

## SECURITIES LITIGATION ADVISORY

November 9, 2006

### **Alston & Bird's Investigation Report Leads to Dismissal of Derivative Lawsuit**

Because of the increase in internal investigations and derivative litigation, judicial opinions concerning the adequacy of a special committee's report are of great interest. A federal court in North Carolina recently issued an instructive opinion holding that a special litigation committee's ("SLC") report provided a valid basis for dismissing a derivative lawsuit.<sup>1</sup> Alston & Bird was honored to serve as counsel to the SLC in question.

Ingles Markets, Inc. ("Ingles") restated its financials in light of an Audit Committee review of certain transactions. The same day that the restatement was announced, Ingles received a shareholder derivative demand letter. Alston & Bird was subsequently retained as counsel to the SLC to investigate the issues raised in the demand letter.

When the investigation was completed, the SLC issued a report concluding that the commencement of a lawsuit against the board or other individuals was not in Ingles' best interests.

### **Alston & Bird Found Independent and Qualified**

Ingles filed a motion to dismiss the lawsuit, relying on the SLC's report. Opposing the motion to dismiss, the plaintiff challenged Alston & Bird's independence based on the work the firm previously had performed in connection with a related Audit Committee investigation. The court, however, held that there was "no allegation or showing that counsel acted in an advocacy role in defending against [the] SEC charges; instead, it appear[ed] from the face of the materials that counsel acted in the same role for both committees, that of an investigator or fact finder."<sup>2</sup> Accordingly, Alston & Bird was found to be "independent." The court also noted that Alston & Bird's "experience[] . . . supports the reasonableness of the inquiry."<sup>3</sup>

In reviewing the SLC's recommendation against the proposed litigation, the court held that the inquiry was limited to determining whether the decision (1) was made by a committee consisting of two or more independent directors; (2) was the product of a reasonable inquiry; and (3) was made in good faith.

<sup>1</sup> *Madvig v. Gaither*, No. 1:05-CV-234, slip op. (W.D.N.C. Oct. 11, 2006).

<sup>2</sup> *Id.* at 14.

<sup>3</sup> *Id.* at 13.

## Independence of Directors

Directors are deemed “independent” for the purpose of an SLC when they are capable of making decisions based on what is in the corporation’s best interest, rather than their own personal interests.<sup>4</sup> The plaintiff asserted that neither of the directors on the SLC was independent. The plaintiff argued that one director lacked independence because (1) he had been invited to join Ingles’ Board by two sitting directors; (2) his former accounting firm had provided auditing services to Ingles and tax services to its chairman; and (3) his accounting firm had employed Ingles’ CFO (who was one of the defendants in the lawsuit) for two years in the early 1980s, and he testified in a deposition that she was a “friend.” Rejecting all three arguments, the court held that (1) North Carolina law expressly provides that a director “shall not be disqualified from serving on [an SLC] due to the ‘nomination or election of the director by persons who are [now] defendants in [a] derivative proceeding’”<sup>5</sup>; (2) the professional services provided by the director’s former accounting firm were rendered approximately 20 years ago and were irrelevant; and (3) the employment of the CFO by the director’s former accounting firm “does not come as a shock to the court” because the “common interests [that] bring a board together will naturally include professional and social relationships.”<sup>6</sup>

The other SLC member was an attorney. The plaintiff challenged his independence on the ground that the director’s law firm had rendered legal services to Ingles. The court, however, noted that the director had not personally rendered any legal services to Ingles since 2003, when he represented the company in a small matter. The court concluded that the director “did not gain financially from his representation inasmuch as he was a non-equity partner . . . and simply providing legal representation does not show a lack of independence.”<sup>7</sup> Thus, the legal fees received by the director’s law firm from representing Ingles did not prevent the director from qualifying as independent.

