

Special Litigation Committee – Best Friend or Worst Enemy?

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A truly independent “Special Litigation Committee” or “SLC” wields enormous power in the context of derivative claims. The SLC will either validate a derivative claim and recommend that it be pursued or settled, or, alternatively, will recommend that it be dismissed. Since the company or corporation must adhere to the SLC’s determinations, and due to the deference provided to an SLC’s determinations by Minnesota courts, the SLC will either be your best friend or worst enemy depending on which side of the determination you support. As a result, you must be properly prepared if an SLC is appointed in a matter you are handling.

To understand why it is necessary to properly prepare for the SLC, one must first understand the appointment of the SLC, the role of the SLC and the deference granted to the SLC. The practitioner must also understand the difference between a derivative claim and a direct claim, and the trends in the law as it relates to SLC determinations and recommendations. Armed with this background information, counsel can understand the importance of preparing for and dealing with the SLC.

In determining whether a claim is direct or derivative, Minnesota courts have “focused the inquiry to whether the complained of injury was an injury to the shareholder

directly, or to the corporation.”¹ The focus by the courts is not on the theory in which the claim is “couched, but instead to the injury itself.”² “Where the injury is to the corporation, and only indirectly harms the shareholder, the claim must be pursued as a derivative claim.”³ Minnesota has “long adhered to the general principle that an individual shareholder may not directly assert a cause of action that belongs to the corporation.”⁴ “When a shareholder asserts a cause of action belonging to the corporation, the shareholder must seek redress in a derivative action on behalf of the corporation rather than in a direct action by the individual shareholder.”⁵ “A shareholder derivative suit is a creation of equity in which a shareholder may, in effect, step into the corporation’s shoes and seek in its right the restitution he could not demand on his own.”⁶

When a shareholder has alleged a derivative claim, the board may form an SLC.⁷ An SLC may be appointed pursuant to statute by a corporation, limited liability company, nonprofit company or co-op.⁸ A properly

¹ *Wessin v. Archives Corp.*, 592 N.W.2d 460, 464 (Minn. 1999).

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ *Blohm v. Kelly*, 765 N.W.2d 147, 153 (Minn. Ct. App. 2009) (quotation omitted).

⁷ *Id.*

⁸ Minn. Stat. § 302A.241, subd. 1 (corporations); Minn. Stat. § 322B.66 (limited liability companies);

appointed SLC should consist of “one or more independent governors or other independent persons to consider the legal rights or remedies of the corporation⁹ and whether those rights and remedies should be pursued.”¹⁰ Every member of a properly appointed SLC is required to be independent.¹¹ Following appointment, the SLC is not subject to the control of the board.¹²

The truly independent SLC should be delegated the board’s power to control the derivative action¹³ and should not have a limited scope placed on its investigation.¹⁴

Special litigation committees provide for an independent evaluation of a derivative action. They serve to balance the rights and duties of the board and the dissenting shareholder by providing a corporation with ‘an important tool to rid itself of meritless or harmful litigation’ while preventing

directors from using the committee to ‘wrest control of bona fide derivative claims away from well-meaning plaintiffs.’¹⁵

While discharging their duties, SLC members are considered governors of the company which they are serving and are subject to the same standards applicable to all governors.¹⁶ One of those standards is the standard of care which requires the SLC to discharge their duties in “good faith”, in a manner they “reasonably believe to be in the best interests” of the company and with the “care an ordinarily prudent person in a like position would exercise under similar circumstances.”¹⁷

An SLC and its investigation after appointment are protected by the business judgment rule.¹⁸ The business judgment rule acts as a presumption to protect a company’s board from derivative claims that the board made an unprofitable business decision.¹⁹ A director will not be liable for company losses if the director is disinterested, makes an informed business decision, and acts in good faith pursuant to the business judgment rule.²⁰ The business

Minn. Stat. § 317A.241 (nonprofit companies); Minn. Stat. § 308B.451 (cooperative associations).

⁹ The terms “corporation” and “company” are used interchangeably as an SLC may be appointed for either and the case law, in most instances, is equally applicable to both.

¹⁰ Minn. Stat. § 322B.66, subd. 1; *In re UnitedHealth Group Shareholder Derivative Litig.*, 754 N.W.2d 544, 550 (Minn. 2008).

¹¹ *UnitedHealth Group*, 754 N.W.2d at 550.

