

The Special Litigation Committee Investigation: No Undertaking for the Faint of Heart

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IN THE SPECIAL world of lawyer-conducted investigations, no undertaking calls for more finesse, diplomacy, independence, care, and judgment than acting as counsel for a special litigation committee. Not unlike the raising of mushrooms, the parties must conduct the process in the dark, manage it to inspire confidence that sanitary conditions have been maintained, and produce a perfect product that can withstand the most careful scrutiny of any number of skeptical inspectors. The lawyer who fails to handle it wisely and well can end up not with the sought-after opaque pearlescent mushrooms, but with nothing more than large quantities of mushroom “soil.”

I. THE SETTING

How many times have the shouts “Strike suit!” “Plaintiffs’ lawyers” or just plain “@#%*#\$ lawyers” reverberated through the corporate board rooms of America? There are few experiences to match that shocking combination of dismay and self-righteous outrage when the titans of our industrial and financial establishment learn that some self-appointed private attorney-general has commenced litigation “on behalf of” the corporation, typically against these very directors. “How dare someone institute litigation over that decision?” “How could anyone suggest that we have acted other than in the best interests of our corporation?” “How are you going to get officers and directors of our stature to serve the corporations of America if frivolous suits like this can be brought at the drop of a hat?”

When the shrill notes are but a lingering echo, the directors will calm down long enough to learn that lawyers not only have created the problem but also can provide, in certain circumstances, an appropriate ap-

proach for dealing with the problem—the establishment of a Special Litigation Committee (SLC, or the Committee) of the board. It is the purpose of this chapter to provide counsel to the SLC with guidelines for the conduct of the SLC’s work, particularly the required investigation that lies at the heart of the SLC’s responsibilities.

II. THE THEORETICAL FOUNDATION FOR A SPECIAL LITIGATION COMMITTEE

As a general proposition, the decision whether a corporation should proceed with any given litigation matter, like the decision to issue subordinated debentures or to hire a new chief executive officer, is a business decision for the corporation’s board.¹ Accordingly, since a derivative action purports to be and, if pressed, is in fact brought on behalf of the corporation, at least in certain instances² and as an initial matter,³ it is the corporation’s full board of directors that is entitled to make the decision whether it is in the best interests of the corporation to pursue the derivative claims. As a result, the requirement has been established that, in certain circumstances, a shareholder who wishes to bring a derivative suit must first make a formal demand upon the board of directors that may, as a matter of business judgment, determine that it is not in the best interests of the corporation for the litigation to go forward. Assuming a board with capacity to so decide, if the decision is not to proceed, that is the end of the matter.

1. See, e.g., *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982) (decision to bring lawsuit normally corporate business decision for board) (citing *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917) (same)), *cert. denied*, 460 U.S. 1051 (1983); *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. Super. Ct. 1990) (decision to litigate is management decision made by board, not shareholders) (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. Super. Ct. 1981) (same)); American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (hereinafter ALI Principles) § 7.05(a) (1994) (“The Board has the authority to dismiss the derivative action as contrary to the best interests of the corporation.”) (Pennsylvania became the first jurisdiction to adopt the ALI Principles in *Cuker v. Mikdauskas*, 547 Pa. 600, 692 A.2d 1042 (1997)).

2. Beyond the scope of this chapter is an extensive discussion of when the matter is taken out of the hands of the corporation entirely. See generally BLOCK, BARTON & RADIN, *infra* note 8.

3. See the discussion at *supra* note 8 relating to when courts are permitted to second-guess the Committee’s judgment.

However, under other circumstances, the courts have held, applying various tests, that the demand requirement is excused as futile.⁴ In the demand-excused setting, the full board must recognize an unpleasant fact: because of the nature of the charges and/or the identity of the defendants, the board is disabled from reaching the decision not to proceed with the derivative claim.⁵ At that point, the board must either permit the suit to go forward or try to identify from among its members (or even add to its membership) board members who are not so disabled. If the board can find a sufficient number of disinterested directors within its own ranks or if the board can add more directors (with due regard to state corporate law and corporate bylaw requirements as to the number of directors required to act in the name of the board and the method for adding new directors), the board can constitute a special litigation committee of the board.⁶ It then becomes the responsibility of the full board to pass an appropriate resolution delegating to the board committee full authority to act in the name of the board with respect to the putative derivative claims. It is important that this resolution clearly provide that final authority rests with the SLC and that the SLC is not simply making a recommendation back to

4. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. Super. Ct. 1984) (standard for determining whether demand is futile is reasonable doubt that “directors are disinterested” or that transaction was “a valid exercise of business judgment”); *Barr v. Wackman*, 329 N.E.2d 180, 188 (1975) (demand excused by allegations of board “participation in and approval of active wrongdoing”); ALI Principles § 7.03 (“Demand on the Board will only be excused if the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result.”) See also *Kamen v. Kemper Fin. Serv., Inc.*, 500 U.S. 90, 92 (1991) (rejects “universal demand” requirement under federal common law).

