DIRECTORS' AND OFFICERS' LIABILITY

SPECIAL LITIGATION COMMITTEES AND DERIVATIVE LITIGATION

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Shareholder derivative litigation follows certain familiar paths. The shareholder makes the threshold directional decision of whether to (i) make a demand on the board of directors asking it to pursue the alleged claim, or (ii) initiate litigation on behalf of the corporation and allege that pre-suit demand is excused as futile. The path chosen by the shareholder determines the standard of review if the corporation decides to move to dismiss the shareholder's derivative complaint. Regardless of the path taken, the board may wish to appoint a special litigation committee to investigate the allegations, and to determine whether assertion of the claim is in the best interests of the corporation. The board must approach with care the appointment of a special litigation committee to investigate derivative allegations (particularly one with complete authority to determine the company's response to a pre-suit demand or a derivative complaint) because the plaintiff invariably will argue that the committee's appointment is a concession of demand futility. This column analyzes the factors that boards confronted with a derivative lawsuit or demand to sue should consider in deciding when and how to appoint a special litigation committee in a manner that does not waive arguments relating to board disinterest and independence.

Two Paths

A shareholder cannot initiate derivative litigation unless it either makes a pre-suit demand on the board of directors asking it to pursue the alleged claim, or alleges with particularity that demand would be futile. In Delaware, to properly allege futility in a paradigmatic derivative action challenging a transaction about which the board made a conscious decision either to act or to refrain from acting, a shareholder must allege facts creating a reasonable doubt either that: (1) the directors are disinterested and independent or (2) the challenged transaction otherwise was the product of a valid exercise of business judgment.[1] Where the board has made no conscious decision to act or refrain from acting, the business judgment rule has no application and the court must determine whether the allegations in the complaint "create a reasonable doubt that, as of the time the complaint is filed, the board of

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directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[2] A plaintiff who files a derivative suit alleging that demand is excused as futile must demonstrate futility within the four corners of the complaint. Ordinarily, a shareholder plaintiff in a demand excused action is not entitled to discovery in the derivative action in order to assist it in seeking to meet the particularized pleading requirements of Rule 23.1.

If the shareholder makes a demand on the board (rather than alleges that demand is excused), in litigation challenging a subsequent demand refusal, the law deems the shareholder to have conceded that a majority of the board is disinterested and independent as to the underlying claims. Thus, once a shareholder makes a demand on the board, the implicit concession that a majority of the board is independent narrows the court's inquiry to the board's good faith and the reasonableness of the investigation, *i.e.*, business judgment rule review.[3] Further, once demand has been made, the shareholder lacks standing to initiate a derivative suit unless and until the board wrongfully refuses to assert the claim. As one court observed, "[e]xcept in extraordinary cases ... tendering a demand to the board puts the plaintiff out of court under Delaware law."[4] Not surprisingly, the difficulty in establishing wrongful refusal of a demand leads most plaintiffs to sue without making a pre-suit demand and litigate the futility of demand.

Special Committee Appointment

Even if demand is not made before suit is filed, the board retains its corporate authority concerning litigation decisions. If a shareholder commences derivative litigation alleging that demand is excused as futile, the board may wish to exercise its right under 8 Del. C. § 141 to appoint a special litigation committee to investigate the shareholder's allegations. In *Zapata v. Maldonado*,[5] a case in which demand was not made, the Delaware Supreme Court held that after an objective and thorough investigation of a derivative suit by an independent committee to whom complete authority to act has been delegated, the committee may move in the name of the corporation to dismiss the suit on the ground that the committee has concluded, in a written report making specific findings, that dismissal is in the best interests of the corporation. *Zapata* enunciated a two-step test under the summary judgment standard: First, after targeted discovery, the court should examine the independence and good faith of the committee and the bases supporting its conclusions. The corporation has the burden of establishing this first step. Assuming the court is satisfied with the committee's good faith and independence, the Court then should determine, applying its own independent business judgment, whether the motion should be granted. The court will weigh how compelling the corporate interest is when faced with non-frivolous lawsuit. Additionally, a court may consider matters of law, public policy, or good corporate governance.

