

DISMISSAL OF DERIVATIVE ACTIONS:
THE DEBATE

BY ROBERT K. PAYSON *

I generally agree with Norm Veasey's thoughts about the business judgment rule, but I must say that his recitation of the *Sinclair*¹ case does not agree with my briefs.

The question of whether a derivative suit against corporate directors can be dismissed at the recommendation of a special committee of disinterested independent directors is presently a matter of sharp debate. The debate calls to mind the story of a lawyer, a clergyman, and an environmentalist who found themselves shipwrecked. They floated around for a day or two and became quite desperate and decided that one of them had to try to swim to shore. The lawyer just happened to have a deck of cards in his pocket, so they cut the cards and unfortunately the lawyer lost. They were in terribly shark-infested waters, but the lawyer drew himself together and dove in. The clergyman and the environmentalist said, "My goodness. Look at what's happening. The sharks have formed a protective wedge around the lawyer to lead him ashore." The clergyman said, "It's a miracle," but the environmentalist said, "No. I think you just call that a matter of professional courtesy."

And so it is, I think, with the debate over whether or not a derivative suit can be dismissed by a special litigation committee. If you are a member of management, you probably believe that the special litigation committee is a wonderful device for getting rid of vexatious lawsuits which are not in the best interests of your corporation.² On the other hand, if you are on the shareholders' side of the debate or perhaps the plaintiffs' bar, probably you will view the device as a method whereby one group of sharks sits in judgment of another group of sharks.³ I am not going to take either side of the debate today because the issues are now pending before the Delaware Supreme Court in a case called *Zapata Corp. v. Maldonado*,⁴ which was

* Member, Delaware State and American Bar Associations. Partner, Potter Anderson & Corroon, Wilmington, Delaware. B.A., 1961, Duke University; LL.B., 1964, Duke University.

1. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

2. See *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d 259 (3d Cir. 1978), cert. denied, 439 U.S. 1129 (1979).

3. See Mulvey, *Special Litigation Committees—An Expanding and Potent Threat to Shareholder Derivative Suits*, 2 CARDOZO L. REV. 169 (1980).

4. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

argued on October 16, 1980. I am also not going to attempt to predict what the Delaware Supreme Court will do because I have stopped predicting what the Supreme Court will do since September 22, 1977. As some of you know, that is the day before the Delaware Supreme Court decided *Singer v. Magnavox*.⁵

Many of you are generally familiar with the *Maldonado* litigation, but for background purposes for some of you I will give a very brief recitation of the facts. In 1970, Zapata's board of directors adopted a stock option plan which was later approved by the shareholders, pursuant to which Zapata's senior officers, who were also directors, were granted options to purchase Zapata common stock at a fixed price. The options could be exercised in five separate installments, the last installment of which was to occur on July 14, 1974.

As the date for the final exercise drew near, Zapata was planning a tender offer for a substantial number of its own shares, with the obvious result that the market price of the stock would go up. The inside officers exercised and accelerated the exercise date so that they were able to take advantage of the increased market resulting from the tender offer.

The plaintiff alleged that the sole purpose for the acceleration of the exercise date was to permit senior management to take advantage of the increased market so as to decrease their own federal income tax liability and thereby also deprive Zapata of a substantial federal tax deduction. In 1975, Mr. Maldonado brought a derivative action in the Delaware Court of Chancery alleging what I have just described generally.⁶ He also filed a companion action in the Southern District of New York,⁷ under section 14(a) of the Securities & Exchange Act.⁸

About four years after Mr. Maldonado's action was filed, the Zapata directors expanded the board and appointed two outside members who had not theretofore been in any way associated with Zapata. That committee was charged with investigating the viability and the underlying merits of the derivative litigation pending in New York and Delaware, and also a third action which had been filed recently in Houston, Texas.⁹

The committee retained special counsel and that counsel directed the investigation. Tens of thousands of pages of documents were

5. 380 A.2d 969 (Del. 1977).

6. *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980).

7. *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980), *appeal docketed*, No. 80-7221 (2d Cir. Dec. 31, 1980).

8. 15 U.S.C. § 78n(a) (1971).

9. *Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980).

reviewed, including all of the depositions and production in all of the litigations. Special consultants were retained by the committee. For example, a compensation consultant was retained with respect to certain allegations of excessive compensation. Dozens upon dozens of personal interviews were conducted by special counsel, including interviews with plaintiff's counsel.

