ESSENTIALS OF A SPECIAL LITIGATION COMMITTEE

JOSEPH M. MCLAUGHLIN[1]
SIMPSON THACHER & BARTLETT LLP

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A. Appointment of SLC

A properly constituted Special Litigation Committee ("SLC") provides a powerful vehicle for a board to fulfill its obligation to investigate and evaluate a demand to assert a claim on behalf of the corporation in a manner that is likely to receive deference on judicial review. Even in a demand-excused case, the board may reassert its authority over a derivative claim in certain circumstances through a Special Litigation Committee of disinterested directors. The SLC procedure re-empowers the board to control litigation on behalf of the corporation, "and takes the case away from the plaintiff, turns his allegations over to special agents appointed on behalf of the corporation for the purpose of making an informal, internal investigation of his charges, and places the plaintiff on the defensive once a motion to dismiss is filed by the Special Litigation Committee . . . ." *Kaplan v. Wyatt,* 484 A.2d 501, 509 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985); s*ee, e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981) ("The [c]ommittee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest."); *Biondi v. Scrushy*, 2003 WL 203069, at *7 (Del. Ch. Jan. 16, 2003) ("By forming a committee whose fairness and objectivity cannot be reasonably questioned, giving them the resources to retain advisors, and granting them the freedom to do a thorough investigation and to pursue claims against wrongdoers, the company can assuage concern among its stockholders and retain, through the SLC, control over any claims belonging to the company itself."); *In re Oracle Corp. Derivative Litig.*, 808 A.2d 1206, 1210-11 (Del. Ch. 2002) (same); *Abbey v. Computer & Communications Tech. Corp.*, 457 A.2d 368, 372 (Del. Ch. 1983) (*Zapata* held that through a special litigation committee "the board of directors still retained all of its corporate powers concerning litigation decisions."); *Richardson v. Graves*, 1983 WL 21109, at *5 (Del. Ch. Mar. 7, 1983) ("uninterested members of the board are in a better position to decide the fate of [the derivative lawsuit]" than derivative plaintiffs who could "effectively destroy the corporation and jeopardize the investment of the general public.").

The authority of a corporation's board of directors to appoint an SLC to investigate derivative claims arises from the fundamental principle of corporate law that directors, rather

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[1] Joseph M. McLaughlin is a litigation partner at Simpson Thacher & Bartlett LLP. This article is an excerpt from the author's forthcoming two-volume treatise, *McLaughlin on Class Actions: Law and Practice*, published by Glasser LegalWorks.

than shareholders, "manage the business and affairs of the corporation." *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990). The decision to pursue, or not to pursue, litigation on behalf of the corporation is a decision concerning management of a business that is committed to the board. *See id*.

The SLC ordinarily is formed by written consent of the board after the corporation receives a demand to bring a claim, or after a shareholder commences litigation in a demand excused case, and it appears that a majority of the board are interested in the challenged transaction or otherwise suffer from potential conflict. "The purpose of the independent committee . . . is to act as an independent arm of the ultimate power given to a board of directors . . . to determine whether or not a derivative plaintiff's pending suit brought on behalf of the corporation should be maintained when measured against the overall best interests of the corporation." *In re Oracle Corp. Deriv. Litig.*, 808 A.2d 1206, 1212 (Del. Ch. July 10, 2002) (citing *Abbey v. Computer & Comm. Tech. Corp.,* 457 A.2d 368, 376 (Del. Ch. 1983)).

The prevalence of SLCs traces in large measure to *Burks v. Lasker*, 441 U.S. 471, 486 (1979). In *Burks*, the Supreme Court held that federal courts must apply state law in determining the authority of independent directors to discontinue derivative suits, and approved the use of an SLC to terminate a shareholder derivative action assuming applicable state law authorized committee to do so. *Id*. at 480. Numerous state and federal court decisions have recognized that applicable state statutory or case law permits a disinterested and independent SLC to terminate a pending shareholder derivative action which the committee determines in good faith to be contrary to the corporation's best interests. *See Hasan v. CleveTrust Realty Investors,* 729 F.2d 372, 375, 379-80 (6th Cir. 1984) (applying Massachusetts law); *Gaines v. Haughton,* 645 F.2d 761, 770-71 (9th Cir. 1981) ("as a matter of California law, a corporation's board of directors may delegate to a disinterested 'special litigation committee' the business judgment authority to dismiss a shareholder derivative lawsuit brought on behalf of the corporation against some of the directors") (citation omitted); *Bach v. National Western Life Ins. Co.*, 810 F.2d 509 (5th Cir.1987) (applying Colorado law); *O'Donnell v. Sardegna*, 336 Md. 18, 26, 646 A.2d 398, 402 (Md. 1994) (corporation, pursuant to the determination of its special litigation committee, moved for summary judgment in a derivative suit, "filing as exhibits the [special litigation committee] report and all of its underlying documentation"); *Genzer v. Cunningham*, 498 F. Supp. 682, 686-89 (E.D. Mich. 1980) (applying Michigan law); *Abella v. Universal Leaf Tobacco Co.*, 495 F. Supp. 713, 717-18 (E.D. Va. 1980) (applying Virginia law); *Gall v. Exxon Corp.*, 418 F. Supp. 508, 514-15 (S.D.N.Y. 1976) (applying New Jersey law); *Roberts v. Ala. Power Co.*, 404 So.2d 629, 632 (Ala. 1981);

The SLC must consist of disinterested members of the board. *See Abbey v. Computer & Comm. Tech Corp.*, 457 A.2d 368, 374 (Del. Ch. 1983) (appointment of an SLC is a concession by the board that it is not in a position to exercise its business judgment as to the demand). Once constituted, the SLC typically retains independent and reputable counsel, and expert advisors as appropriate, to assist it in the investigation of the proposed claim, and thereafter makes a recommendation, in the exercise of its business judgment, as to whether it is in the best interests

of the corporation to pursue, dismiss or consensually resolve the claim. The board's decision to appoint an SLC does not automatically constitute an acknowledgement that demand was excused. *Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. 1990). However, "a board of directors concedes demand futility when it is both interested and establishes a special litigation committee to resolve the derivative plaintiff's suit." *Levine v. Smith*, 591 A.2d 194, 209 (Del. 1991); *see also Spiegel*, 571 A.2d at 777.

The SLC's investigation typically entails, *inter alia*, gathering and reviewing relevant documents, including internal and publicly available information relating to the allegations made, such as news reports, books, SEC filings, reports of securities analysts, internet user-groups, and other relevant information. Counsel will also interview persons who may have knowledge of relevant information. The SLC should invite the derivative plaintiff, and their counsel, to meet with the SLC and its counsel to provide it with any factual or legal material that they believe would be helpful to the SLC in conducting its investigation. The investigation ordinarily culminates in a report setting forth the conclusion of the SLC with respect to the claim and a recommended course of action, *i.e.,* whether the claim should be prosecuted, dismissed or settled, subject to judicial approval. The experience in the great majority of cases has been that the SLC issues a report recommending that the demanded litigation is not in the best interests of the corporation.

