

Zapata and Special Litigation Committees:
Perspectives on What's Working, What's Not,
and How We Can Improve the Process

Weinberg Center for Corporate Governance

April 11, 2024

Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981)Overview of Zapata

- Key Question: can an authorized board committee be permitted to cause litigation to be dismissed when it was properly initiated by a derivative stockholder in his own right?
- 8 *Del. C.* § 141(a) is the source of a board’s managerial decision-making authority, which encompasses decisions of whether to initiate, or refrain from initiating, litigation.
- 8 *Del. C.* § 141(c) permits a board to delegate its authority to a committee.
- The right to delegate to a committee of the Board to “exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation” is an absolute statutory right (except to amend the charter or bylaws, adopting merger agt., recommending sale of substantially all of the corporation’s assets, recommending dissolution and, when not authorized by charter, bylaws or resolutions, to declare a dividend or issue stock)
- No statutory restriction on timing or circumstances surrounding the formation of the committee

Overview of Zapata

- Distinction between Demand Refusal cases and Demand Excused cases.
- Court of Chancery Rule 23.1 is about board member disqualification, it does not expressly or implicitly strip a board of its statutorily-granted managerial authority under § 141(a).
- Competing Interests:
 - Bona fide derivative actions v. “meritless or harmful litigation and strike suits”
 - Whether to adhere to the Business Judgment Rule in connection with the SLC’s determination given the unique context in which SLCs are formed
- Conclusion: “We steer a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to unbridled plaintiff stockholder control.... We recognize that “[t]he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many **factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal.**”

Zapata cont.

- "After an objective and thorough investigation of a derivative suit, an independent committee may cause its corporation to file a pretrial motion to dismiss in the Court of Chancery. **The basis of the motion is the best interests of the corporation, as determined by the committee.**"
- "The Court should apply a **two-step test** to the motion:
- "**First**, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions.
- The **second step** provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted."
- The second step is "purely discretionary" – *Kahn v. Kolberg Kravis Roberts Co., LP*, 23 A.3d 831 (Del. 2011)

Forming an SLC post-MTD

- Issue: whether it is appropriate to form an SLC after a derivative plaintiff survived dismissal under Rule 23.1.
- Zapata states Rule 23.1 is about member disqualification, not the Board's statutory authority to form committees.
- “So deeply rooted is the concept that the board of directors should control the conduct of corporate litigation that a vestige of that authority survives even a judicial finding that demand is excused or has been wrongfully refused.” Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 11.05[a] (2023).

Forming an SLC post-MTD

- *Kaufman v. Beal*, 1983 WL 20295 (Del. Ch. Feb. 25, 1983)
 - Derivative action that challenged the compensation paid to the company's officers and awards granted to key employees.
 - After the awards claim survived dismissal, the Court stated:

“Nothing in this opinion should be construed, however, as prohibiting the current Phibro Board from establishing a special litigation committee to consider the plaintiffs' surviving claims. Because the Board is under a disability as to these claims, such action would be permissible under 8 *Del. C.* § 141 and the rule announced by the Delaware Supreme Court in *Zapata Corp. v. Maldonado*[.]” *Id.* at *9.

Forming an SLC post-MTD

- *In re InfoUSA, Inc. S'holders Litig.*, 2008 WL 762482 (Del. Ch. Mar. 17, 2008)
 - Plaintiffs opposed granting a special litigation committee's motion to stay arguing, among other things, that the SLC formed after certain claims survived dismissal was formed "too late."
 - Chancellor Chandler determined plaintiffs' too late argument "misses the mark."
 - The Chancellor granted the SLC's motion to stay reasoning "[t]he fact that I have already determined demand is excused demonstrates why the board *must* act by means of a committee[.]"

Whether to Grant a “Stay”

- *Pompeo v. Hefner*, 1983 WL 20284, at *2-3 (Del. Ch. Mar. 23, 1983) (recognizing the superior authority of the independent arm of the board to investigate the corporation’s claims in the first instance and concluding plaintiffs’ discovery must be held in abeyance).
- *Katell v. Morgan Stanley Gp., Inc.*, 1993 WL 390525, at *3 (Del. Ch. Sept. 27, 1993) (finding that unless the constitution of an SLC gives rise to a conclusive presumption that the SLC lacks independence, Delaware law requires all proceedings in the action be stayed pending the SLC’s investigation).

Whether to Grant a “Stay”

- *Biondi v. Scrushy*, 820 A.2d 1148, 1165-66 (Del. Ch. 2003)
 - “[T]he general rule that a stay should issue is subject to exception in an atypical case when, based on the undisputed facts in the stay motion record, the committee's later decision to terminate the litigation could not command respect under *Zapata*.”
 - The Court called it an “easy call” to deny the stay because the SLC’s chairman made a public announcement that a report vindicated the defendant at a time when the SLC’s investigation was just underway.

