off" the plaintiff's attorney).

69. Block & Prussin, supra note 65, at 29.

70. R. Hamilton, CORPORATIONS 985 (2d ed. 1981). Champerty is defined as "a bargain by a stranger with a party to a suit, by which such third person undertakes to carry on the litigation at his own cost and risk, in consideration of receiving, if successful, a part of the proceeds or subject sought to be recovered." BLACK'S LAW DICTIONARY 209 (5th ed. 1979).

71. Following the Wood Report on derivative suits, F. Wood, Survey and Report Regarding Stockholders' Derivative Suits (1944), New York and a number of states enacted security-for-expenses statutes. Typically, these statutes require that shareholders owning less than five percent, and less than $50,000 (market value), of corporate stock post a security for the corporation's reasonable litigation expenses. See Note, Security For Expenses in Shareholders' Derivative Suits: 23 Years' Experience, 4 COLUM. J.L. & SOC. PROBS. 50, 51-53 (1968). Once considered the death knell of the derivative suit, these statutes are now relatively easy to avoid. Id. at 50; Coffee & Schwartz, supra note 14, at 261. Nevertheless, between security-for-expenses, demand on directors and shareholders, and the contemporaneous ownership requirement, the obstacles to bringing a derivative suit are not insignificant. Dykstra, supra note 9, at 75.

72. See supra note 9.

73. Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 HARV. L. REV. 746, 747 (1960) [hereinafter cited as Note, Demand in Derivative Suits].

74. See Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949) (derivative suit is the "chief regulator of corporate management"); Dent, supra note 14, at 96 (suit has "long played a crucial role in assuring a modicum of integrity and competence in the management of corporations"); Rostow, To Whom and for What Ends is Corporate Management Responsible?, in THE CORPORATION IN MODERN SOCIETY 48 (E. Mason ed. 1973) (derivative suit is the "most important procedure the law has yet developed to police the internal affairs of corporations"); Note, Demand in Derivative Suits, supra note 73, at 746 (derivative suit serves as a means of enforcing fiduciary duties).

75. See, e.g., Block & Prussin, supra note 65, at 30-31 (derivative suits contributed to the enactment of the Foreign Corrupt Practices Act of 1977); Dykstra, supra note 9, at 77-78 (derivative suits have challenged excessive salaries, watered stock, usurpation of corporate opportunities, secret profits, excessive stock options, unlawful purchases of corporate securities, improvident loans, abuse of subsidiary by parent, and other misconduct).

76. Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548 (1949) (derivative suit is an incentive to avoid mismanagement). To a large extent, attitudes toward the derivative suit depend upon whether its principal purpose is considered one of compensating injured shareholders or
A combination of factors compelled corporate boards to establish committees of outside directors authorized to determine whether a particular derivative suit was in the company's best interests. Increased derivative litigation, burgeoning legal expenses, concern over directorial liability, and the inability of allegedly wrongdoing directors to terminate suits contributed to the development of a device to gain control over the derivative suit. In addition, it had become commonplace to use outside director committees to perform corporate tasks such as auditing, compensating management, and nominating director candidates. Consequently, pursuant to state laws allowing corporate boards to delegate specific authority to committees, special litigation committees were created.

Typically, the special litigation committee is comprised of two or three outside directors elected after the alleged wrongdoing is discovered. Independent counsel often assists the committee, and one aspect of its investiga-

deterrence. The deterrence theory is conducive to a wide use of the suit as a method of preventing misconduct before it occurs. In contrast, the compensatory theory promotes an approach more narrowly limited to correcting the injustice presented. Most courts have favored the compensatory theory, and some have even expressed skepticism of the suit's deterrence rationale. Coffee & Schwartz, supra note 14, at 302; see, e.g., Bangor Punta Operations, Inc. v. Bangor & Aroostok R.R., 417 U.S. 703, 717-18 n.14 (1974) (punishment of a wrongdoer does not justify enrichment of others at the wrongdoer's expense) (quoting Home Fire Ins. Co. v. Barber, 67 Neb. 644, 673, 93 N.W. 1024, 1035 (1903)). But see Coffee & Schwartz, supra note 14, at 302 (a purely compensatory rationale is no longer adequate; deterrence is suit's proper purpose); Dent, supra note 14, at 114 (deterrence may be suit's most important function).

77. Cf. Johnston, supra note 65, at 1993 (increased litigation against management has created interest in protecting directors from liability); Mattar, supra note 9, at 550 (directors are increasingly aware of potential liability).

78. See supra notes 60-62 and accompanying text.

79. See, e.g., Committee on Corporate Laws, The Overview Committees of the Board of Directors, 34 BUS. LAW. 1837 (1979) (discussing nomination, compensation; and audit committees); see also Note, Special Litigation Committees and the Business Judgment Rule: Zapata Corp. v. Maldonado and Joy v. North, 14 CONN. L. REV. 193, 201 (1981) (the litigation committee concept is analogous to ratification of interested director transactions by a disinterested board majority); Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 CORNELL L. REV. 600, 608 n.44 (1980) (Securities and Exchange Commission is partly responsible for litigation committees due to its practice of requiring corporations, pursuant to settlement agreements, to appoint interim outside directors to prevent further violations of securities laws) [hereinafter cited as Note, Business Judgment Rule].


82. See, e.g., Joy v. North 692 F.2d 880, 884 (2d Cir. 1982) (independent counsel); Lewis
The committee’s mandate is primarily business-oriented, however, because it requires weighing the cost of litigation, the interruption of corporate affairs, the effect on employee and public relations, and the extent of the injury suffered by the corporation, as well as ethical considerations. If the committee decides not to pursue litigation, it may recommend an out-of-court settlement or compel counsel to seek an early dismissal of the case. It is in the latter instance that the business judgment rule operates as an affirmative bar to the plaintiff’s derivative suit.

Criticism of the special litigation committee largely centers around the concept of "structural bias." This concept assumes that the committee members are inherently prejudiced against suits attacking their fellow directors. It further assumes that outside directors are not truly independent because in most instances they are selected by the defendants. This situation creates a sense of loyalty to management and allows the defendants to choose individuals who will not "rock the boat." Moreover, the committee members...
tend to have social and professional similarities with the inside directors that engender attitudes highly favorable to the defendants. Structural bias has been an important consideration when courts have attempted to determine the scope of the litigation committees' powers under the law.

In 1975, the special litigation committee made its judicial debut in the United States District Court for the Southern District of New York. In *Lasker v. Burks*—shareholders brought suit against the directors of an investment company alleging violations of the Investment Advisers Act and the Investment Company Act. The plaintiffs sought recovery for the investment company's purchase of twenty million dollars in commercial paper of the Penn Central Transportation Company. The defendants moved for summary judgment based on a litigation committee's business judgment that the suit was not in the company's best interests.

Acknowledging the uniqueness of the argument, the district court held that the derivative suit did not give shareholders a right to maintain a corporate cause of action if the decision not to sue was made in good faith. The court referred to the policy underlying the business judgment rule and reasoned that the directors should be able to control litigation brought on the corporation's behalf. Provided that the committee was genuinely disinterested and independent, the *Lasker* court refused to second-guess the committee's judgment by reviewing the merits of the plaintiff's case.

While *Lasker v. Burks* was on appeal, the Exxon Corporation formed a special litigation committee to evaluate a prospective suit against various directors for contributions to Italian political parties between 1963 and 1971. The United States District Court for the Southern District of New York relied on its decision in *Lasker* and applied the business

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91. Id.
95. 404 F. Supp. at 1174. The committee retained Stanley H. Fuld, former chief judge of the New York Court of Appeals, as an independent legal adviser. Id. at 1175.
96. Id. at 1176.
97. Id. at 1178.
98. Id. at 1180.
99. Id. at 1179.
100. Id. at 1180. Rejecting the plaintiff's argument that the board's refusal amounted to an illegal ratification, the court reasoned that the decision not to sue was a business matter and that many of the early cases applying the business judgment rule to derivative litigation dealt with arguably nonratifiable claims. Id. (citing United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917)); Ash v. IBM, 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966).
judgment rule to the committee's decision to terminate the suit.\footnote{103} Furthermore, the Gall court expanded the justification for using the rule in this context. Since the rights sought to be asserted belonged to the corporation, the committee's decision should be upheld "absent allegations of fraud, collusion, self-interest, dishonesty or other misconduct of a breach of trust nature, and absent allegations that the business judgment exercised was grossly unsound. . . ."\footnote{104} In the Southern District of New York, therefore, litigation committees clearly seemed able to effect "business judgment dismissals."