Once an SLC has been appointed to investigate and decide whether to prosecute a claim, courts have generally rejected attempts by the derivative plaintiff to preempt the SLC by voluntarily dismissing a derivative suit under Fed. R. Civ. P. 41(a)(2) or its state analog. In *In re Oracle Corp. Deriv. Litig.*, 808 A.2d 1206 (Del. Ch. 2002), the derivative plaintiffs filed substantially identical derivative actions against certain Oracle directors and officers in Delaware and California on the same day, and filed a number of related actions thereafter, including a derivative action in California federal court. Shortly after the Oracle board appointed an SLC composed of two outside directors added to the board after the events underlying the suits, plaintiffs moved to voluntarily dismiss the Delaware action. *Id*. at 1207-09.

Recognizing the range of action that the SLC might take upon completing its investigation, including prosecution of some or all of the claims in one of the three derivative actions commenced or seeking dismissal of some or all of the claims in Delaware or elsewhere, the court declined to permit plaintiffs "to usurp the authority of the Committee before the Committee has even had a reasonable time to complete its review and investigation." *Id*. at 1213. The court opined that "such an intrusion on the putative authority of the Committee would be even more substantial than allowing the [plaintiffs] to proceed with discovery during the Committee's process." *Id*.; *see also Catibayan v. Fischer Eng'g & Maint. Co.*, 1997 WL 666969, at *2-3 (Del. Ch. Oct. 17, 1997) (denying motion for voluntary dismissal based on plaintiff's stated preference to litigate in another forum); *In re Walt Disney Co. Deriv. Litig.*, 1997 WL 118402, at *3 (Del. Ch. Mar. 13, 1997) ("One must wonder what theory of judicial efficiency or comity would promote a rule that encourages plaintiffs' counsel to file in multiple jurisdictions, force

defendants to commit resources from coast to coast, and then allow plaintiffs' counsel, at their own whim, to move the lines of battle after they have already begun to form?").

B. Judicial Review of SLC's Recommendation

The standard of judicial review of motions to dismiss derivative suits based upon the determination of an SLC varies depending on the jurisdiction. Three approaches have developed.

Most courts have adopted the Delaware approach enunciated in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), which requires a two-step inquiry after the SLC has made a recommendation to dismiss the suit. "First, the court should inquire into the independence and good faith of the committee and the bases supporting its conclusion . . . . The [c]orporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness." *Id*. at 788; *see also In re Oracle Corp. Derivative Litig*., 824 A.2d 917, 937 (Del. Ch. 2003) ("I begin with an important reminder: the SLC bears the burden of proving its independence."); *Kindt v. Lund*, 2001 WL 1671438, at *1 (Del Ch. Dec. 14, 2001) (same). Limited discovery may be permitted to illuminate these inquiries, usually in the nature of depositions of members of the SLC and any experts relied on in the report, as well as documents germane to the inquiry. *See Kaplan v. Wyatt*, 499 A.2d 1184, 1192 (Del. 1985) ("This discovery is not by right, but by order of the Court, with the type and extent of discovery left totally to the discretion of the Court."); *In re Oracle Corp. Derivative Litig*., 808 A.2d 1206, 1211 (Del. Ch. 2002); *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc*., 1997 WL 38130, at *1, *6 (Del . Ch. Jan. 29, 1997) ("Discovery requests should be tailored to facilitate the determination of the critical issue at this stage in the proceeding."). If the SLC fails to meet any of the requirements of the first step, the motion to dismiss will be denied. *See Kaplan,* 499 A.2d at 1188.

If the reviewing court is satisfied that the committee has met its burden of proving independence, good faith and reasonableness, the court, in its discretion, may proceed to a second step of review, which requires the court to "determine, applying its own business judgment, whether the motion should be granted." *Zapata*, 430 A.2d at 1191-92; *see Johnson v. Hui*, 811 F. Supp. 479, 485 (N.D. Cal. 1991) (same); *Peller v. The Southern Co*., 707 F. Supp. 525, 527 (N.D. Ga. 1988) (same); *Katell v. Morgan Stanley Group, Inc*., 1995 WL 376952, at *13 (Del. Ch. June 15, 1995) ("This discretionary second step is designed to prevent situations where the Special Committee complied with all the technical requirements of *Zapata,* but the outcome violates the spirit of that procedure."). In applying its business judgment, the court may consider whether the results of the SLC's investigation satisfy the "spirit" as well as the letter of the step one of the Zapata analysis. *Zapata*, 430 A.2d at 789. Additionally, a court may consider matters of law, public policy, or good corporate governance. *See id*.

The Second Circuit summarized the resemblance of the court's review to a summary judgment standard:

> the burden is on the moving party, as in motions for summary judgment generally, to demonstrate that the action is more likely than not to be against the interests of the corporation. This showing is to be based on the underlying data developed in the course of discovery and of the committee's investigation and the committee's reasoning, not simply its naked conclusions. The weight to be given certain evidence is to be determined by conventional analysis, such as whether testimony is under oath and subject to cross-examination. Finally, the function of the court's review is to determine the balance of probabilities as to likely future benefit to the corporation, not to render a decision on the merits, fashion the appropriate legal principles or resolve issues of credibility. Where the legal rule is unclear and the likely evidence in conflict, the court need only weigh the uncertainties, not resolve them. The court's function is thus not unlike a lawyer's determining what a case is "worth" for purposes of settlement. Where the court determines that the likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action, it should dismiss the case.

Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); *see also Strougo on Behalf of Brazil Fund, Inc. v. Padegs*, 112 F. Supp.2d 355 (S.D.N.Y. 2000) ("Although the motion is not strictly one for summary judgment, the corporation moving for termination bears the burden of proving the independence, good faith, and reasonableness of the SLC's review by evidence sufficient to eliminate any genuine questions of fact with regard to these issues."); *Johnson v.* Hui, 811 F. Supp. 479, 484-85 (N.D. Cal. 1991) (same); *In re Oracle Corp.*, 824 A.2d at 928-29 (standard of review "requires [court] to determine whether, on the basis of the undisputed factual record, [it is] convinced that the SLC was independent, acted in good faith, and had a reasonable basis for its recommendation. If there is a material factual question about these issues causing doubt about any of these grounds, *Zapata* and its progeny . . . require[e] a denial of the SLC's motion to terminate."); *Kaplan*, 484 A.2d at 519 ("the 'moving party' – here the corporation as represented by the [SLC] – is required 'to meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law'") (quoting *Zapata*, 430 A.2d at 789).

Numerous courts have adopted the *Zapata* approach permitting judicial review of the substance of the SLC's determination. *See, e.g., Joy*, 692 F.2d at 891 (deciding that Connecticut would adopt *Zapata*, as "[t]he function of judicial scrutiny of a committee's recommendation is to determine independently whether the action is likely to harm the corporation rather than help it."); *Strougo on Behalf of Brazil Fund, Inc. v. Padegs*, 1 F. Supp.2d 276, (S.D.N.Y. 2001) (deciding that a Maryland court would adopt *Zapata*); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 799 (E.D. Va. 1982) (court finds reasoning in *Zapata* persuasive).

