Discovery Issues Arising From a Special Litigation Committee’s Decision to Recommend Dismissal of a Shareholder Derivative Lawsuit

By Josh Roseman

I. Introduction

Texas Business Corporation Act article 5.14 authorizes shareholder derivative proceedings whereby a shareholder may bring an action on behalf of a corporation to redress an alleged injury to the corporation.1 Like most jurisdictions, Texas allows boards of directors faced with a shareholder derivative proceeding to appoint a Special Litigation Committee (“SLC”) of independent directors. A SLC is empowered with authority to investigate the merits of the shareholder’s claims and make a recommendation to the court as to whether the lawsuit is in the best interests of the corporation and should or should not be dismissed.2

If a SLC moves to dismiss a shareholder’s case, the law allows the shareholder some limited fact discovery into whether the SLC was independent, investigated in good faith and used reasonable procedures. Because the SLC is a tool for corporations to avert meritless lawsuits with relatively little expense and burden, at the dismissal stage of the lawsuit a plaintiff is prohibited from obtaining any merits discovery.

This arrangement creates some thorny discovery issues. For example, what happens when the plaintiff seeks discovery that speaks both to the threshold SLC procedures and also to the substance of the plaintiff’s claims? Likewise, when the SLC consults outside attorneys to assist in investigating a claim and making a dismissal recommendation, may that counsel assert the attorney-client privilege and work product protections against the plaintiff who, as a shareholder of the corporation, is arguably the “client” of the SLC’s attorneys? This article attempts to shed some light on some of these issues.

II. Framework of a Shareholder Derivative Proceeding

Article 5.14 was revised in 1997 as part of the effort to harmonize the law of business organizations and is based on the 1990 version of the Revised Model Business Corporation Act.3 Under article 5.14, a shareholder has standing to bring a derivative action as long as he is a shareholder at the time he brings the suit and remains a shareholder during the suit.4 However, the duty to manage the business of the corporation belongs to its board of directors, not to the individual shareholders. Accordingly, a shareholder who believes that an actionable wrong has been committed against the corporation cannot sue derivatively unless he first makes a written demand on the corporation and gives the board of directors an opportunity to pursue the claim.5 The shareholder may proceed with his derivative action only after the shorter of the corporation’s refusal of the demand or 90 days.6

A SLC is an important tool for corporations in defending against shareholder derivative suits.7 First, the appointment of a SLC, at the very least, buys the corporation some time because derivative proceedings are commonly stayed while the SLC investigates. More importantly, however, if the SLC determines after investigation that the derivative proceeding is not in the best interests of the corporation, the SLC can recommend that the lawsuit be dismissed.

Thus, the Texas Business Corporation Act provides for bifurcated judicial process when a corporation uses a SLC to investigate a shareholder’s claims. The first stage consists of a judicial review of the SLC’s recommendation to dismiss. The lawsuit progresses to the second stage—consideration of the merits—only if the court gives no deference to the SLC’s recommendation and denies the corporation’s motion to dismiss.

III. The Standard a Texas For Reviewing a SLC’s Recommendation to Dismiss

A SLC’s recommendation of dismissal is subject to different levels of judicial scrutiny depending on the jurisdiction. The three levels of judicial scrutiny can be characterized as: (1) the business judgment rule approach; (2) the Zapata approach; and, (3) the “reasonable and principled” standard.

Under the business judgment rule approach, the trial court reviews the SLC’s decision under the ubiquitous business judgment rule. Under this approach, the court asks only whether the com-
mittee members acted independently, in good faith and reasonably. If the court answers affirmatively, the SLC’s recommendation is adopted and the shareholder's action is dismissed without further inquiry. The Fifth and Ninth Circuit Courts of Appeals and the state courts of New York follow this approach.8

Elsewhere, the Zapata approach appears to be the majority rule and stems from a 1981 Delaware decision, Zapata Corp. v. Mal- donado, 430 A.2d 779-80 (Del. 1981). The courts following the Zapata approach adopt the business judgment rule described above and ask whether the SLC is independent and investigated in good faith and reasonably. These courts, however, take an extra step and seek to determine whether the SLC’s factual findings support the SLC’s decision to terminate the lawsuit. Under this approach, the court is said to apply its own “independent business judgment” to determine whether dismissal is appropriate. This “second step” is intended to “thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where the corporation's actions would simply prematurely terminate a stockholder's grievance deserving of further consideration in the corporation's interest.”9 Jurisdictions following this approach include the Second, Fourth, Seventh, Ninth and Eleventh Circuit Courts of Appeals.10

