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Special Litigation Committees a Practitioner's Guide

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SPECIAL LITIGATION COMMITTEES A PRACTITIONER'S GUIDE

*Alice A. Seebach**

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I. INTRODUCTION

A court may dismiss a shareholder's derivative suit¹ if a special committee of disinterested and independent directors investigates the shareholder's allegations and concludes that litigation is not in the corporation's best interests.²

Dismissal, however, is not a foregone conclusion. The court may grant a motion to dismiss only if no genuine issues of fact exist on four questions. (1) Do the committee members have an "interest" in the transaction that the shareholder challenges? (2) Are the committee members independent of the corporation and its management? (3) Did the committee conduct a good faith reasonable investigation? (4) Does the committee have a reasonable basis for recommending dismissal?³

Thus, a corporation must carefully select the special committee, and the committee must objectively, thoroughly, and in good faith investigate the shareholder's action. This Article discusses how to set up a special committee and what the committee should do.

II. BACKGROUND

Shareholders can bring a lawsuit on behalf of a corporation to redress corporate injuries in certain circumstances.⁴ Typically, shareholders allege that directors have mismanaged the corporation or have otherwise breached their fiduciary duties.⁵ Shareholders may claim, for

1. A shareholder brings a derivative suit on behalf of a corporation to redress a corporate injury. BLACK'S LAW DICTIONARY 399 (5th ed. 1979). The corporation is a necessary party and the relief granted is a judgment against a third person in favor of the corporation. *Id.*

2. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981).

3. *Id.* A court examines all four issues where demand is excused. Where demand is not excused, the interest and independence of committee members are not at issue. *Id.* But see *Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338 (7th Cir. 1990) (when federal law governs whether demand must be made, shareholder does not concede by making demand that directors are independent or disinterested). In some states, including Delaware, a court may not dismiss a shareholder's derivative suit even if the committee is disinterested and independent, conducted a reasonable investigation, and has a reasonable basis for recommending dismissal. The court may apply its own business judgment and dismiss only if it determines that litigation is not in the corporation's best interests. *Zapata*, 430 A.2d at 789.

4. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

5. See, e.g., *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. 1970) (mismanagement,

example, that directors have converted corporate assets,⁶ approved excessive compensation,⁷ violated federal securities laws,⁸ or manipulated corporate machinery to deprive stockholders of a right to consider changes in control, such as takeover proposals.⁹

Before filing a complaint, a shareholder must normally demand that a board of directors redress the alleged wrong.¹⁰ This pre-suit demand permits directors, the managers of a corporation, to bring an action themselves or otherwise to resolve issues that a shareholder raises.¹¹

If a shareholder fails to make such a demand, the shareholder may have no standing to sue on behalf of the corporation.¹² Accordingly, when a shareholder files a derivative complaint without making a demand, a corporation can move to dismiss for lack of standing.¹³

A court will deny a corporation's motion to dismiss for lack of standing, however, if a shareholder's demand is excused. Demand is excused where a request that a board act would have been futile.¹⁴ Such a request is futile where plaintiff's allegations raise a reasonable doubt as to whether: (1) a majority of directors were disinterested in or independent

waste); *Shapiro v. Pabst Brewing Co.*, No. 7339, slip op. at 10 (Del. Ch. July 30, 1985) (waste, entrenchment, and breach of fiduciary duty); *Wilen v. Pollution Control Indus.*, No. 7254, slip op. at 8-9 (Del. Ch. Oct. 15, 1984) (fraud, overreaching); *Harfil v. Kerkorian*, 324 A.2d 215, 217 (Del. Ch. 1974) (mismanagement, waste), *aff'd in part and rev'd in part*, 347 A.2d 133 (Del. 1975).

6. *See, e.g., Mazzetti v. Shepherd*, No. 8198, slip op. at 3 (Del. Ch. Aug. 26, 1986).

7. *See, e.g., Wilderman v. Wilderman*, 315 A.2d 610, 613 (Del. Ch. 1974).

8. *See, e.g., Margolies v. Pope & Talbot, Inc.*, No. 8244, slip op. at 3 (Del. Ch. Dec. 23, 1986).

9. *See, e.g., Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

10. *See* FED. R. CIV. P. 23.1 (the shareholder must allege, "with particularity," the efforts that plaintiff made "to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort"); DEL. CH. CT. R. 23.1 (same pleading requirement as federal rule).

Other states either follow similar statutes or require, by judicial decision, that a shareholder make a pre-suit demand. *See, e.g., Bartlett v. New York, New Haven & Hartford R.R.*, 221 Mass. 530, 109 N.E. 452 (1915); CAL. CORP. CODE § 800(b)(2) (West 1982); N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963); *see also Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338 (7th Cir. 1990) (federal law governs demand requirement when claim is based on federal substantive law).

11. *See Abramowitz v. Posner*, 672 F.2d 1025, 1031 (2d Cir. 1982).

12. *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988).

13. The corporation may also move to dismiss because the shareholder (1) held no stock when the corporation took the action that the shareholder challenges, (2) cannot adequately represent shareholders, or (3) asserts a personal, rather than a corporate, injury. *See, e.g.,* FED. R. CIV. P. 23.1; DEL. CH. CT. R. 23.1.

14. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981). *But see Kamen*, 908 F.2d at 1343 (futility does not excuse demand).

from the challenged transaction,¹⁵ or (2) directors exercised business judgment when they effected a challenged transaction.¹⁶ If a court denies a corporation's motion to dismiss for lack of standing, a shareholder may proceed with a derivative action.¹⁷

A court also may deny a corporation's motion to dismiss for lack of standing where a shareholder makes a proper demand on directors, but the directors wrongfully refuse to pursue or reasonably consider an alleged claim.¹⁸ Directors wrongfully refuse a demand where they fail to exercise proper business judgment in rejecting the demand¹⁹—for example, where they reject the demand in bad faith or without deliberating.²⁰ A shareholder may proceed with a derivative suit where it shows that a board wrongfully rejected its demand.²¹

Until 1981, once a shareholder proved either circumstances excusing demand or that a board wrongfully rejected a demand, some Delaware courts did not permit dismissal of a derivative action short of judgment or settlement.²² In the 1981 landmark case of *Zapata Corp. v.*

15. *Aronson*, 473 A.2d at 814; *see also* *Siegmán v. Tri-Star Pictures, Inc.*, No. 9477, slip op. at 28-29 (Del. Ch. May 30, 1989) (demand excused where majority of directors would receive special dividend from challenged transaction and several directors were also senior executives of company that would combine with corporation under challenged transaction); *Lewis v. Aronson*, No. 6919, slip op. at 11-12 (Del. Ch. May 17, 1985) (demand excused where plaintiff alleged that corporation granted employment contract to majority shareholder in exchange for dropping claims against other corporations in which majority of directors were officers and directors).

Demand is most clearly futile where the challenged transaction actively involves a majority of directors. *Aronson*, 473 A.2d at 815. The First and Ninth Circuits do not consider demand in such circumstances futile unless the plaintiff also shows that the challenged transaction involves fraud, self dealing for a direct pecuniary benefit, or approval of a transaction completely unrelated to a corporate purpose. *See* Block, Prussin & Wachtel, *Dismissal of Derivative Actions Under the Business Judgment Rule: Zapata One Year Later*, 38 BUS. LAW. 401, 410 n.50 (1983).

16. *Aronson*, 473 A.2d at 814; *see also* *Tomczak v. Morton Thiokol, Inc.*, No. 7861, slip op. at 8 (Del. Ch. May 7, 1986) (demand excused where plaintiff specifically alleged that board approved sale of corporate assets while ignoring obvious opportunity to obtain higher price); *Stein v. Orloff*, No. 7276, slip op. at 14 (Del. Ch. May 30, 1985) (demand excused where plaintiffs specifically alleged that transaction was waste of corporate assets).

Demand is not excused just because a corporation creates a special litigation committee to investigate a shareholder's claims. *Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. 1990).

17. *Zapata*, 430 A.2d at 784.

18. *Id.*

19. *Id.* at 784 n.10.

20. *See, e.g.*, *Lewis v. Hett*, 10 Del. J. Corp. L. 240 (Del. Ch. Sept. 4, 1984).

21. *Grobow v. Perot*, 526 A.2d 914, 929 (Del. Ch. 1987), *aff'd*, 539 A.2d 180 (Del. 1988); *see also* *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1134 (D. Del. 1988); *Levine v. Smith*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,581, at 97,604 (Del. Ch. Dec. 22, 1987).

22. Various courts applying Delaware law had dismissed derivative suits when boards or

Maldonado,²³ the Delaware Supreme Court approved early dismissal of shareholder derivative actions even where circumstances excused, or a board wrongfully rejected, a demand.²⁴

In *Zapata*, the Delaware Supreme Court reversed the Delaware Court of Chancery's ruling that a shareholder had an absolute right to prosecute, to judgment or settlement, a properly commenced derivative action.²⁵ The Delaware Supreme Court held that, under certain circumstances, a committee of directors²⁶ may cause a properly initiated derivative suit to be dismissed.²⁷ This Article discusses those circumstances.²⁸

III. DISCUSSION

A. Overview

A court may dismiss a properly commenced²⁹ shareholder's derivative action when a special litigation committee, after investigating the shareholder's claims, determines that the lawsuit is not in the corporation's best interests. The corporation moves for dismissal on the special committee's recommendation.³⁰

their committees determined that dismissal was in the corporation's best interests. See, e.g., *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980); *Abramovitz*, 672 F.2d at 1025; *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980), aff'd in part and rev'd in part, 671 F.2d 729 (2d Cir. 1982); *Siegal v. Merrick*, 84 F.R.D. 106 (S.D.N.Y. 1979).

23. 430 A.2d 779 (Del. 1981).

24. *Id.* at 788-89. Other states had already approved such a procedure. See, e.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

25. *Zapata*, 430 A.2d at 782.

26. A committee that evaluates a shareholder's derivative action and can cause its dismissal is referred to herein as a "special litigation committee," "special committee," or "committee."

27. *Zapata*, 430 A.2d at 784.

28. Discussion is not limited to Delaware law. Whether and under what circumstances a board may appoint a special litigation committee is a matter of state law, except where state law frustrates a federal policy. See *Burks v. Lasker*, 441 U.S. 471, 477 (1979); see also *Mills v. Esmark, Inc.*, 544 F. Supp. 1275, 1281-82 (N.D. Ill. 1982). The laws of the state of incorporation govern a corporation. *Burks*, 441 U.S. at 478. Because Delaware is a popular state of incorporation, Delaware courts have developed much of the case law on special litigation committees. This Article reports the law of other states as well.

Close corporations also use special litigation committees. See, e.g., *Grafman v. Century Broadcasting Corp.*, No. 8238 (N.D. Ill. July 3, 1990) (LEXIS, Genfed library, Dist file); *Houle v. Low*, 407 Mass. 810, 821, 556 N.E.2d 51, 57 (1990).

29. A shareholder derivative action is properly commenced where demand is excused or was wrongfully rejected and the shareholder otherwise has standing. See *supra* notes 10-21 and accompanying text.

30. Iowa courts may require that the recommendation come from a court-appointed "special panel" rather than a director-chosen special litigation committee. *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983). Under Iowa law, directors who

The motion to dismiss is neither a traditional motion to dismiss nor a traditional motion for summary judgment.³¹ Rather, it is a hybrid³²—a court applies summary judgment standards to the special committee's work.³³ Accordingly, unless federal law prevents it,³⁴ a derivative action may be dismissed where no issue of fact exists on four questions:³⁵

- (1) Do special committee members have an interest in the challenged transaction?
- (2) Are special committee members independent from management and the corporation?

are also defendants in the shareholder's suit cannot delegate to a special litigation committee the power to evaluate the shareholder's claims. *Id.* Therefore, where the shareholder names an entire board or its majority as defendants, the corporation cannot use a special litigation committee. *Id.* *But see id.* at 719 (Wolles, J., dissenting) (“[a special panel is] untried, untested, and a potentially unsound system for court appointment of corporate committees”).

The majority rule is to the contrary. A board-appointed special litigation committee can decide whether a shareholder's suit is in the corporation's best interests even where the shareholder names a majority of the board as defendants. *See, e.g.,* *Abbey v. Control Data Corp.*, 603 F.2d 724, 730 (8th Cir. 1979) (applying Delaware law), *cert. denied*, 444 U.S. 1017 (1980); *Gall v. Exxon Corp.*, 418 F. Supp. 508, 519-20 (S.D.N.Y. 1976) (applying federal common law); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785-86 (Del. 1981).

31. *Kaplan v. Wyatt*, 484 A.2d 501, 506 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

32. The “motion finds no ready pigeonhole,” and is “perhaps best considered as a hybrid summary judgment motion for dismissal because the stockholder plaintiff's standing to maintain the suit has been lost.” *Zapata*, 430 A.2d at 787.

33. A court applies the summary judgment standard to a special committee's action or inaction, not to the facts and circumstances of plaintiff's claims. *Kaplan*, 484 A.2d at 519.

The *Kaplan* court applied summary judgment standards, although it criticized the summary judgment motion as a “technically inappropriate procedural vehicle” to test the committee's work. *Id.* at 512 n.*. The motion concedes no liability and does not adjudicate the merits, or even the pleading, of plaintiff's case. “[I]t 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.” *Id.* at 507.

34. *Burks v. Lasker*, 441 U.S. 471, 480 (1979).