The New York approach, enunciated in *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), holds that the business judgment rule prohibits judicial review of the merits of the committee's determination and limits judicial review to an analysis of the independence, good faith, and thoroughness of the committee's investigation. *Id.* at 623-24, 393 N.E.2d at 996, 419 N.Y.S.2d at 922; *see also Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 375-76 (6th Cir. 1984) (noting that *Auerbach* "varies significantly from the Delaware approach in its rejection of judicial authority to apply its own business judgment to the committee's *substantive* recommendations") (emphasis in original). In addition, unlike the Delaware approach, *Auerbach* places the burden of proof on the plaintiff to show "facts sufficient to require a trial of any material issue of fact as to the adequacy or appropriateness of the Modus operandi of [the] committee…" *Auerbach,* 47 N.Y.2d at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929.

A few courts have adopted modified versions of the *Zapata* approach, placing the burden of proof on the corporation to demonstrate, along with the independence, good faith and integrity of the process, that the SLC's conclusion was reasonable on the merits. *See In re PSE & G S'holder Litig.*, 718 A.2d 254, 261 (N.J. Super. 1998) ("The adoption of a modified business judgment rule, the key feature being that the corporation, not the shareholder, would have to meet an initial burden of proof is more consistent with the realities of shareholder-corporate existence. Courts would have to dismiss a shareholder derivative suit in accordance with management's recommendation so long as the corporation could establish the decision maker acted reasonably, in good faith, and in a disinterested fashion.") *Houle v. Low*, 556 N.E.2d 51, 59 (Mass. 1990) (holding that the reviewing court must, in addition to examining good faith and independence, determine "whether the committee reached a reasonable and principled decision"); *Alford v. Shaw*, 320 N.C. 465, 358 S.E.2d 323, 328 (1987) (applying a "modified Zapata rule" where reviewing court must determine whether the transaction complained of was just and reasonable to the corporation).

C. Characteristics of an SLC Likely to Receive Deference

In determining whether the SLC acted independently and in good faith, courts will examine the totality of the circumstances, and usually focus on six factors:

> (1) a committee member's status as a defendant, and potential liability; (2) a committee member's participation in or approval of the alleged wrongdoing; (3) a committee member's past or present business dealings with the corporation; (4) a committee member's past or present business or social dealings with individual defendants; (5) the number of directors on the committee; and (6) the "structural bias" of the committee.

In re Oracle Sec. Litig., 852 F. Supp. 1437, 1441 (N.D. Cal. 1994); *see also Strougo v. Bassini*, 112 F. Supp.2d 355, 362 (S.D.N.Y. 2000); *Johnson v. Hui*, 811 F. Supp. 479, 486 (N.D. Cal. 1991). The totality of the circumstances inquiry does not require the complete absence of any of the six factors; the court only needs to satisfy itself that the SLC was in a position to reach an objective

conclusion. *Oracle*, 852 F. Supp. at 1442; *Srougo*, 112 F. Supp.2d at 362; *Johnson*, 811 F. Supp. at 486.

Under Delaware law, directors traditionally lacked independence only if they were dominated by or so beholden to a fellow director that they surrendered their objectivity. *See, e.g., Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002) (assessing whether board members were "dominated" or "beholden" to corporation's CEO); *Brehm v. Eisner*, 746 A.2d 244, 257 (Del. 2000) (same); *In re The Limited, Inc. S'holders Litig.*, 2002 WL 537692, at *3-7 (Del. Ch. Mar. 27, 2002) (same). In *Telxon,* the Delaware Supreme Court determined that a director lacks independence only where:

> [H]e or she is beholden to the allegedly controlling entity, as when the entity has the direct or indirect unilateral power to decide whether the director continues to receive a benefit upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.

Telxon, 802 A.2d at 264. Similarly, in *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211 (Del. Ch. 2001) (emphasis in original), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002), *cert. denied*, 123 S. Ct. 2076 (2003), the Court of Chancery held that a director may lack independence if "a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind." *Id*. at 1232. Delaware courts have repeatedly held that numerous forms of pre-existing relationships do not call a director's independence into question. *See, e.g., Litt v. Wycoff*, 2003 WL 1794724, at *3-6 (Del. Ch. Mar. 28, 2003) (long-standing personal friendships); *In re Grace Energy Corp. S'holders Litig.*, 1992 WL 145001, at *4 (Del. Ch. June 26, 1992) (common board service); *Seibert v. Harper & Row Publishers, Inc.*, 1984 WL 21874, at *3 (Del. Ch. Dec. 5, 1984) (cousins). Indeed, most Delaware courts have not presumed a lack of independence even where a director who approved the challenged transaction is a named defendant. *See Kindt v. Lund*, 2003 WL 21453879, at *3 (Del. Ch. May 30, 2003).

The *sine qua non* of an effective SLC is members whose fairness and objectivity cannot reasonably be questioned. *See Biondi v. Scrushy*, 820 A.2d 1148, 1156 (Del. Ch. 2003). The majority view recognizes that independent directors forming an SLC are capable of rendering an unbiased decision despite having a common background to the defendants directors, and even if they were appointed by those defendants. *See, e.g., Strougo v. Bassini*, 112 F. Supp.2d 355, 362 (S.D.N.Y. 2000) ("The majority view recognizes that independent directors are capable of rendering an unbiased opinion despite being appointed by defendant directors and sharing a common experience with the defendants."); *Peller v. The Southern Co.*, 707 F. Supp. 525, 527-28 (N.D. Ga. 1988) (noting that "the court must accept the likelihood that members of an [SLC] will have experience akin to that of the defendant directors"), *aff'd*, 911 F.2d 1532 (11th Cir. 1990); *Kaplan v. Wyatt*, 499 A.2d 1184, 1189-90 (Del. 1985) ("[a]llegations of natural bias not supported by tangible evidence . . . do not demonstrate a lack of independence"); *Zapata*, 430 A.2d at 785;

Auerbach v. Bennett, 47 N.Y.2d 619, 632, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927-28 (1979). *Zapata* acknowledged that when directors are appointed by fellow directors to review the decisions of those who appointed them, "[t]he question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role." *Zapata*, 430 A.2d at 787. The court, however, held that its two-step inquiry that does not grant complete deference to an SLC adequately safeguards against this possibility. *See id*. at 787-89; *Stein v. Bailey*, 531 F. Supp. 684, 693 (S.D.N.Y. 1982) (stating that although "[i]t would be naive to believe that a few directors, no matter how uninvolved in the transactions at issue, would have no sense of loyalty to the other members of the Board," . . . it does not follow that such a committee is per se not independent").

