

THE BUSINESS JUDGMENT RULE
UNDER CONNECTICUT CORPORATION LAW
AND COMMENTARY ON *JOY v. NORTH*

In November, 1982, over lunch in New Haven with Prof. Deutsch, the recent decision in the appeal in Joy v. North entered the conversation, and we found a common ground of being puzzled by Judge Winter's opinion. We decided to collaborate on an article about the case. Prof. Deutsch sent me his manuscript while mine was in preparation, but I did not read his piece until mine was finished. At that point, instead of integrating our work, I decided to publish the two articles separately. My views appear first, in Part I, being those of a practicing lawyer in Connecticut, as was Judge Eginton before his recent ascension to the bench. Prof. Deutsch's analysis follows in Part II, he being a teacher of corporation law at Yale Law School as, until recently, was Judge Winter whose opinion in the appeal reversed Judge Eginton. - Editor

PART I

By SAMUEL S. CROSS*

Connecticut has spawned a case, *Joy v. North*,¹ which has placed it at center stage in the corporate community over an application of the business judgment rule. Connecticut's Supreme Court has never had the occasion to pass on the issue raised in the case. As a result the court became the focus of speculation in the federal courts over which of the two leading jurisdictions it would follow: (i) the Court of Appeals of the State of New York, which in 1979 held that the business judgment rule limits judicial screening of the recommendations of a special litigation committee of the board of directors to the committee's good faith, thoroughness, and independence²; or (ii) the

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¹ 692 F.2d 880 (2d Cir. 1982). The appeal also deals with the propriety of the decision to impose a protective order on the contents of the report of the special litigation committee which was appointed by the board to exercise the board's business judgment under the circumstances which arose. This article does not deal with that issue, nor has the author seen the report.

An indication of a decision's impact may perhaps be gauged by the number of articles it invites. The following have so far come to the author's attention: Brodsky, *Business Judgment Rule*, New York Law Journal, Dec. 15, 1982, p. 1 col. 1; 67 SECOND CIRCUIT DIGEST 2 (Dec. 1982); *Business Judgment Rule: Second Circuit Adopts 'Independent Business Judgment' Approach*, 15 SEC. REC. AND TR. REPORTING SERVICE 3 (Dec. 15, 1982); Anderson, *Recent Cases of Interest to Corporate Practitioners*, 4 Conn. Bar Ass'n. Corp. and Other Bus. Organ. Newsletter 34; Parry, *Note: Special Litigation Committees and the Business Judgment Rule: Zapata Corp. v. Maldonado and Joy v. North*, 14 CONN. L. REV. 193 (1981) [written about lower court decision in *Joy vs. North*].

² Auerbach v. Bennett, 47 N.Y. 2d 619, 419 N.Y.S. 2d 920, 393 N.E.2d 994 (1979).

Supreme Court of the State of Delaware, which in 1981 took the review one step further by holding that once the court is satisfied that the committee was independent and showed reasonable bases for good faith findings and recommendations, the court may proceed, in its discretion, to the second step to determine, applying its own independent business judgment, whether the motion to dismiss should be granted.³

There is no mechanism for Connecticut's Supreme Court to make the decision for the federal judiciary, absent an appropriate appeal on the issue from a state court case.⁴ The federal District Court for the District of Connecticut concluded in *Joy v. North* that Connecticut would follow New York⁵, but on appeal, by a two-to-one decision, the Court of Appeals for the Second Circuit reversed and held that Connecticut would adopt a rule similar to Delaware's.⁶

For the uninitiated, some background to this corporation law development will be useful.

Simply stated, the business judgment rule means that absent conflict of interest or fraud, a court will not interfere with business decisions of a board of directors of a corporation made in good faith and in the exercise of honest judgment in the lawful furtherance of corporate purposes.⁷ Expressed another way, the rule is a defensive measure, whereby corporate directors and officers are freed from liability simply for their bad judgment or unsuccessful business decisions.⁸ In other words, shareholders are stuck with the level of competence (or incompetence) of the directors which they have elected to manage their corporation's business, property and affairs. This doctrine evolved at common law and has its roots in the last century.

³ *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Sup. 1981).

⁴ Appeals by certification for review are limited to state court proceedings. CONN. PRACTICE BOOK Sec. 3135 (rev. 1978).

⁵ 519 F.Supp. 1312 (D. Conn. 1981).