Even if a majority of the board is disinterested and independent, the appointment of a special litigation committee has the benefit of isolating any interested directors from material information during the deliberative process on the claim. The committee 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, particularly if it appears that a majority of the board is interested in the challenged transaction or otherwise suffers from potential conflict.

The board's decision to delegate authority to a committee, particularly if made before a motion to dismiss the complaint is made, usually prompts an argument from the shareholder plaintiff that the act of establishing the committee concedes lack of board disinterest and therefore concedes that pre-suit demand was not required. The origins of this argument are in *Abbey v. Computer & Commc'ns Tech. Corp.*[6] Courts frequently turn to the facts of *Abbey* as a touchstone when deciding whether appointment of a special litigation committee waived pre-suit demand, so they are worth examining.

In *Abbey*, a shareholder made a demand on the board of a corporation to sue certain directors, officers and third parties prior to instituting a derivative action. Hearing nothing from the corporation for nearly one month other than a letter stating that review was underway, the shareholder filed suit on behalf of the corporation. At a special board meeting convened to determine what action should be taken in response to the suit, the board determined it would be in the best interests of the corporation to appoint a special litigation committee of one independent director to investigate the demand and "determine whether the corporation should bring an action against" the defendants. The board adopted a resolution adding a new member to the board and appointing him as director on the committee, which would have final and binding authority on the corporation's response to the suit. Shortly after the committee retained independent counsel, the corporation filed a motion to dismiss plaintiff's complaint for failure to comply with Rule 23.1.

The Court of Chancery held that "by divesting itself of any power to make a decision on the pending suit, and by adding a new and independent director and by designating him as a special Litigation Committee of one with the final and absolute authority to make the decision on behalf of the corporation, the incumbent board of directors, in effect," had conceded that a majority of its members had a disqualifying self interest and therefore demand was not required. The court expressly stated that if the board had caused the corporation to move to dismiss the suit for failure to comply with Rule 23.1, and simultaneously appointed a committee empowered only to investigate the allegations and then report back to the board for whatever action the board might decide to take on the allegations, the board would not have forfeited its ability to argue that pre-suit demand was necessary and avoid taking on the two-tier scrutiny of *Zapata*. Further, "the decision of a board of directors to appoint a special litigation committee, with a delegation of complete authority to act on a demand, is not, *in all instances*," the Court ruled, "an acknowledgement that demand was excused and ergo that a shareholder's lawsuit was properly initiated as a derivative action."

Consistent with *Abbey*'s guidance, subsequent decisions have clarified that the overarching inquiry is whether a majority of the board is disinterested and independent as to the allegations. Two key factors emerge in evaluating whether appointment of a special litigation committee will constitute a concession that pre-suit demand was not required: (1) the

timing of the filing of the motion to dismiss, and (2) whether the board vested final and absolute authority in the committee to make a binding determination on the corporation with respect to the claim. In *Spiegel v. Buntrock*,[7] a case in which the board appointed a special litigation committee in response to a shareholder demand, the Delaware Supreme Court rejected the "argument that *Abbey* stands for the proposition that a board of directors, *ipso facto*, waives its right to challenge a shareholder plaintiff's allegation that demand is excused by the act of appointing a special litigation committee and delegating to that committee the authority to act on the demand."[8] Rather, the Supreme Court interpreted *Abbey*'s rule of waiver as applicable only where the board did not file a motion to dismiss under Rule 23.1 until *after* it had surrendered exclusive control of the derivative action to a special litigation committee. Shortly after *Spiegel* was decided, the Eleventh Circuit, applying Delaware principles as adopted by Georgia, in *Peller v. Southern Co.*[9] held that *Abbey*'s demand-excused concession arose where a board responded to a shareholder derivative complaint, which alleged that demand was excused, by appointing a special litigation committee and delegating to it the sole authority to evaluate the merits of the suit and determine the corporation's response. The corporation then waited for the committee to make its report and, upon the committee's conclusion that the allegations lacked merit, moved to dismiss on, among other grounds, that plaintiff failed to make pre-suit demand. The Eleventh Circuit held that the corporation had "effectively acknowledged that [the shareholder] was excused from making a demand" by not moving to dismiss until after they had delegated sole authority to the Committee.

