

# *Zapata Corporation* *v. Maldonado:* Assessing a Precedent

JAN G. DEUTSCH \*

*This article examines the Delaware Supreme Court decision of Zapata Corporation v. Maldonado and attempts to determine whether the opinion is good law. The author contends that the decision will lead to more litigation as there is no clear indication as to what makes a corporation's business judgment not to pursue a court action justifiable. However, only time will tell if it is a good precedent.*

## Law and the Promise of Stability

Law is the process we have chosen as a preferred means for the resolution of conflicts. Because our civilization treats the individual human as a reality entitled to the same respect as the state, the process of law is adversary in nature. Assume the proceedings advance beyond the procedural steps designed to eliminate cases that cannot effectively be supported. We are then confronted with a situation in which both parties argue from precedent, a situation that represents the paradox of law.

In a strict common-law system, the law is a set of precedents. As the realists taught us, however, what law is, in fact, is simultaneously a set of human institutions—a process designed and operated by humans—and a set of precepts treated as binding obligations: as rules governing the activities in which humans engage. What makes this situation paradoxical is that law is successful as a process for resolving conflicts because both of the disputing parties feel justified in arguing that the law is on their side; yet the fact is that people in the end revere the law because what it promises is stability: a stability premised on a logical structure whose clear and definite standards are fundamentally incompatible with

\* Professor of Law, Yale Law School.

the potential conflict that permits both parties to the dispute to appeal to legal rules.

What has been described, while puzzling to the layperson, is a familiar phenomenon to litigators. What litigation accomplishes is the accommodation to the mosaic of the law of a set of facts not agreed clearly to be covered by the existing pattern. Similarly, what we mean by the development of doctrine is a process that changes the existing pattern: a set of decisions that either restrict or expand the precedents contained in earlier opinions. Yet each of the litigators, while aware of this process, believes his reading of the law to be valid. The question becomes, therefore, one of legitimacy, why we feel justified in coercing the losing party to abide by the court's decision. It is ultimately this feeling of justification that underpins the conclusion that a case is "good" law. The question explored in the remainder of this article is whether *Zapata Corp. v. Maldonado*<sup>1</sup> is "good" law.

## Untangling the Judicial Web

In mid-1974, recognizing that a tender offer the corporation was about to make for its shares would cause the market price of those shares to rise, Zapata Corporation's directors amended its corporate stock option plan to permit options to be exercised prior to the announcement of the tender offer. In June 1975, Maldonado brought a derivative action in the Delaware Court of Chancery alleging breach of fiduciary duty. The claims were that the amendment to the stock option plan avoided substantial tax liability for the optionees (including most of the then directors) and deprived Zapata of a tax deduction of a comparable amount.

Two years later, the same claims were made by Maldonado in the U.S. District Court for the Southern District of New York against the same defendants (save one), together with claims under Sections 7,<sup>2</sup> 10(b),<sup>3</sup> and 14(a)<sup>4</sup> of the Securities Exchange Act of 1934. On the

<sup>1</sup> 604 BNA Sec. Reg. & L. Rep. G-1 (Del. May 13, 1981) (hereinafter cited as *Zapata*).

<sup>2</sup> The Section 7 claim alleged that the Federal Reserve Board's margin requirements were violated when the optionees purchased stock with loans from the corporation. The claim was dismissed on the basis that, even if a private cause of action could be brought under Section 7, the corporation had suffered no damage from the alleged violation.

<sup>3</sup> 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

<sup>4</sup> 15 U.S.C. § 78n(a); 17 C.F.R. § 240.24a-9.

basis that it would be futile, no demand that Zapata pursue these claims was made on the board of directors in either case.

### Federal Court Background

#### *District Court Dismisses Suit*

In 1978, the district court dismissed the claims under the securities laws, and then, there being no federal claims to which the common-law claims of breach of fiduciary duty could be pendent, dismissed those as well.<sup>5</sup> On appeal, the Court of Appeals for the Second Circuit affirmed the dismissal of the section 10(b) claim:

Since *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977), an essential element is that the defendants have engaged in some form of deception [and thus] [e]ven if some directors have an interest in the transaction, absent domination or control of a corporation or of its board by the officer-beneficiaries, approval of the transaction by a disinterested majority of the board possessing authority to act and fully informed of all relevant facts will suffice to bar a Rule 10b-5 claim that the corporation or its stockholders were deceived.<sup>6</sup>

