CORPORATE LAW—DIRECTORS OF AN IOWA CORPORATION WHO ARE PARTIES TO A DERIVATIVE ACTION MAY NOT CONFER UPON A SPECIAL LITIGATION COMMITTEE THE POWER TO BIND THE CORPORATION AS TO ITS CONDUCT OF THE LITIGATION—*Miller v. Register & Tribune Syndicate, Inc.*—(Iowa Sup. Ct. 1983).

Paul B.W. Miller, as a minority shareholder, instituted a derivative action in Federal District Court[1] on behalf of the Register and Tribune Syndicate, Inc.,[2] claiming that the corporation has sold its stock at fraudulently undervalued prices and for grossly inadequate consideration[3] to five individual defendants who were members of the board of directors of the corporation.[4] Miller claimed that the individual defendants purchased stock on favorable terms resulting in financial losses to the other stockholders' detriment.[5]

At a meeting of the board of directors to decide on a strategy to defend against the suit, the number of directors was expanded to six,[6] and a resolution establishing an independent litigation committee composed of the two new directors was adopted.[7] The independent litigation committee filed its

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1. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 710 (Iowa 1983). The suit was filed in United States District Court, Southern District of Iowa on September 24, 1979. *Id.*

2. *Id.* The Register & Tribune Syndicate, Inc. was organized under IOWA CODE section 491 on August 8, 1951 and has continued to exist under this section. *Id.*

3. 336 N.W.2d at 710.

4. *Id.* at 709. The defendants named in the suit were David Kruidenier, Dennis R. Allen, Louis P. Norris, Michael G. Gartner and Gary G. Gerlach. *Id.*

5. *Id.* at 710.

6. *Id.* "By action of the board of directors, Rolland E. Grefe and Stacey R. Henderson were nominated and unanimously elected to the added positions." *Id.*

7. *Id.* at 710-11. The relevant portions of the resolution stated:

> RESOLVED, that pursuant to the powers reserved by this corporation and pursuant to Section 3.3 of this corporation's By-laws, there is hereby designated an Independent Litigation Committee which shall not be a standing committee. . . . Mr. Rolland E. Grefe is hereby designated a member and Chairman of the Independent Litigation Committee; Mr. Stacey R. Henderson is designated a member of the committee. . . .
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> RESOLVED, that the committee shall:
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> 1. Conduct such investigation of the circumstances surrounding all matters referred to, or which may be referred to, in the action *Paul B.W. Miller v. Register & Tribune Syndicate, Inc., et. al.*, or any other action which is based in whole or in part upon a common nucleus of operative facts, as the committee deems necessary or desirable to determine whether the corporation or anyone acting on the corporation's behalf shall undertake or continue any litigation against one or more of the present or former Directors or present or former Officers of the corporation. . . .
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> 2. Make the determination contemplated in 1 above, in the exercise of the committee's business judgment and in good faith; and [further] . . .

report and came to the conclusion that there was "no justification for any further expenditure of legal expenses or other expenses, for the purpose of continuing this lawsuit."[8]

As a result of the report filed by the committee, the corporation filed a motion for summary judgment seeking dismissal of the derivative action brought by Miller.[9] The corporation's basis for summary judgment was that the litigation had been determined by the litigation committee to be "not in the best interests of the defendant corporation."[10]

Based on these events, the federal court issued a certified question to the Iowa Supreme Court,[11] the pertinent portion of which dealt with whether a board of directors could appoint a special litigation committee with the power to decide whether the derivative action was in the best interest of the corporation and whether the committee had the authority to bind the corporation with its decision.[12] In answering the certified question, the Iowa Supreme Court held that directors of an Iowa Corporation, who are parties to a derivative action, may not confer upon a special litigation committee the power to bind the corporation as to its conduct of the litigation. *Miller v. Register and Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983).

Miller is a significant decision in the tumultuous development of law dealing with the appointment of special litigation committees by directors having considerable interest in pending litigation.[13] The Iowa court took a bold and unprecedented step in restricting the defendant directors of a corporation in a derivative action from appointing a special litigation commit-

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RESOLVED, that the determination made by the Independent Litigation Committee shall be final, shall not be subject to review by the Board of Directors, and shall in all respects be binding on the corporation.

