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TRANSACTIONS

Special Committees: Process Makes Perfect


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Process is critical in transactions in which a special committee of independent directors is constituted to aid in protecting the public shareholders in connection with a change of control transaction involving a take-private, related-party or controlling shareholder (for ease, such transactions are hereinafter called "related-party transactions").

The use of special committees of boards of directors by public companies in related-party transactions became particularly important when the Delaware Supreme Court suggested in 1983, in *Weinberger v. UOP Inc.*, that its view that the interested party merger was unfair to the minority shareholders could have been "entirely different" had the merger been negotiated on behalf of minority shareholders by a special committee of independent directors.[1]

For approximately 20 years following the *Weinberger* decision, special committee law remained substantially unchanged. In the last 10 years, however, as private equity has become more prominent in the mergers and acquisitions market and transactions involving significant conflicts such as take-privates, controlling shareholder and management buy-outs have increased, the Delaware courts have had the opportunity to develop a body of case law regarding special committee formation and process.[2]

While there are no bright line rules, certain guidelines can be derived from the triumphs of and mistakes made by special committees whose actions have been challenged in the courts.

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Courts approach review of a special committee much as a professor of mathematics approaches review of a student's exam: the method employed to derive an answer is often more important than the answer itself. Credit is given for the process utilized even if that process leads to an incorrect outcome. In recent decisions, the judiciary has recognized that special committee members are real people with imperfections and thus, has judged them by real-world standards which permit flaws, but only within certain bounds. In fact, 20 years ago, *Weinberger* established that in the case of special committee conduct, "perfection [was] not possible or expected." If special committees legitimately follow an appropriately rigorous process in which they evaluate, negotiate and vote on related-party transactions, courts will likely find that minority shareholders' rights were properly protected. Hence, it is process that makes perfect.

Judicial Scrutiny

In analyzing transactions, courts usually apply a deferential standard referred to as the "business judgment rule" reasoning that so long as behavior is rational, decisions are just subjective judgments made by those best suited to evaluate the situation and that hindsight is always 20/20.[3] Related-party transactions, however, are typically subject to a higher standard of judicial review due to their inherent conflicts of interest. This stricter standard, known as "entire fairness," is a scrutinizing two-part exam in which there is a burden to prove whether or not the directors have shown fair dealing and the transaction's fair price.[4]

The initial burden rests with the directors defending the transaction, but that burden may be shifted to the shareholders challenging the transaction if the directors utilize "procedural protections designed to ensure arm's length bargaining or to approximate a fair valuation procedure."[5] Moreover, there are certain instances in which a related-party transaction can be carefully structured so as to fall within the purview of the business judgment rule.

For example, in its 2002 decision, *In re Pure Resources Inc. Shareholders Litigation*,[6] the Delaware Chancery Court held that a related-party transaction would not be subject to the entire fairness test and should be upheld if

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(i) a tender offer by a controlling stockholder is subject to a non-waivable majority of the minority tender condition, (ii) the controlling stockholder agrees to consummate a back-end or "squeeze out" merger at the tender offer price if it acquires more than 90 percent of the shares and (iii) the controlling stockholder has made no retributive threats.

Fair dealing, the first prong of the entire fairness test, focuses on the process by which the board evaluates, negotiates and votes upon the transaction. Typically, if a special committee satisfies the more subjective fair dealing prong, the more objective fair price prong, which relates to the economic and financial considerations in evaluating the value of the transaction, is also satisfied. As a result, there is more detailed guidance in case law on the procedure by which the special committee can inoculate the process from impropriety.

The mere existence of a special committee used to be sufficient to shift the burden of persuasion on the issue of fairness from the directors to the minority shareholders seeking to challenge the transaction.[7] Now, typically, unless a related-party transaction (i) is structured as a tender offer rather than a merger and (ii) a special committee can demonstrate that it was informed and properly functioning, the burden does not shift. Often, unfortunately, the structure is forced upon the special committee as a result of tax or information restraints, for example, rather than carefully considered and chosen.

In addition to permitting a transaction to withstand the intensified standard of judicial review, a robust special committee process may also be essential to directors in avoiding fiduciary duty breaches and associated (personal) liability, as recent cases indicate. For example, *Ryan v. Lyondell Chem., Co.*[8] may be perceived as a shot across the bow to force directors to focus more on the formation and proper conduct of special committees using personal liability as punishment for failure to adhere.

Best Practices

Recent decisions shed light on special committee best practices often by negative implication as the courts admonish past special committees for incorrect actions while providing a road map for what the courts will deem acceptable. The following are several of those lessons illustrated by relevant cases.