In *Santa Fe*, decided in 1977, the U.S. Supreme Court held that where it is not alleged that the transaction is either manipulative or deceptive, a complaint alleging that shareholders were treated unfairly by a fiduciary does not state a cause of action under Section 10(b), which deals with manipulation and deception. The complaint dealt with appraisal rights under the Delaware merger laws, and the opinion ended by acknowledging the possibility that "there may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint,"<sup>7</sup> but refused to create such standards because, "to the extent that Rule 10b-5 is interpreted to require a valid corporate purpose for elimination of minority shareholders as well as a fair price for their shares, it would impose a stricter standard of fiduciary duty than that required by the law of some States."<sup>8</sup>

<sup>5</sup> *Maldonado v. Flynn*, 448 F. Supp. 1032 (S.D.N.Y., 1978).

<sup>6</sup> *Maldonado v. Flynn*, 597 F.2d 789, 793 (2d Cir. 1979).

<sup>7</sup> *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 480-481 (1977).

<sup>8</sup> *Id.* at 480, n. 16.

#### *Court of Appeals Finds Federal Cause of Action*

When the *Maldonado* appeal was argued before the Second Circuit late in 1978, "the state court action was evidently about to go to trial."<sup>9</sup> The Second Circuit held, nevertheless, in connection with Maldonado's claim under Section 14(a) (the statutory basis for rules governing proxy solicitations), that:

We believe that a reasonable shareholder of Zapata Corporation could have considered it important, in deciding how to vote his proxy in 1976 and 1977, to know that the candidates for directorships had voted for, and in some cases benefited substantially from, the resolutions modifying the exercise date and removing the requirement of payment in cash so as to enable certain senior officers to avoid the adverse personal tax effect of the impending tender offer, known to them through inside information, while depriving the Corporation of a corresponding tax benefit.<sup>10</sup>

Since that holding meant that the complaint now stated a federal cause of action, the district court, on remand in Spring 1979, was directed "to determine in its discretion . . . whether the common-law claims should be left for resolution by the state court."<sup>11</sup> Prior to any such determination, however, Maldonado amended his complaint to delete those claims, thus mooting the issue of pendent jurisdiction.

#### *Independent Directors Recommend Dismissing Suit*

By June 1979, four of the defendant-directors were no longer on the board, and the remaining directors appointed two new outside members to the board and created an Independent Investigation Committee composed solely of the two new directors to investigate pending litigation and determine whether Zapata should continue any of it. Such determination was stated to be "final, . . . not . . . subject to review of the Board of Directors and . . . in all respects . . . binding upon the Corporation." In September, the Committee concluded that "continued maintenance [of the litigation] is inimical to the Company's best interests," and Zapata moved for dismissal or summary judgment in both the state and federal actions.

<sup>9</sup> *Maldonado v. Flynn*, note 6 *supra*, at 798, n. 14.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at n. 14.

*District Court Dismisses Case; Business Judgment Rule Properly Exercised*

In January 1980, the district court held that "under the analysis prescribed in *Burks*,<sup>12</sup> if a committee of independent, personally disinterested directors of Zapata has determined in good faith that in its business judgment the continuation of this action is not in the best interests of that corporation, the action must be dismissed." The reference to *Burks* was directed at Maldonado's argument:

[T]hat the "business judgment rule" of Delaware is inconsistent with Section 14(a) of the Securities Exchange Act of 1934 and cannot be used to foreclose prosecution of his claim thereunder: [an argument based on] the recently decided case of *Burks v. Lasker* [in which the Supreme Court of the United States] held that a two-step inquiry was required: As a threshold question, does applicable state law permit independent directors to terminate a derivative action against other board members? And, if so, is such a state law rule consistent with the policies of the federal laws upon which the action is based.<sup>13</sup>

The resulting dismissal was appealed to the Second Circuit.

