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The Standing Demand Committee

Trends and Risks in Entire Fairness Litigation

Recently, corporations and fiduciaries have faced enhanced litigation risk arising from entire fairness claims challenging related-party transactions and other transactions implicating unique interests of corporate fiduciaries. This risk is most pertinent for controlled public corporations, although it has also affected public and private corporations with significant non-majority holders. The prospect of costly entire fairness litigation has also proven to be ripe for exploitation by "entrepreneurial plaintiffs' lawyers,"[1] as this risk can alone supply plaintiffs with considerable settlement leverage. And this risk is not limited to the M&A sale transactions that have historically been the focus of stockholder litigation. Numerous other circumstances, such as financings and compensation awards, could implicate entire fairness review.

But importantly, Delaware Supreme Court decisions over the past several years have confirmed that challenges to these types of commercial arrangements and related-party transactions in the course of business are, in most cases, derivative claims. In the first instance, bedrock Delaware law vests primary management authority over such claims in corporate boards, not stockholder-plaintiffs. As the Delaware Supreme Court has repeatedly emphasized, "it remains a 'cardinal precept' of Delaware law that independent and disinterested directors are generally in the best position to manage a corporation's affairs, including whether the corporation should exercise its legal rights," "even when it involves a controlling stockholder."[2] In order for a stockholder to be vested with standing to commence derivative litigation, the stockholder is required to establish demand futility. To do so, a stockholder generally must allege particularized facts raising a reasonable doubt as to the independence and disinterestedness of at least half of the board. The demand futility requirement is an important safeguard that reinforces the management authority of boards and limits the exposure of corporations and their fiduciaries to inefficient derivative suits whose prosecution is not in a corporation's best interests.

Various dynamics shared among many public corporations may nevertheless limit the effectiveness of this safeguard and allow stockholders to wrest control of derivative claims by pleading demand futility. For example, controlled companies utilizing the "controlled company exemption" offered by the New York Stock Exchange and NASDAQ are not required to have an

[1] *W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.*, 310 A.3d 985, 998 (Del. Ch. 2024); *see also In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 959 n.6 (Del. Ch. 2010) (discussing agency problems arising from the prosecution of derivative litigation by "entrepreneurial litigators").

[2] *In re Match Grp., Inc. Deriv. Litig.*, 315 A.3d 446, 469 (Del. 2024) (quoting *United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1056 (Del. 2021)).

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independent board majority. These corporations may face the greatest risk of entire fairness litigation and be most susceptible to stockholder-plaintiffs successfully establishing demand futility. Even if a corporation has an independent board majority for stock exchange purposes, Delaware does not adhere to exchange independence standards. Instead, Delaware law employs a more fact-specific, case-by-case approach that has resulted in numerous directors deemed independent for exchange purposes having their independence impugned for purposes of demand futility based on factors such as longtime personal friendships, overlapping memberships in multiple exclusive golf clubs, and repeated appointments as an independent director by the same sponsor for multiple portfolio companies. Even if a majority of a corporation's board is truly independent, demand futility is generally determined on a motion to dismiss. At this stage of the litigation, a stockholder need only raise a "reasonable doubt" as to the independence and disinterestedness of at least half of the board. And in doing so, a stockholder may rely on the specified facts alleged in the stockholder's own complaint, which are accepted as true even if cherry-picked or inaccurate, and all reasonable factual inferences that logically flow from these alleged facts. This heightened, yet still plaintiff-friendly, pleading standard may bolster a stockholder's demand futility arguments and could lead to a finding of demand futility based on allegations and inferences that may not hold true.

A Means for Solidifying Independent Director Authority Over Derivative Claims

A recent article in *The Business Lawyer* authored by a Richards, Layton & Finger director proposes a novel solution for corporations seeking to mitigate the growing risks and costs of entire fairness litigation by concentrating the authority over derivative litigation in a committee of independent directors.[3] This solution aligns with existing Delaware law, which views these independent directors as "generally in the best position" to manage derivative claims,[4] and involves the proactive establishment of a standing demand committee of independent directors vested with the sole and exclusive power and authority over derivative litigation demands and related matters. As the article more thoroughly explains, based on specific statutory authority in Delaware's General Corporation Law, longstanding foundational principles of Delaware corporate law, and an overlooked aspect of the seminal duty of oversight case *Marchand v. Barnhill*, the establishment of a standing demand committee by charter provision[5] should result in demand futility being assessed

[3] Robert B. Greco, *A Corporate Governance Solution to the Inefficiencies of Entire Fairness*, 79 BUS. LAW. 993 (2024).

[4] *Match*, 315 A.3d at 469.