Courts have declined to impose a minimum number of members that must comprise an SLC. Indeed, most courts considering the issue will not reject single member committees, although it is clear that exceptionally close scrutiny will be given to a single member committee. *See, e.g.*, *Hasan v. CleveTrust Realty Investors,* 729 F.2d 372, 379-80 (6th Cir. 1984) (stating that board "did not follow 'prudent practice' when it selected [one director] as the only member of its special litigation committee); *See Johnson v. Hui*, 811 F. Supp. 479, 486 (N.D. Cal. 1991) ("The larger the number of directors [on SLC], the less weight accorded to any disabling interest affecting only one director."); *Houle v. Low*, 556 N.E.2d 51, 58-59 (Mass. 1990) ("We decline to adopt a *per se* rule that special litigation committees should have more than one director, but we think the number of committee members should be a factor in determining the committee's ability to act independently."); *Katell v. Morgan Stanley Group, Inc.*, 1995 WL 376952, at *8 (Del. Ch. June 15, 1995) ("*Zapata* is very fact specific . . . . it cannot be cabined into all purpose rules like 'no one member special committees.'"); *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985) ("If a single member committee is to be used, the member should, like Caesar's wife, be above reproach.").

The conclusions of an SLC are much more likely to be accorded deference if a fair and comprehensive process is established and implemented upon the SLC's formation. In reviewing the adequacy of the SLC's investigation, courts will review (1) the length and scope of the investigation, (2) the committee's use of independent counsel and experts, (3) the corporation's or the defendants' involvement, if any, in the investigation, and (4) the adequacy and reliability of the information supplied to the committee. *See, e.g., Johnson,* 811 F. Supp. at 487-89; *Drilling v. Berman,* 589 N.W.2d 503, 509 (Minn. Ct. App. 1999); *Lewis v. Boyd*, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992).

The SLC should be empowered to investigate and evaluate the claims for which demand has been made or which are asserted in a commenced action, and to determine and pursue on behalf of the corporation the appropriate disposition of such claims. To accomplish this objective, the board should expressly authorize the SLC to conduct any factual and legal investigation, review and analysis that it deems reasonable and appropriate, and to retain, at the corporation's expense, any experts and advisors, including independent legal counsel, as it deems necessary. *See Katell v. Morgan Stanley Group, Inc.*, 1995 WL 376952, at *9-10 (Del. Ch. June 15, 1995) (approving committee investigation in which committee conducted interviews

and made informal document requests); *Lewis v. Fuqua*, 502 A.2d at 965-66 (same); *Kaplan*, 499 A.2d at 1189-90 (same). The resolution appointing the SLC also should specify that the determination of the SLC as to the appropriate disposition of the claims will not be subject to approval by the board. At least one court has held that public comments by company executives denying wrongdoing may be deemed to undercut the independence of an SLC investigating that wrongdoing. *See Biondi v. Scrushy*, 820 A.2d 1148, 1157-58, 1166 (Del. Ch. 2003).

The first step in any investigative process is to be certain that the board and its counsel understand and agree as to the role of the board and the way that the work will proceed. Accordingly, at the inception, the SLC and its counsel should meet with the board to discuss several essential matters. First, the independence of the committee, its counsel and any expert advisors retained by the SLC should be confirmed. *See Stein v. Bailey*, 531 F. Supp. 684, 693-94 (S.D.N.Y. 1982). Each of these participants in the investigation should disclose all prior contacts with the corporation and any work performed for or compensation received by the corporation, the defendants in the derivative actions or their affiliates. However, courts have pragmatically recognized that experienced businesspeople may have had dealing with each other and there is nothing untoward in allowing SLC members with past business dealing with the defendants to investigate those defendants' conduct. *See In re Oracle Sec. Litig.*, 852 F. Supp. 1437, 1442 (N.D. Cal. 1994) ("Business dealings seldom take place between complete strangers and it would be a strained and artificial rule which required a director to be unacquainted or uninvolved with fellow directors in order to be regarded as independent."); *Strougo v. Bassini*, 112 F. Supp.2d 355, 364 (S.D.N.Y. 2000) (holding that SLC members' prior business relationships with defendants "are neither inappropriate nor do they suggest that [SLC] would not faithfully discharge their obligations"); *Johnson v. Hui*, 811 F. Supp. 479, 486-87 (N.D. Cal. 1991) (noting favorably the absence of connection between SLC members or its counsel with the corporation); *Kaplan v. Wyatt*, 484 A.2d 501 (Del. Ch. 1984) (holding that SLC member's status as major shareholder and board member of companies having lucrative business relationships with corporation did not compromise independence), *aff'd*, 499 A.2d 1184 (1985).

The SLC members preferably should not be defendants in the derivative action and, it is optimal but not essential that they were elected to the board after the events alleged in the derivative complaint. *See Johnson v. Hui*, 811 F. Supp. 479, 486 (N.D. Cal. 1991) ("Courts have found SLC's independent and unbiased even though a member of the SLC is a nominal defendant or subject to small or indirect liability. However, where liability may be direct and substantial the SLC's independence may be questioned."); *Mills v. Esmark, Inc.*, 544 F. Supp. 1275, 1283 (N.D. Ill. 1982). It is important to eliminate or reduce any potential bases for anyone to subsequently challenge the independence of the any committee member or its counsel.

The importance of the SLC retaining reputable, independent counsel that does not regularly provide legal services to the corporation to assist the SLC in its investigation cannot be overstated. *See Grafman v. Century Broad. Corp.*, 762 F. Supp. 215, 220 (N.D. Ill. 1991) ("Another indicia of good faith and reasonableness of the investigation is the use of capable counsel."); *In*

re Par Pharm., Inc. Deriv. Litig., 750 F. Supp. 641, 647 (S.D.N.Y. 1990) ("Both New York and Delaware law contemplate that a special litigation committee be represented by independent counsel."); *In re Consumers Power Co. Deriv. Litig.*, 132 F.R.D. 455, 478-79 (E.D. Mich. 1990) (noting that law firm "could not serve as counsel to the [SLC] since they represent the defendant directors in this derivative action"); *Spiegel v. Buntrock*, 571 A.2d 767, 772 (Del. 1990) (noting SLC's use of independent counsel in affirming decision dismissing derivative complaint based on SLC's recommendation); *Byers v. Baxter*, 69 A.D.2d 343, 348, 419 N.Y.S.2d 497, 500 (1st Dep't 1979) ("[T]he procedure followed by the Board, consisting of appointing a special litigation committee of non-management directors, advised by independent counsel who made a thorough investigation, is an appropriate way for the corporation to exercise its power to determine whether a lawsuit such as this nominally on behalf of the corporation, should be pursued.").

The SLC and counsel should at the outset discuss the mandate of the SLC, and seek to confirm that the SLC has the full authority of the board to proceed as it sees fit. The SLC should be empowered by board resolution, preferably granting it all the powers and authority of the board to, *inter alia,* (i) investigate all matters alleged in or relating to the action, (ii) retain legal counsel and other advisors as it deems appropriate to assist the investigation, (iii) to appear through counsel on behalf of the corporation in the actions, and (iv) direct the representation of the corporation's interests in the action. If the SLC's power to act is to be restricted in any way, counsel and the SLC need to understand these limitations and discuss their potentially disabling implications for the investigation. *See In re Par Pharmaceutical, Inc. Deriv. Litig.*, 750 F. Supp. 641, 647 (S.D.N.Y. 1990) ("a mere advisory role of the Special Litigation Committee fails to bestow sufficient legitimacy on the Board's decision to warrant deference to the Board by this Court").

