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Special Committee Law

The recommended practices outlined by the Delaware courts offer guidance on what conduct will withstand judicial scrutiny.

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THE APPOINTMENT of special committees of boards of directors by public companies in related party transactions has its genesis in the Delaware Supreme Court's decision in *Weinberger v. UOP, Inc.*, in which the Court held that the parent-subsidiary merger transaction at issue was unfair to minority shareholders.[1] While recognizing that "perfection [was] not possible or expected," the *Weinberger* Court noted that its decision could have been "entirely different" had the target subsidiary appointed a special committee of independent directors to negotiate on behalf of minority shareholders.[2]

Although *Weinberger* spurred the use of special committees as a means of protecting minority shareholders in conflicted transactions, the law in this area remained relatively stable for nearly two decades. With the increase in the number of going-private transactions and other related party corporate transactions during the last few years, however, the Delaware courts have issued several important opinions concerning special committees beginning with *In re Pure Resources, Inc. Shareholders Litigation*[3] and continuing through the recent decision in *Gesoff v. IIC Industries, Inc.*[4]

Like *Weinberger*, these decisions neither demand nor expect perfection in either process or result of the special committees. Nevertheless, in these cases, the Delaware judiciary has provided guidance regarding the formation and conduct of special committees and has, in this sense, refined the bounds of permissible imperfection.

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This guidance is neither mandatory nor conclusive, but use of the recommended practices outlined by the Delaware courts and illustrated in the following discussion should aid special committees in their efforts to ensure that their decisions withstand judicial scrutiny.

Why Pick on Them?

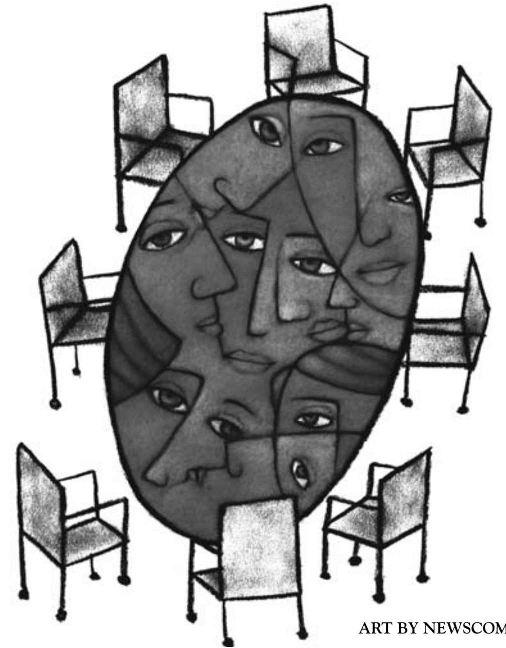
Going-private transactions and other interested party transactions are often subject to a higher level of judicial scrutiny than third party transactions because they involve parties with divided and conflicted loyalties.

Generally, courts do not second-guess the wisdom of directors in business transactions absent a showing that the process, independence or good faith of the directors has been compromised or that the transaction cannot be attributed to a rational business purpose (a.k.a. the business judgment rule).[5]

By contrast, for most related party transactions, directors must show that their decision to pursue or reject a proposal was entirely fair to the minority shareholders. The "entire fairness" standard of review is a demanding two-part test in which the burden may rest with the directors to show their fair dealing and the transaction's fair price.[6]

The more subjective aspect of the standard is fair dealing, in that the judiciary focuses its attention on the process by which the special committee considers, negotiates and approves the transaction, whereas in determining fair price, the courts examine such substantive terms as the intrinsic valuations of the transaction, which are more objective comparatively.

Establishing a special committee often shifts the burden of persuasion on the issue of fairness from the special committee approving a transaction to the minority shareholders seeking to challenge it.[7] Such a burden shift was, at one point, automatic by the sheer formation of a special committee. Under the recent caselaw, however, the use of a special committee has only had a burden-shifting effect to the extent that the special committee could actually show that it functioned in an objective and effective manner.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The following discussion, which is based upon recent Delaware decisions, sets forth some of the guidelines that special committees should follow to show fair dealing, which will enable them not only to effect such a burden shift, but also to protect the interests of minority shareholders. These methods include:

(1) forming a multi-member committee;

(2) establishing a clear and sufficiently expansive mandate;

(3) performing appropriate due diligence;

(4) maintaining distance from the conflicted parties;

(5) choosing independent and competent financial and legal advisors; and

(6) properly compensating financial advisors.

1. A special committee should have more than one independent member. In *Gesoff*, the Delaware Chancery Court held that the transaction at issue did not satisfy the entire fairness standard and found that the flaws in the special committee process began at the committee's inception when only one member was appointed.

The court indicated that it "places more trust in a multiple member committee than in a committee where a single member works free of the oversight provided by at least one colleague."[8] Underlying this notion was the proverbial belief that "two heads are better than one." In this vein, the decisions made by a committee of two or more people who may exchange ideas and viewpoints are likely to be more coherent and well thought out.

In some instances, only one independent director will be available for special committee service. Under those circumstances, the special committee (of one) must be especially vigilant, independent, effective and independent in representing the interests of the minority shareholders. Nevertheless, the one-person committee in *Gesoff* met none of those standards.

