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REPORT

CORPORATE GOVERNANCE

Special Litigation Committees That Have Lost On Motion to Terminate the Derivative Litigation Might Still Prevail

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All too often, lawyers representing special litigation committees (''SLCs'') view a loss on a motion to terminate as an end to the SLC process entirely. This not only translates into a loss for the lawyer's client, it may also mean that the lawyer's engagement on the matter is closed. In select jurisdictions, this very well may be the case. In a number of jurisdictions, however, lawyers representing SLCs who have lost on a motion to terminate might have an additional ''bite at the apple.'' In these jurisdictions, a court is permitted to hold evidentiary hearings to resolve factual disputes about the SLC process that might otherwise preclude the grant of a motion to terminate the derivative litigation. But lawyers may overlook this additional advocacy tool because it is not available in some jurisdictions.

The reasoning in jurisdictions that permit evidentiary hearings to resolve factual disputes that arise in the context of a motion to terminate is sound. Ordinarily, directors are responsible for managing the affairs of a company. As the company's caretakers, directors have the authority—and indeed, the legal duty—to evaluate and assess the consequences of strategic alternatives, and ultimately, to make decisions on behalf of the company and its shareholders. Not surprisingly, a company's decision to bring a lawsuit—like any other business decision—is left to directors.

The law ordinarily protects decisions by directors from second-guessing by courts and shareholders. This doctrine, known as the ''business judgment rule,'' establishes the strong presumption that directors make decisions on an informed basis, in good faith and in the honest belief that the decision serves the company's best interests.

Sometimes, a director's interests may conflict with the company's interests. In such cases, a director cannot be presumed to act in good faith and the business judgment rule does not apply. For example, a conflict might exist when a director decides his or her own level of compensation. Likewise, a conflict might exist when a director decides whether he or she should be sued by the company. Conflicted directors, however, can delegate such decisions to specially formed committees comprised of ''conflict-free'' individuals who, in turn, can be afforded the protections of the business judgment rule in some jurisdictions. In the litigation context, such committees are commonly referred to as spe-

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cial litigation committees, or SLCs.[1] In order for a court to accept an SLC's recommendations as to a particular lawsuit, the SLC generally must establish: (1) independence; (2) good faith; and (3) reasonable diligence.

Several jurisdictions, such as California and Delaware, treat a company's decision not to pursue derivative litigation filed by a shareholder very differently from other business decisions.[2] In those jurisdictions, SLC members have only one opportunity to defend their business decision – SLC members must move to terminate derivative litigation[3] and must support their motion with compelling proof. If any fact disputes exist with respect to committee independence, good faith and/or reasonable diligence, a court may disregard the SLC's decision entirely. No opportunity for an evidentiary hearing is given. No credibility determinations are made. And, no evidence is weighed. Interestingly, while these same jurisdictions leave room for fact disputes and evidentiary hearings with respect to other categories of business decisions made by directors or committee members, a shareholder need only create a single disputed issue of material fact in order to override an SLC's decision to terminate a lawsuit. There appears to be no sound reason why a court must end its analysis after a single disputed issue of material fact and refuse to render credibility and other factual determinations. Indeed, such determinations are within the core competencies of the court.

Lawyers representing SLCs, however, should not necessarily view a loss on a motion to terminate derivative litigation as a complete loss on behalf of their clients. To that end, this article seeks to assist lawyers wishing to exhaust all options available to the SLC before conceding a loss. It does so by arming lawyers representing SLCs with an additional advocacy tool—a petition to the court to hold an evidentiary hearing to resolve outstanding factual disputes that otherwise prevent granting a motion to terminate.

More specifically, this article explores the divergent case law governing the procedural treatment of SLC business decisions. It further attempts to arm lawyers with SLC clients with pertinent authorities and a roadmap to be used to petition courts to hold an evidentiary hearing.