⁶ *Supra*, n. 1, 692 F.2d 880. The Court of Appeals, in reciting the Delaware rule, stated that the second step finding was essential to dismissal, *ibid*, slip op. at 5521. The Delaware Supreme Court said, however, that "the Court may proceed, in its discretion, to the [second] step." 430 A.2d at 789. Judge Cardamone, in his dissent, made note of this point, *supra*, n. 1, at 897. The Delaware opinion goes on, however, as though satisfaction of the court's independent business judgment is essential to an order of dismissal.

⁷ *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (1917); *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979).

⁸ *Supra*, n. 1, at 885.

During the first half of the twentieth century, corporation law management theory had pretty well reached its apogee. The franchise concept of corporate existence had given way to a consensual approach among the interested parties, and the state's role was reduced to a sort of umpire keeping a modicum of order and providing a repository for certain essential corporate documents, while collecting revenues for its services. Indeed, the MODEL BUSINESS CORPORATION ACT, first published in 1950, was a monument to such a structure. In the succeeding quarter century many of the Model Act's provisions were adopted in one form or another by most states.⁹ As part of this good order, Connecticut's corporation code, like many others, provides that, subject to any provisions pertaining thereto contained in the certificate of incorporation, the management of the "business, property and affairs" of a stock corporation is lodged with the board of directors.¹⁰ The shareholders' management role is limited to the annual election of directors¹¹ and a vote on so-called "fundamental changes," like amendments to the certificate of incorporation, or mergers.¹²

The board in turn is empowered, if the bylaws so provide, to designate one or more committees from among its members and to delegate to a committee much if not all of its authority.¹³ Such a delegation is a fine organizational tool from management's point of view for dealing with the very controversy which arose in *Joy v. North*, namely a shareholder's derivative action, i.e., one brought by or in the right of the corporation at the instance of a disgruntled shareholder, against directors and officers for alleged breach of common law fiduciary duties and other illegal acts.¹⁴ There is inescapably a business judgment in deciding whether any litigation is in the best interest of the plaintiff or the defendant, whatever its merits and likely recovery or loss. However,

⁹ MODEL BUS. CORP. ACT ANN. ix (2d ed. 1973 Supp.). Connecticut's Stock Corporation Act, enacted in 1959, was one of those which made use of the Model Act. See S. CROSS, CORPORATION LAW IN CONNECTICUT 38 (1972).

¹⁰ CONN. GEN. STAT. § 33-313(a) (rev. 1958, Supp. 1982). The antecedent to this provision goes back to 1880. Conn. Public Acts, 1880, ch. 62, § 7.

¹¹ CONN. GEN. STAT. § 33-314(c) (rev. 1958, Supp. 1982).

¹² CONN. GEN. STAT. §§ 33-360(b) and 33-366(b) (rev. 1958, Supp. 1982).

¹³ CONN. GEN. STAT. § 33-318 (rev. 1958, Supp. 1982). Statutory authority for the board of a Connecticut corporation to delegate to a committee "any of the powers of the board" goes back to 1903. Conn. Public Acts, 1903, ch. 194, § 10.

¹⁴ Such an action was recognized at common law but was made statutory in 1977. CONN. GEN. STAT. § 52-572j (rev. 1958, Supp. 1982). See Cross, *Reflections on Corporation Law in the 1970's*, 54 CONN. B.J. 126, 131 (1980).

directors who are defendants have a conflict of interest, and so their actions do not fit within the confines of the business judgment rule. What better way for a corporation to handle such a matter than for the board to appoint a committee of disinterested directors, namely those who are not defendants, and empower the committee to make the decision as to whether in its judgment the corporation should proceed with the lawsuit? None, but as we shall see, the Court of Appeals for the Second Circuit and the Supreme Court of Delaware are unwilling to accept at face value such a committee's business judgment and want the trial court to exercise its business judgment.