The Delaware Chancery Court in *In re Emerging Communications, Inc. Shareholders Litigation*, also emphasized the importance of collective deliberation.[9]

There, the court targeted the lack of in-person contact of the three-member special committee, declaring that the members' location on separate continents and in entirely different time zones resulted in the committee members' inability to engage one another in meaningful dialogue. Consequently, the member closest in proximity to the controlling shareholder took the lead in negotiations and often conveyed the special committee's position without extensive input from the other members.

Since special committee members are necessarily independent directors and not employees of the target companies, it is happenstance if they all reside in the same location. In these instances, *properly conducted* telephonic meetings, in which the special committee members actively participate, should satisfy the *Emerging Communications* standard.

2. Special committees should have a clear mandate. In *In re Tele-Communications, Inc. Shareholders Litigation (TCI)*,[10] the ambiguous nature of the special committee's mandate hindered its ability to negotiate effectively.

The transaction in *TCI* involved common stock with a dual class, high-vote, low-vote structure. While one member thought that the special committee's task was to ensure that the low-vote shareholders received a fair deal relative to the high-vote shareholders, another member believed that the committee's assignment was to ensure the best deal for both classes of shareholders.

The responsibilities of the special committee were not established by formal resolutions that would have provided the members a clear understanding of their role. The court reasoned that a transaction in which the mandate of the special committee was so muddled was inherently unfair.

Recent Delaware opinions demonstrate that gross mismanagement of the special committee process is an insurmountable flaw. However, if committees are careful not to take such egregious missteps, they will likely achieve the essential goal of protecting minority shareholders.

The special committee's mandate should also specifically include the ability to negotiate as opposed to merely the ability to accept or reject a transaction proposal. But if the offer by the controlling shareholder is not coercive, the special committee need not be granted the power to stop the offer, e.g., by a poison pill. There are two messages from *Pure Resources*: (1) that a special committee should not just have the ability to say "yes" or "no" to the controlling shareholder's first offer, but rather it must be a formidable counterparty in helping to craft and shape a transaction that is fair to the minority shareholders; and (2) that it does not have to have the power to "just say no."

At the organizational meeting, counsel should provide the special committee with expansive resolutions. After the committee reviews and approves the resolutions, it should insist that the target company adopt them and should not be intimidated into accepting more limited authority.

In *Gesoff*, the court found that the special committee's mandate was both too vague and too restrictive. The mandate failed to clearly articulate whether the special committee had the authority to reject the transaction. Furthermore, the special committee's mandate proved insufficient to address the transaction that was ultimately pursued.

The transaction in *Gesoff* was originally conceived as a tender offer with a short-form merger. However, when the short-form merger was no longer possible, the controlling shareholder decided to proceed with a long-form merger.

The problem was that the special committee's mandate never contemplated what might happen if the short-form merger failed. Despite the transition to a long-form merger, the mandate was neither reviewed nor expanded and, as a result, the special committee took no further action.

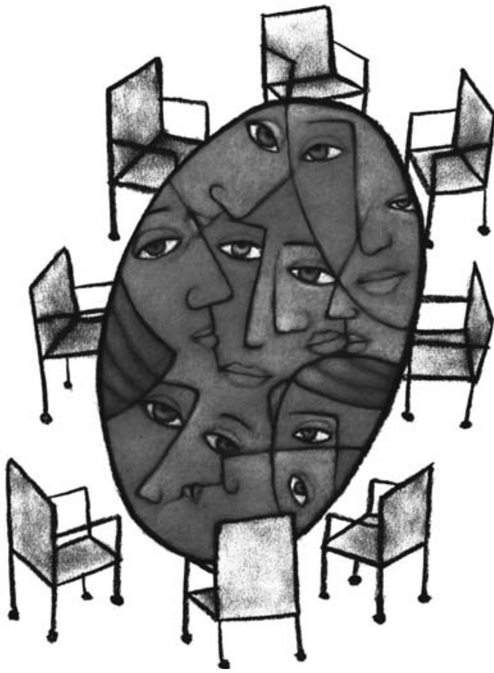
3. Courts reward neither hastily made nor unreasoned conclusions in evaluating the decisions made by special committees. The most important task of the special committee is to evaluate the merits of a related party transaction, both from a financial and strategic vantage-point. Courts deem the process by which a special committee arrives at its answer to be as important as the answer itself.

A special committee must be tenacious in finding and obtaining all due diligence materials necessary to evaluate the controlling shareholder's proposal. In *Emerging Communications*, the special committee was criticized for not having obtained the most recent company financial projections even though it was not aware that such projections existed.

Similarly, in *TCI*, the special committee was chastised for failing to obtain information that the court believed was necessary to reach a carefully considered decision. There were two classes of common stock, one of which had a higher vote than the other. The special committee was not given information on the historical trading premium of the high-vote shares relative to the low-vote shares nor on all of the relevant precedent mergers involving similar two class stock structures.

In some sense, this is akin to an actual knowledge upon due inquiry standard. The special committee must not be a passive receptacle for the information the company chooses to provide, but rather must be active in pursuit of any possibly relevant information.

