Miller & Chevalier

Crisis-Driven Derivative Litigation: The Importance and Role of the Special Litigation Committee

History teaches us that the actions of boards of directors and executive officers come under intense scrutiny during and after times of crisis. As with other modern crises, it is likely there will be a surge of allegations of officer or director misconduct in the preparation for and handling of issues related to the COVID-19 pandemic. Such allegations frequently manifest in shareholder derivative suits rooted in Delaware law. Thus, at a time when so much is beyond our control, it would be wise for companies to revisit the fundamentals of navigating a derivative action, including one important tool: the special litigation committee.

Shareholder plaintiffs in a derivative suit plead a variety of causes of action, including breach of fiduciary duties, corporate waste, usurpation of corporate opportunity, self-dealing, and fraud. Although a derivative suit is brought by one or more shareholders, the claims belong to the corporation. Because the corporation is the true party in interest, the law provides built-in opportunities for the corporation to take control of the claims, manage an investigation, and make decisions regarding what further actions to take, if any. One such opportunity is the ability of a board of directors to appoint a special litigation committee (SLC).

When successfully undertaken, an SLC wrests control of a suit away from the shareholder plaintiffs. The catch is that an SLC must first convince the court that it is independent, disinterested, and has conducted a reasonable investigation in good faith. Thus, the manner and method by which the SLC is composed, conducts its investigation, and presents its findings is crucial to its success.

William P. Barry
Member
wbarry@milchev.com
202.626.5974

Emily M. Kelley
Counsel
ekelley@milchev.com
202.626.5916

Background on Derivative Litigation

Before diving into derivative litigation, shareholders who believe that directors or officers breached their duties to the corporation must generally make a demand on the board of directors, describing the allegations of misconduct and requesting that the board take action. By virtue of making a demand, the shareholders concede that the majority of the board has the ability to impartially consider it, *i.e.*, that the board is entitled to the presumption that it exercises its business judgment in the interest of the corporation. If the board declines to take the requested action, the shareholders would have to overcome significant hurdles should they wish to challenge the board's decisions in court. As a result, many shareholders try to avoid this step.

To avoid the demand requirement, shareholders must plead demand futility – meaning, they must plead specific allegations of fact that, if true, raise a reasonable doubt that a majority of the board of directors could independently, disinterestedly and in good faith consider a demand. For example, shareholders may allege that a majority of the board have a personal stake in a challenged corporate transaction or were directly involved in the alleged illicit activity. Often, a corporation's first line of defense against a derivative action is to argue for dismissal because the shareholders have failed to demonstrate demand futility. If demand is excused and the suit survives such a motion to dismiss, the board has the option of appointing an SLC.

SLC Formation

An SLC should be composed of independent and disinterested directors, empowered with investigative and decision-making authority. When forming an SLC, a board's resolution should therefore set forth the composition of the committee and the scope of its role and authority. An SLC is empowered to respond to the complaint by deciding whether it should be dismissed, pursued by the SLC on behalf of the corporation, continue to be pursued by shareholders on behalf of the corporation, or settle. The board must cooperate with the investigation and be bound by the SLC's decisions.

The SLC should also be empowered to retain independent counsel and other experts to advise on the investigation. Having separate counsel to provide legal advice, guide fact-finding, and ensure an independent and expert analysis of relevant facts and law is essential for an SLC in discharging its obligations reasonably and in good faith. An independent counsel that has cross-disciplinary expertise in enforcement, investigations, and complex civil litigation should be equipped to tackle all aspects of the SLC process.

SLC Composition

The directors who form an SLC should have a relevant background and familiarity with the types of issues involved. More than that, independence and disinterestedness are prerequisites that are strictly enforced. In practical terms, this means that the SLC should be composed of independent, disinterested directors who lack even the specter of bias or personal stake in the matter.

Courts will closely scrutinize any suggestion that an SLC member lacks the characteristics necessary to be independent. Such analysis is highly case-specific. It may be obvious that an SLC should not be composed of the same directors who are alleged to be centrally involved in the misconduct. Yet companies have been surprised to discover that courts find lack of independence for far less. Familial or business ties or close personal relationships to individual defendants or potential personal stakes in the outcome give courts a reason to reject an SLC's attempt to control the litigation.[1] Lack of independence of a single member as to even one defendant may call an entire committee's process into question even where other members' independence is established.[2]

Committee members' background, personal and professional relationships, potential stake in the outcome and connection to the conduct at issue should be carefully considered, and the process documented.

SLC Investigation and Presentation of Findings

The SLC's investigation must be reasonable and conducted in good faith. While the idea of an investigation may seem like an expensive undertaking, skilled SLC counsel should appropriately tailor the fact-finding process to the issues. There are no hard and fast rules regarding the types of documents to review or the minimum number of witnesses to interview. The emphasis should be on discovering and assessing relevant information, not on "scorched earth" second-guessing of oversight or decision-making with the benefit of hindsight.[3]

---

[1] *In re Oracle Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003) (SLC failed to demonstrate independence and ability to impartially consider derivative claims where there were substantial ties between SLC members, who were university professors, and defendants, including the fact that one director was a fellow professor, one SLC member had been student of the director and served with him as senior fellow at think tank, and defendant CEO was considering making large donations to the university where they were employed); *London v. Tyrrell*, Civ. No. 3321-CC, 2010 WL 877528 (Del. Ch., Mar. 11, 2010) (SLC failed to show independence where SLC member's wife was cousin of officer defendant); *compare to Beam v. Stewart*, 833 A.2d 961 (Del. Ch. 2003) (directors' friendship and business with founder was not enough to raise a reasonable doubt concerning their ability to evaluate claims independently, thus demand was not excused).

