No. A08-114

STATE OF MINNESOTA
IN THE SUPREME COURT

In re UNITEDHEALTH GROUP INCORPORATED
SHAREHOLDER DERIVATIVE LITIGATION,

– and –

In re UNITEDHEALTH GROUP INCORPORATED
PSLRA LITIGATION.

On Certified Question from the
United States District Court for the District of Minnesota
The Honorable James R. Rosenbaum
District Court Nos. 06-CV-1216/1691

OPENING BRIEF OF PSLRA PLAINTIFFS CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM AND ALASKA PLUMBING AND PIPEFITTING INDUSTRY PENSION TRUST

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I. CERTIFIED QUESTION AND SUMMARY OF ANSWER

The California Public Employees' Retirement System ("CalPERS"), lead plaintiff in the federal securities class action captioned *In re UnitedHealth Group Incorporated PSLRA Litigation*, U.S. Dist. Ct. No. 06-CV-1691, and Alaska Plumbing and Pipefitting Industry Pension Trust, also a plaintiff in that case (collectively, "PSLRA plaintiffs"), file this opening brief addressing the certified question before this Court. As reformulated, the question is:

> To what extent does the business judgment rule as recognized in Minnesota law require a court, in deciding whether to approve a proposed settlement of a shareholder derivative action, to defer to the decision of a Special Litigation Committee [SLC] duly constituted under Minn. Stat. §302A.241, subd. 1 (2006), that the derivative action should be settled on specific terms?

Order, Feb. 1, 2008. The PSLRA plaintiffs respectfully suggest the following answer. To protect the corporation and its stockholders who will be bound by the settlement and accompanying releases, a trial court must scrutinize a proposed settlement in a shareholder derivative action to ascertain whether the settlement is fair, reasonable and adequate. The court may consider the SLC's support for the proposed compromise as one factor in its judicial review, but the SLC's opinion is not, and cannot be, dispositive.

To summarize the analysis the PSLRA plaintiffs propose, public companies devised the SLC several decades ago as a means to defeat shareholder derivative claims, not to validate them. The SLC continues to be popular in corporate boardrooms because no matter who is appointed or what investigation is undertaken, the committee almost invariably recommends termination of most, if not all, causes of action as not in the corporation's best

interests. This institutional skepticism of derivative litigation reflects what courts and commentators call "structural bias" inherent in the SLC device. Although often coming with impressive credentials, SLC members are typically hand-picked by the defendant managers who have been sued. For a host of reasons, SLC members are more likely to identify with the experiences and outlook of the defendants than the shareholder invoking the judicial system to vindicate the company's legal rights.

Despite these formidable bias concerns, two schools of thought have developed on how much a court should defer to an SLC's proposed disposition. At least when an SLC recommends termination of a derivative suit, not all jurisdictions are convinced that the court may review the SLC's substantive conclusions. Under the more restrictive view of the court's role, the judge is to assess the process followed by the SLC – whether the committee was truly independent, acted in good faith, and undertook a reasonable investigation by collecting evidence, retaining outside counsel and the like. This limited judicial inquiry is exemplified by *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979), and jurisdictions that follow it. On the other hand, many states go one step further: first, the court reviews the SLC's independence, good faith and its investigative process; and, second, the court reviews the SLC's substantive conclusions for whether those conclusions appear reasonable. This review for both process and substance is exemplified by the Supreme Court of Delaware's decision in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), and states following the Delaware approach. Courts nationwide generally agree that, at a minimum, an SLC's procedures must be reviewed along with its good faith and independence from the defendant board members. The disagreement, and extensive scholarly commentary, has centered

around whether the court should be precluded from examining an SLC's substantive conclusions.

For purposes of answering the certified question, however, this fascinating debate provides less assistance than first meets the eye. Nearly all the case law in this area involves terminations, not settlements. Neither *Auerbach* nor *Zapata*, nor most of the decisions in their respective lines, speak to the precise issue now facing this Court. As the framing of the certified question implies – "whether to approve a proposed settlement" – a different analysis is necessary in this context, where the SLC has recommended that part of the case be settled on certain terms.

Most civil suits can be settled by private agreement, but derivative actions are an exception. A derivative suit cannot be "compromised without the approval of the court." Minn. R. Civ. P. 23.09. Although this court approval requirement has not been the subject of Minnesota appellate case law, under analogous Fed. R. Civ. P. 23.1 the trial court has a widely recognized judicial function to scrutinize a proposed derivative settlement for whether it is fair, reasonable and adequate. Of particular interest here, this standard has been applied in cases involving an SLC. A similar inquiry governs court review and approval of proposed class action settlements under Minn. R. Civ. P. 23.05. The fair/reasonable/ adequate test is a familiar one when settlement of a representative action is presented for the court's imprimatur. Stated another way, the proper vantage point here, from which the proper inquiry flows, is that a settlement is at issue – not that an SLC is proposing it.

In a basic sense, the certified question directly implicates whether a trial judge's broad discretionary power in managing derivative litigation should be circumscribed when

deciding whether to approve a proposed settlement potentially impacting, through res judicata, the corporation's entire body of stockholders. An *Auerbach*-like review for the process the SLC followed has value, but the court must be able to go further when a settlement is at issue. The nature of the inquiry – finding the proposed settlement fair, reasonable and adequate before approving it – necessitates judicial parsing of the settlement terms. Although the court should consider the SLC's position and the reasons given for it, the mere involvement of an SLC does not trump or displace the fair/reasonable/adequate test long applied to evaluate such settlements. On whether the proposed settlement satisfies this standard, the court, not a private party, makes the call.

This substantive inquiry, moreover, is sound from a policy standpoint. In light of the manner in which SLCs are formed and operate, shareholders are best protected if the judge scrutinizes the settlement terms themselves. Trial courts should not be required to abdicate their traditional substantive role under Minnesota Rule 23.09, or its federal counterpart Rule 23.1, simply because the SLC supports the compromise.

II. STATEMENT OF THE CASE AND FACTS

On March 18, 2006, the *Wall Street Journal* published a story called the "The Perfect Payday – Some CEOs reap millions by landing stock options when they are most valuable; Luck – or something else?" The article analyzed stock option practices at several companies,

including UnitedHealth Group Inc. ("UnitedHealth"). A9, 74-75.[1] Notably, the *Wall Street Journal* analyzed historical stock option grants to William W. McGuire, then Chairman and CEO. The *Wall Street Journal* found that his grants were repeatedly dated on the very day that UnitedHealth's stock was at its lowest price for the year, or in advance of sharp stock price increases. A75. Indeed, because the dates chosen for Mr. McGuire's stock options were timed over the years to coincide with the lowest points in the company's stock price, the *Wall Street Journal* concluded that the probability that these options were not backdated was less than 1 in 200 million. A75.

Backdating refers to picking an option grant date earlier than the date the option is actually granted – in this case a date when the stock price was lower than the actual grant date. Such a practice provides the executive with an immediate guaranteed profit unrelated to his or her performance. A6. It also creates an expense that must be recognized in a company's financial statements. A6. Here, defendants in the federal securities class action – including Mr. McGuire, former General Counsel David Lubben and current CEO Stephen Hemsley – successfully and repeatedly schemed to conceal their backdating practices in numerous public filings and press releases, including by reporting false financial results. *See, e.g.*, A107-22.

Shortly after the *Wall Street Journal* exposed the likely misconduct at the company, UnitedHealth engaged the law firm of Wilmer Cutler Pickering Hale and Dorr LLP

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[1] Record citations are to the Appendix in Support of Opening Brief of PSLRA Plaintiffs California Public Employees' Retirement System and Alaska Plumbing and Pipefitting Industry Pension Trust.

("WilmerHale") for the sole purpose of investigating the company's historical stock option granting practices from 1994-2006. A241. Throughout the spring of 2006, civil and criminal investigations against UnitedHealth by the Securities and Exchange Commission ("SEC"), the Minnesota State Attorney General, Internal Revenue Service and the Department of Justice ensued. Most of these investigations remain ongoing. A10-11.

Also in late spring 2006, several securities class action lawsuits were filed in the United States District Court for the District of Minnesota. The lawsuits named UnitedHealth and certain of its officers and directors, alleging violations of the Securities Exchange Act of 1934 and the Securities Act of 1933. The related federal class actions were consolidated before the Honorable James R. Rosenbaum and captioned *In re UnitedHealth Group Inc. PSLRA Litig.*, Civil Action No. 06-cv-1691 (JMR/FLN) (the "PSLRA Litigation"). A4. CalPERS was appointed Lead Plaintiff. A203. Several derivative actions were also filed in both state and federal court. A349.

