

INSIDE: *Pro Bono Service* • Special Demand Committees • Privilege in a Corporate Family • Learning to Lead

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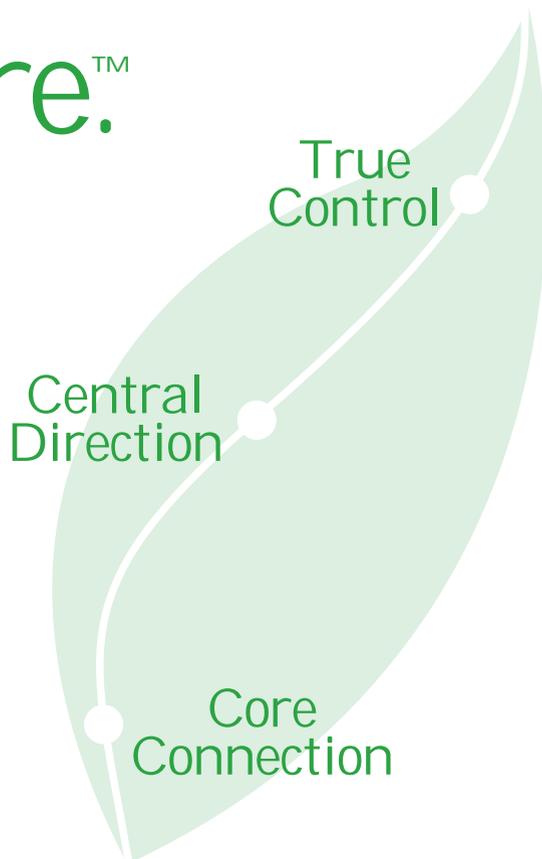
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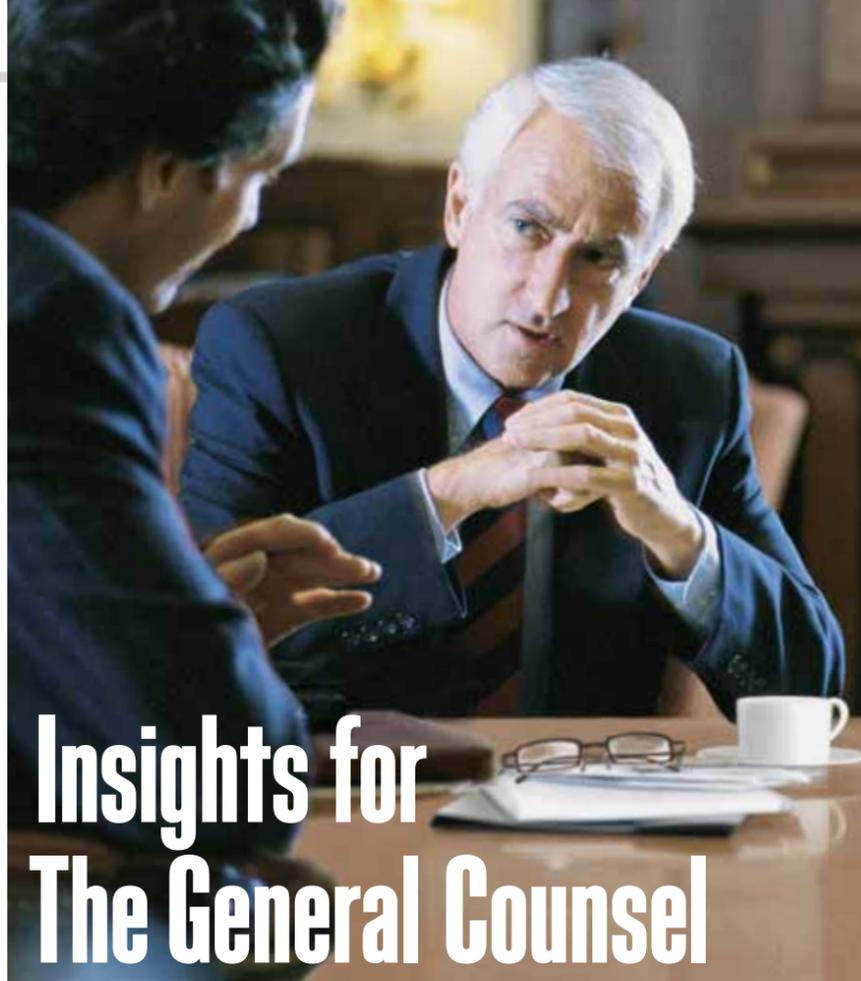


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Special Demand Committees: Practical

Insights for The General Counsel



When a stockholder demands an investigation of a Delaware corporation, the General Counsel faces a unique set of requirements.

