Corporation Law - Shareholders' Derivative Actions - Special Litigation Committees - Business Judgement Rule

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RECENT DECISIONS

CORPORATION LAW—SHAREHOLDERS' DERIVATIVE ACTIONS—SPECIAL LITIGATION COMMITTEES—BUSINESS JUDGMENT RULE—The Supreme Court of North Carolina, withdrawing its prior decision, held that North Carolina courts cannot passively accept a recommendation to terminate shareholder litigation when made by a special litigation committee appointed by defendant directors, but must make an independent inquiry into the merits of the recommendation to determine whether the defendants have met their summary judgment burden of proof.


On November 4, 1975, the All American Assurance Company 1 was placed into involuntary rehabilitation by the North Carolina Department of Insurance2 pursuant to allegations of mismanagement3

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1. At this time, All American was incorporated and headquartered in North Carolina, but had its principal offices in Baton Rouge, Louisiana. It was formed in 1972 when Pyramid Life Insurance Company, which was also incorporated and headquartered in North Carolina, merged with All American Assurance Company, a Louisiana corporation. Swenson v. Thibaut, 39 N.C. App. 77, 82, 250 S.E.2d 279, 284 (1978), disc. rev. denied and appeal dismissed, 296 N.C. 740, 254 S.E.2d 181 (1979). Swenson v. Thibaut was a minority shareholders’ derivative action involving many of the same facts, parties and counsel as Alford v. Shaw, 320 N.C. 465, 358 S.E.2d 323 (1987), rev’g, 318 N.C. 289, 349 S.E.2d 41 (1986). Norman V. Swenson was the former president of Pyramid Insurance Company. 39 N.C. App. at 86, 250 S.E.2d at 286. In 1975, Charest D. Thibaut, Jr. was a director of both Republic Securities Corporation (see infra note 3) and All American Assurance Company, and was a substantial shareholder of each. Id. at 83 n.1, 250 S.E.2d at 284 n.1.

2. 39 N.C. App. at 84-85, 250 S.E.2d at 285.

3. Id. at 82-84, 250 S.E.2d at 284-85. When the events which were set forth
and for the protection of shareholders' interests. Under the terms of the rehabilitation, sixty-five percent of All American's shares were transferred to American Bank and Trust Company, in exchange for which American Bank and Trust agreed to maintain the solvency of All American through December 31, 1976. All American was released from rehabilitation on May 7, 1976, subject to several conditions, including a requirement that the corporation vigorously prosecute claims against parties responsible for it being subjected to rehabilitation.

On October 20, 1976, at an All American substitute annual shareholders' meeting, certain minority shareholders introduced a reso-
lution demanding that the board of directors seek reimbursement from those responsible for the losses which led to the involuntary rehabilitation of the company.\textsuperscript{10} This resolution was defeated by the representatives of the majority shareholders,\textsuperscript{11} which ultimately resulted, on December 30, 1976, in the minority shareholders bringing a derivative action\textsuperscript{12} on behalf of All American to recover the alleged losses.\textsuperscript{13}

American Bank and Trust sold its sixty-five percent of All American's outstanding stock to American Commonwealth Financial Corporation on January 5, 1979.\textsuperscript{14} Subsequent activities by All American resulted in claims of impropriety and mismanagement being asserted against corporate officers and directors.\textsuperscript{15} These allegations were set

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  \item 11. Id. 67,316 votes were cast for the resolution and 1,274,769 against, with the defendants all voting against. \textit{Id.}
  \item 12. A shareholders' derivative suit is an equitable action which allows shareholders to assert a corporation's cause of action on behalf of the corporation. The action is usually brought against directors or managers for wrongdoing which resulted in harm to the corporation by their acts alone, or for their failure to pursue claims of wrongdoing against third-parties. See, e.g., N. Lattin, \textit{The Law of Corporations}, § 103 (2d ed. 1971); Brown, \textit{Shareholder Derivative Litigation and the Special Litigation Committee}, 43 U. Pitt. L. Rev. 601, 601-06 (1982) \textit{[hereinafter Brown]}; Prunty, \textit{The Shareholders' Derivative Suit: Notes on its Derivation}, 32 N.Y. U. L. Rev. 980 (1957) \textit{[hereinafter Prunty]}. See \textit{infra} notes 104-24, 202-18, 233-37 and accompanying text for further discussion of shareholders' derivative actions.

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    \item 14. Alford v. Shaw, 318 N.C. 289, 294 n.4, 349 S.E.2d 41, 44 n.4 (1986), \textit{rev'd}, 320 N.C. 465, 358 S.E.2d 323 (1987). This footnote explains the complex inter-relationships as follows: ACFC [American Commonwealth Financial Corporation], a defendant in this action. . . . was controlled by defendant ICH [Corporation] which in turn was controlled by defendants Shaw and Rice. ACFC then sold this stock to defendant GCL [Great Commonwealth Life Insurance Company], its wholly-owned subsidiary. The offices of AAA [All American Assurance Company] were moved to Dallas, Texas where AAA shares common facilities and personnel with GCL and other affiliated companies under a cost sharing plan. AAA then formed NALICO in 1981. NALICO Insurance Company, a wholly-owned subsidiary of AAA, acquired all of the shares of National American Life Insurance Company (NAL). NAL, a Louisiana company, had been in both receivership and rehabilitation. NALICO was dissolved in December 1982. NAL is wholly-owned by AAA. \textit{Id.}
    \item 15. \textit{Id.} at 293, 349 S.E.2d at 44. In summarizing the specific claims, the North Carolina Supreme Court stated: These [claims] included failing to exercise an option to purchase shares of AAA stock from Great Commonwealth Life Insurance Company (GCL) and failing to exercise a "put" to sell shares of AAA stock to American Commonwealth Financial Corporation (ACFC); paying excessive amounts to affil-
forth in a letter dated October 28, 1981, and sent to All American’s board of directors by Attorney Thomas A. Lockhart, counsel for minority shareholders of All American. Mr. Lockhart, by letter dated May 11, 1982, presented a list of demands to the board pursuant to these allegations. In response to these demands, on June 10, 1982, the board passed a resolution to appoint Walter F. Brinkley as special counsel. Mr. Brinkley was asked to recommend two independent and qualified persons for service on the board of directors as a special litigation committee. On July 9, 1982, Mr.

iated companies for administrative expenses; entering into certain allegedly improper reinsurance and coinsurance agreements; redeeming certain 8% debentures held by affiliated companies; releasing American Bank and Trust Company (ABTC) of Baton Rouge, Louisiana, from an obligation to purchase an office building; and engaging in other allegedly improper transactions with affiliates, including unsecured loans and joint ownership of airplanes.

16. Id. Until its merger with All American of Louisiana, Pyramid Insurance Company had retained the law firm of Cansler, Lockhart, Parker & Young as general counsel. This relationship was discontinued by All American after completion of the merger in 1972. Then, on July 30, 1975, the firm was again retained by All American for representation in the North Carolina rehabilitation proceedings. 39 N.C. App. at 86, 250 S.E.2d at 286.