Subsequently, however, the United States Court of Appeals for the Second Circuit reversed the district court opinion in Lasker.\footnote{105} Litigation committees appeared doomed to an early extinction until 1979, when the United States Supreme Court, in Burks v. Lasker,\footnote{106} rejected the Second Circuit's holding that disinterested directors of an investment company had no power to terminate a nonfrivolous suit against a majority of directors under the Investment Company Act.\footnote{107} In Burks, the Supreme Court established a two-step test for federal court review of committee decisions to end derivative litigation.\footnote{108} Under that test, a court initially must determine whether the law of the company's state of incorporation permits such a dismissal.\footnote{109} If state law allows a business judgment dismissal, the court must then inquire whether the state law conflicts with the policies underlying the federal law in question.\footnote{110}

Following the Burks decision, courts consistently applied the business judgment rule to litigation committee decisions to terminate derivative suits. The leading case in the area became Auerbach v. Bennett.\footnote{111} Decided by the New York Court of Appeals, Auerbach was the first business judgment dismissal granted by a state's highest court.\footnote{112} Similarly, at the federal level the ability

\footnotesize{103. \textit{Id.} at 516.}
\footnotesize{104. \textit{Id.} Expressly avoiding a rule that would involve courts in business decisions, the Gall court allowed the plaintiff time for discovery restricted to the good faith and independence of the committee. \textit{Id.} at 519-20.}
\footnotesize{105. 567 F.2d 1208 (2d Cir. 1978), rev'd, 441 U.S. 471 (1979).}
\footnotesize{106. Burks v. Lasker, 441 U.S. 471 (1979).}
\footnotesize{107. \textit{Id.} at 481-82. The court of appeals based its holding on the Investment Company Act, 567 F.2d at 1209, but the Supreme Court's opinion seemed to encompass both that act and the Investment Advisers Act. 441 U.S. at 486.}
\footnotesize{108. 441 U.S. at 480.}
\footnotesize{109. \textit{Id.} The Court reasoned that corporations were governed primarily by state law, with federal law serving as a regulatory background. \textit{Id.} at 478. Federal courts have construed this initial step as requiring a prediction of how the highest court of the corporation's state of incorporation would interpret its own law. \textit{See, e.g., Genzer v. Cunningham, 498 F. Supp. 682, 686 (E.D. Mich. 1980).}}
\footnotesize{110. 441 U.S. at 480. Essentially, this "consistency test" recognizes that state law is controlling absent specific congressional intent to prevent the termination of suits involving particular federal laws. \textit{Id.} at 486.}
\footnotesize{111. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).}
\footnotesize{112. \textit{Id.} In Auerbach, the plaintiff sought recovery from the directors of General Telephone \\
& Electronics Corp. (GTE) for contributions to foreign political groups. Reasoning that courts were ill-equipped to review business decisions, the New York Court of Appeals found the business}
of independent committees to control derivative litigation had emerged as a "clear trend in corporate law."  

Ironically, this smooth pattern of business judgment dismissals was ruptured by a series of cases which arose from an identical set of facts. William Maldonado, a stockholder in the Zapata Corporation, filed actions against the directors in both state and federal court challenging the modification of a stock option plan that allegedly raised the corporation's income tax liability. In *Maldonado v. Flynn* (Maldonado I), the United States District Court for the Southern District of New York granted a business judgment dismissal of an action based on the federal securities laws. In sharp contrast, the Delaware Chancery Court, in *Maldonado v. Flynn* (Maldonado II), held that the business judgment rule was inapplicable to the committee's decision to terminate a claim alleging breach of fiduciary duty. The vice chancellor concluded that once demand had been refused, shareholders had an individual right to maintain a proper cause of action without corporate interference. Reasoning that "courts and not litigants should decide the merits of litigation," the chancery court rejected the notion that litigation committees had independent power to terminate derivative suits.

judgment rule applicable. The court additionally declared that it was the essence of the directors' responsibility to determine whether such a suit served the company's best interests. *Id.* at 630-31, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926-27. Although the two-step *Burks* test was inapplicable in *Auerbach* because it was a state court decision, *Auerbach* became persuasive for its interpretation of New York law.


116. *Id.* (dismissing a claim based on § 14(a) of the Securities and Exchange Act of 1934). Previous federal decisions had found no inconsistency between state law and other federal securities provisions. See *Lewis v. Anderson*, 615 F.2d 778, 783 (9th Cir. 1979) (§§ 10(b), 10(b)-5, 13(a), and 14(a) of the 1934 Act), *cert. denied*, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724, 731 (8th Cir. 1979) (§§ 13(a) and 14(a) of the 1934 Act), *cert. denied*, 444 U.S. 1017 (1980).


118. *Id.* at 1257.

119. *Id.* at 1262.

120. *Id.* at 1263.

121. *Id.* at 1257. The vice chancellor acknowledged the longstanding application of the business judgment rule as a defensive mechanism, but he disagreed with the federal decisions that had allowed its use in an affirmative manner. *Id.* at 1256-57; see also *supra* note 87. The court reasoned that although the rule might protect committee members from liability for refusing to sue, the plaintiff was challenging the alleged misconduct and not the committee's decision. 413 A.2d at 1259.
Although Maldonado II destroyed the "clear trend" and found acceptance in other jurisdictions, the triumph of shareholders and their counsel was short-lived. In Zapata Corp. v. Maldonado, the Delaware Supreme Court reversed the chancery court decision. The supreme court stated that shareholders did not have an individual right to maintain suit once demand was refused. The Zapata court established a new procedure, however, based on a threshold determination of whether demand was required or whether it was excused for futility. In the former situation the business judgment rule applied, requiring deference to the committee's decision unless that decision was wrongful. When demand was excused, however, the committee only had limited power to terminate litigation. First, the defendant-directors had to prove the independence, good faith, and reasonableness of the committee and its conclusions. Second, if the defendants successfully carried this burden of proof, the court could, in its discretion, apply its own independent business judgment of the corporate interest in continued litigation.

The Zapata decision created a split among courts at both the state and federal levels regarding the extent of judicial deference to special litigation committees. Although a majority of courts had favored the Gall-Auerbach line of cases, following a strict business judgment rule approach, the Zapata court's use of a hybrid test established a powerful minority position. It

123. 430 A.2d 779 (Del. 1981).
124. Id. at 782. The court, however, agreed with the vice chancellor's characterization of the business judgment rule as primarily defensive in nature. Id.
125. Id. at 784-85.
126. Id. at 784 n.10.
127. The Delaware Supreme Court reasoned that because a business judgment dismissal does not reach the merits of the claim, judicial review should be more strict when demand was excused as futile. Id. at 788-89.
128. Id. at 788. The court analogized this approach to the intrinsic fairness standard in interested director transactions. Id. at 788 n.17; see also supra text accompanying note 38.
129. 430 A.2d at 789. In making this judgment, the chancery court could also "give special consideration to matters of law and public policy." Id. As unique as "judicial business judgment" might seem, Delaware case law recognizes this concept as related to judicial approval of the proposed settlement of alleged self-dealing transactions. Neponsit Inv. Co. v. Abramson, 405 A.2d 97, 100 (Del. 1979) (quoting Rome v. Archer, 197 A.2d 49, 53-54 (Del. 1964)).
130. Cf. Stegemoeller, supra note 14, at 346 (Zapata may dictate the future of derivative litigation since over 40% of this nation's businesses are incorporated in Delaware). Courts interpreting Delaware law with regard to litigation committees are now required to follow Zapata.
remained to be seen which course other jurisdictions would take.\textsuperscript{131}

\textit{Joy v. North}\textsuperscript{132} resulted from a series of loans made by Citytrust, a national bank\textsuperscript{133} incorporated in Connecticut, to the Katz Corporation ("Katz"), a developer. These primarily unsecured loans were used to finance the construction of an office building in Norwalk, Connecticut.\textsuperscript{134} Citytrust extended the first loan to Katz in 1971. By the time the last loan was made in 1976, the bank had suffered a substantial loss, the magnitude of which has remained in dispute.\textsuperscript{135}

In 1977, after making an unsuccessful demand on the directors of Citytrust, the plaintiff filed a derivative suit in the United States District Court for the District of Connecticut.\textsuperscript{136} The complaint, which alleged breach of fiduciary duty and violation of the National Bank Act,\textsuperscript{137} named as defendants thirty directors and officers of Citytrust and its parent company, Connecticut Financial Services Corporation.\textsuperscript{138} Shortly after the \textit{Burks} decision in 1979, the directors appointed a special litigation committee, and after nine months of investigation, the committee reached a result.\textsuperscript{139} The two-person committee concluded that it was in the bank's best interests to seek dismissal.

