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Special Committees: A Primer

For more than twenty years,¹ corporations have turned to special committees for their legal and practical benefits where a transaction, for one reason or another, may be tainted by the interest of a director, officer or controlling stockholder. For transactions involving a controlling stockholder or a conflicted board, a special committee provides certain legal benefits that protect both the transaction and the directors. In that context, an understanding of the general body of case law that has developed relating to the proper formation and functioning of special committees is critical to ensure that the transaction, and the directors, benefit from the use of the special committee. Even where a transaction does not involve a controlling stockholder, or where less than a majority of the directors are conflicted, a board may find a special committee, more properly referred to as a “transaction committee” in that context, to have certain practical advantages.

The Function and Purpose of Special Committees

A properly structured special committee process may provide a number of legal and practical benefits. The legal benefits created by the use of a special committee are inextricably tied to one of the most fundamental concepts of corporate law – the business judgment rule. As many of you know, directors must be disinterested and independent with respect to a matter at issue in order to be entitled to the protections of the business judgment rule. In the absence of a special committee or other “cleansing” mechanism, if a majority of the directors are not disinterested and independent, their decisions will not be accorded deference and they will be required to establish that the challenged transaction was “entirely fair” to the corporation and its stockholders.² In addition, if a transaction involves a controlling stockholder, the transaction will be subject to the entire fairness standard of review *ab initio*, and regardless of whether a majority (or all) of the directors are disinterested and independent.³ If a transaction involves a controlling stockholder or is one in which a majority of the board of directors has a disabling conflict of interest, a special committee provides important legal benefits.

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Where a transaction involves a controlling stockholder, the primary legal benefit of the use of a special committee is to shift the burden of proving entire fairness from the defendant corporation and directors to the plaintiff stockholders.⁴ Burden shifting, however, is not the only benefit created by the use of an effective special committee in that context. Utilization of a special committee will also make it more difficult for a plaintiff to meet its burden of showing that the challenged transaction was unfair because, under an entire fairness standard of review, a court will consider how the transaction was structured and negotiated. Indeed, the utilization of a properly functioning special committee provides “powerful evidence of fairness.”⁵

Practice Pointers: *In lieu of utilizing a special committee, the burden may be shifted by conditioning the transaction on a fully-informed vote of a “majority of the minority” of the outstanding voting power of the corporation.⁶ Given the aggressive tactics of hedge funds and the potential for those funds to obtain leverage by threatening to prevent a corporation from satisfying the “majority of the minority” condition, a special committee oftentimes is a more advisable mechanism to shift the burden of proof in a controlling stockholder transaction.⁷*

Where a transaction does not involve a controlling stockholder, but where a majority of the board has a disabling conflict of interest with respect to the transaction, the utilization of a fully-functioning and effective special committee may give rise to the protections of the business judgment rule. Although the relevant case law is less than clear, the Delaware Supreme Court has not held that the business judgment rule is inapplicable in such a situation. Indeed, the Delaware Court of Chancery has expressed the view that the business judgment rule protections should be reinvoked in such circumstances.⁸

Absent a transaction involving a controlling stockholder or a conflicted board, the business judgment rule should still apply to any decision by a board of directors with respect to a particular transaction. A special committee, therefore, is not necessary to shift the burden of proving entire fairness or to reinvoke the business judgment rule. Nevertheless, a special committee, more accurately referred to as a “transaction committee” in such circumstances, may provide certain practical benefits.⁹ For example, the use of a transaction committee may provide for a more efficient process by empowering a committee of directors, rather than the entire board of directors, with the authority to approve a particular transaction (subject to applicable statutory limitations).¹⁰ Such efficiencies have been deemed to be important particularly where the consideration of the transaction will require intense director involvement and multiple meetings. Moreover, a committee may be useful as a mechanism for shielding conflicted directors, officers or advisors from the process. Thus, even where a committee is not necessary to provide the unique legal benefits recognized by Delaware law (e.g., shifting the burden of proving entire fairness or re-invoking the protections of the business judgment rule), a transaction committee remains a useful corporate tool.