5. Beyond the scope of this chapter is a discussion of when it is desirable to forgo forming an SLC even though enough disinterested directors are available. The decision to pursue an SLC is not always the recommended course of action.

6. See, e.g., *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1499 (D. Md. 1985) (adopts majority rule that interested board has power to appoint special committee of independent directors to review derivative action (citing *Zapata*, 430 A.2d at 785 (one shareholder should not have power to incapacitate entire board)); ALI Principles § 7.05(b) (“The Board has the authority to delegate its authority to take any action specified in § 705(a) to a committee of directors or request the court to appoint a special panel in lieu of a committee of directors.”) But see *Miller v. Register and Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983) (adopts minority rule that when all or nearly all directors are named defendants, no power to add or appoint new directors to special committee).

the disabled full board for final action.⁷ A typical board resolution is annexed hereto as Appendix A.

III. DERIVATIVE PLAINTIFF'S COUNSEL

From the beginning, the SLC must guide all its conduct by the overriding expectation that, unless the SLC decides the derivative claim should go forward, plaintiff's counsel will challenge on all available fronts the recommendation of the SLC to terminate litigation. Included will be challenges to the independence of the Committee, the independence of counsel, the adequacy of the investigation, the objectivity of the investigation and, in those jurisdictions where it is available, a challenge that the final decision by the SLC violates the business judgment rule.⁸ Thus, counsel must guide the entire SLC investigative process with one eye firmly fixed on the possibility and content of these challenges and the process by which the challenges will be mounted (i.e., likely discovery, anticipated testimony, the contents of the final Committee report).

IV. THE TOTAL CONTEXT

While the Committee is established in the context of a derivative claim

7. See, e.g., *Zapata*, 430 A.2d at 786 (express provision of Delaware statute allows for delegation of full board authority to special committee by resolution).

8. See, e.g., *Zapata*, 430 A.2d at 788-89 (under Delaware approach, court has discretion in demand—excused cases to apply own independent business judgment to special committee's decision not to file suit even after it is found committee is independent, acted in good faith, and conducted reasonable investigation). See also D. BLOCK, N. BARTON & S. RADIN, *THE BUSINESS JUDGMENT RULE* 522 (4th ed. 1993) (*Zapata* approach followed by federal courts construing Connecticut, Georgia, Maryland, and Virginia law) [hereinafter BLOCK, BARTON & RADIN]. For an excellent discussion of the continued vitality of *Zapata*'s two-step approach to SLC decisions (Was the investigation fair? Is the result reasonable?), see G. Varallo, W. McErlean, E.R. Silberglied, *From Kahn to Carlton: Recent Developments in Special Committee Practice*, 33 BUS. LAW. 397 (1998). But see *Auerbach v. Bennett*, 393 N.E.2d 994, 1000-02 (1979) (under New York approach, court inquires into committee's good faith and independence; once found, business judgment rule shields decision of committee from further scrutiny). The American Law Institute, in its *Principles of Corporate Governance*, adopts the *Auerbach* approach except in cases in which the claim is the defendant committed a knowing and culpable violation of law in a control transaction or a tender offer, where the court can determine whether the grounds warrant reliance.

pending alone, it is equally likely that the derivative claim will arise as the companion to (or be spawned by) a related class action brought in the name of the shareholders of the corporation against both the putative defendants in the derivative action and the corporation itself. This companion action will allege that the same conduct which gave rise in the derivative context to the alleged corporate injury also directly injured the shareholders of the corporation. For example, the situations abound in which a shareholder brings a securities fraud class action alleging a failure to timely disclose some negative information that, when disclosed, resulted in a large drop in the price of a corporation's shares. At the same time, a shareholder might bring a derivative claim against the corporation's officers and directors alleging that their conduct caused the corporation great injury, to wit the need to pay the class significant dollar damages in the class action.

Thus, it is not at all uncommon that as the SLC and its counsel conduct their work, they will have to be mindful of the impact their meetings, deliberations, investigation, decisions, and subsequent report, if any, will have upon companion class-action litigation. Similarly, different counsel will be retained to defend the class-action litigation. Accordingly, the structuring and coordination of the relationship between class-action defense counsel and SLC counsel will require diplomacy and due regard for the often disparate interests or goals of the corporation in each piece of litigation.

V. SELECTION OF COUNSEL

The SLC's first act should be to select counsel to provide legal services to the Committee. While no one should ever select counsel in a casual manner, in this instance, the Committee must look beyond the usual credentials one would seek in counsel (skill, experience, personality, etc.). The Committee must conduct a thorough review of counsel's "independence" and consider whether that independence will withstand the strict scrutiny that will necessarily follow the completion of the Committee's work. It is the job of the Committee members not only to explore that issue, but also to require candidates for the assignment to explore it themselves before "tossing their hats into the ring."

