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Directors' and Officers' Liability:

Guidance on SLCs in Shareholder Derivative Litigation

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A properly constituted Special Litigation Committee of disinterested and independent directors (SLC) empowered by the board to investigate and determine whether the prosecution of derivative claims is in the best interests of the company can be a powerful aspect of a board's management authority. The SLC procedure is of greatest utility in a pending suit in which pre-suit demand on the board has been excused as futile by a court on a motion to dismiss under Rule 23.1. Even where a shareholder plaintiff has survived a motion to dismiss for failure to make pre-suit demand by showing reasonable doubt concerning the disinterest or independence of a majority of board members, that board can properly delegate its authority concerning litigation decisions on behalf of the corporation to an SLC consisting of disinterested and independent directors.

An SLC must be formed with the utmost care to ensure that its members and advisers can, in appearance and fact, objectively evaluate the merits of a demand-excused suit and the best interests of the corporation when a disabled board cannot. It is frequently said that an SLC must be above suspicion—like Caesar's wife Pompeia, whom he divorced on mere suspicion of indiscretion.[1] Memorable, but as a standard it lacks the particularity needed to provide predictable guidance to practitioners. Last month, the Delaware Court of Chancery issued a lengthy decision in *London v. Tyrrell*,[2] providing detailed guidance on how (i) a court examines the independence of the SLC and the process followed by the SLC in reaching its determination, and (ii) investigative lapses will undermine the court's confidence in the SLC's conclusion. The decision admonishes directors that "if the SLC process is to remain a legitimate mechanism," SLCs must foreclose any

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reasonable basis to question whether non-merits factors operated in the SLC's ultimate judgment.

'Zapata' Procedure

In shareholder derivative litigation, the shareholder plaintiff makes the threshold directional decision whether to (i) make a demand on the board of directors asking it to pursue the alleged claim, or (ii) purport to initiate litigation on behalf of the corporation and allege that pre-suit demand is excused as futile. 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] 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.

Even if the plaintiff survives a motion to dismiss for failure to plead demand futility by showing that particularized allegations in the complaint create reasonable doubt that a majority of the board could impartially consider a demand on the subject of the complaint, the board can still retain control of the corporate claim by appointing an SLC of disinterested and independent directors to investigate the plaintiff's allegations. The authority of a corporation's board of directors to appoint an SLC to investigate derivative claims arises from the principle of corporate law that directors, rather than shareholders, manage the business and affairs of the corporation. 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 the merits of a corporate claim 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. "[T]he *Zapata* procedure takes the case away from the [derivative] plaintiff" and "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."[6] As long as the SLC's investigation and analysis withstand judicial review under *Zapata*, the SLC may decide to dismiss an action, or to prosecute it, as its business judgment directs. The general rule under Delaware law is that discovery must be stayed once an SLC is formed to consider whether a derivative action should be prosecuted.

A *Zapata* motion to dismiss brought in response to the report of an SLC is a hybrid motion combining characteristics of a Rule 41(a)(2) motion to dismiss and a motion for summary judgment. The motion "is addressed necessarily to the reasonableness of dismissing the complaint prior to trial without any concession of liability on the part of the defendants and without adjudicating the merits of the cause of action itself."[7] After targeted discovery, the court evaluates whether the SLC was independent, whether the investigation was conducted in good faith, and whether the committee had a reasonable basis for its conclusion.

The SLC is not entitled to any presumptions of independence, good faith or reasonableness. Rather, the corporation has the burden of proof under Rule 56 standards, which require it to establish the absence of any material issue of fact and its entitlement to relief as a matter of law. Assuming the court is satisfied with the committee's independence, good faith and reasonableness of investigation, the court may (a) grant the motion and dismiss the action, or (b) proceed, in its discretion, to a second step and apply its own independent business judgment and determine whether the motion should be granted.

'London'

London arose out of the approval of a stock option plan and stock sale by the then-three-member board of directors of MA Federal Inc., d/b/a iGov, a government contracting firm. Plaintiffs, former board members removed days after they protested the option plan, commenced an individual and putative derivative action in the Delaware Court of Chancery on behalf of iGov, alleging that the directors breached their fiduciary duties by manipulating the valuation of iGov's stock to set (a) an unfairly low exercise price for stock options granted to them and others (pursuant to the stock option plan that required the exercise price be at least the fair market value of the stock on the date options were granted), and (b) an unfairly low price for 65,000 shares of stock sold to one of the directors.