In the earlier Second Circuit case of *Burks v. Lasker*, the issue turned on the special litigation committee's "power" to foreclose the continuation of a derivative action which arose out of an open-end investment company's purchase of \$20 million in Penn Central's commercial paper a few months before the borrower's bankruptcy. The district court upheld the power and dismissed the action.¹⁵ The Court of Appeals for the Second Circuit reversed the dismissal, refusing to accept the district court's holding on the committee's power, basing its decision upon "the unique nature of the investment company and its symbiotic relationship with its investment adviser," and "the situation here, where the terminating directors owe their position as directors to the defendants in the suit."¹⁶

That the court of appeals was breaking new ground was forcefully spelled out in the United States Supreme Court's reversal. The Supreme Court held that federal courts should, as a matter of federal law, apply state law governing the authority of independent directors to discontinue derivative suits.¹⁷ As to the assumed taint of the committee directors, the court observed: "While lack of impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law required by the [Investment Company Act]."¹⁸

¹⁵ 426 F.Supp. 844 (S.D.N.Y. 1977).

¹⁶ 567 F.2d 1208, 1212, n. 14 (2d Cir. 1978).

¹⁷ 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979). There was federal question jurisdiction here, whereas in *Joy v. North*, jurisdiction was based upon diversity of citizenship.

¹⁸ *Ibid*, 441 U.S. at 485, n. 15

On the heels of the Supreme Court's decision in *Burks v. Lasker*, the board in *Joy v. North* appointed a committee of directors who were not defendants and empowered the committee to determine whether the continued prosecution of the derivative action would serve the best interests of the corporations involved in the lawsuit. The committee engaged independent legal counsel, made its own investigation, and concluded that at least as to outside directors, the suit should be discontinued. The corporation filed a motion to dismiss the case as to those directors. In acting favorably on the motion, the district court limited its review to being satisfied as to the committee's independence and thoroughness, and, being so satisfied, dismissed the case, based on the business judgment rule.¹⁹ The actions of the board and of the trial court could not have given more fidelity to good order and respect for statutory mandates and established legal doctrine and practice.²⁰ Yet on appeal, the decision was reversed. Why?

There seem to be two reasons why. For one, the Delaware Supreme Court had recently decided *Zapata Corp. v. Maldonado*.²¹ There the court affirmed without hesitation the power under Delaware law of a special litigation committee to seek dismissal of a derivative action against fellow directors, in the exercise of its business judgment that to do so would be in the best interests of the corporation. However, as noted at the outset of this article,²² the court went on to conclude that after the committee's bona fides was satisfied, the chancellor may proceed to the second step of applying his own business judgment as to whether the motion to dismiss should be granted.²³ The Court of Appeal's enthusiasm for such a decision is indicated by its observation in *Joy v. North* that the Delaware Supreme Court had "unique experience in the area."²⁴

¹⁹ 519 F.Supp. 1312 (D. Conn. 1981).

²⁰ In *Gall v. Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976), the business judgment rule was applied to the special committee's determination that the derivative suit would not serve the interests of the corporation and its stockholders, but the court provided the plaintiff an opportunity to test the bona fides and independence of the special committee after plaintiff had called into question such issues. Both plaintiff and the trial court did likewise in *Joy v. North*, 519 F.Supp. 1312, 1315 (D. Conn. 1981).

²¹ 430 A.2d 779 (Del. Sup. 1981). The decision was also before the district court in *Joy v. North*, 519 F.Supp. 1312, 1317 (D. Conn. 1981).

²² Text at n. 3 *supra*.

²³ *Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. Sup. 1981).

²⁴ *Supra*, n. 1, at 891.

The second reason is, as Judge Cardamone observed in his dissent, that the majority of the panel before whom the appeal was argued "simply [did] not believe that special litigation committees will act independently and in good faith."²⁵ The observation is justified by the statements in Judge Winter's opinion (joined in by Judge Oakes) that: "The *Auerbach* decision gives excessive weight to the recommendations of special litigation committees"²⁶; and "the special litigation committee, as envisioned in *Auerbach*, seems a rather blunt instrument to accomplish that end [of less judicial scrutiny of corporate transactions], since it appears to allow dismissals in actions for deliberate looting as well as in nuisance suits."²⁷

Nevertheless, in accordance with the rule laid down in *Burks v. Lasker*,²⁸ the court's job in *Joy v. North* was to apply Connecticut law. Since the Connecticut Supreme Court has not had occasion to pass on a special litigation committee's powers and the judicial deference to be given to such a committee's business judgment, the federal judges were free to speculate. Judge Eginton, the trial judge who until recently had spent his professional career as a practicing lawyer in Connecticut, opted for New York's *Auerbach v. Bennett* rule, while Judge Winter, until recently a professor of corporation law at Yale Law School, followed, as noted, Delaware's *Zapata Corp. v. Maldonado* and was joined in that view by Judge Oakes. Judge Cardamone reasoned that the Connecticut law is like New York's in this instance and, moreover, he was prepared to accord "substantial deference" to a district judge's interpretation of the law of the state in which he sits.²⁹ So we had two federal judges going one way, and two the other way in answering the question: what is Connecticut law here?³⁰

²⁵ *Ibid.*, at 900.