[5] The article further posits that a charter amendment may not necessarily be needed to produce this shift in the assessment of demand futility. As the Delaware Supreme Court explained nearly 100 years ago, "[t]he right of a stockholder to file [a derivative action] to litigate corporate rights is . . . solely for the purpose of preventing injustice, where it is apparent that material corporate rights would not otherwise be protected." *Sohland v. Baker*, 141 A. 277, 282 (Del. 1927). Where a standing demand review committee of independent directors is established by bylaw or board resolution, an independent committee would be empowered and positioned to protect valuable corporate litigation claims and prevent injustice. This independent committee would be not only duty bound by the directors' fiduciary duties to carry out this mandate, but also would be comprised of the independent and disinterested directors that Delaware law has long deemed best equipped to do so. Delaware law affords stockholders derivative standing "solely to prevent an otherwise complete failure of justice" in circumstances where a corporation's derivative claims would not otherwise be protected, and such circumstances would not exist where authority over those claims is left with those Delaware law considers best positioned to protect them. *Schoon v. Smith*, 953 A.2d 196, 202 (Del. 2008) (quoting 4 POMEROY'S EQUITY JURISPRUDENCE § 1095, at 278 (5th ed. 1941)).

based on the independence and disinterestedness of the members of the committee rather than the independence and disinterestedness of the entire board. That is, demand futility should presumably be assessed based on the independence of the committee members, who are presumably appointed to the committee, at least in large part, due to their independence, and without being negatively affected by the array of potentially interested directors—such as executive directors, founders, family members of interested persons, and representatives of large investors—who are often detrimental in efforts to rebut allegations of demand futility. This would solidify independent director authority over derivative claims, promoting more efficient management of derivative claims and reducing the costs of opportunistic derivative litigation currently faced by many corporations, without necessarily invoking the heightened standard of review that applies when a special litigation committee—a distinct type of investigative committee formed after a stockholder-plaintiff has already filed derivative litigation—conducts an investigation and seeks dismissal of the litigation.

The standing demand committee is a viable solution for not only newly public corporations conducting an IPO, but also existing public and private corporations. This includes even existing controlled public corporations. The article explains that, based on Delaware public policy and precedent, there is reason to believe that the establishment of a standing demand committee on a "clear day" should generally be afforded the protections of the business judgment rule, a conclusion which has been bolstered by the Delaware Supreme Court's recent decision rejecting speculative alleged litigation protections as a basis for subjecting TripAdvisor, Inc.'s proposed move to Nevada to entire fairness review.[6]

Overview of Demand Committees

A demand committee is a flexible vehicle for independent directors to assess and respond to stockholder concerns regarding corporate events. Much like a sale process, there is no single blueprint that a demand committee must adhere to in assessing stockholder demands. Nevertheless, many demand committee processes tend to proceed along the same general path.

A properly empowered committee will have the ability to retain advisors to represent the committee. Often the first advisor hired by a committee is independent legal counsel. A standing demand committee may find it advisable to protectively retain independent counsel upon formation of the committee to assist when and as demands or other matters may be presented to the committee. Independent counsel should have an expertise in the process-related aspects of considering and responding to stockholder demands, including the fiduciary duties owed by committee members. Once independent counsel is engaged and a stockholder demand is directed to the committee, counsel should first assess the independence of the committee members with respect to the subject matter of the demand. Independent counsel can then assist throughout the committee process by advising the committee in satisfying its mandate, as well as in documenting the committee process and handling aspects of its investigation along the way.

After counsel is engaged and the committee's independence is confirmed, a demand committee can embark on its principal obligations upon receiving a stockholder demand: (i) determining "the best method to inform [itself] of the facts relating to the alleged wrongdoing and the considerations, both legal and financial, bearing on a response to the demand"; and (ii) weighing

[6] *Maffei v. Palkon*, --- A.3d ----, 2025 WL 384054 (Del. Feb. 4, 2025).

"the alternatives available to it, including the advisability of implementing internal corrective action and commencing legal proceedings."[7]

The appropriate process for a demand committee to follow should be determined on a case-by-case basis based on the best interests of the corporation. Thus, after engaging independent counsel, a committee should work to develop and proceed with a process tailored to the corporation's situation, including its needs and resources, and the particularized allegations made in the demand. With the assistance of independent counsel, demand committees have the flexibility to employ a process that takes advantage of potential efficiencies when appropriate. This may include, when appropriate, relying on the corporation's outside counsel or other representatives to make use of their subject matter expertise or to efficiently gather factual information. Other potential factors that are regularly considered by demand committees include the specificity of the allegations in the demand, the burden on executives and employees in assisting with the investigation into the allegations, the disruption to the corporation associated with the committee's process and investigation, the pendency of regulatory investigations or other litigation or proceedings, and the monetary costs of conducting any investigations. Based on these and other appropriate considerations, committees may occasionally temporarily defer investigation into a demand.[8]

When beginning its investigation, a common first step for demand committees is to request relevant documentation from the management team and/or advisors of the corporation. These document requests may vary widely based on the readily available record and the subject matter of the demand. The committee can often start its investigation based on a discrete set of documents or records that have already been created by the corporation or are easily accessible. Depending on the matters alleged in the demand, the committee's familiarity with these matters, the available records of the corporation, the merits of the demand, and any other relevant considerations, this first step may comprise a large part (or even all) of the committee's investigative process or it may only be the beginning of the committee's investigation. For example, when the matters raised in the demand have already been the subject of a prior investigation or proceeding, the committee may be able to rely heavily on the record and information already collected or compiled for that purpose.

