A Potent Tool For Boards In Derivative Litigation

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There has been strong focus on derivative suits in recent years in the context of fiduciary claims related to mergers and acquisitions, as well as Caremark oversight claims and COVID-19-related claims, being asserted by stockholders against corporate directors and officers on behalf of the corporation.

In the April 17 In re: Baker Hughes, a GE Company Derivative Litigation decision, the Delaware Chancery Court **granted** a motion to terminate a derivative suit brought against the global oilfield giant's former directors that challenged the fairness of the company's merger with an affiliate of its controller.

The decision serves as an important reminder to boards that a properly formed and functioning special litigation committee — comprised of independent and disinterested members, which acts in good faith and reaches reasonable conclusions — is a potent tool for a corporation to retain control over derivative claims.

This is the case even when the plaintiffs have excused demand on the board to bring the litigation based on the board's nonindependence or conflicts.

Key Points

Special Litigation Committee's Conclusion Accepted by the Court

Even when board-level conflicts excuse stockholders who assert derivative claims from first making a demand on the board to bring the derivative litigation, such conflicts do not strip the board of its authority to make decisions with respect to such litigation if it is brought by the stockholders.

Although the court viewed the special litigation committee in this case as imperfect, the court accepted the committee's determination that it was not in the best interests of the corporation for the derivative litigation to be pursued.

The special litigation committee reached that determination by weighing (1) the extent to which the claims against the company's directors and controller might be meritorious against (2) the expense, uncertainty, reputational damage, indemnification costs and distraction associated with protracted litigation or a settlement.

The Special Litigation Committee's Flaws and Strengths

The court emphasized the independence of the special litigation committee, the thoroughness of its investigation and the reasonableness of its conclusions.

These strengths, the court concluded, outweighed the committee's flaws — namely that:

- It was comprised of only a single member;

- That member exchanged several emails with the company's board chair, who was a subject of the special litigation committee's investigation; and;

- The committee's report failed to discuss the potential transaction adviser conflicts that the special litigation committee had investigated.

Background

In 2017, Baker Hughes Inc. merged with GE Oil & Gas U.K. Ltd., which was a subsidiary of GE Co.

The resulting company, called Baker Hughes, a GE Co. LLC, was controlled by GE; however, GE was subject to restrictions set forth in a stockholders' agreement, including a prohibition on selling its Baker Hughes shares for two years unless it obtained the approval of a Baker Hughes conflicts committee comprised of independent directors — the lockup.

Soon after, as part of a GE restructuring program, GE indicated that it was evaluating its exit options with respect to Baker Hughes. After negotiations between Baker Hughes's conflicts committee and GE, the conflicts committee approved a series of transactions with GE, including a waiver of the lockup and the merger.

Stockholders brought a derivative suit against the Baker Hughes directors and GE, alleging that GE, driven by a desperate need for liquidity, exercised its control over Baker Hughes to force Baker Hughes to agree to the 2018 transactions, which unfairly favored GE. The court, at the pleading stage, determined that demand on the board to bring the derivative litigation would have been futile and thus was excused, and the court rejected dismissal of the case.

Thereafter, the board formed the special litigation committee, which conducted a nine-month investigation.

The committee concluded that the court likely would hold that the 2018 transactions were entirely fair to Baker Hughes; and that, therefore, given the costs and other burdens associated with litigating an entire fairness suit, further prosecution of the claims would not be in the best interests of Baker Hughes or its stockholders.

The special litigation committee moved for an order terminating the action. Following discovery to test the independence, good faith, and reasonableness of the special litigation committee's investigation and conclusions, the plaintiffs opposed the motion to terminate the action.

Vice Chancellor Lori Will heard the oral argument, including live testimony by Baker Hughes director Gregory Ebel, with cross-examination by the plaintiffs' counsel, and granted termination of the action.

Discussion

The Committee's Authority and Conclusions

The Baker Hughes board had fully authorized the special litigation committee to determine whether pursuing the derivative litigation would be in Baker Hughes' best interests, with the determination being final and binding on Baker Hughes.