A third approach, the “reasonable and principled” approach, attempts to strike a balance between the business judgment rule and Zapata approaches. This approach simply asks whether the SLC reached a “reasonable and principled” decision.11 Factors considered under this test include the likelihood of a judgment in the plaintiff’s favor; the expected recovery as compared to out-of-pocket costs; whether the corporation itself took corrective action; whether the balance of corporate interests warrants dismissal; and, whether the dismissal would allow a defendant who has control of the corporation to retain a significant improper benefit.12

Under Texas Business Corporation Act article 5.14(F), “a court shall dismiss a derivative proceeding” if the SLC finds that the derivative proceeding is not in the best interests of the corporation and the SLC (1) is independent; (2) makes its determination in good faith; and (3) conducts a reasonable inquiry.13 Furthermore, the Act provides that if the SLC is independent, the burden is on the shareholder plaintiff to prove that the SLC did not act in good faith or reasonably. These courts, however, take an extra step and seek to determine whether the SLC’s factual findings support the SLC’s decision to terminate the lawsuit. Under this approach, the court is said to apply its own “independent business judgment” to determine whether dismissal is appropriate. This “second step” is intended to “thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where the corporation's actions would simply prematurely terminate a stockholder's grievance deserving of further consideration in the corporation's interest.”9 Jurisdictions following this approach include the Second, Fourth, Seventh, Ninth and Eleventh Circuit Courts of Appeals.10

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Accordingly, regardless of what level of judicial review a court ultimately applies to a SLC’s recommendation, the shareholder must prove—and is entitled to discovery regarding—that the SLC was not independent and disinterested, did not make its determination in good faith, or did not follow reasonable procedures. But in practice, determining exactly what discovery a plaintiff is entitled to is no easy task.

A. Distinguish Between Discovery on the SLC’s Procedures and Discovery on the Merits

The line between full discovery on the merits and discovery relating to the SLC’s procedures in deciding to dismiss the case often is a blurry one. This is because one way of attacking the reasonableness and good faith of a SLC’s decision is to take full discovery over all ground covered by the committee and all facts covered by the complaint in an effort to see what holes, if any, can be found in the committee’s approach.17 Accordingly, the courts have struggled with where to draw the line.

On one hand, the courts have recognized that if a derivative plaintiff is to be permitted full discovery of his case under the guise
of making a record in opposition to a motion to dismiss brought by a special litigation committee, there is no point having a special litigation committee in the first place. Thus, courts have held that at the dismissal stage, the plaintiff is not entitled to take full court authorized discovery of the same matters investigated informally by the SLC and to then compare the one against the other in order to test for good faith and reasonableness. Accordingly, these courts have refused, for example, to allow plaintiffs to depose the people that the SLC interviewed and other key fact witnesses.

On the other hand, a SLC fails to conduct an investigation in good faith when it “plays softball” with witnesses or otherwise fails to “zealously” investigate claims. An investigation is said to not be in good faith when “the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or half-hearted as to constitute a pretext or sham.” Under this standard, a compelling argument can be made that for a plaintiff to prove lack of good faith, it must do exactly what the courts have expressly refused to permit them to do—to take full discovery of the same matters investigated informally by the committee and to then compare the one against the other in order to test for good faith and reasonableness.

Knowing which witnesses a SLC spoke to is helpful, for example, but without actually deposing those witnesses regarding the substance of their testimony there is simply no way for the plaintiff to be sure that the SLC did not “play softball” with that witness or otherwise conduct a pro forma investigation, possibly ignoring “smoking guns” in the witness’s statement. Knowing which documents a SLC considered is likewise helpful but without being able to inspect the actual documents reviewed by the SLC, there is no way for the plaintiff to know whether the SLC’s consideration of that document amounted to anything more than, for example, criticizing the author’s handwriting.