The matters that the Committee should investigate in this context go beyond the usual conflict of interest analysis. Indeed, some possible candidates for the assignment, like present outside corporate counsel, who could "clear the conflict" without even "looking it up," are particularly

unsuitable to act as counsel to the SLC simply because they are so involved with the corporation and its present officers and directors that their independence would be subject to substantial challenge.⁹ Possible connections between putative counsel's firm colleagues and the defendants in the derivative action that would be irrelevant for conflict purposes (membership in the same clubs, service on common boards, etc.) may have an impact on whether the courts eventually view counsel as independent.¹⁰ Thus, the search for independent counsel may be an arduous one, but one well worth the effort if the courts are to give the work of the Committee full effect. Regardless of the Committee's decision, if counsel is eventually found not to be independent, the Committee's work will be for naught, and the decision whether to pursue the claim will be entirely in the hands of derivative plaintiff and his or her counsel.

VI. THE INDEPENDENCE OF THE COMMITTEE

Once counsel is retained, the Committee should conduct a reciprocal independence analysis of its members. While one would hope that the board thoroughly explored these issues when the Committee was first formed by the board, it is not unusual for the Committee to make these appointments in haste, at a time of frenzy in the corporate board room, on a superficial basis (Jack's not named as a defendant; let's put him on the committee), or for precisely the wrong reason (Mary and I serve on the electric company board; I know I can trust her). In any event, a second check on independence is certainly in order, and, at a minimum, it will give counsel for the Committee an early opportunity to provide the SLC

9. See, e.g., Kahn v. Tremont, 694 A.2d 422 (Del. 1997) (criticism of lawyer for special litigation committee who was recommended by counsel for the corporation); Maldonado v. Flynn, 485 F. Supp. 274, 283 (S.D.N.Y. 1980) (shareholder challenged independence of committee on basis of appointment of committee member's law firm as special counsel), *aff'd in part, rev'd in part on other grounds*, 671 F.2d 732 (2d Cir. 1982). See also E. BRODSY & M.P. ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS; RIGHTS, DUTIES AND LIABILITIES § 9:09, 42 (1984 & Supp. 1989) [hereinafter BRODSY & ADAMSKI] (special counsel should be without any regular relationship with corporation or management).

10. See, e.g., Kaplan v. Wyatt, 499 A.2d 1184, 1190 (Del. Super. Ct. 1985) (committee's good faith challenged on basis of appointment of special counsel who was former defendant in unrelated litigation prosecuted by shareholder's counsel).

with counsel's own independent assessment of whether a court will ultimately view the Committee as independent. After all, no special litigation committee is ever free from an attack on the grounds of independence. By definition, the Committee members serve on the board with, or know, the officers or directors who are the defendants in the derivative action because they are directors.

This charge of cronyism is as inevitable as the search by derivative plaintiff's counsel for fees. But it is the other connections, such as those mentioned in the discussion on independence of counsel (Did the president and a member of the special litigation committee room together in college? Is officer A related to SLC member B?), which the Committee and SLC counsel must carefully explore.¹¹ It is far too late to be surprised by such disclosures when derivative plaintiffs' counsel takes the depositions of the Committee members after the work of the Committee is complete.

Similarly, counsel must warn the Committee in the strongest possible terms to maintain its independence while its investigation is ongoing.¹² The Committee members, as board members, by definition will be meeting with their fellow "interested" board members at the regular meetings of the board. In addition, one can never overstate how nervous the putative derivative action defendants will be regarding the work of the Committee. Reciprocally, the Committee members will want to provide some assurances to their fellow directors if, as, and when it becomes likely that the Committee's work will result in a recommendation to drop the derivative claims. However, the Committee must avoid any of these pre-final report discussions lest plaintiff's counsel use them at a later date to prove that the Committee either acted too hastily or was otherwise biased or lacked independence.

11. *See, e.g., In re MAXXAM*, 1997 WL 187317 (Del. Ch. Apr. 4, 1997) (questioning independence of committee members); *Lewis v. Fugua*, 502 A.2d 962, 967 (Del. Ch. 1985) (sole director SLC member "should like Caesar's wife, be above reproach"); *Bach v. National Western Life Ins. Co.*, 810 F.2d 509 (5th Cir. 1967) (plaintiffs challenged independence of SLC members on basis of prior meeting at resort of SLC and defendant director's counsel, among other connections); ALI Principles § 7.09(1) ("The board/committee should be composed of two or more persons, no participating member of which was interested in the action, and should as a group be capable of objective judgment in the circumstances.").

12. *See, e.g., Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 800 (E.D. Va. 1982) (one factor in holding committee was independent was delegation of full board authority to committee without right of review by board); *Spiegel v. Buntrock*, 571 A.2d 767, 776 n.18 (Del. Super. Ct. 1990) (formation of committee isolates board from information during investigation and decision-making).

Human nature being what it is, the need to deliver warnings regarding this type of conduct repeatedly and in the strongest terms is manifest.

VII. THE DILEMMA INHERENT IN THE COMMITTEE'S WORK

Once the Committee and counsel are in place, the work of the Committee can progress. As with the selection process itself, the Committee must conduct every phase of its work with great care, under the guidance, but not the control, of outside counsel.