The price for these transactions was based on a valuation of the company prepared by Chessiecap Securities Inc., which plaintiffs alleged defendants manipulated to deliver a misleadingly low price for their benefit by excluding positive developments which occurred after Chessiecap prepared its valuation. Before bringing suit, plaintiffs made a books and records request, citing their objection to iGov using Chessiecap's valuation as the basis for the per share strike price. Plaintiffs also engaged the McLean Group, a valuation firm, to conduct separate valuations of iGov's equity. McLean reached a per share price approximately $10 higher than Chessiecap's valuation.

While the McLean valuations were being conducted, iGov expanded the size of its board from three members to five, adding Vincent Salvatori and John Vinter as directors. Plaintiffs thereafter sued the three directors who approved the plan without first making pre-suit demand on the board, alleging, inter alia, that defendants breached their (a) duty of loyalty by misrepresenting iGov's business prospects to Chessiecap in order to obtain an artificially low valuation of iGov stock, and (b) duty of care by failing to consider all material information available to them in determining the value of iGov stock for purposes of the option plan. In 2008, Chancellor William B. Chandler III held that pre-suit demand was excused as futile because a majority of the board was interested in the transaction.

Demand having been excused, the iGov board voted to form a two-member SLC composed of the directors added post-transaction (Messrs. Salvatori and Vinter) to consider whether it was in iGov's best interest to pursue the derivative claims. The SLC hired an independent counsel and financial adviser, and conducted a four-month investigation, which included 12 witness interviews, far-ranging document review and the performance by its financial adviser of (a) an independent valuation of iGov during the relevant period, and (b) a review and comparison of the Chessiecap valuations and McLean valuations.

The SLC determined that both sets of party valuations were flawed, and stated that it was unnecessary to determine which set of valuations was more reliable because the SLC concluded that it could make a recommendation about the suit without declaring a winner in the parties' valuation dispute. When the SLC concluded its investigation, it moved to terminate the derivative action on the basis of a recommendation contained in the SLC's written report that pursuit of the claims was not in the best interest of the company and its shareholders because the claims lacked merit and their pursuit would be commercially disruptive.

In a 67-page opinion, Chancellor Chandler denied the motion to dismiss under *Zapata*, citing material questions of fact regarding (1) the SLC's independence, (2) the good faith of its investigation, and (3) whether the grounds upon which it recommended dismissal of the suit were reasonable. Addressing the SLC's independence, the court acknowledged that neither SLC member had a personal stake in the challenged transactions, and neither was appointed to the board until after adoption of the disputed plan. In addition, plaintiffs had not alleged that any of the defendants dominated or controlled the SLC members.

If the independence of these two directors had been challenged on a motion to dismiss for failure to make pre-suit demand, where they would be presumed independent and plaintiffs would have the burden of alleging particularized facts raising reasonable doubt concerning their independence, under *Beam v. Stewart*[8] and similar cases, the plaintiffs would likely be out of court. The crucial difference, the court noted, is that "[u]nlike a board in the pre-suit demand context, SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence," and their relationships with one of the director defendants raised a material question of fact about their independence.

Mr. Vinter's independence was impaired by the fact that his wife is a cousin of one of the director defendants, and even though the cousins were infrequently in contact, the specter of the family relationship was enough to compromise Mr. Vinter's independence under a *Zapata* standard. "Put simply, explaining away a familial association in *Zapata* territory is a more difficult challenge for a corporation than confronting a broad allegation of personal or business relationships in pre-suit demand territory."

Mr. Salvatori's independence was impaired by a prior association with the same director, in which the director had served as the CFO of a company founded by Mr. Salvatori and the director "appears to have made a significant and valued contribution to the efforts to sell" that company. In his deposition, Mr. Salvatori testified that he had "great respect for [the director]. And he was very helpful in helping me get a good price for my company. Very helpful." Again, the court emphasized that he could "not find that Salvatori in fact does feel a sense of obligation to [the director], but there is certainly a strong possibility that he does, and that is enough under *Zapata* to preclude dismissal."

The court reinforced its conclusion that a material question of fact existed regarding the SLC's independence by noting that the SLC members appeared to have reviewed the merits of plaintiffs' claims before the SLC was ever formed in their capacity as audit committee members. Further, the court was troubled that both SLC members used the word "attack" in describing their approach to consideration of plaintiffs' claims, which the court acknowledged was not by itself disqualifying but was hardly a hallmark of independence.

Although the presence of material factual questions regarding the independence of the SLC required denial of the motion to dismiss, the court proceeded to evaluate whether the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions, and concluded that the investigation fell short. An investigation of reasonable scope is one that analyzes all relevant facts and sources of information that bear on the central allegations in the complaint.

