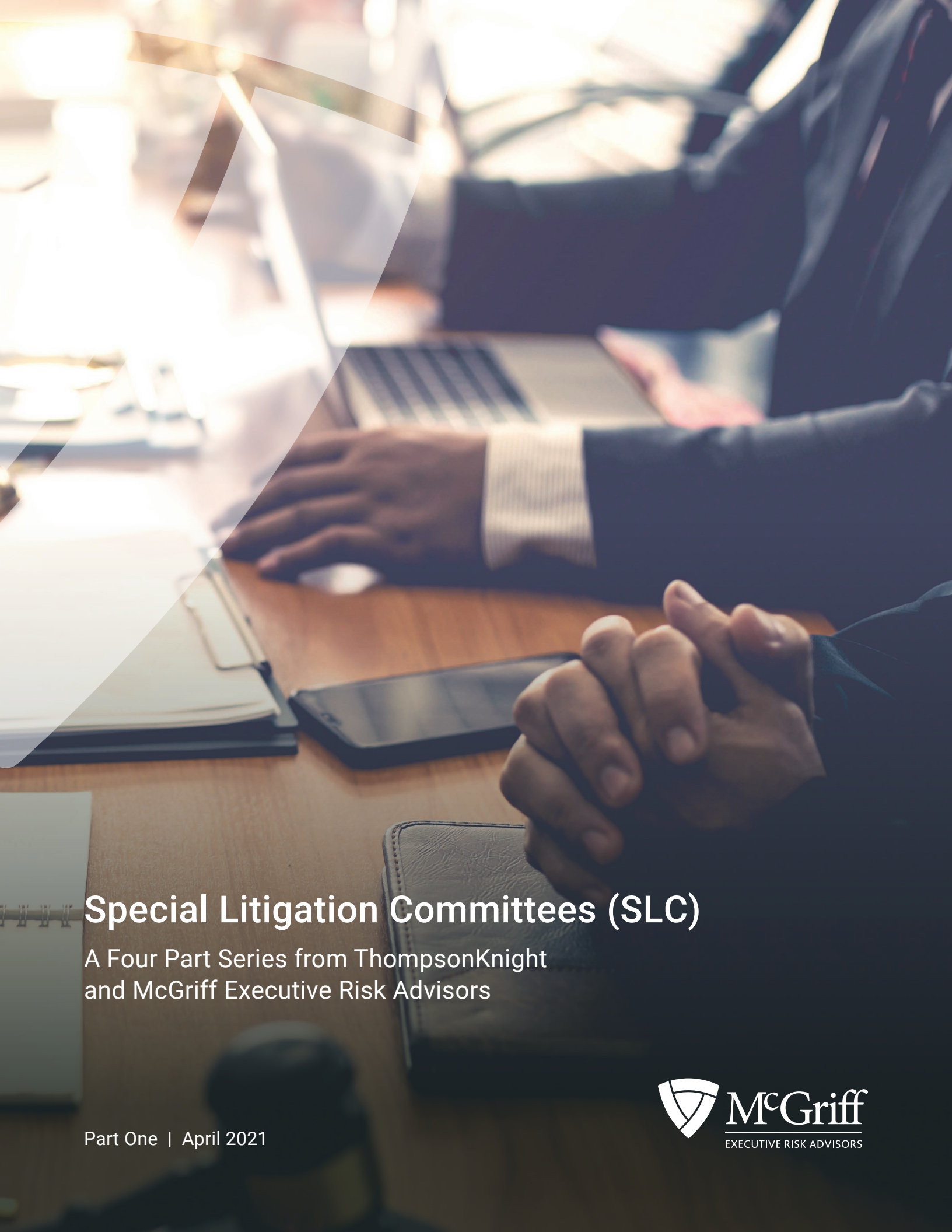


Special Litigation Committees (SLC)

A Four Part Series from ThompsonKnight
and McGriff Executive Risk Advisors

Part One | April 2021

McGriff
EXECUTIVE RISK ADVISORS

Overview

This is Part One in a four-part series on Special Litigation Committees ("SLC"). An SLC is an ad hoc committee often comprised of two or more disinterested directors who are charged with overseeing an investigation of alleged wrongdoing by stockholders against others — including other directors and a company's officers.[1] The need for an SLC is often triggered by stockholder demands or derivative suits. Ultimately, an SLC must determine whether the company's best interests warrant claims against the alleged wrongdoers or, alternatively, that the investigation identified no wrongdoing and, therefore, no further action is necessary. Because such decisions can serve as a complete defense in a derivative action, ensuring proper processes were followed along the away is imperative, beginning with pre-SLC formation stockholder book and record requests.