Practice Pointers: *A special committee should be utilized where a transaction involves a controlling stockholder or a majority conflicted board. A special committee also is recommended where there is only the appearance of a conflict, as the mere appearance of a conflict may be sufficient to invoke application of the entire fairness standard of review. Absent a controlling stockholder or majority conflicted board, a transaction committee may still be useful where it is deemed necessary or advisable to shield conflicted directors,*

*officers or advisors from the process. Indeed, such transaction committees have been encouraged even outside of the Delaware courts, e.g., the SEC's recent amendment of the tender offer best-price rules to provide a safe harbor for executive compensation arrangements that are approved by independent directors.*¹¹

The Prerequisites of an Effective Special Committee

In order to obtain the legal benefits of a special committee, however, it is critical for the committee to be properly formed and to function effectively. The legal benefits resulting from special committee approval of a transaction will accrue only if the special committee is independent, active, informed, and has “real bargaining power.”¹² In that regard, a fully functioning and effective special committee should have the following attributes: (i) the committee members must be disinterested and independent; (ii) the committee members must understand their mandate; (iii) the committee must have real bargaining power; (iv) the committee must be informed and active; and (v) any advisors to the committee should be competent, disinterested and independent.

A. Selection of Committee Members.

In determining the number and identities of the committee members, a board of directors should consider a number of factors, including (i) the total number of directors serving on the entire board, (ii) the time requirements associated with the special committee process and each director's availability to meet those time commitments, (iii) whether a director has specific knowledge and/or expertise relevant to the issues that the committee will consider, and (iv) whether a director is disinterested and independent with respect to the particular matter and parties at issue.

Practice Pointers: *There are no hard and fast rules for determining the number of directors that should serve on a committee. Generally, a committee preferably should consist of at least three and not more than five directors. If it is anticipated that the committee's mandate will require it to be in place for a long period of time, a greater number of committee members may be preferable as it may be difficult to attain a quorum of directors for multiple committee meetings occurring over many months. Alternatively, if the committee's task is likely to require swift and immediate action, a smaller number of committee members may prove to be less cumbersome from a practical perspective.*¹³

In selecting the members of a special committee, care should be taken to ensure not only that the members have no financial interest in the transaction, but also that they have no financial ties, or are not otherwise beholden, to any person or entity involved in the transaction.¹⁴ In other words, all committee members should be independent and disinterested with respect to the particular transaction at issue. To be disinterested, the member cannot derive any personal benefit (or suffer a detriment) from the transaction not shared by the stockholders.¹⁵ Even if a director does not derive a personal benefit (or suffer a detriment) from a transaction and is thus not technically interested in the transaction, a director still may be deemed incapable of making an independent judgment if the director lacks independence with respect to the particular transaction. Broadly defined, a director

is considered independent if his or her “decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”¹⁶ In assessing independence, the courts often look to whether outside influences affect a director’s business judgment, such as whether the director is controlled by or beholden to another person or entity.

Practice Pointers: *Whether or not a director is independent for purposes of serving on a special committee is a question distinct from the question whether a director is deemed to be independent for purposes of any stock exchange rules. Determining whether or not a director is independent for purposes of serving on a special committee requires a context-specific analysis. Mere receipt of director fees will not, in and of itself, raise questions about a director’s independence. Moreover, a personal friendship between an interested party and a director will not, standing alone, result in the director automatically being incapable of making an independent judgment with respect to a transaction. Furthermore, the mere fact that a stockholder has designated a director does not, standing alone, make that director beholden to the stockholder.*

B. The Committee’s Mandate.

A special committee’s mandate will be defined both by the resolutions adopted by the board when it created the committee and the specific circumstances the committee will face when negotiating a transaction. The challenge, ultimately, for counsel and the special committee is to ensure that the scope of the authorizing resolutions coincide with the fiduciary responsibilities of the special committee members in the specific context.

Practice Pointers: *In certain recent decisions, the Delaware Court of Chancery has emphasized that it is critical for committee members to have a proper understanding of their mandate.[18] If the members do not understand their mandate, a court may find that the committee process was flawed. It is, therefore, critical that counsel to the special committee ensures that the committee members understand (at the beginning of the process) their mandate and the requirements for fulfilling their mandate.*

C. The Committee’s Powers.

An effective special committee charged to negotiate a transaction must have “real bargaining power.”¹⁸ In the nascent stages of the precedent that has since arisen around the use of special committees, the notion of “real bargaining power” was quite simplistic, requiring only that a special committee be vested with the power to veto the proposed transaction. While initially the Delaware courts seemed content to accept this limited charge as sufficient indicia of fairness in the process, that outlook ultimately was replaced by one that required far more in the way of special committee authority and performance in order to shift the entire fairness burden from a conflicted and controlling majority.