Whether to Grant a “Stay”

- *Carlton Inv. v. TLC Beatrice Int’l Hldgs., Inc.*, 1996 WL 33167168 (Del. Ch. June 6, 1996)
 - Competing Interests:
 - Company - Section 141; interfering with the SLC’s investigation; and costs associated with potentially funding both sets of discovery.
 - Plaintiff - large stockholder; SLC formed 18-months after the complaint was filed; a previous stay was granted in connection with settlement negotiations; and plaintiff was in the middle of discovery after surviving a complex MTD.
 - Conclusion: stay not granted.

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Plaintiff Perspectives

HAS ZAPATA'S "BALANCING POINT" BEEN FORGOTTEN?

- *Zapata's* fundamental purpose was to achieve balance between efficient elimination of abusive strike suits and meritless claims, and **preservation** of meritorious claims warranting judicial review.
- *Zapata* seeks "**a balancing point** where **bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled** on by the board of directors, but the **corporation can rid itself of detrimental litigation.**" *Zapata* at 787.
 - "[I]f corporations are unable to rid themselves of **meritless harmful litigation and strike suits**, the derivative action, created to benefit the corporation, will produce the opposite, unintended result." *Id.* at 786.
 - "[I]f corporations can **consistently wrest bona fide derivative actions** away from well-meaning derivative plaintiffs through the use of the committee mechanism, **the derivative suit will lose much, if not all, of its generally-recognized effectiveness** as an intra-corporate means of policing boards of directors." *Id.*

SLC INVESTIGATIONS MUST INSTILL CONFIDENCE BY DEMONSTRATING OPEN-MINDEDNESS, DILIGENCE, AND EFFECTIVENESS

- “[W]e must be mindful that **directors are passing judgment on fellow directors** in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. **The question naturally arises whether a ‘there but for the grace of God go I’ empathy might not play a role.** And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient **safeguard against abuse, perhaps subconscious abuse.**” *Zapata* at 787.
- “[I]f the ‘committee behaves in a manner that is inconsistent with the duty to carefully and open-mindedly investigate the alleged wrongdoing, **its ability to instill confidence is, at best, compromised and, at worst, inutile.**”
 - Justice Valihura’s dissent in *Diep v. Trimaran Pollo Partners, L.L.C.*, 280 A.3d 133, 159 (Del. 2022) (quoting *Biondi v. Scrushy*, 820 A.2d 1148, 1156 (Del. Ch. 2023))
- An SLC “**must investigate all theories of recovery**” and “**should explore all relevant facts and sources of information** that bear on the central allegations of the complaint.” *London v. Tyrrell*, 2010 WL 877258, at *17 (Del. Ch. Mar. 11, 2010).

CONTEXT MATTERS

- *Zapata's* faithful application requires courts to consider the ***type of claim being investigated***.
 - Has the case overcome a Rule 23.1 and/or 12(b)(6) motion?
 - Has the case presented credible allegations of wrongdoing deserving of adversarial discovery, placing witnesses under oath, and/or judicial review?
 - *E.g.*, is it an entire fairness controller self-dealing transaction case, or a “gotcha” compensation case with no possibility of moving to dismiss?
 - *E.g.*, is it an oversight case where a corporate trauma is theoretically possible in the future, or one where a corporation agreed to huge civil/criminal fines and penalties following a years-long investigation by the DOJ or another government agency?
- *Zapata's* second prong can be analogized to the “give/get” analysis in a settlement approval context:
 - When an SLC moves to terminate, it is obtaining ***nothing*** for the Company in exchange for releasing the claim
 - All give, no get (other than a large bill for the SLC's investigation)

ZAPATA'S SUMMARY JUDGMENT STANDARD

- “Zapata’s first prong is subject to a **summary judgment standard**....To terminate derivative litigation, the SLC must show, and the court must be satisfied, that **no disputed issues of material fact exist** about the independence, good faith, and reasonableness of the SLC's investigation.” *Diep*, 280 A.3d at 149.
- Under a summary judgment standard, “the Court must view the evidence, and all reasonable inferences taken therefrom, **in the light most favorable to the non-moving party.**” *Acro Extrusion Corp. v. Cunningham*, 810 A.2d 345, 347 (Del. 2002).

ZAPATA'S SUMMARY JUDGMENT STANDARD (CONT'D)

- The context of an SLC motion to terminate makes the faithful application of Rule 56 standards particularly important.
- Consider this disparity on an SLC motion to terminate:

SLC Gets:	Plaintiff Gets:	Plaintiff Does NOT Get:
Full document discovery and access to witnesses	14,000-word answering brief	Equal document discovery as SLC
Report with no word limit	Responsive argument at hearing	Depositions / access to witnesses
14,000-word opening brief		
8,000-word reply brief		
Opportunity to speak first and last		
Opportunity to introduce live testimony?		

