

Special Litigation Committees

A Practical Guidance® Practice Note by Charles F. Smith and Jordan Blain,
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This practice note discusses the use of a special litigation committee (SLC) to investigate shareholder derivative claims under Delaware corporate law. Shareholder derivative claims are actions brought by a shareholder on behalf of the corporation itself. When a shareholder brings a derivative action, the board of directors must determine if such a suit is in the best interest of the corporation. A board may delegate this task to an SLC made up of disinterested, independent directors, who conduct a thorough investigation of the shareholder's claims, typically with the aid of outside counsel. Forming an SLC can be a valuable tool for a board to maintain or regain control of the derivative suit from the shareholder. When advising a board of directors in response to a shareholder demand or the filing of a derivative litigation, you should understand the qualifications for serving on an SLC and requirements for conducting an investigation in order to withstand judicial review.

This practice note addresses the following SLC topics:

- Background: Shareholder Derivative Litigation and the Role of SLCs
- Formation of an SLC
- Required SLC Characteristics
- The SLC Investigation
- The SLC Report
- Judicial Review of SLC Recommendations
- Privilege Issues Raised in SLC Investigations

For additional information on shareholder derivative suits, see [Shareholder Derivative Litigation](#). For additional information related to issues covered in this practice note, see [Market Trends 2019/20: Public Company Reporting and Corporate Governance](#) and [Board Engagement with Shareholders Policy Checklist](#).

For practical guidance on liability provisions and potential defenses under the federal securities laws, see [Securities Act and Exchange Act Liability Provisions](#), [Section 11 Elements and Defenses under the Securities Act](#), [Section 12\(a\)\(2\) Elements and Defenses under the Securities Act](#), [Control Person Liability](#), [Reliance in Securities Fraud Actions](#), [Materiality in Securities Fraud Actions](#), [Scienter Defenses in Securities Fraud Actions](#), [Securities Litigation under the Private Securities Litigation Reform Act \(PSLRA\)](#), [U.S. Supreme Court Securities Litigation Decisions](#), [Defense Strategies under the Securities Act](#), [Jurisdictional Defenses under the Exchange Act](#), and [Jurisdictional Defenses under the Securities Act](#).

Background: Shareholder Derivative Litigation and the Role of SLCs

Shareholder Derivative Litigation

Shareholder derivative litigation generally arises when a shareholder alleges that some misdeed or failure by the board of directors has harmed the corporation. The shareholder's claims are derivative because the shareholder is alleging harm to the corporation caused by the board or officers. Because the power to sue on behalf of the corporation generally belongs to the board, derivative suits are a rare exception to the rule that the board has the power to prosecute or defend suits brought by against the corporation. A typical example is a claim that board members have engaged in self-dealing by taking a business opportunity away from the corporation for their own benefit.

Delaware law requires a shareholder to make a demand on the board prior to bringing a derivative suit. The written demand must set out the alleged wrongdoing and demand that the board take action to remedy it. The demand requirement is excused in cases in which demand would be futile. Futility is most frequently found when the derivative suit challenges a transaction involving a majority of the board members. If the shareholder meets their burden of showing futility, the court grants them authority to pursue the claims on behalf of the corporation. Because the claims belong to the corporation, any recovery from the suit is awarded to the corporation and not the shareholder who initiated the litigation.

The Role of SLCs

The utility of an SLC arises in the context of a shareholder derivative suit. After a shareholder makes a demand, the board of directors must investigate the claims and determine whether pursuing litigation is in the best interest of the corporation. The board's decision is protected by the business judgment rule, meaning that courts will not disturb a board's decision provided it is informed and made in good faith. A court generally favors a board decision based on an independent investigation and recommendation made by an SLC comprised of disinterested directors, and the board should always consider and analyze the need for an SLC, particularly when the board has a financial interest in the disputed transaction.

In determining whether pursuing the litigation would be in the best interests of the corporation, the board, or an SLC in response to a shareholder demand, also typically

undertakes a cost-benefit analysis in addition to the likelihood of success on the merits. For example, even if a claim has some merit, it still may not be in the corporation's interest to pursue it because the cost of pursuing the claim may outweigh the benefit. Courts have approved such an approach in the following circumstances:

- Pursuit of the claims would impair defenses in another proceeding
- The corporation would incur significant costs indemnifying corporate officers
- Bringing suit would constitute a harmful admission in a pending litigation

Given the difficulty of successfully challenging a board's response to a demand, shareholders frequently forego making a demand and plead that a demand would have been futile. If a shareholder proves demand futility, the shareholder gains a provisional right to maintain the litigation on behalf of the company. However, even in that instance, the board has an opportunity to regain control of the litigation by appointing an SLC to investigate the shareholder's allegations. Discovery in the derivative suit is generally stayed while the SLC investigates whether the suit is in the best interest of the corporation.

