APPOINTING AND MANAGING THE SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS

2011 Business Law Institute

Peter C. Buck and Kelly A. Koeninger
Robinson, Bradshaw & Hinson, P.A.

Introduction

Historically, transactions of a corporation in which a corporate director had a conflict of interest were voidable at the option of the corporation.[1] This amounted practically to a prohibition on such transactions. Today, court decisions and corporation statutes have articulated procedures through which a corporation may enter into transactions where a director has a conflict of interest. Those procedures generally require full disclosure of the conflict to the board of directors or to the shareholders. They may also involve delegating the board's authority to a special committee, composed of directors who are independent, that acts for the board in connection with the transaction.

Since 1983, when the Delaware Supreme Court decided *Weinberger v. UOP, Inc.*,[2] corporate directors have more and more frequently relied on special board committees to deal with conflict-of-interest transactions.[3] Recent developments in federal securities regulation and Delaware case law also have resulted in the increased use of special committees in connection with internal corporate investigations.[4] The growing reliance on committees in these two contexts, together with boards' traditional and continuing use of special litigation committees to respond to derivative suits brought by shareholders, makes the appointment and management of special committees increasingly important. This paper will examine some legal and practical issues that a corporation and its counsel must address in the creation and utilization of such committees.

The Statutory Framework

The business and affairs of every North Carolina corporation are "managed by or under the direction of its board of directors."[5] In carrying out these functions, directors must comply with the standards of good faith, due care and loyalty, as prescribed by the North Carolina Business Corporation Act (referred to hereinafter as the "Business Corporation Act").[6]

---

[1] See R. Robinson, Robinson on North Carolina Corporation Law § 15.01. Citations to Robinson on North Carolina Corporation Law will be to the appropriate section of "Robinson." "In 1880 it could have been stated with confidence that in the United States the general rule was that any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction." Marsh, "Are Directors Trustees? Conflict of Interest and Corporate Morality," 22 Bus. Law. 35 (1966).
[2] 457 A.2d 701 (Del. 1983).
[3] See Wolfe and Salomone, "Pure Resources, Printcafe and the Pugnacious Special Committee," The M&A Lawyer May 2003 (available online at http://www.potteranderson.com/news-publications-40-49.html). See also Gerstein and Faris, Special Negotiating Committees: If, When, Who and How – A Guide for the General Counsel, Memorandum Prepared by Latham & Watkins, August 2007 (available at http://blogs.law.harvard.edu/corpgov/files/2007/08/...). The Gerstein and Faris memorandum will be referred to in this paper as the "Latham Paper."
[4] See Smith and Raeber, "The Board's Role in Internal Investigations,"42 BNA Securities Regulation & Law Report 2176 (November 15, 2010).
[5] North Carolina Business Corporation Act, N.C. Gen. Stat §55-8-01(b). See Robinson § 12.01.
[6] Business Corporation Act, N.C. Gen. Stat. Ch. 55. The North Carolina Business Corporation Act is codified in Chapter 55 of the North Carolina General Statutes. Citations to the act in this paper will be to the appropriate section of the "Business Corporation Act." Section 55-8-30(a) of the Business Corporation Act provides that "a director shall discharge his duties as a director, including his duties as a member of a committee: (1) In good faith;

Corporate boards, however, can create committees of directors that exercise the full authority of the board, with certain enumerated exceptions.[7] A committee of the board that exercises board authority must consist only of directors,[8] and must be appointed by a majority of the directors in office.[9] A director is entitled to rely on opinions and reports prepared by board committees, so long as the director "reasonably believes the committee merits confidence";[10] however, the creation of, delegation of authority to, or action by a committee, standing alone, does not constitute compliance by a director with the statutory duties of a board member.[11] Conflict-of-interest transactions entered into by a North Carolina corporation are not voidable by the corporation if the material facts of the transaction and the relevant director's interest in the transaction are disclosed or known to a board committee that authorizes, approves, or ratifies the transaction.[12]

In North Carolina, every plaintiff in a derivative proceeding must make written demand on the corporation to take "suitable action" with regard to the matters complained of, and there is no exception to this requirement based on "futility" of such demand.[13] The Business Corporation Act provides that the court shall dismiss a derivative proceeding brought in the right of the corporation if a special committee consisting of two or more "independent" directors "determines in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interest of the corporation."[14]

<u>Conflict-of-Interest Transactions – The Special Negotiating Committee</u>

As noted above, the Business Corporation Act, like most state corporation statutes, provides that approval by a committee of directors "who have no direct or indirect interest in the transaction" serves to "cleanse" a conflict-of-interest transaction between a corporation and a director who does have a direct or indirect interest in the transaction.[15] That is, a conflict-of-interest transaction is not voidable by the corporation if such a committee of disinterested directors approves the transaction, provided that the "material facts of the transaction and the director's interest" are disclosed to the committee and that the approval receives the affirmative

---

(2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) In a manner he reasonably believes to be in the best interests of the corporation.

[7] Business Corporation Act §55-8-25. See Robinson § 12.07. Board committees shall not: (1) [a]uthorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors; (2) [a]pprove or propose to shareholders action that [the Business Corporation Act] requires to be approved by shareholders; (3) [f]ill vacancies on the board of directors or on any of its committees; (4) [a]mend articles of incorporation pursuant to [Section 55-10-02 of the Business Corporation Act]; (5) [a]dopt, amend, or repeal bylaws; or (6) [a]pprove a plan of merger not requiring shareholder approval. Business Corporation Act §55-8-25(e).

[8] Business Corporation Act § 55-8-25. See Robinson § 12.07, at 12-11.

[9] Business Corporation Act § 55-8-25(b). See Robinson § 12.01[1].

[10] Business Corporation Act § 55-8-30(b) (3).

[11] Business Corporation Act § 55-8-25(f).

[12] Business Corporation Act § 55-8-31(a) (2). See, generally, Robinson § 15.01.

[13] Business Corporation Act § 55-7-42. Norman v. Nash Johnson & Sons' Farms, Inc., 140 N.C. App. 390 (2000). See Robinson § 17.03[1].

[14] Business Corporation Act § 55-7-44(b) (2). See, generally, Robinson § 17.08.

[15] Business Corporation Act § 55-8-31(a) (1) and (c); Robinson § 15.01[2].

vote of a majority of the disinterested committee members.[16] Although the Business Corporation Act provides two other procedural methods for a "disinterested" approval of a conflict-of-interest transactions -- approval by a majority of the disinterested directors of the full board and approval by a majority of disinterested shareholders[17] -- the use of a special committee frequently is the most practical and, in some circumstances, the only workable procedure for such transactions. Absent such disinterested approvals, a conflict-of-interest transaction would be voidable by a corporation unless the transaction was "fair to the corporation," and the burden of establishing such fairness would be on the party seeking to sustain the transaction.[18]

Even with such a prescribed committee approval, fairness to the corporation remains a requirement for a conflict-of-interest transaction, since disinterested director approval must in any event be made in good faith and a director likely would not approve a transaction that was not fair to the corporation.[19] Thus, the practical effect of obtaining the approval of a properly constituted and functioning special committee is to shift the burden of proof to the shareholder or other party seeking to challenge that transaction.[20]

The process outlined above is designed to ensure the enforceability of corporate transactions – perhaps even to guarantee enforceability. But it is important not to overestimate the extent of insulation from court review that an independent committee may provide. Especially as transactions become more significant to the corporation, the possibility of court review becomes greater and the extent of a court's deference decreases. To understand the functioning of special committees in this context, it will be helpful to review briefly the duties of directors and the standards of review that courts use in examining whether directors have carried out such duties.

Delaware Standards in Change-of-Control Transactions

Because of the paucity of North Carolina appellate decisions shedding light on the duties of directors in change-of-control situations, North Carolina courts frequently look to the decisions of Delaware courts as instructive, if not necessarily controlling, precedent.[21] These cases, as summarized in *Robinson on North Carolina Corporation Law*,[22] have developed four different levels of judicial review of director actions:

- Review under the "business judgment rule," applicable in the absence of an indication that directors have not satisfied their duties;
- "Enhanced scrutiny" of defensive measures (such as "poison pill" rights plans or high-vote requirements) implemented by directors without shareholder approval as impediments to changes in control;

[16] Business Corporation Act § 55-8-31(a) (1). See Robinson § 15.01[2]. Since statutory amendments in 2005, such a committee may be composed of only one disinterested director. Business Corporation Act § 55-8-31(c); Robinson § 15.01[2] at note 13.
[17] Business Corporation Act §§ 55-8-31(c) and (d).
[18] Business Corporation Act § 55-8-31(a) (3); Robinson § 15.01[4].
[19] Business Corporation Act § 55-8-30(a) (1); Robinson § 15.01[4].
[20] Robinson § 15.01[4].
[21] Robinson § 9.08[2], citing Alford v. Shaw, 320 N.C. 465, 358 S.E. 2d 323 (1987).
[22] Robinson § 9.08[2].

- "Entire fairness" review of actions as to which one or more directors may not be disinterested; and
- Requirement of a "compelling justification" for action taken for the purpose of interfering or impeding the exercise of shareholders' right to vote.

The business judgment rule, which operates primarily as a rule of judicial review of director action, "creates, first, an initial evidentiary presumption that . . . the directors acted with due care (i.e., on an informed basis) and in good faith in the honest belief that their action was in the best interest of the corporations, and second, absent rebuttal of the initial presumption, a powerful substantive presumption that a decision by a loyal and informed board will not be overturned by a court unless it cannot be attributed to any rational business purpose."[23] Availability of the rule in the review of director action thus gives significant practical assurance that a court would not overturn the challenged action. The strength of the initial presumptions embodied in the business judgment rule, however, will "naturally vary with the importance of the board action" being considered, and thus Delaware courts are inclined to more rigorously review a sale-of-control transaction than the sale of a corporate asset.[24] Especially in change-of-control transactions with controlling stockholders or similar circumstances in which one or more directors clearly is not disinterested, the Delaware courts have applied a much more rigorous standard of review called "entire fairness," and it is in the context of such transactions that the use of special negotiating committees has become most important.

The Delaware precedents indicate that the higher "entire fairness" standard of review will apply to at least the following types of transactions:

- Transactions in which a majority of the board has financial interests adverse to the corporation or in which a majority of the board has other interests adverse to the corporation;[25]
- Transactions in which an individual director or a minority of the board has financial or other interests adverse to the corporation, if the interested director or directors are viewed to control or dominate the board as a whole;[26]
- Transactions in which a majority of the directors receive a special or personal benefit, if material, that may be incidental to an arm's-length transaction;[27] and
- Transactions with a controlling stockholder.[28]

Delaware courts consider a transaction "entirely fair" only if both the process and result replicate a hypothetical arm's-length transaction. The standard thus has two components: "fair dealing" and "fair price."[29] The defendant bears the burden of proof on the question of entire

[23] Robinson § 14.06.
[24] Robinson § 14.06 at 14-17.
[25] See Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994).
[26] See Cinerama, Inc. v. Technicolor, 663 A.2d 1156, 1168 (Del. 1994).
[27] See Cede & Co. v. Technicolor, 634 A.2d 345, 362 (Del. 1993).
[28] See Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994).
[29] The entire fairness standard thus would result in the invalidation of some sale transactions even where the court found the consideration received by shareholders to be a fair price. The additional requirement of fair dealing is necessary in this context because the notion of fair price, at least as viewed by financial advisors, encompasses a

fairness. The Delaware Supreme Court, in *Weinberger v. UOP*, described "entire fairness" as follows:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.[30]

In examining the fair-dealing aspect of control transactions, Delaware courts have scrutinized all significant aspects of the transaction process, including timing, disclosure, structure, negotiations, and approval.[31] The fair-dealing component of Delaware's entire fairness review is thus a very exacting one, and the court's allocation of the burden of proving fair dealing may practically be dispositive of the judicial outcome.[32]

For Delaware corporations, at least, the use of a properly structured special negotiating committee effectively eliminates the need for a corporation's board to establish the fair-dealing component of the entire fairness review standard: when a special negotiating committee functions as a suitable surrogate for "the energetic, informed and aggressive negotiation"[33] one would expect in an arm's-length transaction, Delaware courts are much less suspicious of the possibility of prohibited self-dealing.

The leading Delaware case on special negotiating committees in the change-of-control context is *Weinberger v. UOP Inc.*,[34] decided by the Delaware Supreme Court in 1983, where the court reviewed a proposed merger between a Delaware corporation and its controlling stockholder. Prior to the *Weinberger* decision, Delaware courts had required that such "going-private" mergers have a "business purpose" separate and apart from the controlling stockholder's desire to eliminate the majority.[35] In *Weinberger*, minority shareholders filed a class action challenging a merger between UOP and its majority parent, The Signal Companies. Several years after Signal had acquired a majority stake in UOP, Signal commissioned a feasibility study

---

range – sometimes a broad range – of acceptable prices. See Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1143 (Del. Ch. 1994), aff'd, 663 A.2d 1156; see, also, Latham Paper at 3-4.

[30] Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

[31] Latham Paper at 4-5.

[32] See Bart Schwartz and Amy L. Goodman, Corporate Governance: Law and Practice § 11.02 at 11-7 (hereinafter referred to as "Schwartz and Goodman"); Latham Paper at 7. The Delaware Court of Chancery recently approved a sale transaction under the entire fairness standard, where the presence of an independent special committee put the burden of proof on the complaining shareholders. In re John Q. Hammons Hotels, Inc. Shareholder Litigation, 2011 Del. Ch. LEXIS 1 (January 14, 2011)

[33] In re Trans World S'holders Litig., C. A. No. 9844, 1988 WL 111274, at *4 (Del. Ch. Oct. 21, 1988).

[34] 457 A.2d 701 (Del. 1983); see, generally, Schwartz and Goodman § 11.02.