To bolster any demand or derivative filing, stockholders will often seek information from a company as allowed under state law and a company's formation documents. For example, Section 220 of the Delaware General Corporation Law[2] governs stockholder and director requests to inspect corporate books and records. Delaware Courts—particularly Chancery Courts—have promoted the use of 220 demands before filing derivative actions to make those actions more substantive and less likely to lead to dismissal. This article summarizes "Section 220 basics" and related case-law developments to assist corporate counsel, stockholders, and directors alike in navigating books-and-records requests under Delaware law.[3] This article will also discuss the intersection of Section 220 demands and a SLC, as well as the scope of insurance coverage for Section 220 demands. While we are utilizing DE General Corporation Law for illustrative purposes here, be mindful that laws vary state to state and it is important to know the applicable laws of the company's state of incorporation.

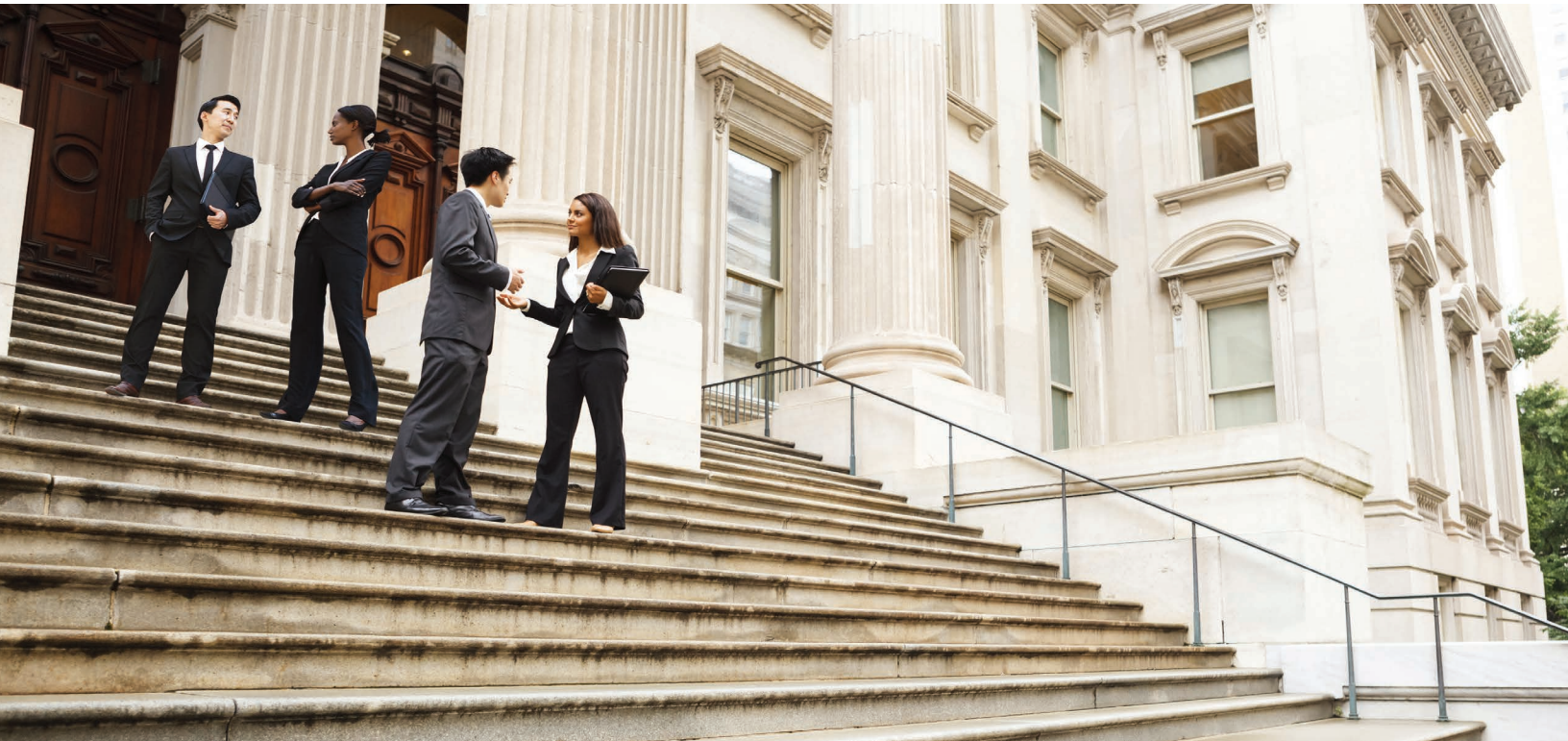
Stockholder Requests

Proper Purpose? Stockholders may inspect corporate books and records for any "proper purpose."[4] Most Section 220 analyses turn on what constitutes a "proper purpose". The statute defines "proper purpose" as "a purpose reasonably related to such person's interest as a stockholder."[5] Recently, in *AmerisourceBergen*,[6] the Delaware Supreme Court recognized that the following requests serve a "proper purpose":

- determining the value of one's equity holdings;
- evaluating an offer to purchase shares;
- inquiring into independence of directors;
- investigating a director's suitability for office;
- testing the propriety of public disclosures;
- investigating corporate waste; and
- Investigating possible mismanagement or self-dealing.[7]

The mere disagreement with business decisions, however, is not a proper purpose. Of course, what is or is not a mere disagreement is in the eye of the beholder and it would appear that the Chancery Court of the State of Delaware has become more liberal in granting broad inspection rights to shareholders.

Burden. A stockholder seeking to investigate alleged corporate wrongdoing has a low hurdle. She need establish only "by a preponderance of the evidence, a credible basis from which the court can infer there is 'possible mismanagement as would warrant further investigation.'"[8] The *AmerisourceBergen* court characterized this as the "lowest possible burden of proof."[9] Indeed, the stockholder need not show that any wrongdoing actually occurred. Rather, "a credible showing, through documents, logic, testimony or otherwise, that there are legitimate issues of wrongdoing" can satisfy this burden. If the stockholder satisfies this threshold showing, she is entitled only to the records that are "necessary and essential" to accomplish the request's stated purpose.[10] The next question is what records may be obtained by a shareholder under Section 220.