Formation of an SLC

A board of directors can form an SLC in response to a shareholder demand, but typically forms an SLC following a court finding that demand would have been futile. The committee should be comprised of independent, disinterested directors. As the Delaware Chancery Court stated in *Obeid v. Hogan*, 2016 Del. Ch. LEXIS 86, at *45–46 (Del. Ch. June 10, 2016), the SLC cannot be made up of (or include) non-directors because a board can only delegate its power to direct the business and affairs of the corporation to a committee of directors under 8 Del. C. § 141(a). However, the board can add new members to the board of directors for the purpose of appointing them to the SLC.

Disinterested directors are those who have no financial stake in the challenged transaction. It is important that the directors on the SLC are free of any conflicts of interest and able to independently and objectively act in the best interest of the corporation. There is no minimum number of members of an SLC—an SLC can be composed of a single director as long as that director meets all of the required criteria.

Required SLC Characteristics

To withstand judicial review, an SLC must be independent, act in good faith, and conduct a reasonable investigation. Delaware courts have elaborated on these requirements in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), and its progeny.

In *Zapata*, a shareholder brought a derivative suit alleging breaches of fiduciary duty by officers and directors of Zapata Corp. The shareholder did not make a demand on the board prior to filing the action, alleging that demand would be futile due to the involvement of the board members in the challenged activities. In response to the derivative suit, the board formed a committee composed of two new directors to investigate the claims and determine whether the litigation should be pursued. Following the investigation, the committee determined that the litigation was not in the best interest of the corporation and Zapata moved to dismiss the derivative action. On appeal in the case, the Delaware Supreme Court set forth a two-step analysis for evaluating decisions of an SLC. First, the court must inquire into the independence of the SLC and the good faith and reasonableness of its investigation and conclusions. Second, the court may apply its own business judgment to determine whether the derivative claims should be dismissed.

Following *Zapata*, an SLC must be formed (i.e., its particular members appointed) and conduct its investigation with a view toward eliminating any doubt as to its independence, good faith, and reasonableness. See *Judicial Review of SLC Recommendations* below.

Independence

Courts commonly focus on the independence factor when reviewing an SLC's motion to dismiss shareholder litigation. The SLC bears the burden of proving its independence. The Delaware Supreme Court stated in *Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985), that an SLC is independent when it can base its decision on "the merits of the issue rather than being governed by extraneous consideration or influences." To be independent, the members of the committee must be capable of making a decision solely in the best interests of the corporation. While courts have traditionally focused on economic connections between the SLC members and conflicted parties, they have also identified other relationships that cast doubt on an SLC member's independence:

- In *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985), the SLC failed to meet its burden of showing its independence where the SLC member was on the board

of directors at the time of the challenged transaction, was a defendant in the suit, and had a relationship and financial dealings with the chief executive of the company. The court also found significant that an SLC member was the president of the same university where the chief executive officer served as a trustee.

- The court in *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003), found the SLC did not meet its burden of demonstrating independence where the two members of the SLC were tenured faculty at the same university and two of the conflicted board members were significant donors to the same institution.
- In *London v. Tyrrell*, 2010 Del. Ch. LEXIS 54 (Del. Ch. Mar. 11, 2010), the court found a material question of fact as to the independence of the SLC where the wife of one member of the SLC was the cousin of an interested director.

However, evidence of a mere personal friendship or unrelated business relationship alone should not cast doubt on an SLC member's independence. An SLC member's presence on the board at the time of the challenged transaction also does not establish that the director is not independent, as the *Kaplan* court noted.

Good Faith

The board can demonstrate good faith in appointing the members of the SLC by selecting qualified individuals with little or no previous contact with the transaction to be investigated. To investigate shareholder claims in good faith, the SLC must conduct an investigation of all theories asserted in the plaintiff's complaint. The investigation should consider all facts and sources of information relevant to the claims.

Reasonableness

The standard for reasonableness overlaps with good faith and courts often consider these factors together. Failure to adequately investigate all theories of recovery will call into question the reasonableness of the investigation. Accepting the defendant's version of events without considering independent sources is a hallmark of an unreasonable investigation. The SLC should demonstrate its reasonableness by showing that the conclusions in its recommendations are based on an accurate understanding of the facts and a knowledge of the relevant law.