On July 16, 1976, Norman Swenson retained Cansler, Lockhart, Parker & Young to represent him in his suit to enjoin All American from holding its substitute annual shareholders’ meeting on July 21, 1976. Id. at 86-87, 250 S.E.2d at 286. In Swenson v. All American Assurance Co., the defendants unsuccessfully petitioned the court to disqualify plaintiffs’ counsel for conflict of interest. Swenson v. All American Assurance Co., 33 N.C. App. 458, 460, 235 S.E.2d 793, 795 (1977). The firm continued to represent minority shareholders in subsequent related actions. See 39 N.C. App. at 82, 250 S.E.2d at 283; Alford v. Shaw, 72 N.C. App. 537, 538, 324 S.E.2d 878, 880 (1985); 318 N.C. at 290, 349 S.E.2d at 42; 320 N.C. at 466, 358 S.E.2d at 324.

17. 318 N.C. at 294, 349 S.E.2d at 45. Included in the list were demands that All American refrain from entering into any coinsurance and reinsurance agreements or transactions with affiliates, without the approval of the North Carolina Department of Insurance; recover loans and advances made to affiliates; recover investments, totalling at least $4,259,149, in National American Life Insurance Company; and recover 232,678 shares of All American’s stock from Great Commonwealth Life, which had purchased them for five dollars per share when All American had a “put” option to sell 51,774 shares to American Commonwealth Financial Corporation for $10 dollars per share. Id.

18. Id. at 310, 349 S.E.2d at 54. Mr. Brinkley, a member of the American College of Trial Lawyers and past president of the North Carolina Bar Association, was experienced as special counsel and in corporation, insurance, and litigation matters. He had not previously represented All American or any of its affiliates. Id.

19. Id. Special litigation committees consist of one or more persons appointed to a corporate board of directors for the purpose of investigating and advising the full board of the merits of pending or threatened litigation. The committee may or
Brinkley recommended Marion G. Follin20 and Frank M. Parker.21 Both men were elected to All American's board of directors on July 21, 1982.22

On November 4, 1982, the minority shareholders filed a complaint23 in the Superior Court of Mecklenburg County, North Carolina, asserting claims on behalf of All American.24 The complaint alleged enormous losses to the corporation25 as a result of fraud, self-dealing, and mismanagement26 by the majority of All American's board of directors.27 Also occurring in November, 1982, was a series of mergers by which All American and other companies controlled by defendant ICH Corporation became wholly-owned subsidiaries of ICH, thereby eliminating the minority shareholders.28

The special litigation committee conducted an extensive investigation of the complaint in the derivative action29 as well as related

may not have the power to bind the full board to its recommendations. Persons appointed to the committee may or may not have been members of the board previous to occurrence of the acts complained of or the creation of the committee. See, e.g., Brown, supra note 12, at 619-40. See infra notes 136-40, 233-35, 238-43 and accompanying text for further discussion of special litigation committees.

20. 318 N.C. at 310, 349 S.E.2d at 54. Mr. Follin had forty years experience in the life insurance business and had been an advisor and trustee with the United States Bankruptcy Court. Prior to his retirement from the company in 1970, he was Vice Chairman of the Board of Directors and Senior Vice President of Pilot Life Insurance Company. Id.

21. Id. Judge Parker had 32 years experience as a practicing attorney, had been a member of the North Carolina Senate and had been an associate Judge on the North Carolina Court of Appeals for twelve years. Id.

22. Id. at 310-11, 349 S.E.2d at 54. At the meeting in which he was elected to the board of All American, Judge Parker, speaking for Mr. Follin as well as himself, made a statement for the record that he and Mr. Follin were undertaking these duties with no preconceptions as to the claims against All American's board, with a commitment to conduct a thorough investigation of these claims, and with a determination to exercise independent judgment and to vigorously prosecute any meritorious claims encountered. Id.

23. Id. at 295, 349 S.E.2d at 45.

24. Id. at 291, 349 S.E.2d at 43.

25. Id.


28. Id. at 294 n.4, 349 S.E.2d at 44 n.4.

29. Id. at 312, 349 S.E.2d at 55. Describing the scope of the investigation conducted by the special litigation committee, the North Carolina Supreme Court noted that "the committee interviewed sixteen people, (footnote omitted) reviewed approximately 3,750 documents, (footnote omitted) submitted interrogatories to each person who served as a director of AAA [All American Assurance] during the relevant period, and prepared a 409 page report in addition to an appendix which included twenty-five exhibits." Id.
claims in a class action suit brought in the United States District Court for the Western District of North Carolina.\textsuperscript{30} The committee completed its investigation and submitted its report to the board in July, 1983.\textsuperscript{31} With regard to the claims asserted in the derivative action, the committee recommended that two be settled and all others dismissed.\textsuperscript{32} The defendant board members, in accordance with these recommendations, approved a settlement agreement covering two of the claims and moved for summary judgment on the others.\textsuperscript{33}

The trial court, considering the defendant’s motions for summary judgment, first looked to the composition of the special litigation committee and the investigatory procedures employed by it and found “no genuine issue of a material fact as to the disinterestedness, independence and good faith of the Special Committee, or as to the scope of the investigation or the appropriateness of the procedures adopted and followed by the Special Committee in investigating the claims asserted.”\textsuperscript{34} Second, the trial judge invoked the business judgment rule,\textsuperscript{35} and granted the defendants’ motion for summary judgment.\textsuperscript{36} The plaintiffs appealed, and the North Carolina Court of Appeals vacated the judgment of the trial court and remanded the case for rehearing.\textsuperscript{37}

The single issue on appeal was whether the business judgment rule was properly applied to the decision of a special litigation committee, when the committee recommended dismissal of minority shareholders’ derivative claims brought against defendant majority directors of the corporation.\textsuperscript{38} The court of appeals, treating the issue as one of first impression in North Carolina, prefaced its analysis by asserting a

\begin{enumerate}
\item[30.] Id. at 291 n.2, 349 S.E.2d at 43 n.2 (the decision of the district court is unreported).
\item[31.] Id. at 313, 349 S.E.2d at 56.
\item[32.] Id. at 291, 349 S.E.2d at 43.
\item[33.] Id. at 292, 349 S.E.2d at 43.
\item[34.] Id. (quoting the trial judge—the opinion of the trial court is unreported).
\item[36.] 72 N.C. App. at 538, 324 S.E.2d at 880.
\item[37.] Id. at 549, 324 S.E.2d at 887 (the opinion of the trial court is unreported).
\item[38.] Id. at 539, 324 S.E.2d at 881.
\end{enumerate}
strong public policy favoring derivative actions. The court then proceeded to discuss the three principle approaches to this issue taken by other jurisdictions.

The approach taken by the Court of Appeals of New York in *Auerbach v. Bennett* was to incorporate the business judgment rule into a two-part test. This test limited judicial inquiry to determining whether the committee was sufficiently disinterested and whether it utilized adequate investigatory procedures. The Supreme Court of Delaware set forth a more stringent two-part analysis in *Zapata Corp. v. Maldonado*. This test not only required judicial evaluation of the good faith and disinterestedness of the committee, but also provided for judicial inquiry into the merits of the committee's decisions. The Supreme Court of Iowa, however, in *Miller v. Register & Tribune Syndicate, Inc.*, rejected the application of the business judgment rule to all special litigation committees appointed by defendant directors because of the potential for structural bias inherent in all such committees.

