June 3, 2010

The Special Litigation Committee Defense in California: Specially Detrimental to Shareholders

Thomas Doniger

Available at: https://works.bepress.com/thomas_doniger/1/
I

INTRODUCTION AND SUMMARY OF THE ARTICLE

The Special Litigation Committee ("SLC") defense is an affirmative defense frequently relied upon by corporate directors when charged, in a derivative action, with misappropriation of corporate assets or waste. The SLC defense allows such defendant directors to themselves appoint a Special Litigation Committee of the board of directors who will determine whether it is in the best interests of the corporation to prosecute the shareholder claims against the defendant directors. If the SLC determines that it is not in the best interests of the corporation that the claims against the defendant directors be prosecuted, the corporation then moves for summary judgment based upon the SLC report. Such motions by the corporation are usually granted by the court.

The defendant directors, in effect, select and/or appoint their own jury from among their fellow board members. The Special Litigation Committee is thus the "only instance in American jurisprudence where a defendant can free itself from a suit by merely appointing a committee to review the allegations of the complaint." Einhorn v. Culea, 235 Wis.2d 646 (2000). As the New York Times notes, "many such committees, convened by boards in response
to accusations of impropriety at their companies, often seem most interested in whitewashing questionable actions.” [1]

In recent years, the reports of officers’ and directors’ receipt of unearned and outrageous compensation in the forms of salary, bonus, stock, “golden parachutes” and warrants (some back dated) have appeared on an almost daily basis in the newspapers. [2] One such example, recently reported in the New York Times, described the severance package for Citigroup’s CEO, to which shareholders objected:

As a thank-you present for running the bank [Citibank] into the ground, the board gave Mr. Prince a parting gift valued at $12.5 million. Yes, you read that correctly, $12.5 Million. That exit bonus was on top of the $68 million he received in stock and options he had accumulated over his many years at the company; and an office, car and driver for up to five years.

***

A couple of intrepid shareholders sued Citigroup’s directors over the payment and several other questionable decisions. A Delaware judge dismissed most of their complaints, ruling that the board was protected by something called the “business judgment rule.” [1]

The SLC defense, based upon the Business Judgment Rule, has proven to be an effective barrier against shareholder redress for such activity and, as a result, the threat of a shareholder derivative action has apparently had little, if any, deterrent effect.
The SLC defense to derivative claims is usually asserted by the corporation in the procedural form of a motion for summary judgment based upon an SLC report (adopted by the board), concluding that it is not in the best interests of the corporation that the derivative claims against defendant directors be pursued. In California, the courts have applied the SLC defense to afford directors, charged with misappropriating corporate assets, a far greater measure of protection from shareholder derivative claims than is available in almost every other state. This greater protection is created by the anomalous standard under which California courts, on summary judgment, review an SLC determination that derivative claims should be dismissed in the “best interests” of the corporation. The California summary judgment standard is, perhaps, the most deferential in the country to such SLC determinations to dismiss derivative claims. [3]

This article will first review the short history of the SLC defense in California, focusing on the legal analysis by which the anomalous California summary judgment standard was developed in the Court of Appeal. Second, this article will compare the California standard for review of SLC determinations on summary judgment with the “Business Judgment Rule” in order to determine whether directors sitting on an SLC are held by California courts to the minimum standard for director performance codified in the California Corporations Code. Finally, this article will argue that the California standard for review of SLC determinations does not provide shareholders with legally mandated or adequate protection and suggest an alternative standard.
II

A BRIEF HISTORY OF THE SLC DEFENSE

The SLC defense was first recognized in California in Finley v. Superior Court, 80 Cal. App. 4th 1152, 96 Cal. Rptr.2d 128 (2000, hereinafter “Finley”). At the time Finley reached the Court of Appeal, there were two leading cases in the United States on the formulation of the SLC defense and most of the other states, which recognized the SLC defense, had adopted the formulation in one of them. [4] The “New York Rule” is derived from Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979, hereinafter “Auerbach”). The “Delaware Rule” is derived from Zapata v. Maldonado, 430 A.2d 779 (Del. 1981, hereinafter “Zapata”).

A. The New York Rule.

Auerbach was a derivative action brought by shareholders against directors, based upon the company’s payment of bribes and kickbacks to foreign and domestic officials, seeking an accounting for such payments. In Auerbach, the derivative claims did not charge self-dealing or breach of the director’s duty of loyalty to the corporation; rather breach of the duty of care, in allowing kickbacks and bribes to be paid, was alleged. The company, GT&E, formed an SLC, consisting of three directors who did not sit on the board at the time the questioned payments were made. The SLC determined that it would not be in the best interests [5] of the corporation for the derivative action to proceed and the corporation moved to dismiss the derivative complaint and for summary judgment. The motions, based upon the SLC report, were granted by the court. The Auerbach court first considered the effect of the Business Judgment Rule upon
the scope of its review of the SLC determination that it was not in the best interests of the corporation to pursue the derivative claims.

“It appears to us that the business judgment doctrine, at least in part, is grounded on the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments.”

***

“Derivative claims against corporate directors belong to the corporation itself. As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation’s board of directors. Necessarily such decision must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calculated to protect and advance the interests of the corporation. This is the essence of the responsibility and role of the board of directors, and courts may not intrude to interfere.”

***

“The business judgment rule does not foreclose inquiry by the courts into the disinterested independence of those members of the board chosen by it to make the corporate decision on its behalf – here the members of the special litigation committee. Indeed the rule shields the deliberations and conclusions of the chosen representatives of the board only if they possess a disinterested
independence and do not stand in a dual relation which prevents an unprejudicial
exercise of judgment.” (Citation). Auerbach, 47 N.Y. 2d at 630 – 632

The Auerbach court found that no triable issue was raised as to the independence and
disinterested status of the GT&E SLC. This element of the test or standard of review used by
courts to review an SLC determination on summary judgment will be referred to as the
“independence” test or element. There is a second element to the test used by most courts to
review SLC decisions on summary judgment which will be referred to here as the “adequacy”
test or element. This test examines, in a limited fashion, the adequacy of the SLC’s investigation
of the derivative claims. The Auerbach court formulated the adequacy test as follows:

“As to the methodologies and procedures best suited to the conduct of an
investigation of facts and the determination of legal liability, the courts are well
equipped by long and continuing experience and practice to make determinations.
In fact they are better qualified in this regard than are corporate directors in
general. Nor do the determinations to be made in the adoption of procedures
partake of the nuances or special perceptions or comprehensions of business
judgment or corporate activities or interests. The question is solely how
appropriately to set about to gather the pertinent data.”

***
“... those responsible for the procedures by which the business judgment is reached may reasonably be required to show that they have pursued their chosen investigative methods in good faith. ... [the SLC] may be expected to show that the areas and subjects to be examined are reasonably complete and there has been a good-faith pursuit of inquiry into such areas and subjects. Proof, however, that the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or halfhearted as to constitute a pretext or sham, consistent with the principles underlying the application of the business judgment doctrine would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine.” Auerbach, 47 N.Y. 2d at 634.

Thus, the New York Rule incorporates three elements in the test by which the court reviews a motion for summary judgment based upon an SLC report recommending that derivative claims be dismissed. First, the members of the SLC must be “independent”– not subject to influences which could affect their evaluation of the derivative claims or the decision as to whether it is in the interests of the corporation to pursue such claims. Second, the SLC must conduct an “adequate” investigation of the derivative claims – the committee must have selected and employed investigative methodologies and procedures appropriate to the claims alleged and pursued those until the areas and subjects to be examined are reasonably complete. Third, an “adequate” investigation must be pursued by the SLC in “good faith”.
B. The Delaware Rule.

The Delaware Rule arose in a different factual setting than that in *Auerbach*. Plaintiff shareholder sued the sitting directors of Zapata Corporation for issuing false and misleading proxy materials leading to their election to the board of directors. These were allegations of self-dealing and breach of the duty of loyalty, as opposed to the allegations in *Auerbach* of breach of the duty of care. A committee of the board, consisting of new members, was selected and concluded that the derivative claims should be dismissed. The corporation then moved to dismiss the derivative claims based upon the committee’s report. The *Zapata* court established the following standard under which it reviewed the corporation’s motion:

“The corporation should bear the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the court determines either that the committee is not independent or has not shown reasonable basis for its conclusions, or, if the court is not satisfied for other reasons relating to the process, including, but not limited to, the good faith of the committee, the court shall deny the corporation’s motion.

If, however, the court is satisfied under Rule 56 standards that the committee was independent and showed reasonable basis for good faith
findings and recommendations, the court may proceed, in its discretion, to the next step.