For even experienced general counsel, the receipt of a stockholder demand urging that the corporation investigate legal claims against its directors, officers, employees or others poses challenges. Responding to such a demand often calls for delicate balancing, as general counsel must ensure that the board of directors takes the appropriate steps to respond to the demand without directing or managing the board's response.

This presents particular challenges given the general counsel's usual role as the trusted advisor to the board regarding legal issues. The purpose of this article is to provide general counsel and other legal practitioners with basic information about the creation and use of a special committee to investigate stockholder demands,¹ focusing on the importance of creating and maintaining a special committee whose members are disinterested and independent.

Stockholder Demands and Demand Committees

When a stockholder of a Delaware corporation believes that the corporation may have a legal claim against its directors, officers, employees or others, as an alternative to filing a lawsuit on

behalf of the corporation and pleading "demand futility," the stockholder can submit a demand to the corporation's board of directors, requesting that the corporation investigate and pursue the potential claim.

"The effect of a demand is to place control of the derivative litigation in the hands of the board of directors."² "While a board of directors has a duty to act on an informed basis in responding to a demand,"³ there "is neither a prescribed procedure that a board must follow in carrying out these tasks nor a set amount of time these tasks must take."⁴

If the board ignores the demand, or if "there is reason to doubt that the board acted independently or with due care in responding to the demand, the

stockholder may have the basis *ex post* to claim wrongful refusal."⁵ "The stockholder then has the right to bring the underlying action with the same standing which the stockholder would have had, *ex ante*, if demand had been excused as futile."⁶

A board may, in some situations, already have enough information to consider the demand without further inquiry. More often, however, the board will need to investigate the issues raised in the demand. If the board believes that an investigation is necessary, one of its first steps is to determine who is going to investigate the demand. As a practical matter, it usually makes sense to appoint a subset of the full board.

Thus, a board in receipt of a demand typically forms by resolution a special committee (often referred to as a "demand committee"), generally consisting of between two and four members, to conduct an investigation. The demand committee usually (and ideally) is granted full power to investigate the allegations made in the demand and to evaluate whether the corporation has any viable claims and, if so, whether those claims should be pursued in court. The demand committee will also make recommendations to the board about how to proceed.

The demand committee's investigation usually consists of the following steps: (1) retention of independent counsel, (2) request for and review of relevant corporate documents, (3) interviews with individuals most likely to have information relevant to the allegations made in the demand, and (4) provision of a written report to the full board summarizing the information obtained during the investigation, reporting the demand committee's conclusions, and recommending how the full board should proceed.

If conducted properly, demand committee investigations can provide a great benefit to the corporation. A recommendation by a demand committee that the demand be refused (that is, that no legal action be taken) will be entitled to

the presumption of the business judgment rule.⁷ In other words, a reviewing court will respect the recommendation of the demand committee unless a stockholder plaintiff can show that the members of the committee were self-interested, lacked independence, acted in bad faith, or otherwise failed to conduct a proper investigation.⁸

If the demand committee determines (and the full board agrees) that the allegations in the demand may have merit, and that the corporation has viable claims that it should pursue, the board can authorize the corporation to initiate and control a lawsuit, or can permit the stockholder making the demand to pursue derivative litigation on the corporation's behalf.⁹

Disinterestedness and Independence: The Legal Backdrop

For a demand committee to be effective, and to issue a recommendation that is entitled to judicial deference, it is critical that its members be disinterested and independent. "Disinterested" and "independent" have the same general meanings in the context of a demand committee that they have in the context of the full board of directors. The case law provides that to be disinterested generally means to have no material personal interest in the outcome of the investigation. To be independent generally means to be free of personal, familial or business relationships with persons who have an interest in the outcome of the investigation.