Why such sensitivity? It is because in conducting its work, the Committee is negotiating a minefield, with potential jeopardy to the effectiveness of the Committee's work at every juncture. On the one hand, the Committee wants to conduct a full and independent investigation, including examining privileged materials, interviewing key people, and following leads wherever they may go. On the other, as already noted, it is more common than not that during the investigation, the corporation is a defendant in a class action arising out of the same set of facts. Thus, the Committee and SLC counsel must do everything to ensure that the work of the Committee, if at all possible, does not enhance class-action plaintiffs' case against the corporation by providing plaintiffs' counsel with a road map, waiving the privilege, or otherwise creating a situation where the corporation ends up with a pyrrhic victory—a splendid claim against present or former directors or officers who have little or no assets, coupled with a multimillion-dollar liability for the corporation *vis-a-vis* its shareholders. The Committee thus must be sure to keep its work as confidential as possible, attempting to protect the attorney-client and attorney work product privileges. Above all, the Committee must make sure its work does not result in greater costs to the corporation than if it had never been formed.¹³ For these reasons, not only the guidance of counsel (who are sensitive to these issues) but also the participation of counsel (who may provide an attorney work product or attorney-client privilege protection) is essential.

13. While beyond the scope of this paper, an issue that must be recognized is that there are certain situations in which the creation of an SLC, though technically possible, simply makes no sense because the risks inherent in it are too great to assume. The fact that the Committee conducts an investigation and produces a report always carries with it the possibility that discovery in related litigation will include inquiry into the working of the Committee and disclosure of its work product.

VIII. IT IS THE COMMITTEE'S INVESTIGATION

At the very first meeting, the Committee must decide upon the allocation of responsibility between counsel and Committee. As important as counsel's role is, one thing is certain: The investigation must be that of the Committee, not counsel, if it is to survive scrutiny.¹⁴ Thus, the Committee must establish early some mechanism to meet regularly, perhaps monthly, with counsel. While counsel may make recommendations as to where the investigation should lead, these should be only in the form of suggestions. The Committee members must ratify those suggestions and have ample opportunity to make their own suggestions. If choices are required, those choices must be those of the Committee, not of counsel.

Similarly, while the Committee members presumably do not have the time, inclination, or ability to conduct interviews or search through what are typically thousands of documents, the Committee should establish a mechanism for reporting progress to counsel for evaluating the substance of what is being revealed. There may even be an understanding at this early juncture that, while counsel will do the "grunt work" for the Committee, the Committee itself, before it reaches a final conclusion, will either conduct or observe counsel conducting several key interviews or review key documents that counsel views as pivotal.

The tension here is obvious and inevitable. The more the Committee itself does, the less likely it may be viewed as a privileged undertaking; the less the Committee does, the more likely it is that the investigation will be viewed as a "counsel investigation" and, thus, not entitled to full effect. Good judgment requires that counsel and the Committee, in full recognition of this additional dilemma, reach a balance that makes sense under the circumstances.

14. See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d at 426 (lack of participation by some members "severely limited the exchange of ideas and prevented special committee as a whole from acquiring critical knowledge of essential aspects of purchase"); *In re MAXXAM*, 1997 WL 187317, at *21 (member of committee cannot recall details, opening position or how many registration meetings were held); *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311, 1328 (S.D. Iowa 1981) (substantial participation of committee members in investigation, though advised by special counsel, supported holding that committee itself made reasonable investigation). See also *BRODSY & ADAMSKI*, *supra* note 9, § 9:09 at 42 (although special counsel may make recommendations to committee, active involvement and supervision of investigation by committee is essential).

IX. COMMITTEE INTERVIEWS

Since the Committee's investigation will inevitably include interviews with employees of the corporation, it is wise for the Committee to adopt a protocol as to how these interviews will be conducted. The role of the special litigation committee and the implications of the investigation it conducts are confusing even to the sophisticated. Because the Committee is a committee of the corporate board, and because counsel are employed by the Committee, interviewees may view counsel as their own lawyer and assume the results are confidential, when in fact just the opposite is the case. Lest any interviewee be misled, counsel should draft a protocol speech similar to the one annexed hereto as Appendix B for the Committee, and the SLC should adopt a resolution stating that no interviews will be conducted without the interviewee first hearing "the speech."

X. MINUTES OF COMMITTEE MEETINGS

The question of recording the work of the Committee is also one that counsel and the Committee must explore at the first meeting. It is best, of course, if only official notes of the Committee meeting exist. Individual handwritten notes that reflect different styles and levels of attention can often be grist for the plaintiffs' counsel's deposition mill when the Committee's work meets its inevitable challenge.

Counsel should prepare the official minutes in the expectation that privilege will not attach to them. The minutes should be written in such a way that Committee members can quickly recall what was discussed, without providing the kind of detail that might come back to haunt all if the court determines the minutes are required to be turned over to plaintiffs' counsel. The minutes ought to reflect the fact that the Committee controlled the investigation, yet the writer should purge the minutes of all tentative conclusions or working hypotheses formed along the way. There will be time and opportunity enough to document the work of the Committee and the reasons for its decision when a final report, if any, is written.

