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## Sixth Circuit Reverses Dismissal of a Shareholder Derivative Action Based Upon the Lack of Independence of the Special Litigation Committee

In [\*Booth Family Trust v. Jefferies\*](#), No. 09-3443, 2011 WL 1237583 (6th Cir. Apr. 5, 2011), the [United States Court of Appeals for the Sixth Circuit](#) reversed the district court dismissal of a shareholder derivative action, holding that the special litigation committee (“SLC”) of the board of directors, which recommended the dismissal, was not sufficiently independent of management. The Court reached its decision despite the fact that one of the two members of the SLC recused himself from considering claims against the defendant Robert S. Singer (“Singer”), CEO of Abercrombie & Fitch Co. (“Abercrombie”), with whom the SLC member had a personal relationship. In fact, the Court held that the SLC member’s recusal constituted an admission that he, and thus the SLC as a whole, lacked independence. This decision, which applies Delaware law, reinforces the high standard of independence imposed on members of SLCs.

Plaintiffs were shareholders of Abercrombie. They filed a shareholder derivative suit against certain of Abercrombie’s officers and directors based upon allegations that they caused Abercrombie to make misleading public statements regarding the company’s business model of selling products with low manufacturing costs at high retail prices, resulting in a high per-unit margin. Plaintiffs alleged that while defendants were making the misleading statements, Abercrombie was amassing a large surplus of inventory such that the company would have to dramatically mark down its merchandise to clear out its inventory. The complaint alleges that insiders, including Singer, were aware that share prices would soon fall and sold a large number of their personally held shares on insider information.

In response to the allegations, Abercrombie’s board of directors created a SLC eventually composed of two board members, Allen Tuttle and Lauren Brisky. The SLC retained the law firm of Cahill Gordon & Reindel LLP, which took the lead in what would be a sixteen month investigation. Cahill did the bulk of the work in interviewing witnesses and reviewing documents and records, advised the two SLC members on the progress and results of the investigation, and made recommendations on how to

proceed. When it came time to consider potential claims against Singer, Tuttle recused himself due to his prior personal and business relationship with Singer. Ultimately, the SLC produced a 144-page report which detailed its investigation and recommended to Abercrombie to seek a dismissal of the case on the ground that pursuing the claims would not be in the best interests of Abercrombie's shareholders. The [United States District Court for the Southern District of Ohio](#) granted Abercrombie's motion to dismiss, finding that the SLC was independent, proceeded in good faith and had a reasonable basis for its conclusions. Plaintiffs appealed.

Under the standard set out in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), a court must determine whether the SLC is independent, and whether it acted in good faith and had a reasonable basis for seeking the dismissal. If the court makes these findings, it then has the option to apply its own business judgment to determine whether to dismiss the derivative action.

In *Booth*, the Sixth Circuit began by noting that other courts have not clearly articulated the standard of review to be applied to a lower court's decision granting a motion to dismiss a derivative action based on the recommendations of an SLC. The Court found that the *de novo* review standard applies with respect to the first prong of the *Zapata* inquiry as to whether the SLC was independent, carried out the investigation in good faith, and had a reasonable basis supporting its conclusions. It also, however, left open the possibility that a more deferential review standard may apply to a lower court's application of its own business judgment under the optional second prong in the *Zapata* test.

The Court then turned to the merits. It reversed the district court's decision to grant the motion to dismiss. It based its reversal upon a finding that SLC member Tuttle was not independent. Because Tuttle lacked independence, the SLC also was not independent. The Court pointed to the fact that Tuttle had recused himself from considering allegations against Singer, a named defendant and central player in the shareholders' allegations. "[B]ecause Tuttle ... recused himself from considering claims against Singer," the Court held "he effectively admitted he was not independent." The Court also considered evidence that Tuttle and Singer had previously worked together, that Singer had spearheaded the effort to add Tuttle as a board member, and that Tuttle was planning on vacationing with Singer and his wife. Additionally, the Court noted that the claims against defendants were "not individual in nature." In other words, Tuttle could not conclude that any claims against any other defendants had merit without implicitly concluding that those against Singer had merit. Abercrombie also did not

establish that Tuttle's recusal was effective. Moreover by recusing himself, Tuttle had impermissibly altered the Board's resolution creating a two-member committee by creating a *de facto* one person committee led by Brisky. The Court did not rule on Brisky's independence.

Under Delaware law, SLC's are not presumed to be independent, and the SLC must prove its independence "beyond reproach." The Court concluded by finding that, "Tuttle's decision to recuse himself from considering claims against Singer, and Singer's central role in the alleged wrongdoing, cast serious doubt on Tuttle's objectivity as to the claims as a whole ... where Abercrombie had the opportunity to work with competent counsel and cherry pick who would serve on its special litigation committee, it cannot now rely on the recommendation of a special litigation committee with such dubious independence."

This decision confirms that Delaware corporations seeking to employ an SLC to investigate the allegations underlying a derivative lawsuit must take great care to ensure that the individuals it nominates to form the committee have no potentially material independence issues, including close personal relationships, with the defendants. At least according to the Sixth Circuit, recusal by a committee member will not automatically cure a potential independence issue. Because the precise contours of independence are highly fact specific and have not been delineated, a board seeking to establish an SLC should take great care to ensure independence of committee members at the outset of the committee's work.

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