I. BACKGROUND

A. Like Other Business Decisions, the Decision to Bring Suit Is Left to Directors. Like other business decisions, directors decide whether a company should bring a lawsuit.[4] Under the ''business judgment rule,'' as that rule exists in most jurisdictions, directorial decisions are protected from second-guessing by shareholders and courts. The rationale for the business judgment rule is that courts are ill-equipped to evaluate business decisions made by directors (particularly given the luxury of 20/20 hindsight).[5] Courts will defer to business decisions made by directors absent a showing of bad faith or lack of due care.[6] The business judgment rule is a presumption that favors directors, and it applies from the outset of a lawsuit.[7] Thus, a shareholder challenging a directorial decision bears the initial burden to rebut the presumption. In other words, the shareholder must make a showing of bad faith, fraud, or lack of due care on the part of the directors.[8]

Because the decision to bring a lawsuit is a business decision, the business judgment rule applies.[9] As noted by the United States Supreme Court in *United Copper Securities Co. v. Amalgamated Copper Co.*:[10]

> Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders.[11]

Normally, there is no question as to the applicability of the business judgment rule to such decisions. Take, for example, a situation where a customer has failed to pay on an account receivable. The directors might decide that a lawsuit against the customer would not serve the company's best interests for any number of business reasons (e.g., preserving the customer relationship, attorney's fees outweighing potential recovery, potential for bad publicity, etc.). In this situation, the directors' decision will be presumed to have been made in good faith. But like other business decisions, conflicts can prevent application of the business judgment rule.

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[1] For purposes of this article, we refer only to those SLCs created once a company loses its demand futility motion.

[2] Much of the impetus to treat a company's decision to bring a lawsuit differently from other business decisions derives from the concern over structural bias. Structural bias refers to the inherent prejudice against any derivative action resulting from the composition and character of the board of directors and of SLCs. *See Arthur R. Pinto and Douglas M. Branson, Understanding Corporate Law* § 14:06, 462-64 (2004). There is no reason for courts to avoid making factual determinations and weighing evidence and credibility in order to account for structural bias because courts that are concerned about structural bias already redress it through other means. For example under certain circumstances, in some jurisdictions courts can substitute their own business judgment for the business judgment of the SLC. *See, e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981)

[3] Courts have used different labels to describe a corporation's motion to terminate derivative litigation. Most courts have treated such a motion as akin to a motion for summary judgment. *See, e.g., Zapata, supra* note 2, 430 A.2d at 788. A few courts have treated such a motion as akin to a motion for a court-approved settlement. *See, e.g., Peller v. Southern Co.*, 911 F.2d 1532, 1539 (11th Cir. 1990). Whatever the label used, most jurisdictions decide the issues under a standard akin to summary judgment – that is, whether there is a dispute of fact as to any of the typical elements an SLC must establish to terminate the litigation. *See, e.g., Zapata, supra* note 2, 430 A.2d at 788.

[4] *See Lewis v. Anderson*, 615 F.2d 778, 782 (9th Cir. 1979).

[5] *See Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979) (''[T]he business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are must be essentially business judgments.'').

[6] *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (''It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.'' (citation omitted)).

[7] *See Cuker v. Mikalauskas*, 692 A.2d 1042, 1046 (Pa. 1997).

[8] *Id.*.

[9] *See Lewis*, 615 F.2d at 781–82; *Findley v. Garrett*, 240 P.2d 421, 426 (Cal. App. 1952).

[10] 244 U.S. 261 (1917).

[11] *Id.* at 263–64.

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Thus, for example, if the customer in the above hypothetical is a company that is owned by several of the directors, then there is a conflict. Certain of the directors essentially are being asked to sue themselves.

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The business judgment rule may not apply to a director who must decide whether to sue himself or herself, particularly where such a director faces a substantial risk of personal liability. For this reason, shareholder plaintiffs commonly argue against application of the business judgment rule when directors—or individuals to whom the directors are beholden—are accused of wrongdoing.[12] In such cases, according to shareholder plaintiffs, directors cannot evaluate fairly the merits of a potential claim by the company.[13]

In order to maintain the protections of the business judgment rule, directors accused of material self-interest in a transaction can delegate the decision to bring suit to a committee comprised of ''conflict-free'' individuals (i.e., an SLC). If the SLC makes a good faith, informed decision that a lawsuit is not in the company's best interests, then the law will ordinarily respect the SLC's decision.