²⁶ *Ibid.*, at 891.

²⁷ *Ibid.*, at 889. It is strange the panel would think that a New York court would bow to a committee's decision allowing "deliberate looting," especially in view of the following dictum of the New York Court of Appeals:

Proof, however, that the investigation has been so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham, consistent with the principles underlying the application of the business judgment doctrine, would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine. *Auerbach v. Bennett*, 47 N.Y.2d 619, at 634-635, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979).

²⁸ 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979). See text at n. 17 *supra*.

²⁹ *Supra*, n. 1, at 900.

³⁰ The mess which such a situation causes for litigants, where a federal court decides what a state's law is before the state court has spoken, is well-illustrated by the *Zapata Corporation* litigation which arose in both federal and state courts, creating a "procedural gridlock." See Deutsch, *Zapata Corporation v. Maldonado: Assessing a Precedent*, 5 THE CORP. LAW REV. 40 (1982).

While none of the federal judges in *Joy v. North* made the *Zapata Corp. v. Maldonado* analysis as to the committee's powers, they all came out at the same end point. The Delaware Supreme Court concluded that the board, though tainted by self-interest of a majority of its members by virtue of being named defendants, can nevertheless, under authority of the statute defining the board's role, legally delegate its authority to a committee of disinterested directors. Also, under an express statutory provision, a committee can exercise all the authority of the board to the extent delegated. In that capacity the committee can act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest.³¹ Connecticut has a similar statutory structure as noted *supra*³²; there is no reason to believe that its Supreme Court would do otherwise than give full recognition to such legislative policy.³³

The departure in reasoning on the law by the New York and Delaware courts comes after such a "powers" analysis. The New York court, in *Auerbach v. Bennett*, then came out as follows:

The [committee's decision not to pursue the claims] falls squarely within the embrace of the business judgment doctrine, involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. To this extent the conclusion reached by the special litigation committee is outside the scope of our review. . . . Inquiry into such matters [factors considered by the committee or the relative weight accorded them in reaching its decision] would go to the very core of the business judgment made by the committee. To permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to actions and determinations of the special litigation committee. Its substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach.

Supra, note 2, 47 N.Y.2d at 633, 634. But the Delaware court, in *Zapata Corp. v. Maldonado*, concluded that "matters of law and public policy" needed to be given consideration in a second step

³¹ 430 A.2d 779, 786 (Del. Sup. 1981).

³² See text at notes 10 and 13 *supra*.

³³ *Osborne v. Locke Steel Chain Co.*, 153 Conn. 527, 218 A.2d 526 (1966). In *Yanow v. Teal Industries, Inc.*, 178 Conn. 263, 422 A.2d 311 (1979), in dealing with Connecticut's "short-form" merger statute, the court stated: ". . . if [the merger is] effectuated in adherence to statutory procedure, considerations of whether such a transaction is good or bad, enlightened or ill advised, selfish or generous, are beside the point." *Ibid*, 422 A.2d at 317.

to the judicial process, after the first step of a showing of the committee's independence and a reasonable basis for its conclusions:

The second step provides, we believe, the essential key in striking 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. This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. 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. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.

Supra, note 3, 430 A.2d at 789.

It would appear, then, that in Delaware a trial judge's visceral reaction "to matters of law and public policy" should be brought in at the second stage. In a nation which prides itself in being governed by laws and not by men, it is hard to believe that to be good law in Delaware or in Connecticut. Understandably, though, the grievance against Zapata Corporation's directors was of a nature which revolts outsiders. The directors amended the company's stock option plan just prior to the announcement of a tender offer by the company for its shares, to permit executives to exercise their options prior to the announcement when the market price of the shares was expected to rise.