35. Courts that follow *Zapata* put the burden of proving that no issue of fact exists on defendants (directors and officers). *See, e.g.,* *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1496, 1500 (D. Md. 1985); *Zapata*, 430 A.2d at 788-89; *Kaplan*, 484 A.2d at 508; *see also* *Lewis v. Fuqua*, 502 A.2d 962, 970 (Del. Ch. 1985) (motion to dismiss denied because corporation failed to establish that special litigation committee was disinterested); *Houle v. Low*, 407 Mass. 810, 822, 556 N.E.2d 51, 58 (1990) (“burden of proving that these procedural requirements have been met must rest, in all fairness, on the party capable of making that proof—the corporation”).

Courts that follow *Auerbach v. Bennett*, 47 N.Y.2d 619, 635, 393 N.E.2d 994, 1003, 419 N.Y.S.2d 920, 929 (1979), put the burden of proving that no issue of fact exists on plaintiff shareholder. *See* *Lasker v. Burks*, 426 F. Supp. 844, 852 (S.D.N.Y. 1977), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979); *Gall*, 418 F. Supp. at 520; *Falkenberg v. Baldwin*, N.Y.L.J., Mar. 3, 1980, at 12, col. 6 (N.Y. Sup. Ct. Nov. 20, 1980).

Where demand is not excused, a court will not review issues under the first two questions. Interest and independence of special committee members are not relevant to the court's inquiry. *See supra* note 3 and accompanying text.

- (3) Did the committee reasonably and in good faith investigate the shareholder's claims?
- (4) Does the committee have a reasonable basis for recommending that the corporation move to dismiss the litigation?

In some states, including Delaware, dismissal is not assured even if a corporation passes these four tests. Under certain circumstances, some courts take a discretionary "second step" and evaluate the merits of the shareholder's suit as well. If these courts find that litigation is in the corporation's best interests³⁶ or that "law and public policy" favor the litigation, the shareholder's suit will proceed despite the special committee's recommendation.³⁷

36. See, e.g., *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 380 (6th Cir. 1984); *Joy v. North*, 692 F.2d 880, 892, 897 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); *Clark v. Lomas & Nettleton Fin. Corp.*, 625 F.2d 49, 53 (5th Cir. 1980), cert. denied, 450 U.S. 1029 (1981).

37. Under Delaware law, where demand is excused, a court first inquires "into the independence and good faith of the committee and the basis supporting its conclusions." *Zapata*, 430 A.2d at 788. Then the court will "determine, applying its own independent business judgment, whether the motion [to dismiss] should be granted." *Id.* at 789. In the second step of its evaluation, the court "should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests." *Id.* The court, in this second step, considers "matters of law and public policy in addition to the corporation's best interests." *Id.* The second step is "wholly within the discretion of the court." *Kaplan v. Wyatt*, 499 A.2d 1184, 1192 (Del. 1985). The second step "is intended to thwart instances where [a corporation] would simply prematurely terminate a shareholder's grievance deserving of further consideration. . . ." *Zapata*, 430 A.2d at 788. Where a shareholder has made a demand, the issue of whether the demand is excused is moot, and courts that follow *Zapata* do not reach the second step. *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990) (citing *Stotland v. GAF Corp.*, 469 A.2d 421, 422-23 (Del. 1983)). But see *Mills v. Esmark, Inc.*, 544 F. Supp. 1275, 1283 n.4 (N.D. Ill. 1982) (applying Delaware law, demand does not "itself bar all such [second-step] review in this court under Delaware law.").

Connecticut, Georgia, Iowa, Maryland, North Carolina, Ohio and Virginia follow *Zapata*. See *In re General Tire & Rubber Co.*, 726 F.2d 1075, 1083 (6th Cir.), cert. denied, 469 U.S. 858 (1984) (applying Ohio law); *Joy*, 692 F.2d at 892 (applying Connecticut law court followed *Zapata* where shareholder claimed corporation directly suffered financial harm); *Peller v. Southern Co.*, 707 F. Supp. 525, 527 (N.D. Ga. 1988); *Buckley*, 613 F. Supp. at 1499; *Holmstrom v. Coastal Indus., Inc.*, 645 F. Supp. 963, 987-88 (N.D. Ohio 1984); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 799-800 (E.D. Va. 1982); *Alford v. Shaw*, 320 N.C. 465, 468-69, 358 S.E.2d 323, 325-26 (1987).

Massachusetts courts take a "second step," but not the *Zapata* second step. The Massachusetts Supreme Court, in *Houle*, 407 Mass. at 824-25, 556 N.E.2d at 59, reversed summary judgment and remanded for an evidentiary hearing on whether the committee was "independent and unbiased." *Id.* The *Houle* court thus did not apply a "second step" but declared that Massachusetts courts must determine "whether the committee reached a reasonable and principled decision." *Id.* Even where a committee "is independent and conducts a thorough investigation, the judge may conclude that the committee's decision is contrary to the great weight of evidence." *Id.* The court must consider such factors as:

the likelihood of a judgment in the plaintiff's favor, the expected recovery as compared to out-of-pocket costs, whether the corporation itself took corrective action,

B. *Appointing a Special Litigation Committee*

1. Procedure

a. *when should a board appoint a special litigation committee?*

A board of directors should appoint a special litigation committee only after a corporation makes standing or jurisdictional objections.³⁸ When a board requests that a special committee investigate and evaluate a shareholder's claims, the board may relinquish any right to act until the special committee has done its work. For example, after it vests plenary authority in a special committee, a board may not move to dismiss the suit—even if plaintiff failed to make a proper demand.³⁹ The board can only move to stay the shareholder's action pending the special com-

whether the balance of corporate interests warrant dismissal, and whether dismissal would allow any defendant who has control of the corporation to retain a significant improper benefit.

Id. at 825, 556 N.E.2d at 59. The corporation bears the burden of proof under Massachusetts law. *Id.* at 824, 556 N.E.2d at 59.

New York forecloses a court's inquiry into the merits of the shareholder's suit. *See Auerbach*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920. The *Auerbach* court, unlike the *Zapata* and *Houle* courts, believed that courts are "ill-equipped" to make business decisions. *Id.* at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926. Absent evidence of bad faith or fraud, courts should respect the special litigation committee decision. *Id.* at 631, 393 N.E.2d at 1000, 419 N.Y.S.2d at 927. Under *Auerbach*, a court determines only whether disinterested, independent directors properly investigated the shareholder's claims. *Id.* at 630-31, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926-27.

California and Minnesota adopted the New York *Auerbach* rule. *See Gaines v. Haughton*, 645 F.2d 761, 771 (9th Cir. 1981) (applying California law), *cert. denied*, 454 U.S. 1145 (1982); *Black v. NuAire, Inc.*, 426 N.W.2d 203, 210 (Minn. Ct. App. 1988).

Michigan follows *Auerbach* where plaintiff does not allege that the directors personally gained from the challenged transaction. *See Genzer v. Cunningham*, 498 F. Supp. 682, 688 (E.D. Mich. 1980). Otherwise, a Michigan court would scrutinize a non-independent committee's decision to dismiss the suit.

Alabama follows *Genzer*. *See Roberts v. Alabama Power Co.*, 404 So. 2d 629, 632 (Ala. 1981).

38. The board, for example, may move to dismiss because the shareholder failed to make a pre-suit demand, failed to hold stock at the time of the challenged transaction or is not a stockholder, cannot adequately represent other shareholders, or does not assert a corporate injury. *See supra* notes 4-21 and accompanying text.

39. *See, e.g., Abbey v. Computer & Communications Tech. Corp.*, 457 A.2d 368, 373 (Del. Ch. 1983) (by appointing special litigation committee and delegating full authority to handle derivative action, board conceded that plaintiff need not make a demand, and individual directors lost standing to move to dismiss before special committee made its recommendation); *Richardson v. Graves*, No. 6617 (Del. Ch. June 17, 1983) (LEXIS, States library, Del file) (when board appoints an independent litigation committee, board concedes that it cannot make unbiased decision). *But see Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. 1990) (appointment of special committee does not necessarily moot question whether lawsuit properly initiated); *Peller v. Southern Co.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,714, at 98,311 (N.D. Ga. Mar. 25, 1988) (applying Delaware law).

mittee's deliberations.⁴⁰

In *Abbey v. Computer & Communications Technology Corp.*,⁴¹ the Delaware Court of Chancery refused to consider a motion to dismiss a shareholder's suit on standing grounds. The corporation brought the motion before a special committee had finished its investigation.⁴² Having delegated to the committee "full, complete and binding authority . . . to take whatever action it deemed appropriate," the corporation "divest[ed] itself of any power to make a decision on the pending suit."⁴³

A board should appoint a special committee, however, before the board determines whether a shareholder's suit has merit. In *Swenson v. Thibaut*,⁴⁴ a board voted to create a special litigation committee after it voted that a shareholder's suit had no merit.⁴⁵ All directors voted against the suit.⁴⁶ The board then appointed several directors to a special litigation committee, which later recommended that the corporation move to dismiss the suit.⁴⁷ The North Carolina Court of Appeals denied the corporation's motion to dismiss.⁴⁸ The court raised, *sua sponte*, an issue of fact on the committee's independence that precluded dismissal.⁴⁹ The court held that special committee members lacked independence because they had prejudged the suit.⁵⁰

b. how much authority should a board delegate?

A board must delegate full and final authority to a special litigation committee to decide whether a corporation should prosecute a shareholder's action or move to dismiss it.⁵¹ If a special committee has no

40. *Computer & Communications Tech. Corp.*, 457 A.2d at 375.

41. 457 A.2d 368 (Del. Ch. 1983).

42. *Id.* at 374.

43. *Id.* at 373. The plaintiff made a demand and then filed suit, alleging that demand was excused. *Id.* at 370-71. The board responded to the suit only by appointing a special litigation committee. The board did not challenge the plaintiff's allegation that demand was excused by moving to dismiss the suit, nor in any other way. *Id.*

Where a board first moves to dismiss and then appoints a special committee in response to a tardy demand, however, it may pursue a motion to dismiss. See *Spiegel*, 571 A.2d at 776.

44. 39 N.C. App. 77, 250 S.E.2d 279 (1978).

45. *Id.* at 107, 250 S.E.2d at 298.

46. *Id.* at 106, 250 S.E.2d at 298.

47. *Id.*

48. *Id.* at 107, 250 S.E.2d at 298.

49. *Id.*

50. *Id.*

51. *Id.* at 106, 250 S.E.2d at 297. The special committee's decision must be more than "advisory." In *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976), the court dismissed a shareholder's suit on the special committee's recommendation because, among other reasons, the special committee had the board's "full authority." *Id.* at 517. The court stated, "In no sense was the decision of the Special Committee not to sue merely an advisory one. Indeed, in

such plenary authority, a court may not grant a corporation's motion to dismiss.⁵² In *Swenson*, the court refused to dismiss a shareholder's action. Among other things, the corporation failed to vest in a special committee the authority to make a binding recommendation.⁵³ The court noted that "the litigation evaluation committee was *not* vested with the plenary powers of the full board, but was *only* an advisory group whose task it was to report to the full board its recommendations as to potential litigation."⁵⁴

The language in the following sample resolutions appeared to vest sufficient authority in special litigation committees:

Sample 1

"[The special litigation committee shall] make and report its findings and determinations to the board of directors, which findings and determinations shall be final and not subject to review by the board of directors and in all respects shall be binding upon this corporation."⁵⁵

Sample 2

"[T]here is hereby established an Independent Committee on Litigation . . . [T]he Committee shall . . . make the determination as to whether the Company should comply with such demand or any part thereof."⁵⁶

Sample 3

"[The special litigation committee has all the power and authority of the Board of Directors to investigate and] to determine the position that the Corporation shall take with respect to said derivative claims alleged on its behalf."⁵⁷

Sample 4

"The Committee shall . . . determine whether or not the Corporation shall undertake any litigation against any one or more of the present or former Directors or present or former officers of the Corporation . . . "⁵⁸

carrying out its investigation and in reaching its conclusions, the Special Committee exercised the full powers of the Board." *Id.*

52. See, e.g., *Greenfield v. Hamilton Oil Corp.*, 760 P.2d 664 (Colo. Ct. App. 1988) (dismissal reversed where corporation failed to delegate to special litigation committee power to make final decision); *Swenson*, 39 N.C. App. at 106, 250 S.E.2d at 297-98 (refusal to dismiss upheld where corporation failed to vest plenary authority in its committee).

53. *Swenson*, 39 N.C. App. at 106, 250 S.E.2d at 297-98.

54. *Id.* (emphasis added).

55. *Computer & Communications Tech. Corp.*, 457 A.2d at 371.

56. *Stein v. Bailey*, 531 F. Supp. 684, 686 (S.D.N.Y. 1982).

57. *Genzer v. Cunningham*, 498 F. Supp. 682, 693 (E.D. Mich. 1980).

58. *Gall*, 418 F. Supp. at 511. See also *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp.

2. Special litigation committee members

Counsel especially employed to help investigate a shareholder's claims ("special counsel"),⁵⁹ a board, or, in most states, even defendant-directors may select a special litigation committee.⁶⁰ Some statutes dictate how many members must be appointed.⁶¹ Even if a statute does not so mandate, a special litigation committee should have more than one member; courts apparently are reluctant to dismiss on the recommendation of a single-member committee.⁶²

Special committee members should have reputations for solving

795, 800 (E.D. Va. 1982) (board delegated "full authority . . . without any right of review by the full Board"); *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311, 1327 (S.D. Iowa 1981) (board vested "full and unconditional authority [to the special committee] to act on [the board's] behalf"); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 781 (Del. 1981) (court noted committee report stated it was final, not subject to review by the Board, and binding on corporation).