[35] Singer b. Magnavox Co., 380 A.2d 969 (Del. 1977); see Wolters, "State Law on Going Private: Developments in Delaware Law," Ch. 68, A.A. Sommer, Jr., ed., Securities Law Techniques (vol. 5).

regarding the potential acquisition of the remainder of UOP's shares. This study utilized information obtained from Signal's two designated delegates on the UOP board and concluded that a price of $24 per share would be a good investment for Signal. Signal's board later approved a purchase price of $21 per share, which had been negotiated with UOP's chief executive officer, and this offer was communicated to the UOP board, which promptly voted to approve a merger at the $21 price. Both of Signal's designated directors excused themselves from the discussion of and vote on the merger – notwithstanding their knowledge that Signal's feasibility study would have justified a significantly higher price. UOP obtained a fairness opinion, prepared in only three days, that the $21 price was fair[36] and the transaction process was done in a rush.

On these facts, the Delaware court declined to apply a substantive business-purpose test, and held instead that the controlling stockholder in a going-private transaction bears the burden of proving entire fairness – both fair dealing and fair price. In a very important footnote, the court stated:

> Although perfection is not possible, or expected, the result would have been entirely different if [the subsidiary] had appointed an independent negotiating committee of its outside directors to deal with [the controlling stockholder] at arm's length. [citation omitted]. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered or pursued. [citation omitted]. Particularly in a parent-subsidiary context, a showing that the action taken as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.[37]

Under *Weinberger* and its progeny, the use of a special negotiating committee does not justify application of the director-friendly business judgment rule in every change-of-control transaction; it does, however, mean that the burden of establishing the entire fairness of such a transaction is removed from the approving board so that complaining shareholders must prove the absence of either fair dealing or fair price.[38] This shift in burden has great practical significance: indeed, the allocation of the proof burden is generally considered to be determinative of the outcome of litigation regarding a control transaction.[39] The Delaware Supreme Court in the 1994 case of *Kahn v. Lynch Communications Systems, Inc.*,[40] extended the logic of *Weinberger* to require an entire fairness review in any negotiated merger in which a controlling or "dominating" stockholder stands on both sides of the transaction and, recently, in

---

[36] 457 A.2d at 706-07; see, generally, Weiss, Balancing Interest in Cash-Out Mergers: The Promise of Weinberger v. UOP, Inc., 8 Delaware J. Corp. L. 1, 38-44 (1983).
[37] 457 A.2d at 709 n. 7.
[38] Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994).
[39] See Nathan, "Practical Implications of CNX Gas on Controlling Shareholder Acquisitions," posted July 13, 2010, at The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at http://blogs.law.harvard.edu/corpgov/2010/07/13/practical-implications-of-cnx-gas-on-controlling-shareholder-acquisitions/; Latham Paper at 7.
[40] 638 A.2d 110 (Del. 1994).

In re John Q. Hammons Hotels Inc. Shareholder Litigation,[41] the Chancery Court held that, absent both a proper special committee process and a majority-of-the-minority vote, the court would place on a controlling stockholder the burden of showing the entire fairness of a merger with an unaffiliated third party in which the controlling stockholder would receive a higher price and additional consideration for his control share position.[42] Practitioners thus have increasingly advised the use of such committees in recent years, and for all intents and purposes universally in negotiated, long-form[43] merger transactions in which a controlling stockholder seeks to take a corporation private.[44]

In some conflict-of-interest transactions, the use of a special negotiating committee may result in application of the business judgment rule, an even better result for a corporation than the shifting of burden applied in change-of-control mergers. Until recently, Delaware courts had applied the business judgment rule to transactions in which a controlling stockholder sought to effect a freezeout of minority stockholders by using a two-step process: a cash tender offer followed by a short-form merger. The courts viewed the tender offer structure as less susceptible to self-dealing abuse than a negotiated merger because, absent coercion in the form of a lower back-end price or similar arrangement, stockholders are free to reject the controlling stockholder's tender.[45] Thus, Delaware courts have applied the business judgment rule to tender offer structures that met three conditions: (i) the offer is subject to a non-waivable condition that a majority of the minority tender their shares, (ii) the controlling stockholder commits to

---

[41] 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

[42] The Hammons case involved the holder of a controlling block of high-vote shares in a dual-class voting structure. See Aronstam and Ross, Retracing Delaware's Corporate Roots Through Recent Decisions: Corporate Foundations Remain Stable While Judicial Standards of Review Continue to Evolve, 12 Delaware Law Review 1, 13-17 (2010). Note that in the recently decided In re John Q. Hammons Hotels, Inc. Shareholder Litigation, supra note 32, the court found that that the transaction at issue was entirely fair. The court noted that the special committee that negotiated the transaction was independent, experienced, and "thorough, deliberate and negotiated at arm's length." Id. at *8.

[43] In North Carolina, like other states, most mergers require both approval by the boards of directors of the two merging corporations and a vote by the shareholders of both the merging and surviving corporation. Business Corporation Act § 55-11-03; see also Robinson § 24.02. Mergers requiring shareholder votes of both corporations, or triangular mergers that require a vote of the target corporation's shareholders, are sometimes referred to as long-form mergers. In certain mergers, however, for example where a parent corporation already owns at least 90 per cent of the outstanding shares of a subsidiary, the merger of the subsidiary with the parent can be approved without a shareholder vote of either corporation. Business Corporation Act § 55-11-04. See also Robinson § 24.02[2]. Such mergers where no shareholder vote is required are often referred to as short-form mergers. Short-form mergers are especially useful in two-step acquisition transactions: the acquiring company makes a tender offer for 90 percent or more of a target company's shares and then, after acquiring the threshold shares, effects a short-form merger. Neither a shareholder vote nor a board recommendation on the proposed merger is required in such a transaction.

[44]Audra Boone and Harold Mulherin, Conflict of Interest in Corporate Transactions: The Role of the Disinterested Special Committee, unpublished, available at http://www.terry.uga.edu/finance/docs/mulherin_corporate_control.pdf, October 2010, 8. Boone and Mulherin studied 845 completed acquisitions of publicly traded targets by either a private bidder or a publicly traded bidder between 2003 and 2007, and found that the frequency of special committee use increased from 15 percent of studied transactions in 2003 to 34 percent in 2007.

[45] In re Silconix Inc., S'holder Litig., 2001 Del. Ch. LEXIS 83 (June 19, 2001); see In Re CNX Gas Corp. S'holder Litig, 2010 Del. Ch. LEXIS 119, *25 (May 25, 2010).

complete a short-form merger[46] at the same price if more than 90% of the outstanding shares are tendered in the offer, and (iii) the controlling stockholder does not make retributive threats.[47]

The Delaware view of such tender-offer structures has changed in recent years, however, and the courts' current approach to such transactions places even greater emphasis on the use of special negotiating committees. In a recent case, Vice Chancellor Strine suggested that the tender offer structure should not be treated differently from a negotiated merger.[48] Therefore, in addition to the three conditions listed above, Vice Chancellor Strine suggested that approval by a special committee of independent directors should be an additional condition of the application of the business judgment rule in the freezeout context.

Very recently, in *In Re CNX Gas Corp*, Vice Chancellor Laster applied the "unified standard" suggested by Vice Chancellor Strine in a going-private tender offer.[49] Here, CONSOL, the parent company of CNX Gas, commenced a tender offer to acquire the remaining outstanding publicly held stock.[50] The tender offer was subject to a non-waivable condition that the majority of the minority shareholders accept the tender offer and CONSOL had committed to effect a short-form merger after the successful completion of the tender offer.[51] After announcement of the tender offer, CNX Gas formed a special committee to evaluate the tender offer; however, the authority of the special committee was limited and "the resolution did not authorize the Special Committee to negotiate the terms of the Tender Offer or to consider alternatives."[52] The special committee reviewed the tender offer and declined to express an opinion. In determining whether to grant a preliminary injunction, the court reviewed the tender offer according to the suggested standard set forth by Vice-Chancellor Strine in *In re Cox Communications* and added the further requirement that the special committee in fact negotiate the arrangements. According to the court, special committee approval is necessary, but not sufficient, to afford protection of the business judgment rule to such a two-step freezeout. If, however, the special committee both negotiates and approves the tender offer, and so long as the three traditional conditions also are met, the court would apply the business judgment rule to the board's action.

So, although Chancellor Laster referred to his ruling in CNX Gas as establishing a unified standard, Delaware law as currently applied is not crystal clear regarding the effect of a properly constituted and functioning special committee. In negotiated mergers, the use of a special negotiating committee with power to negotiate the transaction has been necessary to allow a shift in the burden of showing entire fairness; Delaware courts may follow the lead of CNX in the future to provide that such a committee, when combined with a majority-of-the-minority vote and the absence of coercive or abusive techniques, may afford boards in negotiated acquisitions business judgment protection.[53] Where such committees are used in the absence of

---

[46] See note 43 supra.
[47] In re Pure Resources S'holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002).
[48] In Re Cox Communication S'holder Litig., 2005 Del. Ch. LEXIS 79 (June 6, 2005).
[49] In Re CNX Gas Corp. S'holder Litig, 2010 Del. Ch. LEXIS 119 (May 25, 2010).
[50] Id. at *13.
[51] Id. at *14. Note that T. Rowe Price, the largest minority shareholder of CNX, had already signed an agreement with CONSOL to tender its shares of CNX.
[52] Id.
[53] See Nathan, supra note 39.

a majority-of-the-minority vote, or where such votes are obtained without an effective special committee negotiating process, it is not clear whether boards will still be able to obtain the benefit of the burden-shift on entire fairness.[54]

North Carolina Standards in Change-of-Control Transactions

Although the Delaware approach is still in flux, courts continue to emphasize the cleansing effects of the proper use of special negotiating committees in conflict-of-interest transactions generally and in control transactions particularly. North Carolina law is, if anything, more protective of director actions, at least in control transactions; however, the law in this area is much less developed than that in Delaware and the careful practitioner will continue to look to Delaware cases in advising corporate clients in this regard.

There are two fundamental differences between North Carolina law and Delaware law in this context: (1) North Carolina defines the duties of directors in its corporation statute, whereas Delaware has established such duties entirely through case law;[55] and (2) the Business Corporation Act, unlike Delaware law, provides that "[t]he duties of a director weighing a change of control situation shall not be any different, nor the standard of care any higher, than otherwise provided" in the statute that provides for the standards of good faith, due care, and loyalty.[56] The effect of this statute, added by amendment in 1993 to the Business Corporation Act, is uncertain.[57] While it apparently eliminates certain requirements that apply to boards of Delaware corporations in control transactions, such as "Revlon duties,"[58] the 1993 amendment does not rule out the application of higher standards of review in change-of-control circumstances, particularly in light of North Carolina courts' traditional emphasis on the protection of shareholder rights.[59] Thus, the North Carolina Business Court, in *First Union Corp. v. Suntrust Banks, Inc.*,[60] rejected an argument by the defendant corporations that the 1993 amendment required application of the business judgment rule to the review of certain defensive measures implemented in connection with the proposed merger of Wachovia Corporation and First Union Corporation. The court also rejected plaintiff Suntrust's position that the Delaware "enhanced scrutiny" test should apply to review of such measures. Instead, the court formulated a case-specific and fact-specific review process designed to protect shareholders' rights to an uncoerced vote and the board's ongoing ability to perform its statutory duties,[61] including the duty of loyalty. The North Carolina appellate courts have not clarified the applicable statutory standards of conduct and review, and thus uncertainty remains in this area. It is clear, however, that the statutory standards of good faith, due care, and loyalty would apply in a change-of-

[54] Id.
[55] Business Corporation Act § 55-8-30; see Robinson § 9.08[3].
[56] Business Corporation Act § 55-8-30(d) (last sentence).
[57] Robinson § 9.08[3] at 9-24.
[58] Id. at 9-25. "Revlon duties" refers to the duties of directors of a corporation, once the board has decided that the company is "for sale" or that a sale is inevitable. The term is derived from the 1986 decision of the Delaware Supreme Court in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). Once directors are in "Revlon mode" and have "Revlon duties," their duty is to obtain the best value for the shareholders. See Robinson § 9.08[2].
[59] Id.
[60] 2001 NCBC 9A.
[61] See Robinson § 9.08.

control context, just as in any other board action, and, as the *Suntrust* case makes clear, that the courts will examine vital corporate transactions with more care and rigor than they might apply to more routine events.[62] On balance, under current case law, boards of North Carolina corporations thus may find protections for their actions that are broader than those available under Delaware case law.

Scope of Committee Power and Authority; Committee Effectiveness

The Delaware courts are willing to confer significant procedural benefits where special negotiating committees function as a suitable surrogate for "the energetic, informed and aggressive negotiation" that can reasonably be expected in an arm's-length transaction.[63] To determine whether the committee has functioned properly, the courts will examine both the scope of its authority to approve, negotiate, and otherwise deal with the transaction at issue and the actual steps the committee has taken.[64] For example, in *In re TransWorld Airlines, Inc. Shareholders Litigation*,[65] the court was particularly troubled by testimony from two special committee members suggesting their view that the committee's charge in a going-private transaction with a controlling stockholder was limited to achieving a transaction that could be blessed by an investment banker's fairness opinion. The court stated:

> The special committee did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary. *Weinberger* envisions that minority interests can be protected by a special committee that emulates that arm's-length process. But the burden shifting effect will not occur where the special committee did not adequately understand its function – to aggressively seek to promote and protect minority interests – or was not adequately informed about the fair value of the firm and the minority shares in it.[66]

The authorizing charter or resolution creating the special committee thus is crucial if a corporate board hopes to achieve the benefits of the use of a special negotiating committee.[67] Within the limits prescribed by the applicable corporation act,[68] the special committee should have the authority to take essentially any action that the full board might take in dealing with a similar transaction where there is no disqualifying conflict of interest.