\textsuperscript{133}692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983).
\textsuperscript{134}Citytrust was a federal bank during the period in which the loans were extended, but it became a state bank in 1977. \textit{Id.} at 882 n.1.
\textsuperscript{135}Id. at 895. The litigation committee's report estimated a loss of $5.1 million. \textit{Id.} The majority construed the district court record as indicating that since the issuance of the report, Citytrust had regained title to the building, thereby greatly increasing the size of the loss. \textit{Id.} The defendants, however, protested that Citytrust did not own the building again, and that in fact the company recovered almost $3 million when the building was sold to a third party. Petition of 19 Individual Appellees for Rehearing with Suggestion for Rehearing En Banc at 12, \textit{Joy v. North}, 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983) [hereinafter cited as Rehearing Petition].
\textsuperscript{137}12 U.S.C. § 84 (1976). The National Bank Act limits the aggregate loans a bank can make to a single person or entity to 10% of the bank's combined shareholder equity and capital. \textit{Id.}
\textsuperscript{138}692 F.2d at 882. Connecticut Financial Services Corporation is now known as Citytrust Bancorp, Inc. ("Bancorp"). \textit{Joy}, 519 F. Supp. at 1314.
\textsuperscript{139}692 F.2d at 883-84. The committee consisted of two nondefendant directors elected after all of the alleged acts of mismanagement had occurred. \textit{Id.} Originally, another director was named to the committee but resigned midway through the investigation. \textit{Id.} at 833 n.2. The committee retained independent counsel as well. \textit{Id.} at 884.
of the suit against twenty-three outside directors, and either to continue litigation or settle out of court vis-a-vis seven inside directors. Applying the Burks test, the district court granted a business judgment dismissal of the action against the outside directors.

In an opinion authored by Judge Ralph K. Winter, a divided United States Court of Appeals for the Second Circuit reversed the district court decision. The majority held that Connecticut would adopt a variation of the Delaware Supreme Court's Zapata formulation. Lower courts were to apply the business judgment rule in the demand-required context, but in demand-excused cases they were to exercise their own independent business judgment. The majority opinion went considerably beyond Zapata, however, by requiring, rather than permitting, a business assessment of the corporation's best interests. More significantly, the Second Circuit provided the lower courts with detailed instructions on how to apply their judicial business judgment.

While conceding that courts would encounter difficulties in reviewing committee decisions, the Joy majority reasoned that judges were not wholly inexperienced in this area. Many courts had ruled on the intrinsic fairness of interested director transactions, and it certainly was within a judge's expertise to predict potential liability. The majority also noted that review of the committee's recommendation would not involve the risk of "deceptive hindsight" inherent in most business decisions. Perhaps most importantly, the court stated that limiting judicial scrutiny to the committee's good faith, independence, and thoroughness under the business judgment rule

140. Three of the 23 "outside directors" were either officers, inside directors, or both. Nevertheless, the Joy opinion refers to all 23 as outside directors. Id. at 884. Accordingly, this Note refers to them as outside directors.
141. Id.
142. See supra text accompanying notes 108-10.
143. Joy, 519 F. Supp. at 1312. The district court interpreted the law of Connecticut, the state of incorporation of both Bancorp and Citytrust, as supporting extension of the business judgment rule to decisions to terminate litigation. Id. at 1318-22. Although no Connecticut court had addressed this specific issue, the district court reasoned that the weight of authority from other jurisdictions favored such a construction. Id. at 1318-19. The district court found no conflict with the policies underlying the National Bank Act, especially since Citytrust was no longer a federal bank. Id. at 1322-25. Finally, the lower court expressly disagreed with the Zapata case on the grounds that courts should refrain from second-guessing business decisions. Id. at 1328 n.9.
144. 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983).
145. Id. at 891. Judge Cardamone wrote a vigorous dissenting opinion. Id. at 897-900.
146. Id. at 891.
147. Id. at 897-98 (Cardamone, J., dissenting). Compare Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981) ("The Court may proceed, in its discretion, to the next step.") with Joy, 692 F.2d at 891 ("independent committee . . . may obtain a dismissal only if the trial court finds . . . that in the court's independent business judgment . . . the action should be dismissed").
148. 692 F.2d at 888.
149. Id. at 888-89.
150. Id. at 888.
would eliminate the derivative suit as the only method of enforcing fiduciary duties.\(^{151}\)

On the other hand, acknowledging that the incentives underlying derivative suits encouraged some harmful litigation,\(^{152}\) the *Joy* court rejected the plaintiff's assertion that courts should completely ignore the litigation committee's findings.\(^{153}\) Consequently, although the committee's decision should not be considered presumptively correct, it served a valid purpose as an aid to the court in determining the corporation's best interests.\(^{154}\) Applying step one of the Supreme Court's test announced in *Burks v. Lasker*, the Second Circuit concluded that Connecticut, Citytrust's state of incorporation, would adopt a rule similar to Delaware's *Zapata* test.\(^{155}\) Therefore, in demand-required cases, the committee's decision would be upheld under the business judgment rule absent a showing of self-interest or bad faith.\(^{156}\) When demand was excused, however, a litigation committee could obtain dismissal only after the court had examined the committee's good faith, independence, and thoroughness, and had rendered its own business judgment of the corporation's best interests.\(^{157}\)

Nevertheless, the *Joy* court established some important limitations on its holding. Judicial business judgment would apply only to "cases involving allegations of direct economic injury to the corporation diminishing the value of the shareholders' investment as a consequence of fraud, mismanagement, or self-dealing."\(^{158}\) Because the majority's intent was to protect shareholder investments, its holding excluded claims challenging acts allegedly illegal under foreign or domestic law, ultra vires transactions, and actions seeking non-monetary recovery.\(^{159}\) The court specifically left open the question of what standard applied in these cases.\(^{160}\)

The Second Circuit formulated extensive guidelines to assist the lower courts in determining whether litigation served the corporation's best interests. Initially, the majority held that in a demand-excused context, the defendant-directors had to prove that the suit was "more likely than not" against the
best interests of the company.\textsuperscript{161} For the defendants to sustain this burden, a court had to find that "the likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action."\textsuperscript{162} The majority emphasized that a court's function was essentially to render a cost-benefit analysis of the derivative suit, similar to an attorney's determination of what a case was "worth" in terms of its settlement value.\textsuperscript{163}

The \textit{Joy} majority noted two exceptions to its general rule that only the direct costs and benefits of litigation were to be included in the lower court's calculation.\textsuperscript{164} First, if the cost-benefit analysis indicated a low net recovery in relation to shareholder equity, a court could consider the suit's adverse effect on management productivity.\textsuperscript{165} Second, when net recovery would be low and business prosperity depended on a positive public image, a court could consider potential lost profits due to unfavorable trial publicity.\textsuperscript{166}

Finally, treating the case as a demand-excused situation,\textsuperscript{167} the \textit{Joy} court applied its own business judgment to the facts. The majority stated that there was a strong possibility that liability would attach to at least some of the thirty defendants.\textsuperscript{168} The Katz loans had become increasingly risky, until ultimately the bank faced a "classic 'no-win' situation,"\textsuperscript{169} in which profits would at best be low while losses were potentially great. The court disputed the committee's prediction that there was "no reasonable possibility"

161. Id. at 892. The majority reasoned that the burden of proof traditionally rested with the party moving for summary judgment. Id.; see also supra note 84. A court was to base its judgment on data produced during discovery, information compiled during the committee's investigation, and on the committee's reasoning. The evidence would be weighed according to traditional evidentiary standards, e.g., whether the testimony was taken under oath and subject to cross-examination. 692 F.2d at 892.