The level of detail the author thinks is appropriate is reflected in the hypothetical Committee meeting minutes attached hereto as Appendix C. While the minutes tell the reader who attended and how long the meeting lasted, and give a report on past activities, a preview of future activities, a tentative timetable for completion of the work, and a full discussion of all

these matters, in the final analysis the minutes contain nothing that would provide fodder for plaintiff's counsel.

XI. RELATIONSHIP WITH OTHER INSIDE AND OUTSIDE COUNSEL

Once the board launches the investigation, how does counsel begin? The derivative complaint is a start; thus, counsel can identify some early interviewees and relevant documents at the initial meeting. But the first fact of life that counsel for SLC will quickly learn is that they are dependent on the cooperation of inside counsel and, if there is parallel class-action litigation, counsel for the corporate defendant in that matter. Counsel have no subpoena power, no right to take depositions, no entitlement to see privileged documents, though they probably have free rein otherwise over corporate documents. Counsel also do not want to re-invent the wheel. If counsel wish to review relevant documents and lawyers for the class-action corporate defendant are already gathering the same documents for production to class-action plaintiffs' counsel, it does not make sense for the same corporate entity to pay two different firms to undertake this initial canvassing of corporate records. Thus, counsel for the SLC must to some extent coordinate its work with both of these other counsel.

However, there are two other forces at work that complicate this need to coordinate. First, counsel for the SLC must remain independent and also maintain the appearance of independence from other counsel. Counsel for the SLC should never place themselves in a position in which either inside counsel or counsel for class-action defendants are directing or limiting the scope of the investigation. Suggestions, cooperation, and assistance are appropriate, if not required; meddling, direction, and scope limitations are not. In the foregoing example, then, while it was satisfactory to depend on class-action defense counsel to gather the universe of documents, it would be unacceptable for SLC counsel to accept class-action defense counsel's representation that the documents in a given group were the only relevant ones.

Second, inside counsel and counsel for the class-action defendant are vitally interested in the work of the Committee, and frankly hope that the Committee's work will reach a conclusion favorable to incumbent management. These counsel will express their anxiety in many forms; even

while recognizing fully that they do not want to sully the independence of the Committee, they will be tempted to intervene.

The Committee and SLC counsel must manage this uneasy alliance with diplomacy. Surely the cooperation of regular outside counsel is a treasured thing; there is no reason not to listen to what they have to say. But the investigation should follow a path mandated by the Committee, not general counsel, and Committee members and counsel should keep confidential reports on the course of the investigation, not share them with nervous general counsel who may be putting intense pressure on SLC counsel.

In this context, SLC counsel may and indeed should share with other counsel matters uncovered in the SLC investigation that directly and significantly impact the class-action litigation. Similarly, SLC counsel should share with class-action defense counsel SLC counsel's views on the credibility of witnesses or the likelihood that any particular defense would prevail. After all, counsel are all seeking to act in the best interests of the corporation, which includes mounting the best possible defense to the plaintiff's class action. If SLC counsel has a second opinion or special insights, the parties should encourage an exchange of this information as entirely consistent with counsel's independent role. And if inside counsel has a special need to get an expedited reading from the SLC on a particular charge or employee because of some pressing business reason (for example, a derivative defendant may be about to be promoted to executive vice president and management is attempting to avoid later embarrassment), the parties should agree to communicate that request to the SLC for it to exercise its independent business judgment in balancing the need for independence and the corporation's need for an early answer.

But at the end of the day, while SLC counsel wants to be able to testify that he received full cooperation from these other lawyers, that the corporation granted complete access to documents, that it arranged all interviews that were required, and that other counsel otherwise provided all necessary assistance, SLC counsel also must be able to testify, under what may be the withering cross-examination of derivative plaintiff's counsel, that the Committee was the sole guide for the investigation.

XII. APPEARANCE OF COUNSEL FOR DERIVATIVE PLAINTIFF

Counsel also must decide with the Committee what role plaintiff's deriva-

tive counsel should play in the investigation. After all, it is plaintiff's allegations that are the starting place for the work of the Committee. At a minimum, SLC counsel should invite plaintiff's counsel to submit in writing any presentation plaintiff's counsel wishes the Committee to consider. Though more risky, and perhaps not likely to provide anything more than aesthetics, SLC counsel may invite plaintiff's counsel to meet with SLC counsel or even address the Committee on his or her clients' concerns. The effect of all of this can be quite disarming—it is plaintiff's counsel who may ultimately challenge the Committee's action. Certainly part of that challenge can be blunted if the Committee has considered the views of plaintiff's counsel, and, even more so, if the Committee has followed the leads supplied or suggestions offered by plaintiff's counsel. Moreover, if plaintiff's counsel fails to take advantage of this offer, SLC counsel can feel more comfortable in limiting the investigation to the allegations of the complaint—allegations that are often inartfully crafted and lacking in real substance.

