CCR corp
DIRECT FROM THE EXPERTS

DEAL LAWYERS

8911 N. Capital of Texas Highway, #4200-110, Austin, TX 78759

DIRECT FROM THE EXPERTS FOR 45 YEARS

VOL. 17, NO. 3 MAY-JUNE 2023

Chancery Ruling Highlights Important Role of Special Litigation Committees in Maintaining Board Control Over Derivative Litigation

By Gail Weinstein, Senior Counsel, and Scott B. Luftglass, Peter L. Simmons, Philip Richter and Steven Epstein, Partners of Fried, Frank, Harris, Shriver & Jacobson LLP

There has been strong focus on derivative suits in recent years in the context of M&A-related fiduciary claims, 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 *In re Baker Hughes, a GE Company, Deriv. Litig.* (April 17, 2023), the Delaware Court of Chancery granted a motion to terminate a derivative suit brought against the former directors of Baker Hughes Incorporated 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 ("SLC") — 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, even when the plaintiffs have excused demand on the board to bring the litigation based on the board's non-independence or conflicts.

Key Points

- Judicial acceptance of the SLC's conclusion that the litigation should be terminated. The decision underscores that, 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 brought by the stockholders. The court wrote that, following excusal of demand: "The board still has one final arrow in its quiver to gain control of the derivative litigation — the special litigation committee." Although the court viewed the SLC in this case as "imperfect," the court accepted the SLC's determination that it was not in the best interests of the corporation for the derivative litigation to be pursued. The SLC reached its determination by weighing: (i) the extent to which the claims against the company's directors and controller might be meritorious against, and (ii) the expense, uncertainty, reputational damage, indemnification costs and distraction associated with protracted litigation or a settlement.

Recycled Paper
Copyright © 2023 Executive Press, Inc.

- The SLC's flaws and strengths. The court emphasized that the SLC in this case was independent, had conducted a thorough investigation and had reached reasonable conclusions. These strengths, the court concluded, outweighed the committee's flaws, which were that it was comprised of only a single member; that the member had exchanged several emails with the company's board Chair, who was a subject of the committee's investigation; and that the committee's report failed to discuss the potential transaction advisor conflicts that the committee had investigated.

Background

In 2017, Baker Hughes Incorporation merged with GE Oil & Gas UK Limited, which was a subsidiary of GE Company ("GE"). The resulting company, called "Baker Hughes, a GE company, LLC" ("BH"), was controlled by GE; however, GE was subject to restrictions set forth in a Stockholders' Agreement, including a prohibition on selling its BH shares until 2019 unless it obtained the approval of a BH conflicts committee comprised of independent directors (the "Lockup"). In late 2017, as part of a GE restructuring program, GE indicated that it was evaluating its exit options with respect to BH. After negotiations between BH's Conflicts Committee and GE, the Conflicts Committee approved a series of transactions with GE (the "2018 Transactions"), including a waiver of the Lockup and the merger. In March 2019, stockholders brought a derivative suit against the HB directors and GE, alleging that GE, driven by a desperate need for liquidity as it struggled financially, exercised its control over BH to force BH to agree to the 2018 Transactions, which unfairly favored GE. Certain BH directors were voluntarily dismissed from the case, leaving GE and five directors it had designated as the defendants. On June 7, 2019, the defendants filed motions to dismiss, based on failure to plead demand futility and failure to state a valid claim under Rule 12(b)(6)). On October 8, 2019, 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.

On October 31, 2019, the board formed the SLC, with Gregory Ebel as its sole member. After a nine-month investigation, the SLC concluded that the court likely would hold that the 2018 Transactions were entirely fair to BH; 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 BH or its stockholders. On October 13, 2020, the SLC moved for an order terminating the action. Following discovery to test the independence, good faith and reasonableness of the SLC's investigation and conclusions, the plaintiffs opposed the motion to terminate the action. Vice Chancellor Lori Will heard oral argument, including live testimony by Ebel (with cross-examination by plaintiffs' counsel), and granted termination of the action.

Discussion

Derivative litigation. Shareholder derivative litigation usually involves shareholders alleging that the corporation was harmed by directors' or officers' misconduct or failure to act. As a board has the ultimate authority to manage and direct the affairs of the corporation, including with respect to litigation, a plaintiff asserting derivative claims, under Delaware law, must either first make a demand on the board to bring the litigation, or must establish that such demand would have been futile based on the directors having been non-independent or conflicted such that they would have been incapable of making an impartial

decision whether to bring the litigation. When the court determines that demand would have been futile (and the stockholder-plaintiffs thus can bring the derivative suit), the board can seek to regain control over the litigation by forming an independent SLC to determine whether pursuit of the litigation is in the corporation's best interests.