---

[62] Id.
[63] In re Trans World S'holders Litig., supra note 33, at 4.
[64] See, generally, Schwartz and Goodman § 11.05. Courts also will examine the independence of committee members and other factors as well, as discussed in the text accompanying notes 131 through 160 infra.
[65] CA 9844, 1988 Del. Ch. LEXIS 139 (Oct. 21, 1988).
[66] Id. at *21.
[67] A sample chartering resolution is annexed to this paper.
[68] See note 7 supra with respect to the Business Corporation Act. Section 141 (c) (2) of the Delaware General Corporation Law permits delegation of full board authority except that a committee may not have the power to: (1) approve or adopt, or recommend to the stockholders, any action or matter expressly required by the Delaware General Corporation Law to be submitted to stockholders for approval; or (2) adopt, amend or repeal any bylaws of the corporation. See Schwartz and Goodman, § 11.05[2]. Note that the Delaware statute apparently would permit the full delegation to a special committee of authority to declare a dividend, which is expressly limited by the Business Corporation Act. This could restrict the ability of the board of a North Carolina corporation to empower a special committee to deploy a "poison pill" rights plan as a defensive measure.

At a minimum, a special negotiating committee must have plenary power to say no to a proposed transaction. "It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available."[69] But the power to say no, standing alone, is not enough. In *Gesoff v. IIC Industries, Inc.,*[70] the Chancery Court reviewed the work of a one-person special committee in assessing a majority stockholders' cash-out merger proposal. The court summarized factors it would consider when determining whether the special committee had adequate authority.[71] First, the special committee should be given a clear mandate, which "should include the power to fully evaluate the transaction at issue, and, ideally, include … the 'critical power' to say 'no' to the transaction."[72] "The critical issue here is whether the Special Committee functioned as an effective proxy for arm's-length bargaining, such that a fair outcome equivalent to a market-tested deal occurred" and whether "[t]he controller's commitment to leave the essential fate of the transaction in the hands of the special committee . . . ensures that the merger offer is not negotiated in the shadow of punitive action by the controller if the minority resists the merger."[73] The special committee members should also be able to clearly articulate their authority and responsibility. Thus both the grant of authority to a committee and the actual steps taken by the committee must at least be "consistent" with arm's-length negotiations: "these negotiations need not, of course, be a 'death struggle.' But they should be "vigorous and spirited."[74]

It may be helpful to contrast the actions of the special committee in *In re TransWorld Airlines, Inc. Shareholders Litigation*,[75] discussed above, with the work of a much stronger special committee in the recent going-private merger of Affiliated Computer Systems.[76] ACS was a publicly traded Delaware corporation that provided outsourcing of business processing and information technology services to business and government clients. Darwin Deason, the founder of ACS, owned all shares of a separate class of high-vote common stock, which gave him 42% voting control of the company, although his economic equity stake was much smaller. In late 2005, the company received an unsolicited buyout offer of $65 per share from a consortium of private equity firms. After discussions between the parties, ACS ended talks with the potential buyers in early 2006 and announced that it was no longer considering a sale transaction. Newspaper reports indicated that Deason had used his 42% voting power to block the proposed transaction.

In November 2006, Deason sent the ACS board a buyout proposal for a going-private transaction at $60 to $62 per share. In the proposal, Deason informed the board that he did not intend to vote in favor of or otherwise participate in any transaction with a party other than his

[69] Lynch, supra note 28, at 1119; see Latham Paper at 16-17.
[70] 902 A.2d 1130 (Del. Ch. 2006).
[71] Gesoff v. IIC Industries, Inc., 902 A.2d 1130 (Del. Ch. 2006).
[72] Id. at 1146.
[73] Id.
[74] Id.
[75] Supra note 33.
[76] The factual summary is drawn from a Memorandum Opinion and Order of the Delaware Chancery Court, decided February 6, 2009, in a shareholder derivative action captioned In re: Affiliated Computer Services, Inc. Shareholders Litigation, C.A. No. 2821-VCL, and a complaint filed by the independent directors in the Chancery Court for New Castle County Delaware seeking a declaratory judgment that they had not breached their fiduciary duties. Holland, et al., v. Deason, et al., Complaint filed November 1, 2007 (Case No. 3323).

own buying group. Two days later, the ACS board met and, upon Deason's recommendation, formed a special committee to consider the proposed transaction. The committee was authorized to retain an investment banker and legal counsel. Later, in February 2007, Deason advised the board that Cerberus Capital was the only private equity firm still interested in a buyout proposal and that he expected an offer to be forthcoming in two to three weeks. On March 20, Deason and Cerberus publicly announced a proposal to acquire all shares not owned by Deason and management team members for $59.25 per share. On the same day, Deason, as a stockholder, signed an exclusivity agreement with Cerberus in which he pledged not to support or participate in any alternative transaction that did not involve the Cerberus buyout group.

The ACS board, with Deason and other management members of the board recusing themselves, formed a special committee of three independent directors. This committee later retained Weil, Gotshal & Manges as independent legal counsel and Lazard Freres as independent financial advisor. On April 21, one month after the initial proposal, the Deason-Cerberus group raised its offer to $62 per share and proposed an acquisition agreement that would allow a 40-day "go-shop" period following execution of the agreement. Two days later, the special committee responded in a letter to Deason in which it expressed serious concerns with regard to its ability to attract other bidders during the go-shop period, in large part because of Deason's exclusivity agreement with Cerberus. Two months of discussions followed until, on June 10, Cerberus executed a two-month waiver of the Deason exclusivity agreement, in exchange for the company's undertaking to reimburse certain expenses already incurred by Cerberus. The waiver expired on August 10. In the meantime, because of the nationwide credit crisis and other reasons, the proposed deal fell apart and, on October 30, Cerberus withdrew its buyout proposal.

That same day, Deason demanded the immediate resignation of all outside directors, whom he accused of various breaches of their fiduciary duty, all connected to their "blocking" of a deal that Deason said would be good for all stockholders. The directors then filed a declaratory judgment action in Delaware Chancery Court, seeking a declaration that they had not breached their duties. This action was quickly settled when the independent directors resigned, but only after they had vetted a new slate of independent directors. Two years later, ACS was sold to Xerox Corporation for a purchase price roughly equivalent to $62 per share.

Another dramatic example of a special committee negotiation is the recently announced agreement for J. Crew Group, Inc., the Atlanta-based retail concern, to be acquired in a going-private merger by a buyout group that includes the private-equity firms Texas Pacific Group and Leonard Green, as well as J. Crew's CEO Mickey Drexler.[77] TPG has a long history with J. Crew. In 1997, TPG, with participation from Drexler and management, acquired J. Crew in a going-private transaction. J. Crew completed an initial public offering in July 2006, and TPG sold shares in the offering and subsequently, at a handsome profit. Although TPG sold all its shares, a TPG representative, James Coulter, continued as a member of the J. Crew board. In the fourth quarter of 2008, TPG representatives talked with Drexler about the feasibility of another leveraged buy-out of the company, but TPG concluded in early 2009 that market conditions were not suitable for such a transaction. Later, in August 2010, Leonard Green representatives talked with TPG representatives regarding a potential buyout, and TPG arranged for Leonard Green to

[77] The following summary is based largely on the preliminary proxy statement filed by J. Crew with the Securities and Exchange Commission and various news reports.

meet with Drexler on August 23 to discuss, "on a highly preliminary basis," a potential leveraged buyout. Three weeks later, Drexler and J. Crew's CFO, James Scully, met with TPG and lawyers from Wilkie Farr & Gallagher, personal counsel to Drexler, to gather more information about TPG's interest. In subsequent weeks, various J. Crew executives met with or provided information to TPG. On September 30, Drexler and Scully had a conference call with TPG, in which TPG indicated that Drexler and the management team were of "critical importance" to TPG's view regarding any acquisition of J. Crew, and that any acquisition proposal would be conditioned on Drexler's rolling over a substantial equity stake and continuing his employment with the company. TPG also advised Drexler and Scully that it planned to provide for an equity pool for J. Crew's management team in its potential ownership structure. On October 7, approximately seven weeks after Drexler's preliminary meeting with TPG and Leonard Green, Drexler and Coulter began calls to J. Crew's other board members to inform them of the TPG buyout group's interest. A week later, on October 14 and 15, the J. Crew board, with Drexler excusing himself, discussed and then formed a special committee of four independent board members. The special committee was initially formed to (i) consider any proposal from TPG to acquire the Company and to consider any alternative proposal from any other party, (ii) engage independent legal and financial advisors to the special committee, and (iii) present to the full board a proposal for a more detailed delegation of authority. In the following week, the special committee interviewed candidates to serve as legal and financial advisors to the committee and engaged Cravath, Swain & Moore as counsel and Perella Weinberg as financial advisor. Later, on October 22, the board delegated "full power and authority to the special committee in connection with its evaluation of strategic alternatives, including the full power and authority to (i) formulate, establish, oversee and direct a process for the identification, evaluation and negotiation of a potential sale of the Company, (ii) evaluate and negotiate the terms of any proposed definitive or other agreements in respect of a potential sale of the Company, (iii) make recommendations to the Board in respect of any potential transaction, including, without limitation, any recommendation to not proceed with or to recommend that the Company's stockholders reject a potential sale of the Company and (iv) make recommendations to the Board that the Board take other actions or consider other matters that the special committee deems necessary or appropriate with respect to any potential sale of the Company or other potential strategic transactions." The Board also resolved that it would not approve or recommend to the Company's stockholders any potential sale of the Company without the favorable recommendation of the special committee.

The special committee and its advisors then embarked on negotiations with the TPG/Green buyout group. Early in this process, the special committee met with Drexler and concluded that Drexler would be "unwilling to work for any third party other than TPG." Notwithstanding Drexler's expressed preference for TPG, the special committee decided, for reasons related to the Company's performance, timing of earnings announcements, and other matters, that it would be in the Company's best interests to pursue the possibility of concluding an agreement with TPG by November 23 The parties then held extensive negotiations, which involved at least one circumstance in which the special committee advised TPG that it would not continue discussions, and ultimately agreed to the terms of a buyout on November 23. The negotiations centered on efforts by the committee to obtain a flexible go-shop provision and assurances from Drexler and TPG that Drexler would be free to, and would in fact support, a potentially higher offer from a third party. Following announcement of the transaction, several lawsuits have been filed to challenge the transaction on numerous grounds.

The ACS and J. Crew transactions highlight the difficulties that boards and special committees face when controlling stockholders or senior management stand on the other side of a potential acquisition.[78] Indeed, the Chancery Court has suggested that it may be incumbent on a special committee to implement a "poison pill" plan, or at least insist on a standstill agreement, to prevent a "creeping takeover" by a majority shareholder. In *Louisiana Municipal Police Employees' Retirement System v. Fertitta*,[79] Chancellor Lamb severely criticized a special committee for failing to take action to stop the corporation's largest stockholder from accumulating majority ownership of the company:

> Turning first to the board's failure to employ a poison pill to prevent [the controlling stockholder] from obtaining control without paying a control premium, it is reasonable in the context of a motion to dismiss to infer fiduciary misconduct more serious than a breach of the duty of care. The failure to act in the face of an obvious threat to the corporation and the minority stockholders instead supports a reasonable inference that the board breached its duty of loyalty in choosing not to cross [the controlling stockholder].[80]

Similarly, the Chancery Court in the *CNX Gas*[81] considered a special committee's failure to take such defensive measures. There the board created a special negotiating committee with only one member, the sole independent director on the board. The board authorized the committee only to review and evaluate a tender offer proposed by the controlling stockholder, prepare appropriate SEC filings, and engage legal and financial advisors. The resolution did not authorize the special committee to negotiate the terms of the tender offer or to consider alternatives, notwithstanding the sole independent director's request that it do so.[82] In discussing this issue, the Chancery Court noted:

> Because a board in a third-party transaction would have the power to respond effectively to a tender offer, including by deploying a rights plan, a subsidiary board should have the same power if the freeze-out is to receive business judgment review. This does not mean that a special committee must use that power. The shadow of pill adoption alone may be sufficient to prompt a controller to give a special committee more time to negotiate or to evaluate how to proceed. What matters is that the special committee fulfills its contextualized duty to obtain the best transaction reasonably available for minority stockholders. Here the Special Committee was deprived of authority that a board would have in

[78] See also In re John Q. Hammons Hotels, Inc. Shareholder Litigation, *supra* note 32, in which the court found "entire fairness" in a special committee process that involved "extensive arm's length negotiation with two active bidders for the period of nine months . . . ."
[79] C.A. No. 4339-VCL (Memorandum Opinion and Order) (Del. Ch. July 28, 2009).
[80] Id. at 20.
[81] In Re CNX Gas Corp. S'holder Litig, 4 A.3d 397 (Del. Ch. 2010).
[82] Id. at 402-403.

> a third-party transaction. . . . [T]his fact provides a separate and independent basis to review a controlling stockholder freeze-out for entire fairness.[83]

These decisions show that the courts' insistence on a process that simulates arm's-length bargaining makes a well thought-out board authorization and a vigorously pursued negotiation process essential for obtaining the benefits of shifting the burden of proof or obtaining business judgment protection in conflict-of-interest transactions.