The committee ultimately concluded that the derivative litigation was not in the best interest of Zapata and directed Delaware counsel for Zapata and counsel in the other jurisdictions to seek dismissal of the actions based on the committee's business judgment that the actions were not in the best interest of the company.

There were a number of decisions around the country, both under federal and state law,¹⁰ and in the federal cases some courts surmised what they believed the Delaware courts would hold.¹¹ All of those cases held that derivative litigation could be dismissed at the instance of a special disinterested committee. Vice Chancellor Hartnett disagreed and held that, although a disinterested committee or the board might be able to dismiss an action against a third party, when the directors of the corporation were involved, Delaware would not countenance the dismissal of such litigation; and that it was up to the courts and not up to a special committee of the board.¹²

Prior to Vice Chancellor Hartnett's opinion, Judge Weinfeld in New York had dismissed the New York litigation based upon the same conclusion and recommendation of the special committee. After Vice Chancellor Hartnett's decision, the motion to dismiss made in Houston in the district court was denied, the judge there following Vice Chancellor Hartnett's analysis.

Obviously, if the Vice Chancellor's decision in *Maldonado* is affirmed,¹³ the question of special litigation committees may be a dead letter under Delaware law.¹⁴ In fact, I told my secretary last evening that if the opinion from the Delaware Supreme Court came in this

10. See *Abbey v. Control Data Corp.*, 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Rosengarten v. International Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976).

11. See *Abbey v. Control Data Corp.*, 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

12. 413 A.2d at 1258-60.

13. *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980), *rev'd and remanded sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

14. *But see Abramowitz v. Posner*, 513 F. Supp. 120 (S.D.N.Y. 1981). This federal court has predicted that *Maldonado* will not prove to be the final word under Delaware law.

morning and affirmed Vice Chancellor Hartnett, she should not send it out to me because I would not have anything to talk about.

I would like to make the assumption, not the prediction, that the Delaware Supreme Court will reverse the Vice Chancellor and will establish guidelines for special committees to investigate and make determinations with respect to derivative litigation. I would like to talk about some of the elements which the courts have considered and probably will consider in the future in connection with special committees.

In general, I think committee members should be experienced in the business and financial world. Prominent members of the business and financial community who have previously demonstrated experience and character are obviously well-suited to discharge investigative and decision-making responsibilities conscientiously.¹⁵

The committee members should not have any financial interest in the transaction which is the subject of the derivative litigation, nor, of course, should they be defendants in that litigation.¹⁶ Similarly, immediate family members of the committee should have no financial interest in the challenged transaction.¹⁷

The retention of special counsel for the committees has been a very important consideration by the courts in determining independent disinterestedness and whether or not business judgment has in fact been exercised. I suggest that the special committee members should not come from law firms or from banks or from financial consultants with which the company has done business on a regular basis.¹⁸ The prohibition should extend to special counsel to the committee as well. Obviously, it should not be the outside general counsel to the corporation who has represented the company and management for years.

The SEC has suggested that at least in the context of an audit committee the independence of committee members may be tainted if they are members of the same clubs, alumni of the same schools, or in fact neighbors of the defendant directors.¹⁹

15. See *Genzer v. Cunningham*, 498 F. Supp. 682 (E.D. Mich. 1980); *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971).

16. See *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980).

17. See *Bastian v. Bourns, Inc.*, 256 A.2d 680 (Del. Ch. 1969), *aff'd per curiam*, 278 A.2d 467 (Del. 1970).

18. See, e.g., *Corporate Director's Guidebook*, 33 Bus. Law. 1591, 1619-28 (1978); cf. *David J. Greene Co. v. Schenley Indus., Inc.*, 281 A.2d 30, 33 (Del. Ch. 1971), holding that because of close business relations between bankers and those in control at Schenley, analysis could not be deemed to be in any degree impartial. *But see Genzer v. Cunningham*, 498 F. Supp. 682 (E.D. Mich. 1980), in which a paid consultant to the corporation served on a special litigation committee.

