

Stockholder Derivative Lawsuits: Special Litigation Committee Investigation Checklist

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This checklist provides guidance regarding the investigation of a special litigation committee (SLC) of a board of directors related to a stockholder derivative lawsuit. The guidance includes a reminder of guiding case law from [Zapata Corporation v. Maldonado, 430 A.2d 779 \(Del. 1981\)](#) (Zapata), a review and highlighted summary of the key determinations by the Delaware Court of Chancery in a recent, seminal SLC-related case, [In re Carvana Co. S'holders Lit., 2024 Del. Ch. Lexis 105 \(Del. Ch. Mar. 27, 2024\)](#) (Carvana), and key takeaways for SLC investigations to withstand judicial scrutiny.

Carvana Summary

On March 27, 2024, in *Carvana*, the Delaware Court of Chancery followed the SLC's recommendation and dismissed a stockholder complaint alleging that the company's controlling stockholders enriched themselves through a direct offering by acquiring shares at a depressed price. The court's decision illustrates how an SLC can contribute to litigation concerning an alleged breach of fiduciary duty.

In March 2020, online used car retailer Carvana made a direct public offering of \$600 million at a price of \$45 per share. Carvana's then-controlling stockholders agreed to contribute \$50 million.

The controlling stockholders were restricted from realizing profits from the shares they purchased through the direct offering for six months under the Securities Exchange Act of 1934 (Exchange Act). After the six-month restriction period expired, one of the two controlling stockholders sold shares in Carvana for more than \$1 billion.

Carvana stockholders sued, alleging that the controlling stockholders manufactured an unfair process related to the direct offering to obtain shares in Carvana at a deflated price. The stockholders sought to disgorge the profits realized by the controlling stockholder on an unjust enrichment theory. The Court of Chancery denied subsequent motions to dismiss.

Thereafter, Carvana's board of directors formed an SLC comprised of two directors, supported by financial and legal advisers. The SLC had the Carvana board's full, exclusive authority to investigate and assess the facts and circumstances surrounding the stockholders' complaint. The parties agreed to stay the litigation pending the SLC's investigation.

Seven months later, the SLC issued "a 170-page report, which concluded 'that the costs associated with continuing to pursue the [complaint] or any other claims in connection with the Direct Offering outweigh any benefits'" because the "alleged breaches of fiduciary duty lack merit," and the SLC "did not 'identify any other potential claims that would be likely to succeed.'"

The SLC concluded that there was no evidence that the controlling stockholders exploited opportunistic timing, nor did their "role in . . . negotiations [lead] to the terms of the [d]irect [o]ffering being any less favorable to Carvana."

The Delaware Court of Chancery then accepted the SLC's conclusions regarding the merits of the Stockholders' complaint and dismissed the litigation.

Zapata Two-Step Test

Delaware courts evaluate an SLC's recommendation to dismiss a stockholder derivative action under the Delaware Supreme Court's seminal 1981 decision in *Zapata*. *Zapata* calls for a two-step analysis.

- First, the court reviews the independence of the SLC members and considers whether the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions.

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- Second, the court must apply its own business judgment to the facts to determine whether the corporation's best interests would be served by dismissing the suit.

Directors should not expect to meet the above standard in every investigation.

Application of the *Zapata* Test in *Carvana*

In *Carvana*, the plaintiffs presented four bases to challenge the independence of the SLC's two directors. The Court of Chancery rejected all four challenges and found that the SLC demonstrated its independence.

- First, the plaintiffs argued "that the SLC was improperly influenced by outside counsel" because the SLC's legal advisers were recommended by Carvana's board.

The court swiftly rejected this challenge, commenting that "this is a bad argument [because adopting] a recommendation from management alone does not evidence a lack of independence."

- Second, the plaintiffs argued that the SLC's directors were compromised because they were named defendants in two separate insider trading claims also asserted against Carvana's controlling stockholders.

The court commented that this argument "might gain traction in other circumstances," but found it unpersuasive in *Carvana* because the insider trading cases concerned events that occurred after the direct offering—they were not related to the direct offering itself.

- Third, the plaintiffs argued that the SLC prejudged the investigation because (1) the directors on the SLC approved the direct offering, and (2) they were present on Carvana's board when Carvana initially sought to dismiss the plaintiffs' complaint.

The court rejected both arguments, finding that a director's approval of a transaction does not establish their inability to impartially act with respect to the transaction later. Additionally, the court found that the mere fact that directors were on Carvana's board when Carvana filed its motion to dismiss did not establish a lack of independence because the SLC's "members did not participate in a substantive way in the decision to file the motion [to dismiss]."

Differentiating the facts here from prior cases, the court found that without allegations, the SLC's members "attacked. . . the merits of [the] plaintiffs' claims," as a decision to file a motion to dismiss does not demonstrate that the SLC members are not independent.

- Fourth, the plaintiffs argued that one of the SLC's members lacked independence because they owned auto dealerships that participated in Carvana's pilot programs.

The Court of Chancery found these allegations insignificant.

A Reasonable Investigation in Good Faith

Despite the plaintiffs offering several challenges to the thoroughness and reasonableness of the investigation, the *Carvana* court found that the SLC met its burden of proving it conducted a reasonable investigation in good faith. The court noted that the scope and efforts of the SLC's investigation compared favorably to other SLC investigations upheld by the court.