**State Court Background**

*Chancery Court—One Trial for One Claim*

Two months later, however, the Court of Chancery of Delaware denied Zapata's motion for dismissal, holding that in the absence of judicial scrutiny of allegations of breach of fiduciary duty, Delaware law gave to shareholders an individual right to maintain derivative actions which they instituted, and that the business judgment rule was therefore irrelevant to the question whether Delaware corporations had the right to terminate such suits.<sup>14</sup>

Shortly thereafter, Zapata filed with the Supreme Court of Delaware an interlocutory appeal which was accepted on June 5, 1980. On May 29, however, the Court of Chancery dismissed Maldonado's cause of action on the following grounds:

<sup>12</sup> *Burks v. Lasker*, 441 U.S. 471 (1979).

<sup>13</sup> *Maldonado v. Flynn*, 485 F. Supp. 274, 278 (S.D.N.Y. 1980) (footnotes omitted).

<sup>14</sup> *Maldonado v. Flynn*, 413 A.2d 1251, 1263 (Del. Ch. 1980).

If the action of the District Court dismissing Maldonado's suit is ultimately upheld, an order dismissing the present action, based on *res judicata*, will be entered. If the District Court is reversed, an order will be entered denying Zapata's motion to dismiss.

If the result here seems harsh in view of my March 18, 1980, ruling that Zapata does not have the power under Delaware law to compel the dismissal of a stockholder's derivative suit by relying on the business judgment rule, it should be remembered that sound public policy mandates but one trial for one claim. Maldonado has already once argued and lost in the District Court on the issue of whether Zapata's Board of Directors may compel the dismissal of his claims. He assumed the risk of inconsistent adjudications when he, by his own strategy, elected to commence two actions, one here and one in the U.S. District Court, and then decided to amend out of his federal complaint his pendant common law theory of recovery. Since he created this risk it is entirely proper that he bear its burdens.<sup>15</sup>

*Delaware Supreme Court Ends the Procedural Gridlock*

The Second Circuit, however, ordered the appeal to it stayed pending action by the Supreme Court of Delaware. Responding to Zapata's characterization of the situation as a "procedural gridlock," the Supreme Court of Delaware embarked upon a task it described as an "attempt to resolve the particular question of Delaware law . . . whether the Committee has the power to cause the present action to be dismissed."<sup>16</sup>

Given that Maldonado had made no demand on the board, the Delaware Supreme Court agreed with the Court of Chancery that: "The 'business judgment' rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision [and thus] does not create authority [and] [i]n this sense [is] not relevant in corporate decision making until after a decision is made [by the board]."<sup>17</sup> It agreed, moreover, that the question to be decided was "the power of [Zapata] by motion to terminate a lawsuit properly commenced by a stockholder without prior demand."<sup>18</sup>

<sup>15</sup> *Maldonado v. Flynn*, 417 A.2d 378, 384-385 (Del. Ch. 1980).

<sup>16</sup> See *Zapata*, note 1 *supra*, at G-1.

<sup>17</sup> *Id.* at G-2.

<sup>18</sup> *Id.*

It held, however, that “[e]ven though demand was not made in this case and the initial decision of whether to litigate was not placed before the board . . . the board entity remains empowered under [Delaware statutory law] to make decisions regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.”<sup>19</sup> As a result, the order of the Court of Chancery was reversed, and the cause was remanded to permit a determination whether the Committee’s action “[satisfied] the Court’s independent business judgment,” and if Zapata failed to meet its burden of justifying the dismissal ordered by the Committee, ordering the Court of Chancery “carefully [to] consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit [and] when appropriate [to] give special consideration to matters of law and policy in addition to the corporation’s best interests.”<sup>20</sup>

In January 1980, before the Court of Chancery had declared its view of Delaware law, the district court held that “the final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors . . . and is not a legal but a business judgment.”<sup>21</sup> Similarly, the Delaware Supreme Court:

[R]ecognize[d] that “[t]he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors—ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal.” [citing the District Court]. But we are content that such factors are not “beyond the judicial reach” of the Court of Chancery which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems.<sup>22</sup>

In particular, the Delaware Supreme Court noted that its requirement that a court “apply . . . its own independent business judgment [in determining] whether the motion [of dismissal or summary judgment] should be granted, shares some of the same spirit and philosophy of the statement by the Vice Chancellor [in the Court of Chancery]: ‘Under our system of law, courts and not litigants should decide the merits of

<sup>19</sup> *Id.* at G-4.

<sup>20</sup> *Id.* at G-6.

<sup>21</sup> *Maldonado v. Flynn*, note 13 *supra*, 285.