<u>Internal Investigations – The Special Investigation Committee</u>

Especially since the Enron and WorldCom scandals, corporate boards have increasingly faced the responsibility of conducting internal investigations into corporate misconduct by executives, employees, or even directors.[84] From 2001 to 2008, for example, more than 2,500 public companies retained outside counsel for internal investigations, including inquiries into suspected violations of the Foreign Corrupt Practices Act, alleged options backdating, financial statement improprieties, and other potential criminal violations.[85] Numerous factors account for this increasing reliance on internal investigations. In 1995, Congress added Section 10A to the Securities Exchange Act of 1934 as part of the Private Securities Litigation Reform Act. Section 10A requires that each audit of a public company include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." In addition, the statute requires auditors in some circumstances to conduct an investigation, or see to it that an investigation is conducted, into such matters.[86] The increasing frequency of "whistleblower" allegations since the passage of the Sarbanes-Oxley Act 2002 has created pressure for internal investigations, and the whistle-blower friendly provisions of the newly enacted Dodd-Frank Wall Street Reform and Consumer Protection Act are likely to add to that pressure.[87] Finally, and perhaps most important, various

---

[83] Id. at 410.

[84] See Smith and Raeber, supra note 4.

[85] American College of Trial Lawyers, Recommended Practices for Companies and Their Counsel in Conducting Internal Investigations, 46 Am. Crim. L. Rev. 73, 74 (2008) (hereinafter, "Recommended Practices").

[86] See Vartanian, Bard, and Nelson, "Section 10A and the Internal Investigations at Financial Institutions," ABA Banking Law Newsletter (2006).

[87] On November 3, 2010, the SEC proposed new rules for the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). See Rel. No. 34-63237 (Nov. 3, 2010), in which the SEC proposed its new rules (Release). These whistleblower provisions were enacted to encourage those with knowledge to report violations of the securities law to the SEC. Section 922 of Dodd-Frank added new Section 21F to the Securities Exchange Act of 1934, which requires the SEC to pay whistleblowers who provide original information 10 to 30 percent of any successful action resulting in a monetary penalty. One of the chief concerns about the new rules is that they may undermine the effectiveness of current internal compliance and investigation programs by depriving companies of the ability to investigate potential wrongdoing internally first. See, e.g. Covington and Burling, Advisory: Dodd Frank Act SEC Proposes Whistleblower Rules (November 8, 2010, available at http://www.cov.com/files/Publication/785511f5-59b4-4a26-a4a5-c271c0cd4930/Presentation/PublicationAttachment/0173fe90-fbf0-4dd4-bf6f-c29f4b35754d/Dodd-Frank%20Act%20-%20SEC%20Proposes%20Whistleblower%20Rules.pdf. The new whistleblower program creates economic incentives for individuals with knowledge of a potential securities law violation to report this violation to the SEC. Under Proposed Rule 21F-4, only individuals who provide "original information" are allowed to recover. Employees with information about a potential security violation who delay may find that someone else has already provided the information; thus the rule may encourage employees to bypass internal compliance programs altogether. Proposed Rule 21F-4 attempts to remedy this by providing that an employee who elects to

government agencies have increasingly considered the "cooperation" of corporations whose executives or employees are suspected of criminal wrongdoing in making decisions regarding whether to bring criminal charges against a company and in determining appropriate penalties for consideration in settling such criminal matters through deferred prosecution agreements or other arrangements.[88] For example, the Principles of Federal Prosecution of Business Organizations included in the United States Attorneys' Manual provides that a corporation's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents" will be an important factor in such prosecutions.[89] The United States Sentencing guidelines allot a five-point reduction in the sentencing calculation to a company that properly self-reports wrongdoing.[90] In addition, the SEC reduces penalties for companies that conduct through investigations and report the results to the Commission and the public.[91]

Moreover, apart from federal law concerns, corporate directors have a duty under state statutes and case law to monitor the activities of corporate agents to ensure that the corporation is not involved in illegal activities.[92] Corporate boards confronted with evidence of wrongdoing by directors or senior executives thus have a duty to become "informed" regarding the appropriate response to such allegations or "red flags," at least where illegal – as opposed to imprudent – conduct may be involved.[93] In certain circumstances, properly informing itself may require a board to insist on a thorough, independent investigation by a special committee of independent directors,[94] although corporate boards and counsel should exercise care in deciding whether to create a special committee in this context.[95]

Many of the same concerns applicable to special negotiating committees will be important factors in determining the effectiveness of a special investigation committee charged

---

report a violation internally before going to the SEC will receive the benefit of a 90-day "look back" period during which the SEC will deem the information to have been provided to the SEC on the day the employee reported the potential violation internally. The proposed regulations, however, do not condition the payment of SEC bounties on prior internal reporting. In addition, although internal reporting may be a factor the SEC can consider in determining whether a whistleblower receives more than 10% of the monetary penalty, whistleblowers will not be penalized for not reporting internally first. See Release, Section II.E, at 51. While it thus is unclear how the new rules will affect the sequence of reporting, the magnitude of the potential rewards will almost certainly result in an increase in reported violations and thus in the need for corporations to conduct internal investigations, both before and after matters have been reported to the SEC.

[88] Recommended Practices at 77-78.

[89] United States Attorneys' Manual, 9-28.300 A.4.

[90] U.S. Sentencing Guidelines Manual § 8C2.5 (g) (1).

[91] See generally Report of Investigation Pursuant to Section 21(1) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001) [hereinafter "Seaboard Report"].

[92] See, e.g., In re Caremark Int'l, 698 A.2d 959 (Del. Ch. 1996). See generally Robinson § 14.03[2] and cases discussed therein.

[93] American International Group, Inc., Consolidated Derivative Litigation, 2009 Del. Ch. LEXIS 15 (February 10, 2009)

[94] See, generally, Lindquist & Vennum, "Internal Investigations," paper prepared for Association of Corporate Counsel (February 2007) (hereinafter "Lindquist Paper"); Michels, Internal Corporate Investigations and The Truth, 40 Seton Hall L. Rev. 83 (2010); Henning, Board Dysfunction: Dealing with the Threat of Corporate Criminal Liability, 77 U. Cincinnati L. Rev. 101 (2009); Smith & Raeber, supra note 4.

[95] The protection of confidential information and preservation of attorney-client privilege are paramount in this consideration. See 2 J. Villa, Corporate Counsel Guidelines § 5:10.

with performing an internal investigation. Several recent examples will illustrate the basic issues in this context.

In early 2005, infoGroup, Inc., a Nebraska public company formerly known as infoUSA, was embroiled in a dispute with several of its major shareholders.[96] In response to a shareholder demand for company records, infoGroup disclosed a series of suspicious related-party transactions with its founder and chief executive, Vinod Gupta, or entities that Gupta controlled. The Company requested Vasant Raval, chairman of its audit committee, conduct an investigation into these transactions. Raval, who was chair of the accounting department at Creighton University, investigated the matters, concentrating entirely on transactions that occurred in 2004, and prepared what he termed a comprehensive report in which he recommended that Gupta reimburse the company for several hundred thousand dollars. Raval, however, conducted the investigation by himself, did not engage counsel or forensic accountants to assist him, strictly limited the scope of his inquiry to one calendar year, and ignored several "red flags" pointed out to him by infoGroup's internal auditors. Further inquiries by complaining shareholders and an SEC investigation revealed that the company had paid or reimbursed Gupta or his family for more than $9 million in improper personal expenses and had engaged in another $9 million in unsupportable related-party transactions with entities controlled by Gupta. Shareholders sued the directors alleging breach of fiduciary duty, waste and other matters. In the complaint, they noted Raval's report, but challenged it for, among other reasons, a lack of independence. Gupta had donated more than $1 million to Creighton University, where Raval was employed as an accounting professor, and had other close ties to Raval. The case ultimately settled, without payment of monetary damages by directors other than Gupta. However, in a very unusual action, the SEC subsequently charged Raval with violation of securities laws, relating primarily to inadequate disclosure of Gupta's expenses and self-dealing transactions. The Commission alleged that Raval "failed to respond appropriately to various red flags concerning Gupta's expenses and [infoGroup's] related party transactions with Gupta's entities," and that he failed to take appropriate action regarding concerns expressed to him by two internal auditors. Finally, the SEC alleged that "Raval failed to take meaningful action to further investigate Gupta's misconduct and omitted critical facts in his report to the board concerning Gupta's expenses."[97] Early in 2010, Raval agreed to pay a fine of $50,000 and was barred from serving as a director of any public company.[98]

The SEC's action against Raval is a significant cautionary tale. Once a special committee undertakes to perform an internal investigation, the committee itself is under obligations imposed by state corporation laws and securities laws. If the committee fails to perform its duties in compliance with those laws, not only may its actions be challenged, but the committee members may have personal or even criminal liability.

Several cases involving recent allegations of the backdating of stock options also spawned internal investigations. For example, the board of directors of Staples, Inc., the chain of

---

[96] The following description is based on the Consolidated Complaint filed by infoGroup shareholders in a Delaware derivative action, In re: INFOUSA, Inc. Shareholders Litigation, Consol. C.A. No. 1956-N, filed February 5, 2007 (Del. Ch. New Castle County), and SEC Litigation Release No. 21451, March 15, 2010.
[97] SEC Litigation Release No. 21451.
[98] Id.

office-supply stores, authorized its audit committee to investigate claims of backdating options.[99] The record contains little regarding the investigation process engaged in by the committee; however, the committee did engage outside counsel. The review resulted in a determination that some stock options had been issued with an "incorrect measurement date" but that no intentional wrongdoing had occurred. The company did not press for recovery of any money from recipients of stock options or announce the taking of any other action. Subsequently, a longtime stockholder filed a derivative action against Staples' directors and the court considered the effectiveness of the internal investigation in considering whether demand was excused as futile:

> Before analyzing this issue, the court notes certain troubling aspects of this matter that undermine the court's confidence in the ability of the board to properly consider a demand. Most importantly, the initial complaint was filed only after the company and its audit committee conducted a review of historical option granting practices, concluded that the company erroneously issued options with what were carefully labeled "incorrect measurement dates," without explaining how those dates did not result from backdating, and then did nothing to remedy those past "errors."[100]

Contrast these investigations with the response of UnitedHealth Group, Inc., which responded to allegations of the backdating in a Wall Street Journal article in March 2006.[101] Soon after the article was published, the United Health board appointed a special committee of three "disinterested" directors, who retained an independent law firm and forensic accountants to examine all of the company's option grants going back to 1994.[102] The special committee gave the investigating law firm broad scope in its examination, and the firm uncovered significant problems apart from the option backdating issue. In particular, the investigation revealed that the head of UnitedHealth's compensation committee, who had negotiated the CEO's employment agreement, also managed assets in amounts up to $55 million for the CEO and that the CEO had invested $500,000 in a buyout of the committee chairman's investment firm. The CEO was uncooperative in the investigation, and ultimately was forced to resign as a result of the findings.

Deciding whether a board committee, management, or the full board should take responsibility for an internal investigation depends numerous factors, including the nature of the alleged wrongdoing, potential involvement of senior executives or board members, the need for protecting confidentiality and preserving attorney-client privilege, and the independence requirements – formal or otherwise – imposed by regulators, auditors, shareholders, reviewing courts, or others who may seek to rely upon the investigation.[103] In those contexts where the use of a special investigation committee is warranted, it will be extremely important to address issues related to the independence of committee members, the scope of the committee's authority, the

---

[99] The following description is based on the court's summary of the facts in Conrad v. Blank, 940 A.2d 28 (Del. Ch. 2007).

[100] 940 A. 2d at 37.

[101] See Henning, supra note 94, at 112-15.

[102] The appointment of this special committee actually raised some concerns regarding its independence: one member had served on the company's compensation committee, although only after the period of the grants in question, and all three had, as directors, approved at least some of the grants questioned in the newspaper article. Henning, supra note 94 at 113.

[103] See, generally, sources cited in notes 94 and 95 supra.

engagement by the committee of counsel, accountants, and other advisors, and other matters similar to those that confront special negotiating committees.

<u>Shareholder Derivative Suits – The Special Litigation Committee in Derivative Proceedings</u>

One type of special investigation committee plays a particularly important role in the law of corporations: the special litigation committee appointed by the board of a corporation named in a shareholder derivative action. Although some practitioners and scholars have assumed that derivative claims have lost their importance in recent years,[104] yielding the stage to securities class-action claims, government investigations, and policing through stock-exchange listing rules,[105] recent empirical research reveals that derivative suits continue as an important tool of corporate governance.[106] Many of these claims are settled for non-monetary consideration, such as various changes in a corporation's governance practices,[107] but some recent cases have resulted in very large monetary settlements.[108]

In the context of special litigation committees considering derivative claims, many of the same issues discussed above with regard to other types of special committee will be of vital importance: independence and disinterestedness of committee members, proper chartering of the committee and definition of its scope of authority, and thoroughness and objectivity of the committee's investigation and determination. Chapter 17 of *Robinson on North Carolina Corporation Law* provides an excellent discussion of the statutory and case law applicable to derivative claims involving North Carolina corporations.

Since the mid-1970s special litigation committees have played a crucial role in the dismissal of claims with respect to which the corporation has made a determination that it is not in its best interest to maintain the proceeding.[109] Section 55-7-44 of the Business Corporation Act, which was adopted in 1995, has governed the dismissal of derivative proceedings as a result of a determination by a special litigation committee.[110] That statute, based largely on the Model

---

[104] See, e.g., Davis, The Forgotten Derivative Suit, 61 Vand. L. Rev. 387 (2008).
[105] Erickson, Corporate Governance in the Courtroom: An Empirical Analysis, 51 Wm. & Mary L.Rev. 1749, 1752 (2010).
[106] Id. at 1749.
[107] Id.
[108] E.g., American International Group, Inc. Consolidated Derivative Litigation (C.A. No 769-VCS) (Del. Ch. New Castle County) ($150 million settlement funded by D&O insurance); In re Pfizer Inc. Shareholder Derivative Litigation, No. 09-CV-7822 (JSR) (S.D.N.Y.) (Preliminary $75 million settlement funded by D&O insurance).
[109] Robinson § 17.08[2]. Following the Model Act, the Business Corporation Act since 1995 has made North Carolina a "universal demand" state: that is, any shareholder seeking to bring a derivative proceeding must initially make a written demand on the corporation to "take suitable action." Business Corporation Act § 55-7-42. The plaintiff must then wait for 90 days before commencing a proceeding in court, unless the corporation gives early notice that it will reject the demand or unless "irreparable injury" would result if the plaintiff were forced to wait the full 90 days. Id. Unlike Delaware and prior North Carolina law, the Business Corporation Act does not excuse demand in cases where it is futile because the board of directors lacks independence. Allen v. Ferrera, 141 N.C. App. 284 (2000); see Robinson § 17.03[2].
[110] Settlement of a derivative proceeding, as opposed to outright dismissal upon motion of the corporation, is governed by a separate statutory provision, Section 55-7-45(a), which provides that a derivative proceeding may not be "discontinued or settled" without the court's approval and requires that the court determine whether the proposed settlement would "substantially affect the interests of the corporation's shareholders or a class of shareholders."

