Cutting the Cost of Derivative Claims:
The Role of the Special Litigation Committee

Shareholder-derivative claims are on the rise as economic turmoil roils the markets and corporate governance draws closer scrutiny from investors suffering significant losses. Where conflicts of interest may preclude board involvement, a properly constituted special litigation committee offers an efficient and effective way to address derivative claims.

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As our country suffers from widespread economic turmoil, there is renewed focus on, and a propensity to second-guess, boardroom decisions taking place in our companies.[1] Questions over executive compensation, company perks, and other areas of potential self-dealing attract the attention, as well as the ire, of shareholders suffering significant losses on their investments. This focus is not limited to publicly traded companies, but applies across the spectrum, ranging from the largest Fortune 500 corporations to the smallest closely held companies. No matter the size, shareholders are taking a closer look at their company's dealings, especially when the company's directors or officers have a personal stake in the outcome of those decisions.

The renewed focus on boardroom decisions has led, and undoubtedly will continue to lead, to a significant number of shareholder-derivative lawsuits, in which a shareholder will seek to bring a claim on behalf of the corporation or will bring a direct suit seeking personal damages as a result of injuries to the corporation. Minnesota companies, however, have a powerful tool to address these lawsuits and potentially save at least some of the cost and expense associated with such derivative claims: the special litigation committee. What's so special about a special litigation committee? The answer to that question is of interest to company boards, shareholders, and practitioners alike.

Basic Functions

A special litigation committee ("SLC") is a special committee of disinterested officers, directors or other individuals, formed by the board of directors for the purpose of investigating the merits of proposed litigation and determining whether it is in the company's best interests to pursue it. Such committees are specifically authorized by statute and can be used in corporations, limited liability companies, and other entities governed by a board of directors.[2] What makes an SLC so special? In short, it is the committee's ability to control a derivative lawsuit even when the entire board has a conflict of interest.

Derivative suits are equitable creations designed to allow shareholders to bring a lawsuit on behalf of the corporation. By definition, derivative claims belong to the company, not the individual shareholder.[3] Since the claim belongs to the company, in order to bring a derivative claim, the plaintiff must allege with particularity the efforts, if any, made by the plaintiff to obtain the desired action from the board of directors, and, if necessary, the other shareholders or members. If the plaintiff does not make such a demand, the plaintiff must state the reasons why he or she chose not to do so.[4]

One of the most common reasons cited by shareholders for failing to make such a demand is futility. If a majority of the directors have a conflict of interest, in some circumstances a demand for action may be considered futile.[5] As a result, in those circumstances, the plaintiff's claim may go forward and the company may lose control over the derivative litigation.

Of course, not all claims are worth pursuing. Derivative litigation, without some checks and balances, would allow disgruntled shareholders to bring a wide variety of derivative claims, including "strike suits," which are lawsuits brought based upon their nuisance value rather than to redress meritorious claims. The problem is not limited to strike suits. Rather, even the most meritorious claims may ultimately prove to be prohibitively costly for the company to pursue. The end result may be a lawsuit that proves more detrimental than redeeming to the company.

The use of an SLC generally solves this problem. An SLC ensures that disinterested individuals are allowed to decide how to handle the company's claim. This specifically includes the ability to settle the matter prior to filing a lawsuit or choosing to not pursue the claim at all. A properly created, empowered and independent SLC often defeats a shareholder's claim of futility and prevents a plaintiff from pursuing a derivative claim without the SLC's approval. Because Minnesota courts will defer to an SLC's decision regarding a derivative claim, including a decision to settle or dismiss the claim, SLCs ensure that the decision is based upon an independent weighing of various business factors.[6]

The SLC's power is not without pitfalls, however, and a practitioner must be careful to follow the proper procedures for designating, instructing, and/or serving as a member of an SLC. Courts will defer to an SLC's business judgment only if the board of directors and SLC operate within certain guidelines ensuring the SLC's independence and good faith investigation of the derivative claims. If an SLC fails to adhere to these proper procedures, the SLC's decision may be disregarded and the plaintiff's claim will go forward, turning the SLC's efforts from a means of avoiding unnecessary cost and expense into an additional burden of derivative litigation.