<sup>22</sup> See *Zapata*, note 1 *supra*, at G-5.

litigation.’”<sup>23</sup> It remains true, however, that, whatever the “reach” of the Court of Chancery, Maldonado may, at this point, either settle or terminate his derivative suit. Depending on action taken by the Second Circuit, moreover, it is possible that, even if Maldonado pursues his claim, the Court of Chancery may treat its prior decision on *res judicata* as a final determination.

### A Corporation Must Justify Its Business Decision

The Delaware Supreme Court was quite clear both about the propositions of law presented by the case it was adjudicating—“a stockholder assertion that a derivative suit, properly instituted, should continue for the benefit of the corporation and a corporate assertion, properly made by a board committee acting with board authority, that the same derivative suit should be dismissed as inimical to the best interests of the corporation”<sup>24</sup>—and about the social policies that provided the *rationale* for the precedents supporting each of the propositions:

If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. . . . If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result.<sup>25</sup>

### A Question of Law

It was also aware that placing the burden on the corporation to justify the committee’s business decision transformed that decision into a question of law.

In justifying its holding that Zapata “should have the burden of proving independence, good faith and a reasonable investigation,” the Supreme Court noted that “our approach here is analogous to and consistent with the Delaware approach to ‘interested director’ transactions,

<sup>23</sup> *Id.* at G-6, n. 18.

<sup>24</sup> *Id.* at G-4.

<sup>25</sup> *Id.* at G-4.

where the directors, once the transaction is attacked, have the burden of establishing its "intrinsic fairness" to a court's careful scrutiny."<sup>26</sup> It cited *Sterling v. Mayflower Hotel Corp.*,<sup>27</sup> a precedent familiar to any lawyer who has attempted to understand Delaware's response to the U.S. Supreme Court decision in *Santa Fe*.

*Sterling* was decided in 1952. *Singer v. Magnavox Co.*,<sup>28</sup> the first decision after *Santa Fe* in which the Delaware Supreme Court dealt with fiduciary obligations imposed by the Delaware law governing corporate mergers, held that use of a controlling shareholder position through the merger process for no purpose other than to eliminate the minority interests for cash, regardless of the amount paid therefore, is a violation of the fiduciary duty owed by a majority shareholder to the minority. In *Tanzer v. International General Industries, Inc.*,<sup>29</sup> however, the same court held that a cash-out merger is permissible if the purpose is to further the interests of the majority shareholder, provided that the purpose is not merely a subterfuge to enable the majority shareholder to rid itself of the unwanted minority.

In 1981, the Court of Chancery reconciled those decisions by noting that, in *Singer*, "proof of a purpose other than . . . minority freeze out does not end the matter and there still must be a hearing under the standard of *Sterling*," whereas, under *Tanzer*, "even if the purpose is *bona fide*, there still must be a hearing under the standard of *Sterling*, and at such a hearing it is not sufficient to limit the issue to price alone. Rather, price must be considered along with any other relevant factors."<sup>30</sup>

The citation of *Sterling*, however, while it may serve to reconcile the *Singer* and *Tanzer* precedents, provides no guidance on the question whether or not a given transaction meets the fiduciary obligations imposed by Delaware law. Thus, Justice McNeilly concurred in *Singer* because while he "agree[d] with the holding . . . that a . . . merger, made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process [he was] inclined to think . . . that the [Duffy] opinion waffles in its attempt to establish guidelines for future merger litigation with emphasis on the coined phrase 'business purpose,' which standing alone connotes nothing magic or definitive."

<sup>26</sup> *Id.* at G-5, n. 17.

<sup>27</sup> 93 A.2d 197 (Del. 1952).

<sup>28</sup> 380 A.2d 969 (Del. 1977).

<sup>29</sup> 379 A.2d 1121 (Del. 1977).

<sup>30</sup> *Weinberger v. UOP, Inc.*, 426 A.2d 1333, 1344 (Del. Ch. 1981).