The second step provides, we believe, the essential key in striking a balance between legitimate corporate claims as expressed in the derivative stockholder suit and the corporation’s best interest as expressed by any independent investigating committee. The court should determine, applying its own independent business judgment, whether the motion should be granted. This means, of course, that instances could arise where a committee can establish its independence and sound basis for its good faith decisions and still have the corporation’s motion denied.” Zapata, 430 A.2d 779, 788-789 (1981).

Thus, the Delaware Rule also requires independence, adequacy (expressed as “reasonableness” of the investigation) and good faith. But Zapata also expressly allows the court, employing its own “independent business judgment”, to determine whether the corporation’s motion should be granted – even if it finds that the other elements of the test have been satisfied. The Delaware Rule is, thus, more protective of shareholder rights than the New York Rule.
III

CALIFORNIA’S ADOPTION OF THE SLC DEFENSE

The Special Litigation Committee defense was first approved by the California Court of Appeal in Finley, 80 Cal. App. 4th.1152, 96 Cal. Rptr.2d 128 (2000). In Finley, plaintiff homeowners challenged their homeowners associations’ use of assessments to make contributions to political action committees in a derivative action. The defendant associations answered the complaint asserting, as affirmative defenses, the Business Judgment Rule and that prosecution of the action was not in the best interests of the associations. Plaintiffs then moved for summary judgment and sought a preliminary injunction. Defendants moved to bifurcate and try first the SLC defense. The plaintiffs’ motions were denied and the defendants’ motion granted by the trial court.

By writ petition and appeal, the issues arrived in the California Court of Appeal for decision. The Finley court held as follows:

“Plaintiffs’ primary argument is that a special litigation committee defense has not been recognized, and should not be recognized, in California. Plaintiffs waived this contention by failing to raise it below. As an alternative ground, however, and because this issue seems likely to loom large on remand, we hold that the special litigation committee defense is legally valid in California.” Finley, 80 Cal. App. 4th at 1158.
Thus, the issue as to whether the defense could be asserted in California reached the Court of Appeal as a pleading issue. The record on appeal raised no issues as to the application or elements of the defense and was entirely devoid of evidence as to such issues. Nevertheless, the Court of Appeal reviewed the out-of-state authorities as to application of the SLC defense, describing the New York Rule as the majority rule and the Delaware Rule as the minority rule. The Finley court thus approved the SLC defense but did not decide which version of the defense would be adopted in California – an issue not before the court.

The Finley court also reviewed, in some depth, the earlier decision in Will v. Engebretson & Co., 213 Cal. App.3d 1033, 261 Cal. Rptr. 868 (1989, hereinafter “Will”) which had also considered the SLC Defense. The Finley court stated that the Will court’s ruling: “implicitly but necessarily means the [SLC] defense may in fact be asserted” and that “[w]hat the Will court did decline to decide was which version of the defense may be asserted – the majority (and Model Act) “one step” version [New York Rule], in which the court decides only whether the committee was disinterested, acted in good faith, and investigated adequately, or the minority “two step” version [Delaware Rule], in which the court must additionally apply its own business judgment. Under Will, however, the special litigation committee defense, in some form, is valid in California.” Finley at 1161.

Will was a derivative action brought by a shareholder alleging breach of fiduciary duty by the directors in awarding excessive compensation to themselves to the detriment
of the minority shareholders. The trial court dismissed the suit “under the ‘business judgment rule’ after a compensation committee appointed by the corporation’s board of directors determined that it was in the best interests of the corporation to terminate the lawsuit.” Will, 213 Cal. App.3d at 1035. The Will trial court considered the SLC defense in a “hybrid dismissal” motion involving a “good faith hearing”. Id. at 1038. On appeal, the court held that the “judgment must be reversed on procedural grounds”, finding that “[b]y thrusting itself into the shoes of the trier of fact, the trial court here exceeded its function under the summary judgment statute.” Will, 213 Cal.App.3d at 1039, 1044. Due to the procedural basis for the Will court’s decision, it, like the Finley court, did not consider the elements or application of the SLC defense, despite an invitation to do so from the plaintiff.

“Relying on [Zapata], Will contends the motion for summary judgment should have been denied because the failure to allow judicial scrutiny of the substantive decisions of “special litigation committees” (such as the compensation committee here) will mean the death of the derivative suit, especially in close corporations. We need not address that issue, however, because the judgment must be reversed on procedural grounds.” Will, 213 Cal.App.3d at 1040.

The Finley court also considered certain Ninth Circuit authorities, finding such “[d]ecisions of the federal courts interpreting California law, although not binding on us, are persuasive.” Finley at 1160. “The Ninth Circuit, however, has twice held that the
California Supreme Court would recognize the [SLC] defense.” Id. These decisions, Gaines v. Houghton, 645 F.2d 761, 770–772 (9th Cir 1981, hereinafter “Gaines”) and Lewis v. Anderson, 615 F.2d 778, 782–783 (9th Cir. 1979, hereinafter “Lewis”) cert. den. 449 U.S. 869, 101 S. Ct. 206, 66 L. Ed. 2d 89, did not address the elements or application of the SLC defense.

Thus, neither Finley itself nor the California and federal authorities it relied upon to approve the SLC defense had occasion to delineate the elements or application of the SLC defense under California law. This task was first undertaken by the court of appeal in Desaigoudar v. Meyercord, 108 Cal. App.4th 173, 133 Cal. Rptr. 408 (2003, hereinafter “Desaigoudar”).

IV

THE CALIFORNIA STANDARD FOR
REVIEW OF SUMMARY JUDGMENT
MOTIONS BASED UPON THE SLC DEFENSE

In Desaigoudar, the plaintiff shareholders brought a derivative action against eight of the officers and directors of California Micro Devices Corporation (“CMD”), alleging that they wasted corporate assets and breached their fiduciary duty. The gravamen of the claim was that the defendants had, while the company was under some financial duress, decided to sell CMD’s interest in another company (CellAccess) in order to raise cash and reduce expenses and that, shortly after the sale of CMD’s 56% interest in CellAccess,
CellAccess was acquired in a stock-for-stock transaction. Had CMD retained its interest in CellAccess, it would have had an interest worth $20M in the acquiring company but instead received only $1.6M for a warrant it received as consideration for the sale of its interest.

The derivative claims alleged breach of the duty of care in not adequately investigating the value of the interest in CellAccess sold by CMD, although the plaintiffs also alleged that “defendants had concealed or misrepresented to the shareholders that they had disposed of corporate assets for less than fair market value in order to increase earnings for the pertinent fiscal quarter and thereby secure shareholder approval of stock options for themselves”. Desaigoudar, 108 Cal. App.4th at 180. This latter allegation appears to be designed to characterize the alleged conduct as self-dealing claims in breach of the duty of loyalty. Such claims are sometimes seen as lending more credibility to a plaintiff’s contention that “demand futility” exists, thereby excusing the requirement that a derivative plaintiff make demand on a conflicted board to pursue the claims before filing a derivative suit. The gravamen of the Desaigoudar complaint appears to sound in breach of the duty of care – and not self-dealing.

CMD formed a special litigation committee consisting of two new members of the board of directors. The SLC concluded that pursuit of the derivative claims was, among other things, “wholly opposed to the best interests of CMD.” Desaigoudar, 108 Cal. App.4th at 181. CMD and the individual defendants moved for summary judgment on the basis of the SLC Report and the trial court granted the motion, first stating:
“Plaintiffs have failed to present evidence sufficient to raise a triable issue of fact with respect to whether or not the members of the Special Litigation Committee, J. Daniel McCranie and Donald L. Waite, were ‘disinterested’ or whether or not the Special Litigation Committee conducted an ‘adequate’ investigation of the claims presented in the Amended Complaint.... Will v. Engebretson & Co. (1989) 213 Cal.App.3d 1033, 261 Cal.Rptr. 868 [(Will)].” Desaigoudar, 108 Cal.App. 4th at 182.

On the summary judgment motion, the moving defendants submitted the SLC’s 103 page report, and declarations of each of the SLC members and the SLC’s separate counsel. This evidence was held to have shown that the SLC members were qualified for their positions and had conducted an investigation which included interviews of 18 witnesses with personal knowledge of the challenged transactions and facts relevant to the derivative claims, had reviewed 25,000 pages of documents and had made significant inquiry into the financial circumstances of CMD at the time of the challenged sale. Desaigoudar, 108 Cal.App.4th at 193-194. In response, the plaintiffs submitted only two declarations which failed to address the relevant issues and were “procedurally and substantively deficient.” Desaigoudar, 108 Cal.App.4th at 195. “Plaintiff’s separate statement failed to reference any evidence, at all. In any event, the two declarations that plaintiffs submitted did not meet the issues.” Id.

