

Client Alert

Latham & Watkins
Litigation Department

Delaware Court of Chancery Rejects Special Litigation Committee's Motion to Dismiss

A recent decision of the Delaware Court of Chancery is a stark reminder to boards of directors that the independence of special litigation committees will be judged as Caesar did Pompeia. In *London v. Tyrrell*, Chancellor Chandler rejected a special litigation committee's motion to dismiss a derivative suit purportedly brought on the company's behalf because it questioned whether the committee truly was independent and whether it adopted a neutral approach in evaluating the asserted claims.¹ This outcome means that the company lost the ability to control the pursuit of its own legal rights and incurred the costs and distractions of the committee's investigation. The *London* lesson is that the independence of the persons appointed to a special litigation committee must be above reproach.

The Role of a Special Litigation Committee

The board of directors controls the business and affairs of the corporation. This fundamental precept of corporate governance applies to the prosecution of the corporation's legal claims, as well as other corporate affairs. When it comes to litigation, however, shareholders can usurp the board's prerogative under certain circumstances. Delaware

Court of Chancery Rule 23.1 permits a shareholder to initiate litigation on behalf of the corporation if the board has improperly refused her demand that the board file the suit or if she can demonstrate that she is excused from making a demand. Shareholders most often do not make a demand, instead claiming that demand is excused as futile because a majority of the board is not independent and disinterested.

In the typical case, then, the defendants' and/or the corporation's (as a nominal defendant) first response is to move to dismiss the shareholder's suit arguing that demand has not been excused and that the board retains the ability to decide if the corporation should pursue the claims. If that motion is successful, the action is concluded and the shareholder must either make a demand or stand down.

Alternatively, if that motion is denied the shareholder's suit can proceed, but the corporation can wrest control back from the shareholder through the special litigation committee process. Specifically, the board creates a special litigation committee comprised of disinterested and independent directors and delegates to the committee the sole and complete authority to determine whether the corporation should proceed with the shareholder's suit.

"If the special litigation committee members are later found by the court not to be independent and disinterested, the court will give no weight to their decisions, and substantial burden and expense incurred by the committee's investigation will be for naught."

In order to exercise this authority, the committee must conduct an investigation into the allegations of the shareholder's complaint and determine whether the litigation is in the best interests of the corporation. Importantly, the board should provide the committee with the resources necessary to perform its investigation, including providing funding for the committee to hire legal, financial or other experts. Once the special litigation committee is created, the Court of Chancery "almost invariably" orders a stay of the shareholder's litigation to allow the committee time to conduct its investigation and reach its conclusions.²

The key component in forming a special litigation committee is to ensure that its members are independent and disinterested. If the special litigation committee members are later found by the court not to be independent and disinterested, the court will give no weight to their decisions, and substantial burden and expense incurred by the committee's investigation will be for naught. Moreover, a board should strive to create a committee of at least three qualified persons. The reason is that the Delaware Court of Chancery more closely scrutinizes one-member committees because of a belief that a single director is more susceptible to influence³ and two-member committees are at risk of deadlock. Efforts to create a special litigation committee immune to attack may thus require a board to appoint new directors who are eligible to serve on the committee.

After the committee completes its investigation, it will decide to either take over plaintiff's suit on behalf of the corporation or move to terminate the suit as not in the corporation's best interests.⁴ The court evaluating the special committee's motion to dismiss the action will first evaluate whether the committee's members were disinterested and independent.⁵ If the court determines that they were, it can nevertheless exercise its discretion

to apply its own business judgment to the facts of the case to determine whether the corporation's best interests would be served by dismissing the suit.⁶ The court will do so where the first step is technically satisfied but the committee's decision does not appear to be appropriate.

In evaluating the second step, Delaware courts give broad latitude to an independent and disinterested special litigation committee's determination and will permit it to terminate potentially meritorious claims that are outweighed by the corporation's other interests. Accordingly, a special litigation committee will evaluate not only the factual and legal strength of the claims but also:

- The extent of the claimed injury to the corporation⁷
- The costs of pursuing the action⁸
- The effects the suit will have on the company's operations⁹
- The effect of other remedial measures¹⁰

***London* Demonstrates a Structurally and Operationally Deficient Special Litigation Committee**

London is an excellent example of the intense scrutiny with which the Court of Chancery will evaluate the special litigation committee and its work. As is typically done, the shareholder plaintiff opposed the special litigation committee's motion by arguing that: (1) the special litigation committee was not independent, and (2) the special litigation committee's investigation was inadequate.

The first argument, what we call structural independence, looks to whether the special litigation committee members had any interest that would impact their decision of whether to pursue the litigation. The second argument, or operational independence,

assesses whether the special litigation committee followed an objective process that insured an independent decision was made. In *London* the court found that the special litigation committee was neither structurally nor operationally independent.

Prior to the appointment of the special litigation committee, *London* was not a particularly unusual case: the underlying suit was brought by the founders and former directors of iGov. It alleged that six iGov directors and officers intentionally manipulated the valuation used to set the strike price of stock options in contravention of the Company's equity incentive plan to entrench themselves and dilute plaintiffs' interest in the company.

iGov moved to dismiss the complaint because plaintiffs had not made a demand on the board. The court subsequently denied that motion and the board voted to form a two-member special litigation committee to consider whether pursuing the derivative claims were in the company's best interests on November 21, 2008. The special litigation committee engaged independent legal and financial advisors and conducted a three-month investigation that included interviewing 12 witnesses and reviewing relevant documentation. The special litigation committee issued its formal report on August 5, 2009, which concluded that the suit was not in the best interests of the company and recommended that the suit be dismissed.