That Justice Duffy (who wrote both *Singer* and *Tanzer*) regarded McNeilly's criticism as telling accounts for the fact that *Singer*, although handed down before *Tanzer*, appears in a later volume of the *Reporter*.<sup>31</sup> In *Singer*, moreover, it was Justice McNeilly in concurrence, and not Justice Duffy, who held that "in these cases of going private, be they mergers under §251 or §253, it is my opinion that *Sterling v. Mayflower*, 93 A.2d 107 (1952), establishes an avenue for judicial scrutiny with a firm foundation based upon factual determinations of fundamental fairness and economic reasonableness which should be our guideline for future cases."<sup>32</sup>

### Setting the Framework for Further Litigation

*Sterling*, in other words, though it clearly is the law, is unclear as to what the law is. Similarly, in *Zapata Corp. v. Maldonado*, while it is clear that, under certain circumstances, the issue of business judgment is a question of law, it is unclear what makes a corporate motion to dismiss justifiable, just as it is unclear under *Sterling* what makes a majority shareholder's business purpose *bona fide*. The one thing that is clear is that more litigation will be forthcoming.

### Does the Self-Interest of the Majority of the Directors Taint an Independent Committee?

#### Legal Standard Applicable to Directors

Similarly uncertain in terms of its impact on derivative litigation is the meaning of the legal standard held by the Supreme Court of Delaware to be applicable to corporate directors. What the supreme court holds is that "we do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members."<sup>33</sup> The conclusion of the Court of Chancery's opinion refusing to dismiss the complaint, however, makes clear its acceptance of the legal proposition announced by the supreme court:

This decision, of course, is limited to the issue of whether a Board of Directors or its Committee may compel the dismissal of a deriva-

<sup>31</sup> Only the first part of the slip opinion quotation explaining Justice McNeilly's basis for concurring appears at 380 A.2d 969, 982 (Del. 1977).

<sup>32</sup> *Id.*

<sup>33</sup> See *Zapata*, note 1 *supra*, at G-4.

tive suit without a judicial scrutiny of the allegations of breach of fiduciary duty set forth in the Complaint. It has not been necessary to consider whether the directors of Zapata acted improperly in 1974, or are entitled to any of the protections offered by the business judgment rule; nor has it been necessary to consider the issue of the burden of proof as to the independence of the Committee. Even, however, if the business judgment rule were relevant to the dismissal issue decided here, it would seem that, under current concepts of fairness and fiduciary duty, directors who are made defendants in a stockholder's derivative suit, because they approved a transaction in which they had a self-interest, and who then seek a dismissal of the suit by appointing an Independent Committee to decide whether the suit should continue, should, at least, bear the burden of showing the independence of their Committee. See *Singer v. Magnavox Co.*, Del. Supr., 380 A.2d 969 (1977).<sup>34</sup>

The disagreement between the two courts centers on the question of the impact on the business judgment rule of the directors' interest in the transaction the litigation was brought to challenge—and in particular on how the substantive legal propositions embodied either in the phrase “business judgment” or the word “interest” are to be given effect in legal proceedings. A confusion analogous to that produced by the two Delaware opinions was made part of our law by the opinion in *Globe Woolen Co. v. Utica Gas & Electric Co.*,<sup>35</sup> which held that when the vote on a contract between two corporations was taken, the presence of a director who held that position in both corporations was sufficient to make the contract voidable.

#### The *Globe Woolen* Precedent

What *Globe Woolen* involved was a suit by plaintiff corporation to compel specific performance of contracts to supply electric current to its mills. The facts, as stated in the opinion, are:

Greenidge . . . superintendent and later the general manager of the defendant's electrical department, suggested to Mr. Maynard [who was the director of both plaintiff and defendant corporations]

<sup>34</sup> *Maldonado v. Flynn*, 413 A.2d 1251, 1263 (Del. Ch. 1980).

<sup>35</sup> 224 N.Y. 483, 121 N.E. 378 (1918).

the substitution of electric power . . . Maynard was fearful that the cost . . . would be too great unless the defendant would guarantee a saving. [F]rom time to time the subject was taken up anew [and after] investigation[s] by Greenidge . . . a contract was closed [in] the form of letters exchanged between Greenidge and Maynard.<sup>36</sup>

What had happened was that “Greenidge had miscalculated the amount of steam that would be required to heat the dye houses [because] changes in the output of the mills had not been foreseen by Greenidge, and Maynard had not warned of them.”<sup>37</sup>

