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Board Committees and Litigation Among Conflicted Parties

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The Delaware Chancery Court has issued an opinion(1) deciding that a later-appointed temporary committee of the board of directors of The We Company ("WeWork") could not withdraw a lawsuit that a previously-appointed special committee had filed on WeWork's behalf against Softbank Group Corp. and SoftBank Vision Fund (AIV MI) L.P. (together, "Softbank") seeking an order requiring Softbank to close its negotiated $3 billion tender offer.

On October 22, 2019, WeWork and its controlling stockholder, Softbank, entered into a Master Transaction Agreement (the "MTA") to resolve WeWork's liquidity crisis after the well-publicized failure of its initial public offering. Under the MTA, Softbank agreed to inject additional capital into WeWork, and also to launch a $3 billion tender offer for the benefit of WeWork's minority stockholders. Softbank launched but then, on April 1, 2020, terminated the tender offer, alleging the failure of multiple closing conditions (see our client advisories **M&A Escape Hatches in the Era of COVID-19** and **COVID-19 and MAC Clauses: The Next Shoe Drops**). WeWork promptly filed suit against Softbank, seeking to compel it to close the offer. The lawsuit was filed by a special committee consisting of two directors unaffiliated with Softbank who also had negotiated the MTA on WeWork's behalf. While these two directors stood to benefit significantly from the tender offer since they and entities affiliated with them had tendered 34 million shares, the WeWork board considered them "free of any material conflict of interest."

However, WeWork soon reversed course when Softbank requested that it withdraw the lawsuit. The WeWork board hired a search firm to recommend two temporary directors whom it then appointed to form a new committee for a term of two months with the sole task of determining whether the special committee had authority to bring and maintain the suit against Softbank in the first place. The temporary committee delivered a report to the WeWork board determining that the special committee was not so authorized. It determined that the WeWork board's appointment resolutions did not authorize the special committee to pursue litigation to enforce the MTA, that its members had disabling conflicts of interest and that a lawsuit against its controlling stockholder was not in the best interest of WeWork. Accepting the recommendation of the temporary committee, WeWork moved to voluntarily dismiss its own complaint.

Court applies *Zapata* standard of review to WeWork's motion to dismiss

The court first determined, due to board conflicts, not to review the motion to dismiss under the deferential business judgment standard but instead applied the heightened scrutiny developed by the Delaware Supreme Court for stockholder derivative suits in *Zapata Corp. v. Maldonado*.(2) Under that standard, the court then denied WeWork's motion to dismiss. *Zapata* held that a corporation's board generally has the authority to create a committee to "*rid itself of detrimental litigation*" filed by a stockholder on its behalf, but that because of the obvious potential for abuse of such "*committee mechanism*", a motion to dismiss filed by such a committee must survive an elevated standard of scrutiny. This court applied *Zapata* analogously. It found that while the lawsuit which the temporary committee sought to dismiss was not a stockholder derivative suit, potential for abuse existed here as well because the board creating the temporary committee consisted largely of appointees of Softbank, the defendant in the litigation.

Under the first prong of the *Zapata* test, WeWork had (and failed) to prove (i) the independence and good faith of the members of the temporary committee, (ii) the sufficient quality of the temporary committee's investigation, and (iii) the reasonableness of the temporary committee's conclusions. While the court found that the members of the temporary committee were independent and qualified to serve, it saw significant shortcomings in their investigation and conclusions.

First, the court criticized the absence of any investigation into the merits of WeWork's claim against Softbank and related facts. Second, the court found that the temporary committee had not established a thorough written record as to the reasonableness of its investigation and conclusions. The court rejected the temporary committee's interpretation that the special committee did not have the authority to enforce the MTA through litigation, holding that the temporary committee had ignored the plain meaning of the board resolution as well as extensive extrinsic evidence of such authority: management, as well as company counsel, had prompted the special committee to file suit, company counsel and special committee counsel had collaborated in drafting the complaint and WeWork's disclosure statement to its shareholders said that one of the special committee members would remain on the WeWork board through the conclusion of any litigation in connection with the MTA. The court also found "*significant shortcomings and errors*" in the temporary committee's other determinations.

In addition to dismissing the motion under the first prong of Zapata, the court took the unusual step of also deciding on the second prong, which requires "*striking the balance between legitimate corporate claims as expressed in a . . . suit and a corporation's best interests as expressed by an independent investigating committee*." The court stated that "*the final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal*" and found that such balance favored maintaining the lawsuit against Softbank.

The court determined that, on the one hand, the lawsuit was not frivolous but a viable claim for breach of contract. Dismissing the complaint would also eliminate a viable source of recovery for the shareholders against Softbank, given that they are not parties to the MTA and, therefore, could not bring the lawsuit themselves. The parties' "*enormous effort*" to prepare for the imminent trial would also go to waste. On the other hand, the court stated, the purported conflict of interest of the special committee members had been foreseeable when the WeWork board constituted the special committee and therefore weighed less in the court's consideration. As a result, the court denied the motion and the case is now expected to go to trial in early 2021.

Takeaways

- Board committees should perform their tasks thoroughly and establish a thorough written record of their process, demonstrating, among other things, its reasonableness.

- Delaware courts generally disfavor a board's attempt to curtail shareholder rights. The court used the *Zapata* standard to deny enforcing board action that is formally legal but done with a purpose to curtail shareholder rights.(3)
- The court suggested that it would generally apply the deferential business judgment standard when reviewing a board committee's motion to dismiss a viable lawsuit previously filed on behalf of a corporation by the board or another committee. However, where the board creating the committee to seek such dismissal is conflicted, the court would apply the stricter *Zapata* standard in deciding whether to grant dismissal.
- Finally, the court provided guidance that in a conflicted situation such as the one at hand, a better alternative for a corporation to dismiss a claim filed on its behalf by a committee that it now sees as being against its best interests would be to appoint a second committee of permanent (rather than temporary) directors to take over and manage the litigation free of the first committee's alleged conflicts. The court described the WeWork temporary committee's ability to achieve an overall fair result as "*constrained from the outset*" given that it had been composed of two directors appointed exclusively to conduct a two-month investigation and that were then to "*leave the scene*."

(1) In Re WeWork Litigation, C.A. No. 2020-0258-AGB (Del. Ch. Dec. 14, 2020).

(2) 430 A.2d 779 (Del. 1981).

(3) Other examples of Delaware courts applying the principle that "inequitable action does not become permissible simply because it is legally possible" are Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971),and Blasius Industries, Inc. v. Atlas Corporation, 564 A.2d 651 (Del. Ch. 1988), which nullify board action that the courts found formally legal but intended to disenfranchise shareholders.

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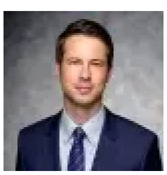

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