The North Carolina Court of Appeals adopted the *Miller* rule, admitting that most jurisdictions which had considered the issue had adopted either the *Auerbach* or the *Zapata* approach. In support of this decision, the court of appeals argued that the problems are too complex in nature and the business judgment rule too broad in scope to permit its effective use as an instrument of judicial review.

39. *Id.* at 541, 324 S.E.2d at 882. Although shareholders have the right to sell their shares to avoid the ill-effects of corporate mismanagement, the court favored the protection of derivative actions as a judicial remedy where the value of shares has been substantially undermined by the mismanagement of corporate directors. *Id.* at 539, 324 S.E.2d at 881.
40. *Id.* at 541-42, 324 S.E.2d at 882.
41. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *See infra* notes 147-64, 253-54 and accompanying text for further discussion of this case.
42. *Id.* at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929.
43. 430 A.2d 779 (Del. 1981). *See infra* notes 165-85, 255-58 and accompanying text for further discussion of this case.
44. *Id.* at 788-89. It is important to note, however, that the *Zapata* court did not mandate the second part of the test, but left it as a matter of judicial discretion. *Id.* at 789. *See infra* note 185 and accompanying text for further discussion of the discretionary aspect of the second part of the *Zapata* test.
45. 336 N.W.2d 709 (Iowa 1983). *See infra* notes 186-201, 256-58 and accompanying text for further discussion of this case.
46. *Id.* at 718. *See infra* notes 184, 197, 201, 238-243 and accompanying text for further discussion of structural bias.
48. *Id.* at 546, 324 S.E.2d at 885.
49. *Id.* at 547, 324 S.E.2d at 886.
Furthermore, the North Carolina Court of Appeals asserted that the *Miller* rule places the burden of proof for summary judgment motions on the defendant directors rather than on the plaintiff shareholders, as does the business judgment rule. The court reasoned that the burden properly belongs on the defendant directors because of the high standard of their fiduciary duty and their greater access to evidence. Finally, it was briefly noted by the court of appeals that its review of the cases failed to produce any instances in which a special litigation committee, under similar circumstances, recommended proceeding with a suit.

By adopting the *Miller* rule, however, the North Carolina Court of Appeals was careful to note that it was rejecting the business judgment rule only as an affirmative defense, and not as traditionally applied during trial as an evidentiary standard for testing the sufficiency of facts presented by plaintiffs. Furthermore, adoption of the prophylactic *Miller* rule was not intended to eliminate the use of summary judgment as a device to terminate meritless claims, or the use of special litigation committees where the claims are against third-party outsiders or a minority of a board of directors.

The Supreme Court of North Carolina granted the defendants' petition for discretionary review, and on October 7, 1986, reversed the decision of the court of appeals, and remanded for reinstatement of summary judgment by the trial court.

Chief Justice Billings, writing for the majority of the North Carolina Supreme Court, began her analysis with a detailed discussion of the historical development of the shareholders' derivative action.

50. *Id.* at 547-48, 324 S.E.2d at 886.
51. *Id.* See infra notes 69-71, 76, 222 and accompanying text for further discussion of the burden of proof.
52. *Id.* at 548, 324 S.E.2d at 886.
53. *Id.* See infra notes 135, 225-27 and accompanying text for discussion of the various applications of the business judgment rule.
54. *Id.*
56. *Id.* at 314, 349 S.E.2d at 56.
57. *Id.* at 290, 349 S.E.2d at 42. Chief Justice Billings was joined by Justices Meyer, Mitchell, Parker (Francis I.), and Browning. Justice Frye concurred in part and dissented in part. *Id.* at 314-17, 349 S.E.2d at 56-58. See infra notes 72-73 and accompanying text for further discussion of Justice Frye's opinion. Justice Martin also wrote a dissenting opinion. *Id.* at 318-30, 349 S.E.2d at 58-65. See infra notes 74-77 and accompanying text for further discussion of Justice Martin's dissenting opinion. See also infra notes 81-101 and accompanying text for a discussion of Justice Martin's majority opinion upon the court's rehearing of the case.
58. *Id.* at 295-300, 349 S.E.2d at 45-48.
The Chief Justice characterized the business judgment rule as a natural outgrowth of the derivative suit. The right of shareholders to maintain an action against fraudulent or untrustworthy directors gives rise to and is counterbalanced by the right of directors to exercise their business judgment, even if erroneous, free from interference. Thus, the business judgment rule protects the ability of good faith business decisions to be made by those best qualified to make them—the officers and directors of the corporation.

Chief Justice Billings then defended the business judgment rule by employing an economic analysis. Since litigation can be extremely expensive for a business in terms of indirect as well as direct costs, the Chief Justice rejected the prophylactic rule of Miller and reasoned that sound economic policy demands judicial deference to the business judgment rule. Therefore, the problem was reduced to determining the appropriate degree of judicial deference that should be accorded to the rule.

The Zapata approach was rejected by the Chief Justice as providing only an illusory improvement over the Auerbach rule because it provided no guidelines for review of the merits of a special litigation committee's decisions.

Finally, turning her attention to the Auerbach approach, the Chief Justice criticized it for failing to adequately safeguard the ability of minority shareholders to maintain derivative suits against defendant majority directors. However, Chief Justice Billings determined that the Auerbach approach would adequately protect minority shareholders in such situations if it were modified so that the burden of proving the good faith, independence and disinterestedness of the special litigation committee was shifted from the plaintiff shareholder-

59. Id. at 298, 349 S.E.2d at 47.
60. Id. at 299, 349 S.E.2d at 47.
61. Id. at 299, 349 S.E.2d at 48.
62. Id. at 302, 349 S.E.2d at 49.
63. Id. See, e.g., Brown, supra note 12, at 617-18; Block & Prussin, The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?, 37 Bus. Law. 27, 29 (1981) [hereinafter Block & Prussin]. See also infra notes 123, 130, 212-14 and accompanying text for further discussion of the costs and other adverse effects of shareholders' derivative litigation.
65. Id. at 302, 349 S.E.2d at 49.
66. Id. at 303, 349 S.E.2d at 50.
67. Id. at 306-07, 349 S.E.2d at 52. See infra notes 100, 185 and accompanying text for further discussion of the limits of the Zapata test.
68. Id. at 308, 349 S.E.2d at 53.
ers to the defendant directors. But, the Chief Justice also held that when the defendant directors are able to carry this burden, the actions taken by the committee will be presumed to have been made in good faith. This modified version of the Auerbach test was then adopted by the majority as the controlling rule in North Carolina.

Justice Frye concurred with the majority's finding that, in this case, the use of a special litigation committee was appropriate. However, Justice Frye dissented from the adoption of the Auerbach rule by the majority, claiming that consistency with North Carolina statutory and case law required adoption of the Zapata approach.