On this evidentiary record, the standard adopted by the court under which to review the defendants’ motion for summary judgment mattered very little. In the absence
of any admissible and relevant evidence submitted in opposition to the defendants’
motion, the defendants could prevail almost regardless of the standard adopted by the
court. More importantly, in an adversary system of civil justice, such a record does not
provide an optimal basis to determine, for the first time in a court of record, the elements
and application of the SLC defense. Undaunted by the lack of necessity to do so, the
Desaigoudar court delineated the SLC defense for the first time, despite an evidentiary
record which could present no triable issues of fact to be determined under any standard.

The Desaigoudar court, evidently aware that it was making new law for California
and writing on a tabula rasa, began at the beginning – explicating the nature of the
derivative action. Noting that it is the corporation which has standing and the right to sue
when it suffers an injury to its property, the Desaigoudar court explained that a
shareholder may file a derivative action when the corporation fails to pursue redress for
an injury to its property. Desaigoudar, 108 Cal.App.4th at 183. Next, the Desaigoudar
court sought to explain the “business judgment rule,” first noting that this principle is
“premised on the notion that management of the corporation is best left to those to whom
it has been entrusted, not the courts.” Desaigoudar, 108 Cal.App.4th at 183. The court
explained the rule as follows:

“The rule requires judicial deference to the business judgment of corporate
directors so long as there is no fraud or breach of trust, and no conflict of
interest exists. (Citations.) The rule has been codified in Corporations
Code section 309, which requires a director to perform “in good faith, in a
manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.”

The court’s two statements of the “Business Judgment Rule” above are problematic for at least two reasons. First, the two standards described above by the Desaigoudar court are very different – Corp. Code section 309 is not a codification of the rule first stated, as Desaigoudar asserts. Business judgment rule deference to director decisions by a court premised on the mere absence of fraud, breach of trust and conflict of interest is a standard far lower than that required under the Corporations Code. Section 309 requires more than the absence of tortious conduct by the director, it requires performance in good faith, in a manner the director believes to be in the best interests of the corporation and its shareholders and holds the director to an objective standard of conduct – an ordinary, prudent director in like position and circumstances, including a duty of reasonable inquiry.

The second respect in which the Desaigoudar court’s statements of the “business judgment rule” are problematic is that the court failed to identify and distinguish between two distinct aspects of the “Business Judgment Rule”. The business judgment rule is sometimes a principle of deference to the decisions of directors. [citation] However, as enacted in the Corporations Code, it is a minimum standard of conduct for directors, below which a director will incur civil liability.
“(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interest of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.”

***

“(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person’s obligations as a director.” Cal. Corp. Code §309.

Next, the Desaigoudar court explained the interplay between the “demand requirement,” codified in Corp. Code section 800, imposed upon shareholders, and the right to bring a derivative action.

“Unless there are reasons for not doing so, a shareholder must first demand that the company’s board of directors pursue the proposed action before the shareholder may undertake the prosecution of a derivative claim.

***
Although the business judgment rule protects a board’s good faith decision to reject a derivative lawsuit, the board cannot avail itself of the protection of the rule if a majority of the board has a personal interest in the outcome. Therefore, when the shareholder alleges wrongdoing on the part of a majority of directors, as plaintiffs have alleged in this case, the common practice is for the board to appoint a special litigation committee of independent directors to investigate the challenged transaction. The parties do not dispute that a decision of a special litigation committee not to prosecute a lawsuit, like the decision of the full board, is a defense to a shareholder’s derivative action in California. “Desaigoudar, 118 Cal.App.4th at 184-185.

With this preface, the Desaigoudar court then considered adoption of each of the two variants of the SLC defense, as exemplified by Auerbach and Zapata. Desaigoudar, 108 Cal.App.4th at 185-190. The Desaigoudar court reviewed the California authorities, acknowledging that Will “expressly declined to decide the question” of whether the New York Rule or the Delaware Rule should be adopted in California. Desaigoudar, 108 Cal.Rptr. at 186. The court then found that “[i]n effect, Finley held that the substance of the derivative claim [subject to judicial “independent judgment’ only under the Delaware Rule] was not an element of the defense. We agree with that conclusion.” Id. However, Finley did not so hold, and could not have, because that issue was not presented on appeal. Indeed, not only were the elements of the SLC defense not considered in the trial
court below, the *Finley* plaintiffs had failed to raise below the issue as to whether the defense was recognized in California. *Finley*, 80 Cal.App.4th at 1158.

Nevertheless, the *Desaigoudar* court announced that it would adopt the New York Rule, as stated in *Auerbach*, based, at least in part, upon the purported authority of *Finley*. Ironically, *Auerbach*, like *Desaigoudar*, reached its court of record on a factual record “devoid of any affidavits or documentary evidence in opposition to the motion for summary judgment.” *Auerbach*, 47 N.Y.2d 619, 635, 393 N.E. 2d 994, 1003. After review of the two dominant views of the SLC defense, the *Desaigoudar* court held as follows:

“... When the special litigation committee defense reaches the trial court on summary judgment, traditional summary judgment rules apply. Although plaintiffs suggest that the trial court should have made a factual finding on the merits of the underlying lawsuit, on summary judgment our trial courts may not make findings of fact, but are limited to determining the existence of a factual dispute. This is in contrast with the Chancery Courts of Delaware, which under *Zapata* are permitted to make factual findings. As was held in *Will*, an evidentiary hearing on the special litigation committee defense is insufficient to protect plaintiffs’ interests. (Ibid.) Therefore, if a trial court detects a factual dispute concerning the independence of the special litigation
committee or the adequacy of its investigation, the case may not be dismissed short of trial.’” Desaigoudar, 108 Cal.App.4th at 189-190.

The Desaigoudar court’s suggestion that the Delaware courts, operating under Zapata, are permitted “to make factual findings”– invoking the “hybrid dismissal” procedure rejected by Will – is incorrect. The suggestion is apparently offered as a rationale to reject, without significant analysis, the Delaware Rule on the ground that Will had already decided that such a procedure, involving “factual findings,” was incompatible with California law. However, the Delaware Rule, as stated in Zapata, does not provide for the procedure rejected in Will and, in fact, provides for a summary judgment procedure no different than that in Auerbach. Zapata departs from Auerbach only in allowing the Delaware equity courts to refuse to grant summary judgment and dismiss the derivative claims if, in the exercise of the court’s own business judgment, justice would be so served. However, the summary judgment aspect of the Zapata procedure complies with F.R.Civ..P. 56, as the decision states. Thus, the Desaigoudar court’s rationale for immediately rejecting the Delaware Rule does not bear scrutiny.

The above Desaigoudar ruling was sufficient to address the “question presented” on the appeal: “1. In considering the defense motion for summary judgment, which was brought on the basis of the special litigation defense, was the trial court required to consider the merits of the derivative claim?” Desaigoudar, 108 Cal.App.4th at 182. Recognizing the limited scope of the issue presented, the Desaigoudar court’s core ruling was first similarly limited: “The trial court therefore did not err in failing to consider the
merits of plaintiffs’ derivative claim.” Desaigoudar, 108 Cal.App.4th at 190. The question presented did not require that the court consider and explicate the operation of the New York Rule, in holding that it would be adopted in lieu of the Delaware Rule.

However, the Desaigoudar court went further and altered the New York Rule as applied in California. In so doing, it departed from the statements of the Rule, albeit in dicta, of earlier California decisions and even Auerbach itself – and did so on a record which never raised, and presumably, never briefed, the issue. The alteration in the New York Rule occurred with respect to the elements of adequacy of investigation and good faith. Auerbach is relatively clear that the SLC must: (1) be comprised of independent directors; (2) have conducted an adequate investigation; and (3) have acted in good faith, if the corporation’s motion for summary judgment is to be granted.

“The business judgment rule does not foreclose inquiry by the courts into the disinterested independence of those members of the board chosen by it to make the corporate decision on its behalf – here the members of the special litigation committee.” Auerbach, 47 N.Y. 2d at 631.

“As to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are well equipped by long and continuing experience and practice to make determinations. In fact they are better qualified in this regard than are corporate directors in general. Nor do the determinations to be made in the
adoption of procedures partake of the nuances or special perceptions or comprehensions of business judgment or corporate activities or interests.....” Auerbach, 47 N.Y. 2d at 634.