Id.

8. *Id.* at 711. The report was filed May 13, 1982. *Id.*

9. *Id.*

10. *Id.*

11. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 710 (Iowa 1983). The certification procedure was pursuant to IOWA CODE § 491 (1981) and IOWA R. APP. P. 451-61.

12. *Id.* at 711. The full text of the certified question was as follows:

Under the law of the State of Iowa, may the Board of Directors of a Corporation organized under Chapter 491, Code of Iowa, with Articles of Incorporation and By-Laws similar to those involved here, acting through directors who are named as defendants in a derivative action brought by a minority shareholder on behalf of the corporation, (1) appoint a Special Litigation Committee composed of two directors who were not serving as directors at the time of the incidents in question, and (2) confer upon such committee the power to (a) investigate the merits of such derivative action, (b) determine in good faith whether, in its business judgment, the best interest of the corporation would be served by the prosecution, dismissal or settlement of such action, and (c) bind the corporation to its decision?

Id.

13. *See* Elfin, *An Evaluation of a New Trend in Corporate Law: Dismissal of Derivative Suits by Minority Board Committees*, 20 AM. BUS. L.J. 179, 179-80 (1982).

tee whose actions would bind the corporation.[14]

The growth of special litigation committees and their use to defeat shareholder derivative actions has been a troublesome problem for minority shareholders trying to correct serious abuses of power in corporation governance.[15] A shareholder can wield power over a corporation in two ways: voting privileges and the right to seek examination and review of management activities.[16] A shareholder's voting rights, however, are very limited and under normal circumstances consist of nothing more than an annual right to elect directors,[17] and approve various fundamental corporate changes.[18] Because of this limited control over corporate activities, a minority shareholder's only effective alternative is to exercise his right to file a derivative suit as a means of exerting corporate authority, protecting his corporate interests and deterring corporate mismanagement.[19] Derivative actions exist to permit a shareholder to "secondarily" enforce a corporate right and thereby indirectly protect the shareholder's own interest in the corporation.[20]

The corporate response to derivative suits has been the increasing use of special litigation committees whose purpose is to consider shareholder demands for action against members of their boards.[21] The Iowa court in *Miller* addressed the serious problems inherent with this technique, criticizing courts which adhere to the illusory premise that interested directors exert insufficient influence to taint the determination made by disinterested directors acting as a special litigation committee.[22] No other court has embraced the views of the *Miller* court and its distrust of litigation committee dismissal without judicial involvement.[23] For the first time a court has rec-

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14. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 718.

15. As reported in Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 N.W.L. Rev. 96 (1980), no instances could be found where a special litigation committee decided it was in the best interest of the corporation to sue. There are important and significant reasons for this occurrence including the possibility of "structural bias." *See* text accompanying notes 45-48 *infra*.

16. 13 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 5717, 5754 (perm. ed. 1970) [hereinafter cited as Fletcher].

17. *See* N. Lattin, Law of Corporations § 87 (1971).

18. *See* H. Henn, Laws of Corporations §§ 513, 517 (3d ed. 1983) [hereinafter cited as Henn].

19. Henn, *supra* at 1036, n.1.

20. Henn, *supra* at 1035.

21. Henn, *supra* at 1075.

22. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 717. *See* Rosengarten v. International Telephone & Telegraph Corp., 446 F. Supp. 817, 825 (S.D.N.Y. 1979) (court held that two outside directors were disinterested as the suit challenged questionable payments, even though one was a defendant and the other a potential defendant in their capacities as directors for other corporations that had made questionable payments); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980) (court approved of presence on committee of one director, because he did not profit from the transaction, even though he was named as a defendant for having acquiesced in the activities in question).

23. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 718.

ognized that the rights of a minority shareholder deserve the protection of the courts rather than judicial deference to a superficial review made by personally selected representatives of alleged wrongdoers.