Scope and depth of request. In the Chancery Court opinion arising from the *AmerisourceBergen* matter, Vice Chancellor Travis Laster discussed the scope of a shareholder's demand. "The court must give the petitioner everything that is 'essential,' but stop at what is 'sufficient.' At bottom, the plaintiff should receive 'access to all of the documents in the corporation's possession, custody or control that (sic) are necessary to satisfy [the plaintiff's] proper purpose." In that regard, he noted three categories of materials subject to disclosure: 1) Formal board materials; 2) informal board materials; and 3) officer-level materials. The Formal or board-level documents are routinely given as part of the response to a 220 Demand however, where plaintiff makes the proper showing an inspection may extend to informal documents. In the appropriate case, and upon proper showing by the plaintiff, an inspection may extend further to encompass communications and materials that were only shared among or reviewed by officers and employees or Officer-Level Materials. Id

"Some corporations have resisted inspection requests on the basis that the alleged wrongdoing was not actionable (for example, because of limitations, lack of standing, or merits-based defenses)."

Unnecessary to State Request's Objective. And, if a stockholder has satisfied the above showing, she need not state the ultimate objective of her request. As the Delaware Supreme Court recently clarified, "when the purpose of an inspection of books and records under Section 220 is to investigate corporate wrongdoing, the stockholder seeking inspection is not required to specify the ends to which it might use the books and records."[11] Additionally, stockholders can state multiple purposes for inspection and use the information obtained for multiple purposes.

Unnecessary to Prove Wrongdoing is Actionable. Some corporations have resisted inspection requests on the basis that the alleged wrongdoing was not actionable (for example, because of limitations, lack of standing, or merits-based defenses). However, *AmerisourceBergen* makes clear that—unless the "sole reason for investigating mismanagement or wrongdoing is to pursue litigation"—"[t]he stockholder need not demonstrate that the alleged mismanagement or wrongdoing is actionable."[12]

