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COVID-19 Economic Downturn: Consider a Special Litigation Committee to Protect Your Company from Meritless Shareholder Derivative Suits

Authors: Marcus Monte Maples
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COVID-19 has forced significant changes to the way business is conducted, often requiring corporations to adjust quickly in the face of challenging conditions. Moreover, economic downturn frequently results in increased commercial litigation, some of which may involve meritless shareholder derivative suits. These suits are sometimes brought by shareholders seeking to blame management or the board of directors for the corporation's losses that were caused by market forces. As will be discussed below, formation of a Special Litigation Committee (SLC) can be an effective way to minimize the impact of these frivolous suits.

Overview of Shareholder Derivative Suits and SLCs

Shareholder derivative suits are designed to allow an individual shareholder to file suit to enforce a corporate cause of action against officers, directors and third parties. Before filing a derivative suit, the shareholder must make a demand that the board of directors acts to address the claims the shareholder intends to bring unless such a demand would be futile. In the event of either a demand or a derivative suit, the board can pass a resolution to form an SLC as an independent arm of the board to determine whether the shareholder's action should be pursued when measured against the overall best interests of the corporation.

SLC Formation and Independence

The SLC should consist of multiple disinterested directors who are independent as to the subjects of the shareholder's action.

A few characteristics of ideal disinterested directors include:

1. that they are not defendants in the derivative action;
2. that they are informed regarding the subject matter of the derivative action but were elected or appointed to the board after the events about which the shareholder complained;
3. that they do not have any direct business ties with defendant directors; and
4. that they do not have an extremely close social or familial relationship with defendant directors.

Courts will evaluate these characteristics when determining if the SLC was independent. In some jurisdictions, such as New York and Alabama, the only factors a court will evaluate are the SLC's independence and the reasonableness of its investigative procedures. In those jurisdictions, where the SLC was independent and performed a reasonable investigation, courts will defer to the business judgment of the SLC. In other jurisdictions, such as Delaware, the court will apply its own business judgment to the facts of the case, but the independence of the SLC will still weigh in favor of the court's support for the SLC's decision. The SLC bears the burden of proof regarding its independence, so these considerations of board members' independence should be thorough and well-documented.

SLC Investigation

The function of the SLC is to perform an independent investigation of the shareholder's claim and, where authorized by the board's resolution, determine how the corporation will proceed with respect to the shareholder's claim. Generally, litigation will be deferred or stayed while the SLC performs its investigation. The SLC can rely on outside counsel and other experts in conducting its investigation, but it must not delegate the entire investigation to outside counsel or other advisors. This means that the SLC can delegate fact-gathering duty to outside counsel and advisors but must review the key evidence and should participate in critical interviews. Also, outside counsel should be separate from the corporation's normal general counsel to avoid the appearance of conflicts of interest.

The SLC, with the advice of independent outside counsel, should formulate a plan regarding the scope, timing and procedures that will allow the SLC to thoroughly investigate all of the shareholder's claims and make an informed decision regarding how to proceed. That plan should typically include allowing the shareholder to present evidence supporting his or her claim, interviewing alleged wrongdoers and those with knowledge regarding matters related to the shareholder's claim, and reviewing documents and records related to the shareholder's claim. The SLC may also engage and rely on the work product of other advisors such as accountants, valuation analysts and forensic experts.

SLC Report and Decision

Upon concluding its investigation, the SLC should prepare a detailed report documenting its findings and decision.

The report should include:

5. the process the board went through to verify director independence;
6. the process the SLC went through to verify the competence and independence of advisors to the SLC;
7. the SLC's plan and procedures for conducting the investigation;
8. the factual findings of the SLC and a legal analysis of plaintiff's claims; and
9. the recommendation of the SLC and the basis for that recommendation.

The report should specifically include the resolution establishing the SLC's existence, purpose and scope of authority. The report should also include detailed documentation of any communication between the SLC and the shareholder plaintiff or his/her counsel.

Assuming the SLC is formed after a suit has been filed, the SLC may decide to pursue one of four alternatives:

10. continue the suit as it is currently situated with the shareholder as the plaintiff;
11. continue the suit with the corporation as plaintiff;
12. settle the claim on a fair and reasonable basis; or
13. file a motion to dismiss the suit because either the claim is groundless or the costs of pursuing the claims outweigh the benefits to the corporation.

The SLC must consider the cumulative effect of all relevant factors in reaching its decision, and such factors include:

14. claim viability;
15. cost of litigation compared to the potential monetary recovery;
16. financial ability of the defendants to pay a monetary judgment;
17. the distraction pursuing the claim would cause to management and employees;
18. the impact of pursuing the claim on the corporation's business relationships; and
19. any other factor that the SLC deems relevant.

Benefits of the SLC

Appointing an SLC takes the case away from overly aggressive plaintiff's counsel who is eager to pressure the board with protracted discovery and unreasonable demands, using the threat of increased litigation costs to leverage a beneficial settlement. Moreover, courts often defer to the business judgment of the SLC. The crucial factors that tend to result in the court's honoring the business judgment of the SLC are independence and thorough investigation, both of which should be well-documented. Assuming the board and the SLC follow the strategy outlined above, the SLC is an effective way for a company to combat meritless shareholder derivative suits.

Final Observations

This alert provides a high-level overview of Special Litigation Committees for board members and executives who are seeking to gain a baseline understanding regarding their options for responding to a shareholder demand or derivative suit. Possible responses to these shareholder actions are not, however, one size fits all. Factors such as state corporate statutes, state case law and the specific scope, nature and materiality of the shareholder's allegation will all impact the selection of a proper response.

If you have any questions about shareholder derivative suits and how to protect your company, please contact Marcus Maples and visit the Coronavirus (COVID-19): Navigating the Path Ahead information page on our website.