Direct v. Derivative

The first step for any corporation considering an SLC is to determine whether the proposed claims are direct or derivative. In Minnesota, as in many states, a shareholder may bring a direct action when the shareholder alleges a direct injury to the shareholder that is separate and distinct from the injury to the company; however, except in extraordinary circumstances, a shareholder generally may not assert for himself a derivative action, *i.e.*, a cause of action that rightfully belongs to the corporation.[7] SLCs can evaluate the company's claims, but an SLC's evaluation of a direct claim carries no real weight.

In analyzing whether a claim is direct or derivative, courts focus not on the theory in which the claim is couched, but instead on the injury itself.[8] When the corporation suffers the injury, and only indirectly harms the shareholder, the claim must be pursued as a derivative claim.[9] Determining whether the claim is direct or derivative requires analyzing whether the injury to the plaintiff is unique or whether the injury is of the same character as the injury to every other shareholder.[10]

Parties will often disagree about whether a claim is direct or derivative. Plaintiffs often allege payment of excessive salaries, use of corporate funds for personal expenses, and preferential treatment as direct claims, under the theory that but for these actions, the shareholder would have received greater value. Claims for corporate waste and misappropriation, however, are traditional derivative claims because the injuries are not unique to the plaintiff-shareholder. That the majority shareholder wrongfully benefited in her role as lessor, director, officer or employee does not change the basic nature of the claim. The key to determining whether a claim is direct or derivative is to ask whether shareholders *in general* have suffered from the same type of injury in their role as shareholders. If so, then the claim is properly a derivative claim and may be appropriate for review by an SLC.

Forming an SLC

If a shareholder presents a derivative claim, whether by making a demand on the board, by starting derivative litigation and claiming that a demand would be futile, or by starting litigation attempting to allege a derivative claim as a direct claim, the company should consider forming an SLC.

Not all derivative claims require an SLC. If the board of directors does not have a conflict of interest or if any directors who do have a conflict of interest take no part in the investigation, deliberation or vote, there is no need for an SLC and the independent directors may exercise their business judgment in deciding whether or not the company should pursue the claim. Often, however, the plaintiff will allege that the entire board of directors is tainted by conflict or is somehow interested in the litigation, making a demand futile. Such cases necessitate the use of an SLC. As a practical matter, a board of directors should consider appointing an SLC, regardless of any conflict, to ensure there are no challenges to the board's impartiality.

Once the corporation decides to use an SLC, the next step is determining who will serve on the committee. SLCs are composed of one or more natural persons appointed by a majority vote of the board of directors, unless otherwise provided under the articles or incorporation or bylaws. Committee members can be, but need not be, existing members of the board of directors.[11]

A key element of any SLC is independence. If the SLC is found to include interested individuals who have a conflict of interest or who remain subject to the board's authority, the court will not defer to the SLC's business judgment. Courts evaluate potential board influence on the SLC under the totality of the circumstances, including the existence of personal or business relationships between the defendants and members of the SLC.[12]

Because courts need not defer to the business judgment of a conflicted SLC, the company should take care to select an SLC which is truly independent. This often means appointing individuals from outside the organization to the committee. One of the most efficient and common means of solving questions of independence is to appoint an outside lawyer to investigate the claim and determine how the company should proceed. Before accepting an appointment to serve as a member of an SLC, such individuals should perform a conflicts check to protect against any potential biases, such as prior representation of the accused directors or officers or other business or social dealings that could create the appearance of a conflict of interest.

Once the company has selected the member or members of the SLC, the next step is to pass a resolution formally appointing and empowering the SLC. Unlike other corporate committees, which remain under the control of the board of directors, the SLC must be delegated full authority to control the litigation. Simply giving the SLC an advisory role is insufficient and courts need not defer to an SLC's recommendations.[13] To protect against challenges of bias or undue influence, the corporate resolution formally appointing the committee should vest full authority to investigate, evaluate and make a binding determination as to whether it is in the company's best interests to pursue, settle or dismiss the claims, including the power to set the terms of any proposed settlement. The resolution should ensure that the board does not retain any ability to influence the committee.[14]

The members of the SLC should also consider their own liability exposure in accepting the appointment. SLC members are, for the purposes set out in the authorizing resolution, directors. Accordingly, they have the same legal exposure in those limited areas as other members of the board of directors.[15] Therefore, SLC members should consider whether the company has eliminated or limited director liability as permitted by Minn. Stat. §302A.251 subd. 4, whether the company has directors and officers insurance coverage, and whether the member's own professional liability insurance provides adequate protection.