Accordingly, the actions of special committees have been scrutinized with increased judicial enthusiasm and the legal benefits of a special committee have been extended only upon a showing that the committee’s capacity and performance accurately approximated arm’s length negotiations. A special committee, therefore, should obtain sufficient power to take

aggressive actions even against a controlling stockholder of a corporation. The Court of Chancery has gone so far as to suggest that a special committee should consider obtaining the power to adopt, and potentially implement, a rights plan against a controlling stockholder in appropriate circumstances.¹⁹ Although the Delaware Supreme Court has suggested that such aggressive tactics may be used against a controlling stockholder only in certain limited circumstances,²⁰ the case law indicates a clear expectation that a special committee must act aggressively both to obtain as much power as possible and to use that power to protect the interests of the minority stockholders and to fulfill its mandate.

Practice Pointers: *Legal counsel for a special committee must carefully consider the board resolutions that provide the special committee with its powers and ensure that the board has provided the special committee with sufficient power to carry out its role as arm's length negotiator. Although the power to negotiate is critical, it may also be necessary for the special committee to obtain certain other powers of the board in order to increase the leverage that the special committee may bring to bear. In any event, counsel for the special committee should be prepared to bargain intensely with legal counsel for the corporation in order to attain the full panoply of powers that the special committee will need in the specific context.*

D. Informed and Active.

A committee with real bargaining power will not cause the burden of persuasion to shift unless the committee exercises that power in an informed and active manner. To be informed, the committee necessarily must be knowledgeable with respect to the company's business and advised of, or involved in, ongoing negotiations. To be active, the committee members should be involved in the negotiations or at least communicating frequently with the designated negotiator.

Practice Pointers: *To the extent a transaction is challenged, a reviewing court will consider, among other factors, the process employed by the committee to negotiate the transaction. Accordingly, it is important for the committee to build a record demonstrating that it has engaged in a thorough and deliberate process, that the committee was fully-informed and that the committee actively fulfilled its obligations. A special committee should meet as often as necessary to faithfully discharge its fiduciary duties under the circumstances. While it may be prudent under certain circumstances for a committee to meet in person, as a general matter telephonic meetings are sufficient so long as each member of the committee can hear, and be heard by, the other members of the committee. The committee should, however, be cautious when outsiders are present, and should avoid the discussion of sensitive issues.*

Retention of independent legal and financial advisors by the special committee also enhances its ability to be fully informed. Because of the short time frame of many of today's transactions, professional advisors allow the committee to assimilate large amounts of information more quickly and effectively than the committee could without advisors. Having advisors that can efficiently process and condense information is important where the committee is often asked to evaluate proposals or competing proposals within days of their making. It will often be appropriate for the committee's advisors to prepare

presentations addressing certain issues. Any written work should be circulated in advance of the presentation, where possible. Once the committee has had sufficient time to digest the written material, the committee's advisors should be encouraged to give a detailed presentation to the members of the committee so that the members of the committee are adequately informed before making their final decision.

The members should meet with their independent advisors as frequently as required in order to permit the members to acquire "critical knowledge of essential aspects of the [transaction]." ²¹ Committee members may rely upon, and should interact with, and even challenge their financial and legal advisors. While reliance is often important and necessary, the committee should not allow an advisor to assume the role of ultimate decision-maker. ²² The committee members should also be encouraged to ask questions of their advisors and to discuss alternatives to a proposed course of action.

In addition to its formal advisors, a committee may desire to invite "outsiders" to attend particular meetings. For example, there may be particular employees of the corporation who possess unique knowledge concerning the business or who can pull together relevant data and other information of interest to the committee.

Practice Pointers: *It is also important, from a process standpoint, to keep accurate and contemporaneous minutes of each committee meeting. If a committee's decision is challenged, courts will give great weight to meeting minutes for purposes of developing the record. Indeed, minutes often provide the most reliable record of what the members of the committee considered and when they considered those issues. The minutes of the meeting at which specific action is taken by the committee should be detailed enough to show the deliberative process, the issues discussed and the specific action taken (including whether or not the action was unanimous). In advance of such a meeting, often it is appropriate for counsel to the committee to prepare draft resolutions for the committee's consideration. Those resolutions should contain recitals setting forth the salient background and factors supporting the committee's decision as well as the specific action taken, authorized or recommended by the committee.*

E. Selection of Advisors.

Although there is no legal requirement that a special committee retain advisors, it is highly advisable that it does so. The choice of advisors and the manner in which they are selected, however, may influence a court's determinations with respect to the independence of the committee and the effectiveness of the process.