Following its investigation, the special litigation committee determined that it was likely that, if the derivative litigation were pursued, the court would find that the challenged 2018 transactions were entirely fair to Baker Hughes.

On that basis, and taking into account the potential negative effects that continued prosecution of the derivative action could have on Baker Hughes — including indemnification and advancement costs, diversion of company resources, and negative publicity — the special litigation committee concluded that terminating the action would best serve the interests of Baker Hughes and its shareholders.

The Special Litigation Committee Investigation

The court found that the special litigation committee demonstrated that it had conducted a thorough investigation in good faith. The court noted that the committee and its advisers spent more than 6,300 hours on the investigation, over a period of nine months; reviewed more than 110,000 documents; interviewed 22 witnesses; met with the plaintiffs to understand their theories of the action; investigated the plaintiffs' allegations in the complaint; investigated certain issues that were not even raised by the plaintiffs — for example, whether GE had tried to undermine the conflicts committee process when seeking approval of the 2018 transactions; and produced a 320-page report that cited to 242 exhibits.

The Committee's Independence

The board selected Ebel, who had joined the board on May 10, 2019, and was the chair of the audit committee, as the special litigation committee's sole member. It was uncontested that Ebel had not been involved in the 2018 transactions and had no personal or business ties to any defendant that compromised his independence.

The plaintiffs asserted, however, that there were material issues of fact as to the special litigation committee's independence based on (1) Ebel having exchanged several emails with the board Chair — who was a subject of the special litigation committee investigation — during the investigation; and (2) certain lawyers at the two law firms representing the special litigation committee having previously represented GE in various other matters.

With respect to (1) above, the court stated that the emails should not have occurred, but concluded that each was nonsubstantive and did not impugn Ebel's objectivity. The court found Ebel's testimony in this regard credible — that he had not communicated with the board chair about the substance of the investigation but only had sought information about an expansion of the board that was being considered and that could impact the special litigation committee.

The court concluded that the emails did not show that the two men were "friends or that they 'regularly' communicated about the SLC's investigation."

With respect to (2) above, the court emphasized that the individual lawyers working with the special litigation committee had not represented GE on other matters; that both law firms had represented to the court that they were willing to sue GE — and, in fact, had sued GE in the past; and that there were no indications that the lawyers working with the special litigation committee were biased or acted with impropriety during the investigation.

Potential Conflicts

The plaintiffs asserted that various other potential conflicts raised issues of material fact as to the special litigation committee's independence. The court found that the special litigation committee demonstrated that it had in fact investigated each of these potential conflicts although not all were discussed in the committee's report.

Moreover, in any event, with respect to the alleged conflicts of advisers to the conflicts committee in connection with the challenged 2018 transactions, the court stated that, even if the special litigation committee's investigation into these conflicts issues had been inadequate, that would be only a single factor in the holistic analysis of whether the 2018 transactions were entirely fair.

The special litigation committee's conclusion — after weighing the process strengths and weaknesses — that the court would likely find the 2018 transactions resulted from a fair process would not be rendered unreasonable by the fact that an adviser had done work for GE, the court stated.

Reasonableness of the Committee's Conclusions

The court found that the special litigation committee:

- Appropriately identified that entire fairness review would apply to the plaintiffs' claims;
- Reasonably determined that the burden of proof might shift to the plaintiffs because of the conflicts committee's role in negotiating the 2018 transactions;
- Concluded that the economic terms of the 2018 transactions fell within the range of fairness; and
- Therefore concluded that Baker Hughes could not reasonably expect to recover meaningful damages or settlement payments from the prosecution of the plaintiffs' derivative claims.

The court stated that the plaintiffs' various criticisms of the special litigation committee largely amounted to disagreements with the special litigation committee's analyses.