Justice Martin, also in dissent, asserted that the modified Auerbach rule adopted by the majority amounted to an abdication of the judicial duty to protect the interests of shareholders, as required by North Carolina statutes. Furthermore, stated Justice Martin, the benefit which plaintiff shareholders received from shifting the summary judgment burden of proof to the defendant directors was offset by the creation of a presumption of good faith on the part of a special litigation committee. Justice Martin found the Miller approach persuasive and advocated the use of court appointed special litigation committees.

On January 6, 1987, the Supreme Court of North Carolina granted the plaintiff shareholders' request for a rehearing. Then, upon rehearing, the supreme court withdrew its previous decision, modified and affirmed the decision of the court of appeals, and remanded for further proceedings.

Writing now for the majority, Justice Martin abandoned the broad historical and economic perspective which dominated the court's

69. Id. at 307, 349 S.E.2d at 52.
70. Id. at 309, 349 S.E.2d at 53.
71. Id. at 307, 349 S.E.2d at 52.
72. Id. at 314, 349 S.E.2d at 56.
73. Id.
74. See infra notes 81-101 and accompanying text for discussion of Justice Martin's majority opinion upon the court's rehearing of the case.
75. Id. at 320, 349 S.E.2d at 59.
76. Id. at 321-22, 349 S.E.2d at 60.
77. Id. at 324-25, 349 S.E.2d at 62.
78. Alford v. Shaw, 318 N.C. 703, 351 S.E.2d 738 (1987). Chief Justice Billings and Justices Parker (Francis I.) and Browning had been replaced by Chief Justice Exum and Justices Webb and Wichard within the 30-day period in which motions for rehearing are permitted by North Carolina law.
80. Id. at 474, 358 S.E.2d at 328.
81. Id. at 466, 358 S.E.2d at 324. Justice Martin was joined by Chief Justice
previous opinion. Instead, Justice Martin chose a narrower approach, and focused upon the legislative intent and the proper interpretation of the North Carolina Business Corporation Act\textsuperscript{82} as it relates to shareholders’ derivative actions.\textsuperscript{83}

Justice Martin asserted that the North Carolina legislature had adopted a policy favoring minority shareholders and shareholders’ derivative actions,\textsuperscript{84} which was manifest in the Business Corporation Act, sections 55-55 \textsuperscript{85} and 55-30(b)(3).\textsuperscript{86} Section 55-55 authorized shareholders’ derivative actions\textsuperscript{87} and set forth rules to govern them.\textsuperscript{88} Section 55-55(c) prohibited the termination of shareholders’ derivative actions without court approval.\textsuperscript{89} It also provided that when a court permits termination, it may also require that notice be given to all parties substantially affected.\textsuperscript{90} Therefore, Justice Martin interpreted the plain language of section 55-55(c) as requiring a judicial inquiry into the merits of a suit in order to determine whether termination would have a substantial affect on the interests of any of the parties, and also concluded that such inquiry would be necessary to determine whether notice to any of the parties was indicated.\textsuperscript{91}

Justice Martin found additional evidence of legislative intent in section 55-30 of the Business Corporation Act.\textsuperscript{92} This section established a “just and reasonable” standard for voiding corporate transactions in which a director has an adverse interest. According to this standard, a transaction is not voidable or void if the adversely interested director can prove that the transaction, relative to the corporation’s interests, was “just and reasonable” when entered into.\textsuperscript{93}

Exum and Justices Frye and Wichard. See supra notes 74-77 and accompanying text for a discussion of Justice Martin’s dissenting opinion upon the court’s first hearing of the case. Justice Mitchell did not participate, and Justices Webb and Meyer dissented. Id. at 474, 358 S.E.2d at 328-29. See infra notes 102-03 and accompanying text for discussion of the dissenting opinions.

\textsuperscript{83} 320 N.C. at 469-70, 358 S.E.2d at 326.
\textsuperscript{84} Id.
\textsuperscript{88} N.C. Gen. Stat. § 55-55(b) & (c) (1973).
\textsuperscript{90} Id.
\textsuperscript{92} N.C. Gen. Stat. § 55-30 (1973); 320 N.C. at 472, 358 S.E.2d at 327.
When read in *pari materia*, according to Justice Martin, sections 55-55 and 55-30(b)(3) indicate a clear legislative intent to place the burden of proof upon defendant directors accused of self-dealing.\(^9\)

Consequently, a court cannot passively accept a recommendation to terminate shareholder litigation when made by a special litigation committee appointed by such directors.\(^9\) Rather, the court must make an independent inquiry into the merits of the recommendation in order to determine whether the defendant directors, by their special litigation committee, have met their burden of proof.\(^9\) Summary judgment in favor of directors accused of self-dealing is permissible only after they have met this burden.\(^9\)

Accordingly, the modified *Auerbach* rule,\(^9\) which was previously adopted by the majority, was now held to grant more deference to the decisions of a special litigation committee than was intended by the North Carolina Legislature.\(^9\) Therefore, consistent with his interpretation of the North Carolina Business Corporation Act, Justice Martin announced a broadened version of the *Zapata* rule.\(^10\)

As a deterrent to frivolous or bad faith shareholders' derivative suits, Justice Martin noted that the North Carolina Business Corporation Act permitted courts, in their discretion, to require plaintiff shareholders to compensate defendants for reasonable litigation expenses, including attorney's fees, for actions brought unreasonably.\(^10\)

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94. 320 N.C. at 473, 358 S.E.2d at 328.
95. *Id.*
96. *Id.*
97. *Id.*
98. *See supra* notes 69-71 and accompanying text for further discussion of this modified version of the *Auerbach* test.
100. *Id.* at 471-72, 358 S.E.2d at 327. The *Zapata* approach did not require judicial inquiry into the merits of a special litigation committee's decision to terminate shareholder litigation unless the demand requirement was excused. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981). The demand requirement mandates that plaintiff shareholders exhaust their intra-corporate remedies, including the presentation of their claims to the board of directors, prior to filing suit. The demand requirement is generally excused when the majority directors are accused of wrongdoing (i.e., when demand would be futile). *Id.* at 784. However, Justice Martin held that N.C. GEN. STAT. § 55-55(c) (1973) mandates judicial inquiry regardless of whether demand is excused. 320 N.C. at 472, 358 S.E.2d at 327. *See supra* note 67 and *infra* note 185 and accompanying text for further discussion of the *Zapata* two-part test, and *infra* notes 119, 127, 220 and accompanying text for further discussion of the demand requirement.
Justice Webb, while in substantive agreement with the majority, had voted against reconsideration and dissented on the basis that it was a mistake to modify such a recent decision, in which all matters had been considered.102 Justice Meyer dissented and asserted the correctness of the previous decision of the court.103

The shareholders' derivative suit originated in the common law of England.104 An early articulation of the common law action appeared in an 1843 English case, *Foss v. Harbottle*.105 These actions began appearing in the United States at about the same time, but initially were not clearly defined as derivative in nature.106