While numerous investigations into UnitedHealth and its executives were beginning in the early summer of 2006, the SLC was established by a formal resolution of UnitedHealth's Board of Directors ("Board"), in response to the derivative actions that had also been filed. A319-21. The Board appointed the Honorable Kathleen A. Blatz (ret.) and the Honorable Edward C. Stringer (ret.) to the SLC, and charged them with evaluating the allegations in the shareholder derivative actions. A320.

On October 15, 2006, after a six-month investigation, UnitedHealth issued the report by WilmerHale. The report concluded, among other things: (a) the grant dates on hundreds of millions of stock options at UnitedHealth were selected with the benefit of hindsight;

(b) former Chairman and CEO Mr. McGuire was central to the option grant process; (c) senior management failed to ensure that the option granting practices were appropriate; and (d) disclosures made by UnitedHealth in various SEC filings with respect to stock option practices and related accounting were not accurate. A14-19, 89-90, 258-63.

Upon this disclosure of Mr. McGuire's substantial involvement in the stock option backdating scheme, he was ousted as Chairman and CEO effective December 2006. General Counsel David Lubben, Director William Spears and Senior Vice President of Human Capital Robert Dapper were also ousted. The company's Chief Financial Officer Patrick J. Erlandson and Controller Scott Thiessen were both demoted. A263. UnitedHealth, however, nevertheless sought to allow Mr. McGuire to depart the company with a retirement package valued at more than $1 billion, including many of his backdated options. A349. This largesse drew immediate, widespread criticism. Senator Charles Grassley (R-IA), Chairman of the Senate Finance Committee, demanded: "I want to know how a top executive can lose his job for allegedly defrauding his own company's investors, but still get rewarded with a billion dollars for doing it." A97. Despite the massive windfall he sought, Mr. McGuire refused to cooperate with the SLC's investigation. A271, 295.

Lead Plaintiffs in the PSLRA and derivative litigations moved quickly to enjoin Mr. McGuire from obtaining his ill-gotten gains. On November 29, 2006, the United States District Court entered the first of several consented-to orders restraining the release of stock options and other compensation valued at more than $1.2 billion to Mr. McGuire, pending issuance of the anticipated SLC Report. A1-3. The federal court's order was extended by agreement of the parties until December 6, 2007. A196-99.

On December 6, 2007, the SLC issued its Report. A233. Simultaneously with the issuance of the Report, the SEC announced that it was filing a complaint and entering into a consent judgment against Mr. McGuire for violations of federal securities laws. The SEC settlement requires Mr. McGuire to return approximately $400 million in stock options and pay a $7 million fine. A355-56; *see also* A346-47. Concurrently with that settlement, the SLC and the derivative plaintiffs announced that they, too, had settled with Mr. McGuire and two other executives. The SLC's and derivative plaintiffs' settlement with Mr. McGuire contained terms similar to those agreed to between Mr. McGuire and the SEC. A211-14, 295-302. Still, as a result of all of Mr. McGuire's settlements, he would obtain more than $800 million remaining in his proposed severance package. A207.

Also on December 6, 2007, CalPERS moved the federal court to maintain the injunction in the class action case and reserved its rights as a shareholder with respect to the just-announced derivative settlement. A224. The derivative plaintiffs changed their position, now joining Mr. McGuire in adamantly opposing the injunction and seeking thereby the release to him of more than $800 million. A211, 350.

The SLC Report also announced that the derivative plaintiffs and the SLC had settled claims with two other UnitedHealth executives, David Lubben and William Spears. A298-302. The SLC recommended that claims against all others involved should be dismissed, despite the acknowledgment that many of them received backdated stock options and that their conduct was "disappointing." A302-09. The SLC recommended:

> The SLC concludes that it is in the best interests of the Company for the claims against Dr. William McGuire, Mr. David Lubben and Mr. William

> Spears in the Derivative Actions to be dismissed pursuant to the terms of the settlements described above. . . .
>
> The SLC concludes that it is in the best interests of the Company not to pursue the claims asserted against all other named defendants [including current CEO Stephen Hemsley] in the Derivative Actions and that such claims should be dismissed with prejudice.

A310.

Importantly, "[a]lthough the SLC concluded that some of the claims against Dr. McGuire may have merit," the SLC chose to recommend dismissal of the claims against Mr. McGuire as part of the proposed settlement. A295-98. And even though Mr. Hemsley received hundreds of millions of dollars in backdated options, the SLC opined it was not in the company's interest to pursue those claims. A304-08. In proposing these outcomes, however:

> The SLC has determined that it would be contrary to the Company's best interests to set forth detailed factual findings regarding the claims asserted in the Derivative Actions, as the Company is subject to ongoing federal securities fraud actions involving similar allegations. Therefore, the SLC sets forth only its conclusions and a summary explanation of those conclusions.

A295. In sum, the SLC agreed to settle claims and dismiss all others outright against some defendants without, in the words of the United States District Court, leaving any "tracks showing why or how its business judgment can be considered reasonable." A357.

On December 26, 2007, the federal court granted CalPERS' motion to extend the injunction in the order giving rise to the certified question now before this Court. A360-61. On January 2, 2008, the federal court formally certified the issue to this Court. A362-64. On February 1, 2008, this Court accepted the certified question, reformulating it slightly, and

set a briefing schedule. The federal class action is ongoing, with the case currently set for trial in July 2008.

III. ARGUMENT

A. Derivative Actions Serve a Useful Social Function by Allowing Shareholders to Challenge Breaches of Fiduciary Duty and Related Abuses by Corporate Managers

The shareholder derivative action has deep roots in American common law. Its judicial lineage dates to the birth of the corporation itself in the 19th century as a form of business organization. "Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'" *Kamen v. Kemper Fin. Servs.*, 500 U.S. 90, 95 (1991);[2] *see also Hawes v. City of Oakland*, 104 U.S. 450 (1882) (discussing legal origins). Among their benefits, "derivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves." *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966). Like most jurisdictions, Minnesota has long recognized the derivative action's basic utility as a form of shareholder democracy and tool for policing corporate wrongdoing. *See, e.g., Horn Silver Min. Co. v. Ryan*, 42 Minn. 196, 44 N.W. 56 (1889).

In its modern precedents, this Court explains: "'[T]he derivative suit is a device to protect shareholders against abuses by the corporation, its officers and directors, and is a

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[2] All emphasis is added and citations are omitted unless otherwise noted.

vehicle to ensure corporate accountability.'" *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 882 (Minn. 2003). It "is an equitable remedy which allows a stockholder to bring an action on behalf of the corporation to enforce a corporate right." *Vista Fund v. Garis*, 277 N.W.2d 19, 22 n.4 (Minn. 1979). The derivative action is available to challenge "'breach of fiduciary duty by officers or directors when the corporation itself refuses to bring such action.'" *Id.*

Procedurally in such cases, the shareholder plaintiff stands in the corporation's shoes. "'The cause of action which such a plaintiff brings before the court is not his own but the corporation's. It is the real party in interest and he is allowed to act in protection of its interest, somewhat as a "next friend" might do for an individual, because it is disabled from protecting itself.'" *McMenomy v. Ryden*, 286 Minn. 358, 363, 176 N.W.2d 876, 879-80 (1970). This Court has recognized the cleansing effect of meritorious derivative cases: "Such actions may have a wholesome effect on the corporate management in keeping it within the limits of its legal responsibility and at the same time act as a deterrent to arbitrary, unreasonable, and harmful managerial conduct." *Bosch v. Meeker Coop. Light & Power Ass'n*, 257 Minn. 362, 366, 101 N.W.2d 423, 426 (1960).

Although originating at common law, proceedings in derivative actions are now governed by a mix of court rules, statutes and case law. The interplay of these sources is instructive in answering the certified question. These sources indicate that when confronted with a proposed settlement endorsed by an SLC, the court must assess not just the SLC's independence, good faith and the investigative process it followed, but also the substance of the settlement itself.

B. Court Approval Is Required of Any Settlement of a Shareholder Derivative Action, Thereby Necessitating Judicial Scrutiny of the Proposal for Whether It Is Fair, Reasonable and Adequate

As discussed at greater length below, the statute mentioned in the certified question – Minn. Stat. §302A.241, subd. 1 – gives corporate boards leeway to appoint an SLC to evaluate derivative claims, but the statute does not address court review of the SLC's conclusions or recommendations. This is unsurprising because matters of court procedure are usually not statutory. In fact, the Legislature has expressly deferred to this Court in the area. In 1947, well before the SLC statute was adopted, the Legislature vested this Court with broad authority to regulate court procedure: "The Supreme Court of this state shall have the power to regulate the pleadings, practice, procedure, and the forms thereof in civil actions in all courts of this state, including the probate courts, by rules promulgated by it from time to time." Minn. Stat. §480.051; *cf.* 28 U.S.C. §2072 (Rules Enabling Act conveying similar authority to United States Supreme Court for proceedings in federal court).