1. A special committee should comprise independent members solely.

Critical to satisfying the fair dealing prong of the entire fairness test is the ability of the special committee to approximate an arm's length bargaining procedure. The surest way to give the court pause that the committee's actions were in good faith is for a special committee member to have a conflict of interest that gives rise to an assumption of allegiance or even worse being beholden to one party or another.

The best method by which to discern independence is to ask each prospective member to fill out an extensive survey designed to root out relationships with respect to finances and otherwise to the transaction parties. The independence questionnaires should be supplemented and updated during the process to ensure that the committee members remain disinterested.

In *In re Loral Space and Communications Inc., Consolidated Litigation*,[9] for instance, the special committee did not disclose to Loral's legal advisers any of its relationships with MHR Fund Management LLC, a large stockholder of Loral that was attempting to enter into a financing deal with the company. In finding that the process failed the fair dealing test, the court explained that "[c]ourts evaluate whether the relationships among the members of the committee and interested parties placed them in a position to objectively consider a proposed transaction, and whether the committee members in fact functioned independently."

> Special committees should interview and choose their own advisers without influence from the company, the general counsel or any shareholder of the company as an additional precaution to establishing the independence of such advisers.

2. Ideally, a special committee should be composed of more than one independent member.

"Two heads are better than one" and for special committees, three heads may be better than two. A committee should consist of at least two people to ensure that decisions are based upon the exchange of multiple thoughts and views. In *Gesoff v. IIC Industries Inc.*, for example, it was established 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."[10]

A three-person committee will allow for a break in the stalemate that might be created when the members of a two-person committee have diametrically opposed ideas. While a committee should contain at least three members, the proverbial view that "too many cooks spoil the broth" should be considered in not making the committee too large as to make the process unwieldy.

It is possible that only one independent member may be available to serve on a special committee if other directors are conflicted or unwilling. As the Delaware Chancery Court has previously noted, the sole member is then required "like Caesar's wife [to be] above reproach" in that despite the false accusation of adultery made against his wife, Caesar divorced her declaring that the truth or lack thereof of the accusation was of no consequence because "Caesar's wife must be above suspicion."[11]

3. Special committees should have a clear set of formal resolutions governing their conduct, but should at the same time not view those resolutions narrowly.

In *Loral*, the court admonished the committee for viewing its charter in a "cramped" manner whereby it only examined the financing at hand, and as a result, failed to explore other financing alternatives or a sale of the company.

At the initial organizational meeting, resolutions should be established which clearly outline the special committee's mandate. Such resolutions should be broadly defined in both scope of the transaction as well as the powers of the special committee to negotiate and decide whether or not to recommend the transaction to the full disinterested board including the authority to retain qualified advisers to assist in those endeavors at the target company's expense.

The special committee should be steadfast in its campaign to encourage the target company to grant it broad authority as this will ultimately benefit both the committee and the company's minority shareholders in that it will enable the special committee to satisfy its fiduciary duties, be a guarantor of fairness and increase the possibility that the transaction will endure the heightened standard of judicial review as a result.

4. Special committees should zealously represent their minority shareholder constituents and in some cases, use reasonable extraordinary measures to do so.

The Delaware Chancery Court in *Mercier v. Inter-Tel. (Delaware) Incorporated*[12] upheld the committee's decision to postpone the stockholder meeting to vote on the merger for a short time as the disinterested directors believed that the merger was in the best interests of the stockholders and knew it would be voted down unless the meeting was rescheduled.

The court applied the "reasonableness" standard consistent with that established in *Unocal Corp. v. Mesa Petroleum Co.*[13] and found that the committee's actions were primarily motivated by its sincere concern that failure to approve the merger would result in an "irretrievable los[s]" of its benefits. Additionally, in *Selectica Inc. v. Versata Enterprises Inc.*, on Feb. 26, 2010, the Delaware Chancery Court upheld the committee's decision to adopt, exercise and amend Selectica's poison pill also applying the *Unocal* test indicating that shareholder rights plans are acceptable takeover defense mechanisms for special committees to use in protecting minority shareholders' interests.[14]

5. Members of the special committee should stay informed and expect to have an active role.

In *Loral*, the court declared that some members of the committee "brought the scientific concept of inertia to the special committee by generally remaining at rest until set in motion by the committee's advisers." Although as previously stated, qualified advisers are important, they do not serve as a complete substitute for the committee. The committee should have frequent meetings including its advisers as guests only where its deliberations and considerations are properly documented in minutes which provide a record in the event of litigation.