The peccadillo in *Auerbach v. Bennett* was of a different nature. There the audit committee of the board of General Telephone & Electronics Corporation was asked to investigate bribes and questionable payments. It reported that it had found evidence that in the period from 1971 to 1975 the corporation or its subsidiaries had made payments abroad and in the United States constituting bribes and kickbacks in amounts perhaps totaling

more than 11 million dollars and that some of the individual defendant directors had been personally involved in certain of the transactions.³⁴

Allegations in cases cited in the dissenting opinion in *Joy v. North* as following *Auerbach v. Bennett* are of similar stripes.³⁵ In contrast, *Joy v. North* has the earmarks of a pure business operations judgment. There the directors of Citytrust in Bridgeport extended additional construction loans to the Katz Corporation for an office building in a redevelopment area in Norwalk, to the point where the bank exceeded its legal loan limit. The bank entered into lease and other transactions, presumably to bail out its position, which in retrospect proved to be improvident. In 1976, the bank charged off \$2 million remaining on a second mortgage and in 1977 wound up with the building on its hands without sufficient rental receipts to service the debt.³⁶

In this era of loan "restructuring," to use the banker's euphemism for extending a promissory note or rewriting the loan on new terms, in order to avoid asserting the bank's legal right to place a delinquent borrower in default, the case appears to be a garden variety management problem, albeit the loss to Citytrust's shareholders may have exceeded 10% of equity.³⁷ Indeed, the committee's report notes that the Katz loans were discussed

³⁴ 47 N.Y.2d 619, 624, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979).

³⁵ *Supra*, n. 1, at 900, n. 3. The cases being referred to in the text are:

Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981) [Lockheed Aircraft Corporation's \$30-38 million in questionable and "off the books" foreign payments from 1961 to 1975]; *H. M. Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir. 1980) [directors conspired to preserve control over the corporation by the executor of Del E. Webb's estate and to divert its assets to further their interests]; *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980) [modification of Walt Disney Productions' stock option plan, to favor defendant directors]; *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) [action to recoup from officers and directors \$1,381,000 in civil and criminal penalties paid by Control Data Corp. upon its guilty plea of criminal charges stemming from illegal payments]; *Abramowitz v. Posner*, 513 F.Supp. 120 (S.D.N.Y. 1981), *aff'd*, 672 F.2d 1025 (2d Cir. 1982) [Posner used corporate funds of NVF Company to pay personal expenses]; *Genzer v. Cunningham*, 498 F.Supp. 682 (E.D. Mich. 1980) [from 1971 to 1975 certain directors of Burroughs Corporation authorized questionable overseas payments to foreign officials]; *Rosengarten v. International Telephone & Telegraph Corp.*, 466 F.Supp. 817 (S.D.N.Y. 1979) ["questionable payments" made by employees of ITT, at home and abroad, between 1971 and 1975]; *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980) [directors of TRW, Inc. in 1974 granted employee stock options conditioned on surrender of options previously granted at higher prices].

³⁶ This factual background is taken from the majority opinion in the Court of Appeals. *Supra*, note 1, 882-883.

³⁷ *Ibid*, at 895.

at a minimum of 25 Citytrust Board and Executive Committee meetings,³⁸ and the committee's recommendation under review was to dismiss the action as to the outside directors only.³⁹ The long and short of it is that Circuit Judges Winter and Oakes just did not like the way the bank was run, as recited in the committee's report,⁴⁰ and concluded:

An individual analysis of each outside defendant's role may show that some are blameless or even that they all were justified in not acting before they did, but neither is an inexorable conclusion on the basis of the present record.⁴¹

So there it is, contrary to the New York Court of Appeals' unwillingness to weigh the factors considered by a special litigation committee,⁴² the Court of Appeals for the Second Circuit seems to have said that the Connecticut Supreme Court would apply the "inexorable conclusion" standard to the committee's assessment of blame, indicating that to do otherwise "would work a major transformation of Connecticut corporation law."⁴³ Even the Delaware Supreme Court supports a lesser standard, namely, "reasonable bases for its conclusions."⁴⁴ One saving grace, perhaps, is that the case is limited to losses like Citytrust's:

The guidelines we establish here are limited to cases involving allegations of acts resulting in direct financial harm to the corporation and a consequent diminishing of the value of shareholders' investment. We express no views on the appropriate calculus to be applied to recommendations of special litigation committees where the derivative action alleges violation of law not designed principally to protect shareholders or, which, if successful, may benefit the corporation in ways other than the recovery of compensatory damages.⁴⁵

The guidelines set out in the opinion follow an earlier recitation of the rationale for the business judgment rule:

First, shareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy stock, for investment markets offer an array of opportunities

³⁸ *Ibid.*

³⁹ *Ibid.*, at 896.