1. Minnesota Rule of Civil Procedure 23.09

This Court responded by adopting its Rules of Civil Procedure in 1951, and amending them as necessary. Derivative litigation is governed by special strictures long covered in the rules. As this Court has explained: "When a shareholder seeks to enforce a right of a corporation, the shareholder may pursue that claim only by following the procedural requirements of Minn. R. Civ. P. 23.06 [now 23.09]." *Wessin v. Archives Corp.*, 592 N.W.2d 460, 461 (Minn. 1999) (syllabus ¶1).

Particularly crucial for the present case, the rules provide: "The [derivative] action shall not be dismissed or compromised without the approval of the court, and notice of the

proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs." Minn. R. Civ. P. 23.09. Advance notice allows shareholders to register any disagreement they have with the proposal before it is approved. *See In re Pemstar, Inc.*, No. A05-2225, 2006 WL 2530388, at *1 (Minn. Ct. App. Sept. 5, 2006) (unpublished) (describing notice procedure under Rule 23.09 in appeal by shareholder objecting to derivative settlement).[3] This opportunity to be heard is significant because, in contrast to class actions, "'there is no opt-out provision in shareholder derivative suits. Thus, all shareholders are bound by the outcome regardless of their objections.'" *Powers v. Eichen*, 229 F.3d 1249, 1255 (9th Cir. 2000). It would make no sense to empower shareholders to challenge the settlement terms, as Rule 23.09 does by making notice mandatory, but somehow preclude the court from reviewing those terms. Even if no shareholders object, "'[t]he silence or the absence of shareholders does not relieve the judge of his duty. Indeed it may charge him with an additional responsibility.'" *United Founders Life Ins. Co. v. Consumers Nat'l Life Ins. Co.*, 447 F.2d 647, 655 (7th Cir. 1971).

Despite its long lineage,[4] the court approval requirement has not been the subject of any Minnesota appellate decision. This reflects that "shareholder-derivative litigation is not an everyday occurrence in Minnesota's courts." *Janssen*, 662 N.W.2d at 882. At least one

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[3] The PSLRA plaintiffs recognize that unpublished opinions are not "precedential," but such decisions nonetheless "can be of persuasive value." *Dynamic Air, Inc. v. Bloch*, 502 N.W.2d 796, 800 (Minn. Ct. App. 1993).

[4] The court approval language has been part of the Rules of Civil Procedure since 1968. The same language was initially codified 40 years ago in Rule 23.06, which was renumbered Rule 23.09 effective January 1, 2006. *See* Minn. R. Civ. P. 23.09 credits.

Minnesota trial court ruling, however, applies the standard this Court should expressly adopt because, as appears below, it is the standard widely followed in derivative litigation. The Honorable Jodi Williamson of the Third Judicial District Court recently approved a derivative settlement after engaging in the required judicial review and finding that the compromise was "fair, reasonable, and adequate," and "confers substantial benefits on and is in the best interests of [the corporation] and its shareholders." *In re Pemstar Inc.*, No. C3-03-003693, 2005 WL 4991303, at *2 (Minn. Dist. Ct. Sept. 15, 2005) (applying predecessor Rule 23.06), *aff'd*, 2006 WL 2530388 (Minn. Ct. App. Sept. 5, 2006).

2. Persuasive Reliance on Federal Rule of Civil Procedure 23.1

Federal Rule of Civil Procedure 23.1 governs proceedings in federal derivative actions. Of persuasive value in interpreting Minnesota Rule 23.09, the federal counterpart has long contained the same judicial approval requirement. Using slightly more comprehensive language – a recent stylistic revision – the federal rule currently provides in relevant part: "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." Fed. R. Civ. P. 23.1(c). This Court has previously drawn on federal case law under Federal Rule 23.1 to flesh out the Minnesota rule of court. *See Vista Fund*, 277 N.W.2d at 23 & n.6. Although "not necessarily controlling," case law applying the Federal Rules of Civil Procedure is "helpful and instructive" where, as here, the state rule is "modeled" on the federal counterpart. *Johnson v. Soo Line R.R. Co* , 463 N.W.2d 894, 899 n.7 (Minn. 1990); *see also Grothe v. Shaffer*, 305 Minn. 17, 22, 232 N.W.2d 227, 231 (1975) (adopting

interpretation from federal case law); *Yamobi v. State*, 672 N.E.2d 1344, 1347 n.4 (Ind. 1996) (observing that consistent construction of state and federal rules of court allows for "development of a uniform body of law").

Federal Rule 23.1 is "intended to prevent plaintiffs from selling out their fellow shareholders." *Burks v. Lasker*, 441 U.S. 471, 485 n.16 (1979). Accordingly, as an illustrative appellate decision explains: "The discretion afforded by [Federal] Rule 23.1 permits the district court to act as a third party to the compromise and a guardian of the corporation's interest." *In re Gen. Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075, 1080 (6th Cir. 1984). "The proponents of the settlement," as in the Minnesota *Pemstar* case discussed above, "have the burden of persuading the court that their compromise is fair, reasonable and adequate." *Id.*

Federal courts have applied this standard virtually since the Federal Rules of Civil Procedure were adopted in 1938. *See, e.g., Winkelman v. Gen. Motors Corp.*, 48 F. Supp. 490, 493 (S.D.N.Y. 1942). In the wealth of precedent on the matter, federal courts recognize that the task is a judicial function, not a business judgment to be left solely to private parties. *See generally* 7C Charles Alan Wright et al., *Federal Practice and Procedure* §1839 (3d ed. 2007); Annotation, *Notice to shareholders and court approval of dismissal or compromise of derivative actions, under Rule 23.1 of Federal Rules of Civil Procedure*, 26 A.L.R. Fed. 465 (1976). As counsel for the federal derivative plaintiffs told the United States District Court, "you have a fiduciary responsibility, Your Honor, as far as we're concerned, to look at this [proposed settlement] and determine if it passes Rule 23 muster." A212. Counsel further acknowledged that if the federal court found the proposal was "not adequate," then the

proposal "ought not be approved under the requirements of Rule 23, and it's back to the drawing board for I believe both the SLC and us." A213.

The Second Circuit, historically a venue for much derivative litigation, identifies the core rationale for this judicial scrutiny: "In stockholder derivative actions . . . because of the vicarious representation involved, the court has a duty to perform before an action can be 'settled.' . . . This approval cannot be a rubber stamp adoption of what the parties alone agree is fair and equitable." *Seigal v. Merrick*, 590 F.2d 35, 37-38 (2d Cir. 1978). The court review now codified in Federal Rule 23.1 "'was adopted to secure not routine approval of a consent decree, but in order to insure supervision of the court for the protection of the corporation and all the stockholders.'" *Winkelman*, 48 F. Supp. at 493. More than this, "[t]he management of a derivative suit gives the trial judge a chance not only to disapprove a compromise but to edge the parties toward more equitable terms." *Seigal*, 590 F.2d at 39; *see, e.g.*, *Winkelman*, 48 F. Supp. at 499-500 (conditionally rejecting settlement unless certain terms were changed). A trial judge who has lived with a case, just as the lawyers have, may call upon "the court's knowledge of the case drawn from pretrial conferences, dispositions of preliminary motions and matters, oral arguments and reading of briefs, transcripts and affidavits, as well as from the evidence adduced at the hearing on the compromise." *United Founders Life*, 447 F.2d at 655. The inquiry is undertaken with a keen judicial eye to "whether the compromise, taken as a whole, is in the best interest of the corporation and all its shareholders." *Id.*

Of particular interest in answering the certified question here, judicial scrutiny is for whether the proposed agreement is fair, reasonable and adequate even where an SLC has

evaluated the merits of the derivative claims. As one case explains, "courts are required to 'independently and objectively analyze the evidence and circumstances before it in order to determine whether the settlement is in the best interest of those whose claims will be extinguished.'" *In re Cendant Corp., Derivative Action Litig.*, 232 F. Supp. 2d 327, 332 (D.N.J. 2002). The SLC's backing of the settlement in *Cendant* "weigh[ed] in favor of approval," but was just one of several factors the federal court considered in reviewing the proposal. *Id.* at 336. To the same effect, the Sixth Circuit reconciled the substantive review mandated by Federal Rule 23.1 with Ohio's business judgment rule and other authorities bearing on deference to an SLC. *See Gen. Tire*, 726 F.2d at 1080-86.

