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The Importance of the Special Committee in Transactions

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Overview

A basic tenet of corporate law is that the Board of Directors assumes responsibility for managing the business and affairs of the corporation. Boards of Directors establish policies for corporate management and make decisions on major company issues. Further, courts have determined that when directors are acting on behalf of the corporation, they owe the company and its shareholders the fiduciary duties of care and loyalty.[1] If, in the face of a corporate transaction, the majority of directors cannot act solely in the best interest of the company and are instead faced with a conflict of interest, the best course of action may be to establish a special negotiating committee.

1 See *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

Fiduciary Duties

In general terms, the fiduciary duty of care requires a Board of Directors to be informed regarding all material information that is reasonably available to them before making a business decision and to use the amount of care that a prudent person would use in similar circumstances. So, for example, in the case of a proposed transaction, the directors must be familiar with the details of the proposal, and they must thoroughly review all of the material information that is available to them, including any possible alternatives to the proposal under consideration. The courts have found that the more important the business decision, the greater the requirement for directors to review and weigh alternatives and ensure they have an informed understanding of the transaction.[2]

Meanwhile, the duty of loyalty relates to fiduciaries' conflicts of interests; it requires that directors put the corporation's interests above their own. Examples of violations of the duty of loyalty include the misuse of corporate assets or opportunities, fraud, bad faith or self-dealing.[3] "The rule…requires an undivided and unselfish loyalty to the corporation" and "demands that there shall be no conflict between duty and self-interest."[4]

History has shown that any corporate transaction involving the alleged violation of these fiduciary duties may become the subject of a lawsuit initiated by the corporation's shareholders. In general, the courts have determined that the standard of judicial review which will be applied in order to determine whether a corporation's directors have fulfilled their duties of care and loyalty as they relate to a transaction is the "business judgment rule." According to the business judgement rule, decisions made by a Board of Directors are presumed to have been made in good faith by informed, disinterested directors and should therefore not be subject to judicial review.[5] The business judgment rule places the burden of proof on the party challenging the board's decision; as a result, the initial burden of proof falls on the plaintiff, who must provide facts which prove that there was a breach of fiduciary duty. If the plaintiff cannot do this, the court will likely dismiss the lawsuit.

2 See *In re Fort Howard Corporation Shareholders Litigation*, 1988 WL 83147, at *1 (Del. Ch. 1988).

3 See *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (1985).

4 *Guth v. Loft, Inc.*, 5 A.2d at 510.

5 See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

If, however, the plaintiff can prove that there was a breach of fiduciary duty, the courts have recognized that the protections offered by the business judgement rule will not serve as a shield for the Board. So, for example, when the interests of a majority of the directors, or of a controlling shareholder, conflict with those of the corporation or its minority shareholders, the business judgment rule will not apply. Instead, in those cases, the courts have determined that a more rigorous "entire fairness" standard of review applies. The entire fairness standard shifts the burden of proof from the plaintiff to the defendant(s) and requires the court to consider whether the director defendants can demonstrate both "fair dealing" and "fair price."[6] As the court noted in *Weinberger v. UOP Inc.*, fair dealing examines questions of when the transaction was timed; how it was initiated, structured, negotiated and disclosed to the directors; and how the approvals of the directors and the stockholders were obtained. Meanwhile, fair price relates to the economic and financial details of the transaction, including assets, market value, earnings, future prospects and any other elements that affect the intrinsic or inherent value of a company's stock.[7] Notably, the *Weinberger* court also indicated that the test for fairness is not a bifurcated one; instead, both aspects of fairness – fair dealing and fair price – need to be examined in order for the court to decide whether or not the transaction was, in fact, conducted with entire fairness.

> "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its shareholders...The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by fiduciary relation."
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> —*Guth v. Loft,* 5 A.2d 503, 510 (Del. 1939).

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6 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

7 *Ibid.*

The Purpose of a Special Committee

Importantly, while the burden of proof rests on the defendant(s) to prove entire fairness, in those cases where the evidence demonstrates that the Board of Directors formed an independent special negotiating committee and the committee functioned effectively, the burden of proof will shift back to the plaintiff to demonstrate that the transaction was not entirely fair.[8] So, when the Board of Directors consists of more directors that have a conflict of interest than those that do not have a conflict, in order to ensure that the transaction is conducted with fair dealing and that a fair price is obtained, the board may take steps to establish a special negotiating committee that will serve as a proxy for a disinterested board in negotiations regarding the transaction.