During the committee's investigation, documents collected are typically reviewed in the first instance by committee counsel. After counsel reports to the committee on the results of its review, the committee may evaluate the necessity and scope of conducting any further investigation, which may include additional document requests and/or interviews with relevant individuals. In deciding whether to conduct additional investigation, the committee members should, consistent with their fiduciary duties, consider the associated burdens and costs imposed on the corporation, including those that would arise from collecting and reviewing any additional documents, conducting any interviews, and the incremental fees and expenses of outside counsel. The committee should

[7] *Rales v. Blasband*, 634 A.2d 927, 935 (Del. 1993).

[8] Deferral may not be available or reasonable in all circumstances, including because deferral without proper protections could inhibit the corporation's ability to remedy wrongdoing. Informed decisions to defer at least portions of investigations are more common when the subject matter of a demand is already the subject of a pending regulatory investigation or another litigation or proceeding involving the corporation. An immediate internal investigation could affect the corporation's ability to optimally resolve any such investigations, litigations, or proceedings. Deferring a committee's investigation may also present significant efficiencies by allowing the committee to utilize records created as part of the external investigations, litigations, or proceedings.

balance these and any other relevant considerations against, among other things, the likelihood of obtaining any new or useful information and the potential utility of any new or useful information in informing the committee's response to the demand and the corporation's potential remedies with respect thereto. In this regard, the demand committee process presents considerable efficiencies in comparison to stockholder-initiated derivative litigation, in which representative counsel is generally incentivized to seek discovery irrespective of its cost to the corporation.[9]

If the committee elects to conduct further investigation, interviews may be used to gather additional facts regarding the underlying events and documents. A properly established committee is vested with the full authority of the board of directors and empowered to require current executives and other employees to participate in an interview.[10] Committees tend to rely on counsel to conduct the bulk of any interviews.[11] During any interviews, there are no inherent subject matter limitations on the questions that may be asked, and it is not uncommon to interview a key participant more than once as facts emerge and the investigation develops. An interviewee can be refreshed on specific documents in advance of an interview to aid his or her recollection on particular issues, and the privilege concerns common in depositions are often minimized in this context.

Once a committee is satisfied that it is equipped with sufficient information to assess the demand and inform its response to it, and that further investigative efforts are not in the corporation's best interests, the committee should form a view of the demand and determine the appropriate response, if any, to the demand and the allegations made therein. To assist with the committee's decision-making process, counsel may prepare a presentation or report to present to the committee. Where a presentation or report is prepared, it will often be accompanied by a compilation of key documents or information on any important matters. In determining the appropriate response to the stockholder's demand and allegations, the committee must evaluate potential alternatives and decide, in its business judgment, which response is advisable and in the best interest of the corporation. In this regard, the committee should examine any considerations relevant to the costs or benefits of a particular response. Relevant considerations may include, among other things, those relating to the potential direct and indirect costs of prosecuting any claims that may arise from the demand's allegations (such as defense costs, indemnification and advancement costs, diversion of company resources, and negative publicity); the likelihood of recovery for any such claims and the potential amount of any recovery; the effectiveness of any internal corrective measures, sanctions or other remedial actions; potential distractions and possible effects on morale and relationships among executives and other employees; and potential reactions from and effects on relationships with customers, suppliers, capital providers, and other

[9] Moreover, sharing privileged materials with a demand committee generally does not jeopardize privilege or present the same concerns as producing privileged materials to counsel prosecuting stockholder-initiated litigation. Accordingly, while significant costs are often incurred in derivative litigation through the privilege review that must be conducted before materials are produced to stockholder-plaintiffs, these costs may be avoided when materials are compiled and prepared for a demand committee. The lack of confidentiality concerns in the demand committee process may present similar efficiencies.

[10] Demand committees do not have subpoena power and, absent contractual agreements, may find it difficult to compel former executives or other employees or third-party representatives to sit for interviews.

[11] During the committee process, a demand committee is entitled to rely on counsel and the information, opinions, reports, and statements provided during its investigation. 8 *Del. C.* § 141(e).

counterparties. After weighing any relevant considerations, the committee could reach a wide array of different outcomes, which may include deferring further investigation, taking no action, proactively improving aspects of the corporation through policy or personnel changes or other remedial measures, or attempting to remedy any harm that the committee deems possible or likely to have arisen from the demand's allegations through internal action or litigation.

After conducting its investigation, an independent and disinterested demand committee's decision is accorded deference and subject to the protections of the business judgment rule.