Corporation Act, provides that "[t]he court shall dismiss a derivative proceeding on motion of the corporation if a [properly appointed special litigation committee composed of independent directors] "determines in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interest of the corporation."[111] In order to qualify for such dismissal, the relevant determination must be made by majority vote of a "committee consisting of two or more independent directors" who were in turn appointed by "majority vote of independent directors present at a meeting of the board of directors, whether or not the independent directors constituted a quorum."[112] Thus, a properly constituted special litigation committee must have at least two members and they must be "independent." Unlike other committees of the board, however, the special litigation committee may be appointed by a subset of the board that consists of the board's independent members; the appointment need not be made by a majority of the board and can be made in a meeting of the independent directors even though they do not constitute a quorum.[113]

In summary, the Business Corporation Act mandates dismissal of a derivative proceeding if a properly appointed committee of independent directors determines (i) in good faith, (ii) after conducting a reasonable inquiry, (iii) upon which its conclusions are based that it is not in the best interest of the corporation to proceed. Importantly, the burden of proving that a special litigation committee has been properly appointed and has made a determination in accordance with these standards falls on the plaintiff shareholder if a "majority of the board of directors consists of independent directors at the time the determination is made."[114] If, at the time of such determination, a majority of the board is not independent, the corporation will have the burden of proving compliance with these tests.[115] It may, therefore, be prudent for a corporation facing a shareholder demand to expand its board of directors to include enough additional "independent" members to ensure allocation of this burden to the plaintiff.[116]

Section 55-7-44(a) appears to refer primarily to the committee's process, as opposed to the substantive merits of its determination; however, case law that predates adoption of the 1995 statute also provided that a court perform its own substantive review of the merits of a shareholder derivative proceeding, exercising its own "independent business judgment."[117] The

---

This statute is very similar to the former Section 55(c), which served as an important basis for the North Carolina Supreme Court decision in the Alford case, discussed at notes 117 through 121 infra

[111] Business Corporation Act § 55-7-44(a) (emphasis added). The statute additionally provides for dismissal upon a "majority vote of independent directors at a meeting of the board of directors if the independent directors constitute a quorum." Id. §§ 55-7-44(a) and (b) (1). Thus, it may not be necessary in many circumstances to formally create a special committee; however, many of the same considerations discussed herein regarding director independence and the quality of the review and determination would be applicable to the independent directors acting as such. In this paper, we have assumed that a committee is established pursuant to the applicable statutes.

[112] Business Corporation Act § 55-7-44(b) (2). The Model Act uses the term "qualified" directors.

[113] Compare Business Corporation Act § 55-8-25(b); see Model Business Corporation Act Annotated, Official Comment to § 7.44.

[114] Business Corporation Act § 55-7-44(e). The North Carolina statute does not specify whether the corporation or the plaintiff has the burden of proving the independence of the directors who appoint a special litigation committee, unlike the Model Act, which places that burden on the plaintiff. Model Business Corporation Act § 7.44(c).

[115] Id.

[116] Curiously, the statute does not seem to require that the board that actually appoints the special committee have a majority of independent directors at the time of appointment, but only at the time the committee makes its determination.

[117] Alford v. Shaw, 320 N.C. 465 (1987). See the thorough discussion in Robinson § 17.08[2].

North Carolina Supreme Court, in the 1987 case *Alford v. Shaw*, adopted a "modified Zapata rule," in which it followed Delaware case precedent to require a substantive review of the merits, in addition to an examination of the independence of committee members and the quality of the committee process.[118] In so ruling, the Court relied heavily on then Section 55-55 of the Business Corporation Act, a 1973 statute that expressly authorized derivative suits and provided some procedural protections. Section 55(c) of the 1973 statute provided as follows:

> [A shareholder derivative action] shall not be discontinued, dismissed, compromised or settled without the approval of the court. If the court shall determine that the interest of the shareholders or any class or classes thereof, or of the creditors of the corporation, will be substantially affected by such discontinuance, dismissal, compromise or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to such shareholders or creditors whose interests it determines will be so affected.

The Supreme Court in Alford placed great stress on this statute as reflective of North Carolina's traditional emphasis on the protection of minority shareholder rights.

In 1995, this statute was amended to follow the Model Act formulation:

> A derivative proceeding may not be discontinued or settled without the court's approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected.[119]

The new statute thus deletes the prior statutory reference to the "dismissal" of a proceeding and applies to the "discontinuance or settlement" of a derivative proceeding, adopting the Model Act language, which aims primarily to allow a reviewing court to protect against collusive or otherwise improper settlements between the defendants and the shareholder plaintiff.[120] The North Carolina courts have not examined whether the second prong of the court review mandated in the Alford case would apply under the new statute, including in the circumstance in which a properly formed special litigation committee[121] determines that the case

---

[118] The Supreme Court specifically applied the ruling in the 1987 Alford case in a subsequent decision, Alford v. Shaw, 327 N.C. 526, 539-40 (1990): "[T]he trial court is to undertake a two-step review of [dismissal motions in derivative actions]: First, it is to decide whether the proposal for disposition of the case which is submitted to the court was reached by qualified independent disinterested decision-makers who in good faith proceeded to thoroughly investigate and evaluate the claims set forth in the complaint. . . . .The second step . . . requires the trial court to exercise its own independent business judgment as to whether the case is to be discontinued, dismissed, compromised or settled."

[119] Business Corporation Act § 55-7-45.

[120] "The requirement seems a natural consequence of the proposition that a derivative suit is brought for the benefit of all shareholders and avoids many of the evils of the strike suit by preventing the individual shareholder-plaintiff from settling privately with the defendants." Model Business Corporation Act Annotated, § 7.45 Official Comment.

[121] Although the Alford case and parallel Delaware cases speak in terms of a separate substantive review that requires the court's independent business judgment, it is possible that courts reviewing dismissal motions may import their views on the merits of the case into the first-prong analysis of process. For example, the United States District Court in Madvig v. Gaither, 461 F.Supp.2d 398 (W.D.N.C. 2006), dismissed a derivative claim against a

should not go forward and the corporation moves for dismissal pursuant to Section 55-7-44(a).[122] In its report that accompanied the proposal to adopt the 1995 derivative proceeding legislation, the North Carolina Commission on Business Laws and the Economy made no reference to the Alford review standard or of any intention to supersede the court's analysis:

> In other respects, *such as the prohibition against discontinuance or settlement of an action without court approval* . . . , the proposed statute is substantially similar to the present North Carolina Act, but follows the language of the Revised Model Act.[123]

Although no North Carolina court has examined the effect of the new statute on Alford in the dismissal context, the Business Court, in a case decided in 1996, just one year after adoption of the new statute, applied the second prong of the Alford analysis in approving the settlement of a derivative claim against the directors of Coastal Physician Group, Inc., a Delaware corporation.[124] The court looked to Section 55-7-47 of the Business Corporation Act to hold that North Carolina law would govern approval of the settlement, even though the proceeding was brought against a Delaware corporation, and then applied both prongs of the Alford test in its review. Note that this case involved a settlement, as opposed to a special committee determination that a derivative proceeding should be dismissed.

The only court that has dealt with a special litigation committee determination regarding termination of a derivative action is the United States District Court for the Western District of North Carolina, which dismissed a shareholder derivative action against directors of Ingles Markets, Inc., a North Carolina corporation.[125] In the Ingles case, the plaintiff shareholder demanded that the company sue its directors for malfeasance or misfeasance in connection with a restatement of Ingles' financials as the result of improper end-of-quarter accounting practices that had come to light as the result of an SEC investigation. In response to the demand, the Ingles board established a special litigation committee of independent directors, and the committee engaged independent counsel to assist in an investigation. Following the statutory 90-day waiting period, but prior to completion of the committee's inquiry, the plaintiff commenced its derivative proceeding. The company then moved to dismiss on the basis of the committee's determination that the proceeding should not go forward. In acting on the motion, the federal

---

North Carolina corporation on the basis of a special litigation committee recommendation. The court noted in that case that the plaintiff's claim was so weak that it might be subject to a Rule 11 analysis.

[122] Federal Rule of Civil Procedure 23.1(c) contains a provision similar to § 55-7-45: "A derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval. Notice of a proposed settlement, voluntary dismissal, or compromise must be given to shareholders or members in the manner that the court orders." The statute is intended to protect against settlements with plaintiff-shareholders that do not properly account for the interests of the nonparty shareholders. See 5 Moore's Federal Practice § 23.1.10.

[123] Annual Report of The North Carolina Commission on Business Laws and the Economy 13 (1995). Federal Rule of Civil Procedure 23.1(c) contains a provision similar to § 55-7-45: "A derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval. Notice of a proposed settlement, voluntary dismissal, or compromise must be given to shareholders or members in the manner that the court orders." The statute is intended to protect against settlements with plaintiff-shareholders that do not properly account for the interests of the nonparty shareholders. See 5 Moore's Federal Practice § 23.1.10.

[124] Scott v. Sokolov, 1996 NCBC 2 (Durham).

[125] Madvig v. Gaither, 461 F.Supp.2d 398 (W.D.N.C. 2006).

court made no mention of Section 55-7-45, but rather analyzed the motion solely with respect to Section 55-7-44(a):

> The inquiry of a court reviewing the corporation's decision not to pursue the proposed litigation is limited to determining whether:
>
> (1) the decision was made by a "committee consisting of two or more independent directors," N.C. Gen. Stat. § 55-7-44(b) (2);
> (2) a reasonable inquiry was conducted; and
> (3) the decision was made in good faith.[126]

Similarly, other courts, in applying statutes which are nearly identical in this respect to the Business Corporation Act, have generally looked only to the analogue of Section 55-7-44 when deciding whether to dismiss a derivative action on the recommendation of a special committee. For example, in *Einhorn v. Culea*,[127] the Supreme Court of Wisconsin reviewed a lower's court decision to dismiss a derivate suit on the recommendation of the special committee. The main issue on appeal was the independence of the directors of the special committee. The lower courts had, according to the Supreme Court, set forth an extremely low threshold for determining the independence.[128] This was a problem because the court was bound by Wis. Stat. §180.0744 in reviewing the dismissal (the analogue of Section 55-7-44 of the Model Corporation Act.) According to the court, under Wis. Stat. §180.0744, independence of the directors of the special committee was particularly important because "the court is bound by the substantive decision of a properly constituted and acting committee" and the "statute requires judicial adherence to the decision of a special litigation committee that is independent and is operating in accordance with the statute."[129]

Regardless of whether the court will make its own substantive review of a special litigation committee determination, it is clear that the court will examine independence both of the appointing directors and of the committee members, in addition to the good faith and reasonableness of the committee's investigation. Determining whether the appointing directors and the members of the special litigation committee are in fact "independent" is both a crucial and a very complicated decision, discussed in more detail below.[130] It is important to note, however, that the Business Corporation Act specifies that none of the following three factors shall cause a director to be considered not independent:

(1) The nomination or election of the director by persons who are defendants in the derivative proceeding or against whom action is demanded;

(2) The naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded; or

[126] Id. at 403-404.
[127] 235 Wis. 2d 646 (Sup. Ct. 2000).
[128] Id. at 661.
[129] Id. See also; Melton v. Blau, 2004 Conn. Super. LEXIS 2399 (Aug. 26, 2004) (granting a motion to dismiss a derivative action under the Connecticut version of Section 55-7-44); Thompson v. Scientific Atlanta, Inc., 275 Ga. App. 680 (2005) (upholding a motion to dismiss a derivative action under the Georgia version of Section 55-7-44).
[130] See text accompanying notes 136 - 160 below.

(3) The approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.[131]

The statute requires that both the committee's "determination" and the "inquiry" be made in "good faith,"[132] a subjective standard that means "honestly or in an honest manner."[133] The term "inquiry," instead of "investigation," affords a special committee flexibility in setting the scope of its work, depending upon the issues raised and the knowledge of the committee members.[134] The phrase "upon which its conclusions are based" goes to the relevancy of the inquiry: whether the conclusions embodied in the committee's determination find support in the inquiry's findings and follow logically.[135]

Independence of Special Committee Members

In most circumstances in which special board committees function, the independence, or "disinterestedness," of the committee members is of paramount importance. Independence in these contexts undergirds the reliability and credibility of the determinations made and actions taken by such a committee. Understanding what is meant by an independent committee member, however, is an extremely complicated and frequently difficult question.

The recent corporate scandals have resulted in increased emphasis on the need for independent members on corporate boards.[136] Stock exchanges and the SEC have imposed rules that require a majority of directors of publicly listed corporations to be independent as defined by their rules, and require that all members of certain board committees be independent.[137] These rules-based approaches generally focus on economic relationships between the directors and the corporation or other persons related to such corporations.