59. See *infra* notes 160-65 and accompanying text.

60. *Roberts v. Alabama*, 404 So. 2d 629, 631-32 (Ala. 1981); *Zapata*, 430 A.2d at 786; *Auerbach v. Bennett*, 47 N.Y.2d 619, 632, 393 N.E.2d 994, 1000-01, 419 N.Y.S.2d 920, 926-28 (1979). Under Iowa law, director-defendants cannot appoint a special litigation committee. *Miller v. Register Tribune Syndicate*, 336 N.W.2d 709, 715-16 (Iowa 1983). The Massachusetts Supreme Court recently denounced the "blanket rule" prohibiting the use of a "special litigation committee . . . where a majority of the board are [sic] named as defendants." *Houle v. Low*, 407 Mass. 810, 821, 556 N.E.2d, 51, 57 (1990). The court opined:

There is no need to create a blanket rule prohibiting the use of a special litigation committee in every case where a majority of the board of directors are [sic] named as defendants Once a special litigation committee is formed, the decision whether to dismiss is removed from the sphere of the interested directors' control. It is sufficiently removed that the board is not disqualified from choosing the Committee.

Id. A shareholder-defendant who controls a corporation may not be able to appoint a special committee. Hugh Hefner, who controlled 67% of *Playboy Magazine*, appointed a one-man special litigation committee in *Pompeo v. Hefner*, Nos. 6806, 6872, slip op. at 2 (Del. Ch. Mar. 23, 1983). The court acknowledged, in dicta, that the plaintiff's attack on the committee's independence may be appropriate. *Id.* at 3. The challenge was premature because the corporation had not yet moved to dismiss on the committee's recommendation. *Id.*; cf. *Clark v. Lomas & Nettleton Fin. Corp.*, 625 F.2d 49, 52-53 (5th Cir. 1980) (seemingly independent directors disqualified from settling derivative action where shareholder-defendant who could "strip them" of director, officer, and consulting positions had elected them to board), *cert. denied* 450 U.S. 1029 (1981).

61. See, e.g., MINN. STAT. ANN. § 302A.243 (West 1985 & Supp. 1990) (two or more members); N.Y. BUS. CORP. LAW § 712(a) (McKinney 1986 & Supp. 1990) (three members). Special committee members must be selected from the board of directors. See, e.g., DEL. CODE ANN. tit. 8, § 141(c) (1983).

62. See, e.g., *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 379 (6th Cir. 1984) (applying Massachusetts law) (special committee member's "personal interests" and "prior affiliation with the corporation" prevent corporation from proving his "good faith and disinterestedness"); *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985) (corporation's motion to dismiss denied where potential conflicts of interest or divided loyalties raised question of fact on whether one-man committee could act independently); *Houle*, 407 Mass. at 823-24, 556 N.E.2d at 58-59 (that committee has only one member does not vitiate committee's qualifications or work, but is factor in determining whether committee can act independently).

complicated business problems. If a court believes that a special litigation committee has made a sophisticated litigation decision, the court is more likely to dismiss a shareholder's suit.⁶³ Courts dismissing shareholder's actions have noted that experienced executives, former judges, economists, university presidents and senators have served on special committees.⁶⁴

a. special litigation committee members must not have an interest in a challenged transaction

Special litigation committee members must not have a personal interest in a challenged transaction.⁶⁵ A director whose "loyalties" are "divided" between personal gain and the corporation's best interests, or who has received, or may receive, "a personal financial benefit from the challenged transaction . . . not equally shared by the stockholders," has an interest in the challenged transaction.⁶⁶

63. One court remarked that a committee member who was "well versed" in corporate affairs, "independently wealthy in his own right," and in no way " beholden" to defendants, was especially qualified. *Kaplan v. Wyatt*, 484 A.2d 501, 512 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

64. *See, e.g., Abbey v. Control Data Corp.*, 603 F.2d 724, 727 (8th Cir. 1979) (applying Delaware law) ("The committee was composed of . . . persons holding responsible positions in government and business"), *cert. denied*, 444 U.S. 1017 (1980); *Abella*, 546 F. Supp. at 800 (economist, university president and senator comprised special committee); *Genzer*, 498 F. Supp. at 693 (chief executive officer of large company and university professor served as committee); *see also* *Rosengarten v. ITT*, 466 F. Supp. 817, 821 (S.D.N.Y. 1979) (one committee member was director of securities company, another was president of oil company, and third was former governor and university president); *Gall*, 418 F. Supp. at 510 (committee members included two chairmen of large corporations); *Roberts*, 404 So. 2d at 633 (court noted that two lawyer special committee members not dependent upon corporation for their livelihood); *Auerbach*, 47 N.Y.2d at 632, 393 N.E.2d at 1001, 419 N.Y.S.2d at 972 (two corporate chairmen and university professor comprised committee).

65. *See Control Data Corp.*, 603 F.2d at 727. The court in *Control Data Corp.* noted that "[t]he [special litigation] committee was composed of seven . . . 'outside' directors — persons holding responsible positions in government and business. No committee member had been named as a defendant, and there is no indication that any member was involved in or had contemporaneous knowledge of the foreign payments." *Id.*

Special committee members must be independent from the directors and the corporation. *See infra* notes 104-59 and accompanying text. Although courts sometimes interchange the words "disinterest" and "independence," facts showing independence are different from facts showing a special litigation committee member has no interest in a challenged transaction.

66. *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). The *Pogostin* court considered when directors are so interested in a challenged transaction that a shareholder need not demand that the directors redress an alleged wrong before filing a derivative suit. *Id.* at 625. *Pogostin* relied on *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), where the court addressed a similar issue. The *Aronson* and *Pogostin* tests apply to special litigation committees. *Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985); *see, e.g., Stein*, 531 F. Supp. at 694 (applying Delaware law) (special committee members not interested where "none had a personal financial stake in the

- (i) do special litigation committee members have an interest in a challenged transaction because they are board members?

Shareholders often contend that special litigation committee members who served on a board when the board effected the challenged transaction necessarily have an interest in a challenged transaction, especially if they voted for it. Merely serving on a board does not make a special committee member interested.⁶⁷ Thus, in *Kaplan v. Wyatt*,⁶⁸ the Delaware Court of Chancery held, “[the] mere fact that a director was on the Board at the time of the acts alleged in the complaint does not make that director interested or dependent so as to infringe on his . . . independent business judgment of whether to proceed with the litigation.”⁶⁹ To avoid an appearance of interest a board often appoints to the special committee directors who joined the board after the corporation made the challenged transaction.⁷⁰

- (ii) do special litigation committee members have an interest in a challenged transaction because a shareholder names them as defendants?

Special litigation committee members do not have an interest in a challenged transaction just because a plaintiff names them as defendants. As the court in *Aronson v. Lewis*⁷¹ explained, “the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors.”⁷²

outcome of the litigation.”). Accordingly, a special committee member has no interest in a challenged transaction merely because the special committee owns stock in the corporation.

67. *Kaplan*, 499 A.2d at 1189. If board members were interested merely because they voted for a challenged transaction, the Delaware rule requiring that a shareholder make a pre-suit demand on a corporation would be meaningless. In a forceful opinion, the Delaware Supreme Court rejected the notion that approving a challenged transaction necessarily makes a board member interested:

[A]ny board approval of a challenged transaction [does not] automatically connote “hostile interest[s]” and “guilty participation” by directors, or some other form of sterilizing influence upon them. Were that so, the demand requirements of our law would be meaningless, leaving the clear mandate of Chancery Rule 23.1 [requiring that a shareholder serve a demand] devoid of its purpose and substance.

Aronson, 473 A.2d at 814.

68. 499 A.2d 1184 (Del. 1985).

69. *Id.* at 1189.

70. *See, e.g., Maher v. Zapata*, 714 F.2d 436, 446 (5th Cir. 1983) (applying Delaware law); *Lewis v. Anderson*, 615 F.2d 778, 780 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); *Abella*, 546 F. Supp. at 800.

71. 473 A.2d 805 (Del. 1984).

72. *Id.* at 815. *See also In re General Tire & Rubber Co.*, 726 F.2d 1075, 1084 (6th Cir.), *cert. denied*, 469 U.S. 858 (1984) (applying Ohio law, court found naming director in a suit

If a shareholder could prove a disabling interest merely by naming directors defendants, procedures permitting early dismissal of shareholder actions on a special committee's recommendation would be severely restricted. If director-defendants were *per se* interested, only directors elected after a challenged transaction could serve on a committee, and that is contrary to established law. The New York court in *Auerbach v. Bennett*⁷³ rejected such a notion, stating, "to disqualify the entire board would be to render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative action."⁷⁴ To raise an issue of interest, a shareholder's complaint must charge a committee member with specific misconduct. Nominal defendants may serve on the special committee.⁷⁵ *Mills v. Esmark, Inc.*⁷⁶ distinguished nominal from specific charges. The court held that two

does not show director's bad faith); *Findley v. Garrett*, 109 Cal. App. 2d 166, 177, 240 P.2d 421, 427 (1952) (general allegations of conspiracy, unsupported by facts and made on information and belief, will not excuse demand); *Dawson v. Dawson*, 645 S.W.2d 120, 127 n.8 (Mo. Ct. App. 1982) (naming directors because they are "under the control and domination" of a wrongdoer does not excuse demand). *But see* *Galef v. Alexander*, 615 F.2d 51, 64 (2d Cir. 1980) (applying Ohio law, court stated named defendant always has an interest); *Control Data Corp.* 603 F.2d at 727 ("where the directors, themselves, are subject to personal liability [they] cannot be expected to determine impartially whether [the suit] is warranted").

73. 47 N.Y.2d 626, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

74. *Id.* at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. Additionally, in *Aronson v. Lewis* the Delaware Supreme Court soundly rebuffed such a "bootstrap argument" where a shareholder advanced it to excuse a pre-suit demand:

Plaintiff's final argument is the incantation that demand is excused because the directors otherwise would have to sue themselves, thereby placing the conduct of the litigation in hostile hands and preventing its effective prosecution. This bootstrap argument has been made to and dismissed by other courts. Its acceptance would effectively abrogate Rule 23.1 [requiring demand] and weaken the managerial power of directors. Unless facts are alleged with particularity to overcome the presumptions of independence and a proper exercise of business judgment, in which case the directors could not be expected to sue themselves, a bare claim of this sort raises no legally cognizable issue under Delaware corporate law.

473 A.2d at 818 (citations omitted).

75. *See, e.g., Anderson*, 615 F.2d at 782 (director-defendants may serve on special committee as long as they did not profit from challenged transaction); *Klotz v. Consolidated Edison Co.*, 386 F. Supp. 577, 580 (S.D.N.Y. 1974) (nominal defendants, against whom plaintiff seeks no relief, are disinterested). Nominal charges do not excuse a shareholder's pre-suit demand. *Recchion v. Westinghouse Elec. Corp.*, 606 F. Supp. 889, 897 (W.D. Pa. 1985) (merely alleging that directors acquiesced in fraudulent activities without alleging that directors themselves realized money from the activities does not excuse demand); *Grossman v. Johnson*, 89 F.R.D. 656, 659 (D. Mass. 1981) (mere approval of alleged unlawful action not sufficient participation to excuse demand), *aff'd*, 674 F.2d 115 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982); *Findley*, 109 Cal. App. 2d at 176-77, 240 P.2d at 427 (general statements on information and belief that directors knew of conspiracy, actively participated in it, knowingly shielded and actively concealed it by affirmative misrepresentations, insufficient to overcome presumption of independence and to excuse demand).

76. 544 F. Supp. 1275 (N.D. Ill. 1982) (applying Delaware law).

defendant committee members had no interest in counts in which plaintiff did not charge specific wrongdoing.⁷⁷ The court noted:

Although [special committee members] were each named as defendants in this action, neither is alleged to have participated in the decisions of the Esmark Compensation Committee or to have received any payment or benefit challenged by plaintiffs in this lawsuit. The disinterested independence of [the special committee members] is not impaired merely because they were named as nominal defendants in this case.⁷⁸

Specific charges made the same defendants interested. Allegations that special committee members in *Mills* agreed to an alleged misrepresentation in a proxy statement presented an issue on their interest. That issue precluded dismissal of the shareholder's claims on the alleged misrepresentation.⁷⁹ The *Mills* court continued: "As Esmark directors, [the special committee members] each participated in the alleged wrongdoing by approving the alleged misrepresentations As a practical matter, neither [of the special committee members] can be expected to exercise truly independent judgment in evaluating the propriety of their own decision to approve the proxy statement."⁸⁰

The *Mills* court permitted plaintiffs to prosecute the claims on which plaintiffs had charged [the special committee members] with specific wrongdoing.⁸¹ A court may not, however, distinguish between nominal and specific charges if a corporation appoints only one director to a special litigation committee. In *Lewis v. Fuqua*,⁸² the issue of a sole member's interest⁸³ prevented dismissal of a shareholder's action.⁸⁴ The court noted, among other things,⁸⁵ that plaintiffs had named the sole

77. *Id.* at 1283.

78. *Id.* (footnote omitted).

79. *Id.* at 1284.

80. *Id.* at 1283-84 (footnote omitted).

81. *Id.* at 1284. Generally, mere approval of a challenged transaction does not make special committee members interested. See *supra* note 67 and accompanying text. The *Mills* court acknowledged this. 544 F. Supp. at 1284 n.6. *Mills* may be an anomaly. The *Mills* court justified its decision on the specific charge of wrongdoing with evidence that "those who profited from the section 14 violation" dominated special committee members, and the federal nature of the alleged securities law violation. *Id.* But see *infra* note 297 and accompanying text.