In *In re Lear Corporation Shareholder Litigation*,[15] the special committee was criticized for allowing the corporation's chief executive officer to conduct the transaction negotiations without members of the committee or any of their financial or legal representatives. Vice Chancellor Leo E. Strine Jr. called this negotiating process "far from ideal" and also noted that while typical business transactions might permit directors to "allow the actual work to be done by management and sign off on it after the fact," related-party transactions required much more than passive participation.

Management should not be hermetically sealed from the process nor from the committee; however, proper guardrails should be utilized to ensure that responsibility for deliberating and deciding is not abdicated to management, outside advisers, or members of the board who are either conflicted or not on the special committee.

In *Louisiana Municipal Police Employees' Retirement System v. Fertitta*, the special committee's "apparent and inexplicable impotence in the case of [the controlling shareholder's] obvious intention to engage in a creeping takeover" in part led the court to reasonably infer that the committee allowed the controlling shareholder to control and manipulate the process owing to the fact that he was the controlling shareholder, and the result was an unfair process.[16] While the special committee expressed dissatisfaction with the controlling shareholder's attempt at a creeping takeover, it failed to take any steps to prevent it, and the court made a point of declaring that standing by and watching was as egregious as (and akin to) participating in the wrong acts.

6. Special committees should seek qualified independent advisers to evaluate the financial and legal merits of a proposal and should hire those advisers on their own.

Just as special committee members should be independent so too should their advisers. Firms that have previously advised or currently advise any of the parties should not be chosen to represent the special committee as this creates the appearance of partiality even if such firms are fervent advocates.

Special committees should interview and choose their own advisers without influence from the company, the general counsel or any shareholder of the company as an additional precaution to establishing the independence of such advisers. The court in *Gesoff* noted that it was of particular concern that counsel had been engaged on behalf of the special committee by the controlling shareholder rather than the special committee itself.

The fairness of the process lies not only in the independence of the committee's advisers, but also in the quality of their advice. In *Loral*, the special committee chose a financial adviser who made two inquiries to gauge interest but never checked market interest or performed a market test. The court decided that the adviser tried to make the deal look fair from the outside, but failed to provide a truly objective opinion, and moreover, that the adviser was "outgunned and outwitted" leading to unfair dealing.

7. Special committees should be careful not to compensate financial advisers entirely on a success fee basis, but may utilize some form of contingent payment.

In *In re Tele-Communications Inc. Shareholders Litigation,* the financial adviser's fee was entirely contingent upon the completion of the transaction.[17] This compensation arrangement, according to the court, created "a serious issue of material fact as to whether [the investment bank] could provide independent advice," but was also in the context of an egregiously poor process. Whereas, in *In re The Mony Group Inc. Shareholder Litigation*, the Chancery Court permitted the financial advisers a success fee compensation structure indicating that at issue is the level at which the financial adviser's fee is related to the outcome rather than the mere existence of a success fee.[18]

Conclusion

Process makes perfect for special committees. The foregoing recent Delaware court opinions show that the courts are effective in discerning sham processes, including instances in which a full written record is provided showing a process which is not actually followed, and favoring special committee processes in which members demonstrate a good faith effort to do the best they can under the particular circumstances to benefit the public shareholders. By adhering to the guidance offered by the Delaware judiciary and outlined above, special committees can continue to expect to be second-guessed by plaintiffs, but will be more likely to succeed in defense of their actions as well as ensure that their constituencies are best served.

1. 457 A.2d 701 (Del. 1983).
2. Delaware is the exclusive jurisdiction examined herein.
3. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
4. See *Weinberger*, 457 A.2d at 711.
5. *In re Sunbelt Beverage Corp. Shareholder Litigation*, C.A. No. 16089-CC (Del. Ch. Jan. 5, 2010).
6. 808 A.2d 421 (Del. Ch. 2002).
7. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 92-93 (Del. 2001); *Weinberger*, 457 A.2d at 710-11.
8. 2008 WL 2923427 (Del. Ch., July 29, 2008).
9. 2008 WL 4293781 (Del. Ch., Sept. 19, 2008).
10. 902 A.2d 1130, 1146 (Del. Ch. 2006).
11. See id at 1146 n.101.
12. 929 A.2d 786 (Del. Ch. 2007).
13. 493 A.2d 946 (Del. 1985).
14. 2010 WL 703062 (Del. Ch. Feb. 26, 2010).
15. 926 A.2d 94 (Del. Ch. 2007).
16. 2009 WL 2263406 (Del. Ch. July 28, 2009).
17. 2005 WL 3642727 (Del. Ch. Jan. 10, 2006).
18. 852 A.2d 9, 22 (Del. Ch. 2004).