If the SLC determines that pursuing the litigation is not in the corporation's best interests, it can petition the Court of Chancery to terminate the action. The SLC then would have the burden of demonstrating (under the *Zapata* test) that there are no material issues of disputed fact as to whether the SLC was comprised of independent members, had conducted a good faith investigation of reasonable scope and had reached reasonable conclusions. If the SLC meets its burden under this first part of the *Zapata* test, the court generally will defer to the SLC's judgment and terminate the litigation. Alternatively, the court in its discretion can apply the second part of the *Zapata* test, under which the court would apply its own judgment as to whether dismissal would serve the company's best interests. The *Zapata* test thus addresses the tension between, on one hand, a board's authority to manage and control its litigation assets, and, on the other hand, the risk that a conflicted board may seek to terminate a beneficial derivative action.

SLC's authority and conclusions. The BH board had fully authorized the SLC to determine whether pursuing the derivative litigation would be in BH's best interests, with the determination being final and binding on BH. Following its investigation, the SLC 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 BH. On that basis, and taking into account the potential negative effects that continued prosecution of the derivative action could have on BH (including indemnification and advancement costs, diversion of company resources and negative publicity), the SLC concluded that terminating the action would best serve the interests of BH and its shareholders.

SLC's investigation. The court found that the SLC demonstrated that it had conducted a thorough investigation in good faith. The court noted that the SLC and its advisors 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.

SLC'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 SLC'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 SLC's independence based on: (i) Ebel having exchanged several emails with the board Chair (who was a subject of the SLC's investigation) during the investigation; and (ii) certain lawyers at the two law firms representing the SLC having previously represented GE in various other matters.

With respect to (i) above, the court stated that the emails "should not have occurred," but concluded that each was "non-substantive" 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 SLC. 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 (ii) above, the court emphasized that the individual lawyers working with the SLC 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 SLC 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 SLC's independence. The court found that the SLC demonstrated that it had in fact investigated each of these potential conflicts (although not all were discussed in the SLC's report). Moreover, in any event, with respect to the alleged conflicts of advisors to the Conflicts Committee in connection with the challenged 2018 Transactions, the court stated that, even if the SLC'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 SLC'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 advisor had done work for GE, the court stated.

- *SLC's legal counsel.* The plaintiffs found fault with the SLC's counsel acting as an intermediary between the SLC and the SLC's financial advisor, allegedly to insulate the financial advisor's work from scrutiny. For example, they pointed to the fact that the financial advisor's evaluation of the terms of the 2018 Transactions was not provided to Ebel or included in the SLC's report. The court responded: "But Ebel was not required to independently review [the financial advisor]'s model or its internal communications." The court observed that Ebel received periodic updates from counsel about the financial advisor's progress and met with the financial advisor before the SLC reached its conclusions. "This approach was reasonable and consistent with the SLC's good faith reliance on its advisors," the court wrote.
- *BH's financial advisor for 2018 Transactions.* The court noted that the SLC had reviewed "thousands of documents" produced by the advisor, had asked interviewees about the advisor's potential conflicts and its interactions with the Conflicts Committee, had been told about the advisor's strict conflicts policy and had received confirmation that no member of the advisor's team had represented GE while working on the project for the Conflicts Committee.
- *BH's legal counsel for 2018 Transactions.* BH had retained its longtime legal counsel which, while advising the company on the 2018 Transactions, separately was also at the same time representing GE on other matters. A few months before the 2018 Transactions were finalized, a GE representative had told a BH executive that the law firm had been doing a large amount of work for GE and "could not be expected to be adverse to GE." After this exchange, the Conflicts Committee charged a different law firm with taking the lead in negotiations with GE. The court noted that the SLC had interviewed the lead attorney about the

conflict (who had explained that, due to the appearance of a potential conflict, the counsel had recommended using the second law firm); had interviewed BH's Head of Business Development about the counsel's potential conflict (who had stated that he had no concern that the counsel's work for GE might have affected its work for BH); and had explored the work that the second law firm had provided as legal counsel to the Conflicts Committee.