... At the same time those responsible for the procedures by which the business judgment is reached may reasonably be required to show that they have pursued their chosen investigative methods in good faith.... The latter [corporate representatives] may be expected to show that the areas and subjects to be examined are reasonably complete and that there has been a good-faith pursuit of inquiry into such areas and subjects.” Auerbach, 47 N.Y. 2d at 634.

Similarly, Finley, in quoting Will and federal authorities, referred to the above three elements under the New York Rule – “‘However, courts which have considered the issue have concluded that judicial review of the independence, good faith, and investigative techniques of a special litigation committee is governed by traditional summary judgment standards.’” Finley, 80 Cal.App.4th 1152, 1160-1161; accord, Everest Investors 8 v. McNeil & Partners, 114 Cal.App.4th 411, 432, 8 Cal.Rptr.3d 31,46 (2003) [quoting Finley above].

The formulation of the test by the Desaigoudar court departed from the above three element test by reducing the separate element of adequacy of investigation into a test for good faith.
“The second question – whether a committee employed proper procedures before rejecting the claim – involves an analysis of the committee’s good faith. This means that the court must look into the procedures employed and determine whether they were adequate or whether they were so inadequate as to suggest fraud or bad faith. That is, “[p]roof ... that the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or halfhearted as to constitute a pretext or sham, consistent with the principles underlying the application the business judgment doctrine, would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine. (Auerbach, supra, 47 N.Y.2d at pp. 634-635)” Desaigoudar, 108 Cal.App.4th at 188-189.

Under Desaigoudar, the court examines the investigative methodology of the SLC – not to see if it is objectively adequate – but to see if it “suggests” bad faith. The three element test on summary judgment, which included a sole objective element of “adequacy,” has become, under Desaigoudar, a test consisting of two subjective elements: (1) Were the SLC members independent; and (2) Was the SLC investigation of the derivative claims so inadequate as to suggest bad faith. In delineating this new standard, it appears that the Desaigoudar court confused the Business Judgment Rule principle of judicial deference to corporate action with the Corp. Code Section 309 standard of director conduct which imposes an objective standard for director’s conduct.
The California Supreme Court denied a petition for review in Desaigoudar and the Desaigoudar “good faith” standard has been approved and applied in unpublished opinions by other districts of the Court of Appeal. Neisar v. Zantaz, Inc. 2007 WL 2330789 (Case no. A111448, Court of Appeal, 1st District, August 16, 2007); Stella v. Western Security Bancorp 2007 WL 3018849 (Case no. B 191874, Second District, October 17, 2007). As it did in Desaigoudar, the California Supreme Court denied review in both Neisar and Stella, and has yet to issue an opinion approving the SLC defense or defining its elements.

V

SOME PROBLEMS WITH THE DESAIGOUDAR STANDARD

The SLC defense represents a compromise between two competing policies, the first of which is the principle of judicial deference to the decisions of corporate directors, sometimes referred to as the “Business Judgment Rule.” The second policy accommodated by the SLC defense is the interest of corporate shareholders to protect the property of the corporation by exercise of the right to bring a shareholder derivative action. These two policies, which embody competing principles with respect to control of the corporation, are most in conflict when shareholders claim that the property of the corporation has been misappropriated by the directors. It is this circumstance which the SLC defense is designed, in part, to address.
The New York and Delaware Rules represent different points on the continuum of compromise between director and shareholder control over the right to assert or extinguish derivative claims. The Delaware Rule vests more control in the shareholders and makes it more difficult for the directors to obtain dismissal of the derivative claims. The New York Rule is more favorable to the directors, making it easier for the directors to obtain dismissal of such claims. The Desaigoudar standard is even more favorable to directors and detrimental to shareholders than the New York Rule – and is at odds with the standard employed in almost every other jurisdiction. [3]


Although the SLC defense may be asserted at trial, it is usually presented on motion for summary judgment, as reflected in the reported decisions. Further, the summary judgment motion, based upon the SLC affirmative defense, is often presented very early in the action for tactical reasons beneficial to the defendant directors. Once the SLC defense has been pleaded, or the motion based thereon has been filed, the defendant directors often move for a stay of all discovery until the SLC issues its report and, if the SLC report recommends dismissal of the claims, a stay of all discovery which is unrelated to the corporation’s motion for summary judgment based on the SLC affirmative defense. Such a motion for a stay is appealing to the court for several reasons. First, if the SLC recommends that the corporation pursue the derivative claims, the corporation may become the true plaintiff (replacing the derivative shareholder
plaintiffs) and should then have control over the discovery. Second, if the SLC recommends that the derivative claims not be pursued, the granting of the motion is still economically efficient – it obviates the necessity that the parties spend money on the full spectrum of discovery on the issues raised by the pleadings until it becomes clear that all such issues will be tried. As noted in Desaigoudar, the scope of the issues to be decided on a motion for summary judgment based upon the SLC defense is far narrower than the scope of the issues raised by the pleadings.

“Unlike the usual summary judgment motion, the issues to be decided on a motion based upon the special litigation committee defense are not those framed by the pleadings. Rather, as we explained above, the issues are the independence of the committee members and the adequacy of their investigation. While we think it is beyond question that a plaintiff ought to be permitted discovery on these issues in order to meet the defendant’s [summary judgment] motion, it is up to the party to request it.”


At trial, assuming the “Business Judgment Rule” affirmative defense was available to the defendants, the defendant directors would have to prove that they performed in accordance with §309 in order to escape liability. This proof would entail the following elements: (1) good faith; (2) performance in a manner which the director believes to be in the best interest of the corporation and its shareholders; and (3) performance with such care, including reasonable inquiry, as an ordinarily prudent person
in like position would use under similar circumstances. Yet under the SLC defense, on
summary judgment, the SLC members are held only to the Desaigoudar subjective
requirements of “independence” and “good faith”. [6]

Thus, the SLC defense has the initial effect of preventing the plaintiffs from
conducting discovery on the transactions which provoked the complaint in the first place,
limiting discovery, when and if permitted, to the narrow issues made relevant by the SLC
defense. Only in the rare instance where the defendants’ motion for summary judgment
on the SLC defense fails, will the plaintiffs ever be allowed to conduct discovery as to the
challenged transactions which form the gravamen of the derivative claims.

As formulated under the New York Rule, the judicial standard for deciding a
corporations’s motion for summary judgment requires that the court decide whether a
triable issue of fact has been raised as to: (1) the independence of the SLC members; (2)
the adequacy of the SLC investigation of the derivative claims; and (3) the good faith of
the SLC members in conducting the investigation. This standard, even as usually
formulated, suffers from several defects. First, while objective phenomena may be
directly observed and measured, subjective phenomena may not. By eliminating the
objective “adequacy” element from the test by which the court decides a corporation’s
summary judgment motion, the Desaigoudar court created an entirely subjective test
consisting only of “independence” and “good faith”.

28
The first and third elements are subjective in nature and therefore difficult to measure. [7] “Independence” and “good faith” each refer to the state of mind of two to three individual members of the committee. It is, of course, possible or even likely that the several members of the SLC will have different subjective states of mind as to either or both of “independence” and “good faith.” Thus, application of these two elements of the test may involve judicial measure of the subjective states of mind of two or more individuals as to two separate subjects. How is this to be done? Must all members of the SLC possess the requisite state of mind? Is a majority of the members sufficient?

1. Independence.

“Independence” has been defined in several cases, generally to the same effect. Desaigoudar describes this state of mind of an SLC member as being “‘in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences.’” (citations.) Desaigoudar, 108 Cal.App.4th at 189. [8] Thus, the court is called upon to determine whether each SLC member is subject to any of a host of thoughts and feelings, including loyalty to the defendants, social pressure through mutual friends, gratitude for the appointment to the board, envy, collegiality, and friendship, to name a only a few, in addition to any economic influences or relationships. [9] The Desaigoudar court, which found the two members of the SLC to be “independent”, did so on the following evidence in the form of declarations:
“[The two members of the SLC] each declared that they had no personal
interest in the outcome of the litigation. Neither had any significant
business dealings with any of the defendants, the company, or its
executive management, and neither had had significant social contact
with the defendants or CMD’s executive management.” Desai

In short, “independence” boiled down to an absence of “significant” business
dealings and social contacts with the defendants or the executives of the corporation. It is
not clear from the decision itself whether the court accepted the declarants’ conclusion
that their dealings and contacts were not “significant” or whether the court itself so
concluded, after reviewing the SLC members’ declarations regarding such dealings and
contracts. While the decision is clear that the SLC members had not had “significant”
social contacts with the defendants, it is not clear as to whether the absence of
“significant” business dealings with the defendants described only the then-current
relationships or applied historically, as well. No explication of the distinction between
“significant” and insignificant contacts and dealings is offered by the court. The
Desai
goudar declarations of the SLC members also do not appear even to address their
compensation for serving on the SLC. Thus, under Desai
goudar, there is little definition
or guidance as to how the presence of a triable issue of fact with respect to the subjective
state of mind of independence will be determined by the court.
2. Good Faith.