THE SUMMARY JUDGMENT STANDARD (CONT'D)

- Faithfully applied, the Rule 56 summary judgment standard **should** mitigate the disparity:
 - Plaintiff need not establish an egregious failure or obvious misstep to overcome a motion to terminate
 - Plaintiff need only establish a single material fact issue regarding the investigation's scope, diligence, reasonableness, or independence
- Was the summary judgment standard faithfully applied in *Baker Hughes*, a **controller entire fairness case** that survived a Rule 23.1/12(b)(6) motion to dismiss, where:
 - The SLC member backchanneled with a key investigation target about the investigation via text message and email?
 - The SLC failed to obtain text messages despite possessing evidence of substantive text messaging?
 - The SLC admittedly failed to identify financial advisor conflicts?

WHAT TO DO: STRATEGIES THAT ENHANCE THE INVESTIGATION'S EFFECTIVENESS AND INSTILL CONFIDENCE

- **Leverage Plaintiff Counsel's Expertise:**
 - Share “core” documents with plaintiff's counsel
 - Collaborate on investigation parameters
 - Provide baseline information (e.g., relevant board/committee minutes, advisor presentations, etc.) with which to help diagnose and identify investigational avenues
 - Collaborate with plaintiff's counsel regarding party / third-party discovery sources, custodians, and search terms
 - Strategize with plaintiff's counsel regarding who to interview, and what to explore in interviews
 - Consider allowing plaintiff's counsel to attend certain or all interviews and suggest/ask questions
 - Include plaintiff's counsel in discussions with financial experts
- **This is a costless force multiplier for the SLC**

WHAT TO DO... (CONT'D)

- **Foster Transparency and Trust:**

- Produce to plaintiff's counsel all documents produced to the SLC
 - This is costless
 - Can occur under Rule 510(f) non-waiver stipulation
 - Mitigates risk/perception of strategic curation or cherry-picking, based upon what the SLC ultimately chooses to “rely upon”
 - “Instills confidence” that a full-throated investigation took place and that the report does not simply document a pre-determined termination recommendation
- Transcribe witness interviews
 - Minimal cost (especially relative to total SLC investigation costs)
 - Potentially **reduces** costs by obviating lawyer-drafted witness interview memoranda
 - Allows SLC, Plaintiff, and the Court to meaningfully analyze interview substance and compare to other evidence
 - Incentivizes thorough and diligent interviews (e.g., using documents and asking follow-ups) rather than box-checking “pow-wow” sessions
- Invite plaintiff's counsel's informed, record-based assessment of derivative claims' strength and value

WHAT NOT TO DO: CONDUCT THAT ERODES TRANSPARENCY AND EFFECTIVENESS, AND UNDERMINES CONFIDENCE

- **Don't** functionally exclude plaintiff's counsel from the process
 - Don't refuse to share even "core" documents
 - Don't refuse to provide any insight into investigation beyond statistical "greatest hits" (e.g., total docs collected, total interviews conducted, etc.)
 - Don't provide only documents "relied upon" by SLC in reaching its (termination) recommendation
- **Don't** forgo critical discovery sources:
 - Text messages
 - WeChat (see *Lao v. Dalian Wanda*)
 - Discovery from third-parties (use the subpoena power!)
- **Don't** conduct unsworn, unrecorded interviews
 - Don't give the witness the answer key before the test (see *Baker Hughes*)
- **Don't** intentionally insulate the process from plaintiff / Court scrutiny
 - Don't use attorney-client privilege as a shield behind which to hide material relevant to the claims/investigation (see *Baker Hughes*)

II. Company Perspectives

SLC NOT ALWAYS BENEFICIAL FROM COMPANY PERSPECTIVE

- May need to add additional board members
- Protracts litigation
- More people to pay
 - SLC
 - SLC lawyers
 - Experts
 - Other vendors
- Give up control of litigation – no guarantee that SLC moves to terminate
- No guarantee that Court accepts SLC's decision (2004 Oracle case)

COMPANY'S INTERESTS BEYOND LITIGATING MERITORIOUS CLAIMS

- “Like a fleet of trucks or a factory, a lawsuit is a corporate asset that must be managed by the board consistent with its fiduciary duties.” *In re Baker Hughes, a GE Co., Deriv. Litig.*, 2023 WL 2967780, at *9 (Del. Ch. Apr. 17, 2023), *aff’d*, *In re Hughes*, 2024 WL 371962 (Del. Feb 1. 2024) (TABLE) (quoting *Diep v. Trimaran Pollo P’rs, L.L.C.*, 280 A.3d 133, 149 (Del. 2022)).
- “Even if there were some potential for a positive monetary recovery, the SLC was not obligated to pursue the litigation if its good faith judgment indicated that doing so was not best for the corporation. . . .The whole point of recognizing the board’s authority and responsibility in this context is to allow the board’s judgment concerning what is in the long-run best interest of the corporation to be acted upon.” *In re Baker Hughes, a GE Co., Deriv. Litig.*, 2023 WL 2967780, at *29 (Del. Ch. Apr. 17, 2023), *aff’d*, *In re Hughes*, 2024 WL 371962 (Del. Feb 1. 2024) (TABLE).
- Costs of litigating – advancement/indemnification (“monetary costs”)
- Negative publicity (“reputational costs”)
- Distraction – time and resources (“operational costs”)
- Need to move on and reset