

## The Practice Corner: Special Committees

For more than twenty years, special committees have served as a structuring device to address fiduciary duty concerns and to help avoid the taint of a conflict of interest of a director, officer or controlling stockholder. Even if 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.

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### Why a Special Committee?

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. 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. 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.

If a transaction involves a controlling stockholder, the primary reason to use a special committee is to shift the burden of proving entire fairness from the defending company to the plaintiff stockholders. 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.

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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. Given the aggressive tactics of hedge funds and the potential for those funds to obtain leverage by threatening to prevent a company from satisfying the “majority of the minority” condition, a special committee often is a more advisable mechanism to shift the burden of proof in a controlling stockholder transaction.

## Practice Pointers

***Forming a “Transaction” Committee*** - Absent a transaction involving a controlling stockholder or conflicted board, the business judgment rule should still apply to any decision by a board considering a transaction. Although a special committee is not necessary to shift the burden of proving entire fairness or to re-invoke the business judgment rule, such a “transaction committee” may provide practical benefits – such as empowering a committee of directors with the authority to approve a particular transaction, which is particularly useful in deals that require intense director involvement and multiple meetings. Indeed, transaction committees have been encouraged even outside of the Delaware courts, e.g. the SEC’s recent amendment of the best-price rules to provide a safe harbor for executive compensation arrangements that are approved by independent directors.

***Selection of Committee Members*** - 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. Single member committees, however, are not advisable as Delaware courts place more trust in multiple member committees.

***Independence of Committee Members*** - All committee members should be independent and disinterested with respect to the particular transaction at issue. 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.

***The Committee's Mandate*** - 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. 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.

***The Committee's Powers*** - 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.

***"Informed and Active"*** - 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.

***Documentation and Minute-Taking*** - It is 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.

***Selection of Advisors*** - 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.

***Role of Advisors*** - 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.