Other federal circuits have echoed the approach followed in *Cendant* and *Gen. Tire*. Although settlement is generally a favored mode of dispute resolution, the court's role requires substantive inquiry before a finding can be made that the proposed settlement is fair, reasonable and adequate. *See, e.g., Jones v. Nuclear Pharmacy, Inc.*, 741 F.2d 322 (10th Cir. 1984) (upholding trial court's conclusion that SLC-endorsed derivative settlement was fair, reasonable and adequate under Federal Rule 23.1). In fact, Federal Rule 23.1 dictates the same level of judicial scrutiny where the SLC believes the derivative claims lack significant merit. *See Bell Atl. Corp. v. Bolger*, 2 F.3d 1304, 1310-16 (3d Cir. 1993) (derivative settlement was fair, reasonable and adequate where SLC determined that "management had acted reasonably and in the best interests of the company and had not engaged in improper behavior"). Either way, the court conducting the review must conclude not only that the

proposed settlement came to fruition through procedurally fair means, but also that the terms are "substantively fair." *Id.* at 1314.[5]

3. Persuasive Reliance on Minnesota Rule of Civil Procedure 23.05

Further guidance is found in Minn. R. Civ. P. 23.05, which mandates similar notice and court approval of class action settlements. In contrast to its derivative counterpart, Rule 23.05's court approval requirement in Minnesota has been the subject of case law. "'The standard . . . is whether the settlement is fair, adequate, reasonable, and is not the product of collusion between the parties.'" *State by Wilson v. St. Joseph's Hosp.*, 366 N.W.2d 403, 406 (Minn. Ct. App. 1985) (quoting *SST, Inc. v. City of Minneapolis*, 288 N.W.2d 225, 231 (Minn. 1979), which adopted this familiar test without citing Rule 23.05). As the Court of Appeals firmly concluded, "the parties' stipulation [to settle] was not binding before approval by the . . . judge. Authority to approve implies an authority to withhold approval." *Id.* It is thus error for the trial judge to "assume[] the agreement between the parties was final and that his approval [is] pro forma. Approval must not be pro forma." *Id.* Other Minnesota appellate decisions reinforce this point. *See, e.g., Heller v. Schwan's Sales Enters.*, 548 N.W.2d 287, 289 (Minn. Ct. App. 1996) (noting that proposed class action

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[5] In one of the earliest reported decisions to explore the role of court approval of derivative settlements, the Supreme Court of California nearly a century ago presaged the inquiry that would eventually be mandated under modern rules of civil procedure and some state statutes. An agreement to settle derivative claims "is cognizable by the trial court alone and will not be given the slightest efficacy until, after scrutiny and examination, it shall be determined by that court that the corporation's rights are fully protected." *Whitten v. Dabney*, 154 P. 312, 317 (Cal. 1915).

settlement is scrutinized for whether it is "fair, adequate, and reasonable, and not the product of collusion between the parties").

Rule 23.05 was amended in 2006 to codify expressly the standard long applied in case law. Now, by letter of the rule, judicial review is for whether a proposed class settlement is "fair, reasonable, and adequate." Minn. R. Civ. P. 23.05(a)(3). The intent behind the 2006 amendment underscores the paramount role of court review in representative suits:

> Rule 23.05 is expanded to define the procedures for review and approval of class settlements. The rule adopts the changes in Fed. R. Civ. P. 23(e) with one stylistic modification. The federal rule, read literally, might appear to suggest that a trial court must approve every settlement submitted for approval; the language is reworked in the proposed rule to make it clear that although court approval is required for a settlement to be effective, the court's options are not constrained. Indeed, many proposed settlements are properly rejected for not being in the interest of class members.

Minn. R. Civ. P. 23.10 advisory committee comment – 2006 amendments.

Class and derivative actions are different things, of course, but as representative actions they have meaningful similarities that are pertinent in answering the certified question. Just as final judgment in a derivative action binds all the corporation's stockholders on the derivative claims asserted, final judgment in a certified class action bars relitigation by any class member of the class claims asserted. *Compare McMenomy v. Ryden*, 276 Minn. 55, 65, 148 N.W.2d 804, 811 (1967) (as to derivative actions) *with Devlin v. Scardelletti*, 536 U.S. 1, 8-10 (2002) (class actions). Moreover, just as the trial judge reviewing a proposed derivative settlement is "a guardian of the corporation's interest," *General Tire*, 726 F.2d at 1080, the court reviewing a proposed class settlement is, likewise,

"a 'fiduciary' of the absent class members." *7-Eleven Owners for Fair Franchising v. Southland Corp.*, 102 Cal. Rptr. 2d 777, 787 (Cal. Ct. App. 2000).

In both derivative and class suits, the court assumes an active supervisory role, especially at the settlement stage, for a fundamental reason. The Third Circuit has explained it well: "In assessing settlements of representative actions, judges no longer have the full benefit of the adversarial process." *Bell Atl.*, 2 F.3d at 1310. "In seeking court approval of their settlement proposal, plaintiffs' attorneys' and defendants' interests coalesce and mutual interest may result in mutual indulgence. The parties can be expected to spotlight the proposal's strengths and slight its defects." *Id.* Or, as Judge Friendly of the Second Circuit once put the matter: "'The plaintiff stockholders or, more realistically, their attorneys have every incentive to accept a settlement that runs into high six figures or more regardless of how strong the claims for much larger amounts may be. . . . Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork . . . .'" *Herbst v. Int'l Tel. & Tel. Corp.*, 72 F.R.D. 85, 92 & n.15 (D. Conn. 1976) (quoting his dissent in *Wolf v. Barkes*, 348 F.2d 994, 997-98 (2d Cir. 1965)).[6]

Thus, as in a class action, the representative nature of a derivative action dictates substantive scrutiny of derivative settlements for whether the compromise is fair, reasonable and adequate – not merely a review of the process the SLC followed. *See also Burks*, 441

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[6] That certainly appears to be the case here. Changing their position after a settlement was reached, the federal derivative plaintiffs now oppose the United States District Court's order enjoining the federal class action defendants from taking any action to Mr. McGuire's stock options – although the options are not implicated by the proposed derivative settlement. A211, 350.

U.S. at 485 n.16 (interpreting Federal Rules 23 and 23.1 in like fashion); *Cendant*, 232 F. Supp. 2d at 332 (to similar effect).

Finally, to anticipate one contention that might be made against the position urged by the PSLRA plaintiffs, the Minnesota rule requires court approval of not just a "compromise," but also any "dismissal" of a derivative suit. Minn. R. Civ. P. 23.09. In light of this, it could be argued that the same mode of judicial scrutiny should be applied to both. Settlements, in other words, really are not different from terminations in the review conducted by the courts. This critique ignores the wealth of precedent under Fed. R. Civ. P. 23.1 applying the fair/ reasonable/adequate inquiry to derivative settlements – a test not normally applied to a proposed termination. In addition, Delaware, a state with unique influence on matters of corporate law, has treated the two things as distinct, not interchangeable.

Without citing its seminal "termination" decision in *Zapata*, the Supreme Court of Delaware has reviewed a proposed shareholder derivative settlement, approved by an SLC, for whether the proposal was reasonable. In *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991), certain shareholder plaintiffs "agreed to a settlement of their class and derivative actions subject to the approval of the Court of Chancery," while other shareholders in related litigation objected. *Id.* at 50. The settlement in *Kahn* was "authorized, on behalf of [the corporation], by" an SLC. *Id.*; *see also id.* at 56 (discussing procedural history). The Supreme Court of Delaware explained that when faced with a proposed derivative settlement under these circumstances, the trial judge's "'function is to consider the nature of the [plaintiff's] claim, the possible defenses thereto, the legal and factual circumstances of the

case, and then to apply its own business judgment in deciding whether the settlement is reasonable in light of these factors.'" *Id.* at 59.

The lack of any reference in *Kahn* to *Zapata* underscores that a court reviewing a proposed settlement is not performing the same inquiry as when an SLC proposes essentially an involuntary dismissal. In the latter situation, the court at least has the benefit of the "adversarial process" that is missing when both sides join forces to sell a settlement proposal to the court. *Bell Atl.*, 2 F.3d at 1310. Indeed, *Zapata* itself carefully distinguished a settlement from a termination. Principles from the settlement context were invoked not as directly applicable, but as one of several useful "procedural analogies" to a termination. *Zapata*, 430 A.2d at 787. Thus, whatever the test for a proposed termination, when a settlement is proposed, the court necessarily must examine its substance before giving approval.