82. 502 A.2d 962 (Del. Ch. 1985).

83. *Id.* at 967-68. The court called it an issue of "independence" and a "conflict of interest or divided loyalt[y]." *Id.* A special committee member must pass two tests, however. First, the member must have no interest in the challenged transaction, see *supra* note 65, and second, must be independent from the board and the corporation. See *infra* note 104.

84. *Fuqua*, 502 A.2d at 967.

85. The committee member was a board member when the alleged wrongdoing occurred.

member a defendant: "the Committee here consisted of but one person Although [he] is well renowned, there are circumstances which must lead the Court to have questions [h]e is one of the defendants in this suit."⁸⁶ A single committee member, the *Fuqua* court warned, should, "like Caesar's wife, be above reproach."⁸⁷ The court rejected the special committee's recommendation to dismiss and let the shareholder proceed with the litigation.⁸⁸

- (iii) do special litigation committee members have an interest in a challenged transaction because it benefits them?

A shareholder may assert that committee members have an interest in a challenged transaction because it benefits them.⁸⁹ Shareholders, for example, may accuse committee members of using a challenged transaction to secure their own jobs ("entrenchment")⁹⁰ or to control shares that they do not own.⁹¹

Conclusory allegations of entrenchment do not establish that directors have an interest in a transaction because it permitted them to keep their jobs.⁹² A plaintiff must show a "logical or factual nexus between the challenged transaction and the asserted entrenchment."⁹³ Such a

Id. at 966. He was politically and financially connected with J.B. Fuqua, Fuqua Industries' CEO, who allegedly controlled the board. *Id.* at 966-67. He was President of Duke University, and Fuqua Industries and J.B. Fuqua, a Duke trustee, had made a \$10 million pledge to Duke. *Id.* at 967.

86. *Id.* at 966 (emphasis added). The single committee member in *Fuqua* also served as one of three special committee members for ITT. *See ITT*, 466 F. Supp. at 821.

87. *Fuqua*, 502 A.2d at 967; *see also Houle*, 407 Mass. at 823-24, 556 N.E.2d at 58-59.

88. *Fuqua*, 502 A.2d at 972.

89. A director is interested where he or she has received, or may receive, "a personal financial benefit from the challenged transaction . . . not equally shared by the stockholders." *Pogostin*, 480 A.2d at 624.

90. *See infra* notes 92-98 and accompanying text.

91. *See infra* notes 99-101 and accompanying text.

92. *See, e.g., Lewis v. Graves*, 701 F.2d 245, 250 (2d Cir. 1983) (conclusory allegations of entrenchment do not excuse demand).

93. *Id.* Thus, a shareholder must specifically plead a "logical or factual nexus" when the shareholder challenges the board's response to a takeover threat or the board's adoption of an anti-takeover device. *See Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1071 (Del. Ch.) ("the complaint must allege specific facts which demonstrate that the primary purpose of management was to retain control"), *aff'd*, 500 A.2d 1346 (Del. 1985); *Grobow v. Perot*, 526 A.2d 914, 922-23 (Del. Ch. 1987) (plaintiffs failed to show interest on entrenchment theory because plaintiffs did not allege directors "believed themselves vulnerable to removal from office by reason of a takeover" or by any other "specific, concrete threat to . . . incumbency"), *aff'd*, 539 A.2d 180 (Del. 1988). Both *Grobow* and *Moran* evaluated whether directors' interest excused a demand. The same standards apply to special committee members' interests. *See generally Kaplan*, 484 A.2d 501.

If courts did not require such specific pleading, demands would be futile where the boards

nexus may exist if management's "primary purpose" in approving a challenged transaction was "to retain control."⁹⁴

If a shareholder pleads the proper nexus between a challenged transaction and entrenchment, even outside directors⁹⁵ may be considered interested. Outside directors have no corporate jobs in which to entrench themselves, but a corporation usually pays them annual stipends or meeting fees.⁹⁶ In *Grobow v. Perot*,⁹⁷ the court held that "lavish" fees may entice directors to entrench themselves.⁹⁸

- (iv) do special litigation committee members have an interest in a challenged transaction because they believe, before investigating, that a shareholder's claims have no merit?

A plaintiff may allege that special litigation committee members believed that a shareholder's suit lacked merit before they investigated.⁹⁹ Such general allegations that a special litigation committee member is sympathetic to the challenged transaction, however, do not raise an issue of interest. The plaintiff must produce "*tangible evidence* of an untoward interest . . . in the outcome of . . . litigation."¹⁰⁰ Thus, where a chal-

approved transactions that kept management in control. In *Lewis v. Graves*, the Court of Appeals for the Second Circuit warned that this would vitiate the Delaware rule requiring a pre-suit demand:

If a derivative plaintiff could show self-interest in a transaction by mere conclusory allegations that the defendant directors approved a business acquisition simply to secure their own positions, without providing any logical or factual nexus between the transaction and the asserted entrenchment, the demand requirement of Rule 23.1 would again become virtually meaningless.

701 F.2d at 250.

94. *Moran*, 490 A.2d at 1071.

95. An outside director is "[a] member of a corporate board of directors who is not a company officer and does not participate in the corporation's day-to-day management." BLACK'S LAW DICTIONARY 994 (5th ed. 1979).

96. Perham, *Now It Pays to Be a Director*, DUN'S REV., Mar. 1981, at 60.

97. 526 A.2d 914 (Del. Ch. 1987), *aff'd*, 539 A.2d 180 (Del. 1988).

98. *Id.* at 923 n.12. The court noted:

The rule that receipt of customary directors' fees does not create a disqualifying interest is one involving the application of a presumption (i.e., the presumption of director disinterest). It is not an unvarying principle that mechanically applies irrespective of the circumstances. Conceivably a situation might arise where directors' compensation, in the form of "directors' fees," becomes so lavish that a mechanical application of the presumption would be totally at variance with reality.

Id.

99. In *Stein v. Bailey*, the court found the committee disinterested, in part, because members had no opinion about the challenged transaction before appointed to the committee. 531 F. Supp. at 694. The court declared that "there is absolutely no evidence that the Committee members held opinions about these matters prior to their appointment to the Committee." *Id.* Thus, some boards appoint to the committee only board members who joined the board after the challenged transaction. *See supra* note 70.

100. *Watts*, 525 F. Supp. at 1328 (emphasis added).

lenged transaction perpetuates management's control, allegations that a special committee member's wealth or "understanding of the 'significance of family control of businesses'" were held insufficient to show bias.¹⁰¹ Likewise, a court will not deem a special committee member interested in questionable payments just because the committee member sat on the board of another corporation when it also made questionable payments.¹⁰²

A court may find "tangible evidence" of an interest in the outcome of litigation where special committee members voted, before the board appointed them to the committee, that a shareholder's suit had no merit. In *Swenson*, the court held that directors had a conflict of interest because they had voted against a shareholder's suit before a board appointed them to a special committee.¹⁰³

b. special litigation committee members must be independent

Special litigation committee members must be independent from a corporation and its management.¹⁰⁴ Independence and interest are separate characteristics. As explained above, special litigation committee members have an interest in a challenged transaction where they have benefited or may benefit from it, where their "loyalties" are "divided" between personal gain and the best interests of the corporation,¹⁰⁵ or where they oppose the shareholder's suit for other personal reasons.

Independence, however, is a matter of influence.¹⁰⁶ Where director-defendants, a board, or a corporation influences a special committee's investigation or recommendation, the special committee members may not be independent. Thus, to remain independent, a director must use

101. *Id.*; see also *Mills*, 544 F. Supp. at 1284 n.8 (defending special litigation committee's findings does not establish hostility or bias "in the *formulation*" of report) (emphasis in original); *Kaplan*, 499 A.2d at 1189-90 (Del. 1985) (where corporation's primary business is oil and petroleum products, allegations that committee member was sympathetic to oil company CEOs, unsupported by evidence that member's inclinations affected his decisions, were insufficient).

102. See, e.g., *ITT*, 466 F. Supp. at 825 (two committee members who were directors of corporations that had made questionable payments not interested).

103. *Swenson*, 39 N.C. App. at 107, 250 S.E.2d at 298. But see *Mills*, 544 F. Supp. at 1283 n.5 (earlier motion to dismiss for failure to make demand does not show bias; decision to dismiss action on procedural grounds not prejudgment of its merits).

104. *Pogostin*, 480 A.2d at 624.

105. *Id.*; see also *supra* notes 89-98 and accompanying text.

106. See *Aronson*, 473 A.2d at 816. Special committee members are not independent when a director or the corporation unduly influences the committee's work. "Independence means that a director's decision is based on the corporate merits of the subject before [him or her] rather than [on] extraneous considerations or influences." *Id.* *Aronson's* independence test applies to special litigation committees. *Id.*

“his or her own informed business judgment . . . without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act.”¹⁰⁷

- (i) do special relationships with director-defendants interfere with a special committee member’s independence?

A relationship with a director-defendant does not necessarily impugn a special committee member’s independence.¹⁰⁸ For example, a special committee member may belong to an organization with a director-defendant and remain independent. In *Rosengarten v. Buckley*,¹⁰⁹ a committee member served with a director-defendant on the board of a national association.¹¹⁰ This did not raise an issue of independence because the association’s board had over 200 members.¹¹¹

The *Buckley* court held that a special committee member may remain independent from a director-defendant while running another company with the director-defendant.¹¹² The court found special committee member/board member (Mr. McGowan) independent from a director-defendant (Mr. Wells) even though Wells helped manage McGowan’s company.¹¹³ Wells even helped set McGowan’s salary.¹¹⁴ The *Buckley* court found McGowan independent because Wells never met with McGowan.¹¹⁵ Wells simply made recommendations to McGowan’s board.¹¹⁶ Furthermore, the recommendations were made after Wells had left and six months before McGowan joined Wells’ board.¹¹⁷ Finally, other special committee members testified Wells did not influence McGowan.¹¹⁸

Where a special litigation committee’s investigation is inadequate on its face, a court may be suspicious of special committee members’ relationships with director-defendants. The court may presume that the spe-

107. *Id.*

108. *Id.* at 815-16. Mere appointment by a chief executive officer also does not raise an issue of independence. “That is the usual way a person becomes a corporate director.” *Id.* at 816.

109. 613 F. Supp. 1493 (D. Md. 1985).

110. *Id.* at 1500.

111. *Id.*

112. *Id.* at 1500-01. A special committee member can also maintain independence even though the corporation hired his or her partner as special counsel to the special committee. *Id.* at 1501; see also *Maldonado v. Flynn*, No. 77-3180, slip op. at 15-16 (S.D.N.Y. Jan. 24, 1980).

113. *Buckley*, 613 F. Supp. at 1500.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

cial committee members are not independent. In *Holmstrom v. Coastal Industries, Inc.*,¹¹⁹ a special committee could not explain how it decided that a shareholder's suit should be dismissed. The court held that pressure on special committee members "hand-picked" by the majority directors may justify "a presumption against independence."¹²⁰ The court explained:

The problems of peer pressure and group loyalty exist *a fortiori* where the members of a special litigation committee are not antagonistic, minority directors, but are carefully selected by the majority directors for their advice. Far from supporting a presumption of good faith, the pressures placed upon such a committee may be so great as to justify a presumption against independence.¹²¹

- (ii) do relationships with a corporation interfere with a special committee member's independence?

Special committee members with no connection to a corporation when it made a challenged transaction are likely to be independent.¹²² Complete disassociation, however, is not necessary. Such a principle would prevent even outside directors from serving on a special committee. The Sixth Circuit Court of Appeals has rejected such a rule.¹²³ The court in *In re General Tire & Rubber Co.*¹²⁴ reasoned that "a flat rule which allows only those individuals with absolutely *no* contact with the Company to exercise independent business judgment . . . would preclude virtually every outside director [from serving on a committee]."¹²⁵

The court in *General Tire* upheld a lower court's ruling that both a partner in the corporation's law firm and a corporate consultant were independent.¹²⁶ The lawyer had "provided legal assistance to the Company as outside counsel . . . for many years."¹²⁷ The lower court concluded that this relationship alone was "insufficient to establish bias . . .

119. 645 F. Supp. 963 (N.D. Ohio 1984).

120. *Id.* at 987.

121. *Id.*

122. See, e.g., *Buckley*, 613 F. Supp. at 1494-95 ("none of them . . . had any connection with the Company at the time of the transaction"). Thus, a corporation may appoint to a special committee directors who joined after a board effected a challenged transaction. See *supra* note 70 and accompanying text.

123. *General Tire*, 726 F.2d at 1084.

124. 726 F.2d 1075 (6th Cir.), *cert. denied*, 469 U.S. 858 (1984).

125. *Id.* at 1084.

126. *Id.* at 1083-84.