The SLC's Investigation

Once an independent SLC has been appointed, the SLC should begin its investigation of each of the derivative claims. While courts will defer to the business judgment of an independent SLC, a court will analyze whether the SLC's investigation was adequate, appropriate and pursued in good faith. This necessarily includes some judicial analysis of the procedure utilized by the SLC to gather the factual data used to support its business judgment.[16]

When evaluating the SLC's investigative procedures, courts do not focus on any one particular element of the committee's investigation, but instead look at the committee's procedure and methodologies as a whole.[17] Ultimately, the scope and nature of the investigation will depend on the type, size, and complexity of the shareholder's claims. While investigations may vary, courts generally look at factors such as the length and scope of the investigation, use of independent counsel or experts, the company and the accused's involvement in the investigation, and the adequacy and reliability of the information supplied to the committee.[18] It is crucial that the SLC take care in its investigation and evaluation of the claims. If a court determines that the SLC's investigative procedures and methodologies were not adequate, appropriate and pursued in good faith, the derivative lawsuit will proceed on its merits. The SLC may not simply go back and cure the deficiencies.

In accordance with these factors and with only one opportunity to conduct its investigation, the SLC must take care in structuring its investigation. The SLC should interview the complaining shareholder and the accused individuals to determine the factual basis of any claim. SLCs should review appropriate company documents, and may wish to invite the proposed parties to make submissions. Once the committee learns more about the factual underpinnings of any claim, the committee may find it useful to obtain outside expert opinions or other independent evaluations to assist in the proper interpretation and evaluation of the information gained during the investigation. As the process continues, additional follow-up interviews, including interviews with willing third parties, may be necessary to provide a complete factual basis for the claim. Finally, once the SLC has completed an investigation sufficient to allow it to make a fully informed and supported business decision that weighs both business and legal factors, the SLC should issue a final report detailing its conclusions, as well as the basis and reasoning for its findings.

Deciding to Settle

When an SLC finds wrongdoing by the accused, it need not simply decide to have the company pursue the claim. Considerations of legal fees, management distraction, public and customer relations, among others, may lead the SLC to decide that a reasonable settlement should be pursued—and to set minimum acceptable terms for such a settlement.

Deciding not to bring or to settle a derivative claim does not mean the company or directors sanctioned or condoned the alleged wrongful acts. Even if the alleged wrongs did occur, settlement or dismissal may be in the company's best interests. It is important to remember that an SLC is charged with making a *business* decision, not simply determining whether the derivative claims could have merit or meet a Rule 12 standard. While the potential for success is certainly one factor to consider, other factors such as adverse publicity, cost of litigation, collectibility and possible disruption of the workforce should be considered as well.

Deciding whether or not to settle or the terms of any such settlement is not a scientific process. An SLC is formed to make a business judgment about how best to handle the proposed claims. SLCs should ensure they conduct a weighing of appropriate factors in the decision, and not simply determine the likelihood of a legal victory.[19] As with any business decisions, such judgments may vary depending upon a host of factors, including personal experiences, education, and general business philosophy.