162. 692 F.2d at 892. The majority emphasized that the court's role was to predict the future benefit of the suit to the corporation and not merely to determine the law and apply it to the facts. Id.

163. Id. The cost of litigation encompassed attorneys' fees and expenses related to the suit, plus the hours devoted by corporate personnel to the litigation. The cost of mandatory indemnification of directors also could be included, yet it was qualified by the probability of finding liability. Discretionary indemnification and insurance coverage, however, were excluded from the cost equation. Id.

164. Id. The court acknowledged the impact of less tangible factors such as damage to corporate morale and image but reasoned that these elements were too elusive to calculate and were generally proportional to the degree of wrongdoing. Id.

165. Id. at 893.

166. Id. The court explained that the potential harm to the company in this context did not necessarily reflect the gravity of the wrongdoing. For the court to consider lost profits due to bad publicity, however, the defendants had to prove the certainty of such damage by reference to empirical evidence. Id.

167. Id. at 891. Although demand had been made and refused, the Second Circuit considered the case as the functional equivalent of a demand-excused situation because demand "was not required as a condition of bringing the action." Id. at 888 & n.7.

168. Id. at 896.

169. Id. (comparing this situation to the one presented in Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940)).
of finding any of the twenty-three outside directors liable, and it questioned the committee's assertion that there was no evidence of intentional misconduct. The Second Circuit concluded that the committee's recommendation that the shareholder's derivative suit be terminated was invalid because the district court might find liability resulting in a return far outweighing the cost of litigation.

**Analysis of the Opinion**

The rationale underlying *Joy v. North* clearly is based on a skeptical view of special litigation committees. The limitations placed on the power of

170. *Id.* The court noted that the committee's basis for recommending dismissal, that the outside directors were ignorant of the Katz situation, was flawed on two counts. First, the inside directors might later deny that assessment. Second, a failure to keep informed might itself be a breach of fiduciary duty for lack of due care. *Id.* The court also dismissed the committee's conclusion that there was merely a "possibility" that the inside directors would be held liable. Not only was this prediction a significant understatement, but it was inconsistent with the outside directors' best defense—that management concealed the problem from them. *Id.*

171. *Id.* at 896-97. The court raised doubts about the conduct of defendant North, Citytrust's chief executive officer and dominant figure on the board. *Id.* Although North had abstained from voting on the Katz loans because his son was employed by the Katz Corporation from 1971 to 1976, the committee report indicated that North had played a central role in the transactions. He also had destroyed his own records. *Id.* at 894. Finally, the court implied that liability might ensue from North's failure to make the board aware of the problems with the Katz loans. *Id.* at 896-97.

172. *Id.* at 897. The court suggested that a finding of liability might result in a net return of several million dollars, or over 10% of the shareholder equity, to the corporation. *Id.*; see *supra* note 137 (National Bank Act). This prediction differed significantly from the committee's maximum estimate of $376,000 plus interest. 692 F.2d at 896. Consequently, without reaching the federal law issue, the majority reversed the order of summary judgment and remanded the case to the district court. *Id.* at 897.

The Second Circuit also reversed the district court order placing the litigation committee report under protective seal. *Id.* First, the court of appeals held that only compelling circumstances justified keeping the report under seal during the pendency of a motion for summary judgment. *Id.* at 893. The public nature of a trial and the interest in maintaining public confidence in the banking and judicial systems demanded such a high standard. *Id.* Second, the majority opinion stated that once a court granted summary judgment, a litigation committee was obligated to divulge not only the contents of its report, but the underlying data as well. *Id.* Furthermore, any material arguably qualifying under the attorney-client privilege or work-product doctrine lost that protection upon its submission to the court in support of a motion for summary judgment. *Id.* at 893-94. Therefore, the court stated, the defendants' conclusory statements in support of the protective order were insufficient. *Id.* at 894. In his dissenting opinion, Judge Cardamone concurred with the majority on the protective seal issue. *Id.* at 897 n.1 (Cardamone, J., dissenting).

173. 692 F.2d at 900 (Cardamone, J., dissenting). The majority stated that the litigation committee did not solve the conflict of interest problem inherent in suits against directors because the defendants effectively chose who would judge them. *Id.* at 888. The court also remarked:

It is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism. Indeed, 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.
these committees to terminate litigation reflect the majority's lack of confidence in the ability of such committees to make an unbiased assessment of the corporation's best interests. What the court's position demonstrates, however, is a misunderstanding of the nature of litigation committees and their function under the business judgment rule. It also ignores their strong record of performance and beneficial role in corporate law. Moreover, the *Joy* majority fails to keep the derivative suit in perspective as only one of many constraints on corporate management. Finally, perhaps the most critical weakness of *Joy v. North* is that it violates certain well-established legal principles.

The *Joy* court's skeptical view of litigation committees ignores the fact that committee members have both a knowledge of the corporation's business and a fiduciary obligation to serve the stockholders. In general, these outside directors are people of integrity who are not easily dominated. Moreover, their positions are not so financially rewarding that they would be inclined to breach their fiduciary duty by refusing to pursue any and all litigation against fellow board members. For example, the committee in *Joy* voted to continue suit or seek settlement with respect to seven inside directors.

Admittedly, courts can be more objective than litigation committees in evaluating derivative suits. This, however, is an "inescapable, given aspect of the corporation's predicament" which does not justify substituting the

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175. Block and Prussin, supra note 65, at 67; Duesenberg, supra note 48, at 339-40.

176. See, e.g., Block and Prussin, supra note 65, at 57 ("the role of outside directors is not so rich in perquisites and emoluments as to necessarily tempt such directors to throw their responsibilities overboard in order to preserve their positions").

177. 519 F. Supp. at 1315. The Second Circuit dismissed this fact as inconsequential for three reasons. First, most of the seven inside directors were no longer involved with Citytrust. Second, the committee was to reconsider maintaining suit if settlement was not possible. Third, the committee might have feared that a decision to dismiss against the seven inside directors would have destroyed its credibility. 692 F.2d at 888 n.8. In contrast, the district court considered the committee's decision to seek only partial dismissal as further evidence of its good faith. 519 F. Supp. at 1327. Three commentators have noted that the willingness of litigation committees to seek alternatives to dismissal is evidence of the legitimacy of these committees. The cases they cite in support of this statement are *Joy* and *Abramowitz v. Posner*, 672 F.2d 1025 (2d Cir. 1982), the latter of which resulted in a $1 million settlement. Block, Prussin & Wachtel, Dismissal of Derivative Actions Under the Business Judgment Rule: Zapata One Year Later, 39 Bus. Law. 401, 407 n.37 (1983).

judgment of a court for that of an informed committee of disinterested directors. Nor does it justify a costly trial on the merits to ascertain whether a claim has any validity. Litigation committees are perfectly capable of both weeding out harmful suits and presenting management with the unpleasant resolution to pursue litigation. More importantly, a sham committee would be a costly charade that would not survive the test of good faith, independence, and thoroughness required for a business judgment dismissal. Joy v. North reflects a cynical view of human nature that has been rejected by many courts and is inconsistent with reality.

The Joy majority's skepticism also ignores the brief history of litigation committees, which has demonstrated their diligence and integrity. Apart from conclusory allegations of structural bias, there has been almost no

179. Id. at 1328 n.9; Block & Prussin, supra note 65, at 30.
180. Duesenberg, supra note 48, at 340; see also Block, Prussin & Wachtel, supra note 177, at 414-15 (the litigation committee is a legitimate tool to deal with the problem of director self-interest). But see Joy, 692 F.2d at 888 (conflict of interest problem "hardly eliminated" by committee).
181. Joy, 692 F.2d at 899 (Cardamone, J., dissenting). The Joy dissent also challenged the majority with failing to answer how a court could determine that a special litigation committee's decision survives the first step of the Zapata test, thereby qualifying as a reasonable, independent, and good faith decision, yet fails the second step when the court's business judgment differs from the committee's. Id. at 898; see also Block & Prussin, supra note 65, at 61 n.147 (Zapata makes it unclear why passing the first step is not enough to protect shareholders).