⁴⁰ See the opinion's recitation, *ibid.*, at 894-895.

⁴¹ *Ibid.*, at 896.

⁴² See *supra*, text following n. 33.

⁴³ *Supra*, note 1, slip op. 5516

⁴⁴ *Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. Sup. 1981).

⁴⁵ *Supra*, note 1, at 892.

less vulnerable to mistakes in judgment by corporate officers. Nor need investors buy stock in particular corporations. In the exercise of what is genuinely a free choice, the quality of a firm's management is often decisive and information is available from professional advisors. Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.

Second, courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Third, because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.⁴⁶

The Connecticut Supreme Court observed recently in examining a director's fiduciary responsibility in another context:

There would be few candidates for positions as corporate officer or director if the requirement of prudential oversight of corporate business came to demand omnipresence or omniscience.⁴⁷

⁴⁶ *Ibid.*, at 885-886.

⁴⁷ *Ferris v. Polycast Technology Corp.*, 180 Conn. 199, 429 A.2d 850, 853 (1980).

PART II

By JAN G. DEUTSCH**

*Joy v. North*⁴⁸ is a shareholder's derivative action against Citytrust, Citytrust Bancorp Inc.'s wholly owned bank subsidiary. Citytrust currently owns an office building in a Norwalk redevelopment area. Its involvement with that building began in 1967, when it signed a 20-year term lease agreement for approximately 9% of the building, which was then still in the planning stage. By the time the building was completed, approximately five years later, it was only half rented and Citytrust had provided unsecured construction financing approximating a million dollars. Thereafter, Citytrust participated in a variety of re-financing arrangements in which it obtained various mortgages in return for further extensions of credit. Various portions of these loans were classified as doubtful and charged off against earnings, once at the behest of the bank examiners. In 1976, approximately a year before it took title to the building, Citytrust extended to the builder loans which exceeded 10 percent of the bank's shareholder equity and capital, a federal statutory maximum on lending.

In October 1977, after an unsuccessful demand on the board of directors, a Citytrust Bancorp shareholder brought a derivative suit against the bank, its officers and directors, alleging violations both of the National Banking Act and common law fiduciary duties. Before the case had been heard, *Burks v. Lasker*⁴⁹ held that, even where the alleged fiduciary breaches involve federal statutes, federal courts must apply state law in determining the propriety of discontinuance of a derivative suit by a committee of independent directors. Immediately thereafter, the boards of the bank and its holding company constituted two newly elected outside directors (who were not defendants) a Special Litigation Committee. Nine months later, after having retained independent counsel, the Committee recommended settlement with the officers responsible for approving the loans and dismissal of the suit against the directors.

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⁴⁸ *Supra*, n. 1, 692 F.2d 880 (2d Cir. 1982).

⁴⁹ 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979).

Defendants' motion to dismiss made in accordance with this report having been opposed, the district court permitted discovery on the issue of the Committee's "bona fides, motivation and thoroughness." Resolving these issues favorably to the Committee, the district judge granted defendants' motion for summary judgment. Finding no particular Connecticut case or statute dispositive, Judge Eginton addressed each statutory and common law argument made by the plaintiff, and concluded that, as held for New York in *Auerbach v. Bennett*,⁵⁰ Connecticut law limits judicial scrutiny of special litigation committees to the question of good faith, thoroughness and independence, so long as what is involved are "corporate wrongs as opposed to public wrongs."

On appeal, the majority, in an opinion by Winter, concurred in by Oakes, reversed the district court. In his dissent, Cardamone makes clear the significance of the district judge's distinction between "corporate" and "public" wrongs. Thus, "public" wrongs are presumably those matters as to which a Special Committee's determination would as a matter of law not be dispositive; and as Cardamone notes, in connection with "corporate" wrongs, *Auerbach* would approve judicial intervention if a Special Litigation Committee were found to be acting in bad faith. Consequently, assuming that the facts found by the trial judge are correct, Winter's reversal means that such Committees are by law deemed incapable of acting in good faith in ascertaining whether or not the alleged harm done to the corporation is sufficient to justify incurring the costs of litigation.

Since the committees in question are appointed by the defendants and in many cases consist of persons who occupy positions similar to the defendants, a great deal can be said in support of such a position, and the Winter opinion seems determined to say it all. Cardamone, however, is equally correct in simply pointing to *Burks v. Lasker*, in which the Supreme Court "concluded that lack of impartiality of disinterested directors is not a determination to be made as a matter of law."

