WHEN (OR NOT) TO CREATE A SPECIAL BOARD COMMITTEE

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Conventional wisdom holds that of the judgment calls boards are required to make, the two most momentous are decisions to sell the company and to hire a CEO. But a third can also keep boards up at night: whether to create a special board committee at all.

Typically the triggering event for creating a special board committee is actual or impending governmental or regulatory action, private litigation, or a material transaction involving the company. A functioning special board committee often requires a significant expenditure of financial and executive resources; the committee must be structured and populated correctly for its decision to receive judicial or regulatory respect, and the decision it makes will have important consequences. If only for these reasons, much writing on this subject focuses on the most prudent ways to structure a special committee and safeguard the integrity of its processes. Important as those subjects may be, corporate boards must also focus with equal sharpness on the threshold issue of whether to form such a committee.

The decision whether to create a special committee falls into one of two categories—easy and hard. Creating a special committee is an easy decision in situations where it is apparent from the outset that doing so is the only legally-tenable choice, such as where the company may be subject to a governmental regulatory mandate (DOJ or SEC consent order) or where a "going private" acquisition is proposed by the controller of a company and a majority of the board is conflicted. Similarly, the decision *not* to create a special committee is easy in cases where the board is not conflicted, is not subject to external regulatory pressure, and/or where senior management is objectively capable of handling any investigation that may be required.

Many circumstances fall in between, with no clear answer immediately apparent. To cite some examples, suppose the board learns that a data breach has occurred. Should the board create a special committee to investigate the cause and assign responsibility before any shareholder demand letter or regulatory inquiry arrives or litigation is instituted? Or, consider situations where a board member is accused of sexual misconduct involving an employee, where the corporation suffers a dramatic drop in stock price, where the company needs to materially restate its financial statements, where the board discovers that the company may be insolvent, or where the corporation discovers prior legally-defective

corporate acts and must decide whether to ratify them. In such circumstances, no clear answer will be immediately apparent.

In these "gray area" cases, should the board preemptively create a special committee and direct it to launch a special investigation? A decision of this kind is a mixed factual and legal judgment that no board should make reflexively without first considering carefully all the factors that bear significantly on the subject. So, what are those factors and how should a well-advised board prudently consider them?

A board considering a special committee investigation should ask, at a minimum, the following questions: (1) Is the "issue" one that lends itself to a formal investigation of any kind? (2) If so, is the issue one that must be addressed at the board level? (3) If so, does the issue already come within the purview of an existing standing committee capable of investigating it? (4) If the issue requires the formation of a special committee to investigate, are there sufficiently independent directors to populate it, and if not, how should the board address that problem? (5) Do the risks of not forming a special committee outweigh the costs (financial and otherwise) of creating one? Finally, (6) will the board and other stakeholders respect the outcome of the special committee's process, whatever it might be?

(1) *Does The Issue Lend Itself To A Formal Investigation?*

No investigation should proceed unless and until it is determined that there is a concrete "issue" amenable to being investigated. A *Wall Street Journal* article that the DOJ is investigating the company's industry (but not the company itself) for possible price-fixing antitrust violations may concern the board, but is not yet a concrete investigable issue. That is equally true where the board learns that the company's stock price has dropped for no apparent operational reason, where no claim of wrongdoing has been asserted. In both cases any investigation is premature. In other circumstances, the issue may either be or become moot, such as product liability claims by third parties where the company will shortly be acquired by a purchaser that will assume those liabilities as part of the deal. When considering whether an issue is sufficiently crystallized, a principal ingredient of "concreteness" will be timing.

(2) *Does The Issue Require Board Level Involvement?*

Not every issue that is amenable to investigation is of board-level significance. Before forming a special board committee, the board should determine if the required investigation can instead be accomplished at the management level. Obviously, a claim of wrongdoing in which board members or the CEO are alleged to be complicit would require board-level involvement. Conversely, information that a company plant has caused or is causing minor environmental damage might require investigation only at the senior (or even middle-management) level.