When a stockholder makes a demand on the board instead of pursuing derivative litigation, he or she is deemed to concede the disinterestedness and independence of a majority of the board.¹⁰ This does not mean, however, that the stockholder is forever foreclosed from challenging the demand committee's investigation or that the stockholder cannot later challenge the disinterestedness and independence of the demand committee. As the Delaware Supreme Court has explained:

If a demand is made, the stockholder has spent one – but only one – "arrow" in the "quiver." The spent "ar-

row" is the right to claim that demand is excused. The stockholder does not, by making demand, waive the right to claim that demand has been wrongfully refused.

Simply because the composition of the board provides no basis *ex ante* for the stockholder to claim with particularity and consistently with Rule 11 that it is reasonable to doubt that a majority of the board is either interested or not independent, it does not necessarily follow *ex post* that the board in fact acted independently, disinterestedly or with due care in response to the demand. A board or a committee of the board may appear to be independent, but may not always act independently. If a demand is made and rejected, the board rejecting the demand is entitled to the presumption of the business judgment rule unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption.¹¹

Thus, for a demand committee to be effective, the full board, the demand committee and other corporate representatives must ensure that the demand committee is disinterested and independent. All directors and members of management should be sensitive to and refrain from taking actions that, with the benefit of hindsight, could cast doubt on the committee's disinterestedness and independence – even if such actions would represent best practices in other contexts.

Ensuring the Disinterestedness and Independence of the Demand Committee

Selection of the Committee Members. The most important step toward ensuring the demand committee's disinterestedness and independence is the careful selection of committee members. General counsel should assist the board in identifying potential members by describing the investigation process and explaining the meaning and importance of disinterestedness and independence.

In certain circumstances it may be preferable that, aside from explaining the applicable law, the general counsel

not be involved in selecting which specific members of the board serve on the committee, particularly where the general counsel is a potential target of the demand. It may be beneficial to seek guidance from company counsel in such circumstances.

Although a stockholder serving a demand on a corporation concedes the disinterestedness and independence of the *majority* of the board, *individual* directors may still be interested or lack independence. The board must carefully consider the specific circumstances of each director when deciding who will serve on the demand committee.

The overarching question that must be answered for each prospective member of the demand committee is whether he or she is “incapable, due to personal interest or domination and control, of objectively evaluating [the] demand ... that the Board assert the corporation’s claims that are raised by plaintiffs or otherwise remedy the alleged injury[.]”¹²

A prospective demand committee member may be considered “interested” and should not serve on the demand committee if he or she has an interest in the outcome of the investigation that is not equally shared with the stockholders generally.¹³ To be disqualifying, the interest must be of “sufficiently material importance, in the context of the director’s economic circumstances” to make it “improbable that the director could perform her fiduciary duties” to stockholders “without being influenced by her overriding personal interest[.]”¹⁴

A disqualifying interest may exist, for example, where a director received a unique personal benefit as a result of the actions challenged by the demand. Importantly, the mere fact that a director approved the challenged decision is not, alone, a disqualifying interest unless the decision in question was so egregious on its face that there is a substantial likelihood that the director will be found liable.¹⁵

A director may be considered to lack independence from someone who is the target of or otherwise has a material in-

terest in the outcome of the investigation, and thus the director should not serve on the demand committee, where “financial ties, familial affinity [or] a particularly close or intimate personal or business affinity” with the interested person would render the director “more willing to risk his or her reputation than risk the relationship with the interested” person.¹⁶

“Mere allegations that” a director and an interested person “move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence[.]”¹⁷ But where the friendship or relationship arguably “give[s] rise to a sense of obligation or loyalty,” doubt can be cast on independence.¹⁸

The “independence of [a committee] member may be impaired if that member feels he owes something to an interested director. That sense of obligation does not have to be financial in nature.”¹⁹ For example, in *In re Oracle Corp. Derivative Litigation*, the Court of Chancery found a lack of independence where the members of a special litigation committee, both professors at Stanford University, were asked to investigate a board member who was a fellow professor at Stanford, and where one of the committee members had been taught by the alleged wrongdoer and had remained in contact with him over the years.