Not only does the finding of an effective special committee aid the defendants through its burden-shifting effect, but it also suggests that the defendants utilized "fair dealing" with regard to the transaction.[9] As a result, when the parties defending a transaction are successful in shifting the burden of proof back to the plaintiff through the use of a special committee, it is often outcome determinative.[10] Although the court will still test the transaction for fairness, in reality, it may become very difficult for the plaintiff to successfully show that the transaction was unfair. As a result, Boards of Directors and majority shareholders often turn to special committees as a way to minimize director liability, increase deal security and undermine the potential settlement value of any lawsuit challenging the deal.[11]

> An interested director is one who may appear to have a potential interest on both sides of the transaction or expects to derive a personal financial benefit from the transaction, as opposed to a benefit that exists for the company or all stockholders generally.
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> (See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

8 See *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

9 Scott V. Simpson and Katherine Brody, "The Evolving Role of Special Committees in M&A Transactions: Seeking Business Judgment Rule Protection in the Context of Controlling Shareholder Transactions and Other Corporate Transactions Involving Conflicts of Interest," *The Business Lawyer*; Volume 69 at 1123 (2014).

10 *Ibid.*

11 *Ibid.*

> "Although perfection is not possible, or expected," unless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a process "as though each of the contending parties had in fact exerted its bargaining power at arm's length," the burden of proving entire fairness will not shift.
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> —*Weinberger v. UOP, Inc.*, 457 A.2d at 709-10 n. 7.

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Forming a Special Committee

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The most important factor in choosing members of the special committee is that they must be both disinterested and independent from the Board. In general terms, a director is considered to be disinterested if he or she lacks a personal interest in the transaction under consideration. Meanwhile, courts have determined that independence "means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[12] Notably, a director will also be found to lack independence if he or she is "beholden" to an interested party or interested director(s), or is under such a party's influence that the director's "discretion would be sterilized."[13]

Nevertheless, not all relationships will prohibit a director from serving on a special committee. For example, the simple existence of a personal relationship between an interested and disinterested director is generally not enough to lead a court to conclude that an otherwise disinterested director is not independent.[14] In that regard, in one case, the court indicated that just because a member of the special committee and other interested directors were part of the same social circle and attended the same social events, "developed business relationships before joining the board, and described each other as 'friends,'" was – by itself – "insufficient" evidence for the court to determine that the member of the special committee was not independent.[15]

12 *Aronson v. Lewis*, 473 A.2d at 816.

13 *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993) (citing *Aronson*, 473 A.2d at 815).

14 See *Beam v. Stewart*, 845 A.2d 1040, 1051 (Del. 2004).

15 *Ibid.*

In any event, whether a special committee member is disinterested and independent should be established from the outset of the establishment of the committee and should be constantly reviewed.[16] Where existing corporate board members are not sufficiently disinterested and independent, the company should consider adding additional outside board members who can serve as special committee members.

Moreover, the members of the special committee should be selected by disinterested and independent members of the Board, as courts will consider the selection process carefully when deciding whether a particular transaction is fair to the corporation and its stockholders.[17]

Independence of the Special Committee

A detailed investigation into each proposed committee member's independence should focus on both obvious conflicts as well as the more subtle relationships that a director may have, including:
-material financial interests the director may have in the transaction or the counterparty;
-board or management positions the director may hold at the counterparty or its affiliates, resulting in conflicting duties or perhaps dependence on financial benefits;
-long-term or close business or personal relationships the director may have with senior persons on the other side of the transaction that may be perceived to constrain hard bargaining; and,
-historical or current relationships the director may have with a person related to the other side that constitutes domination or control of or undue influence over such director (e.g., that would likely make the director feel beholden to such person) in the context of his or her representation of the target in connection with the transaction.

(See Simpson and Brody, *The Business Lawyer*; Volume 69 at 1136).

16 Simpson and Brody, *The Business Lawyer*; Volume 69 at 1135.

17 Frank Aquila, Melissa Sawyer and Keerthika Subramanian, "Speed Reading: Top 10 Issues to Consider When Advising a Special Committee in a Going Private Transaction," *LexisNexis* (2012).

Size of the Special Committee

Although there is no specific rule mandating the number of directors that should compose a special committee, the courts do not generally favor a special committee that consists of just one member. As the court stated in *Lewis v. Faqua*, if a single-member committee will be used, "the member should, like Caesar's wife, be above reproach."[18]

In practice, a two-member committee is also likely to present a challenge because committee action will always require unanimous agreement. In addition, if one committee member becomes unavailable or non-independent during the course of the transaction, the committee is left with a single member, of which – as noted above – the courts are particularly skeptical.

Although the court in *Gesoff v. IIC Industries, Inc.* indicated that more trust is placed in a committee composed of at least two members "than in a committee where a single member works free of the oversight provided by at least one colleague,"[19] as a practical matter, it makes sense for the committee to consist of three directors, as this will allow for a break in any deadlock that may be created if two of the members of the committee have opposing views.