Reasonableness of SLC's conclusions. The court found that the SLC 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 BH 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 SLC "[l]argely amount to disagreements with the SLC's analyses." The question under the first step of the *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 process. The court endorsed the SLC's conclusion that the 2018 Transactions process was imperfect but fair. The strengths of the process included the leverage that BH held over GE while the Lockup remained in effect, BH's proactive and prepared approach to negotiations, the Conflicts Committee's assertiveness and the industry expertise of the BH negotiators. The flaws of the process included the negotiators' status as legacy GE employees, the potential disclosure of BH confidential information to GE, GE's potential non-disclosure of information to BH and rumors that GE might fire BH's CEO. While the court emphasized that "a debate on the merits is inappropriate under *Zapata*," the court nonetheless "briefly consider[ed] each of the plaintiffs' arguments for the sake of completeness" and found that "[n]one raise[d] a genuine issue of material fact about the reasonable bases supporting the SLC's conclusion that the process was fair." For example, the plaintiffs argued that the SLC unreasonably concluded that BH lacked negotiating leverage over the SLC; however, the SLC found that BH *had* leverage (due to the Lockup). Also, the plaintiffs argued that the Conflicts Committee was not aggressive (due to the members' dual loyalties to GE); however, there was evidence that these negotiators "did not pull their punches" in the negotiations with GE and "were incentivized to push for [BH]'s best interests because they were compensated based on [BH]'s performance."

Fairness of the 2018 Transactions price. The court also found reasonable the SLC's conclusion that the price was fair. Although the SLC's financial advisor allegedly made numerous errors in its analyses, the court noted that the SLC was entitled to rely on its advisor and to evaluate its advisor's analyses with advice from the SLC's legal counsel. The court concurred with the SLC'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 BH 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 BH's board (which would have occurred after the Lockup expired).

Practice Points

- Seriously consider utilizing an SLC. Potential advantages of utilizing an SLC include regaining control of derivative litigation from the shareholder-plaintiffs and, if the SLC 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 an SLC include the expense of the SLC's investigation and outside advisors, and the possibility that a court may not agree with the SLC's conclusions. It should be kept in mind that, unlike in other pleading-stage contexts, an SLC 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 an SLC, it should fully authorize the SLC to investigate and determine whether derivative claims should be pursued, and should select as members of the SLC 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 SLC 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. An SLC should retain its own legal counsel and consider retaining its own financial advisors. Potential conflicts of interest of the members and advisors 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 SLC. The general objective should be to foreclose any reasonable basis on which the SLC'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. An SLC should proceed without animosity toward the stockholder-plaintiffs or their counsel and without bias or predetermined conclusions. Together with its advisors, an SLC 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. An SLC should be careful not to take actions that could be interpreted as reflecting any bias in the investigation. Generally, an SLC's final report should detail the work undertaken, the potential conflicts of interest of the SLC's members and/or advisors 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 an SLC can raise significant privilege issues for both the corporation and the SLC. For example, the SLC's providing a detailed report to the board can raise issues of possible waiver of the attorney-client privilege between the SLC and its legal counsel with respect to the matters covered in the report. An SLC should consult with its legal counsel when preparing its report.

Scan the QR code for information on the latest CCRcorp events, products and more!



FOUNDING PUBLISHER - Jesse M. Brill, J.D. Yale Law School
Formerly an attorney with the Securities and Exchange Commission and a leading authority on executive compensation practices, Mr. Brill is also the Founding Publisher of *The Corporate Counsel* and *The Corporate Executive*, and Chair of the National Association of Stock Plan Professionals.

EDITOR - John Jenkins, Managing Editor of DealLawyers.com
EDITOR - Meredith Ervine, Editor of DealLawyers.com

A sister publication of the popular newsletters, *The Corporate Counsel* and *The Corporate Executive*, *Deal Lawyers* is a bi-monthly newsletter for M&A practitioners to keep them abreast of the latest developments and analyze deal practices. This publication is designed to provide accurate and authoritative information in regard to the subject matter covered; it should not be relied upon as legal advice. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. Any views expressed herein are those of the author, and do not purport to represent the views of his law firm or its clients.

CCRcorp • 8911 N. Capital of Texas Highway, #4200-110 • Austin, TX 78759 • 1-800-737-1271 • info@ccrcorp.com

To renew your subscription or sign up for a no-risk Free Trial, please visit DealLawyers.com.