The SLC and counsel should review the tasks and propose achievable time frames for accomplishing them that can be set forth in a work plan. Counsel should seek to establish a regular schedule for meetings of the SLC and to identify dates on which SLC members are available to participate in interviews of witnesses. *Strougo v. Bassini*, 112 F. Supp.2d 355, 360 (S.D.N.Y. 2000) (noting favorably SLC's regular meetings with counsel to discuss progress of investigation and participation in majority of witness interviews). At the earliest convenient time counsel should review with the SLC the advantages (and any disadvantages) of moving to stay derivative proceedings pending the completion of the investigation, and the SLC should determine whether to seek such a stay. *See infra*, section 9.05(D).

It is also useful during this preliminary phase of the investigation to meet with counsel for the corporation and the defendants in the derivative action, in order to inform them of the investigation and to give them notice of the cooperation that the SLC expects from them and their clients.

Before conducting any interviews, it will be necessary for the SLC's counsel to obtain a significant volume of documents from the corporation, the defendants in the derivative actions, public sources and perhaps from third parties. *See Stein v. Bailey*, 531 F. Supp. 684, 695 (S.D.N.Y.

1982) ("'[p]roof . . . 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 a sham . . . would raise questions of good faith'"). In order to facilitate the process of obtaining documents from the corporation, it may be advisable to meet with a representative of the company (likely an in-house lawyer) who could provide a road map to the type and volume of available documents in various categories broadly identified by the SLC and its counsel. No later than this point the SLC and counsel should determine whether to retain the services of an expert consultant to assist in analyzing complex financial or technical information. Counsel and the SLC should fix a reasonable time in which to formulate appropriate document requests, permit the corporation and the defendants to search for and produce the requested documents, and for the SLC and counsel to review the documents produced.

Once the initial round of document collection and analysis is completed, the SLC and counsel should begin to interview relevant witnesses. A thorough investigation will necessitate interviewing, at a minimum, each of the defendants in the derivative action and any other company personnel with knowledge of the relevant events. It is also important to interview counsel for the corporation, the defendants in the derivative suits and the plaintiffs in the derivative suits. As the SLC's objective is to perform an independent evaluation of the allegation asserted by the derivative plaintiffs, it is essential that the SLC offer plaintiffs' counsel every opportunity to speak with the SCL and to present their strongest evidence. To promote balance and fairness, it is equally important to permit defendants' counsel the opportunity to rebut that evidence and otherwise apprise the SLC of any exculpatory information.

The SLC cannot compel any witnesses to appear before it. Moreover, most witnesses will only appear when accompanied by counsel, who will often request that the SLC provide them with advance notice of the topics to be covered in the interviews. Ordinarily, providing such information is a useful step toward expeditiously obtaining relevant information from the witnesses. It is possible that at the conclusion of the initial round of interviews, it may be necessary to re-interview certain witnesses, particularly where new information relating to that witness has emerged in the course of subsequent interviews.

Each SLC member should participate in as many of the interviews as possible, and as many interviews as possible should take place in the presence of at least one (and preferably all) committee members. *See Strougo v. Bassini*, 112 F. Supp.2d 355, 360 (S.D.N.Y. 2000) (noting favorably that both members of SLC participated in majority of witness interviews and reviewed and approved counsel's interview summaries); *Peller v. The Southern Co.*, 707 F. Supp. 525, 529 (N.D. Ga. 1988) ("The conduct of the interviews is a most important factor in determining whether the [SLC] pursued its charge with diligence and zeal, or whether it played softball with critical players."), *aff'd*, 911 F.2d 1532 (11th Cir. 1990). However, it is reasonable and appropriate for counsel to assume the lead role in obtaining documents and conducting witness interviews. *See Johnson v. Hui*, 811 F. Supp. 479, 489 (N.D. Cal. 1991) (approving SLC's reliance on counsel to gather documents and interview witnesses where this did not affect "independence of the SLC, the reliability [of the] SLC's evidence gathering, or the reasonability

of the SLC's analysis); *Katell v. Morgan Stanley Group, Inc.*, 1995 WL 376952, at *10 (Del. Ch. June 15, 1995) (noting that SLC "can select any agent to perform its duties as Special Committee, as long as the agents can perform their assigned tasks competently"). Similarly, it bolsters the credibility of the SLC when its members personally review key documents culled by counsel. *See Strougo v. Bassini*, 112 F. Supp.2d 355, 359 (S.D.N.Y. 2000).

Once the witness interviews (and any necessary re-interviews) are completed and any supplemental documents have been requested and received, the investigation will be essentially complete. It will then be time for the committee to determine what recommendations to make to the board.

The committee will have several options. They may recommend that (i) the derivative actions should continue as they are currently situated, with the counsel representing the derivative plaintiffs continuing to prosecute their claims; (ii) the actions should continue, but the company should take over the task of prosecuting the claims against one or more of the named defendants; (iii) the action should be settled on a fair and reasonable basis; or (iv) the actions should be dismissed based on a determination by the committee that they are either groundless or not in the best interests of the company or both.

Once the committee has decided what action to recommend to the board in response to the pending derivative actions, the next steps will be dictated by the SLC's decision. If it decides to recommend to the board that they allow the derivative actions to continue with the current counsel maintaining their role, there likely will be little else to do. If the SLC recommends that the company should take control of the litigation, it will be necessary either for SLC counsel or the company's regular counsel to engage in negotiations and/or motion practice sufficient to achieve that result. Following that result, counsel should then discuss with the SLC and/or the company whether it would prosecute the actions on behalf of the company, or whether other counsel of the company's choosing would do so.

Finally, should the SLC determine to recommend the termination of the litigation, it would be necessary for counsel to do several things. In order to present the conclusion to the courts in an effective manner, counsel should collaborate with the SLC in the preparation of a detailed written report summarizing the findings. The report would set out the efforts undertaken as part of the investigation (e.g., number of attorney and expert hours spent, number of documents reviewed, number of committee meetings, number of interviews), describe the various investigative techniques, delineate any problems that arose during the course of the investigation, set forth the facts relied on, the appropriate legal principles and the conclusions reached by the committee. It is essential that the report confront the plaintiff's allegations and legal theories head-on. A collection of exhibits, which would include both relevant documents and summaries of witness interviews, should be attached to the report.

Counsel would then prepare motion papers requesting the court to dismiss the derivative action based on the findings of the investigation. Typically, the basis for such motions would be either that the derivative claims were entirely without merit, or that any

potential recovery by the company is outweighed by the cost, burden and other difficulties imposed by the continued prosecution of the litigation. In instances where such motions are made, derivative plaintiffs are likely to seek discovery of the committee, including production of documents relied on by the committee, and depositions of committee members and possibly their counsel. *See infra*, section 9.05(E).

