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Divided Delaware Supreme Court Decision Highlights Issues About Director Independence in Derivative Actions

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The Delaware Supreme Court recently affirmed a Court of Chancery ruling granting a Special Litigation Committee's motion to terminate a shareholder derivative action that had survived a motion to dismiss. The split decision in El Pollo Loco (June 28, 2022) highlights whether a director can be considered independent – especially as a member of a Special Litigation Committee ("SLC") – if he or she had known about and had approved or not objected to the prior motion to dismiss, which had asserted that the claims at issue in the subsequent SLC investigation lacked merit.

The majority in *Diep* concluded that the two relevant SLC members were independent because the record did not show that they had "approved or participated in a substantive way in the decision to file the motion to dismiss." However, Justice Valihura's lengthy dissent disputed that conclusion and opined that the Board (including the two directors who later joined the SLC) must have approved the decision to file the motion, which alleged that the same claims that those SLC members were later charged with evaluating lacked merit.

The majority's ruling will give some comfort to companies and boards that decide to move to dismiss derivative actions but then need to appoint SLCs or perhaps even Demand Review Committees ("DRCs"). But the majority opinion appears to be fact-specific and does not articulate a bright-line rule that a director's involvement in a motion to dismiss does not undermine his or her independence for purposes of a subsequently formed SLC or DRC. The dissent highlights that potential tension and raises questions about the factual assumptions that seem to have undergirded the majority opinion. This debate could cause companies and boards to pay further attention to issues that derivative actions pose, including whether to file a motion to dismiss, whether and when to create an SLC or a DRC, and who the members of any such committee should be.

Factual Background

The *Diep* derivative action was filed in the wake of a securities class action alleging that the corporate defendant (El Pollo Loco) had made misrepresentations about its financial performance. The derivative plaintiff asserted similar disclosure claims cast in the guise of breach of fiduciary duty; he also alleged that company insiders and the controlling shareholder had violated Delaware law by selling large amounts of company stock before the so-called "truth" about the alleged misrepresentations was revealed to the market.

The company and the individual defendants moved to dismiss the case based on the plaintiff's failure to have made a pre-suit demand on the company's Board, and the individual defendants also moved to dismiss for failure to state a claim. The Court of Chancery stayed the count of the Complaint that overlapped with the disclosure claims in the securities class action, but denied the motion as to the insider-trading claims.

The Board then formed an SLC to investigate the allegations at issue in the securities and derivative actions. The SLC consisted of three members, none of whom had been named as a defendant. Two of the directors had joined the Board after the conduct at issue, but before the motions to dismiss had been filed; the third had joined later. The SLC retained independent counsel, conducted a detailed investigation, and concluded that the derivative claims should not be pursued.

The SLC moved to terminate the derivative litigation, and the Court of Chancery granted the motion. Applying longstanding Delaware law under *Zapata Corp. v. Maldonado*, the court held that the SLC had established that its members were independent and that it had conducted a reasonable investigation. The court also concluded, under *Zapata*'s second step, that the SLC's decision to terminate the derivative litigation was reasonable. The Supreme Court affirmed in a 4-1 decision, with Justice Valihura dissenting.

The Majority Decision

The majority's decision discusses the standards applicable to review of SLC (and DRC) decisions and examines questions of director independence where SLC members had some business and social relationships with individual defendants. But perhaps the most interesting part of the decision concerns the plaintiff's allegation that the two SLC members who had been on the Board when the motion to dismiss was filed were not independent because they had prejudged the subject matter of the subsequent SLC investigation through their involvement in the prior decision to move to dismiss those claims for lack of merit.

The majority rejected that contention, holding that the two SLC members had not "approved or participated in a substantive way in the decision to file the motion to dismiss." Noting that "independence is a fact-specific determination made in the context of a particular case," the majority recited what it considered to be the relevant facts:

- The Board (including the two SLC members) had received "an update regarding 'pending litigation'" at a Board meeting.
- The minutes of the meeting "d[id] not mention the motion to dismiss."
- "The record is devoid of evidence that [one of the two SLC members] was involved in any discussion about, or approved the filing of, the motion to dismiss."
- The other SLC member was "'sure' there 'would have' been a 'litigation update' and 'discussion' on the subject, but 'did not recall the details of it.'"
- "Although [that second SLC member] did not recall anyone objecting to the motion, he did not say he 'approved' of its filing."