The Court noted that the former student would “find it difficult to assess [the alleged wrongdoer’s] conduct without pondering his own association with [the alleged wrongdoer] and their mutual affiliations.”²⁰

Selection of Independent Counsel and Advisors. Once the demand committee has been organized with disinterested and independent members, one of its first tasks should be to select independent counsel. General counsel’s role in the selection of independent counsel should be limited.²¹

This is not to say that general counsel or the corporation’s outside counsel cannot have any involvement at all. It is usually appropriate, for example, for general

counsel to offer a list of suggestions of attorneys or law firms known to have experience with demand investigations.²² But the list should include multiple options, and once such suggestions have been made, the demand committee itself should interview the prospective attorneys and make the final selection without the involvement of general counsel or other company representatives.²³

Compensation for Members of the Demand Committee. “Directors serving on a special committee are entitled to reasonable compensation for their efforts.”²⁴ What this means in practice often requires delicate judgment calls. For example, while an argument can be made that directors on the demand committee would be more likely to be considered “independent” if they did not receive compensation for service on the committee, this may not be perceived as equitable from the perspective of committee members – particularly if the company is one in which board members are typically compensated for service beyond regular board service.

If compensation is to be paid, it should not be contingent on the outcome of the investigation. Although there is no specific requirement about how compensation must be structured, it often consists of either a flat fee or payments based on the number of meetings held or months worked.²⁵ The latter may be preferred where it is particularly difficult to gauge in advance the amount of work the investigation will require.

Whether the amount of the compensation is reasonable depends on many factors, including the size of the company, the seriousness and complexity of the claims being investigated, the likely number of documents to be reviewed and witnesses to be interviewed, and the expected length of the investigation. The amount of compensation paid to directors in general and the amount paid for service on other committees may provide some guidance to compensating the demand committee members.

These issues are easier for the general counsel to confront when the company

has policies in place regarding compensation for members of demand committees and special committees. Accordingly, companies that do not have policies may want to consider adopting such policies before there is a need to appoint a demand committee or a special committee.

Interactions Between the Demand Committee and General Counsel. Once the demand committee begins its investigation, the corporation’s general counsel and other corporate representatives should limit their involvement in the investigation. Even where general counsel is not a subject of the investigation, he or she should avoid becoming involved in the investigation process.

The general counsel should avoid checking in with committee members or independent counsel regarding the progress or the substance of the investigation – even though such monitoring is, in other contexts, exactly what an effective general counsel would do.²⁶ If the general counsel receives requests to provide a status report to executive management or the full board, the general counsel should reiterate the importance of independence.

General counsel should avoid questioning or attempting to limit the type and amount of work performed by independent counsel that has been approved by the demand committee. Absent unusual circumstances, general counsel should not challenge or question the need for or propriety of tasks listed in the bills of independent counsel if the demand committee or its chairperson has approved payment for those tasks.²⁷ Otherwise, it may appear that general counsel is attempting to limit the depth or scope of the investigation.

While care must be taken to avoid even the appearance that general counsel is attempting to manage or influence the investigation, general counsel can provide certain types of administrative support to the demand committee at the committee’s request. Once the demand committee determines what company documents it would like to review as part of the investigation, it is

appropriate for the demand committee to direct those requests to the general counsel’s office, which can coordinate the gathering and production of the documents.²⁸

General counsel also may assist the committee in scheduling interviews with company personnel or in locating former directors or employees that the committee wishes to interview. General counsel also may coordinate the payment of independent counsel’s bills that have been approved by the demand committee or its chairperson.

To the extent possible, communications between the demand committee and general counsel that relate to the investigation should be made through independent counsel for the demand committee.

Internal Demand Committee Communications. Although some of the internal e-mail correspondence between the members of the demand committee may be protected by the attorney-client privilege or the work product doctrine,²⁹ the members of the demand committee should operate on the assumption that all of their communications, including even their communications with independent counsel, ultimately will be made available to a stockholder who challenges the committee’s recommendation.

Demand committee members therefore should refrain from making statements in e-mails that could cast doubt on their disinterestedness or independence, including premature statements about the merits of the claims or complaints about the burdens of service on the demand committee.

Most discussions about the investigation process and the merits of the allegations in the demand will take place during committee meetings. The corporation’s general counsel and other corporate representatives should not join the demand committee meetings. To the extent that members of the demand committee have questions or concerns at other times, they should be encouraged to call independent counsel to discuss them.