It is appropriate for counsel to be the principal drafters of the SLC's report, as long as the ultimate report fairly and accurately reflects the conclusion of the SLC. *See Carlton Inv. v. TLC Beatrice Int'l Holdings, Inc.*, 1997 WL 305829, at *12 (Del. Ch. May 30, 1997) ("Where there is no evidence of overreaching by counsel or neglect by the SLC, the court ought not second guess the SLC's decisions regarding the role which counsel played in assisting them in their task.") Indeed, an informed evaluation of the factual and legal claims typically will require application of the resources counsel is better equipped to provide, and the SLC should not hesitate to avail itself of these resources. *See id*. ("While the directors bear ultimate responsibility for making informed judgments, good faith reliance by a SLC on independent, competent counsel to assist the SLC in investigating claims is legally acceptable, practical, and often necessary."); *Katell v. Morgan Stanley Group, Inc.*, 1995 WL 376952, at *10 (Del. Ch. June 15, 1995) ("I find nothing unreasonable about [SLC'c] reliance on counsel.").

Strougo v. Bassini, 112 F. Supp.2d 355 (S.D.N.Y. 2000), illustrates the operation of an SLC whose recommendation that continued prosecution of derivative litigation was detrimental to the best interests of the corporation was accorded deference. Derivative plaintiff alleged that a rights offering by an investment company constituted a breach of duties under the Investment Company Act of 1940 because it purportedly was motivated by a desire to increase the investment adviser's fees rather than to benefit shareholders. The board appointed a two-member SLC consisting of directors appointed after the rights offering, and granted the SLC broad authority to investigate the derivative claim.

The SLC and its counsel reviewed 36,000 pages of documents and interviewed 11 witnesses, conducting follow-up interviews of certain witnesses. The SLC participated in the majority of the interviews, and reviewed and approved counsel's written interview summaries. The SLC met regularly with counsel to discuss the investigation's progress, and ultimately concluded that there was no evidence supporting plaintiff's allegations, and moved to dismiss the case as not in the best interests of the corporation.

The court granted the motion. Noting the extensive business experience of the SLC's members and their appointment to the board after the events at issue in the action, the court concluded that a few prior business relations with members of the board did not compromise the independence of the SLC's members. *See id*. at 362-64. The court held that a five month period between the commencement of document production to the SLC and the filing of the report and its five volumes of exhibits afforded reasonable time to conduct a thorough investigation. Upon reviewing the report, the court concluded that it reflected reasoned analysis of the factual and legal theories advanced by plaintiffs, and convincingly demonstrated them to be without merit. *See id*. at 366-68; *see also In re Oracle Sec. Litig.*, 852 F. Supp. 1437

(dismissing derivative litigation based on SLC's recommendation); *Johnson*, 811 F. Supp. 479 (same); *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1499 (D. Md. 1985) (same); *Katell*, 1995 WL 376952 (same); *cf. Carlton Inv.*, 1997 WL 305829 (approving settlement of derivative litigation based on SLC's recommendation).

In contrast, in *Peller v. The Southern Co.*, 707 F. Supp. 525 (N.D. Ga. 1988), *aff'd*, 911 F.2d 1532 (11th Cir. 1990), the court applied the *Zapata* standard and determined that the committee did not establish reasonable bases for its conclusion. Counsel for the SLC in *Peller* conducted a "thorough" investigation pursuant to a plan created by counsel, and conducted 70 interviews (most of which at least one SLC member attended). Counsel prepared annotated summaries of each witness interview for the SLC. An expert consultant provided assistance on technical aspect of the investigation. Nevertheless, on the facts of the case, the court was "troubled by the fact that the [SLC] relied almost exclusively on [counsel] to conduct the substantive aspects of the investigation." *Id*. 529. Although the court acknowledged that an SLC's "reliance on counsel is an accepted practice," it was concerned that counsel had drafted the entire report, and disapproved that the SLC did not even review a key document underlying the report. Moreover, noting that counsel failed to disclose annotated summaries of witness interviews to plaintiffs, the court stated that "by relying on counsel to outline and to conduct all interviews and then prepare interview summaries that contain 'privileged information,' the [SLC] has insulated its investigation from scrutiny by plaintiff." *Id*.

In *Biondi v. Scrushy*, 2003 WL 203069 (Del. Ch. Jan. 16, 2003), the court recently took the "very unusual" step of declining to stay derivative actions pending an SLC's investigation because even upon formation of the SLC, the court concluded it was "clear that th[e] court [would] never be able to defer to a decision by the . . . SLC to terminate these actions." *Id*. at *1. The court summarized the factors most likely to raise doubts about an SLC's objectivity:

> Critical to the accomplishment of these objectives, however, is the proper composition and empowerment of the committee. If a special litigation committee is comprised of directors with compromising ties to the key officials who are suspected of malfeasance, if the committee is not fully empowered to act for the company without approval by the full board, or if the committee behaves in a manner inconsistent with the duty to carefully and open-mindedly investigate the alleged wrongdoing, its ability to instill confidence is, at best, compromised and, at worst, inutile.

Id. at *7. The court adverted to "an odd confluence of unusual and highly troubling facts" that led to the conclusion that the "SLC could not meet its burden to prove independence, if it eventually decided to seek termination of" the derivative action, including (a) the board seeking dismissal of the action while the SLC was investigating it, (b) the board's retention of counsel to conduct an investigation before the SLC was constituted, and (c) the resignation of an SLC member shortly after the SLC's formation under a cloud of questions about his independence, at which time he "publicly and prematurely issued statements exculpating one of the key

company insiders whose conduct is supposed to be impartially investigated by the SLC." *Id*. at *15.

In a significant ruling, the Delaware Court of Chancery recently issued an opinion denying the motion of the Oracle Corporation SLC to terminate derivative actions pending in Delaware against Oracle's CEO, CFO and directors on the ground that the SLC failed to carry its burden of establishing a lack of material fact concerning its independence. *See In re Oracle Corp. Derivative Litig*., 824 A.2d 917 (Del. Ch. 2003). In doing so, the court embraced a radically new definition of director independence that, if affirmed, has far reaching ramifications for corporate governance.

In January 2001, four Oracle officers and directors sold substantial amounts of company stock. On March 1, 2001, Oracle issued a press release announcing disappointing financial results for the third quarter of its 2001 fiscal year ("Q3 FY 2001"), and the company's stock price declined 21% following the announcement of the revenue and earnings shortfall. A series of derivative and shareholder class action suits ensued. The central allegation in each of the derivative actions was that the Trading Defendants knew Oracle was going to miss its revenue and earnings guidance at the time of their Q3 FY 2001 stock sales.

In response to the derivative complaints, Oracle formed a special litigation committee comprised of two outside directors – Professors Joseph Grundfest and Hector Garcia-Molina of Stanford University – to investigate the allegations and determine whether pursuit of the derivative actions was in the best interests of Oracle.

Over the course of seven months, the SLC and its advisors conducted an exhaustive investigation into the allegations set forth in the various derivative actions, reviewing hundreds of thousands documents and interviewing more than 70 witnesses. At the conclusion of its investigation, the SLC determined, *inter alia,* that the Trading Defendants did not know that Oracle was going to miss its revenue and earnings guidance at the time of their Q3 FY 2001 stock sales and therefore the derivative suits lacked merit and their continued pursuit was not in Oracle's best interest. The SLC documented its findings in an 1100-page report and moved to terminate the Delaware derivative action on the basis of that report.