Selection of advisors should be made by members of the special committee and not by management of the company, general counsel, or the board. Although the special committee may rely on the company's professional advisors, a reviewing court's perception of the special committee's independence is enhanced by the separate retention of advisors who have no prior affiliation with the company or interested parties. Accordingly, the special committee should interview potential advisors to ensure that they have no prior or current, direct or indirect, material affiliations with the company or the interested parties. When analyzing the process, a Delaware court also is likely to consider whether the advisor's sophistication and expertise is appropriate for the engagement.

Practice Pointers: *If management recommends the legal or financial advisors, the committee should take steps to ensure that the advisors are sufficiently disinterested and independent. The committee should also ensure that the advisors are sophisticated and have experience to merit advising the special committee in the particular context. Indeed, the Delaware courts have questioned the competence of legal advisors to special committees and found those questions to be relevant in determining whether the committee functioned properly, and thus whether the legal benefits of the special committee were obtained.*²³

Importantly, a legal advisor to the special committee should not be actively representing the corporation, its officer or directors, or any party to the relevant transaction. Prior representations of the corporation may also raise an issue as to whether the legal advisor is independent.²⁴ The legal advisor should not have any other monetary or personal relationships with the corporation or its officers or directors of a type or level that may raise the suspicion that the legal advisor would somehow have an interest in seeing the special committee reach a particular result when it is considering a transaction. In addition, the legal advisor should provide an engagement letter to the special committee, setting out the scope of the legal advisor's representation.

As with the legal advisor, the special committee should retain a financial advisor who is experienced in providing the particular advice that is required for the particular task at hand. The special committee should consider whether the financial advisor has the requisite expertise to provide the anticipated advice, is experienced in representing special committees, and has expertise in the industry (particularly if such expertise would be useful in advising the committee).

Practice Pointers: *The legal advisor should assist the committee in approving an appropriate engagement letter with the financial advisor, which will set forth the anticipated scope of the financial advisor's duties and the fee structure. It is critical for the legal advisor to ensure that the scope of any fairness opinion to be provided by the financial advisor is appropriate in light of the special committee's mandate, and to ensure that the fee structure properly incentivizes the financial advisor to provide advice to the special committee that is in line with, and does not raise the potential for a conflict with, the special committee's mandate. In several recent cases, the Court of Chancery has emphasized the importance of ensuring that the financial advisor provides the proper advice to the special committee, particularly where there are two classes of stock at issue and thus where it is important for the special committee to determine not only the fairness of the transaction to a particular class of stock, but also the relative fairness of the transaction to one class of stock as it relates to another class of stock.*²⁵

The special committee and its advisors should also consider whether it is appropriate and/or advisable to retain other advisors. Depending on the circumstances and the committee's mandate it may be possible that a special committee would benefit from the expertise of other advisors who may provide the committee with advice that is additional to the advice that would be provided by its legal counsel and financial advisor.

CONCLUSION

In today's litigious environment, special committees play an integral role in the approval of transactions where conflicts of interest may exist. In an attempt to avoid jeopardizing the successful consummation of a transaction and to minimize the risk to directors, many Delaware corporations turn to special committees for their legal and practical benefits. Although the benefits of special committees are real, the challenges to properly forming a special committee and effectively running a special committee process are numerous. In forming a special committee, care must be taken to ensure that the members of the special committee are independent and disinterested, and that the special committee has the proper power to perform its duties. In running an effective committee process, care also must be taken to ensure that the special committee has access to independent advisors, becomes fully informed, and acts deliberately and aggressively, if necessary. Properly utilized, special committees not only minimize risk, but also maximize stockholder value in transactions by creating arm's length negotiations that help to generate a fair process and fair price.

¹ The origin of the special committee as a structuring device to deal with fiduciary duty concerns can be traced back to the Delaware Supreme Court's landmark decision in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

² See *Weinberger*, 457 A.2d at 710; *Williams v. Geier*, 671 A.2d 1368, 1378 (Del. 1996).

³ See *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1121 (Del. 1994).

⁴ See *id.*; *Emerald Partners v. Berlin*, 787 A.2d 85, 93 (Del. 2001).

⁵ *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 550 (Del. Ch. 2003).