The SLC Investigation

Once established by the board, an SLC should retain its own outside counsel. Because the SLC must be independent of the board in fact and appearance, the

outside counsel for the SLC should be sufficiently independent of the board and corporation. This does not mean the outside counsel can never have done work for the corporation. However, at a minimum, counsel should have had no prior involvement in any litigation or issues related to the subject matter of the derivative claim.

The scope of the investigation should be based on the allegations in the shareholder's complaint. As discussed above, the SLC must meet the good faith and reasonableness requirements in conducting its investigation. In practice, this means the SLC must adequately investigate the factual bases for all theories of recovery. The particular allegations will determine the scope of a sufficient investigation, but the SLC will likely need to review documents, conduct interviews, and obtain expert guidance on the relevant issues.

If the SLC determines that the potential benefits of investigating some allegations do not outweigh the costs, the SLC should have factual support for the decision to withstand judicial scrutiny. While retaining outside counsel and conducting a thorough investigation is expensive, an SLC investigation can ultimately be valuable to the corporation. If the SLC determines the continuation of the suit is not in the best interest of the corporation, it can avoid a costly settlement or the risk and burden of continued litigation of the derivative claims.

At the conclusion of the SLC's investigation, it will provide a recommendation about whether pursuing the litigation is in the best interest of the corporation. If the SLC was organized in response to a shareholder demand, the SLC will make its recommendation to the full board. The full board will then determine how to respond to the shareholder demand.

If the SLC was created after a finding of demand futility—meaning there is a case pending in court—the SLC can move to dismiss the derivative claims that it determines are not in the corporation's best interest. Prior to moving to dismiss, the SLC, in conjunction with its counsel, typically will prepare a detailed report summarizing its investigation and recommendation. Because, as described below, a court reviews an SLC's motion under a summary judgment standard, the SLC will rely on the report to meet its burden to show it is entitled to dismissal.

If, however, the SLC finds that the suit is in the best interest of the corporation, it must decide whether the SLC or the shareholder should pursue the claims. Typically, the SLC would retain control of the litigation in this case, giving the independent board members on the SLC more influence over the proceeding. However, in one recent case,

the SLC determined that the shareholder plaintiff should be allowed to proceed with the derivative litigation. In re Oracle Corp. Derivative Litig., 2019 Del. Ch. LEXIS 1381, at *25 (Del. Ch. Dec. 4, 2019).

The SLC Report

At the conclusion of the SLC's investigation, the SLC and its counsel should prepare a detailed report. The SLC's report should:

Establish the legitimacy of the SLC's formation by demonstrating the disinterest and independence of the directors on the SLC

- Describe the process through which the SLC conducted its investigation (This process should satisfy a court that the investigation was undertaken in good faith and with reasonableness.)
- Set forth the facts and law that the SLC and its counsel considered
- Articulate the recommendation on whether the suit is in the best interest of the corporation and bases on which the SLC made its recommendation

Judicial Review of SLC Recommendations

If, after the investigation, an SLC determines that litigation is not in the best interest of the corporation, it can file a motion to dismiss the derivative claims. This motion to dismiss is not governed directly by the Delaware rules of civil procedure. As explained in *Zapata*, it is derived by analogy to the Delaware Chancery Rule 41(a)(2), which concerns a plaintiff's motion for voluntary dismissal after the defendant has filed an answer. Courts review these motions to dismiss using a summary judgment standard. The SLC bears the burden of proving that no issue of material fact exists as to its independence, good faith, and reasonableness. The putative shareholder plaintiff is generally permitted to conduct discovery in order to oppose the motion to dismiss.

Unlike decisions of the full board of directors, an SLC's determination is not entitled to judicial deference under the business judgment rule. Rather, as discussed above, courts apply a two-step analysis to SLC's motions to dismiss, articulated in *Zapata*. Under the first mandatory step, the court determines whether the SLC demonstrated its independence, good faith, and reasonableness. If the court is satisfied the SLC met its burden, it may either grant the SLC's motion to dismiss or move on to the

second discretionary step. In the second step, the court applies its own business judgment to determine whether the motion should be granted. This step is intended to resolve situations in which the actions of the SLC satisfy the criteria of step one but not the spirit of it. This means that even in cases in which the independence, good faith, and reasonableness of the SLC's investigation are without doubt, the court, at its discretion, can allow the derivative suit to proceed if it determines that in the court's business judgment the challenged transaction or conduct is not in the best interests of the corporation.