That said, in some cases even issues appearing at first blush to be management-level issues may be more prudently addressed by the board. For example, if the environmental issue involves toxic waste

that the US EPA or a state environmental agency is certain to investigate, the board may decide to involve itself more visibly in an internal investigation in order to control the process. Alternately, the issue may involve activity for which the corporation has previously been criticized by regulators, such that a board (rather than a management) investigation may demonstrate the board's commitment to avoiding future missteps. In those circumstances, the board may decide to create a special investigating committee even if it is not legally required to do so.

(3) *Can An Existing Committee Perform the Investigation?*

Not every issue that calls for a board-level investigation requires creating a separate committee. If the issue falls within the purview of an existing standing committee that is not otherwise conflicted or legally disabled, there is no need to reinvent the wheel. The most common example would be financial reporting issues, e.g., where the board learns that prior financial statements are inaccurate and needs to determine the scope of the inaccuracy, who is responsible, and how to rectify it. Issues of that kind, even if they may later have serious repercussions, are often addressed by the audit committee charged with responsibility for the accuracy of financial statement reporting and filings. That assumes, of course, that the audit committee itself is not compromised or otherwise legally disabled. Another example would be a sexual harassment complaint by an employee leveled at a member of senior management, which would normally be addressed by a standing committee charged with overseeing HR issues.

(4) *Does The Board Have Sufficient Independent Directors To Form A Special Committee?*

If analysis of whether to form a special committee to conduct an investigation also is a question of numbers: does the board have enough independent directors? If there are at least two independent directors, that should suffice, as exemplified in several public company special board investigations (e.g., the former Yahoo!). Anything less would be inadvisable, given Vice Chancellor Hartnett's admonition in *Lewis v. Fuqua Industries*, *Inc.* that a one-person committee must be "like Caesar's wife, beyond reproach." Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985). If the number of independent directors is insufficient, then the board should consider expanding its size to assure a sufficient number to conduct a credible internal investigation. In some jurisdictions, such as Nevada, the board could also consider including a person on the special committee who is not a board member. That can be a worthwhile option where the person in question is particularly reputable (i.e. a former judge) or has particular expertise in the subject area.

(5) *Balancing The Risks Against The Costs*

The fifth stage of the inquiry should involve what economists describe as a cost-benefit analysis: do the likely risks of *not* creating a special committee outweigh the almost certain high cost (both financial and internal) of doing so? In many cases that judgment call will be easy because a decision *not* to create

a special committee would be so fraught with risk as to be foolhardy. But, as with many judgment calls there is a gray area. One such area might be where the board is competently advised that the cost of litigating—or settling – a pending derivative or class action will likely be less than the cost of a special investigation. Another might be where the facts to be investigation already have been established by outside sources (such as the government or the plaintiffs in private litigation) and the board is competently advised that there is nothing else likely to be uncovered by a separate investigation.

(6) *Commitment to Respect the Process*[1]

The final step in deciding to create a special committee is as much a commitment as a decision point. The purpose of using a special committee is to insulate decision makers from outside influences and enable them to take control of, and bring to bear the corporation's resources and decision making power upon, a specific issue. For the special committee process to work, the board, senior management, and significant or controlling stockholders must commit to, and be willing to accept the outcome, of that process. Regardless of how many of the other factors discussed above weigh in favor of creating a special committee, the corporation will be worse off if a committee is created and then interfered with or otherwise compromised, (as occurred for example in *In Re Dole Food Co. Stockholder Litigation*, 110 A.3d 1257 (Del. Ch. 2015) and *In Re Emerging Communications Stockholder Litigation*, 2004 WL 1305745 (Del. Ch. 2004)). Thus, before the board creates a special committee, it should confirm that its members can and will permit the committee to act independently and obtain similar confirmation from other stakeholders.

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In summary, an analysis of the kind outlined here (which can always be reviewed on an ongoing basis) should increase the board's comfort with its decision to create—or not create—a special committee to conduct an internal board investigation.

[1] The phrase "Trust the Process" is the subject of a trademark application filed by the Philadelphia 76ers, a Delaware entity, with the U.S. Patent and Trademark Office. https://www.nbcsports.com/philadelphia/the700level/sixers-have-filed-trademark-trust-the-process-unofficial-motto-of-sam-hinkie-regime.