⁶ See *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *14-15 (Del. Ch. Aug. 18, 2006) (stating that, at least outside the controlling stockholder context, a vote of a majority of the *outstanding* minority, rather than a majority of the *voting* minority, could reinvoke the business judgment rule). The *PNB Holding* decision also suggests that a conflicted board's decision to enter into a transaction (absent a controlling stockholder) may be protected by the business judgment rule merely by obtaining a majority of the outstanding minority vote as a mathematical matter and without conditioning the transaction on the attainment of that vote. See *id.*

⁷ At least one Vice Chancellor of the Delaware Court of Chancery has suggested, contrary to settled Delaware law, that the utilization of both a fully-functioning and effective special committee and a fully informed vote of a "majority of the minority" should reinvoke the protections of the business judgment rule. See, e.g., *PNB Holding*, 2006 WL 2403999, at *14 n.71; *In re Cox Communications, Inc.*, 879 A.2d 604, 606 (Del. Ch. 2005).

⁸ See, e.g., *PNB Holding*, 2006 WL 2403999, at *14 n.69; *In re Western Nat'l Corp. S'holders Litig.*, 2000 WL 710192, at *26 (Del. Ch. May 22, 2000).

⁹ The term "transaction committee" is preferred in such circumstances in order to bolster the argument that the business judgment rule applies to the transaction. If the committee is referred to as a special committee, a plaintiff may argue that the corporation has conceded that the transaction is subject to the entire fairness standard of review.

¹⁰ Section 141(c) of the General Corporation Law of the State of Delaware, which governs the creation and authority of board committees, does not permit the board of directors to delegate to a committee the final authority to approve mergers, asset sales and other transactions requiring a stockholder vote. In such circumstances, the committee can be given full power to negotiate a transaction and the authority to determine whether the full board should consider the approval of the transaction.

¹¹ Amendments to the Tender Offer Best-Price Rules, Release No. 34-54684 (Nov. 1, 2006) (“A special committee of the board of directors of the subject company or the bidder, as applicable, comprised solely of independent members and formed to consider and approve the arrangement may approve the arrangement and satisfy the safe harbor requirements if the subject company’s or bidder’s board of directors, as applicable, does not have a compensation committee or a committee of the board of directors that performs functions similar to a compensation committee or if none of the members of those committees is independent.”).

¹² *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997); see also *Cysive*, 836 A.2d at 548.

¹³ The Delaware courts place 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.” *Gesoff v. IIC Industries, Inc.*, 902 A.2d 1130, 1146 (Del. Ch. 2006). If a single member committee is used, the Delaware courts have required the sole member “like Caesar’s wife, to be above reproach.” *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del.Ch.1985); see also *Gesoff*, 902 A.2d at 1146 n.101.

¹⁴ See *In re Tele-communications, Inc. S’holders Litig.*, 2005 WL 3642727, at *10 (Del. Ch. Dec. 21, 2005, revised Jan. 10, 2006) (“TCI”).

¹⁵ See, e.g., *Orman v. Cullman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002). Delaware courts have generally found that a director will have a disabling interest with respect to a particular transaction where the benefit (or detriment) is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its stockholders. However, whenever a director stands on both sides of the challenged transaction, he or she is deemed to have a conflict of interest, and a showing of materiality has not been required. See *id.*

¹⁶ *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984).

¹⁷ See, e.g., *Gesoff*, 902 A.2d at 1146-47; *TCI*, 2005 WL 3642727, at *9.

¹⁸ *Kahn v. Tremont*, 694 A.2d at 429; see also *Cysive*, 836 A.2d at 548.

¹⁹ See *In re Pure Resources, Inc. S’holders Litig.*, 808 A.2d 421, 431 (Del. Ch. 2002).

²⁰ See, e.g., *Black v. Hollinger Int’l Inc.*, 872 A.2d 559, 567 n.16 (Del. 2005).

²¹ *Kahn v. Tremont*, 694 A.2d at 430.

²² See *TCI*, 2005 WL 3642727, at * 10-11.

²³ See *Gesoff*, 902 A.2d at 1151-52.

²⁴ See, e.g., *Benchmark Capital Partners IV, L.P. v. Vague*, 2002 WL 31057462 (Del. Ch. Sept. 3, 2002) (addressing whether legal counsel who had met with a corporation to discuss its possible representation of a special committee should be disqualified for later representing an investor adverse to the corporation).

²⁵ See, e.g., *TCI*, 2005 WL 3642727, at *13-14; *Levco Alternative Fund Ltd. v. The Reader’s Digest Assoc., Inc.*, 2002 WL 1859064, at *2-3 (Del. Aug. 13, 2002).