While a special committee may consist of more than three members, experts note that the special committee should not be too large as to make the process of reviewing the transaction cumbersome or unwieldy; in that situation, it may become difficult for a large group to actively manage the review and decision-making process.[20]

The Special Committee's Mandate

Once the special committee is formed, the committee's mandate needs to be established by a clear, well-drafted written resolution that outlines the powers and purpose of the committee. The mandate must not be narrow; instead, it must provide the directors with real bargaining power and "authority comparable to what a board would possess in a third-party transaction."[21]

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18 502 A.2d 962, 967 (Del. Ch. 1985).
19 902 A.2d 1130, 1146 (Del. Ch. 2006).
20 Simpson and Brody, *The Business Lawyer*; Volume 69 at 1138.
21 *In re CNX Gas Corporation Shareholders Litigation*, 4 A.3d 397, 414 (Del. Ch. 2010).

As a result, the resolution should authorize the special committee to have access to all of the information which will allow the committee to diligently evaluate the proposed transaction, to forcefully negotiate the terms of the transaction and to consider alternatives. In addition, it must give the committee the "'critical power' to say 'no' to the transaction."[22] In other words, members of the special committee will stand in place of the directors who have a conflict, and they will act as independent, arms-length negotiators. They must be active participants in the process and in key decisions, including whether to pursue alternatives to any proposed deal. Further, the resolution establishing the special committee must permit the special committee to retain its own independent legal and financial advisors.

> "The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price."
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> —*Kahn v. Lynch Communication Systems*, 638 A.2d 1110, 1119 (Del. 1994) (Quoting *In re First Boston, Inc. Shareholders Litigation*, Del.Ch., C.A. 10338 (Consolidated), Allen, C., 1990 WL 78836, slip opinion at 15-16 (1990).

22 *Gesoff v. IIC Industries, Inc.*, 902 A.2d at 1146 (Del. Ch. 2006) (citation omitted); See also *In re MFW Shareholders Litigation*, 67 A.3d 496, 506 (Del. Ch. 2013) (citing the proposal letter whereby the special committee was created and empowered with a broad mandate), affirmed sub nom. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

Independent Financial & Legal Advisors

Shortly after it is established, the special committee should select independent financial and legal advisors. The advisors should serve as qualified resources upon whom the members of the special committee can rely. As courts have observed, the effectiveness of a Special Committee often lies in the quality of the advice its members receive from their legal and financial advisors.[23]

In light of the fact that the use of independent financial and legal advisors supports the special committee's role as an independent body, potential advisors should be screened for conflicts and significant relationships with the target company, potential acquirers, large shareholders and other interested parties.[24] Advisors that have previously advised or currently advise any of the parties should generally not be chosen to represent the special committee, as this creates the appearance of partiality.[25]

Further, special committees should interview and choose their own advisors without influence from the company, the company's attorneys or any shareholder of the company as an additional precaution to establishing the independence of such advisors. Although the committee may receive suggestions from company management regarding which advisors have sufficient expertise, ultimately, the special committee must make the final choice of advisors. In that regard, the court in *Gesoff v. IIC Industries, Inc*. noted that it was of particular concern when counsel is engaged on behalf of the special committee by the controlling shareholder rather than by the special committee itself.[26]

Notably, financial advisors to a transaction are oftentimes asked to provide the special committee with a fairness opinion. A fairness opinion is a letter stating whether, from a financial point of view, a particular transaction is fair. The letter is accompanied by a formal report which contains valuation analysis to support the opinion in the letter. Experts suggest that if the special committee's financial advisor provides a fairness opinion, the special committee should request at least one presentation, with materials provided in advance, regarding the diligence, methodologies and procedures applied and the outcome reached when preparing the fairness opinion.[27]

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23 *In re Tele-Communications, Inc. Shareholders Litigation*, 2005 WL 3642727, at *10 (Del.Ch. 2005).

24 Simpson and Brody, *The Business Lawyer*; Volume 69 at 1139.

25 Stephen Fraidin & Stefanie M. Wool, "Special Committees: Process Makes Perfect," *New York Law Journal* (April 8, 2010).

26 902 A.2d 1130 at 1150.

27 Simpson and Brody, *The Business Lawyer*; Volume 69 at 1139.

Summary

In the case of a transaction in which a majority of a Board of Directors has a conflict of interest but fails to adequately address these conflicts by establishing an independent special negotiating committee, the members of the Board risk litigation.

Additionally, even if a special committee is established, courts are more likely to agree with minority shareholders who dispute the fairness of the transaction for reasons such as: the special committee was too small; the special committee did not have the power to negotiate the terms of the transaction; at the time of the transaction, one or more of the special committee members was not both disinterested and independent; or the special committee was not permitted to select the financial and/or legal advisors to the committee.

However, if the court finds that a special committee was established and that, based on the committee's record of its proceedings, the committee was – from the very start – properly formed and that it properly discharged its duties, there is a much higher likelihood that the burden of proving that the transaction was not fair will be borne by the plaintiff.

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