The court determined that the SLC was not independent due to various affiliations between Oracle, the Trading Defendants, the SLC and Stanford University. Specifically, the Court found, *inter alia*:

- One defendant, a Stanford alumnus, made substantial donations to Stanford University;
- Another defendant was one of 1700 professors at Stanford;
- An SLC member took a course from a defendant 25 years ago;
- That same SLC member and a defendant were on the steering committee of SIEPER, an on-campus Stanford organization in which the SLC member had been inactive for 6 years;

- A medical foundation with which the CEO defendant was affiliated made donations to numerous researchers, including researchers at Stanford;
- Stanford made a proposal to the CEO defendant, which he rejected, to fund a program similar to the Rhodes Scholars program;
- The CEO defendant speculated in an interview that he might make a large donation to Stanford or Harvard; and
- Ellison is a prominent figure in Silicon Valley, where both SLC members resided.

The court found these associations created an issue of material fact on independence notwithstanding the court's finding that there was nothing in the record to suggest the SLC members favored the defendants or acted in any way other than with fidelity to their duties. *See id*. at 942 ("the SLC has not met its burden to show the absence of a material factual question about its independence. I find this to be the case because the ties among the SLC, the Trading Defendants, and Stanford are so substantial that they cause reasonable doubt about the SLC's ability to impartially consider whether the Trading Defendants should face suit."). In so holding, the Court effectively rejected the actual subjective person test and adopted an objective, appearance of impropriety test based on speculation of what might be expected to cross the mind of a reasonable director with these associations. It is unclear what subset of the identified factors, if any, might raise a material issue on independence. The Court reached its conclusion, however, notwithstanding the existence of a host of factors previously considered sufficient under Delaware law to establish a director's independence.

At bottom, an SLC is independent if it is in a position to base its decision on the merits of the issue presented rather than being governed by extraneous considerations or influences. *See Biondi v. Scrushy*, 2003 WL 203069, at *7 (Del. Ch. Jan. 16, 2003) ("one of the key reasons for the formation of a [SLC] is to insulate the company's decision making process from the influence of those under suspicion"); *Carlton Inv. v. TLC Beatrice Int'l Holdings, Inc.*, 1997 WL 305829, at *10 (Del. Ch. May 30, 1997); *Kaplan*, 484 A.2d at 1189 (citing *Aronson v. Lewis*, 473 A.2d 805 (Del. 1985)). "[I]t is the care, attention and sense of individual responsibility to the performance of one's duties that touch on [the] independence" of an SLC. *Kaplan*, 499 A.2d at 1189.

The *Oracle* decision raises particular issues for directors who are affiliated with charitable institutions that benefited – or could benefit – from contributions from other directors or the corporation even if the directors have absolutely no fund-raising responsibility and never solicited any contribution from the corporation or any of its directors. Moreover, the net that must now be cast to capture potentially disqualifying associations is incredibly wide, *e.g.*, affiliations that have been dormant for 6 years; a course taught by a defendant director 25 years ago; and being residents of the same geographic area in which a defendant director is a prominent person. If such gossamer relationships are potentially disqualifying, it difficult to know where to draw the line. It is clear that any association, however tenuous, should be identified. An effort should be made to select directors who have none, or if that is not feasible, the least amount of associations, since it is not clear how many are sufficient to tip the scales.

D. Stay of Discovery During SLC's Investigation

As one court recently noted, numerous courts have acknowledged that once a special litigation committee is appointed to investigate the allegations, the court has a "duty to stay derivative actions at the instance of a special litigation committee, 'pending the investigation and report of the Committee. . . . Otherwise, . . . the inherent right of the board of directors to control and look to the well-being of the corporation in the first instance, collapses." *In re Oracle Corp. Derivative Litig.*, 808 A.2d 1206, 1211 (Del. Ch. 2002). As another Delaware court observed, "[i]t would . . . seem reasonable to hold normal discovery and other matters in abeyance during this interval. If a derivative plaintiff were to be permitted to depose corporate officers and directors and to demand the production of corporate documents, *etc.* at the same time that a duly authorized litigation committee was investigating whether or not it would be in the best interests of the corporation to permit the suit to go forward, the very justification for the creating of the litigation committee in the first place might well be subverted." *Abbey v. Computer Comm. Tech. Corp.*, 457 A.2d 368, 376 (Del. Ch. 1983).

The entry of the stay is based on a fundamental principle of substantive corporate law: that the business judgment rule grants an SLC the right to control derivative litigation to the exclusion of derivative plaintiffs during the pendency of its investigation. *See id.; Peller v. The Southern Co.*, 707 F. Supp. 525, 526 (N.D. Ga. 1988) (noting stay of discovery pending issuance of SLC report), *aff'd*, 911 F.2d 1532 (11th Cir. 1990); *Biondi v. Scrushy*, 2003 WL 203069, at *1 (Del. Ch. Jan. 16, 2003) ("the sensible general rule is that such a stay should ordinarily issue" during SLC's investigation); *Kindt v. Lund*, 2001 WL 1671438, at *1 (Del Ch. Dec. 14, 2001) ("[A]llowing full-blown discovery would eviscerate the very purpose of having a special committee."); *Strougos v. Padegs*, 986 F. Supp. 812, 815 (S.D.N.Y. 1997) ("courts normally grant a stay of proceedings for a reasonable period to permit an SLC to complete its investigation"); *Lichtenberg v. Zinn*, 663 N.Y.S.2d 452, 454 (trial court has discretion to suspend discovery pending SLC's report); *Katell v. Morgan Stanley Group, Inc.*, 1993 WL 390525, *4 (Del. Ch. Sept. 27, 1993); *Josephson Int'l Inc. Shareholders Litig.*, 1988 WL 112909, at *2 (Del. Ch. 1988) (approving stipulated stay as consistent with Delaware law); *Pompeo v. Hefner*, 1983 WL 20284, at *2 (Del. Ch. Mar. 23, 1983) ("the control power of the board is still predominant over any right of the derivative shareholder plaintiff to act on behalf of the corporation."); *Kaplan v. Wyatt*, 484 A.2d 501, 510 (Del. Ch. 1984) (stay necessary to preserve "the inherent right of the board of directors to control and look to the well-being of the corporation in the first instance"), *aff'd*, 499 A.2d 1184 (1985); *but see In re Bank of N.Y. Deriv. Litig.*, 2000 WL 1708173, at *3 (S.D.N.Y. Nov. 14, 2000) (denying motion for stay where case had been pending for more than one year, discovery was proceeding in a parallel action and serious questions about SLC's independence were present); *Carlton Inv. v. TLC Beatrice Int'l Holdings, Inc.*, 1996 WL 33167168 (Del. Ch. June 6, 1996) (permitting discovery to proceed where SLC was formed 18 months after commencement of derivative action and substantial document and deposition discovery was already underway), *amended in* 1997 WL 38130, at *3 (Del. Ch. Jan. 29, 1997) (limiting discovery derivative plaintiffs could take after SLC entered into a proposed settlement with defendants).