Language in some cases indicates that the reasonableness of the litigation committee's decision can be reviewed. See Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978) (court may consider reasonableness of decision); Gall v. Exxon Corp., 418 F. Supp. 508, 516 (S.D.N.Y. 1976) (committee's judgment may not be "grossly unsound"). Although this Note recommends that "reasonableness" be added as an additional safeguard to the test for a business judgment dismissal, it is not clear that this criterion is even necessary. A clearly unreasonable decision not to sue would be evidence of the committee's bad faith. See Hinsey & Dreizen, Delaware Court Addresses Business Judgment Rule, Legal Times of Wash., June 8, 1981, at 19, col. 1 (querying whether Zapata's judicial business judgment really means a "reasonableness" test).

182. See Burks v. Lasker, 441 U.S. 471, 485 n.15 (1979) (lack of impartiality cannot be presumed as a matter of law); Joy, 519 F. Supp. at 1321-22 (structural bias alone is insufficient to nullify a committee decision); Maldonado v. Flynn, 485 F. Supp. 274, 282 (S.D.N.Y. 1980) (impeaching a committee's good faith merely due to its appointment by alleged wrongdoers is a cynical attitude), modified, 671 F.2d 729 (2d Cir. 1982); cf. Auerbach v. Bennett, 47 N.Y.2d 619, 633, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979) (committee's hesitancy to prosecute fellow directors is inherent in the board's predicament).

183. Estes, supra note 174, at 52, 56. Management has carefully followed the criteria established by the courts for committee independence. For instance, these outside directors are usually elected by the board after the alleged misconduct; they are generally well-respected individuals; they are advised by outside counsel; and their investigations have been painstakingly thorough. Id.; see also Payson, Goldman & Inskip, After Maldonado—The Role of the Special Litigation Committee in the Investigation and Dismissal of Derivative Suits, 37 Bus. Law. 1199 (1982) (discussing proper methods of choosing committee directors, following investigatory procedures, retaining special counsel, and performing a thorough investigation).

184. See supra text accompanying notes 88-91; see also Joy, 519 F. Supp. at 1327 (noting the plaintiff's "vigoroust and imaginative hypothesizing" in an attempt to impeach the committee's credibility) (quoting Auerbach v. Bennett, 47 N.Y.2d 619, 632, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927 (1979)).
evidence to the contrary. In those cases in which the independence of the committee has been impeached, courts simply have refused to grant a business judgment dismissal. Litigation committees also serve the salutary purpose of utilizing internal measures to correct corporate problems—the same purpose underlying the demand requirement. Furthermore, it is inconsistent to encourage corporations to bring in outside directors as “watchdogs” of management and then deny them the authority to perform this function on litigation committees. Widely accepted as useful tools for disposing of harmful derivative suits, special litigation committees are a natural development in the trend toward independent board committees.

In addition, the majority opinion incorrectly assumes that derivative suits are the “sole enforcement method” of fiduciary duties. Dissatisfied shareholders also have recourse to individual and pure class action suits, neither of which is contingent on board approval. Moreover, corporate transactions are subject to numerous state and federal regulations, the violation of which is readily exposed by a vigorous national press. And where the law ends, the market imposes its own controls on corporate directors. Perhaps the most effective weapon against mismanagement is the shareholders’ power to sell their stock. Directors have a compelling


186. See supra text accompanying notes 53-56.
187. See Burks v. Lasker, 441 U.S. 471, 485 (1979) (noting the inconsistency of relying on “watchdogs” to protect shareholder interests, then “muzzling” them when they perform this role); Block & Prussin, supra note 65, at 67 (the presumption that committee directors are not independent conflicts with the rationale for outside directors).
189. See Coffee & Schwartz, supra note 14, at 321 (the power to terminate litigation encourages trend toward independent board committees); Duesenberg, supra note 48, at 337 (litigation committees are consistent with the trend toward independent board committees). In addition, the Supreme Court implicitly recognized the legitimacy of litigation committees in Burks v. Lasker, 441 U.S. 471 (1979). In that case, the Court noted that Congress’s intent was to entrust independent directors with the responsibility to act as a check on management rather than resort to judicial supervision. Id. at 483-85. Also, the Burks case dealt with mutual fund directors, who are generally held to a higher standard of care than the directors of other corporations. Note, Termination of Section 36(b) Actions by Mutual Fund Directors: Are the Watchdogs Still the Shareholders’ Best Friends?, 50 FORDHAM L. REV. 720, 726-28 (1982). If the Supreme Court accepted the litigation committee in this context, then arguably the Court does not share the skeptical view held by the Joy majority.
190. 692 F.2d at 889; see supra text accompanying note 151.
191. See Joy, 519 F. Supp. at 1321 (shareholder may also bring direct action to enforce his rights).
192. See, e.g., Duesenberg, supra note 48, at 334 (almost every major corporate decision involves examination of wide-ranging regulations).
193. See, e.g., Business Roundtable, supra note 5, at 2091 (an “adversary-minded” press quick to publicize violations of the law is an effective deterrent to corporate corruption).
194. Wolfson, supra note 31, at 993-94.
interest in performing honestly and competently; job security and career advancement are powerful incentives. Furthermore, adherence to ethical principles is sound business policy in an economic system based on mutual trust and confidence. The *Joy* decision is an example of a failure of the legal system to understand the institution it governs.

Perhaps the most serious criticism of *Joy v. North* is that it breaches important principles of law. First, a federal court of appeals should not reverse a district court decision interpreting the law of the state in which it sits unless that decision appears to be clearly erroneous. The majority opinion constitutes judicial second-guessing of the district court’s interpretation of Connecticut law on a highly controversial issue. Second, by placing the burden of proof on the litigation committee in demand-excused cases, *Joy v. North* undermines the business judgment rule’s presumption of good faith and correctness surrounding the decisions of directors. When the Second Circuit, in *Lasker v. Burks*, presumed that directors could never be impartial in deciding whether to sue fellow board members, the Supreme Court later rejected that view. Furthermore, the majority freely substitutes its judgment for that of the committee on several matters. Most importantly, however,

195. Manne, *Controlling the Giant Corporation: Myths and Realities*, in *Corporate Governance: Past and Future* 134-38 (H. Manne ed. 1982). Waste of corporate assets through directorial misconduct causes stockholders to sell their shares, which drives down their market price. The corporation is then vulnerable to a takeover that could result in new management. Id. at 134-35. Directors who wish to advance in the corporation, or obtain better employment elsewhere, damage their own chances of success by raiding corporate assets or spending them recklessly. Wolfson, *supra* note 31, at 971-72. The directors also face reelection by the shareholders periodically, providing further incentive for them to perform honestly and competently. See, e.g., *Model Bus. Corp. Act* § 36 (1979).


197. Lomartira v. American Auto Ins. Co., 371 F.2d 550, 554 (2d Cir. 1967); see also Butner v. United States, 440 U.S. 48, 58 (1978) (federal district judges are more familiar with state law in their district and are better able to determine how a state court would decide the issue); *Joy*, 692 F.2d at 900 (Cardamone, J., dissenting) (federal appellate judges should accord substantial deference to district court interpretations of the state law in their district); Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979) (same), *cert. denied*, 449 U.S. 869 (1980).

198. Moreover, neither the district court nor the parties to the action had an opportunity to consider the relevancy of the Connecticut indemnification statute, Conn. Gen. Stat. Ann. § 33-320a(b) (West Supp. 1983), which was discussed in the majority opinion. Rehearing Petition, *supra* note 135, at 7; see *supra* note 152.

199. See *supra* text accompanying notes 32-36; see also Panter v. Marshall Field, 646 F.2d 271, 294 (7th Cir.) (the presumption of good faith is heightened when a majority of the board are outside directors), *cert. denied*, 454 U.S. 1092 (1981); Block & Prussin, *supra* note 65, at 57 (outside directors should be accorded a presumption of good faith).

200. Burks v. Lasker, 441 U.S. 471, 485 n.15 (1979); see also *Joy*, 692 F.2d at 900 (Cardamone, J., dissenting) (recalling the Supreme Court’s holding in *Burks*).