Subsequent Delaware pronouncements (and those of courts applying Delaware law) have moved away from a narrow examination of whether the board delegated authority to a committee before moving to dismiss for failure to make pre-suit demand and sensibly refocused the inquiry on the core issue of the disinterest of a majority of the board. In *Seminaris v. Landa*,[10] then Vice Chancellor Chandler clarified that a board may delegate its right to exercise control over derivative litigation to a special litigation committee without automatically thrusting the committee's determination into *Zapata* scrutiny. Reviewing Delaware case law, the court ruled that "a disinterested board of directors does not waive its right to control derivative litigation merely by delegating that control to a special committee." Rather, the court emphasized, a board is not deemed to concede demand futility unless and until a derivative plaintiff alleges particularized facts that support a factual finding that the board in fact made the concession. In *Seminaris*, the board appointed a special committee of current outside directors to investigate alleged misrepresentations made about the corporation's financial condition three weeks before the shareholder plaintiff filed his complaint. Shortly after plaintiff filed the complaint, the board delegated its decisional authority over plaintiff's derivative claims to the special committee already investigating the problem. The plaintiff, however, failed to allege any facts (apart from conclusory statements that the mere act of appointment of the committee operated as a concession by a board of directors that demand would have been futile) to demonstrate that the board considered itself incapable of considering plaintiff's demand, and the court held that plaintiff failed to create a reasonable doubt that any of the directors were disinterested.

It bears emphasis that the board's appointment of a special litigation committee that only has an advisory role, *i.e*, to investigate the facts underlying the demand make a report and

recommendation regarding the allegations, does not even arguably constitute a concession that the board is interested or lacks independence and that pre-suit demand therefore would have been futile. A committee that is advisory in nature also does not have to conform to the requirements of 8 Del.C. § 141(c) regarding committee appointment and composition, so that its membership may include third-party, non-Board members. In *In re Merck & Co., Inc.*,[11] a New Jersey federal court recently reiterated that under *Abbey* the mere establishment of a special committee is not a concession that pre-suit demand was not required, and held that Merck's board did not concede demand futility by appointing a committee composed of six of the company's twelve *existing* outside directors. The act of appointing existing directors, the court reasoned, was the opposite of a concession that the board was not disinterested and independent. Moreover, because the special litigation committee only had authority to investigate and make a recommendation to the board, not to act on plaintiffs' demand, there was no basis to conclude that the board conceded it could not act independently and disinterestedly on the demand.

Conclusion

The decision to appoint a special litigation committee, the timing of the appointment, and its composition and authority, must be approached deliberately and with regard to the board's posture in a challenged transaction. If the board appoints an independent special litigation committee in a demand excused case and the committee ultimately recommends dismissal of a shareholder derivative action, the corporation and the other defendants may wish to move to dismiss the action on the ground that plaintiff failed to comply with Rule 23.1, or in the alternative, on the basis of the special committee's report recommending dismissal. A board concedes demand futility only when it is both interested and establishes a special litigation committee to resolve the derivative plaintiff's suit. If a board wants to preserve the argument that it was disinterested in relation to the transaction, in an abundance of caution it should move to dismiss the derivative complaint before it appoints a special litigation committee. The board's appointment of a committee that only has an advisory role, *i.e.*., to investigate the facts underlying the demand make a report and recommendation regarding the allegations, does not constitute a concession that the board is interested or lacks independence and that pre-suit demand therefore would have been futile. Even the mere fact of delegation of decisional authority over plaintiff's derivative claims to a special committee, however, does not, without additional evidence of lack of disinterest by the board, waive demand futility.

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[1] *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

[2] *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

[3] *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990).

[4] *Kamen v. Kemper Fin. Serv., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991).

[5] 430 A.2d 779 (Del. 1981).

[6] 457 A.2d 368 (Del. Ch. 1983).

[7] 571 A.2d 767 (Del. 1990).

[8] 571 A.2d at 777.

[9] 911 F.2d 1532 (11th Cir. 1990).

[10] 662 A.2d 1350 (Del Ch. 1995).

[11] 2006 WL 1228595 (D.N.J. May 5, 2006) (unpublished op.).