Not surprisingly, the law is fairly unsettled as to exactly what discovery is and is not allowed at the dismissal stage of a shareholder derivative proceeding. For the most part, the following can be gleaned from the case law.

- **SLC Report:** Typically, the shareholders are entitled to obtain a copy of the SLC’s report and drafts of the report.

- **Witness interview materials:** Courts are split on whether to allow a plaintiff to obtain transcripts of witness interviews, notes and summaries of interviews, and pre-interview outlines. One camp holds that such discovery is necessary “to assess whether the SLC pursued its charge with diligence and zeal” while the other camp disallows such discovery as too broad and speaking to the merits.

- **Documents made available to the SLC:** Courts are likewise split on whether to allow a plaintiff shareholder to obtain copies of any documents relied upon by the SLC.

- **Depositions of SLC members and SLC’s counsel:** Plaintiffs are generally entitled to depose SLC members, but not the SLC’s attorneys.

- **Minutes of the SLC’s meetings and the corporation’s meeting appointing the SLC:** Courts typically have no problem ordering the discovery of the minutes of the SLC’s meetings and the corporation’s meetings appointing the SLC.

**B. The Applicability of the Attorney-Client Privilege and Work-Product Protection**

The bifurcated SLC process in a shareholder derivative proceeding raises a host of muddy legal issues related to discovery privileges and protections. Typically, a SLC will retain its own outside counsel to help it investigate a plaintiff’s claim and make its recommendation regarding dismissal. Accordingly, much of the discovery that a plaintiff seeks related to the SLC’s good faith investigation will implicate matters involving communications between the SLC’s attorneys and the SLC and/or the SLC’s attorneys’ work product. Yet, the applicability of the attorney-client privilege and/or work product protection in this regard is problematic and has been largely unaddressed in the case law.

The SLC’s counsel represents not only the SLC, but the corporation as a whole. Accordingly, courts have suggested that the shareholder plaintiff may be considered the “client” of the SLC’s counsel such that communications between a SLC’s counsel and the SLC may not enjoy the full protection of the attorney/client privilege to the extent that it is asserted against the plaintiff in a shareholder derivative suit. The American Law Institute, conversely, has taken the position that all communications between a SLC and its counsel are privileged, reasoning that “the special counsel has undertaken to serve only a narrowly defined client—the disinterested members of the board, or a litigation committee—and counsel’s communications uniquely relate to the appraisal of the pending litigation.”

In any case, if a communication between a SLC’s counsel and the SLC is otherwise privileged, it may be subject to disclosure upon a showing of “good cause.” In the context of a shareholder derivative suit, factors tending to show good cause include: the number of shareholders and percentage of stock they represent; the bona fides of the shareholders; whether the shareholder’s claim is obviously colorable; the necessity or desirability of the information and its availability from other sources; whether the communication related to past or prospective actions; whether the communication concerns advice regarding the litigation itself; the extent to which the shareholders may be blindly fishing; and the risk of revelation of trade secrets or other confidential information.

A different analysis applies with respect to the work product protection. The “good cause” exception exists with respect to the attorney-client privilege because there exists a “mutuality of inter-
est" between the defendant corporation and the plaintiff shareholders with respect to communications from the corporation's attorneys. But once there is sufficient anticipation of litigation to trigger the work product immunity, this mutuality is destroyed and the "good cause" exception no longer applies. Accordingly, the SLC's work product will enjoy typical protections — near absolute protection for "core" or "opinion" work product reflecting the attorneys' mental impressions, theories and conclusions, and qualified protection for "non-core" work product that does not reflect the attorneys' mental impressions.

V. Conclusion

After a SLC in a shareholder derivative lawsuit recommends dismissal of the plaintiff's lawsuit, the plaintiff will attempt to obtain as much discovery as possible regarding the SLC's decision. In Texas, that discovery should be limited to those matters reflecting whether the SLC was not independent and disinterested, did not make its determination in good faith, or did not follow reasonable procedures. Because a fine line exists between discovery related to only the SLC's procedures, on the one hand, and full blown merits discovery on the other, it is very difficult to determine what specific discovery a plaintiff in a shareholder derivative lawsuit can expect to be allowed. The courts consistently allow discovery that does not speak to the merits; consistently prohibit discovery that does speak to the merits; and, consistently remain inconsistent regarding discovery that speaks both to the merits and to the SLC's procedures.