In situations where special committees are most important, it is state law that governs the independence question, and here courts have tended to apply a more nuanced, case-by-case analysis of each committee member's independence. The fundamental question, according to the Delaware Supreme Court, "is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences."[138] Thus, the court must ask: "independent from whom and independent for what purpose?"[139] It will examine both whether the director is "disinterested" in the sense of financial benefits: a personal financial benefit not equally shared by all stockholders is disqualifying. In addition, the court will look at subjective factors, such as whether the director is under the domination or influence of someone who is interested in the matter at hand.[140]

---

[131] Business Corporation Act § 55-7-44(c).
[132] Model Business Corporation Act Annotated § 7.44(a) Official Comment 2.
[133] Id.
[134] Id.
[135] Id.
[136] Page, Unconscious Bias and the Limits of Director Independence, 2009 U. Ill. L. Rev. 237, 238.
[137] Id. at 238-39.
[138] Beam ex rel. Martha Stewart Living Omnimedia, Inc., v. Stewart, 845 A.2d 1040, 1049 (Del. 2004).
[139] Id.
[140] Id. See Page, supra note 136 at 242-46.

Several recent Delaware Supreme Court cases are illustrative. In *In re Loral Space and Communications, Inc.*,[141] the court easily determined the special committee directors were not independent. There, the special committee was appointed to consider the issuance of $300 million in equity to the controlling stockholder. Since one of the special committee directors was an "investment manager" for the controlling stockholder and was simultaneously attempting to raise capital from the controlling stockholder for another company while serving on the special committee, and the other special committee director did not understand the process, the court concluded, without much discussion, that the special committee process was inadequate and applied the "entire fairness" standard to the transaction.[142]

In *Beam* ex rel. *Martha Stewart Living Omnimedia, Inc. v. Stewart,*[143] the court dealt with the issue of demand futility in connection with a shareholder derivative action involving a Delaware corporation majority-owned by the television personality. The plaintiff alleged that Stewart had breached fiduciary duties to the corporation by engaging in an illegal sale of stock of an unrelated company. In Delaware, demand on the board of directors generally is excused as futile unless a majority of the board is considered independent. The plaintiff argued that two directors were not independent because of longstanding personal relationships with Martha Stewart, and further that the remainder of the board lacked independence because of the potential they could face liability for failure to properly monitor Stewart's activities and the "fact" Stewart's position as a controlling stockholder made it impossible that the directors, who were dependent on her for their positions, could be unbiased.

In examining the claim of disqualifying personal relationships, the court acknowledged that some professional or personal relationships may be even closer than family relationships, which normally prevent a finding of independence. But in order to disqualify a director in this context, such a relationship must be "of a bias-producing nature," and the court believed that few relationships rise to this level. In addition, Stewart's dominant control, by itself, was not enough to create a reasonable doubt of independence.

The *Stewart* case should be contrasted with a decision of the Delaware Chancery Court, decided one year prior to *Stewart* in 2003. In the much-publicized *Oracle* decision, the court questioned and found that directors on a special litigation committee were not independent due to personal ties with defendants.[144] In *Oracle*, which dealt with a special litigation committee determination not to proceed in response to a shareholder demand, the corporation formed a special litigation committee when allegations of insider trading by four members of Oracle's board of directors surfaced.[145] On the special litigation committee were two Stanford professors, both well known and respected in their fields. The court found that personal ties the professors had with the interested directors at issue cast doubt on their independence: there was just too much "cardinal red." Factors noted by the court included:

---

[141] 2008 Del. Ch. Lexis 136 (Sept. 19, 2008).
[142] Id. at *1-*12.
[143] 845 A.2d 1040 (Del. 2004). Page, supra note 136 provides a thorough discussion of the case.
[144] In Re Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003). It is important to note that the Oracle also indicated in its opinion that it might apply more rigorous scrutiny to the independence of directors on a special litigation committee than in other contexts.
[145] Id. at 921.

…that among the directors who were accused of insider trading are (1) another Stanford professor, who taught one of the SLC members when the SLC member was a Ph.D. candidate and who serves as a senior fellow and a steering committee member alongside that SLC member at the Stanford Institute for Economic Policy Research or "SIEPR"; (2) a Stanford alumnus who has directed millions of dollars of contributions to Stanford during recent years, serves as Chair of SIEPR's Advisory Board and has a conference center named for him at SIEPR's facility, and has contributed nearly $600,000 to SIEPR and the Stanford Law School, both parts of Stanford with which one of the SLC members is closely affiliated; and (3) Oracle's CEO, who has made millions of dollars in donations to Stanford through a personal foundation and large donations indirectly through Oracle, and who was considering making donations of his $100 million house and $170 million for a scholarship program as late as August 2001, at around the same time period the SLC members were added to the Oracle board.[146]

The combination of these factors led the court to conclude that the special litigation committee was not sufficiently independent. The Oracle case appears to be the high-water mark for courts in Delaware in finding personal and social relationships disqualifying to independence As the Stewart case shows, at least in pre-suit demand cases, the pendulum seems to be swinging back toward focusing exclusively or primarily on direct financial matters.[147] In a very recent decision, however, the Court of Chancery in *London v. Tyrrell*[148] again demonstrated the importance of carefully evaluating the independence of directors who serve on special litigation committees when it denied a special litigation committee's motion to dismiss a derivative action for lack of independence. The special committee in question was formed by the directors of iGov, a government contracting company, in response to a derivative action related to an equity incentive plan.[149] After hiring independent advisors and conducting a four-month investigation into the allegations, the special committee made a motion to dismiss.[150] Plaintiffs argued that the special committee members' relationships with the interested directors rendered them unable to act impartially and in the best interests of the corporation. One special committee member's spouse was the cousin of an interested director, and the other had hired and worked with an interested director at his prior company and "had great respect for [the interested director]…

[146] Id.

[147] See, generally, Dallum, The Oracle That Wasn't: Why Financial Ties Have Remained the Standard for Assessing the Independence of Corporate Directors, 46 Willamette L. Rev. 99 (2009-10). But see discussion of infoUSA case supra notes 96 through 98). But see Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985). In this case, Fuqua Industries appointed Terry Sanford, then president of Duke University, to act as a special committee to examine derivative claims against J. B. Fuqua, founder and CEO of the company. In easily finding a lack of independence, the Delaware Chancery Court noted that Sanford: "was a member of the board of directors . . . at the time the challenged actions took place; he is one of the defendants in this suit; he has had numerous political and financial dealings with J. B. Fuqua who is the chief executive officer of Fuqua Industries and who allegedly controls the Board; he is President of Duke University which is a recent recipient of a $10 million pledge from Fuqua Industries and J. B. Fuqua; and J. B. Fuqua has, in the past, made several contributions to Duke University and is a Trustee of the University." Id. At 966-67. See James D. Cox and Thomas L. Hazen, II Cox & Hazen on Corporations § 15.08 (2d. ed. 2003).

[148] 2010 Del. Ch. LEXIS 54 (Del. Ch. Mar. 11, 2010)

[149] Id. at *1.

[150] Id. at *2.

[who] was very helpful in helping me get a good price for my company."[151] Defendants argued that, in light of *Stewart*, these relationships were insufficient to raise a reasonable doubt as to the independence of the directors. The court disagreed, noting that *Stewart* was a pre-suit demand case. According to the court, the burden in pre-suit demand cases is on the plaintiffs to allege facts sufficient to create a reasonable doubt that the board could not be objective. Here, where the special litigation committee sought dismissal of lawsuit already filed, "the SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence."[152] The court found the defendants did not meet their burden of proof and found a material question of fact as to whether each director felt a "sense of obligation or loyalty" to the interested directors of iGov.[153]

Although there is little helpful precedent from the North Carolina appellate courts, both the North Carolina Business Court and the United States District Court for the Western District Court of North Carolina have stated that personal and professional relationships, without much more, would not be disqualifying in the determination of independence. In a recent case in the Business Court for Mecklenburg County, the court considered whether demand against Horizon Lines, Inc., a Delaware corporation, was excused as futile and in so doing examined the independence of Horizon's outside directors.[154] The court looked to Delaware law to describe the applicable test of independence as "whether or not the particularized factual allegations of a . . . complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[155] In this case, the plaintiff claimed that Horizon directors either were involved in, or had breached their fiduciary duties by failing to monitor, activities by corporate officers that resulted in penalties for violations of antitrust laws. In essence, the plaintiff claimed that Horizon's directors must have been aware of price-fixing, because Horizon's shipping prices continued to go up even in markets where demand for shipping was slowing. The court rejected the plaintiff's challenge to the board's independence on the ground that the board had approved the alleged misconduct and noted that plaintiff's mere allegations fell far short of demonstrating that the board members were actively involved in the alleged misconduct and, on that basis, rejected the plaintiff's independence challenge.

In an earlier case that examined the independence of a special negotiating committee in a cash-out merger of a Delaware corporation,[156] the Business Court for Forsyth County also examined challenges to the independence of committee members. The court held that professional and social relationships – serving on the boards of each other's companies, belonging to the same club, socializing frequently, sharing family vacations – were, without more, not enough to disqualify the directors. The plaintiff must allege facts to show that such relationships would make the directors "beholden" to conflicted directors or that a conflicted director had "leverage" over the committee member.[157]

---

[151] Id. at *48
[152] Id. at *41.
[153] Id. at *49.
[154] Smith ex rel. Horizon Lines, Inc. v. Raymond, 2010 NCBC 18 (Mecklenburg 2010).
[155] Id, citing Rales v. Blasband, 634 A.2d 927 (Del. 1993).
[156] Marcoux v. Prim, 2005 NCBC 5 (Forsyth 2004).
[157] Id.

And in the Ingles Markets case discussed above,[158] the court rejected challenges to the independence of a special litigation committee on grounds that committee members had been nominated or asked to join the board by a conflicted director, because of personal friendships, and past relationships between certain members' law firm and accounting firm.[159]

Still, while not every social or personal relationship with interested directors will disqualify a director from being independent, the *Oracle* and *London* cases discussed above should motivate counsel to carefully investigate and consider whether directors selected for a special committee are truly independent. As the court in *Oracle* made clear, corporations may be required to expand their range of consideration from those they know well when choosing directors to sit on special committees.[160]

Some Practical Matters

Special committees perform different functions in each of the three contexts that this paper has considered – special negotiating committees in fundamental corporate transactions, special investigation committees in connection with potential management or board wrongdoing, and special litigation committees formed in response to shareholder derivate claims. Thus, the practical considerations that apply in deciding whether and how to charter and appoint a special committee, how the committee should conduct the process of negotiating, investigating, or making determinations, what lawyers and other advisors should assist the committee, how committee members should be compensated, and the like will vary with the context. Nonetheless, each of these committee circumstances involves conflicts of interest that will affect decisionmaking on all these practical matters. The following is intended to highlight briefly some of the matters that corporate lawyers should bear in mind in connection with the formation of special committees.

Who Should Be on Committee?

Once a board of directors has made the determination that a special committee is necessary, it must determine how many and which independent directors should serve as committee members. Many experienced practitioners recommend a committee that comprises three to five members.[161] While a committee with fewer than three members may suffice in certain circumstances, particularly where only one or two directors qualify as independent, courts are likely to be more suspicious of the process employed by a one-person committee.[162] For example, the one-person investigations in the infoUSA matter and Lewis v. Fuqua, discussed

---

158 See text at notes 125 and 126 supra.

159 461 F. Supp.2d at 404-07.

160 824 A.2d at 947-48 (noting that "if there are 1,700 professors at Stanford alone…how many must there be on the west coast of the United States, at institutions without ties to Oracle and the [defendants] as substantial as Stanford's?").

161 Latham & Watkins Paper at 8.

162 The Business Corporation Act mandates a minimum of two members for a special litigation committee that will make a determination of how to respond to a shareholder derivative claim. Business Corporation Act § 55-7-44(b)(2).

above, were not effective.[163] As one Delaware court noted, the sole member of a special committee, must "like Caesar's wife, be above reproach."[164]

On the other hand, a committee that has too many members may prove inefficient and unwieldy. Special committee work likely will take significant time and effort, and courts will pay special attention to the quality of the committee process. One Delaware court criticized the work of a special committee whose members lived in different time zones, never met in person, and never met as a full group, even by telephone.[165] And, in addition to meeting independence standards, committee members must be both capable and willing to perform the negotiation or investigation well, and be able to respond to sometimes hostile questioning about the process.[166]

<u>Compensation of Committee Members</u><u>Ryan</u>

Special committee members will devote significant time and effort to their tasks, and thus deserve to be compensated fairly. There is no standard formulation or safe harbor available with respect to compensation. Fixed fees, monthly fees, and per-meeting fees have all been used in various circumstances.[167] Fees that seem unreasonably large or could in any way be viewed as contingent on a particular outcome of the committee process obviously should be avoided. For example, in a Delaware Chancery Court decision, the court was troubled by the payment of $1 million each to the two committee members whose work spanned only one week of meetings. The court found the fee arrangement "suspiciously contingent."[168] It generally will be helpful to set fee arrangements at the time of creation of the committee, and helpful to include a statement of compensation as part of the board's authorizing resolutions.[169]

<u>Engagement of Counsel and Advisors</u>

The chartering resolution should expressly authorize a special committee to engage its own independent legal, financial, and other advisors, all at the corporation's expense. The Delaware Chancery Court has viewed the availability of completely independent advisors as "critical."[170] Courts have found troublesome situations in which management or a controlling stockholder "pre-selected" advisors for a committee[171] or in which a special committee decided to retain the same legal or financial advisors who were acting on behalf of the corporation, although there may be some circumstances in which the use of existing company counsel might