Therefore, shareholder plaintiffs unsatisfied with the SLC's decision will seek to show that the committee is not independent from the accused directors and/or that the SLC did not make a fully informed decision (i.e., the SLC failed to adequately investigate the claims before deciding against a lawsuit). If a corporation fails to demonstrate the SLC's independence, good faith and reasonable diligence, the law will permit the shareholder plaintiff to step into the directors' shoes and to bring a derivative lawsuit on behalf of the company and its shareholders.[14] Judicial review of the SLC's decision is a critical phase in the life of a derivative suit. If the shareholder plaintiff prevails, the litigation moves forward and the shareholder plaintiff regains control of the litigation. If the SLC prevails, the SLC regains control of the litigation. An SLC victory at this phase generally ends the involvement of the shareholder plaintiff; once it regains control, the SLC can terminate the lawsuit immediately as against the company's best interests or resolve it.

The remainder of this article discusses how lawyers representing SLCs might petition courts for an evidentiary hearing after their clients have lost on a motion to terminate, and how courts treat the issue of evidentiary hearings in various jurisdictions. As a matter of substance and procedure, many jurisdictions evaluate the SLC's conclusions differently from other business decisions made by directors and committee members. From a substantive standpoint, the SLC bears the burden to affirmatively prove its case for the grant of a motion to terminate the derivative litigation. More specifically, the SLC has the burden of proving independence, good faith and reasonable diligence.[15] Unlike ordinary business decisions, there is no presumption of independence, good faith, or reasonable diligence.[16] From a procedural standpoint, several jurisdictions such as California and Delaware require SLCs to make this showing with compelling evidence. If the SLC cannot do so, then its conclusions can be disregarded by the court.

B. The SLC's Procedural Tool—the Motion To Terminate. The SLC typically fires the first shot in the battle for control of the company's litigation decisions – the motion to terminate. A proper description of the motion to terminate depends on the jurisdiction in which it is filed. As stated in *Johnson v. Hui*[17]:

> Without explicitly ruling on the issue, some courts have treated a motion to terminate as one for summary judgment brought under Rule 56. Other courts have treated this type of motion as one which borrows heavily from Rule 56, but which ultimately arises under Rule 23.1.
>
> Finally, Delaware courts have defined a motion to terminate *sui generis*, referring to it as neither a ''neither a motion to dismiss under Rule 12(b), nor . . . a motion for summary judgment pursuant to Rule 56. . . . Rather, the motion is a hybrid one, derived by analogy to a motion to dismiss a derivative suit based upon a voluntary settlement. . . .''[18]

Regardless of the label used, however, courts decide such motions in one of two ways: (1) as a motion decided under the summary judgment standards set out in Rule 56; or (2) as a motion decided under the summary judgment standards set out in Rule 56, followed by an evidentiary hearing (if necessary to resolve evidentiary disputes).[19]

An SLC motion to terminate differs from the typical Rule 56 motion for summary judgment in one key way. Indeed, the ''issues to be decided in a motion based upon the special litigation committee defense are not those framed by the pleadings. Rather . . . the issues are the independence of the committee members and the adequacy of their investigation.''[20] The court in *Kaplan v. Wyatt*[21] articulated this distinction:

> [I]t does not seem . . . that the facts and circumstances relating to the plaintiff's allegations of wrongs to the corpora-

[12] *See, e.g.*, *Lewis*, *supra* note 4, 615 F.2d at 782.

[13] *See Deborah DeMott, Shareholder Derivative Actions: Law and Practice* §§ 5:14, 5-901.1–.2 (2003 & Supp. 2007).

[14] *See Taormina v. Taormina Corp.*, 78 A.2d 473, 475 (Del. Ch. 1951).

[15] *See In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 928 (Del. Ch. 2003) (''In order to prevail on its motion to terminate . . . the SLC must persuade [the court] that: (1) its members were independent; (2) that they acted in good faith; and (3) that they had reasonable bases for their recommendations.'').