The question posed by the *Globe Woolen* decision is why Maynard was held responsible for having failed to warn Greenidge about possible future developments, despite the facts that “plaintiff's books were thrown open to Greenidge”<sup>38</sup> and that “[Maynard] may have trusted to the superior technical skill of Mr. Greenidge.”<sup>39</sup> The answer consists of propositions of law phrased in terms of general rules: “A beneficiary, about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word. The trustee is free to stand aloof, while others act, if all is equitable and fair. He cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface, or lurking beneath the surface, but visible to his practiced eye,”<sup>40</sup> and “a finding that there was [a relation of trust reposed, of influence exerted, of superior knowledge on the one side and legitimate dependence on the other] has evidence to sustain it. A trustee may not cling to contracts thus won, unless their terms are fair and just.”<sup>41</sup> The conclusion is that “the contracts before us do not survive these tests. The unfairness is startling, and the consequences have been disastrous.”<sup>42</sup>

The difficulty with this precedent is the lack of clarity as to what made the contract voidable: that Maynard was Greenidge's superior in terms of the corporate hierarchy, that “as a result of [defendant's contractual guarantee], it has supplied the plaintiff with electric current for nothing, and owes, if the contract stands, about \$11,000 for the privi-

<sup>36</sup> *Id.* at 486, 121 N.E. at 378-379.

<sup>37</sup> *Id.* at 488, 121 N.E. at 379.

<sup>38</sup> *Id.* at 486, 121 N.E. at 380.

<sup>39</sup> *Id.* at 491, 121 N.E. at 380.

<sup>40</sup> *Id.* at 489, 121 N.E. at 380.

<sup>41</sup> *Id.* at 490, 121 N.E. at 380.

<sup>42</sup> *Id.* at 491, 121 N.E. at 380.

lege,"<sup>43</sup> or that Maynard was a director of both corporations. The one thing that is clear is the opinion's holding that the legal consequence of invalidity flows from the fact that the director could be said to have an interest in the transaction on which the vote was being taken rather than from the vote itself:

The plaintiff does not deny that [the contracts would be voidable] if the dual director had voted for their adoption. But the argument is that by refusing to vote he shifted the responsibility to his associates, and may reap a profit from their errors. One does not divest oneself so readily of one's duties as trustee. The refusal to vote has, indeed, this importance: It gives to the transaction the form and presumption of propriety, and requires one who would invalidate it to probe beneath the surface. . . . But "the great rule of law" . . . which holds a trustee to the duty of constant and unqualified fidelity is not a thing of forms and phrases.<sup>44</sup>

It is, of course, true, as *Globe Woolen* notes, that "a dominating influence can be exerted in other ways than by a vote,"<sup>45</sup> but the relevant question—whether the dominating influence has in fact been exerted and the vote thereby rendered void—is today answered solely by analyzing whether the contract or transaction in question is covered by the state statute governing interested directors. Thus, in answering the question whether a "board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors," it was "by analogy to our statutory section on interested directors" that the Delaware Supreme Court concluded that it "seems clear that the Delaware statute is designed to permit disinterested directors to act for the board."<sup>46</sup>

### Moving From Common Law to Statutory Law

The shift from common law to statute that defines the difference between *Globe* and *Zapata* does not necessarily mean that the judiciary has surrendered authority, so long as it is a court that determines whether

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 488, 121 N.E. at 379.

<sup>45</sup> *Id.*

<sup>46</sup> See *Zapata*, note 1 *supra*, at G-4.

or not the statute applies to the contract or transaction being challenged. What it does suggest, however, is that the lack of clarity concerning the applicability of the standard promulgated by *Globe* may have contributed to the development of statutory standards. Since there is no a priori basis which justifies treating statutory law as inferior to common law, *Globe Woolen* remains a "good" precedent even if the law it made was produced by legislatures rather than judges. The question raised by that decision, however, is whether "good" precedent is necessarily unclear, and, if so, what it was in the conflict resolved by *Globe Woolen* that the opinion in that case left unclear.

Two judges in the appellate division, whose decision was being reviewed in *Globe Woolen*, had found "that the contracts were made in good faith and that the fact that Maynard was a director in the defendant company did not influence them or have anything to do with their making or affect their validity; that the contracts, however, resulted solely from a mutual mistake of fact, and the defendant should [therefore] be allowed to rescind. . . ." <sup>47</sup> The doctrine of mutual mistake of fact was established in *Sherwood v. Walker* (Rose II of Abalone),<sup>48</sup> which involved a contract for sale of a cow at a price calculated in terms of pounds of beef. The seller attempted to repudiate when, before delivery to the buyer, it was learned that the cow was with calf. The value of a cow as a breeder far exceeds her value as beef. The trial judge nevertheless ruled that a mistake about the possibility of pregnancy did not constitute grounds for avoiding the contract, holding that whether or not a cow was barren was not material to the contract.