The court described when a SLC can and cannot stop short of full-scale study of certain allegations. The SLC may not properly decline to explore specific acts of alleged misconduct because the costs of a full investigation outweigh any harm that may have been caused by those specific acts, unless it first carefully analyzes whether a summary investigation of those specific acts could shed light on the more serious allegations in the plaintiffs' complaint. Total failure to explore the less serious allegations in plaintiffs' complaint also may cast doubt on the reasonableness and good faith of an SLC's investigation, the court observed, when exploring those less serious allegations, at least summarily, would have helped the SLC gain a full understanding of the more serious allegations in plaintiffs' complaint.

And an SLC fails to conduct a reasonable investigation if it simply accepts defendants' version of disputed facts without consulting independent sources to verify defendants' assertions. "Moreover, if the SLC gets the undisputed facts wrong in its report, and then relies on its erroneous recitation of the undisputed facts in making its dismissal recommendation, it also goes without saying that the basis for the recommendation is not reasonable." To demonstrate that its recommendations are supported by reasonable bases, the SLC must show that it correctly understood the law relevant to the case.

Applying these standards to the SLC's conclusion on a claim-by-claim basis, the court began by rejecting as unreasonable the SLC's determination that plaintiffs' duty of care claim, which sought both damages and rescission, was barred simply because the company's charter contained an exculpatory provision barring money damages claims for breaches of the duty of care: "The SLC simply fails to understand that Delaware law permits a suit seeking rescission to go forward despite a §102(b)(7) provision protecting directors against monetary judgments."

As to the duty of loyalty claims, the SLC had concluded that these claims should be dismissed on the ground that the 2007 Plan was entirely fair to iGov because (1) the process the directors employed to secure approval of the Plan, including the process employed to develop the exercise price, represented entirely fair dealing, and (2) the option strike price adopted by the board was a fair exercise price.

Without weighing the merits of plaintiffs' claims, the court identified several lapses in the thoroughness of the SLC's investigation into the fairness of the plan's adoption process that precluded a finding the investigation was reasonable in scope and supported by reasonable bases, including: (1) why the company's CFO initially provided Chessiecap with a financial forecast containing projections that he admitted he did not believe were attainable, particularly where plaintiffs were alleging the board manipulated forecasts to depress iGov's valuation; (2) why the CFO provided a lender with a revised forecast showing an EBITDA of $3.1 million after he provided Chessiecap with a revised forecast for valuation showing an EBITDA of $1.8 million—"where it appears that the only character…to rely on the relatively lower, but 'actually achievable' numbers reflected in the Revised Chessiecap Forecast was Chessiecap, the firm that, according to plaintiffs' complaint, was manipulated to provide a low valuation that directly benefited defendants…[a]n objective SLC would have been duty bound at this point to thoroughly explore why management pervasively used forecasts it did not believe were realistic, but the SLC failed to do this;" (3) the failure to seriously investigate plaintiffs' allegation that the Revised Chessiecap Forecast ignored positive developments while incorporating negative developments; (4) an award of 25,000 options to the new company CFO several months after adoption of the disputed plan at the same exercise price as the options under the plan, which may have shed light on defendants' motivations with respect to the plan; (5) the timing of plaintiffs' removal from the board—"the SLC Report wholly fails to analyze or explain why plaintiffs were removed from the board only three days after objecting to the Final Valuation."

Finally, the court concluded that a material question of fact existed concerning whether the SLC had reasonable bases for its conclusion that the option price was fair, citing the SLC's rejection of the Chessiecap and McLean valuations and the SLC's only partial reliance on the valuation of its own adviser, which left the SLC "with no professional valuation upon which to hang its hat entirely."

Conclusion

London reminds practitioners that the unique posture of an SLC motion to dismiss a demand-excused derivative suit, in which the SLC has the burden of demonstrating the absence of genuine issues of material fact regarding the committee's independence, means that SLC members are not given the benefit of the doubt as to their objectivity. The decision to appoint an SLC, the timing of the appointment, and its composition and authority, therefore must be approached deliberately and with regard to the board's posture in a challenged transaction.

The SLC must be formed with an eye toward foreclosing any meaningful basis for doubt about the members' impartiality on the subject of the suit. The decision also underscores that the touchstone of good faith in the SLC context is willingness—demonstrated in the investigative record and report—to search for and evaluate in an even-handed manner all information relevant to the claims alleged in a demand-excused action. If loose threads are evident, the entire process may unravel.

Endnotes:

1. Plutarch's Life of Caesar, 224 (B&N ed. 2006).

2. 2010 WL 877528 (Del. Ch. March 11, 2010).

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. *In re Oracle Corp. Deriv. Litig.*, 808 A.2d 1206, 1210-11 (Del. Ch. 2002).

7. *Sutherland v. Sutherland*, 2008 WL 1932374 (Del. Ch. 2008).

8. 845 A.2d 1040 (Del. 2004).