- First, the plaintiffs argued that the SLC's legal counsel played an outsized role in the investigation because the SLC's members delegated the investigative plan to its legal counsel.

But the Court of Chancery concluded that an SLC heavily relying on counsel and advisers is not unreasonable, and the "SLC's level of engagement was sufficient" because the SLC participated in decisions regarding the investigation and attended witness interviews performed by the SLC's legal counsel.

- Second, the plaintiffs suggested that the SLC's investigation was unreasonable because the SLC's members could not remember details of the investigation when interviewed after the SLC published its report.

The Court of Chancery rejected this argument, finding that the SLC's lack of recall was not significant because human memory is fleeting, and the SLC's legal conclusions were well documented in its exhaustive report and supported by an extensive factual record.

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- Third, and the strongest basis the plaintiffs presented to challenge the reasonableness of the SLC's investigation, arose from comments an SLC director made in an interview after the SLC published its report. The director commented that he "was concerned about how much time [the SLC process] would take," viewed his role on the SLC as a "part-time responsibility," and was concerned that his involvement would subject him to personal exposure.

The Court of Chancery reflected that "[c]omments of this nature are not helpful to an SLC's cause," but nonetheless concluded that they failed to demonstrate that the investigation was unreasonable because there was no evidence that the SLC member's lack of enthusiasm for his role "affected his diligence."

- Fourth, the plaintiffs also made a series of challenges to the scope of the SLC's investigation, suggesting that the SLC failed to consider several allegations in the complaint. But in each instance, allegations that the plaintiffs argued that the SLC failed to consider had not actually been omitted from the SLC's investigation or report, according to the Court of Chancery.

Instead, the SLC "adequately considered the allegations contained in the Complaint and evaluated the facts and law relevant to those allegations."

Moreover, in evaluating the scope of the investigation, the court compared the investigation to prior SLC investigations that the court approved, noting that the SLC conducted a seven-month investigation, reviewed over 100,000 pages of documents from 18 different custodians, interviewed 16 witnesses, and held nine SLC meetings before submitting a 170-page report of its findings.

Given these facts, the court found that these efforts compared favorably with previous SLC investigations upheld by the court.

The Court's Business Judgment

In closing, the Court of Chancery concluded that *Zapata's* second step was also satisfied. The court, applying its own business judgment, was called "to determine whether the SLC's recommended result falls within a range of reasonable outcomes that a disinterested and independent decision maker for the corporation, not acting under any compulsion and with the . . . information then available, could reasonably accept."

In the court's view, this was easily satisfied because the court already probed the plaintiffs' challenges to the SLC's report and found that the conclusions stated in the report were reasonable.

What Boards of Delaware Corporations Should Know for an SLC Investigation

Forming an SLC is a powerful tool that boards can use when faced with shareholder litigation, allowing the board of directors to maintain or regain control of the derivative suit.

After determining that an SLC should be engaged, *Carvana* emphasizes several key points that must be met for the investigation to withstand judicial review.

- **SLC members are entitled to good faith reliance on outside legal counsel and other experienced advisers to lead the investigation and delegate certain tasks.** In most situations, the Court of Chancery expects this to be the case.

This does not mean, however, that SLC members can be entirely passive. Necessary steps to establish that the SLC's investigation was reasonable include, but are not limited to:

- o Taking initiatives to be engaged with the document collection process
- o Identifying key custodians
- o Coordinating communications with outside advisers
- o Attending witness interviews –and–
- o Reviewing witness interview summaries and reports from outside advisers

Otherwise, plaintiffs can allege that the directors did not engage with the investigation in good faith and were merely rubber-stamping the process.

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- **The court will consider statements made by SLC members concerning the investigation and the directors' role.** In *Carvana*, the court expressly noted that the director's comments were not necessary, and even though the court determined that the comments did not "affect[] his diligence," other statements could be construed as indications that the investigation was unreasonable or evidence of bad faith.
- **The SLC should carefully consider and document its investigation into all facts, specific acts of alleged misconduct, and sources of information in a plaintiff's complaint, even for less serious allegations.** Even if the SLC determines that a full investigation into certain allegations is not warranted, the SLC's report should document that it considered those allegations and discuss the SLC's reasoning for not pursuing a summary investigation. A total failure to explore less serious allegations may cast doubt on an otherwise reasonable and good faith SLC investigation.
- **The court expects that companies and directors retain and provide documents for outside counsel to review.** As occurs in nearly all investigations, the court noted the expansive number of documents collected and reviewed during the investigation.

Of note, the Court of Chancery rejected the plaintiffs' claims that the SLC should have gathered text messages from numerous individuals, finding that the SLC's motion to dismiss "cannot stand or fall on a failure to gather text messages." While this does provide support that text messages do not have to be collected—which can be intrusive to directors and add significant costs in terms of review—SLCs and their counsel should still consider whether it is necessary to collect text messages on a case-by-case basis.

Morgan Lewis partner Mike Blanchard contributed to this article.

This checklist is adapted from an article first published by Law360, a LexisNexis company, on April 25, 2024.

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