127. *Id.* at 1084.

or control . . . by inside management.”¹²⁸ The appellate court affirmed, “[t]he district court properly concluded that [the special committee member’s] mere legal association with General Tire does not alone disqualify him from exercising independent business judgment.”¹²⁹

The consultant had investigated “questionable corporate practices” for General Tire.¹³⁰ The appellate court agreed with the district court that he, too, was independent.¹³¹ He had not participated in the questionable practices but only in “the corporation’s attempt to scrutinize those affairs after they had occurred.”¹³² Furthermore, special counsel employed to assist the special litigation committee had concluded that the consultant was “absolutely and totally unassociated” with the events at issue in the shareholder suit.¹³³

In *Genzer v. Cunningham*,¹³⁴ a corporation had previously employed a special committee member as a consultant.¹³⁵ The court found no issue on this former consultant’s independence.¹³⁶ He had completed his consulting work before the corporation made allegedly questionable payments, the subject of the shareholder’s complaint.¹³⁷ Moreover, special committee members had discussed the issue among themselves and with special counsel and concluded that the consulting work would not affect the committee member’s independence.¹³⁸ Significantly, “plaintiffs concede[d] that [committee members, including the former consultant were] ‘unquestionably individuals of unique stature and accomplishment.’ ”¹³⁹

To raise an issue that a special committee member lacks independence because of relationships with a corporation, a shareholder must show how the relationships influenced the committee member. The Delaware Supreme Court in *Kaplan v. Wyatt*¹⁴⁰ showed how extensive a relationship between a committee member and a corporation can be without implicating the committee member’s independence. The *Kaplan* committee member owned nine percent of a company that did substan-

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

134. 498 F. Supp. 682 (E.D. Mich. 1980).

135. *Id.* at 693.

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. 499 A.2d 1184 (Del. 1985).

tial business (\$100-\$226 million/year) with the corporation for whom he served as special committee member.¹⁴¹ In addition, the special committee member and the corporation were partners in a limited partnership.¹⁴² The corporation had invested millions of dollars in the partnership, from which it had made \$2.5 million.¹⁴³ Finally, the special committee member owned nineteen percent of another company that did business with the corporation.¹⁴⁴ These business relationships with the corporation did not impugn the special committee member's independence because plaintiffs failed to show how the relationships influenced him.¹⁴⁵

- (iii) do relationships with a board or a majority stockholder interfere with a special committee member's independence?

A general charge that a special committee member has a relationship with a board or a majority stockholder does not raise an issue of independence.¹⁴⁶ Specific allegations showing how such a relationship has influenced a committee member, however, may raise the issue.¹⁴⁷

For example, a general charge that a special committee member consistently votes with a majority of a board does not establish a lack of independence.¹⁴⁸ Such an assertion in *Mills* failed to raise an issue of fact regarding special committee members' independence. The *Mills* board members customarily resolved disagreements before a formal vote, so almost every vote was unanimous.¹⁴⁹ The voting pattern did not establish bias.¹⁵⁰ Likewise, in *Stein v. Bailey*,¹⁵¹ a charge that "three members of the Board cannot impartially assess the actions of their fellow directors, friends and associates,"¹⁵² did not raise an issue of fact.¹⁵³ The plaintiffs produced "absolutely no evidence . . . to suggest even the appearance of impropriety."¹⁵⁴

141. *Kaplan*, 484 A.2d at 513.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.* at 517.

146. *See, e.g., Pompeo*, Nos. 6806, 6872, slip op. at 5-6 (no conclusive presumption of influence where majority stockholder could remove committee member from board).

147. *See Stein*, 531 F. Supp. at 693-94.

148. *Mills*, 544 F. Supp. at 1284-85.

149. *Id.*

150. *Id.* at 1285-86 & n.9.

151. 531 F. Supp. 684 (S.D.N.Y. 1982).

152. *Id.* at 693.

153. *Id.* at 694.

154. *Id.*

Furthermore, the special committee members in *Stein* “endeavored to ensure they would remain unaffected by any potentially improper influences.”¹⁵⁵ Among other things, the committee’s special counsel, “known . . . for its high professional standards,” declared in an affidavit, “[t]he Independent Committee performed its function without interference or influence of any sort by any director, officer, employee or agent of [the corporation].”¹⁵⁶ The court agreed with the corporation that the special committee was independent.¹⁵⁷

Declarations that a special committee is impartial, like that of special counsel in *Stein*, help show independence, especially when made before a special committee begins its work. In *Alford v. Shaw*,¹⁵⁸ a prospective special committee member warned that the special committee would “let the chips fall where they may.”¹⁵⁹ Thus, the prospective special committee member, a former Associate Judge of the North Carolina Court of Appeals, stressed that the committee intended to act independently of the board.

155. *Id.*

156. *Id.* at 690 n.13. The court in *Abella v. Universal Leaf Tobacco Co.* quoted similar testimony and remarked that the special committee repeatedly consulted with its independent counsel about matters “that might have, or appear to have, any bearing on its members’ independence.” 546 F. Supp. at 800.

157. *Stein*, 531 F. Supp. at 694.

158. 318 N.C. 289, 349 S.E.2d 41 (1986), *withdrawn on other grounds*, 320 N.C. 465, 358 S.E.2d 323 (1987).

159. *Id.* at 311, 349 S.E.2d at 54. The prospective special committee member further noted:

Speaking for [the committee], should you decide to elect us to the Board of Directors and to name us as the members of a Special Investigative Committee, we will accept the appointment provided that it is clearly understood that in undertaking our duties:

- (1) We have no preconceived ideas concerning the merits of any claims which may have been asserted or may in the future be asserted against All American Assurance Company or any of its present or former officers or directors;
- (2) We will conduct as thorough investigation [sic] as we possibly can make of all matters pertinent to such claims;
- (3) Based on the information developed as a result of our investigation and the facts as we find them to be, we will make our own independent determination as to what actions, if any, should be undertaken with respect to these claims in the best interest of all shareholders of All American Assurance Company; and
- (4) If after our investigation we determine, in our independent judgment, that some legal action or actions should, to protect the best interest of all shareholders, be undertaken against any person or entity, we will see that such actions are initiated and prosecuted vigorously to a conclusion.

In short, we want it clearly understood that in carrying out our duties as members of the Board of Directors and as members of the Special Investigative Committee, we intend to exercise our own independent judgments and to let the chips fall where they may.

Id.

C. *Appointing Special Counsel*

A corporation should hire "special counsel" to advise and assist a special committee.¹⁶⁰ Courts satisfied with a special committee's investigation often remark that qualified special counsel guided the special committee. In *Rosengarten v. Buckley*,¹⁶¹ where shareholders complained about entrenchment, the court noted that special counsel was a law school dean, an American Bar Association committee chairman and a securities and corporate law expert.¹⁶² In *Alford v. Shaw*,¹⁶³ a former president of the North Carolina Bar Association, "learned" in corporate, insurance and litigation matters, helped the special committee investigate claims that the board committed fraud.¹⁶⁴ The lawyer, especially experienced as special counsel, had never represented the corporation or any of its affiliates.¹⁶⁵

D. *Committee Work*

1. The investigation

A special litigation committee investigates a shareholder's claims. A special committee must determine whether a shareholder's allegations have merit and whether a shareholder is likely to prevail.¹⁶⁶ Where "serious questions exist" whether a complaint states a cause of action, a

160. See generally *Rosengarten v. Buckley*, 613 F. Supp. 1493 (D. Md. 1985); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795 (E.D. Va. 1982); *Stein v. Bailey*, 531 F. Supp. 684 (S.D.N.Y. 1982); *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311 (S.D. Iowa 1981).

161. 613 F. Supp. 1493 (D. Md. 1985).

162. *Id.* at 1495. The court dismissed the shareholder's complaint on the special committee's recommendation. *Id.* at 1504.

163. 318 N.C. 289, 349 S.E.2d 41 (1986), *withdrawn on other grounds*, 320 N.C. 465, 358 S.E.2d 323 (1987).

164. *Id.* at 310, 349 S.E.2d at 54.

165. *Id.* Others who have served as special counsel include professors and former judges. See, e.g., *Watts*, 525 F. Supp. at 1315; *Cramer v. General Tel. & Elecs.*, 443 F. Supp. 516 (E.D. Pa. 1977), *aff'd* 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Gall v. Exxon Corp.*, 418 F. Supp. 508, 514 n. 12 (S.D.N.Y. 1976).

In *Stein v. Bailey*, the corporation hired a law firm which, the court noted, had never acted as counsel to the corporation or to any of the special committee members and was "known in [the] legal community for its high professional standards." 531 F. Supp. 684, 694 (S.D.N.Y. 1982). The relevant prior relationship is between the corporation and special counsel. *Id.* at 687. In *Kaplan v. Wyatt*, a law firm that had no relationship with the corporation but had suffered a \$50 million judgment at the hands of the shareholder-plaintiff's attorneys was not biased. 484 A.2d 501 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985); see also *Genzer v. Cunningham* 498 F. Supp. 682, 693 (E.D. Mich. 1980) (special counsel had no prior dealings with the corporation or its directors).

166. See *Kaplan v. Wyatt*, 484 A.2d 501, 507-08 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

court will likely dismiss on a special litigation committee's recommendation.¹⁶⁷ Similarly, courts dismiss where a challenged transaction achieved proper corporate goals and did not waste corporate assets¹⁶⁸ or where a shareholder's action is unnecessary to "police" the board.¹⁶⁹ Even if a special committee concludes that a shareholder's claims have merit and a shareholder is likely to prevail, the special committee may recommend dismissal where litigation will cost more than a corporation would gain.¹⁷⁰

Special litigation committees often conclude that shareholders' claims have no merit or that litigating would cost more than it would benefit a corporation. A special committee presents its conclusions and supporting analysis in a thorough, comprehensive, and detailed report.¹⁷¹ The report should support a recommendation to dismiss with "persuasive factors" and "valid legal analysis."¹⁷² If a special committee presents flawed legal analysis, a court may permit a shareholder's action to proceed.¹⁷³

167. *See id.* at 520-21.

168. *Rosengarten v. ITT*, 466 F. Supp. 817, 822 (S.D.N.Y. 1979) (shareholder's complaint dismissed because alleged improper corporate payments were made in furtherance of legitimate business objectives).

169. *Id.*; *see also Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979) (defendants not involved in any wrongdoing and did not personally profit from their actions; allegedly wrongful activities were customary business practices that served corporation's interest), *cert. denied*, 444 U.S. 1017 (1980).

170. The committee should consider "ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal" factors. *Maldonado v. Flynn*, 485 F. Supp. 274, 285 (S.D.N.Y. 1980), *rev'd in part on other grounds*, 671 F.2d 729 (2d Cir. 1982); *see, e.g., Stein v. Bailey*, 531 F. Supp. 684, 690 (S.D.N.Y. 1982) (cost of litigation—its effect on morale, disruption of management, and concomitant loss of business — far outweighed any benefit litigation could possibly produce; wrongdoers had already been sanctioned; corporation had already changed its procedures).

The Court of Appeals for the Second Circuit may permit a special litigation committee to consider, in certain circumstances, only the out-of-pocket cost of litigation. In *Joy v. North*, the court, applying Connecticut law, held that a special litigation committee may consider attorney's fees, out-of-pocket litigation expenses, and time corporate employees would spend preparing for and participating at trial. 692 F.2d 880, 892-93 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983). Costs of indemnifying directors or others for liability from derivative suits also should be considered. *Id.* at 892. Indirect costs count only where the amount the corporation may recover (likely damages discounted by probability of success) is insubstantial relative to shareholder equity. *Id.* Indirect costs include the distraction of key employees and lost profits from the publicity of a trial. *Id.* at 892-93. Other indirect costs, such as "a negative impact on morale and upon the corporate image," may not be included. *Id.* at 892.

171. The committee should present a thorough written record of the committee's work, including its investigation, findings, and recommendation. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981); *Kaplan*, 484 A.2d at 506. The corporation may not keep its report confidential. *See infra* notes 250-64 and accompanying text.

172. *Gall v. Exxon Corp.*, 418 F. Supp. 508, 514 n.14 (S.D.N.Y. 1976).

173. *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985).

Most courts, however, do not second guess a special committee's conclusion as long as the special committee conducted a reasonable good faith investigation and has a reasonable basis for recommending that the corporation move to dismiss.¹⁷⁴ Courts do not expect a perfect investigation or report. Courts have criticized, but nevertheless found reasonable, investigations done in good faith.

For example, the court in *Kaplan v. Wyatt*¹⁷⁵ criticized an investigation but dismissed a shareholder's suit on a special committee's recommendation.¹⁷⁶ Among other things, special counsel had destroyed original notes of interviews with witnesses to the challenged transaction.¹⁷⁷ In addition, the special committee failed to pursue a rumor that a defendant was prepared "to flee [the] country."¹⁷⁸ The special committee also ignored an acknowledged wrongdoing,¹⁷⁹ failed to investigate adequately a certain allegedly improper oil trading transaction,¹⁸⁰ and failed to investigate a related party transaction involving the sale and leaseback of a vessel.¹⁸¹ The special committee's report suggested that special counsel had personally interviewed a witness when counsel had not done so.¹⁸² Finally, the report showed that special counsel, hired to assist the special committee, conducted virtually the entire investigation.¹⁸³ The court nevertheless found the investigation reasonable and accepted the report's recommendations because the special committee did its work in good faith.

The report in *Rosengarten v. ITT*¹⁸⁴ was even skimpier than the report in *Kaplan v. Wyatt*.¹⁸⁵ The *ITT* report "noticeably" lacked detail of

174. Of course, the special committee must have no interest in the challenged transaction and be independent from the board, director-defendants, and the corporation. See *supra* notes 65-159 and accompanying text.

In addition, certain courts may take a "second step" and apply their own business judgment to dismissing the shareholder's suit. See, e.g., *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311, 1326 (S.D. Iowa 1981); *Houle v. Low*, 407 Mass. 810, 824-25, 556 N.E.2d 51, 59 (1990). Such a court can reevaluate the committee's conclusion even if the committee conducted a reasonable investigation and has a reasonable basis for recommending that the corporation move to dismiss. See *supra* note 37 and accompanying text.