C. The Minnesota Business Corporations Act Is Fully Consistent with Judicial Review of Derivative Settlements for Whether They Are Fair, Reasonable and Adequate

This brings the analysis to the Minnesota Business Corporation Act ("MBCA"), Minn. Stat. §302A.001 et seq. The statute this Court has been asked to address, Minn. Stat. §302A.241, is part of the MBCA. As appears below, nothing in the history of the MBCA, the SLC statute in particular, or the case law applying the SLC statute conflicts with the fair/reasonable/adequate inquiry courts normally undertake when evaluating a derivative settlement. In some respects, these sources of law underscore the need for a substantive review.

1. Enacted in 1981, Minnesota Statute §302A.243 Initially Suggested Limited Judicial Scrutiny of SLC Recommendations

In 1979, the Advisory Task Force on Minnesota Corporation Law ("Task Force") was formed to draft new corporate laws for the state. The Task Force was charged with "revising and modernizing Minnesota's business corporation laws to meet the legitimate and contemporary business needs of local businesses, large and small, whose corporate affairs are governed by those laws." Report to the Senate by Advisory Task Force on Corporation Law (1981), *reprinted in* Minn. Stat. Ann. §302A.001 (West Supp. 2000) ("Task Force Report"). By the end of 1980 – the timing is material, as appears below – the Task Force completed its work and made recommendations to the Legislature. *Id.* A new MBCA based on the recommendations was enacted effective July 1, 1981. *See* 1981 Minn. Laws ch. 270 (codified at Minn. Stat. §302A.001 et seq.).

Coincidentally, the MBCA came into being just as the SLC began receiving extensive attention in courts across the country. As of 1979, the scant law on SLCs emanated mostly from federal district court opinions giving the so-called "business judgment rule" a sweeping application. *See, e.g.*, *Rosengarten v. Int'l Tel. & Tel. Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979). The appellate precedent, both state and federal, was just in its infancy.

When the MBCA was being debated and shaped in 1979-80, the most significant appellate opinion on SLCs was *Auerbach*, 393 N.E.2d 994. The New York Court of Appeals issued *Auerbach* in July 1979, just one month after the Task Force began its work. *See* Task Force Report. The next significant high court decision would not come until May 1981, when the Supreme Court of Delaware issued *Zapata*, 430 A.2d 779. *Zapata* did not factor

into the MBCA because, by that time, the Task Force had completed its work and the MBCA was on the verge of becoming law in the summer of 1981. As already discussed, *Auerbach* on the one hand (refusing to scrutinize an SLC's substantive conclusions) and *Zapata* (adopting a two-step review for both process and substance) became the doctrinal goalposts in this field.

The original MBCA section authorizing a board of directors to appoint an SLC reflected the influence of *Auerbach* during the 1979-81 window before *Zapata*. As adopted in 1981, the MBCA contained the following statute on special litigation committees:

> Unless prohibited by the articles or bylaws, the board may establish a committee composed of two or more disinterested directors or other disinterested persons to determine whether it is in the best interests of the corporation to pursue a particular legal right or remedy of the corporation and whether to cause the dismissal or discontinuance of a particular proceeding that seeks to assert a right or remedy on behalf of the corporation. For purposes of this section, a director or other person is "disinterested" if the director or other person is not the owner of more than one percent of the outstanding shares of, or a present or former officer, employee, or agent of, the corporation or of a related corporation and has not been made or threatened to be made a party to the proceeding in question. The committee, once established, is not subject to the direction or control of, or termination by, the board. A vacancy on the committee may be filled by a majority vote of the remaining members. ***The good faith determinations of the committee are binding upon the corporation and its directors, officers, and shareholders.*** The committee terminates when it issues a written report of its determinations to the board.

1981 Minn. Laws ch. 270, §43 (formerly codified at Minn. Stat. §302A.243).

Hence, although suggesting deference to an SLC's recommendations, the statute did not address how a court should go about scrutinizing a settlement an SLC has proposed, as here, in a derivative action found to have merit. Instead, the statute deliberately focused on an SLC's power to halt baseless derivative litigation. As the Task Force explained, Minn.

Stat. §302A.243 was adopted "to avoid any uncertainty with respect to the power of a Minnesota corporation to use this mechanism to terminate the patent abuses of strike suits." Task Force Report. The deferential language in the original statute, and the Task Force's reference to "patent abuses," reflects a static reality of the SLC device. When an SLC completes its investigation "nearly all committees recommend that the corporation not join in the derivative action." Eric J. Moutz, *Janssen v. Best & Flanagan: At Long Last, the Beginning of the End for the Auerbach Approach in Minnesota?*, 30 Wm. Mitchell L. Rev. 489, 492 (2003) ("*End for the Auerbach Approach*").

2. In 1988, the Court of Appeals Interpreted Minnesota Statute §302A.243 to Adopt the Limited Judicial Inquiry Applied in *Auerbach*

Minnesota Statute §302A.243, codifying a measure of deference to SLCs in this state, had a short lifespan. It was the subject of just one reported appellate decision in 1988, and then was promptly repealed.

In *Black v. NuAire, Inc.*, 426 N.W.2d 203 (Minn. Ct. App. 1988), *review denied* (Minn. Aug. 24, 1988), the shareholder plaintiff attempted to pursue a derivative action against current or former directors. *Id.* at 205. The defendants responded by designating an SLC, which urged dismissal. *Id.* at 206-07. Relying on the SLC, the trial court dismissed the suit. *Id.* at 207. A proposed settlement, accompanied by a recovery for the corporation, was not at issue.

To the extent anything pertinent to the certified question may be taken from *Black*, the shareholder plaintiff argued on appeal that the lower court "erred by interpreting Minn. Stat. §302A.243 to limit the court's inquiry to whether the committee members were disinterested

and conducted their investigation in good faith." *Black*, 426 N.W.2d at 209. The plaintiff contended that "the trial court erred in failing to review the merits of the committee's recommendation." *Id.* Affirming the dismissal, the Court of Appeals disagreed: "We interpret section 302A.243 to preclude our courts from reviewing the merits of a recommendation to dismiss a shareholder's derivative action when that recommendation is made by a disinterested committee conducting its investigation in good faith." *Id.* at 209-10. For this constrained review, the Court of Appeals cited, among other authorities, the New York Court of Appeals' decision in *Auerbach*. *Id.* at 210-11.

3. In 1989, the Legislature Repealed Minnesota Statute §302A.243, and Enacted a New SLC Provision in Minnesota Statute §302A.241, but the Court of Appeals Has Continued to Apply the Interpretation Given the Superseded Statute

In 1989, only one year after *Black*, the Legislature repealed Minn. Stat. §302A.243. In its place, the Legislature adopted the following language in a different MBCA provision:

> A resolution approved by the affirmative vote of a majority of the board may establish committees having the authority of the board in the management of the business of the corporation only to the extent provided in the resolution. Committees may include a special litigation committee consisting of one or more independent directors or other independent persons to consider legal rights or remedies of the corporation and whether those rights and remedies should be pursued.

Minn. Stat. §302A.241, subd. 1. Right on the heels of *Black*, then, the Legislature eliminated the *Auerbach* phraseology in the prior statute that "[t]he good faith determinations of the committee are binding upon the corporation and its directors, officers, and shareholders." 1981 Minn. Laws ch. 270, §43.

As appears from its lean text, the statute now in place is silent on the judicial scrutiny to give an SLC recommendation regarding the proper disposition of derivative litigation. The Legislature here recognized that "[c]reation of court procedure is purely a judicial function." *Lombardo v. Seydow-Weber*, 529 N.W.2d 702, 705 (Minn. Ct. App. 1995); *see also* Minn. Const. Art. III, §1 (separation of powers); Minn. Stat. §480.056 (declaring that any law "in conflict" with a rule of court "shall thereafter be of no further force and effect"). When a settlement is at issue, it becomes necessary, as shown above, to glean a mode of review from Minn. R. Civ. P. 23.09 and, by analogy, Fed. R. Civ. P. 23.1 and its implementing case law.

On this score, the fair/reasonable/adequate inquiry in the settlement context forcefully advances, not undermines, the MBCA's overarching goals. According to its authors, one of the "fundamental functions" of the new MBCA was "[t]o increase the accountability of management and the flow of information to shareholders by providing expanded protection for the rights of shareholders, particularly those holding minority interests." Task Force Report. A related objective was "[t]o permit recourse to the courts to remedy any possible abuses resulting from substantially increased managerial flexibility." *Id.* "In essence," the Task Force explained, "a sound business corporation law should embody substantial flexibility and informality in matters of procedure" – thus the SLC statute – but accompanied by "substantial disclosure of and accountability for the corporate actions resulting from those procedures." *Id.*

Judicial scrutiny of an SLC's proposed settlement for whether the compromise is fair, reasonable and adequate furthers these broad purposes. It is also in line with the MBCA

provision governing director conflicts of interest. Because an SLC is usually appointed by the board members who have been sued, an SLC urging a settlement on certain terms should have to demonstrate that "the contract or transaction was fair and reasonable as to the corporation at the time it was authorized, approved, or ratified." Minn. Stat. §302A.255, subd. 1(a); *see also Zapata*, 430 A.2d at 788 n.17 (under Delaware law, "once the transaction is attacked," interested directors "have the burden of establishing its 'intrinsic fairness' to a court's careful scrutiny").