While the Desaigoudar opinion addresses, to a limited extent, the evidence adduced on the “independence” element of the test, it does not specifically refer to any evidence directly adduced on the “good faith” of the SLC members. The court did address the evidence of the “adequacy” of the SLC’s investigation, concluding that “[w]ith the forgoing facts defendants met their burden of producing evidence to establish the independence of the Committee and the appropriateness of its investigation.” Desaigoudar, 108 Cal.App.4th at 194. Thus, Desaigoudar provides no insight into the methodology for identifying and measuring “good faith” other than review of the “adequacy” of the investigation. Nor does the decision inform as to the measure or scale by which the court will determine when the level of adequacy falls to a level which “suggests” an absence of good faith, less fraud.

“Good faith” is defined as “honesty of intention and freedom from knowledge of circumstances which ought to put the holder upon inquiry” and “an honest intention to abstain from taking any unconscientious advantage of another, even through technicalities of law, together with absence of all information, notice, or benefit or belief of facts which render transaction unconscientious.” Black’s Law Dictionary (4th ed. 1968). A court cannot observe or measure “intention” as it can conduct. At best, what may be indirect evidence of this state of mind can be observed. However, such indirect evidence is subject to manipulation and control by the parties to the litigation and their counsel.
On summary judgment under the Desaigoudar standard, the court must decide: (1) Did the derivative plaintiffs’ evidence raise a triable issue of fact as to the “independence” of each SLC member’s state of mind? (2) Did the derivative plaintiffs’ evidence raise a triable issue of fact sufficient to “suggest” a bad faith or fraudulent state of mind on the part of each SLC member? The nature of the evidence which the court will receive for this purpose will be less than revelatory on these issues. In most cases, the court will receive the SLC report which is written by counsel for the SLC and declarations of the SLC members, sometimes quite perfunctory, also written by attorneys for the SLC. The SLC members will never appear in court, may or may not be deposed and, if deposed, may claim the lawyer/client privilege for the committee’s communications in the presence of counsel. In addition, the court may receive evidence submitted by the derivative plaintiffs as to the SLC members’ states of mind. It is from this indirect evidence, primarily written by lawyers, that the court is to peer into the minds of the SLC members to learn their true intentions toward the defendants who appointed them to sit as their judges – usually for generous compensation. Thus, the Desaigoudar standard relies upon indirect and less reliable evidence to determine whether the derivative plaintiffs will even be allowed a day in court to address the merits of their claims.
B. The Desaigoudar Standard Permits a Court to Sanction And Give Effect To An SLC Determination By An SLC Whose Performance Has Not Met The Minimum Standard For Director Performance.

The Desaigoudar standard is applied in a factual circumstance in which human experience suggests that judicial review of the board’s selection of an SLC and the SLC’s determination should be most rigorous, not least. In the common circumstance in which directors are charged, in a derivative action, with misappropriating corporate assets through the receipt of unjustified and unearned compensation (in its myriad corporate forms), the jeopardy of the defendant directors is high for several reasons. First, the Business Judgment Rule affirmative defense will not be available to them in the underlying derivative action because it may not be invoked as a defense to self-dealing claims. [10] Second, it will be relatively easier for an insurance company to deny such directors an insurance-funded defense where the charge is an intentional tort in the form of self-dealing, breach of fiduciary duty. Third, insurance will likely not cover compensatory damages for such an intentional tort. Fourth, insurance will certainly not cover any award of punitive damages against such directors. Thus, the directors will be highly motivated by their personal financial jeopardy to select an SLC which will protect them by recommending dismissal of the derivative claims – thereby allowing the defendants to capitalize on their one opportunity to sail into the safe harbor of the “Business Judgment Rule” – in the form of the SLC defense. [11] Under the Desaigoudar standard, therefore, a weak and easy-to-satisfy judicial standard is applied to
The SLC directors’ performance of their duties on the SLC may be sufficiently deficient to subject them to civil liability – yet, under the Desaigoudar standard for review of summary judgments, such a deficient SLC determination to dismiss derivative claims may be given effect by the court. That the SLC members were independent and lacked both bad faith and fraudulent states of mind is sufficient, under the Desaigoudar standard, for the court to endorse the SLC determination, grant the corporation’s motion for summary judgment and dismiss the derivative claims. However, under Corp Code section 309, in order to avoid civil liability, the directors are also required to have performed the SLC function: (1) with such care, including reasonable inquiry, as an ordinary prudent director in like position would use in investigating the derivative claims and reporting to the board of directors; and (2) in a manner the director believes to be in the best interests of the corporation and its shareholders. [12] Under the Desaigoudar standard, however, the court does not even hold SLC directors to the minimum standard of director conduct under section 309. It is illogical that the performance standard to which directors are held would be reduced when directors are appointed to an SLC to investigate claims asserted against the defendant directors who appointed the SLC directors – the very circumstance which should raise the level of scrutiny into the SLC directors’ performance. Under Desaigoudar, therefore, the derivative claims may be lost to the plaintiffs without the SLC directors’ decision to dismiss the claims measuring up to the minimum standard for director conduct. [13]
C. The SLC Affirmative Defense, As Applied In All Jurisdictions, Suffers From A Logical Flaw.

Another problem with the Desaigoudar standard, shared with all other forms of the SLC defense, is logical in nature but exacerbated by the Desaigoudar standard’s extreme deference to the determination of the SLC committee. Invocation of the SLC defense by a corporation signals a special circumstance in which a majority of the corporation’s board itself is under suspicion for breach of the duties of care or loyalty. In this circumstance, the board itself is prohibited from considering and disposing of the derivative claims with its disposition subject to deference under the Business Judgment Rule. The board, therefore, selects an SLC whose decision may receive the benefit of the Business Judgment Rule if it passes muster under the judicial standard for review of the corporation’s summary judgment motion. The function of the standard for judicial review of the corporation’s summary judgment motion is to determine whether that SLC decision will receive deference under the Business Judgment Rule in a specially suspicious circumstance.

Auerbach, Zapata and Desaigoudar all assume that the court’s inquiry on summary judgment to determine whether the SLC determination will receive the benefit of the Business Judgment Rule is itself limited by the Business Judgment Rule. Therefore, the Business Judgment Rule limits the court’s inquiry to determine whether the Business Judgment Rule will apply to the SLC determination. The three decisions
referred to above differ from each other only in the degree to which each concludes that
the judicial inquiry is limited by the Business Judgment Rule, with the Desaigoudar
inquiry being the most limited. This is putting the cart before the horse or assuming the
outcome of the inquiry for the very purpose of conducting the inquiry. Why logically
should the judicial inquiry to decide whether the Business Judgment Rule will apply to
the SLC determination and corporate motion for summary judgment be itself limited by
the Business Judgment Rule? An unfettered judicial inquiry is certainly likely to produce
a more just result.

D. The Purpose of Business Judgment Rule Deference Is Inapplicable in The

The purpose of the Business Judgment Rule principle of deference is to prevent a
court from second guessing a corporate board’s business decisions as to which the board
is presumed to be well qualified and a court presumably is not – “the notion that
management of the corporation is best left to those to whom it has been entrusted, not to
the courts.” Desaigoudar, 108 Cal.App.4th at 183. [14] However, in the SLC context,
the predicate circumstance is not only one in which the board is charged with failure to
discharge its trust but also one in which the shareholder-selected board is disqualified
from its usual function because the board members charged with breach of duty may not
sit on an SLC which will evaluate the claims against them. The question raised by the
SLC defense is whether deference is still due to the defendant-selected SLC, for whom
shareholders may have never ever voted. [15] All of the decisions (except Zapata) seem
to suggest that a decision of such designees is entitled to a full measure of deference under the Business Judgment Rule.

Further, “whether it is in the best interests of the corporation to pursue the derivative claims” – the ultimate question determined by the SLC – is a question unlike traditional business management decisions. It is not a “management” decision in the usual sense which “is best left to those to whom it has been entrusted, not the courts.” Evaluation of derivative claims is primarily an analysis and evaluation of the merits of the derivative claims and the likely amount of recovery thereon. This is a function which courts are, in fact, better qualified to perform than most boards and SLC’s. [16] While SLC’s sometimes also evaluate, as a significant factor, the level of business interruption to the corporation that prosecuting the derivative claims will entail, such an analysis is not arcane or beyond the ken of judges. No special education or experience is required of the court to examine and evaluate an SLC’s analysis of the impact, if any, on executive time and corporate function.