[16] *See Peller*, *supra* note 2, 911 F.2d at 1539; *Zapata*, *supra* note 2, 430 A.2d 779 at 788; *Kaplan v. Wyatt, 484 A.2d 501, 505 (Del. Ch. 1984)*.

[17] 811 F. Supp. 479 (N.D. Cal. 1991).

[18] *Id.* at 484 (citations omitted) (quoting *Kaplan v. Wyatt*, 484 A.2d 501, 506 (Del. Ch. 1984), *aff'd* 499 A.2d 1184 (Del. 1985)).

[19] Not all SLC cases explicitly discuss what type of motion the corporation should bring to terminate the derivate suit. Thus, this list of options is based only upon those cases that have explicitly referred to the type of motion used.

[20] *Desaigoudar v. Meyercord*, 108 Cal. App. 4th 173, 190 (Cal. App. 2003).

[21] 484 A.2d 501, 519 (Del. Ch. 1984), *aff'd* 499 A.2d 1184 (Del. 1985).

> tion should furnish the basis for the application of the summary judgment requirement that there be no genuine dispute as to any material fact. Rather, it is the conduct and activity of the Special Litigation Committee in making its evaluation of the factual allegations and contentions contained in the plaintiff's compliant which provide the measure for the Committee's independence, good faith and investigatory thoroughness. This is because it is the Special Litigation Committee which is under examination at this first-step stage of the proceedings, and not the merits of the plaintiff's cause of action.

Labels aside, courts generally adjudicate motions to terminate by applying summary judgment standards. Only after a determination has been made as to the existence of factual disputes do judicial attitudes vary. Some jurisdictions end the analysis, and deny the SLC's motion to terminate. Other jurisdictions permit the use of an evidentiary hearing to resolve factual disputes. Both of these schools of thought are discussed more fully below.

II. TWO VIEWS WITH RESPECT TO THE USE OF EVIDENTIARY HEARINGS

A. View No. 1: Court Cannot Resolve Factual Disputes. Courts in California do not permit the use of evidentiary hearings following an SLC's loss on summary judgment. While not directly deciding the issue, courts in Delaware also appear to disfavor the use of evidentiary hearings. Thus, if California or Delaware law is controlling, there is little a lawyer representing an SLC can do following a loss on summary judgment (short of an appeal).

1. California. California rejects the use of evidentiary hearings in connection with SLC motions to terminate. In *Will v. Engebretson & Co.*,[22] a minority shareholder in a closely-held corporation filed a derivative lawsuit alleging that the majority shareholder received excessive compensation for his role as a director. The corporation formed an SLC, which in turn, moved to terminate the lawsuit. After finding that factual disputes precluded the entry of summary judgment in the SLC's favor, the trial court held an evidentiary hearing.[23] On appeal, the court reversed the trial court's decision to hold an evidentiary hearing, noting that a limited hearing would not protect potentially legitimate shareholder claims because it would hide the structural bias of the SLC.[24] The court held that the trial court should have denied the SLC's motion outright once it found triable issues of fact to exist.[25]

[22] 213 Cal. App. 3d 1033 (Cal. App. 1989).
[23] *Id.* at 1038.
[24] *Id.* at 1043.
[25] *Id.* at 1044.

Unlike California and Delaware, a number of jurisdictions permit the use of evidentiary hearings to resolve disputed issues of material fact that arise in connection with an SLC's motion to terminate.

Similarly, in *Desaigoudar v. Meyercord*,[26] plaintiffs, trustees of a corporation, alleged that the corporate directors and officers wasted corporate assets and breached their fiduciary duties. The corporation formed an SLC, which moved to terminate the litigation. While the court granted the SLC's motion to terminate, it nonetheless cautioned against the use of evidentiary hearings:

> [A]n evidentiary hearing on the special litigation committee defense is insufficient to protect plaintiffs' interests. Therefore, if a trial court detects a factual dispute concerning the independence of the special litigation committee or the adequacy of its investigation, the case may not be dismissed short of trial.[27]