Courts routinely permit the SLC to appear in a commenced derivative action as a representative of the corporation without having to intervene. American Law Instit., *Principles of Corp. Governance: Analysis and Recommendations as Adopted and Promulgated by the American Law Institute at Washington, D.C., May 13, 1992* § 7.05(a)(2) (1994) (stating that an SLC "has standing on behalf of the corporation to move for a stay of the action, including discovery"); *See also Spiegel*, 571 A.2d 767; *Kindt v. Lund*, 2001 WL 1671438 (Del. Ch. Sept. 28, 2001); *Katell v. Morgan Stanley Group*, 1993 WL 205033 (Del. Ch. May 13, 1993); *Lewis*, 502 A.2d 962; *Kaplan*, 484 A.2d 501.

E. Discovery from SLC

The legal work performed by counsel for the SLC ordinarily is protected by the attorney-client privilege (as to communications between counsel and the SLC relating to the investigation) and the work product doctrine (as to materials prepared in anticipation of or in response to the derivative or other litigation). *See Matter of Continental Illinois Sec. Litig.,* 732 F.2d 1302, 1314 (7th Cir. 1984); *In re Dayco Corp. Derivative Sec. Litig.*, 99 F.R.D. 616, 620-22 (S.D. Ohio 1983). However, if the SLC ultimately determines that it is in the best interests of the corporation that it move to dismiss or settle the derivative action, and therefore create a written report summarizing the investigation and conclusions, the filing of the report in support of the motion will make the report discoverable. Moreover, the filing of the report will likely result in partial or full waiver of the privilege and work product immunity attaching to the investigation, subjecting some or all of the work done by counsel to discovery by the derivative plaintiffs. *See Continental Illinois Sec. Litig.,* 732 F.2d at 1314 ("special litigation committee reports used in the adjudication stages of derivative litigation should be available for public inspection unless exceptional circumstances require confidentiality"); *Joy v. North,* 692 F.2d 880, 889 (2nd Cir. 1982) (requiring production of report and underlying data and stating that "work product immunity will apply to the documents usually included within its terms to the extent that they are working papers of the committee's counsel and are not communicated to the committee. Once communicated, the immunity may not be claimed since the papers may be part of the basis for the committee's recommendation."), *cert denied sub nom., Cititrust v. Joy*, 460 U.S. 1051 (1983); *Strougo on Behalf of Brazil Fund, Inc. v. Padegs*, 1 F. Supp.2d 276, 282 (S.D.N.Y. 2001) (granting discovery of, *inter alia*, witness interview notes and drafts of report); *Weiser v. Grace*, 683 N.Y.S.2d 781, 787 (Sup. Ct. N.Y. Co. 1998) (ordering *in camera* review of SLC's notes, outlines and summaries of witness interviews to determine if they may be withheld as privileged or work product and stating that work product immunity was unlikely to be sustained because these materials "provide the only means by which to make an assessment of the reasonableness and good faith of the SLC's investigation, to the extent that the information is otherwise unavailable"); *Zitin v. Turley*, 1991 WL 283814, at *5 (D. Ariz. 1991) ("By filing its motion for summary judgment based on the report of the Committee, the Corporation has waived any claims of privilege and any work product immunity to the extent that counsel communicated the information or documents to the committee."); *Peller v. The Southern Co.*, 707 F. Supp. 525, 528-29 (N.D. Ga. 1988) (declining to dismiss action based on SLC report, in part because SLC counsel did not provide summaries of witness interviews to plaintiffs in response

to request for the summaries), *aff'd*, 911 F.2d 1532 (11th Cir. 1990). Counsel is strongly urged to bear this potential disclosure in mind during all stages of the investigation.

The scope of discovery a derivative plaintiff is entitled to obtain following the submission of a report recommending dismissal or settlement is narrow. Courts have consistently limited such discovery to depositions and materials that bear directly on the independence and good faith of the SLC, and the bases for its conclusions. *See, e.g., Padegs*, 1 F. Supp.2d at 282 (following submission of report, permitting plaintiff to review documents produced to the SLC, "inspect the notes of interviews and drafts of the Report . . . and depose the members of the SLC"); *Johnson v. Hui*, 811 F. Supp. 479, 490 n.9 (N.D. Cal. 1991) ("strict limitation of the plaintiffs' ability to take discovery regarding the SLC's report arises as an essential corollary of *Zapata*'s efficiency rational: Allowing adversarial discovery on the merits would eviscerate the SLC's power in a way that Delaware law has deemed more timely and cost effective than full litigation"); *Weiser v. Grace*, 683 N.Y.S.2d 781, 785 (Sup. Ct. N.Y. Co. 1998) ("The court, in the exercise of its discretion, may permit the parties to engage in limited discovery to assist the court in its inquiry regarding the good faith and independence of the committee as well as the bases supporting the committee's conclusions."); *Zapata*, 430 A.2d at 788 ("Limited discovery may be ordered to facilitate . . . . inquiries . . . . into the independence and good faith of the committee and the bases supporting its conclusions."); *Kindt*, 2001 WL 1671438, at *1 ("allowing full blown discovery into a special litigation committee's investigation would eviscerate the very purpose of having a special committee."); *Kaplan*, 484 A.2d at 510 ("'limited discovery' . . . . may be ordered to facilitate the inquiries of the trial court into the independence and good faith of the Committee and the reasonableness of its investigation and conclusions."); *Abbey v. Computer & Communications Tech. Corp.*, 1983 WL 18005, at *1-2 ("'limited discovery'. . . would seem clearly to confine discovery to that which the court may choose to permit in a given case . . . if a derivative plaintiff is to be permitted full discovery . . . what would be the need for having the special litigation committee procedure to begin with?"). As one court summarized how the nature of the court's review circumscribes the available discovery:

> [O]nce a special litigation committee has entered into a proposed settlement with defendants, a derivative plaintiff is no longer entitled to engage in expansive discovery, but rather must tailor its discovery requests to the narrow scope of the inquiry appropriate for the state in the proceeding . . . . Under the first step of the *Zapata* test, the Court must 'inquire into the independence and good faith of the committee and the bases supporting its conclusion. Limited discovery may be ordered to facilitate such inquiries'. . . . [D]iscovery into the merits of the derivative plaintiff claims are generally or presumptively beyond the scope of this inquiry . . . . The efficiency of the utilization of a special litigation committee would be defeated, at the least in part, by permitting full discovery on the merits by a party objecting to the committee's

> recommendation, without any showing of evidence that the committee did not proceed in good faith.

Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc., 1997 WL 38130, at *3 & n.4 (Del . Ch. Jan. 29, 1997).

Ordinarily, the court will permit depositions of the members of the SLC, but will not permit depositions of counsel to the SLC on the theory that "it is the decision of the directors and their basis for their action that is centrally relevant." *Id.* at *5 (general rule is that "counsel to special litigation committees are not deposed regarding the assistance or advice they provide to their clients in this type of action"); *but see Maher v. Zapata Corp.*, 714 F.2d 436, 447 (5th Cir. 1983) (noting that "depositions of the members of the Investigation Committee and of the attorneys retained by the Committee to assist in its investigation" were taken respecting the independence and good faith of the Committee, the nature and extent of its investigation, and the bases for its recommendations").