The United States District Court, however, perceived a fly in the ointment in the Court of Appeals decisions construing the successive SLC statutes, both the original one and then the successor. The 1989 repeal would seem to mandate the easy conclusion that the prior judicial interpretation, linking an *Auerbach* standard to the repealed statute, was no longer a viable interpretation. *See State v. Target Stores, Inc.*, 279 Minn. 447, 474, 156 N.W.2d 908, 925 (1968). But, this is not what the Court of Appeals has concluded.

As relevant here, the panel in *Skoglund v. Brady*, 541 N.W.2d 17 (Minn. Ct. App. 1995), *review denied* (Minn. Feb. 27, 1996), declared, without detailed analysis, that "[t]his court's interpretation of the section in *Black* . . . was not affected by the repeal." *Id.* at 21. Four years later, the Court of Appeals reiterated the *Auerbach* gloss again, but merely on grounds of *stare decisis*:

> This is not a question of first impression. On review from the dismissal of a derivative suit based on the recommendation of a special litigation committee, we limit our inquiry to whether the committee was independent and conducted its investigation in good faith. *Skoglund*, 541 N.W.2d at 21; *Black*, 426 N.W.2d at 209-10.

Drilling v. Berman, 589 N.W.2d 503, 507 (Minn. Ct. App. 1999), *review denied* (Minn. May 18, 1999). After some discussion of other jurisdiction's approaches to SLCs, the Court of Appeals signaled in *Drilling* that cleaning up the law here would be left to this Court. *Id.* at 509 (citing *Tereault v. Palmer*, 413 N.W.2d 283, 286 (Minn. Ct. App. 1987), which states that "the task of extending existing law falls to the supreme court or the legislature").

For purposes of the certified question, the Court of Appeals decisions have only limited relevance because each involved a termination. Court review under Minn. R. Civ. P. 23.06 (now 23.09) of an SLC-sponsored settlement was simply not at issue. *See Black*, 426 N.W.2d at 205-07; *Skoglund*, 541 N.W.2d at 19; *Drilling*, 589 N.W.2d at 505-06. Indeed, without citing the Rules of Civil Procedure, the first opinion in this line loosely implied there is no role for "'approval of the court'" when an SLC is involved. *Black*, 426 N.W.2d at 209; *see also Drilling*, 589 N.W.2d at 509 (following *Black* on this point). At least as to a settlement, this voluntary resolution is subject to court review and approval. *See Burks*, 441 U.S. at 485 n.16.

4. When It Revised the Statutory Framework Governing the SLC Nearly Two Decades Ago, the Legislature Simply Intended to Leave the Appropriate Standard of Judicial Scrutiny to Other Sources of Law

Of greater interest than the distinguishable circumstances in the Court of Appeals decisions, the legislative history illustrates that rigid adherence to a one-dimensional *Auerbach* standard, as a matter of judicial interpretation, is untenable.

The Court of Appeals distilled the relevant legislative history:

> In repealing the [prior] section, the legislature made it clear it was not commenting on the substance of the section and that its repeal "must be

> interpreted in the same manner as if section 302A.243 had not been enacted." [1989 Minn. Laws ch. 172], §12. The legislature took that action in recognition that Minnesota was one of the few states with legislation governing judicial review of special litigation committees. Hearing on S.F. No. 190 Before the Senate Comm. on the Judiciary (Apr. 11, 1989) (statement of Sen. Luther). The repeal represented "a commitment to let the caselaw develop," *id.*, and a desire to give our courts flexibility. Hearing on S.F. No. 190 Before the Senate Comm. on the Judiciary, Civil Law Division (Mar. 17, 1989) (statement of Sen. Luther).

Drilling, 589 N.W.2d at 506.

Thus, the Legislature did not intend for a single review standard to control in every case involving an SLC, as the Court of Appeals has twice assumed since the 1989 repeal. Rather, the Legislature, on further thought after the first decision in *Black*, simply removed the extent of judicial deference to an SLC from the statutory domain. As a commentator has observed, the statements quoted in *Drilling* "at least imply that the legislature envisioned that Minnesota courts would someday deviate from the rule in *Auerbach*." *End for the Auerbach Approach*, 30 Wm. Mitchell L. Rev. at 497.

5. In 2003, This Court Recognized the Flexibility Intended by the 1989 Legislative Revamp of the SLC Statute

Consistent with the legislative history, this Court signaled five years ago that a more flexible jurisprudence is in order. In *Janssen*, 662 N.W.2d 876, this Court addressed the role of SLCs in derivative actions on behalf of nonprofit corporations, but discussed at length general principles of corporate law that provide some guidance on the inquiry here.

As in the three Court of Appeals decisions, *Janssen* involved not an SLC recommendation to settle on certain terms, but a recommendation to dismiss the derivative suit as not in the company's best interests. *Id.* at 879. This Court held that the board of a

nonprofit corporation has the power to appoint an SLC, but deference under the facts presented was inappropriate. "Because the investigation conducted by appellant's litigation committee lacked independence and good faith, the conclusion of that committee does not deserve deference from the court as a business decision." *Id.* at 876 (syllabus ¶3). "When the committee authorized with making a business decision for the corporation lacks independence and good faith, a member's derivative suit proceeds on its merits." *Id.* (syllabus ¶4).

In a departure from the Court of Appeals decisions, then, this Court rejected an SLC's recommendation to terminate the derivative action. *Janssen* held that the party relying on the SLC's recommendations carries the burden of showing that the court should act as the SLC has proposed. *Id.* at 888-89. This is in line with federal law placing the onus on the proponents of a derivative settlement to "persuad[e] the court that their compromise is fair, reasonable and adequate." *Gen. Tire*, 726 F.2d at 1080.

Instructive in another sense, *Janssen* explored broader considerations that animate the judicial scrutiny to give an SLC recommendation. At the heart of its opinion, this Court emphasized the need to "strike a balance between two competing interests in the judicial review of corporate decisions." *Janssen*, 662 N.W.2d at 881. "On one hand, courts recognize the authority of corporate directors and want corporations to control their own destiny." *Id.* "On the other hand, courts provide a critical mechanism to hold directors accountable for their decisions by allowing shareholder derivative suits." *Id.* at 882. These considerations of equal dignity are reflected in the "business judgment rule." *Id* As to SLCs in particular, this Court instructed in *Janssen*: "If the board properly delegates its authority to

act to the special litigation committee, the court will extend deference to the committee's decision under the business judgment rule." *Id.* at 884.

The exact scope of the business judgment rule, therefore, becomes significant. Exhibiting healthy suspicion of the SLC device, *Janssen* indicates that judicial deference to an SLC is relative, not absolute. This Court explained that liability for corporate losses will generally not attach to a corporate fiduciary who is (1) "disinterested," (2) "informed," and (3) acts "in good faith." *Id.* at 882. These criteria reflect that "courts are ill-equipped to judge the wisdom of business ventures." *Id.* But, importantly for the present context – court review of a proposed derivative settlement – the business judgment rule will not extend to managerial decisions that are "an abuse of discretion." *Id.* The judiciary accords only "a degree of deference to corporate boards," not complete deference, and will protect only "reasonable risks" directors take, not all risks. *Id.*

Janssen's measured approach reflects the "balance" that must be struck in derivative litigation seeking to protect the corporation without unduly intruding into the management sphere. *Id.* at 881. Recognizing the social utility of derivative actions as a check on corporate abuse, Minnesota strikes this balance in other areas of its law governing derivative litigation. For example, some states employ what is called "universal demand," mandating that shareholders make a demand on the board of directors before instituting any derivative suit. *See generally In re Guidant S'holders Derivative Litig.*, 841 N.E.2d 571, 574 (Ind. 2006) (noting universal demand statutes nationwide). Minnesota, however, follows a "demand futility" standard excusing a shareholder's presuit demand where this would be a useless exercise, most often because the board is disabled from taking action itself. *See*

Wessin, 592 A.2d at 467 (stressing that Minnesota's presuit demand requirement is "not onerous").