2. Delaware. Delaware does not expressly provide for the use of evidentiary hearings should an SLC be unable to meet a Rule 56 standard in connection with its motion to terminate. In *Zapata Corp. v. Maldonado*,[28] Zapata Corporation formed a SLC to investigate a shareholder lawsuit concerning the alleged wrongful reissuance of stock options. The SLC recommended against the lawsuit and moved to terminate the derivative litigation. The Delaware Court of Chancery denied the SLC's motion. In affirming that decision, the Delaware Supreme Court set forth guidance as to how Delaware courts should resolve SLC motions to terminate:

> After an objective and thorough investigation of a derivative suit, an independent committee may cause its corporation to file a pretrial motion to dismiss . . . . The basis of the motion is the best interests of the corporation, as determined by the committee. . . . Under appropriate Court supervision, akin to proceedings on summary judgment, each side should have an opportunity to make a record on the motion. As to the limited issues presented by the motion noted below, the moving party should be prepared 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.[29]

Thus, *Zapata* can be read to require that a court deny an SLC's motion to terminate if factual disputes exist with respect to the SLC's independence, good faith and

[26] *Desaigoudar*, *supra* note 20, 108 Cal. App. 4th at 173.
[27] *Id.* at 189–90.
[28] *Zapata*, *supra* note 13, 430 A.2d 779 (Del. 1981).
[29] *Id.*, 430 A.2d at 787–88 (citations and internal quotations marks omitted) (emphasis added).

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reasonable diligence. Indeed, *Zapata* does not expressly provide for the use of an evidentiary hearing to resolve outstanding factual disputes.

In *Kaplan v. Wyatt*,[30] the Delaware Court of Chancery clarified the Delaware Supreme Court decision in *Zapata*. Although the issue of the propriety of an evidentiary hearing was not squarely presented by the litigants in the case, the *Kaplan* court—in strongly worded dicta—appeared to foreclose the use of evidentiary hearings to resolve factual issues presented by SLC motions to terminate:

> If, after the motion has been argued or submitted for decision, the Court . . . is satisfied on the record presented by the motion that there is a genuine issue as to one or more material facts . . . then the Court shall deny the motion for such reason and need go no farther, the result being that the shareholder plaintiff may resume immediate control of the litigation with a view toward prosecuting it to a conclusion regardless of the position taken by the special investigating committee appointed by the corporation's board of directors.[31]

Thus, under *Zapata* and *Kaplan*, it appears that an SLC must make its case for independence, good faith and reasonable diligence with compelling proof.[32] If it cannot do so (i.e., if the shareholder plaintiff manages to create a factual dispute), there is little more that a lawyer representing an SLC can do.

B. View No. 2: Court Can Resolve Factual Disputes at an Evidentiary Hearing. Unlike California and Delaware, a number of jurisdictions, notably New York, Florida, Massachusetts and Colorado, permit the use of evidentiary hearings to resolve disputed issues of material fact that arise in connection with an SLC's motion to terminate. Thus, if the law of one of the jurisdictions discussed below is controlling, a lawyer representing an SLC that has lost on summary judgment should consider petitioning the court to hold an evidentiary hearing.

1. New York. New York permits the use of evidentiary hearings. Significantly, the plaintiff bears the burden of establishing that the SLC decision is not protected by the business judgment rule. In *Rosen v. Bernard*,[33] the SLC moved to terminate a derivative lawsuit based on an SLC recommendation. The trial court found factual disputes existed with respect to the SLC's independence, good faith and reasonableness diligence.[34] Rather than deny the motion outright, the court ordered a limited evidentiary hearing.[35] The court reasoned that the factual disputes concerned issues that were ''potentially dispositive'' of the lawsuit, and thus, resolution of the issues merited a separate hearing before trial.[36]