Conclusion

An effective general counsel will no doubt endeavor at all times to be responsive to executive management and board members, and to stay on top of important legal issues. When a demand committee investigates a stockholder demand, however, the general counsel should maintain distance from the process to enable an independent investigation to take place.

While this may call for the general counsel to depart from typical methods of oversight, the general counsel as well as executive management and board members should understand that this will enable the corporation to implement a process that is most likely to be entitled to judicial deference at the end of the day. ♦

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FOOTNOTES

1. This article focuses on the special committee organized to consider a pre-suit demand. Such a committee differs in certain respects from a special litigation committee (SLC), which is a committee appointed by a conflicted board to investigate claims raised in a stockholder derivative suit. The two types of committees are subject to different levels of review: while a demand committee is presumed to be disinterested and independent, with the burden of proof on the stockholder plaintiff to show otherwise, an SLC has the burden of establishing its own disinterestedness and independence by “a yardstick that must be ... ‘above reproach.’” *Beam v. Stewart*, 845 A.2d 1040, 1055 (Del. 2004). Nevertheless, disinterestedness and independence have the same meaning in the SLC context as in the demand committee context. Cases involving SLCs can therefore be highly instructive in the demand committee setting, and several such cases are discussed in this article.
2. *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990).
3. *Levine v. Smith*, 591 A.2d 194, 214 (Del. 1991).
4. *Canadian Commer. Workers Indus. Pension Plan v. Alden*, No. 1184-N, 2006 Del. Ch. LEXIS 42, at *45-46 (Del. Ch. Feb. 22, 2006).
5. *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996).
6. *Id.*
7. *Scattered Corp. v. Chicago Stock Exch.*, 701 A.2d 70, 73 (Del. 1997).
8. *See id.*
9. *Cf. Am. Int’l Group, Inc. v. Greenberg*, 965 A.2d 763, 809 (Del. Ch. 2009) (explaining



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that where an SLC determines that the claims in a derivative suit should go forward, it can prosecute the claims or permit the stockholder plaintiff to continue pursuing them).

10. *Scattered*, 701 A.2d at 73.

11. *Grimes*, 673 A.2d at 1218-19 (footnotes omitted).

12. *Brehm v. Eisner*, 746 A.2d 244, 257 (Del. 2000).

13. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

14. *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999).

15. *See Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984) (explaining that demand is not futile simply because a majority of the board approved the challenged transaction).

16. *Beam*, 845 A.2d at 1051-52.

17. *Id.* at 1051.

18. *London v. Tyrrell*, No. 3321-CC, 2010 Del. Ch. LEXIS 54, at *49 (Del. Ch. March 11, 2010).

19. *Id.* at *49 (footnotes omitted).

20. 824 A.2d 917, 943 (Del. Ch. 2003) (finding also that SLC members, both Stanford professors, were not independent from one of the targets of the investigation because he was an "extremely generous and influential Stanford alumnus").

21. *See Kahn v. Tremont*, 694 A.2d 422, 429 (Del. 1997).

22. *See generally* Gregory Varallo *et al.*, *Special Committees: Law and Practice* 240 (2011).

23. *See id.*

24. *SEPTA v. Volgenau*, No. 6354-VCN, 2013 Del. Ch. LEXIS 197, at *51 (Del. Ch. Aug. 5, 2013).

25. Varallo *et al.*, *supra* note 23, at 45.

26. *Id.*

27. *Id.* at 241.

28. *Id.* at 242.

29. Attorney-client privilege and the work product doctrine in the context of demand committees can involve complex issues that are beyond the scope of this article. Boards of directors in receipt of demands and demand committees formed to investigate demands should request that their respective counsel explain the various privilege and work product issues that can arise in the demand context. The board's and the demand committee's respective counsel can explain, for example, that while communications between the board and its counsel, and the demand committee and its counsel, are generally privileged, that privilege may arguably be waived when information (such as, for example, the committee's report) is shared between the demand committee and the full board, at least in situations where members of the board are targets of the investigation. *See Ryan v. Gifford*, No. 2213-CC, 2008 Del. Ch. LEXIS 2 (Del. Ch. Jan. 2, 2008); *Ryan v. Gifford*, No. 2213-CC, 2007 Del. Ch.

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