201. For example, the majority expressly contradicted the committee’s conclusion that there was no evidence of impropriety in the transactions. 692 F.2d at 896. Whether the continued employment of one’s son creates an incentive to extend millions of dollars in loans to the son’s employer is highly questionable. The *Joy* court also completely disregarded an expert opinion submitted to the committee stating that the costs of litigation would offset any poten-
it is judicially imprudent for courts to arrogate power over questions of corporate management. Ordering judges, and perhaps juries, to make business decisions is simply bad law.

THE EFFECT OF JOY

Courts required to follow Joy v. North with respect to Connecticut corporations will face a difficult, complicated task. The Zapata test was sufficiently complex in itself, but the Joy formulation extends far beyond Zapata by creating a series of elaborate mini-trials based on collateral issues. First, the demand-required/demand-excused dichotomy which the Second Circuit borrowed from Zapata presents a crucial threshold issue that ultimately will undermine the demand requirement. Second, the Joy court’s guidelines for reviewing the litigation committee’s decision are excessively cumbersome and expose the inherent weakness of the judicial business judgment concept.

Moreover, Connecticut corporations will not welcome Joy v. North. They will find it more difficult to dismiss harmful derivative suits, and, as a result, they can anticipate increased derivative litigation. To the detriment of the shareholders who ultimately finance this litigation, special litigation committees will become a thing of the past in Connecticut. Finally, the Joy decision comes at a time when a “land weary of overregulation” can ill afford further controls on business activity.

The majority’s adoption of the Zapata dichotomy between demand-required and demand-excused cases promises to confuse both courts and litigants and lead to inconsistent results. Although demand on directors originated as a

tial recovery. Id. at 895 n.12. The court of appeals reasoned that this opinion was “not substantiated by verifiable historical evidence or other factual material.” Id. Finally, the Second Circuit flatly rejected the committee’s conclusions. Id. at 896-97. In contrast, the district court found the thoroughness of the committee’s investigation to be “self-evident,” and it considered the committee’s recommendation to continue or settle with respect to the inside directors to be strong evidence of good faith. 519 F. Supp. at 1327; see also supra note 135 (court of appeals is apparently mistaken that Citytrust regained ownership of a building, a fact that greatly affected potential loss).

202. Most businessmen and not a few lawyers consider it not only imprudent but arrogant for the legal profession to establish rigid rules governing corporations. See, e.g., Lewin, supra note 1, at D6, col. 4-6 (discussing corporate backlash to the American Law Institute’s proposed rules on corporate governance). They protest that the proponents of such rules know little about the realities of business yet accept the fact that government regulation is good for the public. See Russo and Wolfson, supra note 2, at F16, col. 4; see also Coffee, Corporate Misconduct, supra note 2, at 1239 (a court’s substitution of its judgment for that of a corporation on whether to proceed with a lawsuit is “inappropriate”).

203. See Ross v. Bernhard, 396 U.S. 531, 532-33 (1970) (shareholders have the right to a jury trial pertaining to “those issues in derivative actions as to which the corporation . . . would have been entitled to a jury”).

204. Block & Prussin, supra note 65, at 63. “The very concept that courts have independent business judgment is, in fact, a contradiction of over 250 years of legal development.” Id. 205. See id. at 62.


207. Id. at 898 (Cardamone, J., dissenting).
routine procedural requirement, its legal significance has long been the subject of considerable confusion and uncertainty. The demand-required/demand-excused dichotomy exacerbates this problem by greatly enhancing the importance of the demand issue. It is likely that a court's classification of a case as "demand-required" or "demand-excused" will dictate its response to the defendants' motion to dismiss, depending on the applicability of the business judgment rule. Consequently, cases will be decided on the basis of a judge's speculation as to whether demand was, or would have been, a futile gesture. Demand has thus evolved into an esoteric substantive issue that will require close examination before a court can begin scrutiny of the litigation committee. Moreover, the demand-required/demand-excused dichotomy is bound to appear arbitrary as interpretations of demand, and rulings on motions to dismiss, vary by jurisdiction.

The most serious drawback of the demand dichotomy which inherited from Zapata is that it discourages shareholders from making a demand on the directors. To avoid the demand-required situation in which the business judgment rule applies, the plaintiff will attempt to establish a demand-excused situation. Strategically, the plaintiff will prefer to allege futility in the com-

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208. See supra note 51.
209. See, e.g., Block, Prussin & Wachtel, supra note 177, at 413-14 (demand is a complex and highly uncertain procedure). State laws differ on the definition of when demand is excused for futility, and judicial interpretations of the demand requirement in Federal Rule of Civil Procedure 23.1 vary among the circuits. For instance, federal decisions are inconsistent on the issue of what the plaintiff must allege in the complaint to show that a board majority was dominated by the accused wrongdoer and, therefore, not sufficiently disinterested to require demand. Another point of controversy between the courts is whether directors who merely authorized or acquiesced in a transaction are considered interested for purposes of demand. Id. at 410-11.
210. Id. at 410.
211. Id. at 414 n.66 (this dichotomy gives "dispositive significance" to the demand issue) (citing Coffee, The Problem of Corporate Remedies: The View from ALI Tentative Draft No.1, at 19, paper presented at Ray Garrett, Jr., Corporate and Securities Law Institute (1982)) [hereinafter cited as Coffee, Corporate Remedies].
212. See Block & Prussin, supra note 65, at 60 n.144 (the dichotomy is likely to generate confusion); Block, Prussin & Wachtel, supra note 177, at 410 (Zapata is a substantive test being applied to a procedural rule); Coffee, Corporate Remedies, supra note 211, at 19 (the dichotomy "asks the demand rule to bear more weight than it can realistically carry"). To further complicate matters, plaintiffs in some cases have urged the court to treat a board refusal to bring action as the functional equivalent of futility. See, e.g., Joy, 692 F.2d at 888 n.7 (demand made but not required to bring suit); Abramowitz v. Posner, 672 F.2d 1025, 1033 (2d Cir. 1982) (court refuses to treat refusal of demand as the equivalent of futility).
213. Block, Prussin & Wachtel, supra note 177, at 414. Three commentators also have suggested that varying interpretations of the demand requirement will encourage plaintiffs to "forum shop" in order to find jurisdictions in which demand is often excused. Id.; see also Note, Demand in Derivative Suits, supra note 73, at 747 (requirement of demand varies according to court's view of derivative suits).
214. Block, Prussin & Wachtel, supra note 177, at 413.
215. Id.
plaint rather than try to persuade the court that the board’s refusal was wrongful. He may even fear that the very act of making demand will appear to the court as a concession that the directors’ judgment was not sufficiently impaired to excuse demand. Accordingly, the plaintiff might consider it advantageous to sue the entire board and claim futility. As a result, the demand-required/demand-excused dichotomy adopted in Joy will defeat the demand rule’s basic purpose: deference to the directors’ discretion by requiring the plaintiff to exhaust his intracorporate remedies.

In the demand-excused context, the Zapata test merely permits the courts to render a business judgment of whether certain litigation serves the corporation’s best interests. Joy makes this discretionary step mandatory, however, and attempts to reduce this decision to a mathematical formula. Courts following Joy v. North will find the majority’s guidelines complicated, cumbersome, and “subject to judicial caprice.” Weighing the costs of litigation against the probable amount of recovery, less the likelihood of finding liability, engages courts in a comparison of disparate quantities based on almost pure speculation. To evaluate the many variables in the committee’s decision, judges will be required to have a knowledge of public and employee relations, advertising, and corporate finance. Courts simply are

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216. Id. Arguably, plaintiffs can be far more creative in alleging futility in the complaint than in attempting to prove wrongful refusal on the basis of evidence presented to the court. Id.

217. Id. This prediction especially applies to jurisdictions in which the standards for futility and wrongful refusal are the same. Id.; see also supra note 62.