On the question of state law, Winter relies, not on cases, but on Connecticut's indemnification statute. He describes the statute as "adopt[ing] the middle ground between no indemnification and permissible indemnification without regard to outcome and thus does not bespeak a negative attitude toward enforcement of

⁵⁰47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979).

fiduciary obligations through meritorious derivative litigation.” He particularly notes that “the Connecticut statute is exclusive and cannot be varied by corporate bylaws,” and that “[i]t calls for indemnification without court approval only in circumstances in which the defendant directors and officers secure a judgment in their favor.”

Like many persuasive statements, this bit of statutory analysis stacks the deck by asking the wrong question. That the Connecticut indemnification statute is not incompatible with *Joy v. North* is true; but it is equally true that a mandatory statutory scheme can be read as a legislative attempt to free a given area from the uncertainty inherent in litigation; and opposition to the result reached by Winter centers precisely on the fear that he is rendering uncertain the dimensions of the fiduciary duty assumed by the corporate official.

Thus Eginton:

No decision which plaintiff has cited to this Court has held that [the] unique relationship between defendant directors and the directors they chose to determine the fate of the derivative suit is grounds, standing alone, either to dissolve the Committee or invalidate its results. In fact, to take this position would compel the Court to find self-dealing by the directors even though they followed procedures prescribed by statute and corporate bylaws in appointing an independent Committee. Moreover, to find these procedures infirm and voidable under the statute would place in jeopardy the concept of a litigation committee at a time when such committees have become widely accepted, useful tools for disposing of detrimental derivative actions.

In my view, there is at this point no basis on which to choose between the positions espoused by Eginton and Winter. Thus, *Auerbach* is of course appropriate if the question is what to do about “detrimental actions,” just as a court should not read a statute so as to adopt a negative attitude towards “meritorious litigation.” The question presented, however, is not whether derivative litigation is either detrimental or meritorious, but rather how much such litigation should be permitted. Winter simply assumes rather than demonstrates that the Connecticut indemnification statute strikes the same balance as his opinion between the costs and the benefits of derivative litigation.

The judgment that the costs can be too great underlies the business judgment rule, which recognizes that meeting the pres-

tures of competition may well justify business decisions that prove disastrous in hindsight. Winter acknowledges this problem, and meets it by noting that “the difficulties courts face in evaluations of business decisions are considerably less in the case of recommendations of special litigation committees. The relevant decision — whether to continue litigation — is at hand and the danger of deceptive hindsight simply does not exist.”

The result reached in *Joy v. North*, in short, is based on the proposition that there is a distinction in kind between business judgment and the question of whether or not to continue litigation. An assessment of Winter’s position must test this proposition, just as an assessment of Cardamone’s dissent must test the validity of the distinction between “corporate” and “public” wrongs.

The Committee’s decision to discontinue the litigation apparently rested on the opinion of the expert who “concluded that the impact on morale of bank personnel, on the image of Citytrust among the banking public, upon persons who might be asked to become directors and upon potential new customers would offset even a recovery of \$5.5 million.” The other expert consulted by the Committee stated that “a recovery of even \$2 million would be worth pursuing.” Winter, sitting as an appellate judge rather than a finder of fact, is forced, therefore, to the following comment (in a footnote) about the first expert’s conclusion:

This opinion was not substantiated by verifiable historical evidence or other factual material. As such we believe it is entitled to no weight in the determination whether a suit such as this should be dismissed.

In arguing that “the danger of deceptive hindsight simply does not exist,” Winter devotes a great many pages to outlining in detail the facts a court must weigh in balancing the costs of litigation against the likelihood and value of recovery. Whether such a calculus is workable at all is a question that Winter resolves by “emphasiz[ing] that what we say here applies [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.” This restriction, however, states no more than a pleading requirement, which means that *Joy v. North* will be applied to cases to which the “business judgment” rule would have been applicable.