*Taylor v. Miami Exporting Co.*,107 was a seminal American shareholders' derivative action.108 In *Taylor*, a shareholder sought to hold bank directors liable for fraudulent activities that resulted in deprecating stock values, withholding dividends, suspension of operations, and monetary losses to the corporation.109 However, rather than grant standing to the plaintiff as a derivative right of shareholders, the court addressed the action on the basis that the relationship between directors and shareholders was analogous to a trust.110 Other early American decisions followed this trust analogy in deciding shareholder actions.111

The types of claims which could be pursued in these early actions were also limited.112 In *Dodge v. Woolsey*,113 a shareholder sought to prevent the corporation from paying an allegedly unconstitutional state tax.114 Although the *Dodge* decision clearly recognized the right of even a single shareholder to sue on behalf of the corporation in

102. Id. at 474, 358 S.E.2d at 328.
103. Id. at 474, 358 S.E.2d at 329.
104. See, e.g., Prunty, supra note 12, at 980-85. See also supra note 12 and infra notes 105-24, 202-18, 236-37 and accompanying text for further discussion of shareholders' derivative actions.
106. See, e.g., Prunty, supra note 12, at 985-91.
107. 5 Ohio 99 (1831).
108. Prunty, supra note 12, at 988.
109. 5 Ohio at 99-100.
110. Id. at 103.
111. Prunty, supra note 12, at 986-89. The most notable case which applied the trust analogy to early American shareholder litigation was Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832). Prunty, supra note 12, at 986.
113. 59 U.S.(18 How.) 331 (1855).
114. Id. at 339.
cases involving a breach of trust by corporate directors, this right was held not to include cases involving only error, bad judgment or negligence on the part of the directors. In 1882, shareholders' derivative actions, as such, were recognized by the Supreme Court of the United States in Hawes v. Oakland. In Hawes, a shareholder of a private water supply company sought to prevent the City of Oakland, California, from continuing to receive free, non-emergency water service. The Court recognized a limited right of shareholders to sue derivatively on behalf of the corporation where a breach of trust was not alleged, but held that Hawes lacked standing as a result of his failure to make a demand upon the directors prior to instituting the suit. This requirement was considered necessary to permit the corporation to retain control of the litigation, a right that the Court held belongs first to the corporation, and only secondarily to the shareholders.

With the development and expansion of the right of shareholders' to bring derivative actions, there came a growing concern for limiting the right so as to preclude frivolous or bad faith actions. Furthermore, it was recognized that some meritorious actions, instituted by shareholders in good faith, could be contrary to overall corporate interests. These concerns gave rise to the doctrine known generally as the business judgment rule.

115. Id. at 343-44.
117. Id. at 451.
118. Id. at 460. However, the expanded right was limited by the Court to instances where directors are alleged to have engaged in illegal, fraudulent, or self-dealing activities; activities outside the scope of their authority; and other non-specified activities only if necessary to prevent irreparable harm to the corporation. Id.
119. Id. at 460-61. A shareholders' derivative suit is an action in equity, available only in the absence of any other adequate remedy. Therefore, directors must be given the opportunity to refuse to pursue a claim, after a demand by shareholders for them to do so, before the shareholders themselves acquire the right to pursue the claim on behalf of the corporation. Id. See supra notes 12, 104-18 and infra notes 120-24, 236-37 and accompanying text for further discussion of the nature of shareholders' derivative suits. See supra note 100 and infra notes 127, 220 and accompanying text for further discussion of the demand requirement.
120. Id.
121. Id.
122. See, e.g., Dent, supra note 35, at 137-40.
123. Id. See supra note 63 and infra notes 130, 212-14 and accompanying text for further discussion of the costs of shareholders' derivative actions, and other reasons for their early termination.
The leading statement of the business judgment rule was made by the Supreme Court in *United Copper Securities Co. v. Amalgamated Copper Co.*125 This case clearly established the basic elements of the ongoing controversy involving the application of the business judgment rule in shareholders' derivative actions. In describing the application and limitations of the rule within this context, the Court stated:

Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment. . . . 126

The Court then reaffirmed the demand requirement, except in cases where the shareholders had no opportunity to present their demands to the board of directors, where delay would threaten successful pursuit of the action or where a majority of the directors are accused of wrongdoing.127

The possibility of shareholders' derivative actions has been generally acknowledged to provide a deterrent to misconduct by corporate directors.128 Consequently, shareholders' litigation was usually not terminable by directors where the action sought enforcement of a legal duty owed by the board or where the action involved claims of fraud or self-dealing by the directors.129 However, even when the claims are meritorious, there can be powerful reasons for an early termination of the action. These reasons include the cost of carrying on the litigation, disruption to the business, diversion of management's time and attention, and bad publicity for the corporation.130

In these situations, the business judgment rule was often invoked by

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125. 244 U.S. 261 (1917).
126. Id. at 263-64.
127. Id. at 264. *See supra* notes 100, 119 and *infra* note 220 and accompanying text for further discussion of the demand requirement.
130. Id. at 29. In summary, Block and Prussin state that "although some derivative suits do provide valuable benefits to the corporation, more often they are losing propositions." *Id.* at 30. *See also* Brown, *supra* note 12, at 617-19.
directors to effect early termination.\textsuperscript{131} The rule thus provided directors with necessary business discretion without fear of interference by the courts.\textsuperscript{132}

The business judgment rule has traditionally operated as a presumption of good faith and due care as to the actions taken by corporate directors.\textsuperscript{133} It was used to defend the merits of decisions made by corporate directors.\textsuperscript{134} But a more recent development has been the application of the business judgment rule to justify the power of directors to terminate shareholder litigation.\textsuperscript{135}

The use of a special litigation committee is one method by which directors apply the business judgment rule to terminate shareholders' derivative litigation.\textsuperscript{136} \textit{Gall v. Exxon Corp.}\textsuperscript{137} was the first shareholders' derivative action involving the use of a special litigation committee.\textsuperscript{138} In \textit{Gall}, a shareholder claimed damages on behalf of the corporation for waste, mismanagement and misrepresentation by directors for activities involving the payment of fifty-nine million dollars in bribes to foreign officials.\textsuperscript{139} The \textit{Gall} court affirmed the power of a disinterested committee to terminate shareholder litigation when the committee acted with due care.\textsuperscript{140}

In \textit{Burks v. Lasker},\textsuperscript{141} mutual fund shareholders charged directors with violations of the Investment Company Act of 1940,\textsuperscript{142} the Investors Advisors Act of 1940\textsuperscript{143} and failure to exercise due care when they made purchases of twenty million dollars in Penn Central commercial paper shortly before that company became insolvent.\textsuperscript{144} The Supreme Court reversed the decision of the court of appeals,  

\begin{footnotes}
\item[131] Block & Prussin, \textit{supra} note 63, at 38.
\item[132] \textit{Id.} at 32-33.
\item[133] \textit{Id.} at 33.
\item[134] \textit{Id.}
\item[135] \textit{Id.} at 38. This application of the rule is termed "offensive," \textit{id.}, as opposed to its traditional "defensive" application: \textit{Id.} at 31.
\item[136] See, e.g., Dent, \textit{supra} note 35, at 105.
\item[138] Block & Prussin, \textit{supra} note 63, at 38.
\item[139] 418 F. Supp. at 509.
\item[140] \textit{Id.} at 516-17. However, the court did deny the defendant's motion for summary judgment in order to allow the plaintiff to engage in discovery adequate to determine whether or not the committee acted with due care. \textit{Id.} at 520.
\item[141] 441 U.S. 471 (1979).
\item[144] 441 U.S. at 473-74. The petitioners claimed the directors breached their fiduciary duty when, without any independent investigation, they relied upon the recommendation of an investment firm to make the purchase. \textit{Id.} at 474 n.3.
\end{footnotes}
which had denied the power of the defendant majority directors to terminate the litigation. The Court affirmed that disinterested directors may terminate shareholder litigation when permitted by applicable state law, providing the state law is not inconsistent with federal law.