175. 484 A.2d 501 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

176. *Id.* at 519.

177. *Id.* at 514.

178. *Id.* at 515.

179. *Id.* The plaintiff accused the committee of "sweep[ing] the matter [of double-billing] under the rug." *Id.*

180. *Id.* at 516.

181. *Id.*

182. *Id.* at 502-03.

183. *Id.* at 503.

184. 466 F. Supp. 817 (S.D.N.Y. 1979).

185. *Id.* at 825-26; see also *Kaplan*, 484 A.2d at 511.

the wrongdoing, "skip[ped] somewhat over the . . . negligence of one director," and failed to quantify certain questionable payments.¹⁸⁶ Despite the criticism, the court held that the investigation was reasonable.¹⁸⁷

Discrepancies between draft and final reports did not taint the *Rosengarten v. Buckley*¹⁸⁸ investigation, for the differences were insignificant or explained.¹⁸⁹ In addition, neither the failure to record committee meetings stenographically (minutes were good enough), nor the failure to interview certain witnesses, made the investigation unreasonable.¹⁹⁰

Notwithstanding such judicial deference, a plaintiff may successfully attack an investigation where committee members are unfamiliar with or cannot explain their conclusions. In *Holmstrom v. Coastal Industries, Inc.*,¹⁹¹ each committee member "steadfastly believe(d) that the action should be dismissed."¹⁹² Each had trouble, however, explaining why the challenged transaction had no "disabling taint."¹⁹³ No committee member could articulate how the committee decided to recommend dismissal "given the taint issue."¹⁹⁴ The court ruled that issues of fact on the "independence and the thoroughness of the [committee's] work" precluded dismissal.¹⁹⁵

In sum, to raise a triable issue that an investigation is unreasonable, a shareholder must prove that it is "so restricted in scope, so shallow in execution, or otherwise so *pro forma* or half-hearted as to constitute a pretext or sham."¹⁹⁶ Thus, shareholders may attack the length and the scope of an investigation. Shareholders may also complain about who conducted the investigation — special committee members, special counsel, plaintiff or director-defendants.

a. how long should a special committee investigate?

A special litigation committee should investigate a challenged transaction for as long as necessary to be thorough. "[I]nvestigative methods

186. *ITT*, 466 F. Supp. at 825-26.

187. *Id.* at 826.

188. 613 F. Supp. 1493 (D. Md. 1985).

189. *Id.* at 1502.

190. *Id.* at 1502-03.

191. 645 F. Supp. 963 (N.D. Ohio 1984).

192. *Id.* at 988.

193. *Id.*

194. *Id.* The court also noted that a director-defendant had appointed the committee members, who moved to dismiss a "brief six day[s]" after issuing their report. *Id.*

195. *Id.*

196. *Stein*, 531 F. Supp. at 695. In some states the corporation bears the burden of proving that the investigation is reasonable. *See supra* note 36.

must always turn on the nature and characteristics of the particular subject being investigated."¹⁹⁷

In *Stein v. Bailey*,¹⁹⁸ the shareholder alleged that the corporation failed to disclose "secret, unauthorized, and illegal payments [for] business and special political favors."¹⁹⁹ The shareholder also alleged that the corporation paid an "exorbitant" price for the shares of a company that the corporation merged with a subsidiary.²⁰⁰ The special committee reached a tentative conclusion after meeting only twice and investigating these claims for only seven weeks.²⁰¹ The *Stein* court found the investigation reasonable.²⁰²

Courts have also found the following investigations reasonably thorough: The special committee in *In re Continental Illinois Securities Litigation*²⁰³ deliberated about losses resulting from the demise of the Penn Square Bank for two and one-half months.²⁰⁴ The special committee in *Zapata Corp. v. Maldonado*²⁰⁵ investigated alleged breaches of fiduciary duty for three months.²⁰⁶ The *ITT* committee met sixteen times over a year,²⁰⁷ and the *Buckley* committee met regularly over five months to investigate the opposition to a takeover attempt.²⁰⁸

b. how broad should an investigation be?

A broad investigation appears thorough. Courts accepting special committees' recommendations to dismiss often comment on the number of witnesses interviewed. For example, one special committee that considered claims that a CEO misused a corporation interviewed 140 witnesses "throughout the world."²⁰⁹ The court found the investigation reasonable.²¹⁰

197. *Auerbach v. Bennett*, 47 N.Y. 2d 619, 636, 393 N.E.2d 994, 995, 1003, 419 N.Y.S.2d 920, 930 (1979). The committee need not always meet face-to-face but can confer by telephone. *Watts*, 525 F. Supp. at 1328.

198. 531 F. Supp. 684 (S.D.N.Y. 1982).

199. *Id.* at 686 n.3.

200. *Id.*

201. *Id.* at 685-87, 694.

202. *Id.* at 693.

203. 732 F.2d 1302 (7th Cir. 1984).

204. *Id.* at 1304.

205. 430 A.2d 779, 787 (Del. 1981).

206. *Id.* at 781.

207. *ITT*, 466 F. Supp. at 824.

208. *Buckley*, 613 F. Supp. at 1493-95.

209. *Kaplan*, 484 A.2d at 511.

210. *Id.* at 519-20. Compare with *Stein*, where a special committee made a "tentative" determination after interviewing only two witnesses. 531 F. Supp. at 694. The *Stein* court found the investigation reasonable. *Id.*

Regardless of the number of witnesses it interviews, a special committee that fails to interview important witnesses does not conduct a reasonable good faith investigation. In *Hasan v. CleveTrust Realty Investors*,²¹¹ a special committee failed to interview two companies from which the corporation bought its own stock to avert a takeover.²¹² The shareholder claimed that the transactions wasted corporate assets, had no corporate purpose, and entrenched management.²¹³ The two companies, the court held, "could have provided crucial evidence of the purpose of that challenged transaction and the value of the [corporation's] transferred assets."²¹⁴ The court reversed a lower court that had granted the corporation's motion to dismiss.

How a special committee conducts interviews does not seem to matter. Interviews may be in person,²¹⁵ by telephone or questionnaire,²¹⁶ or by interrogatory.²¹⁷ Testimony need not be under oath; a plaintiff need not cross-examine witnesses.²¹⁸

Corporation counsel generally should not attend interviews of corporate employees. Corporate counsel represents a corporation, whose interests and objectives may not be the same as a special committee's. In *Kaplan*, however, the court upheld an investigation even though the corporation arranged, and corporate counsel attended, interviews of corporate employees.²¹⁹ The *Kaplan* court warned that, although "not fatal," corporate counsel's assistance is "not recommended."²²⁰

Courts also may infer that an investigation is thorough from the number and type of documents that a special committee examines. Reviewing every deposition taken, examining documents of the company and its attorneys, reviewing all pleadings, and studying "reams and reams" of paper supplied by counsel help show thorough

211. 729 F.2d 372 (6th Cir. 1984).

212. *Id.* at 379.

213. *Id.* at 373.

214. *Id.*

215. *Auerbach*, 47 N.Y.2d at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 930 (special committee met personally with defendants, but sent written questionnaires to non-management directors).

216. *In re General Tire & Rubber Co.*, 726 F.2d 1075, 1085 (6th Cir.), *cert. denied*, 469 U.S. 858 (1984) (committee interviewed some witnesses by questionnaire and others by telephone).

217. *Alford v. Shaw*, 318 N.C. 289, 313, 349 S.E.2d 41, 55 (1986), *withdrawn on other grounds*, 320 N.C. 465, 358 S.E.2d 323 (1987).

218. *Id.* *But see Joy*, 692 F.2d at 892 (weight given certain evidence affected by whether testimony subject to cross-examination). Presumably, the special committee can permit a plaintiff to examine a witness.

219. *Kaplan v. Wyatt*, 499 A.2d 1184, 1190 (Del. 1985).

220. *Id.*

investigation.²²¹

c. how much should a special litigation committee rely on special counsel?

A special committee need not investigate every detail itself.²²² A special committee may delegate tasks to special counsel. Special counsel may merely advise or assist a special committee or may conduct much of an investigation.²²³

In *ITT*, special counsel set standards for reviewing the challenged transaction, conducted all fact-finding, reviewed 10,000 documents, interviewed forty witnesses, gave legal advice and prepared the special committee's final report.²²⁴ The court held that the special committee could rely extensively on special counsel:

221. See, e.g., *Lewis v. Graves*, 701 F.2d 245, 247 (2d Cir. 1983) (reviewed all pleadings); *Buckley*, 613 F. Supp. at 1495 (examined documents of company and its attorneys); *ITT*, 466 F. Supp. at 824 (studied reams of paper supplied by counsel).

222. *Stein*, 531 F. Supp. at 694.

223. One court announced that a diligent special litigation committee is one which is familiar with counsel's report, asks searching and probing questions, and prepares a recommendation articulating its conclusions. The committee relied "on its staff" no more than "many busy public officials, including legislators, agency heads and even members of the judiciary." *ITT*, 466 F. Supp. at 824-25.

In *Continental Illinois*, special counsel interviewed eighty witnesses, researched applicable law, and advised whether an insurance policy covered any potential liability. 732 F.2d at 1305. In *Stein*, the special committee retained special counsel for the following tasks:

- (1) advise the Committee on the appropriate manner in which it should proceed; (2) conduct legal research and prepare memoranda for the Committee on the merits of the claims stated in plaintiffs' demand letter; (3) assist the Committee in fact-finding . . . (4) arrange . . . for the Committee to interview relevant witnesses and obtain and analyze pertinent documentary evidence; and (5) prepare a report to embody the conclusions reached by the Committee.

Stein, 531 F. Supp. at 687.

In *Abella v. Universal Leaf Tobacco Co.*, counsel gathered and reviewed documents, conducted interviews, and prepared 160 investigative reports and seven memoranda, while the special committee met ten times only to consider and discuss the materials submitted by counsel. 546 F. Supp. 795, 800-01 (E.D. Va. 1982).

In *Buckley*, special committee members did not attend every interview; counsel conducted some alone. Interview summaries, the court held, are good enough, especially where the special committee could reinterview any witness interviewed by counsel alone. 613 F. Supp. at 1503.

In *Watts v. Des Moines Register & Tribune*, the special committee met only four times (though its members conferred frequently by phone). 525 F. Supp. 1311, 1328 (S.D. Iowa 1981). The committee relied extensively on special counsel. *Id.* The investigation was nevertheless sufficient because committee members reviewed every deposition and many corporate documents, interviewed seven defendants, consulted with the attorneys for plaintiff and defendants, and compiled the report. *Id.* The committee conducted a reasonable good faith investigation even though one member could not understand the report and could not remember how much the committee spent on legal fees. *Id.*

224. *ITT*, 466 F. Supp. at 824.

[T]he Committee's reliance on its staff was not unreasonable in extent and, in fact, was no greater than that of many busy public officials, including legislators, agency heads and even members of the judiciary. The Committee appears to have supervised those aspects of the investigation in which it was not involved personally and was responsible for the conclusions set out in the report. Moreover, it was entirely proper, indeed desirable, for the Committee to rely on counsel for legal advice.²²⁵

The *ITT* special committee, however, also actively investigated the challenged transaction.²²⁶ The court quoted one committee member, who described the special committee's extensive work on a draft report:

"[W]e took the first draft, which was not in the form of a report, but purely in the form of a draft, added our own recollections to it, changed it where we thought it ought to be changed, asked [counsel] to work it over again, so that I would say that word for word, I participated in every word in this report."²²⁷

Thus, despite special counsel's dominant role, the court described the special committee's work as "impressively thorough."²²⁸

Special counsel, after investigating a shareholder's claims, may recommend that a corporation pursue a cause of action. If a special committee ignores this advice, a court may deny a corporation's motion to dismiss and order that a plaintiff have further discovery.

In *Watts v. Des Moines Register & Tribune*,²²⁹ special counsel concluded that litigating would best serve the corporation's interests.²³⁰ The special committee rejected this advice and sought dismissal.²³¹ Because the special committee could not explain or otherwise support its decision to ignore special counsel, the court denied the corporation's motion to dismiss.²³² Although satisfied with the special committee's independence and good faith, the court ordered further discovery on why the special

225. *Id.* at 825.

226. *Id.* at 824.

227. *Id.* at 825 (quoting deposition transcript).

228. *Id.* at 824.

The Committee, which met sixteen times during the course of its year-long investigation, determined the scope of the review . . . studied reams and reams of documents supplied by counsel . . . personally interviewed all but one of the defendants and received oral summaries from counsel of the interviews during which a Committee member was not present . . . and closely supervised the preparation of the report.

Id.

229. 525 F. Supp. 1311 (S.D. Iowa 1981).

230. *Id.* at 1329.

231. *Id.* at 1315.

232. *Id.* at 1329 (rejecting the advice raised "question[s] as to the premise for the committee's recommendation that dismissal of [one count] was appropriate").

committee ignored special counsel's advice.²³³

d. can a special litigation committee use the corporation's research or consultants?