2. Florida. Florida also permits the use of evidentiary hearings. In *De Moya v. Fernandez*,[37] plaintiffs, a group of minority shareholders, appealed an order dismissing a derivative lawsuit. The receiver for the corporation moved to terminate the lawsuit as being against the best interests of the corporation. The trial court granted the motion and dismissed the lawsuit. On appeal, the court reversed. The court found a lack of sufficient evidence in the record with which to evaluate the thoroughness of the receiver's report or the independence of the receiver's attorney, whose recommendation was accepted by the trial court.[38] In addition, the court noted that the record lacked adequate sworn testimony or evidence from which to make any findings.[39] In remanding the case for further proceedings, the court noted:

> Nevertheless, we are satisfied the objections raised were sufficient to require either the protection of a summary judgment proceeding *or an evidentiary hearing* with respect to the disputed issues of bias, conflict of interest, objectivity and reasonableness in the preparation and presentation of the report.[40]

Similarly, in *Klein v. FPL Group, Inc.*,[41] shareholders brought a derivative lawsuit against a corporation's board of directors, alleging violations of the securities laws. The corporation formed an SLC which moved to terminate the lawsuit. While the court denied the SLC's motion, it did note in dicta that an evidentiary hearing would have been available if the court had found factual disputes existed:

> A full evidentiary hearing is costly and time consuming. It is unnecessary if the parties agree, or the court independently finds, that there are no material issues of fact as to any of the criteria to be applied, and the matter may be decided as a matter of law on the evidentiary record. If, however, the court finds that there are material issues of fact, or there is a need for credibility determinations, then the court, consistent with . . . [*De*] *Moya*, *should hold an evidentiary hearing on the material issues of fact in dispute*, and determine matters of credibility, in order to decide whether to exercise its discretion . . . to dismiss the derivative proceeding.[42]

Thus, there is solid authority permitting the use of an evidentiary hearing in Florida.

3. Massachusetts. Like New York and Florida, Massachusetts also permits the use of evidentiary hearings. In *Houle v. Low*,[43] an individual shareholder/director

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[30] *Kaplan*, *supra* note 16, 484 A.2d at 501.

[31] *Id.* at 508. The court also noted that motions to terminate should be denied if the trial court finds on the undisputed facts that the SLC is not independent, has acted in bad faith, or has failed to show reasonable bases for its conclusions. *See id*.

[32] There is contrary federal authority. In *Johnson v. Hui*, 811 F. Supp. 479, 485 n.5 (N.D. Cal. 1991), the court, applying Delaware law, noted: ''Under *Zapata* and Rule 23.1, the Court may order evidentiary hearings *before* ruling on a motion to terminate . . . .'' The court found, however, that the corporation does not possess a similar right to ''proceed to a bench trial *after* the court has ruled on all issues raised by a *Zapata* motion.'' *Id.* Note that the court did not actually say whether an evidentiary hearing would be permitted after the court has ruled on all issues raised by a *Zapata* motion; it only refers to the prohibition on a having a full bench trial.

[33] 108 A.D.2d 906 (N.Y. App. 1985).

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] 559 So. 2d 644 (Fla. Ct. App. 1990).

[38] *Id.* at 645.

[39] *Id.* (''At no time have the appellants had the opportunity to cross examine witnesses, nor were the lawyers, speaking individually or on behalf of the receiver, under oath.'').

[40] *Id.* at 645 (emphasis added).

[41] *Klein v. FPL Group, Inc.*, No. 02-20170-CIV, 2004 WL 302292 (S.D. Fla. Feb. 5, 2004).

[42] *Id.* at *17. The court noted that the defendant requested an evidentiary hearing at oral argument only after the court raised the issue. *Id.* at *6 n.11. This fact seemed to weigh against the defendant, though it did not affect the outcome, since the court did not find any disputed issues of material fact.