¹² *UnitedHealth Group*, 754 N.W.2d at 550; Minn. Stat. § 322B.66 (“Committees other than special litigation committees are subject at all times to the direction and control of the board of governors”).

¹³ *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 888 (Minn. 2003).

¹⁴ *Id.*

¹⁵ *Janseen v. Best & Flanagan*, 645 N.W.2d 495, 498-99 (Minn. Ct. App. 2002), *aff’d*, 662 N.W.2d 876 (Minn. 2003) (internal quote omitted).

¹⁶ Minn. Stat. §322B.66, subd. 6.

¹⁷ Minn. Stat. §322B.663, subd.1.

¹⁸ *UnitedHealth Group*, 754 N.W.2d at 550-51.

¹⁹ *Id.*

²⁰ *Janssen*, 662 N.W.2d at 884.

judgment rule prevents judges from second guessing a board's well-intentioned decision.²¹

Whether the SLC has investigated in good faith will depend on the nature of the particular investigation and the SLC's procedures and methods as a whole.²² The length and scope of the SLC's investigation, the SLC's use of independent counsel or experts, the corporation's or defendant's involvement in the SLC's investigation, and the adequacy and reliability of the information supplied to the SLC are all factors relevant to the adequacy of the SLC's investigation.²³

After completing its investigation, the SLC must decide whether it is in the company's best interests to pursue the derivative claims, settle the derivative claims, or seek dismissal of the derivative claims.²⁴ Making this determination "involves the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems."²⁵ The SLC should consider the long-term as well as short-term interests of the company and its members, and the employees, customers, suppliers and creditors of the company.²⁶ In considering these factors as it relates to the costs of litigation, in certain circumstances, even non-frivolous derivative

claims "may not be worth pursuing when the likelihood of victory is compared with the time, money, and hostility necessary to win."²⁷ Whether the company should ultimately pursue a cause of action is a matter of internal management and left to the discretion of the SLC.²⁸

[I]t must be remembered that the dismissal of meritorious litigation may be justifiable, such as when pursuit of the claim will prove more costly than beneficial. As to the settlement of a meritorious claim, it is a fact of modern legal practice that settlements are commonplace and the rule rather than the exception; moreover, it is broadly acknowledged that settlements are favored because they conserve judicial resources and minimize litigation expenses. It seems to us of little concern that, under the standard we set forth today, a substantial number of cases may end in settlement rather than adversarial litigation.²⁹

Once the SLC determines whether to pursue, settle or dismiss the derivative claim, the company must follow this determination. If the derivative plaintiff disagrees with the

²¹ *UnitedHealth Group*, 754 N.W.2d at 551.

²² *Drilling v. Berman*, 589 N.W.2d 503, 507 (Minn. Ct. App. 1999).

²³ *Id.*

²⁴ *Janssen*, 662 N.W.2d at 883.

²⁵ *Id.*

²⁶ Minn. Stat. §322B.663, subd.5.

²⁷ *Janssen*, 662 N.W.2d at 883.

²⁸ *Black v. NuAire, Inc.*, 426 N.W.2d 203, 210 (Minn. Ct. App. 1988) (internal citations and quotations omitted).

²⁹ *UnitedHealth Group*, 754 N.W.2d at 559.

SLC's determination, the board of directors must establish that the SLC was independent and that the SLC's investigation was adequate, appropriate and pursued in good faith.³⁰ If the board establishes both of these criteria, the court must defer to the SLC's decision and enter an order accordingly.³¹ If the board fails to establish either of these criteria, the court need not defer to the SLC's decision and the plaintiff's derivative claim(s) may move forward on its merits with no opportunity to rectify the SLC's deficiencies.³²

A review of ten recent Minnesota cases which examined the determination of the SLC reveals a growing trend by SLCs to dismiss or not pursue derivative claims. In fact, nine of the ten SLCs recommended the derivative claims be dismissed or not pursued, and only one of the SLCs recommended the derivative claims be settled. A multitude of factors were cited for dismissing/not pursuing the claims including: the derivative claims were frivolous; lack of benefit to the company; and costs of pursuing the claims to the company.

With an understanding of the purpose of the SLC, the power and deference granted to the SLC, and the recent trend of SLC determinations, it is easy to grasp the importance of dealing with the SLC. Whatever side of the derivative claim you may find yourself representing, derivative plaintiff, defendant, or corporation, it is vital

to properly prepare for and to deal with the SLC.