XIII. PROTECTING THE PRIVILEGE

Perhaps the most critical part of the investigation for counsel is dealing with documents that are subject to the attorney-client privilege and attorney work-product doctrine. In the context of an SLC investigation, each of these privileges exists on two different levels. On the first level, there are communications between SLC counsel and the Committee that, if properly handled, qualify for the attorney-client privilege.¹⁵ For example, counsel's opinion to the Committee members on the likelihood of their being deemed independent would come within this doctrine. There is also the work of SLC counsel that—again, if properly handled—should come within the attorney work-product doctrine.¹⁶ Examples of this would in-

15. See, e.g., Dennis J. Block & Nancy E. Barton, *Internal Corporate Investigations: Maintaining the Confidentiality of a Corporate Client's Communications with Investigative Counsel*, 35 BUS. LAW 5, 9-13 (1979) [hereinafter Block & Barton] (attorney-client privilege extends to communications between client and counsel if purpose for retention is legal advice rather than investigation). See also chapter 2, "Attorney-Client Privilege and the Work-Product Doctrine," and chapter 11, "Reporting to Management."

16. See, e.g., Block & Barton, *supra* note 15, at 21-23 (work-product doctrine protects documents prepared by counsel in anticipation of litigation absent de-

clude counsel's interview notes, counsel's analyses of documents and counsel's working hypotheses regarding the possibility that the corporation might have a claim. Because all of this work is conducted in anticipation of litigation (either a motion to have the derivative claim dismissed based on the Committee's work and business judgment or the actual prosecution of a claim on behalf of the corporation), it is not a stretch to argue that the attorney work-product doctrine should apply.

On a second level, there is the review by SLC counsel and the Committee of documents created by other counsel, their experts, or corporate employees that qualify for the attorney-client and/or attorney work product privileges. For example, the SLC counsel may review privileged documents created by general counsel at the time the corporation made an important decision whether to disclose a potentially material fact in filing its report on Form 10-k. Or SLC counsel may review, as part of the SLC investigation, witness notes created by counsel defending the companion class action. Protection of these two privileges is the subject of a separate chapter in this book, and the principles outlined therein apply with equal vigor here. And because counsel for the SLC is simply another counsel for the corporation, SLC counsel's review of the second-level documents subject to the attorney-client and attorney work product privileges should not, if analyzed properly, act as a break or waiver of either.

However, there is one aspect of the SLC investigatory and report process that has special impact on both privileges, at both levels. The Committee must reach a decision. If it is a decision not to proceed with the derivative claim, the SLC must be prepared to demonstrate in some way or other that it reached its decision after a thorough investigation, after numerous interviews, after the review of all relevant documents by an independent committee that met regularly, guided by independent counsel, and, in some jurisdictions, that the decision fits well within the business judgment rule. It also must be prepared to resist an inevitable challenge from the derivative plaintiff's counsel to all of the foregoing. This means that discovery will occur into the work of the Committee and its counsel.

Anticipating the probable scope of this discovery has an inevitable effect on the scope of the Committee's investigation. If the Committee's report mentions a particular document, regardless of its privileged charac-

monstrated substantial need by plaintiff). See also *In re LTV Sec. Litig.*, 89 F.R.D. 595, 620 (N.D. Tex. 1981) (work product of special counsel to audit committee protected because investigation and report required legal acumen and expertise).

ter, derivative plaintiff's counsel certainly will seek and likely receive it in discovery.¹⁷ Similarly, if the Committee relies on privileged material to reach its conclusion, the Committee can expect that plaintiff's counsel will succeed in discovering those documents despite their confidential character. However, mere review of privileged material by counsel for the Committee should not have the effect of acting as a waiver. Nonetheless, all of the foregoing suggests that the SLC and its counsel should take care in deciding what to review.

While it might at first appear that the SLC would benefit from appearing to have had its members or counsel review the universe of available documents, there might be situations in the area of privileged documents where it is better to avoid reviewing them—for example, if the Committee or SLC counsel can elicit factual information in a different way. (Why look at counsel's notes of a key interview when the interviewee can be reinterviewed by SLC counsel?) Moreover, while it is clearly helpful, if not necessary, for counsel to have access to underlying privileged documents as well as privileged documents created in connection with the parallel class-action litigation, counsel does not want this access to result in disclosure to derivative plaintiff's counsel. Thus, SLC counsel must make judgments at every step of the way when it comes to privileged documents—whether SLC counsel should review the documents, whether SLC counsel should share the documents with the Committee, whether the documents should play a role in the conclusions reached by the Committee, and whether the final report should reference the documents.

The fine line that must be drawn is exemplified by *Zitin v. Turley*.¹⁸ After the plaintiffs had filed their derivative suit, the corporation created an SLC to investigate their demands. The SLC (with assistance of counsel) produced a report recommending against the action. The company then used the report as a basis for its summary judgment motion.

The plaintiffs thereafter sought drafts of the report, any documents reviewed in preparing the report, and any communications between counsel

17. See, e.g., *In re Matter of Continental Illinois Sec. Litig.*, 732 F.2d 1302, 1314 (7th Cir. 1984) (report prepared by committee to evaluate derivative claims is discoverable, since it was admitted into evidence to support motion to terminate claims) (citing *Joy v. North*, 692 F.2d 880, 893 (2d Cir. 1982) (committee reports used in adjudicative stages of derivative litigation are discoverable; protected only if confidentiality is maintained)).