---

[163] See discussion at notes 96 through 98 and 147 supra.
[164] Lewis v. Fuqua, supra notes 147, at 967.
[165] In re Emerging Communications, Inc. S'holders Litig., 2007 Del. Ch. LEXIS 70 (May 3, 2004).
[166] In In re MAXXAM, Inc. /Federal Dev. S'holders Litig., 23 Del. J. Corp. L. 277, 318-19 (Del. Ch. Apr. 4, 1997), the court found it very troubling when one special negotiating committee member could recall very little of the negotiation process.
[167] Johnston & Hurd, "Special Committees of Independent Directors," BNA Corporate Practice Series Portfolio No. 79 at A-16.
[168] In re Tele-Communications, Inc. Shareholders Litigation, C.A. 16470, 2005 WL 3642727, at *8 (Del. Ch. 2006).
[169] Going Private 2010: Doing the Deal Right, Practicing Law Institute (February, 2010), http://www.pli.edu/Content.aspx?dsNav=Ny:True,Ro:0,N:4294964150-167&fromsearch=false&ID=59304 (on demand web program)
[170] In re Fort Howard Corp. Shareholders Litig., 1988 Del. Ch. LEXIS 110, at *36 (Aug. 8, 1988); see Latham Paper at 16; see, generally, Schwartz and Goodman § 11.06[6].
[171] E.g., Kahn v. Tremont Corp. 694 A.2d 422, 429 (Del. 1997)

be warranted. In one case, while the committee was authorized to select its own counsel and financial advisors, the court found that the majority stockholder "hand-picked" the advisors, whom the court determined to be of "little use" in the committee's process.[172] Experienced practitioners advise special committees to interview several candidates for legal and financial advisory positions, asking questions to verify both the independence and the competence of the advisors. They recommend against selecting from a "short list" of advisors obtained from corporate management or a controlling stockholder. Some practitioners also recommend engaging an accounting firm, separate from an investment bank or other financial advisor, to perform a quality-of-earnings analysis on the corporation and vet, to the extent possible, any earnings projections that management supplies to the committee in the context of a management buyout.[173]

In connection with internal investigations or determinations in derivative actions, counsel who acts on behalf of special committees should pay special attention to Rule 2.3 of the Rules of Professional Conduct, which governs a lawyers' "evaluation for use by third persons."[174] The rule provides that a lawyer may undertake such an evaluation only if the lawyer "reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client."[175]

<u>Attorney-Client Privilege</u>

Because special committees independently engage their own counsel, and such counsel typically do not represent the corporation separately, questions regarding the scope and waivability of the attorney-client privilege can be especially complicated. Disclosure of committee reports or legal advice to others in the corporation can, for example, result in an inadvertent waiver of the attorney-client privilege. In *Ryan v. Gifford*,[176] the Delaware Chancery Court held that disclosure to a board of directors of the findings of the special committee charged with an internal investigation constituted a waiver of the privilege. The court noted that several of the directors who were "targets" of the investigation, along with their individual attorneys, were present at the meeting where the special committee presented its findings.[177] When these directors sought to make use of the investigation's findings in their own defense,[178] the court found that they had attended the board meeting in their individual capacities rather than as directors of the corporation.

The reasoning in the *Ryan* case suggests that disclosure of committee findings and confidential advice to the full board would not constitute a waiver, so long as conflicted board members are excluded from such disclosure. In *In re OM Group Securities Litigation*, however,

---

[172] Gesoff v. IIC Industries, Inc., 902 A.2d 1130, 1150-51 (Del. Ch. 2006). See Schwartz and Goodman § 11.06[6] at 11-29.
[173] Going Private 2010: Doing the Deal Right, Practicing Law Institute, "The Special Committee: Not Just Window Dressing" (February, 2010), http://www.pli.edu/Content.aspx?dsNav=Ny:True,Ro:0,N:4294964150-167&fromsearch=false&ID=59304 (on demand web program)
[174] North Carolina Rule of Professional Conduct 2.3.
[175] Id. Rule 2.3(a) (1).
[176] Ryan v. Gifford, No. 2213-CC, 2007 WL 4259557 (Del. Ch. Nov. 30, 2007)
[177] Id. at *4.
[178] Id.

the court found that the attorney-client privilege was waived when attorneys for the audit committee presented their findings to the full board. The court assumed, without much discussion, that disclosure to the full board was similar to disclosure to an external entity.[179] In contrast, other courts that have considered this issue have held that a board of directors and its committees should be considered part of the corporation for privilege purposes.[180]

Other questions may arise in the context of intentional disclosures, for example to government agencies as a means of cooperating with governmental investigations in order to protect the corporation's interests. In shareholder derivative actions, disclosure of a committee's determination and findings to the reviewing court will generally be required in order to obtain a dismissal.[181]

Privilege and work-product issues can be especially tricky where special committees will be involved, and the proper way to address such issues may vary dramatically depending on the circumstance. Counsel should address questions regarding privilege early in the process and advise committee members accordingly.[182] In some circumstances, a common-interest agreement or joint defense agreement between the corporation and a special committee may even be helpful to guard against inadvertent problems.

Indemnification; D&O Insurance

It should be clear that directors serving on special committees are doing so in their capacities as directors and therefore entitled to indemnification and advancement of expenses as provided in the corporation's bylaws generally. Especially for members of special negotiating committees in major conflict-of-interest transactions, but in other contexts as well, counsel should review with special committee members the indemnification that would be available to them in the event of a claim against them. In addition, counsel and committee members should review available directors' and officers' liability insurance policies, both to confirm coverage for committee activities and to understand applicable policy limits.[183]

In one recent case, a D&O insurer challenged a corporation's claim for reimbursement of legal expenses incurred by a special litigation committee in responding to shareholder derivative proceedings.[184] In *MBIA, Inc. v. Federal Insurance Co.*, the United States District Court for the

[179] In re OM Group Sec. Litig, 226 F.R.D. 579, 591-92 (N.D. Ohio 2005)
[180] See, e.g., Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 244 F.R.D. 412 (N.D. Ill. 2006); SEC v. Brady, 238 F.R.D. 429 (N.D. Tex. 2006).
[181] Note that Section 55-749 of the Business Corporation Act provides that no shareholder in a derivative proceeding "shall be entitled to obtain or have access to any communication within the scope of the corporation's attorney-client privilege that could not be obtained by or would not be accessible to a party in an action other than on behalf of the corporation." This statute rejects the balancing approach of Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), under which shareholders in derivative proceedings may defeat a claim of privilege upon a showing of good cause. See Robinson § 3/03[3]. The statute speaks in terms of the corporation's attorney-client privilege, and does not address whether its protection would extend to matters of privilege as between a special litigation committee and its counsel. In that regard, the fact that such a special litigation committee may be appointed by a majority of independent directors, even if less than a quorum of the full board, may complicate a court's analysis.
[182] See Villa, note 95 supra.
[183] See Johnson & Hurd, supra note 167 at A-16 and A-17.
[184] MBIA, Inc. v. Federal Insurance Co., 08 Civ. 4313, S.D.N.Y. Order Filed December 30, 2009.

Southern District of New York required the insurer to reimburse significant fees incurred by MBIA, Inc., the bond insurer, in obtaining dismissal of two shareholder derivative actions spawned by investigations by the SEC and the New York Attorney General. In response to the derivative suits, MBIA's board created a special litigation committee, which in turn engaged Dickstein Shapiro as its separate counsel. The insurer argued that the applicable policies did not apply to the legal fees, because the firm did not represent the corporation.[185] "Defendants counter . . . that '[a] special litigation committee must engage in 'independent decisionmaking': [t]therefore, Dickstein could not have represented the company 'through' its representation of the SLC."[186] The court rejected the insurer's defense, noting among other things that Dickstein had actually made appearances as counsel for MBIA in the actions and filed numerous motions as counsel for "Nominal Defendant MBIA, Inc." But even apart from that, the court said, the SLC was composed exclusively of members of MBIA's board of directors who had full and exclusive authority to determine whether MBIA should pursue the derivative lawsuits. The fact that the committee members were independent and involved in "independent decisionmaking" did not convince the court.[187]

Documenting the Committee's Work

Counsel to any type of special committee should pay close attention to documenting the work of the committee. For special negotiating committees in conflict-of-interest transactions, this will primarily mean the preparation of minutes, a task that will typically fall to counsel. There is no standard format for preparation of such minutes, but experienced practitioners often recommend minutes that are more detailed with respect to committee actions and deliberations than those that might be prepared for regular board meetings. The high likelihood of a legal challenge and the close scrutiny that committee process will receive from a reviewing court make it important that minutes be complete and detailed enough to reflect a thorough and objective process. Practitioners recommend that two attorneys participate in all in-person and telephone meetings of the committee, and that one of those attorneys be responsible for taking careful notes and preparing draft minutes. It is important that minutes be prepared regularly and reasonably promptly after meetings: a raft of minutes prepared at or near the end of the committee process can cause a lack of credibility regarding the committee's diligence and objectivity.

For special investigation committees and special litigation committees, minutes remain important but the decision on whether and how to prepare a final report of the committee's conclusions or determinations may be more important. Generally, a special investigation committee that is looking into potential officer or director misconduct will prepare, or commission counsel to prepare, a thorough and detailed report. In some circumstances,

---

[185] In another context, counsel to a special investigation committee has urged that its representation of the committee meant that it could not be sued for legal malpractice by the corporation's bankruptcy trustee, who was asserting claims on behalf of the company. See Passarella, "K&L Gates Responds to Malpractice Suit by LeNature's Trustee," The Legal Intelligencer December 17, 2009 (discussing filings in Kirschner v. K&L Gates, a state court action filed in Allegheny County, Pennsylvania, in September 2009).
[186] MBIA, Inc. v. Federal Insurance Co, supra note 184.
[187] D&O coverage for counsel fees in derivative litigation is a much-debated issue. See Hirsch, "Special Litigation Committee Legal Fees and Expenses Covered under Directors' and Officers' Policies? The Southern District of New York Answers 'Yes.,'" Howrey Insurance Coverage Monitor, March 22, 2010.

however, an oral report to the full board may be as good as or better than a written report.[188] Counsel and the committee should take this decision advisedly and consider the pros and cons of the two approaches.

Favorable considerations include:

- Written reports are often more comprehensive than oral reports and can be preserved for future use;
- Written reports reduce ambiguity and the possibility of miscommunication or differing recollections;
- A written report is in and of itself evidence of serious, thorough effort by the investigating body; and
- Provision of a written report to government regulators or enforcement agencies can be instrumental in winning cooperation credit for the company.[189]

Risks and disadvantages of a written report[190] include:

- Written reports sometimes tend to cast misconduct in stone and can lack the nuance that can be communicated orally;
- A written report can be leaked, may be discoverable in subsequent civil litigation, and may even increase the pressure to disclose the investigation's findings to regulators;
- Written reports can serve as a "road map" for regulators or adverse private litigants which can increase the prospect of liability for the company; and
- Disclosed investigatory material could even result in defamation litigation by implicated individuals.[191]

Counsel also should consider advising committee members regarding their own note-taking. It is very likely that most committee members will want to take notes, and the taking of notes can be very helpful in the process. Nonetheless, the taking of copious notes may be a guarantee of lengthy depositions and interrogatories in any challenging litigation, and casual or unclear references may permit negative inferences that were never intended. Practitioners often counsel committee members to take very clear notes, limiting them to specific and plainly worded remarks or questions. Counsel frequently also recommends that notes be discarded prior to the commencement of litigation or threatened litigation, but careful coordination with litigation counsel can be important, particularly when a lawsuit is anticipated.[192]

[188] See Villa, supra note 95, § 5:11[C].
[189] Smith & Raeber, supra note 4, at 4.
[190] See, generally, Villa, supra note 95, at § 5:11[c].
[191] Id.
[192] See Johnston & Hurd, supra note 167 at A-19 through A-20A.

SAMPLE RESOLUTIONS
TO CREATE
SPECIAL NEGOTIATING COMMITTEE[193]

WHEREAS:

A. The Board of Directors of the Corporation has determined that it is appropriate review, consider, evaluate, and possibly take action with respect to a proposal [describe conflict-in-interest proposal] (the "Proposed Transaction") and with respect to the Corporation's possible strategic alternatives to the Proposed Transaction.

B. Certain members of the Board of Directors have advised the Board that they may be deemed to have interests in, or in connection with, the Proposed Transaction that may be different from the interests of the Corporation's shareholders generally [and such directors have abstained from voting with respect to these resolutions/have voted in accordance with the recommendation of the independent members of the Board with respect to these resolutions].

C. The Board deems it appropriate to establish a special committee of directors (the "Special Committee"), none of whom is an officer or executive of the Corporation and none of whom has any interest (other than an interest that the Board deems to be not material) in, or in connection with the Proposed Transactions, that may be different from the interests of the Corporation's shareholders generally, to review, consider, evaluate, and, to the extent permitted in these resolutions, possibly take action with respect to the Proposed Transaction or possible strategic alternatives to the Proposed Transaction.

NOW, THEREFORE, BE IT RESOLVED, THAT:

1. Pursuant to Section 55-8-25 of the North Carolina Business Corporation Act and Section 4.9 of the Corporation's Bylaws,[194] the Board of Directors hereby creates the Special Committee.

2. The Board of Directors hereby appoints ______, _______, and _______, to serve as members of the Special Committee, each such member to serve for so long as the Special Committee shall exist or until such member's resignation, if earlier.

3. The Board of Directors hereby appoints ____ to serve as the chairman of the Special Committee.

4. Based upon disclosures made by such persons and inquiries performed [by counsel/general counsel to the corporation] and by the Board of Directors, the Board of Directors hereby determines that each member of the Special Committee so appointed is independent, is

---

[193] These sample resolutions are based in part on the description of similar resolutions contained in the Proxy Statement, Schedule 14A, Proxy Statement filed by J. Crew Group, Inc., January 25, 2011, with the Securities and Exchange Commission and on Form 4.72 contained in 3 R. Balotti and J. Finkelstein, The Delaware Law of Corporations & Business Organizations (2011 Supp.).
[194] Based on Form 25 in Robinson.

not an officer or executive of the Corporation, and has no interest in, or in connection with, the Proposed Transaction that is different from the interests of the Corporation's shareholders generally (other than an interest that the Board of Directors deems to be not material).