218. Brief for Defendants-Appellees Citytrust & Citytrust Bancorp, Inc., at 20 n.61, Joy v. North, 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983); see also Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981) (incapacitating board by suing all its members gives too much power to minority shareholders) (quoting Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980)); Block & Prussin, supra note 65, at 67 (plaintiffs usually sue the entire board); Coffee & Schwartz, supra note 14, at 279 (strong incentive for manufactured pleadings if plaintiff can incapacitate board by making all directors defendants). Although demand will not ordinarily be excused merely because the plaintiff has named most or all of the directors as defendants, see In re Kauffman Mut. Fund ‘Actions, 479 F.2d 257, 264 (1st Cir.), cert. denied, 414 U.S. 857 (1973); Weiss v. Temporary Inv. Fund, Inc., 516 F. Supp. 665, 672-73 (D. Del. 1981), a court will then become embroiled in a determination of which directors were improperly joined.

219. See supra text accompanying note 51.


221. See supra note 147 and accompanying text.


223. See id. at 892; supra text accompanying note 158. Courts will have to perform a veritable juggling act to calculate items such as attorneys’ fees, litigation-related expenses, personnel hours spent on the litigation, and mandatory indemnification—minus insurance. It is also questionable whether courts will be able to quantify “distraction of key personnel” and lost profits due to bad publicity in cases when there will be a low net return relative to shareholder equity. 692 F.2d at 898 (Cardamone, J., dissenting).

not competent to make business decisions, which are often based on unquantifiable subtleties and do not lend themselves to structured analysis. In short, the Joy opinion illustrates the futility of saddling courts with elaborate guidelines for making business decisions.

note 163. A judge may have to rule on summary judgment motions a number of times. Rehearing Petition, supra note 135, at 10. In Joy, the sale of the office building after the issuance of the committee report may have substantially lowered the potential amount of recovery, thereby changing the suit's potential value. Id.; see also supra note 135. The dissenting opinion also raised some important business considerations which the majority failed to address:

Should a court also take into account the potential adverse impact of continuing litigation upon the corporation's ability to finance its operation? Should future costs be discounted to present value, and, if so, at what rate? Must the income tax ramifications of expected future costs be considered, and, if so, how?

692 F.2d at 898 (Cardamone, J., dissenting). Moreover, the court's statement that review of the committee's decision would not involve the risk of "deceptive hindsight," id. at 888, ignores the fact that the committee's inquiry includes a retrospective analysis of the alleged wrongdoing to determine the merits of the claim. See supra text accompanying note 83. Therefore, it is considerably more difficult to review the litigation committee's decision than to determine the intrinsic fairness of an interested director transaction. See 692 F.2d at 888.


226. Cf. Joy, 692 F.2d at 886 ("entrepreneur's function is to encounter risks and confront uncertainty"); Note, Continuity Viability, supra note 4, at 568 (encouraging managerial initiative requires discretion to implement bold, even unorthodox, schemes).

227. Brodsky, Business Judgment Rule, N.Y.L.J., Dec. 15, 1982, at 2, col. 5. In addition, Joy v. North created its own mini-trial on the issue of whether the alleged wrongdoing resulted in direct economic injury to the corporation. To be sure, the court's holding wisely excluded claims which, if left unredressed, pose no threat to shareholder equity. 692 F.2d at 891. Shareholders are not "guardians of the public," Ashwander v. Tennessee Valley Auth., 297 U.S. 288, 343 (1936) (Brandeis, J., concurring), and courts should not encourage expensive litigation when the motivations to bring suit are somewhat disingenuous. For example, when attorneys initiate litigation attacking corporate payments in foreign countries, any professed desire on their part to purify the business community is highly suspect. These transactions usually further the stockholders' pecuniary interests. Moreover, the costs of litigation, including substantial attorneys' fees, make the actual benefit to the corporation dubious at best. See Joy, 692 F.2d at 890 (recognizing that motives behind derivative litigation often lead to suits resulting in no net corporate benefit); Coffee & Schwartz, supra note 14, at 308 (questioning the practice of allowing "bounty hunters” to continue financially detrimental suit for the sole purpose of deterring corruption); 2 MODEL BUS. CORP. ACT ANN. § 49, ¶ 2, at 33 (1971) (in the derivative suit context, “lawyers . . . sometimes act out of self-interest”).

Nevertheless, the "direct economic injury" limitation presents another complex issue for the court. In demand-excused cases, it may have to be determined whether or not the plaintiff's complaint states a primarily economic cause of action, thereby avoiding the business judgment rule. For instance, corporate payments to foreign officials may be illegal under the Foreign Corrupt Practices Act of 1977. Pub. L. No. 95-213, tit. 1, 91 Stat. 1494 (amending various sections of the Securities Exchange Act of 1934, 15 U.S.C. § 78). A shareholder-plaintiff might argue, however, that he is not attacking the illegality of the payments, but rather that the transactions constituted a waste of corporate assets. Consequently, analysis of the claim will require the judge to draw fine distinctions based on sophisticated, and perhaps disputed, economic standards.
When the plaintiff is successful in creating a demand-excused situation, the *Joy* decision prevents quick disposition of harmful suits. Surviving a motion to dismiss, or one for summary judgment, is a low hurdle for plaintiffs to clear. Yet, requiring the defendants to prove the absence of a genuine issue of material fact on the question of whether litigation is "more likely than not" against the corporation's best interests will be difficult indeed.

In addition, the expansion of liability, especially that of outside directors, will militate against outright dismissal. With a greater chance to reach a decision on the merits, the plaintiff's prospects for success will improve. More importantly, although findings of ultimate liability may remain rare, mounting legal expenses will force out-of-court settlements regardless of the validity of the claim. Derivative suits will become even more attractive in an era of unprecedented court congestion.

Without the full benefit of the business judgment rule, boards of Connecticut corporations will have little incentive to establish litigation committees. In demand-required cases, the committee will only be therapeutically useful because a decision by the full board not to sue will be upheld unless wrongful. The litigation committee "plays its role," therefore, primarily in demand-excused cases. By placing the committee under judicial supervi-

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228. See *supra* text accompanying notes 180-83.
229. 692 F.2d at 892.
230. *See id.* at 890 (surviving motions to dismiss and those for summary judgment establishes little evidence of a claim's merit); Block & Prussin, *supra* note 65, at 30 (courts are notoriously reluctant to grant summary judgment).
231. *See, e.g.*, Note, *Safe Harbors and Stormy Seas: Trends and Counter trends in Outside Director Liability*, 47 *BROOKLYN L. REV.* 359, 364 (1981) (courts have become far more strict in applying the standard of due care to outside directors). An excellent example of this is *Joy*, in which the court refused to dismiss a suit against 23 outside directors because their ignorance of the wrongdoing may itself have been a breach of fiduciary duty. 692 F.2d at 896; *see supra* text accompanying note 218.
233. *See Dawson, supra* note 49, at 859 (settlement may represent submission to escape costs and disruption of litigation). One corporate commentator has illustrated this scenario dramatically:

The over-deposed, over-interrogated and over-discovered defendant, pursued by teams of lawyers, becomes victimized by the process, not by the effects of the allegedly wrongful conduct. Pragmatists as they are, managers reluctantly turn their attention to settlement, not to avoid adjudication of their alleged guilt, but to end the process and return their labors to the ongoing affairs of the entities they are charged to manage.

Duesenberg, *supra* note 48, at 333.
234. *See Olson, Delaware Court Addresses Business Judgment Rule, Legal Times of Wash.*, June, 1981, at 19, col. 2 (shifting the burden of proof away from a presumption of good faith will add to court congestion); *see also* Duesenberg, *supra* note 48, at 331 ("Few would disagree . . . that . . . contemporary America is an overly litigious society."); Wiedrich, *Frivolous Lawsuits Get Just Desserts, Chicago Tribune*, Mar. 8, 1983, § 2, at 1, col. 1 (America has become an increasingly litigious society).
235. *Joy*, 692 F.2d at 887; *see supra* text accompanying note 59.
236. *Joy*, 692 F.2d at 888.
sion in this context, Joy puts the board in a no-win situation. Demand will be excused more readily because derivative plaintiffs usually sue the entire board; under the Joy court's approach, directors may be deemed interested whether they participated in, acquiesced in, or merely failed to prevent the alleged wrongdoing. With an "interested" board unable to terminate litigation, the litigation committee becomes the last viable corporate organ that could dispose of harmful suits. The Zapata-Joy formulation, however, gives control over the derivative suit to the courts at the behest of minority shareholders and their attorneys. Reduced to an advisory capacity, special litigation committees will become a needless and expensive formality.