## Reasonable Inquiry

The second prong of the court’s analysis focused on whether the SLC’s decision not to pursue litigation was the product of a “reasonable inquiry.” Whether an inquiry is reasonable “is judged from the magnitude of the issue raised. . . . To be reasonable, the inquiry must be commensurate in scope with the nature of the issues raised by the complainant.”<sup>8</sup> The court found that the SLC’s decision not to pursue litigation was the

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<sup>4</sup> *Id.* at 7 (citing *First Union Corp. v. Suntrust Banks, Inc.*, No. 01-8036, 2001 WL 1885686, at \*32 (N.C. Bus. Ct. Aug. 10, 2001)).

<sup>5</sup> *Id.* at 8 (quoting N.C. Gen. Stat. § 55-7-44(c)).

<sup>6</sup> The court also rejected the shareholder/plaintiff’s assertion that the director was rendered interested by virtue of the fact he had met the CFO for business lunches during which the pair discussed Ingles’ accounting issues. The court reasoned, “[t]o hold that discussing company business, even business that might be related to this lawsuit, somehow disqualifies a director from a Special Committee would simply be absurd inasmuch as discussing company business is one of the primary missions of any director.” *Id.* at 9.

<sup>7</sup> *Id.* at 11 (citing *In re Walt Disney Co. Derivative Litigation*, 731 A.2d 342 (Del. Ch. 1998)).

<sup>8</sup> *Id.* at 12 (citing Russell M. Robinson, II, *Robinson on North Carolina Corporation Law*, §17.08 (2005)).

result of a “reasonable inquiry that **exceeded** plaintiff’s allegations.”<sup>9</sup> Based on advice from Alston & Bird, the SLC had (1) authorized an investigative work plan; (2) interviewed three individuals and obtained affidavits from eight others; (3) conducted a document review; (4) investigated potential claims against two former officers who were not even named in the demand letter; and (5) reviewed legal memoranda and received legal advice from counsel, which included meeting with counsel on ten separate occasions. Referring to Alston & Bird, the court noted that the reasonableness of the inquiry was further supported by the fact that the SLC had retained “experienced outside counsel.”

## Good Faith

The third prong of the court’s analysis addressed whether the SLC acted in good faith in deciding not to pursue the derivative litigation. A decision is made in “good faith” when it is made “honestly, conscientiously, fairly, and with undivided loyalty to the corporation.”<sup>10</sup> In the context of a shareholder derivative action, directors serving on an SLC act in bad faith where the committee’s investigation is “so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham.”<sup>11</sup> The plaintiff maintained that the SLC did not act in good faith because the directors were defendants in the underlying litigation. The court, however, rejected this argument because N.C. Gen. Stat. § 55-7-44(c) provides an express exception to disqualifying directors who also are named as defendants. With regard to the directors’ prior service on the Audit Committee, the court held that this fact had “absolutely **zero** impact on whether a person can act, serve, and render an opinion in ‘good faith’ as a member of a special committee composed to investigate a derivative action.”<sup>12</sup> The court stated that in addition to the protection of the business judgment rule, “the overwhelming evidence before this court is the extensive Report that documents the Special Committee’s investigation.”<sup>13</sup> Again referring to Alston & Bird, the court noted that its finding of good faith was supported by the SLC’s reliance on “experienced counsel.”

The court concluded that the SLC’s decision not to pursue the derivative litigation was made for the benefit of Ingles’ shareholders and not the directors personally. The court found that “every aspect of the [SLC’s] report had earmarks of a committee determined not only to comply with the statute, but to determine what was in the best interests of Ingles.”<sup>14</sup>

If you would like a copy of the Opinion, please email or call Geri Amitin at (404) 881-7773. Email: [geri.amitin@alston.com](mailto:geri.amitin@alston.com).

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<sup>9</sup> *Id.* at 18 (emphasis in original).

<sup>10</sup> *Id.* at 15 (quoting *Robinson, supra*, at §14.02).

<sup>11</sup> *Id.* (quoting *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979)).

<sup>12</sup> *Id.* at 16 (emphasis in original).

<sup>13</sup> *Id.* at 15.

<sup>14</sup> *Id.* at 18.

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