The court noted that the criticism leveled at the liberalization of litigation committee powers was focused primarily on the committee's independence and not on the terms of limitations on a board's power of delegation.[24] Since the certified question did not include potential problems of special litigation committee independence from the board of directors, the court declined to address that issue, restricting their discussion to the extent of the board of director's powers of delegation.[25]

The *Miller* court began its analysis by comparing the differing aspects of Iowa's two corporate organization acts, IOWA CODE sections 491 and 496A.[26] The court noted that although the older of the acts (section 491) did not contain the broad powers of delegation which are provided in the modern act (section 496A), that failure to include delegation of powers did not indicate an intent by the legislature to deny that power.[27]

The court held that the defendant's articles of incorporation[28] and the implicit authority in IOWA CODE section 491 normally gives a board of directors the power to assign authority to a special litigation committee: in actuality, the power to use the business judgment rule as a means of defeating a derivative suit.[29] The business judgment rule creates a judicial presumption in favor of management's decision-making authority by protecting management from liability where a decision is within the authority and powers of the corporation, made in compliance with applicable fiduciary duties, and

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24. *Id.* at 716. The court cites ten law review articles to support its point. *Id.*

25. *Id.*

26. *Id.* at 713. IOWA CODE section 491 was the first statutory enactment of business corporation laws in Iowa, remaining without general revision until 1959 when IOWA CODE Ch. 496A (Iowa Model Business Corporation Act) was adopted. Section 491 was changed as various provisions of the old law were considered undesirable. One weakness was the failure to provide that a board of directors should have authority to conduct the business of the corporation. A board of directors was not even a statutory necessity under this section. Cosson, *The Iowa Business Corporation Act*, 45 IOWA L. REV. 12, 21 (1959).

27. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 714.

28. *Id.* at 715. The pertinent portion of the Register & Tribune's Articles of Incorporation is section 2 of article VI which provides:

> The officers of this corporation shall be a president, chairman of the board, one or more vice presidents, a secretary, and a treasurer, who shall be elected by the board of directors on the day of and immediately following the adjournment of the annual meeting of the stockholders, or as soon as practicable after the adjournment of said meeting. . . . The board of directors may also appoint such assistant officers, superintendents, managers, and other agents, as may be authorized by the by-laws or by resolution of the board of directors; provided, however, that the action of the directors in these respects shall be subject to control or change by action of the stockholders.

Id.

29. *Id.* at 714, 715.

made in good faith.[30] The court further stated that it would be inconceivable, however, that the business judgment rule could be invoked by a board of directors if a majority of the directors were involved in self-dealing.[31]

Additionally, the court suggested that where a majority of the board of directors are defendants in a suit, the board is not at liberty to seek dismissal of the suit by invoking the business judgment rule.[32] The inevitable question becomes whether a board has the power to delegate authority to a committee to act, in light of the fact that the board is not able to act on behalf of itself.[33] Although a number of courts have found that a board does have the authority to delegate to a committee the use of the business judgment rule, even where a majority of the directors are involved in the lawsuit,[34] the *Miller* court did not adhere to that view.[35]

The court noted that other courts have established certain elements which must be shown whenever the business judgment rule is invoked in

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30. *See* Henn, *supra* note 18 at 661.

31. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 715-16.

32. *Id.* The Iowa court referred to *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917), wherein the Supreme Court held that internal management is left to the discretion of the directors and that courts should seldom interfere to control except where the directors stand in a dual relation (as defendants and as corporate managers) which prevents an unprejudiced exercise of judgment.

The *Miller* court also referred to *Nussbacher v. Chase Manhattan Bank*, 444 F. Supp. 973, 977 (S.D.N.Y. 1977), wherein the court held that the business judgment rule should not apply where the directors themselves are charged with complicity in the allegedly wrongful action. The *Nussbacher* court stated, "[i]t is inconceivable that directors who participated in and allegedly approved of the transaction under attack can be said to have exercised unbiased business judgment in declining suit based on that very transaction." *Id.* at 977.

33. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 716.

34. *Id.* at 716-17 (citing Abbey v. Control Data Corp., 603 F.2d 724, 729 (8th Cir. 1979)). In *Abbey*, shareholders brought an action to compel several directors to repay penalties that had been paid by the corporation as a result of illegal payments to foreign governments. 603 F.2d at 726. The U.S. Court of Appeals for the Eight Circuit held that the business judgment rule applied in any situation where there had been a good-faith determination by an independent board of directors that a stockholder derivative suit was not in the corporation's best interests. *Id.* at 730.