Obviously, the benefits on whether to appoint an SLC depends on which side of the derivative claim you find yourself. From the company's perspective, the SLC can save the company significant time and expense in investigating the derivative claim prior to protracted litigation. From the shareholder's perspective, the SLC's determination/recommendation will either give credence to the derivative claim or may be the demise of the claim. Either way, the SLC's determination/recommendation early in the derivative action may also save the derivative plaintiff and individual defendant significant sums in litigation expenses.

If you are in the role of advising on the appointment of the SLC, it is imperative to emphasize the independence of the SLC. Factors regarding the independence of the SLC include, but are not limited to: whether the members of the SLC are defendants in the litigation; whether the members of the SLC are exposed to direct and substantial liability; whether the members of the SLC are outside, non-management directors; whether the members were on the board when the alleged wrongdoing occurred; whether the members of the SLC participated in the alleged wrongdoing; whether the members of the SLC approved conduct involving the alleged wrongdoing; whether the members of the SLC had business dealings with the company other than as governors or directors; whether the members of the SLC had business or social relationships with one or more of the

³⁰ *Id.* at 561.

³¹ *Id.* at 559.

³² *Janssen*, 662 N.W.2d at 889.

defendants; whether the SLC received advice from independent counsel or other independent advisors; the severity of the alleged wrongdoing; and the size of the SLC and whether the board retains the right to change the number of SLC members during the SLC's investigation.³³

Following the appointment of the SLC, if there are questions surrounding the independence of the SLC, it is best to raise these questions immediately. Because of the costs involved in retaining a SLC—most often a lawyer or retired judge experienced in this area of law—and the costs of the SLC investigation, none of the parties benefit from a protracted investigation followed by a challenge to the independence of the SLC. It is best to ensure that the SLC is independent from the start rather than having to restart the process if the SLC is later determined to be biased. Moreover, you run the risk of simply looking like a disgruntled participant if you challenge the independence of the SLC after their determination (most likely against your client). During this equitable process, perception in the eyes of the court is important.

Following their appointment, the truly independent SLC will request information from all sides of the dispute during their investigation. Most often, the SLC will meet with the parties and their respective attorneys to discuss the factual basis surrounding the derivative claim early in the investigation. As applicable in most areas,

you do not get a second chance to make a good first impression. Thus, it is important to have the factual support, or factual defense, for the derivative claim prior to meeting with the SLC. Evidentiary support for the respective positions should come via financial statements, witness statements, emails, etc. Do not make the mistake of being unprepared for a meeting with the SLC. Instead, look at the meeting with the SLC as a trial; you must convince the SLC that your respective position has evidentiary support upon which the SLC can base their determination.

Following the initial meeting, the parties will often have additional opportunities to provide the SLC with further evidentiary support. Do not make the SLC do unnecessary researching or digging to support your view of the derivative claim. If you have the evidentiary support, or come across additional evidentiary support, provide it as soon as possible to the SLC. The SLC investigation should not be a game of hide-and-seek between you and the SLC. If you believe the other side of the claim has additional information which is not in your possession, inform the SLC as such and request that the SLC obtain such information. Unlike the unfortunate trend in litigation of simply objecting for the sake of objecting to discovery requests in hopes of 'hiding the ball', if the SLC asks for information from your client, it is best to provide it. It would be disingenuous to later object to the adequacy of the SLC's investigation if you or your client refuses to provide relevant information to the SLC.

³³ *UnitedHealth Group*, 754 N.W.2d at 560 n.11.

If you believe that the SLC has conducted an improper or inadequate investigation, it is best to raise this complaint as soon as possible. Again, because perception is important during this equitable process, questioning the SLC's investigation following its determination against you raises the question as to whether you are simply raising this issue because the SLC recommended against your client or if there really was an issue with the adequacy of the investigation.

Following the SLC's investigation, the SLC will issue its determination/recommendation. As set forth above, the truly independent and well investigated determination by the SLC is entitled to significant deference. Challenging the determination of the independent and well investigated SLC most

likely will be fruitless and may be a waste of your client's resources. If, however, the SLC missed something in its investigation or it was later determined that the SLC was not independent, again, it is important to immediately raise these issues with the court.

The SLC can either be your best friend or your worst enemy. Knowing the role of the SLC and being properly prepared in dealing with the SLC will help ensure the appointment of an independent SLC and the adequacy of the SLC's investigation. Knowing the role of the SLC and being properly prepared in dealing with the SLC will also, hopefully, result in a SLC determination favorable to your client.



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