Moreover, “business judgment” deference is not justified on a policy value basis – its justification, as usually stated, is practical – directors are said to be better qualified to make business decisions than judges for the ultimate benefit of the shareholders. Business judgment deference is not like deference to institutions of learning under the “academic freedom” rubric which is justified on a policy value basis to preserve first amendment values, freedom of research and prevent governmental interference with education and learning. Thus, if the court is, in fact, qualified to conduct an evaluation,
unfettered by deference, of an SLC determination, there is no policy reason for limiting the court’s ability to do so.


None of the California decisions expressly address the ironic circumstance which necessarily obtains in all SLC cases that, when defendant directors are charged with breach of fiduciary duty, the court is proscribed from measuring the SLC directors’ performance in evaluating the derivative claims by the statutory standard (Corp. Code §309) enacted for that very purpose. Not one reported decision has addressed this irony or attempted to harmonize or explain the operation of the SLC defense in relation to the minimum standard of performance for directors specified in Corp. Code §309. The duty of directors is owed to two beneficiaries – the corporation and its shareholders. Section 309 was enacted for the benefit of both. Yet in a derivative action, the corporation, the nominal plaintiff, and its shareholders, the beneficial plaintiffs, are usually denied an opportunity by the SLC defense to ever measure the SLC directors’ or defendant directors’ conduct under the §309 standard. Thus, the judge-made SLC defense is allowed to defeat the statutory protection for the corporation and its shareholders enacted in §309.
VI

A PROPOSED STANDARD UNDER WHICH A COURT SHOULD REVIEW AN SLC DETERMINATION TO DISMISS DERIVATIVE CLAIMS

The standard proposed here assumes adoption and application of the SLC Defense and incorporates several elements used in the New York and Delaware Rules, as well as new elements. The standard proposed here also requires that the court review the determination of the SLC under the minimum standard for director performance established by California Corporations Code §309.

The proposed standard contains the following elements: 1) Review of the specific qualifications of the SLC members; 2) Review of the independence of the SLC members; 3) Review of the appearance of independence of the SLC members; 4) Review of the adequacy of the SLC’s investigation of the derivative claims; 5) Review of the substance of the SLC’s determination as to disposition of the derivative claims. Review is conducted under the minimum standard established by Corp. Code §309, with no deference under the Business Judgment Rule. The existence of a triable issue of fact as to any of the five above elements should defeat summary judgment. Under this proposed standard, the SLC’s good faith is reviewed by the court as part of the review of other elements under Section 309 which requires good faith, and not as a separate element.
A. Qualifications of the SLC Members

In reviewing an SLC determination, the court should scrupulously review the qualifications of the SLC members. This test is an objective one. The SLC members are usually selected at a time when the derivative claims are on file and, accordingly, the specific transactions to be investigated are alleged in the derivative complaint and known to the board of directors who will select the SLC. Reported cases have assumed, or merely briefly noted, the qualifications of the SLC members to investigate the subject derivative claims. However, a court should specifically evaluate the qualifications, education and experience of the SLC members in light of the subject matter of the derivative claims as one objective test by which the SLC determination is reviewed by the court. For example, where accounting or financial reporting violations form the gravamen of the derivative claims, the SLC should consist of at least one CPA, or similarly qualified person, with the expertise to understand the applicable legal and accounting standards and to analyze the relevant reports, filings, books and records, and to work with the SLC’s expert forensic accountants.

In Desaigoudar, two members of the board of directors, who had joined the board after the events placed in issue by the derivative complaint, were appointed to the SLC. The gravamen of the derivative complaint was that the directors had breached their duties by selling an interest in another company (CellAccess) far too cheaply without conducting an appropriate financial analysis of CellAccess’ value and prospects. The company’s justification for the sale was that it was then in “financial crisis”. The court
found that the two directors selected to sit on the SLC were qualified to analyze the issues presented by the derivative claims. One SLC member was a CPA, an experienced manager of public companies and had been the chief administrative officer of another technology company. He had the expertise to analyze and understand CMD’s financial condition and CellAccess’ valuation at the time of the sale and was experienced in making management decisions for public corporations like CMD. The second SLC director was a trained electrical engineer and a former executive vice president of a semiconductor company who, by reason of his training, was qualified to evaluate the prospects for CellAccess’ success as they appeared at the time CMD determined to sell its interest in that company.

That the SLC may include such a director, qualified to analyze the derivative claims, will not obviate the need for the SLC to engage appropriate experts. But the presence on the SLC of directors genuinely qualified to evaluate the derivative claims and work with the SLC’s experts provides assurance that the SLC is “independent” and able to determine whether prosecution of the derivative claims is in the best interests of the corporation.

The failure to select SLC directors who possess the task-specific qualifications necessary to investigate the challenged transactions should be important to the Court’s decision. Such a failure signals a lack of independence on the part of the SLC members who, lacking appropriate qualifications, should be presumed to have been selected in
order to protect the incumbent directors charged with malfeasances -- who appointed them.

B. Independence of the SLC Members.

The court’s “independence” inquiry is not limited by the Business Judgment Rule. In Desaigoudar, the court described the inquiry as a determination of whether each member of the SLC is “‘in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences.” Desaigoudar, 108 Cal.App.4th at 189. In Re Oracle Corp. Derivative Litigation, 824 A.2d 917, 938 (Del. 2003, hereinafter “Oracle”), the court determined “whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind.”

The “independence” inquiry by the court should be far ranging, thorough and penetrating. Particularly in a large city environment, where numerous qualified bankers, lawyers, accountants, professors and consultants are available locally to serve as SLC directors, the selection of SLC members who have, at any time, had any social or business connections to the defendants should be regarded as another strong signal that the SLC is not independent. See, Grosset v. Wenaas, 133 Cal.App.4th 710, 35 Cal.Rptr.3d 58 (2005) [SLC members never met defendants, board members or executives in a professional or business setting and had no business dealings with them and owned no stock]. A lack of “substantial” business or social connections to the
defendant directors, or any directors on the board, as found, but not described, in Desaigoudar, should not satisfy the “independence” inquiry for two reasons. First, as the Zapata court described, and as the Desaigoudar court recognized, there exists the problem of “structural bias”.

“[a] derivative action invokes a response of group loyalty, so that even a ‘maverick’ director may feel compelled to close ranks and protect his fellows from the attack of the ‘strike suitor’. As a result, an outside director independent enough to oppose a chief executive officer with respect to a proposed transaction he thinks is unfair or unwise may still be unable to tell the same officer that he thinks the suit against him has sufficient merit to proceed. . . .”” [citations].

The problem of structural bias was the reason for Zapata’s two step review: ‘[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 as [SLC] committee members. The question naturally arises whether a ‘there but for the grace of God go I’ empathy may not play a role.” Desaigoudar, 108 Cal.App.4th at 187.

Structural bias cannot be eliminated under the Desaigoudar standard [17] but it should not be enhanced by permitting even “insubstantial” business or social connections
between the defendant directors and board members, on the one hand, and the SLC members they appoint, on the other hand.

Even where there exist no “substantial” social or business connections directly between the SLC members and the defendant and other directors on the board, directors of major or publicly traded corporations will often be part of the same social fabric or network. They may serve on other boards together, be members of the same clubs or civic organizations, participate in the same charities, send their children to the same private schools, hire the same professionals, have had more substantial connections in the past — and certainly share many of the same friends and acquaintances. Such less direct relations nevertheless influence human behavior, as recognized in Oracle.

“Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are “just not done,” or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. . . . our law cannot assume . . . that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk”. Oracle, 824 A.2d at 938.
Thus, on review of an SLC’s determination that pursuit of derivative claims is not in the best interests of the corporation, the court, in pursuing its independence inquiry, should brook no connections of any kind between the SLC members and the defendant directors or their fellow board members.

C. The Appearance of Independence of the SLC Members.

A second reason to brook no connections also exists – the appearance of impropriety is created by the SLC mechanism itself. The questionable appearance of the mechanism should not be aggravated by any discernable connections between those directors who nominate their SLC jurors and those SLC jurors who then judge their nominators.