The first use by a highest state court of the business judgment rule to validate the decision of a special litigation committee not to pursue shareholder derivative claims occurred in *Auerbach v. Bennett*. In *Auerbach*, shareholders brought a derivative action on behalf of General Telephone and Electronics Corporation seeking an accounting by defendant directors for alleged payment of bribes and kickbacks to foreign public officials and political parties. The board established a special litigation committee of three directors who had joined the board subsequent to the alleged activities. Vested with the full power of the board with respect to matters relating to the litigation, the committee determined that the defendant directors had not violated the standard of care established by state law and had not personally profited from the transactions. Furthermore, the committee determined that pursuit of the litigation was not in the best interest of the corporation because the claims were meritless. The committee sought dismissal of the suit, which was granted by the trial court on the basis of the business judgment rule. An appeal was taken, and the appellate division reversed on the basis that the business judgment rule could not operate to allow summary judgment prior to discovery. The New York Court
of Appeals affirmed the application of the business judgment rule to permit summary judgment prior to substantive discovery so as to preclude "fishing expeditions."\(^\text{157}\)

Judge Jones, writing for the majority in *Auerbach*,\(^\text{158}\) began the opinion by asserting the power of directors to terminate shareholder litigation through the use of a special litigation committee.\(^\text{159}\) This assertion was defended by invoking the business judgment rule and reasoning:

Derivative claims against corporate directors belong to the corporation itself. As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation's board of directors. Necessarily such decision must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calculated to protect and advance the interests of the corporation. This is the essence of the responsibility and role of the board of directors, and courts may not intrude to interfere.\(^\text{160}\)

In defending the business judgment rule itself, Judge Jones claimed that directors are specially qualified to render business judgments, while courts are ill-equipped to do so.\(^\text{161}\) Furthermore, the responsibility of rendering business judgments was held to be a non-delegable fiduciary duty of a board of directors.\(^\text{162}\) It was admitted, however, that "the [business judgment] rule shields the deliberations and conclusions of the chosen representatives of the board only if they possess a disinterested independence and do not stand in a dual relation which prevents an unprejudicial exercise of judgment."\(^\text{163}\)

And, although judicial inquiry is permitted "as to the adequacy and appropriateness of the committee's investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment."\(^\text{164}\)

\(^{157}\) *Id.* at 636, 393 N.E.2d at 1003-04, 419 N.Y.S.2d at 930.

\(^{158}\) Judge Jones was joined by Judges Jasen, Wachtler, Fuchsberg and Meyer. *Id.* at 638, 393 N.E.2d at 1005, 419 N.Y.S.2d at 931. Judge Gabrielli took no part in the decision. *Id.* Chief Judge Cooke dissented on the basis that he would affirm the decision of the appellate division. *Id.* at 636, 393 N.E.2d at 1004, 419 N.Y.S.2d at 930.

\(^{159}\) *Id.* at 623-24, 393 N.E.2d at 996, 419 N.Y.S.2d at 922.

\(^{160}\) *Id.* at 631, 393 N.E.2d at 1000-01, 419 N.Y.S.2d at 927.

\(^{161}\) *Id.* at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.

\(^{162}\) *Id.* at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.

\(^{163}\) *Id.* at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927.

\(^{164}\) *Id.* at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929.
The Supreme Court of Delaware took a more restrictive view of the proper application of the business judgment rule in Zapata Corp. v. Maldonado. In Zapata, the Delaware Supreme Court attempted to resolve conflicting interpretations of Delaware law arising out of related actions in a lower state court and a federal district court. Shareholder Maldonado had originally brought a derivative action in the Delaware Court of Chancery in June, 1975, alleging breaches of fiduciary duty by ten officers and directors of the Zapata Corporation. No prior demand that the board of directors pursue the claim had been made because, at that time, all of the directors were named as defendants. Two years later, Maldonado brought a similar, related action against the same directors in the United States District Court for the Southern District of New York.

In 1979, the Zapata Corporation Board of Directors appointed two new directors to serve as a special litigation committee to investigate the pending claims of Maldonado as well as those in a similar action pending in a Texas district court. The committee was given authority to make a final determination regarding the litigation, which was to be binding upon the corporation. At the conclusion of its investigation, in September, 1979, the committee recommended that these actions be terminated as contrary to the best interest of the corporation.

The district court in Maldonado I granted summary judgment for the defendant directors on the basis of the committee's recommendation and the business judgment rule. In Maldonado II, however, the Delaware chancery court rejected the decision of Maldonado I and held the business judgment rule to be defensive in nature, operating as a standard of review rather than an authority to confer

166. Id. at 780.
167. Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980) [hereinafter Maldonado II], see infra note 169.
168. Id.
169. Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980) [hereinafter Maldonado I] (although this action began later, this decision was handed down earlier than the decision in Maldonado II, supra note 167).
171. 430 A.2d at 781.
172. Id.
173. 485 F. Supp. at 287.
174. Id. at 286.
decision making powers upon directors.175 The Delaware chancery court stated:

The stockholder's right to litigate is secondary to the corporate right to bring suit only for so long as the corporation has not decided to refuse to bring suit. Once the corporation refuses, or impliedly refuses, to assert an apparently valid claim, involving a breach of fiduciary duty by the corporate directors, the stockholder is vested with a primary and independent right to redress the wrong by bringing the derivative suit.176

Consequently, the chancery court denied the motion of the defendant directors for dismissal or summary judgment.177 In Zapata,178 the Delaware Supreme Court attempted to resolve the conflicting reasoning of the Maldonado I 179 and Maldonado II 180 decisions181 by balancing the interest of the shareholders in maintaining meritorious litigation with that of directors in terminating litigation not in the best interest of the corporation.182 While affirming, in general, the power of defendant majority directors to delegate authority to pursue or terminate shareholder litigation,183 the court questioned whether judicial inquiry merely as to a special litigation committee's independence, good faith and diligence provided an adequate guard against abuse, especially "subconscious abuse."184 In order to protect the legitimate interests and concerns of the parties, a two-part test was adopted and set forth as follows:

First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. (footnote omitted). The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. (footnote omitted)....