18. No. Civ. 89-2061-PHX-CAM, 1991 U.S. Dist. LEXIS 10084 (D. Ariz. June 25, 1991).

and the committee. The court held that all of the documents requested were protected by the attorney-client or work product privileges.¹⁹ However, the court held that by disclosing the report, “the Corporation has waived any claims of privilege and work product immunity to the extent that counsel communicated the information or documents to the committee.”²⁰

*Farber v. Public Service Co.*²¹ is also instructive. In preparation for expected derivative suits, the corporation in *Farber* created an SLC, which then produced a report. The report was subsequently filed in one of the pending derivative suits. The plaintiffs then sought the disclosure of all documents reviewed, the notes of the SLC members, and any communications to or from SLC members. Examining the corporation’s work product claims, the court held that to permit such broad categories of discovery would militate against common sense and undermine the work-product doctrine.²² The court permitted disclosure of any documents reviewed, but protected the SLC members’ notes and the communications to or from SLC members.²³

XIV. THE INVESTIGATION

Describing how the actual investigation should be conducted is about as elusive a topic as how to defend litigation. All investigations are fact-specific, and the conscientious and imaginative lawyer must structure and complete the necessary work in an appropriate manner. Nonetheless, there are a few rules that SLC counsel should apply, given the special characteristics of the SLC and the goal of counsel to see the SLC’s ultimate decision given full effect.

First, since it is known that plaintiff’s counsel will mount an inevitable challenge to the scope of the SLC’s investigation in reaching its decision, it may be that counsel will want to extend its work beyond what the normal cost/benefit analysis might suggest was appropriate in other contexts.²⁴

19. *Id.* at 10-11.

20. *Id.* at 15.

21. Civ. No. 89-0456 JB/WWD, 1991 U.S. Dist. LEXIS 18051 (D.N.M. Apr. 4, 1991).

22. *Id.* at *3.

23. *Id.* at *3-4.

24. *See, e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. Super. Ct. 1981) (under Delaware approach, corporation must prove “reasonable investigation” con-

While it is almost unavoidable that at least one witness will be left un interviewed and one box of documents un reviewed, the ability to say that counsel extended the investigation beyond normal limits could be helpful.

Second, the Committee and SLC counsel should leave no reasonable leads (regardless of their anticipated value) un followed. If witness A insists that witness B was a key participant, it is far better to interview B to put that allegation to rest rather than to reject A's suggestion on the basis of other information available to counsel.

Third, the Committee and SLC counsel should thoroughly investigate and evaluate any information supplied by derivative plaintiff's counsel. There is no more likely challenge to the Committee's work than that plaintiff's counsel's allegations were ignored as part of a "cover-up."

Fourth, if at all possible, the Committee and SLC counsel should interview each derivative claim defendant. Confronting the alleged perpetrators of the injury to the corporation lends a credibility to the investigation that will carry great weight later.

Fifth, SLC counsel should not hesitate to hire an expert to help the Committee evaluate any technical or arcane factual issues that are beyond the expertise of counsel and the Committee members. For example, if the allegation is that pre-release tests should have revealed an inherent defect in a particular product, the SLC should retain an expert to assist with the physics or chemistry in order to enhance its work.²⁵

Finally, it should be remembered that in determining whether it is in the best interests of the corporation to pursue derivative litigation, the Committee must evaluate more than the merits of the claim.²⁶ The Com-

ducted before motion to dismiss will be granted); *Auerbach v. Bennett*, 393 N.E.2d 994, 1000-02 (N.Y. 1979) (under New York approach, court may look at methodologies and procedures of investigation; if restricted in scope, shallow in execution or pro forma, question of good faith raised). The views of Chancellor Allen in *Carlton Invs. v. Beatrice Int'l Holdings, Inc.*, 1997 WL 38130, at *5 (Del. Ch. Jan. 29, 1997) are instructive: "[T]o be reasonable in getting information doesn't mean to be perfectly informed," even if the investigation does not locate a "smoking gun."

25. Experts should meet the test of independence as well. See *Kahn v. Tremont*, 694 A.2d 422, 426 (Del. 1997) (challenge to an investment adviser to a special transaction committee who had earned fees from affiliates of majority shareholder).

26. See, e.g., *Auerbach*, 393 N.E.2d at 1002 (decision to file suit involves "weighing and balancing legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of ...corporate problems."). See also *Abella v.*

mittee also must add into the equation (a) the likely disruption to the corporation that will result from such a suit going forward, and (b) the likely recovery to the corporation if the corporation were successful. With respect to the former, the investigation should focus on the value of the putative defendants to the ongoing operations of the business, the effect of pursuing the litigation on the putative defendants' ability to continue to operate as effective officers or directors, and the effect on other employees' morale of the corporation's suing the putative defendants. With respect to the latter, the investigation must explore the likely cost in legal fees, expert witnesses, and other litigation costs to pursue the claim; the personal wealth of the putative defendants; and the availability of insurance coverage for any of the claims. The Committee or SLC counsel should explore each of these matters independently.