[43] 556 N.E.2d 51 (Mass. 1990).

brought a derivative action on behalf of the corporation.[44] The board of directors appointed one director (who was not named as a defendant) to serve as an SLC.[45] That director then retained an attorney to recommend a course of conduct. After an investigation, the attorney concluded that pursuit of the derivative claims would not be in the corporation's best interests. The board accepted the attorney's report and voted to seek dismissal of the action.[46]

The trial court granted the corporation's motion for summary judgment without any hearing, over plaintiff's objection. The Supreme Judicial Court reversed.[47] The court reasoned that the sole committee member's relationship to the interested director was ''particularly suspect'' because she was not an independent, outside director, and her professional advancement was dependent upon the individual defendants.[48] Therefore, the court remanded the case for an evidentiary hearing as to the SLC's independence.[49]

At least one lower court in Massachusetts has interpreted *Houle* to entitle plaintiffs to an evidentiary hearing whenever an SLC moves to terminate a derivative suit.[50] Although *Houle* discusses the use of an evidentiary hearing for the benefit of a shareholder plaintiff, there appears to be no reason why the court's reasoning would not apply to an SLC's request for an evidentiary hearing.

4. Colorado. One federal court sitting in the District of Colorado allowed the use of an evidentiary hearing to resolve the issue of an SLC's independence. In *Grynberg v. Farmer*,[51] the defendant corporation moved to terminate a derivative lawsuit based on an SLC recommendation that the lawsuit did not serve the best interests of the corporation. The court determined that the motion raised factual disputes. Rather than deny the motion, however, the court held a two-day evidentiary hearing to resolve such issues. At the hearing, the parties introduced documentary evidence, and members of the SLC testified at length.[52] Based on findings reached at the hearing, the court denied the corporation's motion to terminate.[53]

III. THE ALI APPROACH: COURT CAN RESOLVE FACTUAL DISPUTES AT EVIDENTIARY HEARING

The American Law Institute (ALI) Principles of Corporate Governance (''ALI Principles'') provide a comprehensive mechanism to address shareholder derivative actions.[54] The ALI approach appears consistent with View No. 2. In fact, section 7.13(c) of the ALI Principles provides:

> [I]f the plaintiff has demonstrated that a substantial issue exists whether the applicable standards of § 7.08, § 7.09, § 7.10, or § 7.12 have been satisfied and if the plaintiff is unable without undue hardship to obtain the information by other means, *the court may order such limited discovery or limited evidentiary hearing*, as to issues specified by the court, as the court finds to be (i) necessary to enable it to render a decision on the motion under the applicable standards of § 7.08, § 7.09, § 7.10, or § 7.12, and (ii) consistent with an expedited resolution of the motion.[55]

Thus, the ALI Principles permit the use of evidentiary hearings. The Official Comment to section 7.13 notes, however, that parties are not entitled to evidentiary hearings as a matter of right. Rather, the decision to hold an evidentiary hearing lies within the sound discretion of the court:

> Section 7.13(c) does not require an evidentiary hearing, but the *use of such a hearing is within the sound discretion of the court*. Instances will arise when the conflicting views of experts or other witnesses can be most efficiently tested through cross-examination. As always, however, control of such hearings remains with the court and the scope of any such hearing should be focused on the criteria of §§ 7.08 and 7.10.[56]

Therefore, under the ALI approach, a court may nonetheless deny an SLC's motion to terminate without holding an evidentiary hearing if the shareholder plaintiff manages to create factual disputes.[57]

IV. ADVANTAGES OF EVIDENTIARY HEARING

As explained above, courts generally adjudicate motions to terminate by applying summary judgment stan-

[44] *Id.* at 52.
[45] *Id.* at 53.
[46] *Id.*
[47] *Id.* at 60.
[48] *Id.* at 58.
[49] *Id.* at 60.
[50] *See Berkowitz v. Legal Sea Foods, Ins.*, No. 9506084, 1996 WL 1357434, at *2 (Mass. Super. Ct. Oct. 30, 1996) (''Should [the defendant] move to dismiss derivative claims based on recommendations by the special litigation committee, the plaintiffs will be entitled to an evidentiary hearing as put forth in *Houle*.'').
[51] 1980 WL 1456 (D. Colo. Oct. 8, 1980).
[52] *Id.* at *1.
[53] *Id.* at *16.
[54] *See Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations* (1994); *id.* §§ 7.02 (standing), 7.03 (demand rule), 7.04 (procedure in derivative action), 7.05 (board authority in derivative action), 7.06 (judicial stay of derivative action), 7.07–.08 (dismissal of derivative action based on motion requesting dismissal by SLC), 7.09 (procedures for requesting dismissal of derivative action), 7.10 (standard of judicial review with regard to SLC motion requesting dismissal of derivative action), 7.13 (judicial procedures on motions to dismiss derivative actions).
[55] *Id.* § 7.13.
[56] *Id.* § 7.13 cmt.
[57] Pennsylvania also permits evidentiary hearings in SLC cases. In *Cuker*, *supra* note 7, the Supreme Court of Pennsylvania specifically adopted section 7.13 of the ALI Principles, noting that a ''court might order limited discovery or an evidentiary hearing to resolve issues respecting the board's decision.'' 692 A.2d at 1042.