The second step provides, we believe, the essential key in striking

175. Maldonado v. Flynn, 413 A.2d 1251, 1256 (Del. Ch. 1980).
176. Id. at 1263.
177. Id. at 1262.
181. 430 A.2d at 781.
182. Id. at 784-85.
183. Id. at 786.
184. Id. at 787. See infra notes 197, 201, 238-243 and accompanying text for further discussion of "subconscious abuse" or structural bias.
the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted.\textsuperscript{185}

The Iowa Supreme Court, in Miller v. Register & Tribune Syndicate, Inc.,\textsuperscript{186} rejected the approaches taken by both the Auerbach\textsuperscript{187} and Zapata\textsuperscript{188} courts.\textsuperscript{189} Miller involved a derivative action brought by a minority shareholder alleging self-dealing by the entire four-member board of directors.\textsuperscript{190} After the action had commenced, the four defendant directors expanded the board to six directors and filled the two new positions with outsiders.\textsuperscript{191} The defendant directors then created a special litigation committee consisting of the two new directors,\textsuperscript{192} which was empowered to investigate the pending derivative claims and make a good faith determination as to whether the

\textsuperscript{185} Id. at 788-89. Explaining further, the Delaware Supreme Court stated: "The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest." Id. Further, the second step is applicable only to those cases in which the demand requirement is excused, otherwise the business judgment rule applies. Id. See supra notes 67, 100 and accompanying text for further discussion of the second part of the Zapata test.

\textsuperscript{186} 336 N.W.2d 709 (Iowa 1983). This case was heard en banc, to consider a certified question from the United States District Court for the Southern District of Iowa. The district court sought a determination of Iowa law as to whether defendant majority directors have the power to delegate to a special litigation committee the authority to bind the corporation relative to shareholders' derivative litigation. Id. at 710. See infra note 201 and accompanying text for discussion of the court's interpretation of the certified question. Justice Carter wrote for the majority. Id. Justice Uhlenhopp, joined by Justice Harris, concurred specially. Justice Uhlenhopp noted that, in addition to the reasoning of the majority opinion, § 7.03(c)(iii) of the Restatement and Recommendations on Corporate Governance applied to this case, and precluded the use of a special litigation committee by the defendant board. Id. at 718-19. Justice Wolle dissented, arguing for adoption of a Zapata-like approach. Id. at 719-20. Justices Reynolds and McCormick did not participate in the decision. Id. at 718. See supra note 45 and infra notes 256-58 and accompanying text for further discussion of this case.

\textsuperscript{187} Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). See supra notes 41, 147-64 and infra note 253 and accompanying text for further discussion of this case.

\textsuperscript{188} Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). See supra notes 43, 165-85 and infra note 255-58 and accompanying text for further discussion of this case.

\textsuperscript{189} 336 N.W.2d at 718.

\textsuperscript{190} Id. at 710.

\textsuperscript{191} Id.

\textsuperscript{192} Id. at 710-11.
The decision of the committee was not to be subject to review by the board and was to be binding upon the corporation.\textsuperscript{194} In \textit{Miller}, the Iowa Supreme Court announced the third major approach to evaluating the authority and function of special litigation committees.\textsuperscript{195} This court held that defendant majority directors lack the authority to delegate the power to terminate shareholders' derivative litigations.\textsuperscript{196} The court's reasoning for adopting this prophylactic rule was based upon the structural bias theory, "which suggests that it is unrealistic to assume that the members of independent committees are free from personal, financial, or moral influences which flow from the directors who appoint them."\textsuperscript{197} Citing a line of precedent originating in \textit{United Copper Securities},\textsuperscript{198} the Iowa Supreme Court concluded, but for the device of the special litigation committee, a board of directors could not terminate litigation if the majority were accused of self-dealing.\textsuperscript{199} And, since the full board in such a situation could not terminate the litigation, the court questioned whether the power to terminate could be delegated by the board to a special litigation committee.\textsuperscript{200} In deciding the matter, however, the court merely held that defendant directors should be precluded from delegating the power to terminate shareholders' derivative suits to a special litigation committee because the potential for structural bias is so great and so difficult to prove.\textsuperscript{201}
An analysis of the proper use of the business judgment rule in shareholders' derivative actions requires an inquiry into the nature and rationales of each. Both embrace or are influenced by significant public policy considerations. These may be described generally as society's need for corporate effectiveness and its need for public confidence in corporate management. Although these considerations may seem compatible, if not nearly identical, they are often placed in opposition within the context of shareholders' derivative litigation. Consequently, the application of the business judgment rule in these actions creates a need to balance conflicting policies so as to provide the maximum benefit to all parties, including (and perhaps especially) the public. Shareholders' derivative suits have a dual nature. They are actually a combination of two distinct but interrelated causes of action. First, shareholders have an equitable right to compel the corporation to sue, or to bring suit in its behalf. Second, the corporation itself possesses an underlying right to commence and maintain the action.

Shareholders' derivative actions also have two principal rationales, deterrence and compensation. The ability of shareholders to sue derivatively on behalf of a corporation functions as a deterrent to misconduct and breach of duty by its directors and officers. And, successful pursuit of a corporation's underlying claim can result in the corporation receiving compensation for the claimed losses. However, since the cost of pursuing this type of litigation often greatly exceeds the potential compensation, the compensatory rationale is often more illusory than real. The weakness of this rationale is underscored by the fact that shareholders who successfully pursue

203. See, e.g., Elfin, supra note 202, at 198-99.
204. Id.
205. Id.
206. See, e.g., Brown, supra note 12, at 603.
207. Id.
208. Id.
209. See, e.g., Coffee & Schwartz, supra note 128, at 302-09.
210. Id.
211. Id.
212. Id. See supra notes 63, 123, 130, and accompanying text for further discussion of the costs of shareholder litigation.
213. Id.
derivative litigation stand to gain only indirectly, in the degree to which a recovery of damages produces an increase in corporate assets and owner's equity, which in turn results in higher dividends and stock values.214

It can be said that those having the greatest interest in many shareholders' derivative actions are plaintiffs' counsel.215 At times, unscrupulous attorneys have been able to extort settlements for frivolous or even bad faith claims because it is less costly for a corporation to settle than to litigate.216 By harming the corporation, these so-called "strike suits" also harm the shareholders.217 In these situations the corporation suffers a double loss, that which results from the claimed misconduct or breach of duty, as well as the cost of litigation or settlement.218

Various procedural barriers have been proposed or established to block nuisance and bad faith shareholders' derivative actions.219 The demand requirement is one such barrier.220 Another is a requirement that plaintiff shareholders post a security to cover litigation costs if the action is later deemed frivolous or unwarranted.221 The burden of proof can also be allocated so as to make it more or less difficult for shareholders to maintain an action.222 In addition, discovery can be restricted as a means of limiting or precluding shareholder litigation.223

Procedural barriers alone, however, often prove unsatisfactory for terminating shareholder litigation which is meritorious, but not in the best interest of the corporation to pursue.224 In this situation, the business judgment rule has been a favored device for effecting an

214. Id.
215. Id. at 318.
216. See, e.g., Dent, supra note 35, at 137.
217. Id. Settlements can sometimes benefit plaintiff shareholders more than obtaining a judgment if the settlement exceeds the shareholders' cost of litigation. Id.
218. Id.
219. See, e.g., Coffee & Schwartz, supra note 128, at 309; Brown, supra note 12, at 604, 610-16; Dent, supra note 35, at 97.
220. See, e.g., Brown, supra note 12, at 604; Dent, supra note 35, at 99. See also supra notes 119, 127 and accompanying text for further discussion of the demand requirement.
221. See, e.g., Brown, supra note 12, at 605.
222. See, e.g., Dent, supra note 35, at 133-34. See supra notes 50-51, 69-71, 76 and accompanying text for further discussion of the burden of proof.
223. See, e.g., Dent, supra note 35, at 131-33. See supra notes 156-57 and accompanying text for further discussion of restrictions on discovery.
224. See, e.g., Brown, supra note 12, at 616.
early termination of the action. But, except where the plaintiff shareholders are able to demonstrate self-interest or bad faith by those seeking termination, unrestricted application of the business judgment rule can effectively block all shareholder derivative litigation. Consequently, procedural barriers are often imposed in conjunction with the business judgment rule in order to limit its application.