See also Gall v. Exxon Corp., 418 F. Supp. 508, 510-11 (S.D.N.Y. 1976), wherein the defendant corporation's board of directors appointed three of its members to a special litigation committee to investigate the use of bribes in foreign countries in an attempt to gain business influence. 418 F. Supp. at 510-11. The committee determined that the president of the defendant corporation's wholly owned Italian subsidiary was responsible for the bribes and that several American directors knew of the illegal payoffs. *Id.* at 514. The litigation committee's findings were that it would not be in Exxon's best interest to maintain an action against any director or officer and that a dismissal of the derivative action should be sought. *Id.* Exxon's use of the business judgment rule to seek summary judgment was sustained even though the plaintiffs objected that the committee's decision was in effect a decision by those accused of the misconduct. *Id.* at 519-20. The *Gall* court appeared to be influenced by the fact that there was not any evidence that the bribes were illegal under either American or Italian law. *Id.* at 518.

35. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 718.

derivative action.[36] These elements include: "1) whether the special litigation committee appointed by the board of directors is endowed with the requisite power to bind the corporation to its recommendation of dismissal; and 2) whether it has been demonstrated that the special litigation committee was disinterested, independent, acted in good faith, and based its conclusion upon reasonable investigative techniques."[37]

Even if both of these elements are shown, there is still confusion in determining the role of a special litigation committee and the invocation of the business judgment rule as a means of dismissing shareholder litigation for the reason that only a handful of state courts have addressed this topic.[38] The cases fall into two distinct and opposite categories: 1)abdication of judicial responsibility over corporate matters and 2) judicial review.

The Iowa court in *Miller* examined *Auerbach v. Bennett*,[39] a case falling into the former category. In *Auerbach*, a shareholder brought a derivative action against four of General Telephone and Electronics Corporation's fifteen directors seeking an accounting for questionable payments to foreign governments and foreign political parties.[40] The New York Court of Appeals held that unless there was a substantial question regarding the independence of a special litigation committee or an impropriety in arriving at its determination, the substantive aspects of a decision to terminate a derivative suit against the defendant corporate directors were not within the reach of judicial inquiry under the business judgment principle.[41] Therefore, the *Auerbach* court effectively prevented judicial delving into corporate decisions.

The alternative view encompasses the liberal use of judicial examination in reviewing the business judgment of a special committee. This judicially invoked review is best illustrated in a case examined by the *Miller* court, *Zapata Corporation v. Maldanado*.[42] There, a stockholder brought a derivative action on behalf of the corporation to recover against numerous directors on the theory that they had breached their fidiciary duties.[43] An independent "investigative" committee was formed which later determined that the action should be dismissed as its maintenance would be against the company's best interests.[44] The Supreme Court of Delaware, in deciding whether a committee had the power to cause a derivative action to be dis-

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36. *Id.* at 712 (citing Abbey v. Control Data Corp., 603 F.2d at 730).

37. *Id.*

38. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 N.W.L. Rev. 97 (1980) [hereinafter cited as Dent].

39. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), *quoted in* 336 N.W.2d at 712.

40. 47 N.Y.2d at 625, 393 N.E.2d at 997, 419 N.Y.S.2d at 923.

41. *Id.* at 623, 393 N.E.2d at 996, 419 N.Y.S.2d at 922.

42. 430 A.2d 779 (Del. 1981), *quoted in* 336 N.W.2d at 712.

43. 430 A.2d at 780.

44. *Id.* at 781.

missed, held that a court should apply its own business judgment when determining whether or not to grant a motion for summary judgment.[45] Thus, *Zapata* cleared the way for establishing a balance which requires courts to become actively involved with decisions affecting corporate governing.

While the *Zapata* court applied a test[46] to determine whether directors should have the power of appointment, the *Miller* court followed a different tack. The Iowa Supreme Court determined that when members of a litigation committee are appointed by directors of a corporation who themselves are defendants, the potential for abuse is extensive.[47] The problem which the court recognized is known as "structural bias."[48] This concept revolves around the notion that directors who have a direct interest as defendants in a lawsuit might appoint loyal, empathetic managerial colleagues to special litigation committees.[49] These appointees cannot realistically be expected to be free from the pressures of their newly found positions on corporate litigation committees.[50] The financial and personal influences which the appointees must endure[51] could result in abuses (blatant or subconscious) when making the determination whether a shareholder derivative suit against a fellow director is valid.[52]

The logic of the *Miller* court's holding is put in better perspective when

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45. *Id.* at 789.