As for the precise deference a court should give an SLC recommendation, *Janssen* plainly left open the possibility, in an appropriate case, that a court will examine not just the process followed, but also the substantive conclusions. Of particular interest, this Court did not embrace the restricted review previously applied by the Court of Appeals in *Black* and its progeny. Instead, liberally citing case law from other jurisdictions, this Court explained: "All the state variations upon the business judgment rule as applied to committees reviewing litigation have two common elements. ***At a minimum***, the board must establish that the committee acted in good faith and was sufficiently independent from the board of directors to dispassionately review the derivative lawsuit." *Janssen*, 662 N.W.2d at 888 (emphasis added). Because the party urging dismissal in *Janssen* could not establish these most elementary requirements, this Court did not address whether a substantive parsing of the SLC's report was necessary. *Id.* at 888-89 & n.5.

In sum, none of the Minnesota appellate decisions to date on the SLC device involved a trial judge's authority and duties when scrutinizing a proposed shareholder derivative settlement under Minn. R. Civ. P. 23.09. The *Black/Skoglund/Drilling* trio from the Court of Appeals is especially unhelpful because those decisions clung to a single standard of judicial review, based on *Auerbach*, that disregards the express legislative intent to follow a flexible approach on a case-by-case basis. *Janssen* signals that the business judgment rule is not given an extreme application foreclosing a court from examining the terms of an SLC-proposed settlement, in addition to the process the committee followed. To the contrary, the

"balance" is struck in favor of the shareholder seeking judicial relief, not the directors accused of wrongdoing. *Janssen*, 662 N.W.2d at 890 (expressly "limiting a board of directors to one opportunity to exercise its business judgment").

D. The Approaches of Other Jurisdictions Support Substantive Judicial Scrutiny of a Proposed Settlement in a Shareholder Derivative Action

A wealth of case law from other states and the federal courts addresses the quantum of deference a court should give an SLC's recommendation in a shareholder derivative action. Nearly all the court rulings stem from terminations, however. Extrapolating this case law to the setting here, involving a proposed settlement, is an imperfect fit at best. The proper judicial inquiry emanates, quite simply, from Minn. R. Civ. P. 23.09, as informed by the settled body of case law under Fed. R. Civ. P. 23.1. Nonetheless, consistent with the fair/reasonable/adequate inquiry for a proposed settlement, many jurisdictions in the termination context allow the court to parse the substance of an SLC's recommendations, and for sound reasons. In the aggregate, "a majority of jurisdictions have recognized the fundamental problems inherent in the special litigation committee system . . . and found that these problems necessitate substantive judicial intervention." *End for the Auerbach Approach*, 30 Wm. Mitchell L. Rev. at 511.

1. Delaware's *Zapata* Two-Step Inquiry

For this viewpoint, the Supreme Court of Delaware led the way in *Zapata*.

Just as this Court has emphasized the need to find the right "balance" in this area (*Janssen*, 662 N.W.2d at 881, 890), the Supreme Court of Delaware framed a similar objective. The court sought "a balancing point where bona fide stockholder power to bring

corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation." *Zapata*, 430 A.2d at 787. The court questioned whether "the 'business judgment' rationale at this stage of derivative litigation is a proper balancing point." *Id.* *Zapata* then discussed the "structural bias," inherent in the SLC, that dictates a more searching judicial inquiry than a limited review for process:

> [W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

Id.

Taking heed of these real-world considerations, the Supreme Court of Delaware announced what has become known as the "*Zapata* two step." "First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness." *Id.* at 788. If the corporation makes this showing, "the Court may proceed, in its discretion, to the next step." *Id.* at 789.

The Supreme Court of Delaware called its second step "the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the

motion should be granted." *Id.* As used here, "business judgment" simply means "to provide a safeguard against the danger that the difficult-to-detect influence of fellow-feeling among directors (*i.e.*, so called 'structural bias') does not cause cessation of meritorious litigation valuable to the company." *Biondi v. Scrushy*, 820 A.2d 1148, 1164 n.40 (Del. Ch. 2003). In the Supreme Court of Delaware's words, the second step "is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest." *Zapata*, 430 A.2d at 789.

As appears, the substantive analysis under *Zapata* resembles the judicial inquiry when a court is called upon to scrutinize a proposed settlement in a derivative action. The PSLRA plaintiffs caution, however, that under no circumstances should substantive review of a proposed settlement be a matter of "discretion." *Id.* at 789. The fair/reasonable/adequate inquiry under Fed. R. Civ. P. 23 is the judge's duty, not an option. It is difficult to envision workable guidelines for allowing a substantive review of some proposed settlements in derivative litigation, but not others.

To the extent this Court answers the certified question by borrowing from decisional law in the termination context, *Zapata* is a sensible framework. "Delaware [is] widely recognized as 'the fountainhead of American corporations' whose courts 'are known for their expert exposition of corporate law.'" *McMinn v. MBF Operating Acquisition Corp.*, 164 P.3d 41, 53 (N.M. 2007); *see also Bayberry Assocs. v. Jones*, 783 S.W.2d 553, 560-63 (Tenn. 1990). Accordingly, "Minnesota courts often look to the decisions of Delaware

courts for guidance in this area." *In re Xcel Energy, Inc.*, 222 F.R.D. 603, 606 & n.2 (D. Minn. 2004). Indeed, this Court's balancing approach in *Janssen* – reflecting sound skepticism of the SLC – "is more reminiscent of *Zapata* than *Auerbach*." *End for the Auerbach Approach*, 30 Wm. Mitchell L. Rev. at 510; *see Janssen*, 662 N.W.2d at 881, 888-90 (referencing Delaware law).

2. Other States

Some states have adopted iterations of *Zapata* that call for substantive review of an SLC's recommendations. This case law offers an alternative framework to the extent this Court is inclined to draw on precedent from the termination context.

In *Janssen*, 662 N.W.2d at 884, 888-89, this Court repeatedly cited one of these decisions, *Houle v. Low*, 556 N.E.2d 51 (Mass. 1990). There, the Supreme Judicial Court of Massachusetts recognized that the limited *Auerbach* review, focusing on the SLC's process and refusing to review its conclusions, "places 'the corporate fox in charge of the shareholders' hen house.'" *Id.* at 55. Using *Janssen*-like terminology, the Massachusetts court came down on the side of substantive review: "The balancing of these various concerns requires reviewing judges to go beyond establishing the committee's independence, good faith and the adequacy of its investigation. The judge must determine, on the basis of the evidence presented, whether the committee reached a reasonable and principled decision." *Id.* at 59. *Houle* then elaborated some of the factors the judge should consider, including, as relevant to a proposed settlement, "the likelihood of a judgment in the plaintiff's favor, the expected recovery as compared to out-of-pocket costs," and whether the resolution "would

allow any defendant who has [or had] control of the corporation to retain a significant improper benefit." *Id.*

As applied here, the United States District Court's ability to consider these factors, or not, makes a big difference. The federal court might conclude, for example, that the derivative claims are so strong on the merits that the settlement consideration is simply inadequate – unless the federal court's hands are somehow tied by the SLC's own belief that the monetary recovery is sufficient. The sum recovered for the corporation injured by its own fiduciaries is not rendered fair, reasonable and adequate merely because the SLC, as often occurs, is well credentialed, talks to dozens of witnesses and reviews millions of pages of documents.

Like *Houle*, the Supreme Court of North Carolina announced what it called a "modified *Zapata* rule." *Alford v. Shaw*, 358 S.E.2d 323, 326 (N.C. 1987). Rejecting "slavish adherence to the business judgment rule," the court cited "growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose institutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interest of plaintiffs forced to bring suit on behalf of the corporation." *Id.* Accordingly, "[t]he fact that a special litigation committee, appointed by those directors charged with self-dealing, recommends that the action should not proceed, while carrying weight, is not binding upon the trial court." *Id.* at 328.

This analysis resembles that applied by federal courts in the settlement context under Fed. R. Civ. P. 23.1. *Cf. Cendant*, 232 F. Supp. 2d at 336 (SLC's backing of proposed settlement "weigh[ed] in favor of approval" but was just one factor considered). The

Supreme Court of North Carolina ultimately used settlement-like terminology in the standard it announced: "[T]he court must make a fair assessment of the report of the special committee, along with all the other facts and circumstances in the case, in order to determine whether the defendants will be able to show that the transaction complained of was just and reasonable to the corporation." *Alford*, 358 S.E.2d at 328.[7]

Other state appellate courts have issued decisions in the same vein as *Houle* and *Alford*. Most recently, the Supreme Court of Tennessee summarized that state's law: "Given that a shareholder derivative action cannot be dismissed or settled without court approval, courts deciding whether to accept a litigation committee's recommendations consider a number of factors, including the committee's independence, good faith, procedural fairness, and the soundness of the committee's conclusions and recommendations." *House v. Estate of Edmondson*, ___ S.W.3d ___, 2008 Tenn. LEXIS 16, at *24-*25 (Tenn. Jan. 25, 2008) (applying to a settlement the standards first announced in *Lewis on Behalf of Citizens Sav. Bank & Trust Co. v. Boyd*, 838 S.W.2d 215, 222-25 (Tenn. Ct. App. 1992)).