“One of the obvious purposes for forming a special litigation committee is to promote confidence in the integrity of corporate decision making by vesting the company’s power to respond to accusations of serious misconduct by high officials in an impartial group of independent directors. By forming a committee whose fairness and objectivity cannot be reasonably questioned . . . the company can assuage concern among its stockholders and retain, through the SLC, control over any claims belonging to the company itself.” Biondi v. Scrushy, 820 A.2d.1148, 1156 (Del. Ch.2003).
Whether shareholders and investors should have confidence in the integrity of an SLC where the defendant directors literally appoint and select their own jurors from among their fellow board members, who have identifiable social and business connections to the defendants, can reasonably be doubted. Nevertheless, courts have approved the independence of SLC members although the SLC member and the defendant directors were members of the same club, shared the same lawyer, had traveled together, invested together, known each other for decades and the defendant director had previously engaged the SLC member to render services to the corporation. [18] It is to avoid such appearances that a court should require that there be absolutely no social or business connections between the defendant directors and their fellow board members, on the one hand, and the SLC directors, on the other hand.

If “appearance of independence” requires adherence to a strict standard which brooks no prior connections, substantial or insubstantial, between the SLC members and the members of the board of directors (whether charged in the derivative complaint, or not), then application of the standard will become more practically objective. While “independence” will ultimately remain a subjective state of mind which must be measured by the court, the identification of business and social connections is one objective measure of that state of mind.

SLC’s are often composed of directors who are newly appointed to the board for the very purpose of serving on the SLC. Such newly appointed directors have no connection to, and did not participate in, the challenged transactions which form the
subject matter of the derivative complaint. Thus, their newly appointed status contributes to the appearance of independence. However, it would also contribute to the appearance and the reality of their independence if their appointment were for the limited purpose of sitting on the SLC, after which their terms as directors would lapse.

Such a limited appointment as a director would be an important factor in the independence of the SLC director for several reasons. First, the financial benefits of holding a directorship can be substantial. The director’s stipend can amount to tens of thousands of dollars each year, aside from the travel and other benefits associated with such positions. Limited appointment to the board would reduce the benefits to the SLC member for which the member may feel beholden to his nominators. Second, it would also contribute to the genuine independence of the SLC member because he would not be required to collaborate, in the future, with those whom he is required to judge. Third, appointment to the board, limited to service on the SLC, would allow selection of SLC members whose qualifications would be determined primarily by the nature of the derivative claims to be evaluated. General qualifications to sit on a board of directors would not be required. This would allow the selection of SLC members with a higher level of specific expertise and, presumably, lead to better SLC functioning. Finally, since SLC directors are often effectively selected by the defendant and other directors, and not the shareholders, it is appropriate that such SLC directors not take permanent seats on the board with directors who have been elected by the shareholders. [18] A court should consider appointment of SLC members for the sole purpose of sitting on the SLC, after which their terms lapse, as a factor militating toward a finding of independence. [19].
D. Adequacy of the SLC Investigation

The court’s review of the “adequacy” of the SLC procedures, methodologies and conclusions is the primary objective prong of the test (aside from examining the qualifications of the SLC members and their appearance of independence under the test proposed herein). The court’s review should therefore be vigorous. The SLC should be required to demonstrate, through documents (minutes, agendas, reports, memos, transcribed interviews, etc.) and its final report, that it has employed methods and procedures as are appropriate to assess the merits of each derivative claim against each defendant, having identified the correct legal standards of liability and having marshaled the facts relevant to each claim. Where the evaluation of claims involving specialized subject matter is involved – the granting of lucrative compensation, in any form, for example – the SLC members should either possess genuine expertise in such executive compensation procedure or be required to demonstrate that they have employed qualified consultants and experts to assist in the evaluation of such derivative claims.

The procedures, and implementation of those procedures, employed by the SLC should be subjected to close scrutiny by the court. For example, it is insufficient for a court to merely note (as most do) that the SLC conducted “ten interviews” of witnesses and conclude that such a procedure was adequate. The court must examine the criteria for selection of the witnesses and the substance of such interviews. An SLC may deliberately eschew interviews of non-defendant, unbiased witnesses with firsthand knowledge of the challenged transactions. The SLC interviews may then give a
superficial appearance of an “investigation” but may be designed to conceal the truth -- not to reveal it. Thus, if the SLC defense is to fairly protect shareholder rights, the court’s inquiry into the “adequacy” of the SLC investigatory procedures and methods must be deep and substantive.

The end product of an adequate SLC investigation should be a matrix which reflects the SLC conclusions as to each separate claim against each defendant, assessing the likelihood of prevailing and the likely measure of recoverable damages. Analysis of the defendants’ ability to respond in damages, the availability of any applicable insurance and the likely cost of the litigation must also form part of the SLC’s analysis. Where this analysis shows the likelihood of a substantial recovery for the corporation, a heavy burden should be placed upon the SLC to justify a determination that it is not in “the best interests” of the corporation to pursue the derivative claims. The usual conclusory argument that litigation is “disruptive” to the operation of the company or will constitute a “diversion” of executive time should not be accepted by the court in the context of modern corporate life in which litigation is commonplace.


Judges have far more experience in the investigation and evaluation of claims than do corporate directors. Thus, a court is no less qualified to measure the adequacy of an SLC investigation of derivative claims or the merits of such derivative claims than any conceivable board directors. Therefore, the justification for judicial
deference, under the Business Judgment Rule, to the SLC does not apply to the court’s adequacy inquiry. Further, there is substantial doubt that even business decisions, unrelated to litigation, should be immunized or sheltered from ordinary judicial review by the Business Judgment Rule based upon the premise that such decisions are beyond the ken of a judge or jury. [20]

In the suspect circumstance in which the board of a corporation must appoint an SLC, it is particularly important that the shareholders and corporation be assured that the performance of the SLC conform to the minimum legal standard for director performance. The Court’s inquiry into the objective “adequacy” of the SLC investigation should, therefore, be conducted without any deference under the Business Judgment Rule. The court should specifically measure the SLC directors’ performance by the Section 309 standard. It is not unfair that directors, who accept fiduciary responsibility, be required to perform to the statutory minimum standard of fiduciary performance.

The court must also be free to examine the merits of the SLC’s determination because, although the “adequacy” of the SLC investigation is objective, detectable and measurable, the “independence” of the SLC members and their “good faith” are subjective states of mind, easily concealed and difficult to discover. Thus, there exists a substantial risk that biased individuals will be appointed to the SLC who may place protection of the directors who appointed them above the best interests of the corporation and its shareholders. If any subjective lack of “independence” and “good faith” of the SLC members are not detected in the course of judicial review, then their presence should
be inferred from an SLC decision not to pursue derivative claims where the court independently concludes that pursuit of such claims is in the best interest of the corporation and its shareholders. Such a logical inference may not be drawn by the court if it is barred from examining the merits of, and the justification for, the SLC’s decision by application of the Business Judgment Rule to the court’s inquiry. [21]
FOOTNOTES

1. Gretchen Morgenstern, “Sharper Claws for Recovering Executive Pay,” New York Times, December 9, 2007, III:1. In a more recent article, the New York Times reported on an attempt by Citigroup shareholders to hold directors responsible for rewarding departing directors for “running the bank into the ground.” The shareholders were thwarted by the “business judgment rule” – a key legal principle underlying the Special Litigation Committee Defense. Although “Citigroup’s market value had dropped by $64 billion during Mr. Prince’s [chairman and CEO] tenure” and “he resigned from Citigroup under pressure,” on leaving the company, he received the following:

As a thank-you present for running the bank into the ground, the board gave Mr. Prince a parting gift valued at $12.5 million. Yes, you read that correctly, $12.5 Million. That exit bonus was on top of the $68 million he received in stock and options he had accumulated over his many years at the company; and an office, car and driver for up to five years.

***

A couple of intrepid shareholders sued Citigroup’s directors over the payment and several other questionable decisions. A Delaware judge dismissed most of their complaints, ruling that the board was protected by something called the “business judgment rule.”


4. See, Decisions of Special Litigation Committees: Solving the Problem of Control Under Texas Law, 44 Baylor Law Review 171 (1992) for a review of the basic approaches. At one end of the spectrum, all decisions (board or SLC) to reject derivative claims receive the protection of the Business Judgment Rule – at the other, a board lacking independence is completely prohibited from creating an SLC. Id at 178-187.
Under the Model Business Corporations Act, SLC members must be appointed by a majority of independent directors present at a meeting or by the court. Model Business Corporate Act §7.44.

5. Will v. Engebritson & Co., Inc., 213 Cal.App.3d 1033, 1040, 261 Cal.Rptr. 868, 872 (1989) [“special litigation committee to decide whether the maintenance of a shareholder’s derivative suit is in the corporation’s best interests.”] An SLC should find that pursuit of a derivative action is in the best interests of the corporation where liability is probable and the damages are significant and recoverable, taking into account the cost of the litigation. Consideration is also sometimes given to the possibility of business interruption caused by the pursuit of litigation. See, Findley v. Garrett, 109 Cal.App.2d 166, 178 (1952) [“...duty to weigh the advantages of a probable recovery against the cost in money, time and disruption of business of the company which the litigation would entail.”]