Structural Independence: The *London* decision demonstrates that even the slightest amount of potential interest can result in a court rejecting a special litigation committee's recommendation to terminate litigation. Indeed, the court explained that the special litigation committee bears the burden of "fully convinc[ing] the Court that the special litigation committee can act with integrity and objectivity."¹¹ Where an interested director and

a special litigation committee has some sort of family relationship, "the corporation must fight an uphill battle to demonstrate that, notwithstanding kinship, there is no material question as to the special litigation committee member's objectivity."¹² In *London* the interested director and special litigation committee member were not blood relatives, but rather the special litigation committee member's wife was a cousin of an interested board member who had approached that director about joining the board. The court held that even this tenuous relationship raised a material question of fact as to how much the family association may have influenced his objectivity.

The court similarly expressed concerns regarding a prior business relationship between an interested director and a special litigation committee member. In particular, the court felt one of the special litigation committee member's independence might have been compromised because the interested director was CFO of the committee member's company and was "very helpful" in assisting that board member in getting a "good price" for his company.¹³ Thus, the court believed that committee member may have felt he "owe[d] something to an interested director" and would be less likely to find that the interested directors breached their fiduciary duties.¹⁴

Thus, it is of utmost importance that board members fully vet all potential special committee members before they are appointed. It is imperative that the board identify any personal, business or familial relationships between the interested directors and the special litigation committee so that an informed decision can be made regarding whether any of these potential conflicts could compromise the independence of the special committee.

Operational Independence: The court also took issue with the special litigation committee's operational independence

because it appeared that the members had reached their conclusion that the complaint lacked merit before the investigation began. This does not mean that a special litigation committee member cannot be exposed to or become familiar with a derivative suit before the special litigation committee is formed; rather, "if evidence suggests that the special litigation committee members prejudged the merits of the suit based on that prior exposure or familiarity, and then conducted the investigation with the object of putting together a report that demonstrates the suit has no merit, this will create a material question of fact as to the special litigation committee's independence."¹⁵

In *London*, the plaintiffs' counsel sent a letter to iGov outlining many of the allegations that ultimately appeared in the complaint and requesting a meeting to begin resolving the dispute. In response, iGov's counsel sent a letter explaining that it disagreed with plaintiffs' allegations and would not agree to meet until defendants and iGov's two new board members, who ultimately served as the special litigation committee, had time to review the valuation of the options, which the evidence suggested did in fact occur. In addition, the evidence suggested that "the special litigation committee might have engaged in a combative assault rather than an investigation" because in his deposition one of the special litigation committee members stated that he "attacked" all the allegations in plaintiff's complaint. Likewise, the special litigation committee member's notes from a special litigation committee meeting also used the word "attack." Therefore, the court held that these issues provided the court additional reasons to question the special litigation committee's independence.

Conclusion

When it comes to creating a special litigation committee and appointing its members, boards of directors are well-served by insisting that members and the manner in which they conduct their work be unquestionably independent and disinterested. There is little reason to bear the burden and expense of the special litigation committee process if unique and dedicated attention is not devoted to insuring that the committee's determination will be enforced by the court. As *London* amply demonstrates, even apparently tenuous inter-personal relationships and the wrong choice of words can negate a special litigation committee's work.

Endnotes

- ¹ *London v. Tyrrell*, 2010 Del. Ch. LEXIS 54 (Del. Ch. Mar. 11, 2010).
- ² *In re InfoUSA, Inc. S'holders Litig.*, 2008 WL 762482, at *3 (Del. Ch. Mar. 17, 2008).
- ³ *Sutherland v. Sutherland*, 2008 WL 1932374, at *3 (Del. Ch. May 5, 2008) (“It should be noted that one-member special litigation committees are less insulated from the influence of interested directors, and are closely scrutinized.”)
- ⁴ As *London* and other decisions recognize, a special litigation committee’s motion to dismiss “is a bit of a curiosity, procedurally speaking” because it does not arise directly from the rules of civil procedure and is “derived by analogy to a motion to dismiss a derivative suit based upon a voluntary settlement between parties and by analogy to a Rule 41(a)(2) motion whereby a plaintiff unilaterally seeks voluntary dismissal of a complaint after the defendant files an answer.” *London*, 2010 Del. Ch. LEXIS 54, at *12.
- ⁵ *Zapata Corp. v. Maldonado* 430 A.2d 799, 784 (Del. 1981).
- ⁶ *Id.*
- ⁷ *Kaplan v. Wyatt*, 499 A.2d 1184, 1188 (Del. 1985) (noting that the committee concluded that the underlying transactions were “reasonably fair” to the corporation).
- ⁸ *Lewis v. Fuqua*, 502 A.2d 962, 971 (Del. Ch. 1985), *appeal denied*, 504 A.2d 571 (Del. 1986) (observing that expense was one of the “decisive factors” in the committee’s recommendation that the company move for dismissal of the derivative action).
- ⁹ *Id.* (*considering, inter alia*, the disruptive effect of derivative litigation including its impact on corporate morale).
- ¹⁰ *Stein v. Bailey*, 531 F. Supp. 684, 690 (S.D.N.Y. 1982) (committee properly based its recommendation not to pursue the derivative claims on, *inter alia*, the “sufficiency of the sanctions previously imposed by the Board against the executives most directly involved with the improper payments”).
- ¹¹ *London*, 2010 Del. Ch. LEXIS 54, at *41.
- ¹² *Id.* at *45.
- ¹³ *Id.* at *48-49.
- ¹⁴ *Id.* at *48-49.
- ¹⁵ *Id.* at *51.

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