The majority concluded that “these facts do not raise a material question of fact about whether [the two SLC members] prejudged the merits of the suit because they were exposed to a litigation review that included a less than in-depth discussion of the motion to dismiss.”

The Dissent

The dissent viewed those facts differently. According to Justice Valihura, “the record shows more than just [the two SLC members’] mere presence on the Board when the 2016 Motion [to Dismiss] was filed.” Rather:

- The motion to dismiss “was discussed with the Board and . . . no director objected to its filing.”
- One SLC member “specifically stated that he did not object to its filing.”
- “The logical conclusion is that the Board, at least tacitly, approved and authorized filing the 2016 Motion after that discussion.”
- “The 2016 Motion was obviously authorized by someone. Given that a corporation acts through its board of directors, and given that the motion was the subject of a Board discussion, the record suggests that the Board authorized it.”

Justice Valihura also rejected as irrelevant the possibility that the two SLC members might not have read the motion to dismiss. “Given that it is completely reasonable to conclude that they authorized the filing, they should have known what they were authorizing.” Justice Valihura therefore concluded that the SLC had not satisfied its burden of proving its independence.

Implications

Reading the majority opinion, one cannot help wondering whether the SLC was saved by the vagueness of the minutes of the Board meeting, by the lack of evidence of an actual Board vote on whether to file the motion to dismiss, and by the SLC members' lack of memory of details of the Board meeting. But inasmuch as independence decisions depend on the facts of a particular case, another court could interpret similar events differently. The dissent raises the common-sense point that corporate decisions must be authorized by individuals, and those individuals might include board members. Accordingly, a court might conclude that, where a litigation matter (including a potential responsive motion) was discussed at a board meeting, and where a motion was then filed, the board authorized the motion.

This potential tension between directors' involvement in litigation decisions and the possible desire to preserve directors' independence for purposes of an SLC or a DRC might cause corporations to give further consideration to how they handle derivative actions. If, as in the Diep case, the company moves to dismiss, directors could be charged with having prejudged the merits if those directors are later needed to participate in an SLC or a DRC. A company cannot necessarily escape this potential conflict by moving to dismiss only for lack of demand futility (as El Pollo Loco did), rather than on the merits. The demand-futility analysis will likely involve consideration of whether a majority of the board faced a substantial likelihood of liability – a question that implicates the same underlying substantive issues involved in a motion to dismiss on the merits. A corporation that wishes to create an SLC or a DRC after filing a motion to dismiss can avoid this potential dilemma by populating the committee with directors appointed after the underlying events occurred and after the motion to dismiss was filed – as El Pollo Loco did with the third SLC member, whose independence was undisputed.

A corporation and board faced with a derivative suit might also choose to forgo an early motion to dismiss and, instead, to treat the complaint like a pre-suit demand letter and to appoint a DRC to investigate the allegations and make recommendations about how to proceed. This approach would avoid allegations that DRC members had prejudged the merits of the claims through a prior motion to dismiss (although the DRC members would still need to be independent under other standards, such as not facing a substantial threat of liability).

Although the vagueness of El Pollo Loco's Board minutes and the lack of evidence about the substance of the Board's discussion might have saved the SLC members in the Diep case, it would probably be unwise to conclude that boards should strive for vague, skeletal, generalized minutes of board meetings. Many other considerations militate in favor of providing details about what boards discuss and determine – for example, the desire to establish and document that board members engaged in thorough, informed deliberations and made reasoned business decisions. Board members frequently (and not surprisingly) are unable to recall the details of board meetings when called upon to do so in subsequent litigation, often years later. Having a specific, contemporaneous record usually can provide greater protection for board members than can generic recitations applicable to any board.

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