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Case Study: In Re Smith & Wesson

The U.S. District Court for the District of Massachusetts, in In re Smith & Wesson Holding Corp. Derivative Litigation[1], recently addressed an issue that many securities litigation practitioners face: How long is too long for a special litigation committee to investigate a shareholder's demand? Perhaps not surprisingly, like most things in the law, it depends.


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Background

The chronology of the Smith & Wesson case is important. On May 28, 2009, and June 5, 2009, two shareholders of Smith & Wesson Holding Corp. issued demand letters requesting that Smith & Wesson's board sue certain current and former officers and directors stemming from the company's disclosure of preliminary financial results in late 2007 that sharply departed from its prior earnings estimates and allegedly caused the stock price to decline. The demand letters broadly alleged that the officers and directors breached their fiduciary duties.[2]

The board responded, through counsel, on July 6, 2009. It explained that a special litigation committee (SLC) consisting of independent and disinterested members of the board was formed to evaluate the demands. Although the board's letter requested additional information from the shareholders regarding their capacity to serve as derivative plaintiffs, the shareholders did not respond.[3]

On Aug. 17, 2009, claiming that the demand letters did not provide sufficient information, the SLC sent a letter to the shareholders requesting additional information regarding the nature and scope of the demands. About a month later, the shareholders responded that "all the information the SLC needs to consider and respond to the demand letter is already within the possession, custody and control of Smith & Wesson."[4]

The SLC sent another letter on Oct. 14, 2009, reiterating that it needed additional information, but also stating that it would proceed with the investigation.[5]

The next day — approximately 4 1/2 months after making their demands — the shareholders filed a derivative lawsuit on behalf of Smith & Wesson.[6]

The Court's Dismissal

The defendants moved to dismiss the derivative action on several grounds, including that it was premature given the pending SLC investigation. The court agreed.

Looking to Delaware law for guidance, the court noted that "[a] shareholder derivative action is an action of last resort."[7] The court also noted that "there is no precise rule governing how much time must elapse following a demand on a

corporation before plaintiffs may file suit."[8] Rather, "'the test is one of reasonableness under the circumstances.'"[9]

As another court recently stated: "The requirement that a corporate board be given time to act prior to a derivative suit being prosecuted is to permit the board, who [sic] has the obligation to act in the best interest of the company, the opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise. Much like the concept of exhaustion of administrative remedies in other contexts, the requirement of making a demand and allowing time for a response conserves the resources of both the corporation and the court."[10]

In terms of timing, according to the Smith & Wesson court, courts must consider, among other things, whether the board was given full knowledge of the basis for the claim and a full opportunity to act.[11]

The court ultimately concluded that plaintiffs' suit was premature. It highlighted the following factors:

- the breadth and vagueness of the demands made it difficult for the SLC from the outset.

- the extent and complexity of the alleged misconduct warranted a probing and scrupulous investigation.

- the plaintiffs refused to elaborate on their demands, which delayed the investigation.

- steps were taken to commence investigating the plaintiffs' demands despite these obstacles: defendants formed an SLC and the SLC attempted to gather information from the plaintiffs.[12]

The court rejected the plaintiffs' alternative arguments, including that a pending securities class action was enough to put the SLC on notice of what the plaintiffs' demands were. The plaintiffs never referred to the securities class action in their demand letters, nor was the SLC obligated to assume that the plaintiffs were demanding that the company investigate every statement alleged in the securities class action — "Plaintiffs have the responsibility to make their demands clear enough so that the SLC can conduct a focused investigation."[13]

The court dismissed the case without prejudice (rather than merely stay the lawsuit until the SLC completed its investigation).

Implications

What are the takeaways from the court's decision in Smith & Wesson? First, there is no hard-and-fast rule dictating how long an SLC investigation should take — it naturally depends on the facts and circumstances of each case.

Second, and more practically, it pays to carefully scrutinize a demand letter and promptly request additional information if the demand is overly broad or vague, or both. "A shareholder demand must explain the details of the allegation, including the responsible parties, the relief requested and the injury caused." Energytec Inc. v. Proctor, 2008 U.S. Dist. LEXIS 68690, at *12 (N.D. Tex. Aug. 29, 2008). An SLC is not, according to the Smith & Wesson court, required to simply guess what plaintiff is demanding. The old adage applies: When in doubt, ask.

Third, ask for the information promptly. Undue delay is likely to support an argument that a derivative suit is not premature.

Fourth, it's important for the SLC to document its efforts, such as the written communications with the demanding shareholders in Smith & Wesson. See also Shearer v. Adams, 2010 U.S. Dist. LEXIS 100315, at *18 (M.D. Tenn. Sept. 21, 2010) (stating that the company's counsel notified the plaintiff's counsel of the factual deficiency in the plaintiff's demand, and requested the specific facts for the plaintiff's assertion, but the plaintiff never responded).

The Smith & Wesson court appeared to be influenced by not only the apparent good faith efforts by the board and SLC to reach out to the demanding shareholders, but by the demanding shareholders' unresponsiveness. If a shareholder does file a derivative suit prematurely (i.e., before the investigation is complete and before the company determines whether to

pursue a lawsuit on its own), you'll want to be able to show the court that the SLC had acted diligently and promptly every step of the way.

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[1] 2010 U.S. Dist. LEXIS 111608 (D. Mass. Oct. 20, 2010).

[2] Id. at *4.

[3] Id. at *5.

[4] Id. at *5-*6.

[5] Id. at *6.

[6] Id. at *7.

[7] Id. at *9.

[8] Id. at *12. In a footnote, the court stated that "[c]ourts have dismissed as premature derivative suits that were filed at various times after the initial demand. See, e.g., Piven v. Ryan, No. 05-cv-4619, 2006 U.S. Dist. LEXIS 12745, 2006 WL 756043, at *3-4 (N.D. Ill. Mar. 23, 2006) (eight months); MacCoumber v. Austin, No. 03-c-9405, 2004 U.S. Dist. LEXIS 14772, 2004 WL 1745751, at *5 (N.D. Ill. Aug. 2, 2004) (four months); Charal Investment Co. v. Rockefeller, No. 14397, 1995 Del. Ch. LEXIS 132, 1995 WL 684869, at *4 (Del. Ch. Nov. 7, 1995) (five months); Renfro v. F.D.I.C., 773 F.2d 657, 659-60 (5th Cir. 1985) (two months); Mozes on Behalf of Gen. Electric Co. v. Welch, 638 F. Supp. 215, 221-22 (D. Conn. 1986) (eight months); Recchion v. Kirby, 637 F. Supp. 1309, 1319 (W.D. Pa. 1986) (two months) ..."

[9] 2010 U.S. Dist. LEXIS 111608, at *13 (quoting Mozes on Behalf of Gen. Electric Co. v. Welch, 638 F. Supp. 215, 220 (D. Conn. 1986)).

[10] Stoller v. Funk, 2010 U.S. Dist. LEXIS 108820, at *6 (W.D. Okla. Oct. 12, 2010) (internal quotation and citation omitted).

[11] 2010 U.S. Dist. LEXIS 111608, at *13 (citing Halprin v. Babbitt, 303 F.2d 138, 141 (1st Cir. 1962)).

[12] Id. at *13.

[13] Id.