237. E.g., Block & Prussin, supra note 65, at 67 (most derivative suits challenge actions of the entire board in either participating, or failing to participate, in certain transactions).

238. See Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979) ("To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders."), cert. denied, 449 U.S. 869 (1980); see also Clark Enters., Inc. v. Holywell Corp., 559 F. Supp. 1307, 1310 (E.D. Va. 1983) ("Demand is almost always excused in derivative suits alleging that the directors have engaged in wilful or negligent breach of their fiduciary duties . . . [or] where the board of directors is subject to the control of the alleged wrongdoers."). But see Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983) (affirming dismissal of derivative action against entire board of directors on grounds that "mere approval and acquiescence [of the alleged wrongdoing] are insufficient to render demand futile"); Galef v. Alexander, 615 F.2d 51, 59-60 (2d Cir. 1980) (rejecting the contention that suing the entire board, without considering whether each director actually participated in the wrongdoing, rendered that board unable to decide whether to pursue the shareholder's claim for purposes of demand; nominal defendants are not "interested" for purposes of demand). The Joy court confirmed the fears of the Ninth Circuit in Lewis v. Anderson, however, by excusing demand even though defendant North dominated the board and the 23 outside directors were suspected of guilt for being "left in the dark." 692 F.2d at 896. The majority opinion seems to present a classic situation of "damned if you do and damned if you don't."

239. Joy, 692 F.2d at 887-88; see also Auerbach v. Bennett, 47 N.Y.2d 619, 633, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979) (investing authority to decide the merits of a shareholder's claim in persons not associated with the board would itself be a breach of fiduciary duty).

240. Cf. Hinsey, supra note 174, at 18, col. 1. Hinsey analogizes the special litigation committee situation to the "Massachusetts Rule," whereby if a disinterested corporate organ exists, it should decide whether certain litigation serves the corporate interest. Id. (citing Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951); S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E.2d 241 (1951)). He notes that "[a] disinterested internal organ of the corporation has the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure." Id. (quoting Pomerantz, 101 F. Supp. at 344). Although the Massachusetts Rule originally referred to a determination by the stockholders as to whether the corporation should pursue a derivative claim, the fact that often only a small percentage of shareholders vote on corporate issues renders this application of the rule somewhat impractical.

241. See Joy, 519 F. Supp. 1312, 1328 n.9 (D. Conn. 1981) ("neither shareholders nor the courts should be free to second-guess the directors"); Auerbach v. Bennett, 47 N.Y.2d 619, 633, 393 N.E.2d 994, 1002, 419 N.Y.S.2d 920, 928 (1979) (judicial supervision of the decision whether to litigate undermines the board's basic responsibility for corporate management); Dent, supra note 14, at 119 (an attorney has little incentive to consider the corporation's best interests).

242. See, e.g., Bishop, supra note 101, at 160 (1980) (the litigation committee is an expensive defensive strategy).
By rendering litigation committees useless to Connecticut corporations, the Joy court has damaged the interests of the shareholders it intended to protect. Typically, shareholders are concerned solely with achieving a maximum yield on their investment, not asserting their rights as part-owners. Apart from egregious acts of mismanagement or abuse, they probably would oppose most suits against directors for one simple reason. In most instances, they have nothing to gain from the litigation, yet win, lose, or settle, they indirectly pay for the often exorbitant costs of those suits. Not only are derivative suits disruptive to the corporation, but the fact that the directors frequently prevail on the merits means that the corporation will pay for teams of defense lawyers and sometimes the losing plaintiff's attorneys' fees as well. Most derivative suits are financial losses for the corporation, and even the deterrent value of successful litigation may be nullified by corporate indemnification of the directors' liability. Consequently, the only parties truly threatened by special litigation committees are entrepreneurial attorneys and dissident shareholders who are not particularly concerned with making a profit on their investment. In a well-meaning effort to protect the interests of the shareholders, the Joy court has imposed unwanted costs on the majority by asserting the rights of a few.

The type of judicial activism embodied in Joy v. North drains the vitality of the business community. One commentator has written that "extensive judicial scrutiny of business decisions on behalf of 3 percent shareholders . . . entail[s] rigid rules restricting management's ability to make business judgments." In this light, the attitude that the deterrent value of derivative suits justifies even harmful litigation, because corporations can afford it, is both dangerous and naive. It is dangerous because in a highly competitive world economy, risk taking and entrepreneurialism are essential to economic growth, which is directly related to employment and the production of goods and services. It is naive because the real winners in this litigation are the attorneys who thrive on stirring up lawsuits at corporate expense. Moreover, this attitude reflects and perpetuates the antibusiness

244. See supra note 47-48 and accompanying text.
245. See supra text accompanying note 65.
246. Block & Prussin, supra note 65, at 29.
247. See supra note 49 and accompanying text.
249. Duesenberg, supra note 48, at 327-30; see supra note 65.
250. Cf. R. Winter, *Government and the Corporation* 31 (1978) (calls for more shareholder powers are invariably made by small groups of people who are not interested in maximizing shareholder investments). 
251. Id. at 15.
252. See, e.g., Dawson, supra note 49, at 870 (discussing social policy that corporations "can afford to pay and should pay for the 'therapy' administered in stockholders' suits").
253. See, e.g., Russo & Wolfson, supra note 2, at F16, col. 6 ("Business cannot generate jobs, goods and services if it is stifled by unnecessary Governmental regulation.").
254. Duesenberg, supra note 48, at 333.
bias in society that has led to the wholesale acceptance of much unnecessary governmental regulation. Admittedly, courts should endeavor to prevent fraud and corruption in business. There is a point, however, at which judicial regulation imposes greater social costs than it prevents. The Joy court has crossed this threshold by contributing to a commercial climate that will neither attract nor keep business in Connecticut.

CONCLUSION

In Joy v. North, the Second Circuit adopted a variation of the approach to special litigation committees established in the Delaware Supreme Court’s decision in Zapata Corp. v. Maldonado. Requiring judges, in demand-excused cases, to render a business judgment of a corporation’s best interests, reflects a skeptical view of litigation committees that is founded more in theory than in fact. The Joy decision ignores the strong record of performance established by these committees, and it overlooks the safeguards inherent in the business judgment rule. The Second Circuit also failed to recognize that the derivative suit is only one of many constraints, both legal and economic, placed on corporate directors. The Joy court’s most significant errors, however, are based on its derogation of traditional legal principles. The majority second-guesses the district court’s interpretation of Connecticut law, reverses the business judgment rule’s historic presumption of directorial good faith, and flagrantly intervenes in the management of corporate affairs.

The significance of Joy v. North lies in the fact that it compounds the confusion inherent in the Zapata court’s approach to special litigation committee decisions. In the analysis that Joy inherits from Zapata, the elusive issue of demand assumes paramount importance, creating an outcome-determinative test that discourages shareholders from deferring to the directors’ authority to pursue corporate claims. In addition, the Joy decision transforms Zapata’s dubious concept of judicial business judgment into a complex equation of imprecise variables that is sure to lead to judicial misapplication. Moreover, Joy v. North will impose unnecessary costs on Connecticut corporations and their shareholders. With litigation committees mere advisory bodies in the demand-excused context where they are most needed, the boards of these corporations will not bother to establish impotent committees. As a result, derivative litigation will increase at the expense of the stockholding majority.

Finally, while this kind of judicial intervention in business affairs may

256. Cf. R. Winter, supra note 250, at 12-13 (attempts to eliminate business corruption by creating mandatory legal rules often reduce corporate efficiency and impose costs on the public).
257. Rehearing Petition, supra note 135, at 1-2; see also Genzer v. Cunningham, 498 F. Supp. 682, 687 (E.D. Mich. 1980) (noting the legislative intent to create a favorable business climate); R. Winter, supra note 250, at 8 (discussing benefits of Delaware corporate laws).
be a boon to derivative plaintiffs and their attorneys, it bears hidden costs which society cannot afford. The Second Circuit's decision can only make corporate counsel more wary of new business ventures, an effect that is particularly unfortunate in light of today's uncertain economic climate. *Joy v. North* is one more example of the judicial penchant for stepping in to arrange private affairs without realizing that the cure is more harmful than the disease.

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