Privilege Issues Raised in SLC Investigations

The use of an SLC can raise significant privilege issues for both the corporation and the SLC. Confidential communications for the purpose of obtaining legal advice between the SLC and its outside counsel are protected by the attorney-client privilege. That privilege belongs to the SLC, the client here, not to the board of directors that appointed the SLC. However, as usual, disclosing privileged communications or work product to third parties can result in a waiver of privilege. Waiver is most common in these circumstances when an SLC produces a detailed written report or a presentation to the board based on its investigation. Whether to risk waiver in these circumstances is a strategic decision. The benefit of providing a thorough report of the investigation—especially if the SLC finds that pursuing the claims are not in the best interest of the corporation—may outweigh the risk of the shareholder plaintiff getting discovery into the privileged investigation communications. Also, in the rare instance in which the SLC determines that the shareholder should pursue the derivative claims, a Delaware court has held that the shareholder is entitled to the documents and communications that the SLC relied on to form its conclusions. *In re Oracle Corp. Derivative Litig.*, 2019 Del. Ch. LEXIS 1381, at *47.

Practical Considerations

Whether you are in-house counsel advising a board of directors in response to a shareholder demand or derivative litigation or outside counsel retained by an SLC, you must ensure the SLC is formed and conducts its business with a view toward withstanding judicial review. The following tips will help you with your analysis:

- **Engage in a cost/benefit analysis.** Before forming an SLC, balance the potential costs and benefits.
 - Relevant costs include the attorney's fees for outside counsel, the expense of conducting the investigation, the risk that the SLC will find the litigation is in the interest of the corporation, and the potential that even if the SLC finds the claims should be dismissed that a court will disagree.
 - The benefits include regaining control of the litigation from the shareholder plaintiff and avoiding the expense of a settlement or protracted derivative litigation if the SLC finds the claims are not in the corporation's interest.
- **Keep in mind judicial scrutiny.** Form an SLC with the goal of withstanding judicial review. The disinterested directors selected for the SLC must not only be independent of the conflicted board members but must also be free of relationships that would call their independence into question.
- **Retain outside counsel.** The SLC should hire experienced and diligent outside counsel to conduct the investigation. This will enhance the independence of the investigation and ensure that it is conducted with good faith and reasonableness.
- **Conduct a thorough investigation.** The SLC should investigate the shareholder's allegation thoroughly. The investigation likely will require reviewing financial data, conducting witness interviews, and retaining expert guidance. Any indication that the outcome of the investigation was predetermined or that theories were not fully investigated will call the good faith and reasonableness of the investigation into question.
- **Prepare a detailed report.** The report should document that the SLC's formation and investigation satisfy the requirements of independence, good faith, and reasonableness. The report should demonstrate that the shareholder allegations were adequately investigated and the SLC's recommendation is supported by fact and law.

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Charles F. Smith is an experienced trial lawyer, having tried many cases in federal and state courts around the country. These cases typically involve complex securities, accounting, financial or bankruptcy-related issues. He has represented many companies and their officers and directors in securities and derivative litigation, including Bank of America, Fifth Third Bank, UBS, Sprint Corporation, Technical Consumer Products and Aon Corporation.

He has extensive experience navigating complex multi-layered matters that involve both litigation and regulatory enforcement. Mr. Smith has represented many companies and individuals in SEC, DOJ, CFTC and FINRA enforcement matters. Among these clients are Bank of America, CME Group and Ameriprise Financial. He regularly represents corporate officers and directors in investigations.

Mr. Smith also has represented a number of clients in high-profile investigations under the Foreign Corrupt Practices Act. He has represented a major financial exchange, manufacturers, medical device companies and many other clients in investigations, as well as transaction due diligence and training on compliance matters.

Mr. Smith is a frequent speaker on litigation, compliance and enforcement issues. He is a 2014 recipient of the Excellence in the Law Award from the National Diversity Council. This award recognizes attorneys in the Chicago area who have distinguished themselves through their leadership, resolve and outstanding achievements for the benefit of their clients, collaborators and communities. Mr. Smith is a member of the board of directors of the Joffrey Ballet of Chicago and is chair of the board of trustees of Knox College, in Galesburg, Illinois. Selected by the board of trustees of the University of Chicago, Mr. Smith serves on its Law School Council. The council — comprised of judges, senior corporate executives and practicing lawyers — advises the law school on strategic matters.

Mr. Smith repeatedly has been ranked in the top tier for securities litigation in Illinois in *Chambers USA*, in which he is described by clients as an “outstanding attorney,” and repeatedly selected for inclusion in *The Best Lawyers in America*. He also was named a Client Service All-Star by The BTI Consulting Group in 2018.

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