The trial judge's ruling was reversed. What the appellate court held was that the mistake was not about the value of the cow but about the "substance of the thing bargained for." That the decision in *Sherwood* contemplates the possibility of a mutual mistake as to value (and therefore does not rule on the question whether such a mistake would be sufficient to void the contract) is indicated by the fact that it lists price as one of the material factors in a contract about which a mistake could occur. The question raised by *Sherwood*, therefore, is the meaning of the holding that a mistake as to the possibility that a cow is barren is sufficient to make a contract for its sale voidable.

That the mistake in *Sherwood* was, in fact, mutual is apparent on the

<sup>47</sup> *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 170 App. Div. 940, 941, 254 N.Y.S. 1123, 1124, (1915).

<sup>48</sup> 66 Mich. 568, 33 N.W. 919 (1887).

face of the opinion. As the majority views the facts, "it appears from the record that both parties supposed this cow was barren and would not breed."<sup>49</sup> And while the buyer's knowledge of the cow's condition was based on what the seller told him, it is nevertheless true, as the dissent notes, that the buyer "believed the cow was farrow; but still that she could be made to breed."<sup>50</sup> Since what "farrow" means is barren for the season, and since much of the law spawned by the Rule against Perpetuities is based on the understanding that one can never be wholly certain about the duration of a barren condition, it is clear that the mistake in *Sherwood* could in fact be treated as mutual, in that the two parties based their beliefs on the same facts and would have agreed, in the abstract, on the general rules in terms of which inferences could be drawn from those facts concerning the subject of the contract they were entering.

Language, while often ambiguous, does not, however, permit many such situations to occur, and it is therefore not surprising that almost none of the cases citing *Sherwood* in fact deals with a mistake that is mutual. *Sherwood*, in short, while "revered by teachers of contract law,"<sup>51</sup> is not in operational terms an effective precedent. And it is presumably for this reason that Cardozo did not analyze *Globe Woolen* as a case of mutual mistake. The fact remains, however, that *Sherwood* had been decided, that two appellate division judges had regarded the doctrine of mutual mistake of fact as dispositive, and that, at the time *Globe Woolen* was written by Cardozo, electricity was a sufficiently revolutionary technological innovation to make the economics involved in its use the subject of a mutual mistake.

### The Role of Precedents

The paradox of law can perhaps best be expressed by focusing on the way in which precedent functions. Thus, while the proposition of law promulgated in a judicial opinion is itself based on facts, that proposition—once it is cited in a later opinion as precedent—itself operates as a fact, a given proposition beyond human power to change. In this sense, a precedent functions as fact because it is a statement about the

<sup>49</sup> *Id.*, 33 N.W. at 923.

<sup>50</sup> *Id.*, 33 N.W. at 924.

<sup>51</sup> *H. Kook & Co. v. Scheinmann Hochstein & Trotta, Inc.*, 414 F.2d 93, 98 (2d Cir. 1969).

past, and it is the paradox of law that the function of precedent is to guide human behavior in the future.

What makes law so paradigmatic a human institution, moreover, is that this paradox is mirrored in the function served by the words used to describe the controversy being resolved by the court. Words are used to designate feelings causing the behavior that results in litigation, and words constitute the best means humans possess for communicating to each other information about such feelings. Because I use the same word to describe both my feeling and yours, however, does not mean that the two emotional states are identical; yet it is only our insistence that the same word describing the same thing should have the same consequence that makes a decision adjudicating my behavior applicable to the same act committed by someone else, that in the end justifies coercion in the name of the law.

### The Unanswered Question

The question left to the future, then—whether *Zapata* is a good precedent—is the question whether the uncertainty inherent in that decision will prove as fruitful as the ambiguities inherent in the law made by *Globe Woolen* and *Sherwood*.

---

### NEPOTISM

Bill Cosby: "If at first you do succeed—it's probably your father's business."

—Joey Adams' "Strictly For Laughs"  
*The New York Post*  
 June 18, 1981