XV. CONCLUSION

The Special Litigation Committee investigation is one of the more challenging and gratifying assignments counsel can be retained to undertake. From start to finish, the tasks involved must be undertaken with conscientious and finely honed skills, ever mindful of the traps for the unwary that lie at every step along the way. If successfully completed, the result will permit the SLC to implement fully its well-considered decision as to how the Corporation should treat a derivative claim whose initial filing was undoubtedly met with a mixture of scorn and dismay. Counsel who fulfill the assignment conscientiously will have empowered the client in a meaningful way, acting in the finest traditions of the profession.

Universal Leaf Tobacco Co., 546 F. Supp. 795, 801 n.3 (E.D. Va. 1982) (factors considered in weighing costs against benefits included large attorney's fees, loss of time and energy by management, reduction in morale of employees and management, adverse consequences to insurance coverage, and adverse reaction by customers, banker, and stock market). *Cf. Joy*, 692 F.2d at 892 (court may initially weigh attorney's fees, expenses of litigation, and mandatory indemnification of directors and officers, but may not consider existence of insurance; if court then finds no substantial net return compared to shareholder's equity, court may consider impact to key personnel and lost profits from trial publicity).

APPENDIX A

Resolution Establishing a Special Litigation Committee

WHEREAS a class action has been instituted against the Company, its present and former directors and officers as well as a derivative action on behalf of the Company against the same present and former directors and officers; and

WHEREAS it would be proper for the Board of Directors of the Company to delegate to a Special Litigation Committee the responsibility for determining whether it is in the best interests of the Company to pursue any of the claims alleged in the derivative action;

NOW THEREFORE, the following resolution is adopted by the Board of Directors of the Company:

RESOLVED that, pursuant to the Bylaws of the Company, a Special Litigation Committee shall be appointed by the Executive Committee to be ratified by the full Board of Directors; further, it is

RESOLVED that the Special Litigation Committee is authorized to exercise all lawful authority of the Board of Directors in determining what action, if any, the Company should take with respect to the above-referenced derivative litigation and any similar suits that have been or may be filed on the Company's behalf.

APPENDIX B

Advice to Witnesses

As you may know, litigation has been instituted against the Company by a shareholder purporting to represent a class claiming that the Company overstated earnings in the years 1984 and 1985, thereby allegedly defrauding shareholders who bought the Company's stock in those years. The Company's Board of Directors has now received a demand from a shareholder of the Company requesting that the Company institute litigation against those who were already responsible for the alleged overstatement of earnings. A derivative lawsuit on behalf of the Company has also been filed that makes the same demand to recover from these individuals any damages the Company may be forced to pay in the class action.

Because the decision to institute litigation is, like any other business action, subject to the business judgment of the Board, and because some of the present Board members were on the Board at the time of the allegedly inflated earnings reports, the Board has delegated to a three-member Committee of the Board, all of whom joined the Board since 1986, the decision whether it is in the best interests of the Company to pursue litigation against anyone for any conduct associated with these financial statements.

In reaching its decision, the Committee will investigate the facts and circumstances surrounding the issuance of the financial statements to determine whether those in positions of responsibility properly fulfilled their duties in issuing the financial statements. The Committee, of course, recognizes that disclosures that were made in good faith and involved no actionable conduct may appear incorrect with the benefit of hindsight. On the other hand, it is the responsibility of the Committee to determine whether all concerned acted in a manner consistent with their duties to the corporation and its shareholders.

The Committee, in turn, has retained our law firm to be counsel to the Committee to assist the Committee in the conduct of its investigation. It is in that role that we have asked for an opportunity to interview you. It is important that you understand that our firm neither represents the Company generally nor do we represent you. Our only client is the three-member independent Committee to whom we shall report the results of this, as well as our other interviews, so that the Committee can fulfill its important responsibilities.

APPENDIX C

Confidential Attorney-Client and Attorney Work Product Privilege

Minutes of the Special Litigation Committee Meeting of June 1, 2001.

The Special Litigation Committee of X Corporation met on June 1, 2001. All members of the Special Litigation Committee were present as well as Michael Burns and Bobbi Miller, counsel to the Committee. The Chairman of the Committee asked Mr. Burns to keep the minutes of the meeting.

1. The minutes of the previous meeting were reviewed and approved.
2. Counsel reported on the most recent interviews with the Controller and the Chief Financial Officer of the Company. The Committee discussed whether the Committee ought to meet with the CFO at some future date.
3. A review of the due diligence files of the Company conducted by counsel for the Special Litigation Committee was described.
4. Counsel shared her research into the independence of the members of the Special Litigation Committee.
5. A preliminary investigation by counsel into questions of available coverage under the Company's Directors and Officers Liability policy was discussed.
6. A preliminary chronology of key events was circulated.
7. Counsel provided members of the Committee with a schedule of upcoming interviews as well as an explanation of why counsel had selected this particular order for the interviews.
8. Counsel explained the basis for their fees for the last month and a budget for completing counsel's work was discussed.

The next meeting of the Committee was scheduled for July 17, 2001.