Securities Regulation Daily Wrap Up, DIRECTORS AND OFFICERS—D. Mass.: Court shoots down derivative suit against Smith & Wesson directors, (Mar. 17, 2014)

Click to open document in a browser

By John M. Jascob, J.D.

The U.S. District Court of Massachusetts has dismissed a shareholder derivative suit against the officers and directors of Smith & Wesson Holding Corp. (Smith & Wesson), holding that the plaintiff failed to establish that the special litigation committee appointed by the board to investigate the claims lacked independence or failed to conduct a reasonable, good faith inquiry. Accordingly, the court granted summary dismissal for the defendants on the plaintiff's claims for breach of fiduciary duty, waste of corporate assets and unjust enrichment (*Sarnacki v. Golden*, March 12, 2014, Ponsor, M.).

Background. The suit was the latest in a series of cases alleging that the defendants falsely represented the demand for Smith & Wesson's products between June 2007 and October 2007, despite being aware that the firm's inventory far exceeded demand. In the midst of that litigation, the plaintiff filed a derivative complaint on behalf of the corporation, alleging that the special litigation committee failed to conduct an independent evaluation of the claims involved in one of the prior actions. After denying the defendants' initial motion to dismiss without prejudice, the court ordered limited discovery to allow the plaintiff to investigate the committee's adequacy.

Independence of the SLC. The court noted that Nevada law, which governed the case, follows the Delaware approach in determining whether dismissal of a derivative suit is appropriate based upon the special litigation committee's recommendation. Under the two-part test set forth by the Delaware Supreme Court in *Zapata Corp. v. Maldonado*, the court must first ask whether the committee was independent and acted in good faith and upon reasonable grounds in reaching its conclusion. If so, the court then has the discretion to either: (1) end the analysis and defer to the special litigation committee's recommendations; or (2) apply its own business judgment and examine whether litigation is in the company's best interest.

In deciding the first prong of the *Zapata* test, the court found no evidence to support the plaintiff's assertions that the three committee members were biased and were significantly involved in making the allegedly fraudulent statements. Although two of the special committee members were also members of the audit committee that approved certain of the statements at issue, nothing in the record tied those two defendants to the specific accusations in the case. The court also rejected the plaintiff's allegations that the committee members were prejudiced against the claims before they conducted their investigation. Although the committee members had filed motions to dismiss in two of the prior actions, they sought dismissal based on procedural and pleading deficiencies. Moreover, statements in the committee members' deposition testimony emphasized that they had not drawn any formal conclusions before the special litigation committee was formed.

The court also rejected claims that the special litigation committee relied on biased advisors whose interests conflicted with those of the committee. The court stated that this argument fell flat in the face of strong evidence of the committee's independence. Any reliance on the law firm and the economic expert retained by the board in the previous securities class action was reasonable under the circumstances, the court concluded, given the significant factual overlap between the two cases. Crucially, the committee members independently reviewed the process used by the law firm to conduct discovery before determining that the documents obtained through that process were reliable, the committee also expanded its investigation beyond those documents, where appropriate.

Finally, the court found that even if the plaintiff's arguments had merit, he had tacitly conceded the independence of the special litigation committee by making a demand on the board. By making an election to wait for the board to conduct an investigation through the special litigation committee, the plaintiff implicitly conceded that the majority of the board was independent and capable of investigating the matter.

Reasonableness of the investigation. The court concluded that the plaintiff's challenge to the reasonableness of the special committee's investigation also failed. Apart from lapses in memory during the committee members' deposition testimony, no evidence backed the plaintiff's argument that the committee abdicated its authority by allowing outside counsel to control the entire investigation. Instead, the court found that the tasks the committee delegated to outside counsel, such as obtaining advisors and collecting and culling documents, were precisely those that were appropriate to delegate. Further, members of the committee reviewed all of the records, conferred with counsel where necessary, and were the individuals who ultimately reached the final decision.

The plaintiff's contention that the special litigation committee improperly limited the scope of its investigation also lacked merit. The plaintiff alleged that the committee unreasonably curtailed the scope of its analysis by relying primarily on evidence produced in the previous securities class action. The court observed, however, that nothing in the record pointed to any significant piece of evidence or any line of inquiry that the committee ignored. In addition, the committee had considered hundreds of thousands of relevant documents, reviewed transcripts and exhibits from the securities class action, conducted witness interviews, met with additional board members, sought out input from an economic expert, and had intensive discussions about the claims being made with outside counsel.

Accordingly, the court found the special litigation committee's inquiry to be a "prototypical example of a reasonable, thorough, and good-faith investigation." Given that the overwhelming evidence supported a conclusion that the special litigation committee was independent, and acted reasonably and in good faith, the court declined to apply its independent business judgment under the second prong of *Zapata*. As a result, the committee's decision to bypass litigation ended the case.

The case is No. 11-cv-30009-MAP.

Attorneys: Ashley R. Palmer (Robbins Arroyo LLP) for Aaron Sarnacki. Jason C. Moreau (McDermott Will & Emery) for Michael F. Golden and Smith & Wesson Holding Corp.

Companies: Smith & Wesson Holding Corp.

LitigationEnforcement: DirectorsOfficers CorporateGovernance MassachusettsNews