Corporations be Wary. Prior to the Delaware Supreme Court's clarification of these principles in *AmerisourceBergen*, Section 220 requests were a source of confusion. The Delaware Supreme Court's clarification and relaxation of Section 220's requirements as applied to stakeholders was perhaps in response to defendants' "overly aggressive defense strateg[ies]."[13] Indeed, as the Court of Chancery observed in November 2020, "defendants are increasingly treating Section 220 actions as 'surrogate proceeding[s] to litigate the possible merits of the suit' and 'place obstacles in the plaintiffs' way to obstruct them from employing it as a quick and easy pre-filing discovery tool."[14] But Delaware courts "ha[ve] the power to shift fees as a tool to deter abusive litigation tactics" and, depending on the facts of any case, may do so.[15] So, even though corporations are entitled to assert defenses in a Section 220 action and probe the bonafides of a plaintiff's stated purpose, they should do so judiciously.

Director Requests

"[T]here are fundamental differences between inspection demands made by stockholders and those made by directors."[16] Section 220(d) governs a director's right to examine corporate records, and provides she may exercise that right so long as it is "for a purpose reasonably related to the director's position as a director."[17] Undoubtedly—and in contrast to stockholder requests—a director's access to such records is "virtually unfettered."[18]

Burden. Unlike stockholder requests in which they bear the burden, the burden is reversed in the director-request context. In those situations, it is the company that "bears the burden of proving by a preponderance of the evidence that [the director's] purpose is not 'reasonably related to [his] position as a director.'"[19]

No standing to bring a claim. The most important difference between a stockholder and director request is the fact that "standing to bring a claim on behalf of the corporation has not been extended to a director under Delaware law."[20] In practice, even if a director obtains records in response to a demand, the documents can only be used internally to advance the director's position. In Papa John's, the director-plaintiff recognized this limitation and stipulated that, if obtained, he would "not use any documents produced in response to the Demand to assert a claim as a stockholder without first obtaining the Company's consent to do so."[21] Since a director lacks standing to sue, the real focus of any request should be on post-production use.

Scope of production. Strong public policy dictates that a director charged with fiduciary duties must have access to the corporation's books and records.[22] "[A] director 'who has a proper purpose is entitled to virtually unfettered access to the books and records of the corporation….'"[23] Also, a corporation cannot force a director to sign a confidentiality waiver because a director is "already obliged as a fiduciary to protect the Company's information…."[24] The director must still "direct the Court to specific books and records related to the [director's] proper purpose."[25] But, if a corporation receives a request from a director, the analysis is not so much the validity of the same, but a post-production observation that the director does not misuse the records.

What if there is also a plenary claim? Said another way, what if the director, in her role as a stockholder, also brings a suit against the directors in addition to a Section 220 request? The Papa John's court tackled this and found there was no authority "in which a director's right to access books and records under Section 220(d) has been denied based on his filing of a plenary claim as a stockholder."[26] Accordingly, a court is likely to allow the request to proceed unless the corporation is able to prove the records are going to be used in the plenary claim.[27] Corporations, if they wish to deny the request, will need to develop a factual basis that the director intends to use the records in a plenary claim. In the reverse, an SLC facing a stockholder demand should be wary of records that can be tied to a director 220 demand.

Coverage Considerations

Historically, a Section 220 demand would not have triggered insurance coverage under a typical Directors & Officers Insurance policy because only "Claims" alleging wrongdoing trigger insurance policies. A Section 220 demand is technically only a request for information—not an allegation of wrongdoing. Practically, however, because Section 220 demands are often used to lay the groundwork for a "Claim", carriers recognized the value of appropriate legal representation in responding to these demands.

In recent years, so-called "Books and Records Endorsements" have become standard in D&O policies. These endorsements differ from carrier to carrier and policy to policy, however, so examining them carefully is important to maximize access to insurance limits. Some policies include the coverage within Derivative Investigation language, while others include it within Pre-Claim Inquiry Coverage like an interview request for a regulatory investigation. Others may require the Books & Records request to relate to an otherwise-covered Securities Claim before extending insurance coverage. These are significant distinctions. For example, derivative investigation coverage is generally not subject to a retention but is almost always sub-limited. Coverage for pre-claim inquiries and securities claims will allow access to the full limits, but will be subject to a retention, which is usually significant under public company D&O policies. Additionally, while independence issues need to be carefully assessed, it is also important to consider your policy's carrier consent to counsel requirements and whether the carrier has a panel of defense counsel to avoid uncovered costs incurred in responding to the 220 demand or being forced to shift counsel as the matter escalates and your carriers do become involved.