The relevant question, under the applicable Zapata test, however, is "not whether there were disputed issues of material fact about the merits-based issues raised by the plaintiffs," the court explained; rather, "the relevant inquiry is whether disputed issues of material fact were raised about the reasonableness of the SLC's conclusions."

Fairness of the 2018 Transactions

The court endorsed the special litigation committee's conclusion that the process for the 2018 transactions was imperfect but fair. The strengths of the process included:

- The leverage Baker Hughes held over GE while the lockup remained in effect;
- Baker Hughes' proactive and prepared approach to negotiations;

- The conflicts committee's assertiveness; and
- The industry expertise of the Baker Hughes negotiators.

The court also found reasonable the special litigation committee's conclusion that the price was fair.

The court concurred with the special litigation committee's determination that the appropriate frame of reference for its analysis on price was a comparison between the economic terms of the 2018 transactions and those that Baker Hughes would likely have received in an arms-length transaction with GE or another turbine supplier after GE no longer had the right to appoint a majority of Baker Hughes' board, which would have occurred after the lockup expired.

Practice Points

Utilizing a Special Litigation Committee

Potential advantages of utilizing a special litigation committee include regaining control of derivative litigation from the shareholder-plaintiffs, and, if the committee determines that pursuing the litigation is not in the corporation's best interests, avoiding the expense and other disadvantages of protracted litigation or settlement.

Potential disadvantages of utilizing a special litigation committee include the expense of the special litigation committee's investigation and outside advisers, and the possibility that a court may not agree with the special litigation committee's conclusions.

It should be kept in mind that, unlike in other pleading-stage contexts, a special litigation committee bears the burden of showing, and enjoys no presumptions in its favor with respect to, its independence and good faith, nor the reasonableness of its investigation and conclusions.

Formation

If a board determines to utilize a special litigation committee, it should fully authorize the committee to investigate and determine whether derivative claims should be pursued; and should select as its members independent and disinterested directors, who, in appearance and in fact, can objectively evaluate the merits of a demand-excused litigation when a disabled board may not be able to.

It is, of course, critical that the special litigation committee be empowered to make and be capable of effecting whatever determinations it ultimately makes, including bringing a suit against the corporation's officers and directors.

A special litigation committee should retain its own legal counsel and consider retaining its own financial advisers. Potential conflicts of interest of the members and advisers should be addressed, with a record maintained — such as in meeting minutes — of the deliberations and actions taken.

The highest standard for independence may be applied where there is only one member of the special litigation committee. The general objective should be to foreclose any reasonable basis on which the special litigation committee's conclusions could be questioned as having

been based on factors other than the merits of the derivative claims.

Investigation

Any investigation should be thorough, with analysis of all relevant facts and sources of information that bear on the central allegations in the complaint, potentially including even issues that have not been raised by the plaintiffs.

An investigation typically, although not always, includes conducting witness interviews, reviewing financial data and analyses, and retaining expert advice.

A special litigation committee should proceed without animosity toward the stockholder-plaintiffs or their counsel and without bias or predetermined conclusions. Together with its advisers, a special litigation committee should seek to ensure that it understands the law relevant to the case; investigates the relevant facts, without simply relying on the defendants' version of disputed facts; and applies the appropriate legal and financial frameworks to guide its conclusions.

A special litigation committee should be careful not to take actions that could be interpreted as reflecting any bias in the investigation.

Generally, a special litigation committee's final report should detail the work undertaken; the potential conflicts of interest of the special litigation committee's members and advisers that were considered and how they were addressed; the substantive issues investigated; the legal and financial frameworks that guided the analyses; and the committee's specific conclusions.

Privilege Issues

Although not an issue in Baker Hughes, the use of a special litigation committee can raise significant privilege issues for both the corporation and the committee.

For example, the special litigation committee providing a detailed report to the board can raise issues of possible waiver of the attorney-client privilege between the special litigation committee and its legal counsel with respect to the matters covered in the report. Legal counsel should ensure it consults with the special litigation committee when the committee is preparing its report.

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