6. “Under this approach, a court’s review of a challenged decision focuses largely, if not exclusively, upon the subjective motivations for the action. While courts use a variety of terms to identify the pertinent inquiry – such as the presence or absence of good faith, honesty, or fraud – the heart of the matter is whether or not the directors believed that what they were doing was in the best interests of the corporation. Excluded from the courts’ inquiry for the most part is any review of the objective reasonableness of such a belief.” Gevurtz, “The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?” 67 S. Cal. Law. Rev. 287 (1993 – 19940 hereinafter “Gevurtz”).

55
7. An objective legal standard is always preferable to a subjective standard because it is detectable, measurable and predictable and, thus, allows corporations and committees to guide their conduct and predict the outcome of such conduct. See, Cobb v. Grant, 8 Cal.3d 229, 245, 502 P.2d 1 (1972).


9. “The potential for structural bias requires the court to be ‘mindful of the need to scrutinize carefully the mechanism by which directors delegate to a minority committee the business judgment authority to terminate derivative litigation, particularly when the lawsuit is directed against some or a majority of the directors.’ [citations]” Desaigoudar, 108 Cal.App.4th at 188.

   An SLC member “may be compromised if he is beholden to an interested person. Beholden in this sense does not mean just owing in the financial sense, it can also flow out of ‘personal or other relationships’ to the interested person.” In Re Oracle Corp. Derivative Litigation, 824 A.2d 917, 939-940 (Del.Ch.,Court, 2003).

10. Directors may not rely upon the Business Judgment Rule defense if their conduct placed at issue in the complaint is self-dealing [Everest Investors 8 v. McNeil Partners,
114 Cal.App.4th 411, 8 Cal.Rptr.3d 31, 45 (2003)] and because the Business Judgment Rule applies only to director conduct *qua* director.

“The five inside directors who are the beneficiaries of the Golden Parachutes and the Consulting Agreement abstained from voting on their approval and, accordingly, are not subject to liability on the ground of having approved the amended Employment Agreements.

As discussed *ante*, these inside directors were not performing the duties of a director in seeking approval of the agreements or accepting the benefits thereunder. Section 309's standard of care therefore does not apply to a determination of their liability on appellants’ claims, and the trial court’s reliance on section 309 in granting summary judgment in their favor constituted error.” Gaillard v. Natomas Co., 208 Cal.App.3d 1250, 1268, 256 Cal.Rptr. 702, 713 (1989).

Similarly, claims asserted against directors based upon breach of majority shareholder duty owed to minority shareholders [*Jones v. H.F. Ahmanson & Company*, 1 Cal.3d 93, 108, 81 Cal.Rptr. 592, 599, 400 P.2d 464 (1969)] are claims as to which the Business Judgment Rule does not apply. Such claims have no connection whatsoever to (1) any activity of the defendants as directors or (2) the business of the corporation. Of course, the Business Judgment Rule does not apply to the conduct of defendants as officers. See, Cal. Corp. Code §204
11. While applicable law may bar a director’s direct reliance upon the Business Judgment Rule defense, nevertheless, the SLC defense effectively shelters self-dealing corporate defendants under the Business Judgment Rule because a decision by an SLC “is protected by the Business Judgment Rule.” Finley, 80 Cal.App.4th 1152, 1158, 96 Cal.Rptr.2d 128, 132 (2000).

12. It is axiomatic that the entirety of the business and affairs of a corporation “shall be managed and all corporate power shall be exercised by or under the direction of the board.” Cal. Corp. Code §300. The function of an SLC falls within “the business and affairs of a corporation.” As a matter of law, the minimal standard for the performance of the directors who serve on an SLC – that standard which will not give rise to liability – is specified in Corporations Code §309. Thus, as a matter of law, the SLC members must, at the very least, perform their SLC functions in accordance with §309. Indeed, it would make no sense at all that the performance standard for a director would be reduced when he is appointed to an SLC to investigate claims of breach of fiduciary duty and corporate looting alleged against the directors who appointed the SLC member – the very circumstance which should raise the level of scrutiny of a director’s investigation and determination.

13. “Accordingly, the desirability of the business judgment rule rests on one fundamental question: Should directors’ liability require a showing of greater fault than ordinary negligence? In addressing this question one must start with the presumption that
the standard of ordinary negligence is correct because it is the norm throughout the law of
torts. It is also the norm when dealing with the duty of care of agent to principal.

Accordingly, the burden exists on those who would establish a different standard for
director liability—whether it is good faith only, gross negligence, or a focus on process
rather than substance—to justify special treatment.”  Gevurtz, 67 S. Cal. L. Rev. at 304.

14. “Courts justify their deference to the decision making power of the board on the
ground that judges do not possess the specific knowledge necessary to make business
decisions and thus should not substitute their decisions for those of the directors.”  Social
Ties, 79 S. Cal. L. Rev. at 463, 463n.46.

15. A significant number of cases arise in the context of closely held or privately
traded corporations. In such circumstance, the director defendants, charged with breach
of duty in the derivative action, will own or control enough shares to effectively select the
new board members who sit on the SLC – and sometimes the SLC’s counsel.

16. Courts are better qualified to perform the function of an SLC than most SLC
members, as noted by Auerbach, the New York decision upon which Desaiagoudar relies.

“As to the methodologies and procedures best suited to the conduct of an
investigation of facts and the determination of legal liability, the courts are
well equipped by long and continuing experience and practice to make
determinations. In fact they are better qualified in this regard than are
corporate directors in general.” Auerbach, 393 N.E.2d 994, 1002, 47 N.Y.2d 619, 634.

17. The Desaigoudar court accepted, without significant analysis, the most problematic aspect of the SLC defense – that the defendant directors appoint the members of the SLC who will sit in judgment of them:

“As Lewis recognized, it is an inescapable aspect of the corporation’s predicament that a special litigation committee has to be appointed by interested directors. The corporation may not assign responsibility for evaluating a claim against the company to a wholly independent body separate from the corporation, because to do so would itself be a breach of the fiduciary duty of the board. Desaigoudar, 108 Cal.App. 4th at 188 [Emphasis added].

However, under other circumstances, courts regularly appoint directors to sit on corporate boards. For example, under California Corporation Code §308, application may be made to the court by another director or the shareholders to appoint a provisional director in the circumstance of a “blocked” board,. Under the Model Business Corporations Act §7.44, a corporation may apply to the court to appoint directors to an SLC.
The Desaigoudar court’s facile conclusion that the defendant directors “inescapably” must appoint the SLC is wrong because the court assumes that, if such directors do not themselves appoint their SLC jurors, the SLC will be a “wholly independent body separate from the corporation”. As in the instances referred to above, the selection process can be in the hands of the court and, once complete, the individuals selected may be appointed to the board. As appointed directors, the SLC members will not be a “wholly independent body” any more than the other directors who do not sit on the SLC.

Substantial benefits could flow from a system for appointment of SLC members which did not permit the defendant directors, or their fellow board members, to appoint SLC members. For example, a system in which the derivative plaintiff/shareholders and the non-defendant directors each submit a list of nominees to the court for appointment to the SLC would help to restore confidence in the SLC procedure and help to assure the selection of qualified and independent SLC directors. Where the court will select the SLC directors based upon the qualifications of the nominees [see, infra §   ] and their lack of business or social connections to the defendant directors [see, infra §   ], as reflected in the declarations of the nominees submitted to the court, the SLC will present both the appearance and reality of “independence.” Moreover, because SLC directors selected by the court would likely give their depositions, as is now customary, any lack of accuracy or completeness in the nominee declarations, which later came to light in their depositions, would likely result in a denial of the corporation’s motion for summary judgment for lack of SLC “independence.” See, Oracle.

19. The appearance of independence would also be enhanced if the process of selecting board members to sit on the SLC were removed from the control of the defendant directors. Judicial selection from lists submitted by the parties is one such alternative method. See footnote 17 ante.


21. “There are a number of variations on this process-versus-substance theme. All have in common, however, the notion that the business judgment rule calls for less judicial scrutiny of the merits of the directors’ decision than of the process the directors used in arriving at the determination. One obvious extreme is to conclude that the business judgment rule precludes any review at all of the substance of the decision. The opinion of the New York Court of Appeals in Auerbach v. Bennett provides an example of this extreme.” Gevurtz, 67 S. Cal. Law Rev. at 302.