The SLC's Decision

Once the SLC has completed its investigation, the corporation must follow the SLC's determination. If the SLC finds the claims meritorious, then the derivative litigation should move forward or the corporation should pursue the claims on its own. If, however, the SLC determines that it is in the company's best interests not to pursue any claims or to settle the claims, the company can move the court, which must approve any dismissal or compromise of the derivative litigation, to dismiss the plaintiff's derivative complaint in accordance with the SLC's determination.[20]

A derivative plaintiff may disagree with the SLC's decision and may object to the court's approval of a determination to dismiss or settle a derivative claim. If a plaintiff does challenge the SLC's directive to the company, the burden is on the board of directors to establish that (1) the members of the SLC possessed a disinterested independence; and (2) the SLC's investigative procedures and methodologies were adequate, appropriate and pursued in good faith.[21] If the board fails to establish either of these two criteria, the court need not defer to the SLC's decision and the derivative claim may move forward on its merits, with no opportunity to rectify the SLC's deficiencies.[22] If the board does demonstrate both disinterested independence and an adequate, appropriate and good faith investigation, the court must defer to the SLC's decision and enter an order accordingly.[23]

It is the court's deference to an SLC's decision that makes the SLC a powerful tool in derivative litigation. Just recently, the Minnesota Supreme Court reaffirmed the SLC's power in the headline-grabbing case *In re United Health Group, Inc. Shareholder Derivative Litig.*, in which an SLC determined that it was in the best interest of the company to settle derivative claims against UnitedHealth Group's officers and directors for their role in the now-infamous backdating scandal.[24]

The key issue in *UnitedHealth Group* was the level of deference Minnesota courts will give an SLC's decision to settle or dismiss a derivative lawsuit. Facing several derivative claims, UnitedHealth Group appointed two former Minnesota Supreme Court justices to serve as the SLC. After its investigation, which included the use of independent outside advisors, the SLC determined that UnitedHealth Group should settle the derivative claims. This included settling claims against UnitedHealth Group's former chairman and CEO, Dr. William McGuire, who allegedly received backdated UnitedHealth Group stock options worth over $1 billion, for approximately $420 million. After the issuance of the SLC report, the derivative plaintiffs and defendants moved the court to release Dr. McGuire's stock options in excess of the settlement terms. Although it had not yet been asked to approve the settlement, which is required under Fed. R. Civ. P. 23.1(c) (as well as the state counterpart, Minn. R. Civ. P. 23.09), the court opined that releasing the stock options would make "any further 'approval' … an empty act."

While some states, including Minnesota, limit a court's review to a determination of the disinterested independence of members of an SLC and the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee (known as the *Auerbach* approach), other states, including Delaware, give the court discretion to apply its own business judgment to evaluate the merits of the SLC's decision (known as the *Zapata* approach).[25] Although the Minnesota Court of Appeals had previously cited to *Auerbach*, prior to *UnitedHealth Group* the Minnesota Supreme Court had never formally stated the level of deference that should be afforded to an SLC's decision.

Before releasing Dr. McGuire's stock options, the federal district court wanted clear direction from the Minnesota Supreme Court. Therefore, the federal district court submitted a certified question to the Minnesota Supreme Court on whether the "business judgment rule foreclose[s] a court from a) examining the reasonableness of, or b) rejecting on the merits, a settlement of a derivative action proposed by a [s]pecial [l]itigation [c]ommittee." As the court stated in more basic terms, "the [c]ourt asks whether Minnesota law makes an SLC an impenetrable 'black box,' whose decisions and evaluative processes are immune from review in a shareholders' derivative suit. Put another way, does the business judgment rule foreclose any action, beyond the [c]ourt's rubber stamping an SLC's decision?"

In answering the certified question, the Minnesota Supreme Court specifically adopted a test modeled on the *Auerbach* standard, limiting a court's review to the SLC's independence and investigative procedures only.[26] Under this standard, Minnesota courts must defer to an SLC's decision to pursue, settle, or dismiss a derivative claim if the proponent of that decision demonstrates that the SLC possessed a disinterested independence and the SLC's investigative procedures and methodologies were adequate, appropriate, and made in good faith. By adopting this standard, the Minnesota Supreme Court ensured that a properly constituted and conducted SLC would make the ultimate decision on how best to manage a company's claims.

It is the SLC's ability to fully investigate, evaluate, and make a binding decision on whether or not to pursue the company's claim that makes an SLC so "special." By properly appointing, empowering, and following the decision of an independent and diligent SLC, a company can end or resolve costly and disruptive derivative litigation and the uncertainty attendant to the litigation process. SLCs allow companies to effectively and efficiently manage the risk, cost and business disruption associated with litigation through a well-informed independent cost-benefit analysis of the pursuit, settlement, or dismissal of any derivative claim.