Thus, it is clear that Citytrust was repeatedly faced with the question whether the possibility of recapturing some of the money already advanced to the builder was sufficiently great to justify a further extension of credit. The facts which, for Winter, serve to remove this case from the protections afforded by the business judgment rule are set out in the survey of the Committee's report contained in his opinion:

"The management of Citytrust was completely dominated by . . . Nelson L. North, Citytrust's Chief Executive officer. . . , [who] also exercised strong control over the activities of the Board of Directors. . . , apparently brought the original proposal for the Katz loan to Citytrust . . . [had a] son [who] was employed by Katz . . . [was] deeply involved in the Katz transactions . . . [and] destroyed his records."

The impact of these facts on the Special Committee's determination was presumably one of the facts incorporated in the decision arrived at by the district judge. It can be argued, therefore, that what Judge Winter is doing is condemning a business judgment that resulted in a loss. The question that *Joy v. North* poses, however, is whether Connecticut law forced that duty upon Winter, a proposition the district judge denied.

In addition to derivative actions and suits brought by the corporation, the Connecticut indemnification statute, on which Winter based his reading of Connecticut law, covers a second category of cases, third-party actions involving threatened litigation and all kinds of proceedings, whether civil, criminal, administrative or investigative. Since this categorization can be read as paralleling the public/corporate distinction, on which the district judge's analysis rested, we are left with the possibility that Eginton's reading of Connecticut law may be more representative of what a Connecticut state judge would hold than the position Winter derives from the indemnification statute.

After setting forth the process courts should follow in cases like *Joy v. North*, however, Winter rests his case on judicial authority. Thus, in "[a]pplying the standard of review set out above to the Committee's recommendation," what Winter concludes is that "The Katz venture . . . is so similar to the classic case of *Litwin v. Allen, supra* (bank purchase of bonds with an option in the seller to repurchase at the original price, the bank thus bearing the entire risk of a drop in price with no hope of gain beyond the stipulated interest) that we cannot agree with the Committee's

conclusion that only a 'possibility of a finding of negligence' exists." Earlier in the opinion, moreover, Winter lists *Litwin* as a case to which the business judgment rule does not apply because it "is so egregious as to amount to a non-win decision."

*Litwin v. Allen*⁵¹ involved the Van Sweringens, one of the group of entrepreneurs identified with the Great Depression. In particular, the transactions attacked in that suit involved arrangements between J. P. Morgan & Co. and the Guaranty Trust Company in connection with the organization of the Allegheny Corporation as a holding company to provide funds for investment in railroad securities. The option in question was the result of borrowing limitations in Allegheny's charter. Because the bonds were convertible, the Van Sweringens insisted on the right of repurchase to avoid the possibility of loss of control of the railroad which had issued them, and because the transaction could not be structured as a loan, the option form was utilized. As the court pointed out, "there [was] no case directly in point," and the fact that the Van Sweringens were valued customers certainly raises a business judgment issue. Needless to say, the precipitous decline in bond values that characterized the early 1930's did indeed convert the transaction into a "no-win decision," but it is at least open to question both whether *Litwin* was correctly decided in holding that the transaction was so unusual as not to qualify as a business judgment, and whether it is a precedent so clearly applicable to the facts of *Joy v. North* as to justify the conclusion that a Connecticut court would reach Judge Winter's result.

Whatever our view of the extent to which the particular result reached by Winter was justified, moreover, the rule promulgated in *Burks v. Lasker* requires that the judicial role he enunciated in fact comport with the way in which Connecticut courts enforce "traditional fiduciary obligations." On this point, Winter relies on the "eminent judicial support" provided by a Delaware case, *Zapata Corp. v. Maldonado*,⁵² which he characterizes as holding that "an independent committee of directors may obtain a dismissal only if the trial court finds both (a) that the committee was independent, acted in good public faith and made a reasonable

⁵¹ 25 N.Y.S.2d 667 (N.Y.Co. Sup. Ct. 1940).

⁵² 430 A.2d 779 (Del. Sup. 1981).

investigation; and (b) that in the court's independent business judgment as to the corporation's best interest, the action should be dismissed." That reading, however, is significantly overstated. As the dissent points out, "the majority goes beyond *Maldonado* by requiring that the court *must* proceed to apply its own business judgment, rather than leaving the decision to resort to the second step within the trial court's discretion."

Winter attributes the Delaware Supreme Court's "eminence" to its "unique experience in the area [of derivative suits]." It is presumably as a result of that experience that Delaware corporate law relies heavily on the development of the facts that define the particular controversy being reviewed, and that trial courts are afforded considerable discretion in the finding of those facts. Neither of those propositions are exemplified by the *Joy v. North* opinion.