(i) corporate research

As long as a special committee does not "blindly rely" on it, a special committee need not redo the corporation's research on a challenged transaction.²³⁴ For example, in *Stein*, a special committee used a corporate audit committee's report.²³⁵ The court held that the special committee need not "redo" the audit committee's report because it was "comprehensive."²³⁶ In *Genzer v. Cunningham*,²³⁷ a special committee relied on a corporate "Business Practices Committee's report" of questionable payments. The report presented an investigation made by the corporation's accountant (a defendant) and the corporation's counsel.²³⁸ The shareholder's derivative complaint alleged that the directors violated the Securities Exchange Act, among other laws, when they approved the payments. The court held that the special litigation committee could rely on the report because the special committee had "looked into [the accountant's] participation" with "extra care" to assure that it was thorough and objective.²³⁹

(ii) corporate consultants

In *Buckley*, a shareholder criticized a special committee for using the corporation's financial advisors instead of hiring an independent consultant.²⁴⁰ The court held that, because the corporation's investment bankers were "firms with national reputations," their participation did not taint the investigation.²⁴¹ Furthermore, accounting, on which the

233. *Id.* at 1327. The court permitted plaintiffs to depose committee members about why they urged dismissal. *Id.* The court, however, circumscribed the discovery. *Id.* at 1329. Plaintiffs could ask about the factors that affected the decision, but not why the committee members considered such factors. *Id.*

234. *Stein*, 531 F. Supp. at 694-95. The *Continental Illinois* court permitted the special committee to review "summaries of interviews conducted earlier by [corporate] counsel in [prior] litigation." *Continental Ill.*, 732 F.2d at 1304-05.

235. *Stein*, 531 F. Supp. at 694.

236. *Id.* Presumably, a special committee must redo an incomplete report.

237. 498 F. Supp. 682 (E.D. Mich. 1980).

238. *Id.* at 684.

239. *Id.* at 696.

240. *Buckley*, 613 F. Supp. at 1503.

241. *Id.* The shareholders in *Buckley* also complained that defendants purged corporate files of certain documents before permitting the special committee to review them. *Id.* The court found that excising "extraneous materials relating to other clients of [corporate coun-

investment bankers gave advice, was an insubstantial issue.²⁴²

e. must special litigation committee members do equal work?

Special litigation committee members need not do equal work. In *ITT*, one special committee member spent "far less time" on an investigation than two other committee members. His "grasp of the issues was less thorough" than that of other committee members.²⁴³ Because the less active committee member was "familiar with the substance of the findings and participated in formulating the Committee's conclusions," however, the unbalanced division of work did not matter.²⁴⁴ The court held that the investigation would have been valid even if two, rather than three, special committee members had done it.²⁴⁵

f. may a shareholder-plaintiff participate in an investigation?

A shareholder-plaintiff has no right to participate in a special litigation committee's investigation even though, as a litigant, it can invoke the subpoena power of a court.²⁴⁶ A shareholder-plaintiff cannot tell the special committee how to do its work.²⁴⁷

Moreover, a shareholder cannot even challenge a special committee's qualifications until a board has considered the special committee's report.²⁴⁸ Once appointed, a special litigation committee "should be af-

sel]" before the committee investigated did not make the committee's work "inherently biased or inadequate." *Id.*

242. *Id.*

243. *ITT*, 466 F. Supp. at 825.

244. *Id.*

245. *Id.*

246. A shareholder plaintiff, as a party to a lawsuit, can issue subpoenas requiring non-party witnesses to appear for depositions and to produce documents under court order. *See, e.g.,* FED. R. Crv. P. 30(a), 45. This subpoena power does not give a shareholder plaintiff a right to participate in a special litigation committee's work. *Pompeo v. Hefner*, Nos. 6806, 6872, slip op. at 7 (Del. Ch. Mar. 23, 1983).

A special litigation committee may invite a plaintiff to help the committee assess plaintiff's claims. In *Alford v. Shaw*, the court noted with approval "plaintiffs' counsel . . . was afforded every opportunity to provide the Committee with information which might have been helpful in assessing the merits of the claims." 318 N.C. 289, 313, 349 S.E.2d 41, 55 (1986), *withdrawn on other grounds*, 320 N.C. 465, 358 S.E.2d 323 (1987).

247. "The derivative plaintiff should not be permitted to intermeddle." *Pompeo*, Nos. 6806, 6872, slip op. at 7. In *Rosengarten v. Buckley*, the special committee recommended dismissal before it interviewed plaintiff's counsel. 613 F. Supp. 1493, 1501 (D.C. Md. 1985). The court rebuffed plaintiff's contention that the investigation was incomplete. *Id.* at 1502. The special committee, the court opined, can draw tentative conclusions. "Indeed," the court remarked, "the absence of such a tentative conclusion would, in the court's mind raise more suspicion."

Id.

248. *See, e.g.,* *Stotland v. GAF Corp.*, 469 A.2d 421, 423 (Del. 1983); *Pompeo*, Nos. 6806,

forded a reasonable time to carry out its function."²⁴⁹

g. must a special litigation committee disclose its report to the public?

Courts generally do not permit special litigation committees to keep their reports confidential. In *Kaplan v. Wyatt*,²⁵⁰ a special committee sought to protect an exhibit to its report.²⁵¹ The special committee believed that the exhibit contained false information that would damage the corporation if released to the public.²⁵² The special committee also sought to protect names of fifteen current or former corporate employees whom the special committee had interviewed.²⁵³ The fifteen witnesses spoke with special committee members only after the special committee promised that it would apply for the protective order.²⁵⁴ The court nevertheless refused to keep the exhibit and the names confidential.²⁵⁵

The Court of Appeals of the Seventh Circuit in *Continental Illinois* also declined to seal a special committee's report that the corporation contended would damage the corporation.²⁵⁶ The court released the report to two national newspapers because the corporation had used it in open court.²⁵⁷ The court had relied upon it, and, in a public courtroom, witnesses referred to it and counsel quoted from it.²⁵⁸ The court held that where a committee uses a report "in an adjudicative procedure to advance the corporate interest, there is a strong presumption that confidentiality must be surrendered."²⁵⁹

6872, slip op. at 3 (shareholder could not challenge independence of one-man committee appointed by 67% shareholder until corporation moved to dismiss on committee's recommendation).

249. *Abbey v. Computer & Communications Tech. Corp.*, 457 A.2d 368, 375 (Del. Ch. 1983).

250. No. 6361, slip op. (Del. Ch. June 23, 1983).

251. *Id.* at 2.

252. *Id.*

253. *Id.*

254. *Id.*

255. *Id.* at 7. *But see* *Byers v. Baxter*, 69 A.D.2d 343, 349, 419 N.Y.S.2d 497, 501-02 (N.Y. App. Div. 1979) (report may be protected (dictum)); *Weiland v. Central & S.W. Corp.*, No. 9769 (Del. Ch. May 9, 1989) (LEXIS, States library, Del file) (court denied plaintiff's request that special committee produce its report). In appropriate circumstances, a court may give limited protection to sensitive material. *See, e.g.*, DEL. CH. R. 5(g).

256. *Continental Ill.*, 732 F.2d at 1309.

257. *Id.* at 1304.

258. *Id.* at 1304-05.

259. *Id.* at 1315. The court stated that the material was not as damaging as the corporation claimed: "very little of the Report [is] . . . materially damaging to Continental." *Id.* at 1315 n.21. The court also remarked that Continental could have proposed to edit particularly sensitive portions of the report rather than request that the court seal the entire document. *Id.*

Likewise, in *Joy v. North*,²⁶⁰ the Court of Appeals of the Second Circuit held that a special litigation committee "must disclose to the court and the parties not only [a] report but also all underlying data."²⁶¹ A motion for judgment based on a report waives any attorney-client privilege.²⁶² Moreover, if special counsel's working papers are "communicated" to a special committee, a corporation may not claim work product protection.²⁶³ The court opined, "confidence in the administration of justice would be severely weakened" if "special litigation committees were routinely allowed to do their work in the dark of night."²⁶⁴

2. Plaintiff's discovery

A court stays plaintiff's discovery for a reasonable time while a special litigation committee investigates and writes its report.²⁶⁵ Under Delaware law, "it is a foregone conclusion that such a stay must be granted."²⁶⁶ The court decides how long the discovery stay should last,

260. 692 F.2d 880 (2d Cir. 1980), *cert. denied*, 460 U.S. 1051 (1983).

261. *Id.* at 893.

262. *Id.*

263. *Id.* at 893-94.

264. *Id.*

265. *See, e.g., Grafman v. Century Broadcasting Corp.*, No. 89 C 5372 (N.D. Ill. July 3, 1990) (LEXIS, Genfed library, Dist file) (discovery stayed pending report). The plaintiff cannot conduct discovery before the special committee makes its report, but the corporation cannot have a decision on a summary judgment motion until the plaintiff has completed discovery. *See, e.g., ITT*, 466 F. Supp. at 823 (summary judgment motion postponed pending depositions of committee members); *Pompeo*, Nos. 6806, 6872, slip op. at 7 (Del. Ch. Mar. 23, 1983).

The court also must conduct a hearing. *See, e.g., De Moya v. Fernandez*, 559 So. 2d 644, 645 (Fla. Dist. Ct. App. 1990) (summary judgment reversed where lower court had conducted no hearing on "bias, conflict of interest, objectivity and reasonableness in the preparation and presentation of the report"); *Rosen v. Bernard*, 108 A.D.2d 906, 909, 485 N.Y.S.2d 791, 793 (N.Y. App. Div. 1985) (court may not deny corporation's motion to dismiss without hearing on special committee's independence and investigation). During such a hearing, however, courts that do not follow *Zapata* may not make even a limited review of the merits. *See, e.g., Will v. Engebretson & Co.*, 213 Cal. App. 3d 1033, 1043, 261 Cal. Rptr. 868, 874 (1989) (dismissal of shareholder's action reversed where lower court conducted limited review of merits).

266. *Kaplan*, 484 A.2d at 510; *see, e.g., Stotland*, 469 A.2d at 421, 423. Such a stay is not a "foregone conclusion" under Minnesota law. In *International Broadcasting Corp. v. Turner*, the Minnesota court refused to stay plaintiff's discovery while the special committee investigated. 734 F. Supp. 383, 393 (D. Minn. 1990). The court permitted plaintiff to perform discovery while the special committee investigated because the court determined that the committee members were not disinterested and independent. Plaintiff named two of three defendants, and a shareholder who had obtained stock in the challenged transaction designated the third. *Id.*

See also Grafman, No. 89-C-5372, at *4 (court implied that plaintiff may have discovery while committee investigates). In dicta, the court stated that *the court* will decide how long the investigation should take, what discovery plaintiff should have in the interim, and whether discovery would interfere with the committee's investigation. *Id.*

dependent "upon the particular facts and circumstances of [each] case."²⁶⁷

When it lifts a stay, a court may permit a shareholder to conduct limited discovery on selected issues: a special committee's independence, disinterest, investigation and report.²⁶⁸ If shareholders fail to limit their discovery requests to these subjects, courts may deny all discovery.²⁶⁹

A court not only decides how long discovery should last,²⁷⁰ but also how much discovery a plaintiff shall have and how a plaintiff shall conduct it. "[T]he type and extent of any discovery . . . is . . . left to the . . . Court"²⁷¹ Thus, a court may limit discovery to depositions of special committee members concerning their investigation and to documents that they used.²⁷²

267. *Computer & Communications Tech.*, 457 A.2d at 376. The court must balance the committee's need to investigate with the plaintiff's need to prosecute. *Kaplan*, 484 A.2d at 511-12 (plaintiff's discovery delayed for two years); *Pompeo*, Nos. 6806, 6872, slip op. at 7-8 (where special committee had to review over 500 exhibits and testimony from more than 170 witnesses, action stayed for five months).

268. "[D]iscovery is not by right, but by order of the Court" *Kaplan*, 499 A.2d at 1192. Valid subjects for such limited discovery are "what the Committee did or did not do, and the actual existence of the documents and persons purportedly examined by it" *Kaplan*, 484 A.2d at 519. Accordingly, where the committee investigated activities of corporate officials not named defendants, plaintiff may have discovery on them.

269. *See, e.g., Control Data Corp.*, 460 F. Supp. at 1246 (failure to challenge independence of litigation committee may lead to summary dismissal without discovery on any issue); *Auerbach*, 47 N.Y.2d at 636, 393 N.E.2d at 1003-04, 419 N.Y.S.2d at 930 (where plaintiff raises no question about independence of committee or adequacy of its investigation, court may dismiss without discovery); *Auerbach v. Aldrich*, N.Y.L.J., Dec. 23, 1977, at 13, col. 6 (N.Y. Sup. Ct. Dec. 21, 1977)(shareholder who does not question independence of the reviewing committee also may lose the right to discovery).

Where shareholders demand that the board redress the injuries that are the subject of their complaint, the shareholders concede that the board (and thus a special litigation committee of board members) is independent. Under these circumstances, the shareholder may only have discovery on the special committee's investigation, not on the independence or interest of the committee. *See, e.g., Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. 1990).

270. In *Gall*, where the committee investigated claims that the Exxon Corporation made \$59 million of questionable payments to the Italian government over 11 years, the court gave plaintiff 60 days to conduct discovery. *Gall*, 418 F. Supp. at 509, 520. In *Byers*, where the shareholders complained that the corporation irresponsibly discharged toxic waste, the court gave the shareholders four months to do discovery. *Byers*, 69 A.D.2d at 349, 419 N.Y.S.2d at 501. The court apparently believed that four months was long but necessary because "with the summer season coming on, it may be difficult to get lawyers and witnesses together." *Id.*

271. *Kaplan*, 484 A.2d at 507.

272. *Id.* at 519. Plaintiff may (1) depose committee members concerning their good faith and whether their conclusions are reasonable and (2) request documents about the nomination of committee members and their business affiliations. *Id.* Plaintiff may not request all documents that the committee reviewed and upon which it relied pending the completion of the committee's investigation and issuance of its report. *Computer & Communications Tech.*, 457 A.2d at 375.