5. That, in accordance with Section 55-8-25(d) of the North Carolina Business Corporation Act and Section 4.9 of the Corporation's Bylaws, the Special Committee may exercise, and shall have exclusive authority to exercise, the authority of the Board of Directors under Section 55-8-01 of the North Carolina Business Corporation Act and Section 3.1 of the Corporation's Bylaws[195] to take any and all actions with respect to the Proposed Transaction or any other strategic alternatives available to the Corporation that the Special Committee determines to be necessary or advisable, including but not limited to the following:

a. To formulate, establish, oversee, and direct a process for the identification, evaluation, and negotiation of a potential sale of the Corporation, by merger or otherwise, specifically including the Proposed Transaction, and any potential stock repurchase, special dividend, or recapitalization of the Corporation that the Special Committee may determine to be necessary or advisable;

b. To evaluate and negotiate the terms of any proposed definitive acquisition agreement or any other agreements in respect of a potential sale of the Corporation, by merger or otherwise, specifically including the Proposed Transaction and any potential stock repurchase, special dividend, or recapitalization of the Corporation that the Special Committee may determine to be necessary or advisable;

c. [If the Corporation has a shareholder rights plan in place, to declare a share dividend and take such other steps as the Special Committee shall deem appropriate pursuant to the Shareholder Rights Plan, all in accordance with the formula for dividends set forth in the Shareholder Rights Plan;]

d. To make recommendations to the Board of Directors in connection with any of the foregoing, including with respect to the Proposed Transaction, that the Special Committee deems necessary or advisable, including without limitation that the Board of Directors: (i) approve any definitive agreement or plan of merger, (ii) recommend to the Shareholders of the Corporation that they approve or reject any definitive agreement, plan of merger, or other potential sale or recapitalization of the Corporation, (iii) adopt or establish any shareholder rights plan, or take action with respect to any similar defensive measure as to which the Special Committee does not have authority pursuant to Section 55-8-25(e) of the North Carolina Business Corporation Act, and (iv) take any other actions and consider any other matters that the Special Committee deems necessary or appropriate with respect to any potential sale of the Corporation, any potential share repurchase, special dividend or recapitalization of the Corporation, and any other potential strategic alternative, including any such action described in Section 55-8-25(e) of the North Carolina Business Corporation Act;

[195] Id.

e. To take any and all actions and to do or cause to be done any or all things that the Special Committee determines to be necessary or advisable with respect to any of the foregoing, with the same effect as if the Board of Directors had taken such action or done or caused such things to be done.

6. Notwithstanding the foregoing, the Special Committee shall not have authority to approve or propose to shareholders action that the North Carolina Business Corporation Act requires be approved by shareholders, approve a plan of merger acquiring shareholder approval, or take any other action that the Special Committee is not permitted to take pursuant to Section 55-8-25(e) of the Business Corporation Act.

7. So long as the Special Committee shall continue to exist, the Board of Directors shall not approve the Proposed Transaction, any potential sale of the Corporation, by merger or otherwise, any share repurchase, special dividend or recapitalization of the Corporation, or any other strategic alternative transaction, or recommend any of the foregoing to the Corporation's shareholders, in the absence of a prior favorable recommendation of such action by the Special Committee.

8. The Special Committee is authorized to select and engage one or more independent legal counsel to represent and advise the Special Committee to otherwise assist the Special Committee in carrying out its responsibilities as provided in these resolutions [provided that, for purposes of Section 55-7-49 of the North Carolina Business Corporation Act and for all other purposes, communications between the Special Committee and its other advisors, on the one hand, and such counsel, on the other hand, shall be deemed within the scope of the Corporation's attorney-client privilege].

9. The Special Committee is authorized to select and engage such other consultants, advisors, and agents, including without limitation investment bankers, financial advisors, and accountants, as the Special Committee deems necessary or advisable in connection with fulfilling its responsibilities as provided in these resolutions and to perform such other services and deliver such opinions as the Special Committee shall in its discretion request.

10. The Special Committee is authorized to enter into such engagement agreements and other contracts as the Special Committee deems necessary or advisable with respect to the retention, compensation, and indemnification of such counsel, consultants, advisors, agents, bankers, and accountants; that the Corporation is authorized to pay, and shall pay, all fees, expenses, and disbursements of such counsel, consultants, advisors, agents, bankers and accountants; that the Corporation is authorized to perform, and shall perform, all undertakings, including undertakings to indemnify, and other agreements of the Corporation pursuant to any such engagement agreement or other contract; that any such engagement agreement or other contract is approved, ratified and adopted by the Board of Directors; and that the officers of the Corporation are hereby authorized and directed to execute and deliver, in the name and on behalf of the Corporation, any such engagement agreement or other contract.

11. The officers of the Corporation are authorized and directed to assist the Special Committee and provide to the Special Committee, each member thereof, and any such counsel, consultant, advisor, agent, banker or accountant, and their designees, such information and

materials, including the books, records, projections, forecasts, and financial statements of the Corporation and any documents, reports or studies obtained or prepared in connection with the Proposed Transaction or any alternative thereto, all to the extent requested by the Special Committee.

12. The Board of Directors hereby determines that service by directors as members of the Special Committee shall constitute service by a director of the Corporation for purposes of determining whether such director is entitled to indemnification and advancement of expenses pursuant to the North Carolina Business Corporation Act and Article VIII of the Corporation's Bylaws, and further that the Corporation shall indemnify each director who is a member of the Special Committee, to the fullest extent permitted by law, in accordance with Article VIII of the Corporation's Bylaws, with respect to any matter arising from or related to the Special Committee.

13. The chairman of the Special Committee shall receive payment of $[___] per month and that each other member of the Special Committee shall receive payment of $[___] per month for the duration of their service as members of the Special Committee, such payments to be paid regardless of whether the Proposed Transaction or any alternative is completed, and that the Corporation shall reimburse each member of the Special Committee for all reasonable, out-of-pocket expenses incurred in connection with the performance of their duties as a member of the Special Committee.

14. The officers of the Corporation are authorized to take all such actions and to perform any and all acts (including execution, filing, and delivery of any and all instruments and documents) that they deem necessary or appropriate to effectuate the purpose and intent of the these resolutions.

SAMPLE RESOLUTIONS OF THE [INDEPENDENT MEMBERS OF] THE BOARD OF DIRECTORS TO CREATE SPECIAL LITIGATION COMMITTEE[196]

WHEREAS:

A. The Corporation has received a written communication from [____], a shareholder of the Corporation, alleging misconduct by certain officers/directors of the Corporation and demanding that the Corporation take suitable action with respect to such alleged misconduct (such communication, together with any additional related written communications from shareholders, the "Shareholder Allegation").

B. The Shareholder Allegation purports to be a written demand on the Corporation to take suitable action within the meaning of Section 55-7-42(1) of the North Carolina Business Corporation Act.

C. Having reviewed and considered the Shareholder Allegation, the Board of Directors has determined that it would be desirable and in the best interests of the Corporation and its shareholders to create a committee (the "Special Litigation Committee") of the Board of Directors in response to the Shareholder Allegation, and that those members of the Board of Directors who are independent directors with respect to the Shareholder Allegation within the meaning of Section 55-7-44 of the North Carolina Business Corporation Act (the "Independent Directors") shall appoint two or more Independent Directors to serve as members of the Special Litigation Committee.

D. The Board of Directors intends, and has determined, that the Special Litigation Committee shall be deemed a committee "consisting of two or more independent directors appointed by majority vote of independent directors" within the meaning of Section 55-7-44(b)(2) of the North Carolina Business Corporation Act.

NOW, THEREFORE, BE IT RESOLVED THAT:

1. Pursuant to Sections 55-8-25 and 55-7-45 of the North Carolina Business Corporation Act and Section 4.9 of the Corporation's Bylaws,[197] the Board of Directors hereby creates the Special Litigation Committee.

2. Pursuant to Section 55-7-44(b) (2) of the North Carolina Business Corporation Act, the Independent Directors hereby appoint [____], [____], and [___] to serve as members of

[196] Based in part on resolutions of the Board of Directors of Chiquita Brands, Inc., adopted on April 3, 2008, in connection with Service Employees International Union v. Hills et al., No. A07-11383 (Ohio Common Pleas Ct. Hamilton County); Hawaii Annuity Trust Fund for Operating Engineers v. Hills et al., No. C-379-07 (N.J. Super. Ct. Ch. Div. Bergen County); and In re: Chiquita Brands International, Inc., Alien Tort Statute and Shareholders Derivative Litigation, No. 08-1916 (S.D. Fl.)

[197] Based on Robinson Form 25.

the Special Litigation Committee, and hereby appoint [____] to serve as chairman of the Special Litigation Committee. The Board of Directors ratifies and approves such appointment.

3. Based upon disclosures made by such persons and inquiries performed by [counsel/general counsel to the Corporation] and by the Board of Directors, the Board of Directors and the Independent Directors hereby determine that each of the members of the Special Litigation Committee is an independent director within the meaning of Section 55-7-44 of the North Carolina Business Corporation Act.

4. The Special Litigation Committee shall consider, investigate, review, and analyze the facts, allegations, and circumstances that are the subject of the Shareholder Allegation, as well as any additional facts, allegations, and circumstances that may be raised or put at issue in any related inquiry, investigation, or proceeding.

5. The Special Litigation Committee shall have the full and exclusive authority to consider and determine whether or not the prosecution of any claims described or asserted in the Shareholder Allegation or any other claims related to the facts, allegations, and circumstances of the Shareholder Allegation is in the best interests of the Corporation and its shareholders, and what action the Corporation should take with respect thereto, including the authority to determine whether the maintenance of any "derivative proceeding," as defined in Section 55-7-40.1 of the North Carolina Business Corporation Act, with respect to any such claims is or is not in the best interest of the Corporation as provided in Section 55-7-44(a) of the North Carolina Business Corporation Act.

6. The determinations made by the Special Litigation Committee in accordance with paragraph 5 of these resolutions shall be final, shall not be subject to review or reconsideration by the Board of Directors, and shall in all respects be binding upon the Corporation.

7. The Board of Directors shall not authorize any action, nor take any action, with respect to the Shareholder Allegation, any derivative proceeding related to the Shareholder Allegation, or any facts, allegations, and circumstances that are the subject of the Shareholder Allegation in the absence of a prior recommendation by the Special Committee that such action be authorized or taken.

8. The Special Litigation Committee shall continue in existence until such time as the Special Litigation Committee shall recommend to the Board of Directors that it be dissolved.

9. The Special Committee is authorized to select and engage one or more independent legal counsel to represent and advise the Special Committee to otherwise assist the Special Committee in carrying out its responsibilities as provided in these resolutions [provided that, for purposes of Section 55-7-49 of the North Carolina Business Corporation Act and for all other purposes, communications between the Special Committee and its other advisors, on the one hand, and such counsel, on the other hand, shall be deemed within the scope of the Corporation's attorney-client privilege].

10. The Special Committee is authorized to select and engage such other consultants, advisors, and agents, including without limitation forensic accountants and investigators, as the

Special Committee deems necessary or advisable in connection with fulfilling its responsibilities as provided in these resolutions and to perform such other services and deliver such opinions as the Special Committee shall in its discretion request.

11. The Special Committee is authorized to enter into such engagement agreements and other contracts as the Special Committee deems necessary or advisable with respect to the retention, compensation, and indemnification of such counsel, consultants, advisors, agents, and accountants; that the Corporation is authorized to pay, and shall pay, all fees, expenses, and disbursements of such counsel, consultants, advisors, agents, and accountants; that the Corporation is authorized to perform, and shall perform, all undertakings, including undertakings to indemnify, and other agreements of the Corporation pursuant to any such engagement agreement or other contract; that any such engagement agreement or other contract is approved, ratified and adopted by the Board of Directors; and that the officers of the Corporation are hereby authorized and directed to execute and deliver, in the name and on behalf of the Corporation, any such engagement agreement or other contract.

12. The directors, officers, employees, accountants, and advisors of the Corporation are hereby authorized and directed to assist the Special Committee and provide to the Special Committee, each member thereof, and any such counsel, consultant, advisor, agent, or accountant, and their designees, such information and materials, including the books, records, and financial statements of the Corporation, and other information, all to the extent requested by the Special Committee.

13. The Board of Directors hereby determines that service by directors as members of the Special Committee shall constitute service by a director of the Corporation for purposes of determining whether such director is entitled to indemnification and advancement of expenses pursuant to the North Carolina Business Corporation Act and Article VIII of the Corporation's Bylaws, and further that the Corporation shall indemnify each director who is a member of the Special Committee, to the fullest extent permitted by law, in accordance with Article VIII of the Corporation's Bylaws, with respect to any matter arising from or related to the Special Committee.

14. The chairman of the Special Committee shall receive payment of $[___] per month and that each other member of the Special Committee shall receive payment of $[___] per month for the duration of their service as members of the Special Committee, such payments to be paid regardless of the determination of the Special Committee with respect to the Shareholder Allegation, and that the Corporation shall reimburse each member of the Special Committee for all reasonable, out-of-pocket expenses incurred in connection with the performance of their duties as a member of the Special Committee.

15. The officers of the Corporation are authorized to take all such actions and to perform any and all acts (including execution, filing, and delivery of any and all instruments and documents) that they deem necessary or appropriate to effectuate the purpose and intent of the these resolutions.