Ultimately, in light of the structural bias that infects SLCs, it seems unremarkable that a court being asked to adopt the SLC's conclusions might examine whether those fall within a realm of reason. A more restricted judicial review only for good faith, supposed

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[7] The *Alford* case was before the Supreme Court of North Carolina several times. A majority of the court initially issued an opinion adopting the *Auerbach* test. *Alford v. Shaw*, 349 S.E.2d 41, 52 (N.C. 1986). In what is surely a rarity in appellate litigation, the court then granted rehearing, withdrew its original opinion and issued the decision discussed above aligning North Carolina firmly with *Zapata*. In light of this sequence, the dissent in the first opinion is of some interest because the views expressed there eventually carried the day and became the law. *See id.* at 58-65 (Martin, J., dissenting).

independence, and the SLC's investigative process is at loggerheads with the "accountability" stressed by the 1979 Task Force that drafted the MBCA, and this Court in its only decision on SLCs. *See Janssen,* 662 N.W.2d at 882. The SLC Report here highlights this issue. It is deliberately silent as to the factual basis for its conclusions. *See* SLC Report at 59. If the defense in a derivative suit wants a truly disinterested panel whose recommendations will bind the court, the corporation should, instead of hand-picking the SLC members, "apply to the court for appointment of a 'special panel' to make an investigation and report on the pursuit or dismissal of a stockholder derivative action." *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983) (adopting "prophylactic rule" that "directors of Iowa corporations . . . who are parties to a derivative action may not confer upon a special committee . . . the power to bind the corporation as to its conduct of the litigation").

3. Views of Federal Courts

The federal judiciary, typically applying state law, has also extensively addressed the weight a court should give an SLC's proposed disposition of a derivative action.

In *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), the Second Circuit put its finger on the fundamental problems with the limited judicial scrutiny under *Auerbach*. "The reality is," the court stated, "that special litigation committees created to evaluate the merits of certain litigation are appointed by the defendants to that litigation." *Id.* at 888. Hence, "[i]t is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism. Indeed, if the involved directors expected any result other than a

recommendation of termination at least as to them, they would probably never establish the committee." *Id.*

The Second Circuit was frank in its critique of *Auerbach*. "Limiting judicial scrutiny in cases such as the one before us to the good faith, thoroughness and independence of the special litigation committee would effectively eliminate the fiduciary obligation of directors and officers." *Id.* at 889. These stringent fiduciary duties "can hardly be said to exist if the sole enforcement method can be eliminated on a recommendation of the defendants' appointees." *Id.* A limited judicial examination for process, but not the substance of the SLC's report, "appears to allow dismissals in actions for deliberate looting as well as in nuisance suits." *Id.* The *Auerbach* approach is also "a major departure from the traditional scrutiny courts have given to the underlying fairness of corporate decisions which benefit directors." *Id.* at 888. Again, in Minnesota, the Legislature built this careful scrutiny into the MBCA itself. *See* Minn. Stat. §302A.255, subd. 1(a) (when corporate transaction is infected by conflict of interest, directors must establish that the transaction was "fair and reasonable as to the corporation at the time it was authorized, approved, or ratified").

This does not mean, however, that a court should give the SLC's conclusions no weight when determining whether to approve a settlement in a shareholder derivative action. The Second Circuit stated the point well: "There is no reason . . . to treat the recommendation of such a committee as having presumptive weight or to accord it deference beyond its inherent persuasiveness." *Joy*, 692 F.2d at 891. Federal district court decisions, of which there are many, are to the same effect as *Joy*. As one illustrative case underscores: "While the Court recognizes the limitations of its own expertise in applying its business

judgment to the decision as to dismissal, it also recognizes the relative ease with which a committee could construct a record of apparently diligent investigation after having predetermined the outcome of the investigation." *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 799 (E.D. Va. 1982); *see also Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 377 (6th Cir. 1984) (arguing that "the pressures placed upon such a committee may be so great as to justify a presumption against independence").

Beyond its useful discussion of general principles, the federal case law also speaks specifically to how the SLC Report here should be treated. An SLC report that contains no factual findings, like this one, has little persuasive force. The Second Circuit has held that an SLC's opinion was "entitled to no weight" because it was "not substantiated by verifiable historical evidence or other factual material." *Joy*, 692 F.2d at 895 n.12. In the present case, the SLC refused to set forth "detailed factual findings" because "the Company is subject to ongoing federal securities fraud actions involving similar allegations." SLC Report at 59. This explanation, however, does not excuse the utter lack of factual support for the SLC's recommendations. As the Second Circuit reasoned in rejecting an effort to keep an SLC report under seal: "The argument that disclosure of poor management is so harmful as to justify keeping the Report under seal proves too much since it is a claim which grows stronger with the degree of misconduct." *Joy*, 692 F.2d at 894.

In fact, as another federal decision observes, it is questionable whether an SLC under the circumstances here – dueling class and derivative actions against the same board – will truly have the corporation's best interests at heart. Where an SLC's embrace of derivative claims "would conflict with the defensive posture [the corporation] intends to take in

response to the class action suit," the SLC actually suffers from a "conflict of interest." *In re Par Pharm., Inc. Derivative Litig.*, 750 F. Supp. 641, 647 (S.D.N.Y. 1990). Put another way, where the SLC wants to tango with the derivative action, but has its eye on another dance partner, the SLC's loyalties are divided. Even assuming no conflict exists, the SLC is not excused from making factual findings in the derivative case merely because there might be collateral consequences in a related class case. "The issue here is whether such claims are viable in this derivative action not whether they conflict with the position taken in another litigation." *Id.*

Thus, not only must courts undertake a substantive review of an SLC's report, but also, the judge must be given sufficient factual background to assess whether the SLC's recommended disposition is reasonable. A conclusion unaccompanied by any meaningful explanation is ultimately of little value to the court. After all, in conducting its substantive review, the court must "rely upon the record generated by the Committee." *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1503 (D. Md. 1985). A conclusory SLC report "effectively insulates [the] investigation from scrutiny by a Court or otherwise," and accordingly should receive no weight when the judge undertakes the substantive review. *Par Pharm.*, 750 F. Supp. at 647. Respect for the judicial system and the integrity of capital markets demands no less. As the Second Circuit aptly observed: "We cannot say what the effect on investor confidence would be if special litigation committees were routinely allowed to do their work in the dark of night." *Joy*, 692 F.2d at 893.

IV. CONCLUSION

For the reasons given, the PSLRA plaintiffs respectfully suggest that the certified question be answered as follows. To protect the corporation and its stockholders who will be bound by the settlement and accompanying releases, a trial court must scrutinize a proposed settlement in a shareholder derivative action to ascertain whether the settlement is fair, reasonable and adequate. The court may consider the SLC's support for the proposed compromise as one factor in its judicial review, but the SLC's opinion is not, and cannot be, dispositive.

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CERTIFICATE OF COMPLIANCE

I hereby certify that the foregoing **OPENING BRIEF OF PSLRA PLAINTIFFS CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM AND ALASKA PLUMBING AND PIPEFITTING INDUSTRY PENSION TRUST** complies with the word count limitations of Minn. R. Civ. App. P. 132.01, subd. 3(a) for a brief produced with a proportional font. The length of this brief is 12,569 words. This brief was prepared using Microsoft Word 2002.

DATED: February 29, 2008

KEVIN K. GREEN

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DECLARATION OF SERVICE BY MAIL

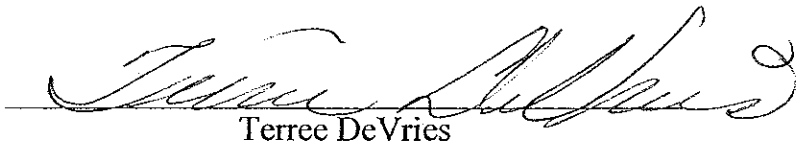
I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interested party in the within action; that declarant's business address is 655 West Broadway, Suite 1900, San Diego, California 92101.

2. That on February 29, 2008, declarant served the **OPENING BRIEF OF PSLRA PLAINTIFFS CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM AND ALASKA PLUMBING AND PIPEFITTING INDUSTRY PENSION TRUST** by depositing a true copy thereof in a United States mailbox at San Diego, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this twenty-ninth day of February, 2008, at San Diego, California.



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