[2] *See, e.g., Booth Family Trust v. Jeffries*, 640 F.3d 134 (6th Cir. 2011) (applying Delaware law, finding that two-member SLC failed to prove its independence, where one committee member recused himself from considering claims against a single director-defendant who was central to the claims in the action based on their work and personal relationship, but it was unclear whether two-member committee had authority to act with only one remaining member).

[3] *London v. Tyrrell*, Civ. No. 3321-CC, 2010 WL 877528 (Del. Ch., Mar. 11, 2010) (To conduct a good faith investigation of reasonable scope, the SLC must investigate all theories of recovery asserted in the plaintiffs' complaint, explore relevant facts and sources of information that bear on the central allegations, show that it correctly understood the law relevant to the case, and cannot simply accept defendant's version of disputed facts without verifying through consultation of independent sources).

Often, a court will stay the derivative action while the investigation is ongoing. An investigation completed overnight is likely not done in good faith; yet any undue delay in completion or lack of movement could be evidence of bad faith as well. SLC counsel should therefore ensure the investigation is both thorough and deliberate as well as right-sized and focused.

Although the format of an SLC's investigation conclusions varies, the result is often a written report detailing the SLC's composition, fact-finding process, analysis, and decisions. The SLC should assume that its report and the materials referenced therein will be discoverable by shareholder plaintiffs. Recent case law has even permitted discovery in certain circumstances into privileged materials belonging to the corporation where those materials were evaluated by an SLC and relevant to its determination on derivative claims.[4] Careful attention should therefore be paid to privilege considerations so as to ensure sufficient review and yet avoid inadvertent waiver. Independent SLC counsel can be instrumental in assessing these thorny issues.

When deciding whether to move to dismiss a derivative litigation, pursue the claims in some form, or instruct the corporation to take other measures, courts have acknowledged that an SLC can consider factors other than the claims' likelihood of success. For instance, a breach of fiduciary duty claim against a former officer may have legal merit, but where any expected recovery would be far less than the costs of a prolonged and public litigation, a lawsuit may be detrimental to the corporation's financial and reputational interests.[5] Other steps, such as implementation of new training and policies going forward, may better serve the corporation. Such circumstances may be taken into account, and SLC counsel should understand the corporation's business operations as well as the legal issues involved.

Review by the Courts

Courts will not presume that an SLC appropriately exercised its judgment in the interests of the corporation. However, if a committee empowered with decision-making authority can prove that it is independent and disinterested and conducted a reasonable investigation in good faith, courts will grant a motion to dismiss litigation deemed not in the business interests of the corporation or, although less common, a motion for the SLC to take over as plaintiff.

There is no magic formula for meeting this burden of proof, and the court's analysis will be fact-specific. Yet the alternatives to an SLC investigation include potentially costly settlement or lengthy litigation. A corporation that understands and follows the steps for forming an SLC will ensure that the corporation's interests stay the priority.

The Rise of Derivative Litigation in Times of Crisis

Derivative actions are often driven by how companies prepare for and respond to crises that have more widespread repercussions than a single corporation's success or failure. Though many such cases end in dismissal or settlement, the possibility of prolonged, highly publicized litigation should make corporations consider whether they would be prepared to engage in an effective derivative litigation strategy should a crisis arise.

In recent years, major events, crises and movements that have motivated high-profile derivative actions include: the subprime mortgage crisis; the opioid crisis; the #MeToo Movement; the proliferation of cybersecurity breaches; and environmental disasters and climate change concerns; among others.

---

[4] *In re Oracle Deriv. Litig.*, C.A. No. 2017-0337-SG, 2019 WL 6522297 (Del. Ch., Dec. 4, 2019) (where SLC took the unusual step of recommending that the shareholder plaintiffs continue to control and pursue derivative claims, the shareholders should have the benefit of the SLC's investigative analysis and were entitled to materials that had been reviewed and relied upon by the SLC, including privileged materials; however, the SLC could continue to assert its own attorney-client privilege); *Ryan v. Gifford*, Civ. No. 2213-CC2007 WL 4259557 (Del. Ch., Nov. 30, 2007) (plaintiff shareholders were entitled to production of SLC report, as well as communications with counsel regarding the investigation and report, that were given to full board of directors and/or disclosed to third parties, including the director defendants).

[5] *See, e.g., In re Primedia Inc. Shareholders Litig.*, 67 A.3d 455 (Del. Ch. 2013) (SLC was reasonable in deciding not to pursue claim on stock purchase where "the costs, burdens, and distractions of pursuing the litigation easily could outstrip the value to Primedia from the limited potential recovery of the profits on that purchase"); *In re Oracle Deriv. Litig.*, C.A. No. 2017-0337-SG, 2019 WL 6522297 (Del. Ch., Dec. 4, 2019) (as with all litigation, a derivative litigation "may be rationally abandoned if the risk-adjusted recovery appears to be negative, net of litigation costs.").

The COVID-19 pandemic is unlikely to be an exception to the trend of events-driven derivative lawsuits. Even companies with no obvious or immediate financial impact or connection to the issues are at risk of having board and officer activity questioned in unanticipated ways. Fortunately, the steps for creating and implementing an effective SLC can be applied regardless of the specific situation. Companies that understand the tenets of the SLC process and are prepared to deploy it when needed will be better positioned to weather such times of crisis.