Conclusion

The use of a special litigation committee is an efficient and effective way to address derivative claims. Harnessing the SLC's power requires ensuring that the SLC is completely independent and takes appropriate steps to apprise itself of the facts and legal basis for proposed claims by completing an adequate, appropriate and good faith investigation of each of the derivative claims. If the proper steps are followed, companies can exchange the risk and cost of derivative litigation for a neutral and independent evaluation of how to best handle any derivative claims that may arise. #

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Notes

[1] Because SLCs apply to both corporations and limited liability companies, we will use the terms "company" and "corporation" interchangeably.

[2] *See, e.g.*, Minn. Stat. 302A.241, subd. 1 (corporations); 322B.66 (limited liability companies); 317A.241 (nonprofit companies); 308B.451 (cooperative associations).

[3] *Jansen v. Best & Flanagan*, 662 N.W.2d 876, 882 (Minn. 2003).

[4] Minn. R. Civ. P. 23.09.

[5] *See Winger v. Farmers Educ. & Coop. Union of Am.*, 107 N.W.2d 226, 233 (Minn. 1961).

[6] *Jansen*, 622 N.W.2d at 884; *Black v. NuAire*, 426 N.W.2d 203, 209-10 (Minn. App. 1988).

[7] *Skoglund v. Brady*, 541 N.W.2d 17, 21 (Minn. App. 1996).

[8] *Wessin v. Archives Corp.*, 592 N.W.2d 460, 464 (Minn. 1999) (*citing Northwest Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche*, 535 N.W.2d 612, 618 n.6 (Minn. 1995)).

[9] *Wessin*, 592 N.W.2d at 464.

[10] *Skoglund*, 541 N.W.2d at 21; *see also Northwest Racquet*, 535 N.W.2d at 617-18; *International Broadcasting Corp. v. Turner*, 734 F.Supp. 383, 392 (D. Minn. 1990); *Arent v. Distribution Sciences, Inc*, 975 F.2d 1370, 1373 (8th Cir. 1992); *Seitz v. Michel*, 181 N.W. 106 (Minn. 1921).

[11] Minn. Stat. §302A.241, subd. 2.

[12] *See In re UnitedHealth Group Lit.*, 754 N.W.2d 544, 560 n.11 (Minn. 2008) (citing 2 Dennis J. Block et al., *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 1746-53 (5th ed.1998)).

[13] Minn. Stat. §302A.241, subd. 1; *Jansen*, 622 N.W.2d at 884.

[14] Examples of disqualifying influences include the ability to change the number of members on the committee, directions on how the SLC should conduct its investigation, and undue limitations on the scope of the SLC's investigation. *See UnitedHealth Group*, 754 N.W.2d at 560.

[15] Just as any other director, SLC members "shall discharge the duties of the position of director in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." Minn. Stat. §302A.251 subd. 1.

[16] *See In re UnitedHealth*, 754 N.W.2d at 559.

[17] *Drilling v. Berman*, 589 N.W.2d 503, 509 (Minn. App. 1999) (quoting *Lewis v. Boyd*, 838 S.W.2d 215, 224 (Tenn. App. 1992)). *See also Scalisi v. Grills*, 501 F. Supp. 2d 356, 363 (E.D.N.Y. 2007)

[18] *Drilling*, 589 N.W.2d at 509.

[19] *See Jansen*, 662 N.W.2d at 889.

[20] Minn. R. Civ. P. 23.09.

[21] *UnitedHealth Group*, 754 N.W.2d at 561.

[22] *Jansen*, 662 N.W.2d at 889.
[23] *UnitedHealth Group*, 754 N.W.2d at 559.
[24] *In re UnitedHealth Group, Inc. Shareholder Deriv. Lit.*, 2007 WL 4571127, *6 (D. Minn. Dec. 26, 2007).
[25] *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).
[26] *See UnitedHealth Group*, 754 N.W.2d at 561.