19. See 401 SEC. REG. & L. REP. (BNA) A-5 (May 4, 1977).

At least one court has suggested that it would be inappropriate for special committee members to have been involved in a transaction similar to that under attack in the derivative litigation.²⁰ For example, a director who sat on the board of a corporation and was charged with breach of fiduciary duty in connection with a foreign bribes transaction probably should not be appointed as a special committee member where there is an attack on a similar transaction.²¹

Some courts have held that an indication of independence of committee members is the fact that they were appointed after the transaction was challenged in the derivative action. As many of our professors in law school say: "Query." I don't understand that rationale, but at least two courts have suggested it.²²

As to the appointment of the committee itself, one element which bothered Vice Chancellor Hartnett was the fact that two outside committee members had been appointed by the alleged bad guys. It was obvious from his opinion that the Vice Chancellor believed they were tainted by the very appointment.²³ A possible way around this is to have the board appoint an independent nominating committee which would then nominate outside directors; there would also be a disclosure in the proxy statement that, if elected, the outside directors would be appointed as a special litigation committee to look into the matters challenged in the derivative action.

The investigation itself obviously should be very thorough and very complete. It is an expensive task, something that should be considered when appointing a special committee. The depth of the investigation itself will obviously help in a determination that the committee has exercised its business judgment.²⁴

What power should be given to the special committee? In the *Maldonado* case the two members of the special committee were given total, unrestricted, unreviewable authority to take any action which they deemed appropriate with respect to the challenged transactions,

20. *Rosengarten v. Int'l Tel. & Tel. Corp.*, 466 F. Supp. 817, 825 (S.D.N.Y. 1979).

21. *Rosengarten v. Int'l Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979).

22. *Auerbach v. Bennett*, 64 A.D.2d 98, 408 N.Y.S.2d 83 (1978), *aff'd as modified*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980), *appeal docketed*, No. 80-7221 (2d Cir. Dec. 31, 1980).

23. 413 A.2d at 1263.

24. In both *Auerbach v. Bennett*, 64 A.D.2d 98, 408 N.Y.S.2d 83 (1978), *aff'd as modified*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), and *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980), *appeal docketed*, No. 80-7221 (2d Cir. Dec. 31, 1980), the special litigation committee reviewed prior testimony of parties and other witnesses, examined thousands of relevant documents, and conducted numerous interviews with officers, employees, auditors, and others.

including firing the defendants in the derivative litigations, demanding reimbursement if they found that something had been taken from the corporation wrongfully, adding supplemental defendants or bringing additional litigation; and, of course, the authority to terminate the litigation if they determined that it was not in the best interests of the company. It is very important that the committee's powers not be reviewable by the entire board, and that, of course, ties into the appointment of special committee members by the alleged wrongdoers.

What, then, should the committee look at? One of the areas which seemed to trouble the Delaware Supreme Court was the extent to which the court should look at the underlying merits of the challenged transactions. In my view, there should not be a full scrutiny as if we were in a plenary hearing, because you would end up having the trial which the committee has determined should be avoided because of time, expense, and the like.

Perhaps the test should be as in a settlement hearing. Our courts have continuously held that the settlement hearing should not be a rehearsal of the trial, but that the merits of the underlying challenged transaction should be scrutinized to some extent.²⁵ That is probably the most difficult element to quantify in directing the committee as to what it should do.

Obviously, the committee should consider whether the corporation has been injured and whether that injury is recoverable, and, importantly, the expense of the litigation, both direct and indirect—including, of course, the costs of the litigation, direct costs as well as the time and effort that management would be called upon to give in discovery and testifying and so forth—that should be carefully weighed by the committee.

Is there a likelihood that the violation will re-occur? In many of the sensitive payment cases, as I describe them, foreign bribe cases,²⁶ settlements were reached pursuant to which special audit committees were formed and special precautions taken so as to avoid the recurrence of any future similar transactions.

Employee morale may be important.²⁷ There were certain allegations in the *Maldonado* case that would have caused discovery of

25. *Perrine v. Pennroad Corp.*, 47 A.2d 479 (Del. 1946), *cert. denied*, 329 U.S. 808 (1946).

26. *See* *Rosengarten v. Int'l Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Auerbach v. Bennett*, 64 A.D.2d 98, 408 N.Y.S.2d 83 (1978), *aff'd as modified*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

27. *See also* *Abbey v. Control Data*, 460 F. Supp. 1242 (D. Minn. 1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980). The committee was also concerned about the safety of corporate employees abroad.

some middle management people, which could have created morale problems. Relationships with customers and suppliers and obviously public relations in general should all be considered by the committee.

The issues have been raised pursuant to Rule 23.1²⁸ or Rule 23.1 in the Delaware Court of Chancery²⁹ and in the federal rules through motions for summary judgment.

28. FED. R. CIV. P. 23.1.

29. DEL. CH. CT. R. 23.1.