Conclusion

Section 220 demands and a SLC will often be focused on the same alleged wrongdoing. But corporations should be aware that courts will likely allow the 220 demand to proceed even when the "section 220 action" would "interfere with the working of a special litigation committee."[28] For this reason, Section 220's nuances must not be overlooked: with reversed burdens, standing issues, and potentially heavy penalties for corporations who engage in overly aggressive defensive tactics, corporate counsel would be well advised to familiarize themselves with the issues discussed herein. Also, a close reading of their D&O policy, or a call to their broker, may reveal that the corporation's policy contains a "Books and Records Endorsement" that covers any response.

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[1] In the future installments of this four-part series, we will cover how to establish an SLC, how to use an SLC to conduct the investigation, and how to conclude, wind down, and communicate the SLC's findings to prevent stakeholder challenges to the SLC's process and findings.
[2] *See* DEL. CODE ANN. tit. 8, § 220.
[3] The law of the state of incorporation and an entity's formation documents govern the scope of any books and records request. This white paper covers Section 220 because of Delaware's prominence in the corporate governance arena. If incorporated outside Delaware, check your local statutes, as variations exist.
[4] *Id.* § 220(b).
[5] *Id.*
[6] *AmerisourceBergen Corp. v. Lebanon Cty. Employees' Ret. Fund,* 243 A.3d 417 (Del. 2020).
[7] *Id.* at 425–26 (collecting cases); *see also id.* at 426 n.30.
[8] *Id.* at 426 (quotation marks omitted).
[9] *Id.* (quotation marks omitted) (emphasis supplied).
[10] *Id.* ("Once a stockholder has established a proper purpose, the stockholder will be entitled only to the books and records that are necessary and essential to accomplish the stated, proper purpose.") (Quotation marks omitted).
[11] *Id.* at 426-27.
[12] *Id.* at 437.
[13] *Pettry v. Gilead Scis., Inc.*, No. CV 2020-0132-KSJM, 2020 WL 6870461, at *2 (Del. Ch. Nov. 24, 2020), judgment entered, (Del. Ch. 2020).
[14] *Id.* (quoting James D. Cox et al., *The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation,* 75 BUS. LAW. 2123, 2150 (2020)).
[15] *Id.* ("Defendants like Gilead adopt this strategy with the apparent belief that there is no real downside to doing so, ignoring that this court has the power to shift fees as a tool to deter abusive litigation tactics. Gilead's approach might call for fee shifting in this case, and the plaintiffs are granted leave to move for their expenses, including attorneys' fees, incurred in connection with their efforts to obtain books and records.").
[16] *Schnatter v. Papa John's Int'l, Inc.*, No. CV 2018-0542-AGB, 2019 WL 194634, at *12 (Del. Ch. Jan. 15, 2019), *abrogated in part by Tiger v. Boast Apparel, Inc.*, 214 A.3d 933 (Del. 2019).
[17] DEL. CODE ANN. tit. 8, § 220(d).
[18] *E.g., McGowan v. Empress Entm't, Inc.*, 791 A.2d 1, 5 (Del. Ch. 2000); *see Chammas v. Navlink, Inc.*, No. CV 11265-VCN, 2016 WL 767714, at *7 (Del. Ch. Feb. 1, 2016) ("Under Section 220, Plaintiffs, as NavLink directors, are entitled to NavLink's books and records 'for a purpose reasonably related to the director's position as a director.'").
[19] *Schnatter,* 2019 WL 194634, at *8 (quoting DEL. CODE ANN. tit. 8, § 220(d)).
[20] *Id.* at *12.
[21] *Id.*
[22] *Bizzari v. Suburban Waste Servs., Inc.*, No. CV 10709-JL, 2016 WL 4540292, at *8 (Del. Ch. Aug. 30, 2016).
[23] *Schnatter*, 2019 WL 194634, at *12.
[24] *Id.* at *17.
[25] *Id.* at *14.
[26] *Id.* at *13.
[27] *See id.* ("[T]he Company has not proven that the acts of mismanagement [the director] seeks to investigate through his Demand necessarily concern the same conduct he put at issue in the Fiduciary Action.").
[28] *Kaufman v. Computer Assocs. Intern., Inc.*, CIV.A. 699-N, 2005 WL 3470589, at *3 (Del. Ch. Dec. 13, 2005).

Want to Learn More?

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