46. *Id.* at 788-89. The two-step test to be applied stipulated:

> First, the Court should inquire into the independence and good faith of the committee and bases supporting its conclusions. The corporation should have the burden of proving independence, rather than presuming independence, good faith and reasonableness. If the Court determines that the committee is not independent or has not shown reasonable bases for its conclusions, or if the Court is not satisfied for other reasons including the good faith of the committee, the Court shall deny the corporation's motion. If the Court determines that the committee is both reasonable and for good faith, the Court may proceed to the next step.
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> The second step provides the essential key in striking the balance between legitimate corporate claims as expressed in a derivative suit and a corporation's best interests as expressed by an independent investigation committee. The Court should determine applying its own business judgment whether the motion should be granted. 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 best interests.

Id.

47. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 718.

48. *Id.* at 716.

49. Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1234 (1977).

50. *Id.*

51. In *Auerbach v. Bennett*, 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928, the New York Court of Appeals noted that there was an inherent risk that independent directors on a litigation committee may be hesitant to investigate fellow board members thoroughly when such a report could affect the reputation of another director.

52. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 718.

compared to standards of disinterestedness required in the legal system. Since bias is often difficult to prove and there is a need for the appearance of fairness in the judicial determination of controversies, many people are disqualified from resolving legal disputes whenever there is an apparent conflict of interest in the dispute, regardless of the integrity of the individual.[53] A judge must recuse himself *sua sponte* if there is a reasonable concern that impartiality might be sacrificed.[54] Jurors may also be disqualified from duty if there is an interest in the dispute or a substantial connection to one of the parties.[55]

Because of the potential for structural bias and the uncertainty of whether bias exists, the *Miller* court deemed the expansive use of a prophylactic rule necessary as a means of effectively restricting the powers directors have in delegating authority to committees.[56] In instances when directors are not able to appoint a litigation committee because of the holding in *Miller*, the court may appoint a "special panel" to examine and report on the status of a derivative action.[57] Courts have upheld the use of independent panels to establish the fair and equitable handling of corporate governing problems.[58] A court-appointed committee would eliminate the structural bias problems associated with an interested director-appointed committee as it would allow courts to test a possible judgment conflict.

As with any unprecedented decision, there are problems associated with the "newness" of a court's holding. The use of a prophylactic rule in the *Miller* case points to many procedural ramifications of the judicially appointed process. Justice Wolle in his dissent in *Miller*, points to numerous concerns including when an application for a panel would be approved, who would be appointed to the panel, who would pay the cost of the panel and what would be the cost?[59] These problems will undoubtedly be resolved as the use of the prophylactic rule becomes more prevalent.

The *Miller* court's approach to the problem of appointments of special litigation committees by interested directors is a needed response to the serious problem of corporate directors attempting to circumvent the use of derivative suits brought by shareholders with valid legal disputes. The Iowa

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53. Dent, *supra* at 115.

54. *Id.*

55. *Id.* at 116.

56. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 718.

57. *Id.*

58. In *J.C.F. Holding Corp. v. General Gas & Electric*, 181 Misc. 283, 46 N.Y.S.2d 605 (Sup. Ct. 1943), where a derivative stockholders suit was brought against the defendant corporation concerning the transfer of four subsidiary companies, the court upheld a plan by the directors that it would be in the best interests of the corporation and stockholders to refuse bringing the suit, but rather, to present a plan for reorganization to the Securities Exchange Commission, before whom proceedings for a fair, equitable compromise could be worked out. 181 Misc. at 283, 46 N.Y.S.2d at 605.

59. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d at 720-21.

Supreme Court took an important step in realizing the realities of corporate decision-making processes while preserving the practical need for derivative actions. Without restraints, corporate action in derivative suits threatens to eliminate the protections and management deterrence offered by shareholder derivative actions. *Miller* is a needed precedent which could prove to be a model for other courts to follow in restricting the use and powers of independent litigation committees.

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