In spite of its potential for overbroad application, the business judgment rule is supported by significant public policy considerations. First is the desire to have directors function as managers rather than insurers of the corporation. Second is the desire to have corporations controlled by directors elected by shareholders rather than by the judiciary or other outsiders. Third is the desire to encourage corporate directors to take reasonable risks, since entrepreneurial risk-taking is the very essence of business activity. Fourth is the desire to avoid the expense to the public of unnecessary judicial involvement in business affairs.

The special litigation committee is a device which, at least ideally, imposes the least restriction on the use of the business judgment rule while attempting to maintain an adequate safeguard against overbroad application. The extent to which the device actually provides this safeguard varies significantly in different situations and is obviously a matter of considerable controversy. However, there is a predictable relation between certain types of shareholder actions and the extent to which use of the special litigation committee device can prevent overbroad application of the business judgment rule.

Shareholders’ derivative actions can be classified in terms of types of defendants. The possibilities include majority directors, minority directors, and third parties. These actions can also be classified in terms of the type of wrong alleged. First, the wrongs may or may

225. Id. at 614-16.
227. See, e.g., Coffee & Schwartz, supra note 128, at 309.
228. Id. at 280-84; Dent, supra note 35, at 135.
229. See, e.g., Dent, supra note 35, at 135.
230. Id.
231. See, e.g., Coffee & Schwartz, supra note 128, at 281.
232. See, e.g., Dent, supra note 35, at 135.
234. Id.
235. See generally Elfin, supra note 202, at 181-82.
236. Id.
not have benefitted the defendants. Second, they may have resulted in a benefit, no benefit, or harm to the corporation. Special litigation committees should be considered as a special category when they are appointed by defendant majority directors accused of self-dealing to the detriment of the corporation. This “special category” has the greatest potential for structural bias, and is the most difficult to evaluate in terms of good faith, diligence and disinterestedness. The Auerbach test, the Zapata test, or any of their variations may be appropriately applied to the recommendations of other types of committees. However, a prophylactic rule should apply to this “special category” because the structural bias presumption is strong enough to cast suspicion on the recommendations of even the most disinterested committee, working in good faith and with the greatest possible diligence.

The denial of any positive presumptive weight to the recommendations of “special category” committees is consistent with the historical development of the shareholders’ derivative action. The equitable origins of the action permitted shareholders to institute and maintain these actions only in extraordinary circumstances involving a breach of trust and other early American shareholders’

237. Id. at 194-95.
238. Id. at 202; Coffee & Schwartz, supra note 128, at 322; Dent, supra note 35, at 110, 122. See supra notes 184, 197, 201 and accompanying text for further discussion of structural bias.
239. See supra notes 41-42, 68, 164 and accompanying text for further discussion of the Auerbach test.
240. See supra notes 43-44, 67, 185 and accompanying text for further discussion of the Zapata test.
241. See supra notes 69-71, 75, 100 and accompanying text for a further discussion of variations of the Auerbach and Zapata tests which were set forth by North Carolina courts.
242. See, e.g., Dent, supra note 35, at 122-23.
243. Id. at 122; Coffee & Schwartz, supra note 128, at 323; Elfin, supra note 202, at 199. But see Ricci, The Perils of Caesar’s Wife: Special Litigation Committees v. The Judiciary; Is Anyone Above Reproach?, 22 WAKE FOREST L. REV. 57 (1987). According to Professor Ricci, if corporate directors were “judicially sensitized” they would be better able to avoid actual and apparent bias when serving as members of a special litigation committee. Id. at 75. In cases involving “special category” special litigation committees, however, it seems unlikely that adoption of a judicial model of conduct separated from the long-standing traditions and enforcement mechanisms of the judicial system would be sufficient to establish the committee’s immunity to structural bias. The Alford opinions demonstrate that structural bias remains a significant issue even when the good faith, disinterestedness and diligence of the special litigation committee was not disputed by the plaintiffs except in terms of structural bias. Alford v. Shaw, 318 N.C. 289, 310, 349 S.E.2d 41, 54 (1986).
244. See, e.g., Prunty, supra note 12, at 980-85.
derivative actions based the right to bring suit solely upon a breach of trust between the directors and shareholders. The *Dodge* Court foreshadowed the application of the business judgment rule in shareholders' derivative litigation when it distinguished cases involving a breach of trust from those which merely alleged error, bad judgment or negligence by directors.

The *Hawes*, *United Copper Securities*, *Gall*, *Burks*, and *Auerbach* cases indicate that the greatest expansion of the applicability of the business judgment rule to shareholders' derivative actions has occurred in cases where the defendants were either minority directors, or third parties, or did not personally benefit from the alleged misconduct. In contrast, those cases that involved self-dealing by majority directors, such as *Zapata*, *Miller*, and *Alford* have indicated a need to limit the application of the business judgment rule.

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246. *See supra* notes 107-11 and accompanying text for further discussion of *Taylor*, and other early American shareholders' derivative actions.


248. *See supra* notes 113-15 and accompanying text for further discussion of this case.


250. *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917). *See supra* notes 125-27 and accompanying text for further discussion of this case.


254. These cases all involve allegations of harm to the corporation, but not self-dealing by the defendant directors. *Hawes v. Oakland*, 104 U.S. 450, 453 (1882); *United Copper Securities*, 244 U.S. at 262-63; *Gall*, 418 F. Supp. at 509; *Burks*, 441 U.S. at 471; *Auerbach*, 47 N.Y.2d at 624-25, 393 N.E.2d at 996-97, 419 N.Y.S.2d at 922-23. *See supra* notes 116-21 (*Hawes*), 125-27 (*United Copper Securities*), 137-40 (*Gall*), 141-46 (*Burks*), 41-42, 147-64 (*Auerbach*) and accompanying text for further discussion of these cases.


258. *Zapata* involved allegations of self-dealing to the detriment of the cor-
In *Alford*, North Carolina courts sought to develop a rule which would not only balance opposing public policy considerations, but would also be generally applicable to all types of shareholders' derivative actions. This action, however, involved an extreme example of those factors which constitute a special litigation committee of the "special category." Therefore, if any case called for adoption of the prophylactic approach, surely it was *Alford v. Shaw*.

Samuel R. Zuck