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dards. Some courts deny motions to terminate after a determination has been made as to the existence of factual disputes concerning an SLC's independence, good faith and reasonable diligence. Thus, a single disputed issue of material fact can effectively end the SLC's role in the litigation. Other courts permit an evidentiary hearing on factual disputes.

An evidentiary hearing can confer several advantages to the SLC and defendant corporation. First, an evidentiary hearing can preserve the SLC's role in the litigation. A court must weigh evidence gleaned through the parties' limited discovery to evaluate the propriety of the SLC process. Second, an evidentiary hearing likely results in a more favorable burden of proof for the corporation. Without an evidentiary hearing, the plaintiff shareholder need only establish a single disputed issue of material fact to proceed to trial. With an evidentiary hearing, however, the preponderance of the evidence standard as to whether the SLC lacked independence, good faith and reasonable diligence ought to apply.[58] In other words, the plaintiff shareholder must furnish evidence that bests (or at least equals) the evidence offered by the defendant corporation. Finally, an evidentiary hearing permits courts to weigh evidence and render credibility determinations. The defendant corporation can benefit from the opportunity to cross-examine adverse witnesses and rehabilitate the credibility of SLC members.

An evidentiary hearing also preserves the policy goals that undergird the business judgment rule. A plaintiff should not be able to so easily wrest control of a company's affairs by virtue of a single disputed issue of material fact. If there are fact disputes as to an SLC's independence, good faith and reasonable diligence, the company should have an opportunity to explore those disputes at an evidentiary hearing. Terminating derivative litigation without holding an evidentiary hearing could end up tying up a company's affairs on even the most trivial of fact disputes.

An evidentiary hearing also promotes efficiency and sound judicial administration. An evidentiary hearing on the threshold issues of an SLC's decision-making progress can potentially save parties the time and expense of protracted derivative litigation. Moreover, courts are particularly well-suited to weigh evidence and render credibility determinations; holding an evidentiary hearing as to the SLC's independence, good faith and reasonable diligence is part of a court's core competencies.

V. CONCLUSION

Following a loss on a motion to terminate derivative litigation, a lawyer representing an SLC should not assume that all is lost, or that the lawyer's engagement on the matter has closed. Rather, the lawyer should look to the law of the jurisdiction to determine if the SLC has an opportunity to present its case at an evidentiary hearing. This is particularly true if the court has denied, or signaled that it plans to deny, a motion to terminate derivative litigation on the ground that factual disputes exist.

If the law to be applied is California or Delaware law, there appears to be little SLC's counsel can do following denial of a motion terminate. On the other hand, if the law of New York, Florida, Massachusetts or Colorado is controlling, then SLC's counsel should consider petitioning the court to hold an evidentiary hearing to resolve outstanding factual disputes, citing the authorities referenced herein. If the controlling law is from a jurisdiction that has yet to decide the issue, the lawyer nonetheless should consider petitioning the court to hold an evidentiary hearing since the majority of jurisdictions have yet to formulate a view on the issue. In so doing, a lawyer representing an SLC that has lost on a motion to terminate derivative litigation can further assure that he or she has exhausted all of the client's options at that stage of the proceedings.

[58] *See Boit v. Gar-Tec Products, Inc.*, 967 F.2d 671, 676-77 (1st Cir. 1992) (proper burden of proof for evidentiary hearing is a ''preponderance of the evidence'').