The plaintiff can discover facts that the committee considered, but not the committee's

A court will drastically restrict discovery where a plaintiff fails to plead specific wrongdoing. The Delaware court in *Kaplan* limited document production to a special committee member's nomination and the business organizations to which the member belonged.²⁷³ The court held that other documents that the special committee reviewed were immaterial because plaintiff had charged director-defendants with general, not specific, wrongdoing.²⁷⁴

E. Motions to Dismiss Denied

In sum, courts do deny motions to dismiss that corporations bring on the recommendations of their special litigation committees. Summaries of such cases follow:

1. Connecticut: *Joy v. North*²⁷⁵

The Court of Appeals for the Second Circuit, applying Connecticut law, reversed a lower court's decision dismissing a shareholder's derivative suit on the recommendation of a special litigation committee.²⁷⁶ Using its own business judgment, the appellate court determined that "plaintiff's chances of success [were] rather high."²⁷⁷ The shareholder claimed that the officers and directors of a bank negligently loaned millions of dollars to a construction company.²⁷⁸ The court disagreed with a special litigation committee's conclusion "that only a 'possibility of a finding of negligence' exists"²⁷⁹ and concluded that the shareholder's suit probably would bring a "substantial net return."²⁸⁰

2. Delaware: *Lewis v. Fuqua*²⁸¹

The Delaware Court of Chancery denied a corporation's motion to dismiss a shareholder's suit.²⁸² Questions of fact existed on a special liti-

reasons for considering those facts. *Watts*, 525 F. Supp. at 1330. Nor can the plaintiff get discovery on the committee's decision not to consider other facts or to pursue other avenues of inquiry. *Id.* at 1329-30; see also *Lasker v. Burks*, 404 F. Supp. 1172, 1180 (S.D.N.Y. 1975), *rev'd*, 567 F.2d 1208 (2d Cir. 1978) (discovery granted on independence of committee members), *rev'd*, 441 U.S. 471 (1979).

273. *Kaplan*, 484 A.2d at 507.

274. *Id.* at 521.

275. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

276. *Id.* at 882-83.

277. *Id.* at 896.

278. *Id.* at 882-83.

279. *Id.* at 896.

280. *Id.* at 897.

281. 502 A.2d 962 (Del. Ch. 1985).

282. *Id.* at 964.

gation committee's interest and independence.²⁸³ The special committee also failed to show a reasonable basis for concluding that the corporation should not pursue the shareholder's claims.²⁸⁴

The shareholder claimed that directors had usurped a corporate opportunity when they purchased stock of a company that the corporation had considered purchasing.²⁸⁵ The stock would have given the corporation a tax loss to shelter future earnings.²⁸⁶

The board appointed a one-man special litigation committee.²⁸⁷ The court found that issues of fact existed on both his interest in the challenged transaction and his independence from the board.²⁸⁸ He sat on the board when the directors purchased the stock; he had had many "political and financial dealings with . . . the chief executive officer"; and the shareholder had named him a defendant.²⁸⁹

In dicta, the court also opined that the corporation "ha[d] not borne its burden of establishing a reasonable basis for [the committee's] conclusions."²⁹⁰ The special committee had concluded that the opportunity to purchase the stock was a personal opportunity, not a corporate opportunity.²⁹¹ The court found this conclusion "flawed" because it was contrary to Delaware law and thus had no "reasonable basis."²⁹²

3. Illinois: *Mills v. Esmark, Inc.*²⁹³

The United States District Court for the Northern District of Illinois, applying Delaware law, denied a corporation's motion to dismiss. The shareholders claimed that the corporation violated section 14 of the Securities Exchange Act of 1934 by making an alleged misrepresentation in a proxy statement.²⁹⁴ Board members who sat on the special litigation committee had approved the alleged misrepresentation.²⁹⁵ The court held that the special litigation committee members could not "be expected to exercise truly independent judgment in evaluating the propriety

283. *Id.* at 966-67.

284. *Id.* at 967-68.

285. *Id.* at 965.

286. *Id.* at 964.

287. *Id.* at 965.

288. *Id.* at 966-67.

289. *Id.*

290. *Id.* at 967.

291. *Id.*

292. *Id.*

293. 544 F. Supp. 1275 (N.D. Ill. 1982).

294. *Id.* at 1293-96; see 15 U.S.C. § 78n (1988).

295. *Mills*, 544 F. Supp. at 1283-84.

of their own decision to approve the proxy statement.”²⁹⁶ The court noted that section 14 claims must be “saved” from “premature death.”²⁹⁷ Federal policy, the court held, prevented summary dismissal.²⁹⁸

The shareholder also claimed that directors violated their fiduciary duties when they granted certain shares of common stock to key employees. The court denied the corporation’s motion to dismiss this claim because the special litigation committee’s report lacked “factual detail and legal analysis” of the claim.²⁹⁹

4. Massachusetts: *Hasan v. CleveTrust Realty Investors*³⁰⁰

The Court of Appeals for the Sixth Circuit, applying Massachusetts law, reversed a lower court that had granted a corporation’s motion to dismiss.³⁰¹ The appellate court remanded the case for a trial on the merits.³⁰²

A shareholder claimed that a board had wasted corporate assets to protect directors’ “lucrative” positions.³⁰³ The board had caused the defendant corporation to purchase large blocks of its own stock at an inflated price and to sell the same stock at two-thirds of its appraised value to a friendly investor who agreed to support management.³⁰⁴ The court reversed the lower court because the corporation failed to show that a special litigation committee made a reasonable and good faith inquiry of the shareholder’s claims.³⁰⁵

The sole-member special committee’s report “demonstrate[d] several significant business relationships between [him] and the defendants”³⁰⁶ The business relationships, the court held, “preclude[d] any

296. *Id.*

297. *Id.* at 1284 n.6. *Mills* may be an anomaly. Other courts have refused to give section 14(a) claims such deference. See *Abbey v. Control Data Corp.*, 603 F.2d 724, 731-32 (8th Cir. 1979) (applying Delaware law), *cert. denied*, 444 U.S. 1017 (1980); *Stein v. Bailey*, 531 F. Supp. 684, 696 (S.D.N.Y. 1982) (applying Delaware law); *Genzer v. Cunningham*, 498 F. Supp. 682, 691 (E.D. Mich. 1980) (section 14(a) claim “very weak”); *Rosengarten v. ITT*, 466 F. Supp. 817, 828-29 (S.D.N.Y. 1979); see also *In re General Tire & Rubber Co.*, 726 F.2d 1075, 1082 (6th Cir.) (summary dismissal permitted where policies behind section 14(a) do not clash with business judgment rule), *cert. denied*, 469 U.S. 858 (1984). See also *supra* note 81.

298. *Mills*, 544 F. Supp. at 1284 n.6.

299. *Id.* at 1287 n.17, 1290 n.27.

300. 729 F.2d 372 (6th Cir. 1984).

301. *Id.* at 373.

302. *Id.* at 380.

303. *Id.* at 373.

304. *Id.*

305. *Id.* at 378.

306. *Id.* at 379.

affirmative demonstration of disinterest."³⁰⁷

Furthermore, the special committee failed to interview the companies from which the corporation had bought its own stock. Those interviews, the court held, "could have provided crucial evidence of the purpose of that challenged transaction and the value of [the corporation's] transferred assets" and "further concrete evidence of . . . possible self-interested motivation for the transaction."³⁰⁸

5. North Carolina: *Swenson v. Thibaut*³⁰⁹

The North Carolina Court of Appeals upheld a lower court's decision denying a motion to dismiss. The shareholder complaint alleged that directors had looted the corporation.³¹⁰ Among other things, the shareholder alleged that the corporation bought worthless or overpriced stock from, and made unsecured loans to, a majority shareholder.³¹¹

The special committee lacked independence. The appellate court stated, "there appears of record no evidence that any independent judgment was at any time exercised by the litigation evaluation committee in regard to the derivative action claims."³¹² The "litigation evaluation committee" was only an advisory committee, whom director-defendants had nominated and elected.³¹³

In addition, the corporation had brought a motion to disqualify plaintiff's counsel and voted that the derivative action had no merit before appointing the litigation evaluation committee.³¹⁴ The motion to disqualify counsel, the court found, supported "an inference" that the board (including the litigation evaluation committee) had decided to resist the shareholders' suit before appointing the litigation evaluation committee.³¹⁵

6. Ohio: *Holmstrom v. Coastal Industries, Inc.*³¹⁶

The United States District Court for the Northern District of Ohio denied a corporation's motion to dismiss because the court doubted the "thoroughness of the [litigation oversight committee's] work" and a spe-

307. *Id.*

308. *Id.*

309. 39 N.C. App. 77, 250 S.E.2d 279 (1978).

310. *Id.* at 107, 250 S.E.2d at 298.

311. *Id.* at 83-84 n.2, 250 S.E.2d at 284-85 n.2.

312. *Id.* at 107, 250 S.E.2d at 298.

313. *Id.* at 106, 250 S.E.2d at 297-98.

314. *Id.* at 90, 250 S.E.2d at 288.

315. *Id.* at 106-07, 250 S.E.2d at 298.

316. 645 F. Supp. 963 (N.D. Ohio 1984).

cial committee's independence.³¹⁷ A shareholder challenged the corporation's purchase of 390,000 shares of its common stock and redemption of 800 shares of its preferred stock.³¹⁸ The corporation bought the stock to avert a takeover.³¹⁹ The shareholder claimed that the purchase served no corporate purpose, wasted corporate assets, and entrenched management.³²⁰

The court found issues of fact on the special committee's independence because the corporation's principal managing officer, who had proposed that the board buy the stock, arranged for each of three special committee members to serve on the special committee.³²¹

In addition, the court found issues of fact on whether the special committee thoroughly investigated the shareholders' claims. The special committee members could not explain how they could recommend that the corporation move to dismiss given a "blatant conflict of interest" that permeated the transaction.³²² Finally, the court noted that the special committee deliberated for only six days after completing its investigation before recommending dismissal.³²³

IV. SUMMARY

A. *Special Litigation Committee*

A board should appoint a special litigation committee to investigate a shareholder's claims after a corporation makes standing or jurisdictional objections, but before the board determines whether the claims have merit. The board must delegate to the special committee full and final authority to decide whether litigation is in the corporation's best interests. A special committee should have more than one member. Members should have reputations for solving complicated business problems.

1. Interest in a challenged transaction

Special litigation committee members should have no personal interest in a challenged transaction. Special committee members do not necessarily have such an interest in a challenged transaction because they served on a board, voted for the transaction, or because a shareholder

317. *Id.* at 988-89.

318. *Id.* at 985.

319. *Id.*

320. *Id.*

321. *Id.* at 988.

322. *Id.*

323. *Id.*

named them as defendants. To raise an issue of interest, plaintiff must charge special committee members with specific misconduct.

Conclusory allegations that a challenged transaction benefits a special committee member also do not establish that the special committee member has an interest in it. A plaintiff must show how a transaction benefits a special committee member by pleading a factual and logical nexus between a challenged transaction and an alleged benefit. Finally, special committee members are not necessarily interested because they have opinions on the merits of a lawsuit. A plaintiff must produce tangible evidence that special committee members have an untoward interest in the outcome of litigation.

2. Independence from directors and a corporation

Special litigation committee members also must be independent from a corporation and its management. General charges that special committee members have relationships with director-defendants, a corporation, a board or a majority stockholder does not raise an issue of independence. Plaintiffs must specifically allege how such relationships have influenced special committee members.

Yet, where a special litigation committee's investigation is inadequate on its face, a court may be suspicious of special committee members' relationships with director-defendants. A court may find that director-defendants influenced a special committee that failed adequately to investigate—even if plaintiff fails to show how such relationships influenced committee members.

B. Committee Work

Once appointed, a special committee, with special counsel, investigates a shareholder's claims and writes a report evaluating whether litigation is in the best interests of a corporation. How it does that work affects whether a court will dismiss.

1. Investigating

To show that a special committee failed to investigate in good faith, either a shareholder must prove that an investigation is a sham (or the corporation must prove that it is not a sham, depending upon what state law governs). Thus, plaintiffs attempt to show that special committees failed to investigate thoroughly plaintiffs' claims. Plaintiffs criticize the length, scope and record of such investigations, as well as the relative participation of special committee members, special counsel, plaintiff and

defendants. A shareholder can show bad faith if special committee members are unfamiliar with or cannot explain their conclusions.

Special committee members need not do equal work. A special committee need not attend to every detail or redo a corporation's research, but a special committee may not blindly rely on others' work. Special counsel may conduct much of an investigation. Defendants or a corporation may even participate, although the better practice is to avoid involving them, especially in witness interviews. Shareholders have no right to participate in an investigation.

2. Reporting

A special litigation committee culminates its investigation in a report to a corporation. The report is crucial. Without an analysis (or if an analysis is faulty), a court may refuse to dismiss a shareholder's action. If a special committee recommends dismissal, a report must show why litigation is not in a corporation's best interests. A committee should discuss, if true, that litigation probably will fail, will cost more than a corporation could hope to recover, and will unduly interrupt business and undermine morale.

A court decides whether a special committee's report and its exhibits become public documents. Courts generally release the report. Even if a corporation is successful in sealing a report, it may be protected only until a court concludes dismissal proceedings.

C. Plaintiff's Discovery

While a special committee investigates and prepares its report, a court stays the shareholder litigation, including discovery. A shareholder cannot even challenge a special committee's qualifications until a special committee issues its report. A court determines how long a stay should last. When it lifts a stay, a court usually limits discovery to a special committee's independence and disinterest and to whether a special committee's investigation and conclusions are reasonable.