4. Discussions among the members of a special committee and the controlling



shareholder are permissible and do not, in and of themselves, taint the process.

Indeed, arm's-length bargaining requires lively conversation and negotiation. Nevertheless, a special committee should avoid excessive contact with the company and/or the controlling shareholder, unless the contact includes the advisors to the special committee.

The *Emerging Communications* case illustrates one of the most "careless, if not reckless" mistakes made in failing to establish boundaries.[11] There, a special committee member routinely communicated with the other members of the committee on matters ranging from valuation to negotiating strategy by utilizing the secretarial services of the controlling shareholders' assistant. Although there was no evidence that the controlling shareholder was privy to this confidential information, the appearance of impropriety was such that the Chancery Court could not find that there had been fair dealing.

5. Special committees routinely seek financial and legal advice to evaluate a proposal. Yet, sometimes, in the view of the courts, special committees do not make appropriate choices for such specialized representation. Again, the courts do not demand perfection, but competent and effective legal and financial advice is paramount to entire fairness.

Advisors absolutely should not be chosen by the controlling shareholder or management. The special committee may seek recommendations from the other interested parties, but ultimately, the special committee should interview and consider several advisors so that it acquires sufficient knowledge to make an informed choice.

Special committees should also be careful not to use firms that have represented other interested parties on prior occasions—especially counselors who are currently advising such parties—as this gives rise to great concern that such advisors' advice is not impartial.

In *TCI* and *Gesoff*, the judiciary was displeased that the special committees' legal counsel had allegiances to their respective counterparties.[12] As an additional matter, the court in *Gesoff* noted that it was particularly alarming that counsel had been engaged on behalf of the special committee by the controlling shareholder rather than the special committee itself.

6. While some form of contingent compensation for financial advisors is permitted, a purely success fee-based structure is troublesome.

For example, in *TCI*, all $40 million of the financial advisor's fee was contingent upon the completion of the transaction. The court asserted that this arrangement created "a serious issue of material fact as to whether [the investment bank] could provide independent advice."[13] Note, however, that in the recent opinion in *In re The Mony Group Inc. Shareholder Litigation*, the Chancery Court approved the use of a contingent compensation arrangement.[14]

The issue, in the case of a special committee, seems to be the level to which the financial advisor's fee is tied to the outcome rather than the fact that a contingent arrangement exists. In related party transactions in which there is a risk that the transaction does not occur at all, some form of a contingent fee arrangement may actually be advantageous. Furthermore, as it is the Delaware courts' objective to see that the minority shareholders get the best price for their shares, they should not deny the special committee the right to provide the financial advisor with an incentive to get the highest price.

A fee structure that is contingent upon the value of the transaction with some upfront compensation for expenses, a flat minimum fee for retention and a fee for issuing or refusing to issue a fairness opinion is likely to be more palatable to the judiciary than a fee structure that is wholly contingent upon the consummation of the transaction.

Conclusion

"Perfection is not [considered] possible or expected" when the Delaware judiciary is evaluating the formation and processes of special committees in the context of related party transactions, but the judiciary has set a range of permissible imperfection.

The recent Delaware opinions demonstrate that gross mismanagement of the special committee process is an insurmountable flaw.[15] However, if special committees are careful not to take such egregious missteps, they will likely achieve the essential goal, which is the protection of the rights and interests of the minority shareholders.

Following the foregoing guidelines, even if imperfectly, is the means by which special committees may ensure adequate if not superior protection.

1. 457 A.2d 701 (Del. 1983).
2. Id. at 709 n. 7.
3. 808 A.2d 421 (Del. Ch. 2002).
4. 902 A.2d 1130 (Del. Ch. 2006).
5. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
6. See *Weinberger*, 457 A.2d at 711.
7. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 92-93 (Del. 2001); *Weinberger*, 457 A.2d at 710-11.
8. See *Gesoff*, 902 A.2d at 1146 n.101. The Chancery Court specifically noted the sole member, "like Caesar's wife [must] be above reproach." Upon a false accusation of adultery, Caesar divorced his wife declaring that the truth or lack thereof of the accusation was of no consequence because "Caesar's wife must be above suspicion." Vice Chancellor Hartnett first employed this quote in *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985).
9. 2004 WL 1305745 (Del. Ch. 2004).
10. 2005 Del. Ch. LEXIS 206 (Del. Ch. Dec. 21, 2005).
11. *Emerging Communications*, 2004 WL 1305745, at *36.
12. But see *Emerging Communications*, in which Justice Jacobs thought the special committee would have been better served by engaging the company's long-standing advisors who likely possessed superior knowledge. This provides further evidence that the entire fairness review lacks precision and thus, special committees are permitted reasonable mistakes.
13. *TCI*, 2005 Del. Ch. LEXIS 206, at *41.
14. 852 A.2d 9, 22 (Del. Ch. 2004).
15. But see *In re Cysive Inc. Sh. Litig.*, 836 A.2d 531 (Del. Ch. 2003), for a case in which the actions of a special committee show, by positive rather than negative example, the best practices of such a committee in an interested transaction.

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