ENDNOTES

4. See, e.g., Zuber v. Murray Sav. Ass'ns, 591 S.W.2d 932, 937 (Tex. Civ. App.—Dallas 1979, ref. n.r.e. per curiam), 601 S.W.2d 940 (Tex. 1980) (a shareholder must remain a shareholder to have standing to bring a derivative suit, but a shareholder's standing will not be destroyed where a corporation takes act to destroy the shareholder's standing without a valid business purpose).
6. Id.
7. There exist few reported cases wherein a special litigation committee was appointed and decided not to recommend dismissal of the plaintiff's lawsuit. See, e.g., Kaplan v. Patz, M arwick, M ichell & Co., 529 A.2d 254, 256 (Del. Ch. 1987); Joy v. North, 622 F.2d 880 (2nd Cir. 1982).
12. Id.
14. Id.
15. 2 PRINCIPLES OF CORPORATE GOVERNANCE § 7.13, cmt. c (2001) ("It would defeat the purpose of the SLC procedure if the plaintiff could stretch out the proceeding or otherwise engage in fishing expeditions through expansive discovery requests that made a low-cost settlement preferable to the corporation"); see Genzer v. Cunningham, 498 F. Supp. 682, 683 (E.D. Mich. 1980) (allowing discovery on the merits).
18. Id.
21. See, e.g., Peeler v. The Southern Co., 707 F. Supp. 525, 529 (N.D. Ga.1988), aff'd 911 F.2d 1532 (11th Cir.1990) ("the conduct of the interviews is a most important factor in determining whether the ILC pursued its charge with diligence and zeal, or whether it played softball with critical players. Plaintiff has not been given an opportunity to review the annotated summaries of the interviews"); Weiser, 683 N.Y.S.2d at 785 ("it is impossible for the Court to assess whether the SLC pursued its charge with diligence and zeal, if the Court is unable to review the factual record that underlies the Revisited Report.").
23. Id.
29. Kaplan, 529 A.2d at 256.
31. Saparoff, Special Litigation Committee: Not Universally Effective Tools, American Law Institute, SEB2 ALI-ABA 723 (2000) ("The SLC should consult with legal counsel to provide legal advice to the committee and to aid in its factual investigation").
32. Weiser, 683 N.Y.S.2d at 785.
33. Id. (because the "SLC's counsel represents both the SLC and the corporation as a whole (e.g., the plaintiff shareholders),...the attorney-client privilege would not bar discovery of all communications between counsel and the SLC"); see also Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970) ("good cause" exception to attorney-client privilege exists in derivative action because the privilege may not be asserted by the attorney against the client); Zimm v. WLI Corp., 621 A.2d 773, 761-2 (Del. Sup. Ct. 1993) (if legal advice relates to a matter which becomes the subject of the suit by shareholders against corporation, privilege may be restricted or denied); Riggins Nat' Bank of Washington D.C. v. Zimmer, 355 A.2d 709 (Del. Ch. 1976) (trustee cannot assert attorney client privilege against beneficiaries of trust because memorandum was prepared for the benefit of the trust beneficiaries, the client).
34. 2 PRINCIPLES OF CORPORATE GOVERNANCE § 7.13 (2000).
35. Id. cmt. e. Even the American Law Institute recognizes, however, that a corporation or SLC cannot rely on legal advice of counsel that an action is not meritorious as a ground for dismissing a plaintiff's lawsuit and then deny the plaintiff access to that legal opinion. Id.
36. Garner, 430F.2d at 1103.
37. Weiser, 683 N.Y.S.2d at 787; Garner, 430F.2d at 1103.
38. See Garner, 430 F.2d at 1103; In re International Systems and Controls Corp., 693 F.2d 1235, 1239-41 (5th Cir. 1982).
39. In re International, 693 F.2d at 1239-41; In re Dayco Corp., 99 F.R.D. 616, 620 (S.D. Ohio 1983); but see Weiser, 683 N.Y.S.2d at 787 (applying "good cause" exception to SLC's counsel's work product).
40. Id.