The Use of Special Committees in Mergers and Acquisitions

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THE USE OF SPECIAL COMMITTEES IN MERGERS AND ACQUISITIONS

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I. INTRODUCTION

Significant burdens are placed upon corporate directors when considering a possible business combination. Directors must navigate through the treacherous path created by the magnitude of the consideration payable, the intense focus of stockholders, the media, and the plaintiffs bar, as well as the conflicting interests of management, employees, stockholders and other constituents. The challenges become particularly acute in transactions where there are either controlling stockholders or directors with conflicts of interest.

It is critical for boards of directors to address properly conflicts of interest in business combinations. Many boards have appointed special committees of independent directors to ensure that stockholders’ interests are protected in mergers and acquisitions (M&A) and, in certain circumstances, to shift the burden from directors, who must establish the “entire fairness” of the transaction, to the stockholder-plaintiffs, who must establish unfairness. This article addresses the fiduciary framework governing M&A and the requirements for appointing and conducting the activities of a special committee under Delaware law. This article does not address the laws of any other state nor does it address the use of special committees in non-M&A contexts.
II. FIDUCIARY FRAMEWORK

A. Business Judgment Rule

The business judgment rule is the fundamental defense in litigation challenging the prudence or wisdom of director action, including the approval of an M&A transaction. It is

A ‘presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.’ A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter’s decision can be ‘attributed to any rational business purpose.’

If the requirements of the business judgment rule are satisfied, a court may not overturn the directors’ decision if the decision is rationally related to a legitimate business purpose. When the business judgment rule applies, the burden is on the party challenging the conduct of the directors to establish that the board’s decision was not rationally related to a legitimate business purpose. Whether the decision is the best decision, or even a reasonable decision, is beyond the scope of the court’s consideration.

Directors receive the deference of the business judgment rule so long as they satisfy the conditions of care, loyalty and independence. In other words, when a decision of the board is challenged by a plaintiff-stockholder, unless that stockholder can demonstrate a lack of care, loyalty, or independence by the board, the Delaware courts require only that the decision be rationally related to a legitimate business purpose. But if one of those three conditions is deemed wanting, the decision of the board will be subjected to the more exacting “entire fairness” standard.

1. Duty of Care

Directors have a duty to stockholders and the corporation to perform their duties with the care that an ordinarily prudent person would use under similar circumstances. Directors may generally discharge this duty in the M&A context by acquiring sufficient knowledge of the proposed transaction, personally examining the available information, and taking adequate time to consider the transaction.

In 1985, the implications of the requirement of due care were forcefully set forth in Smith

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4 See Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).
v. Van Gorkom, a Delaware Supreme Court decision that shocked the business world. The Delaware Supreme Court later underscored these implications in Cede & Co. v. Technicolor, Inc. Both cases imposed personal liability on directors. Each arose before the adoption of section 102(b)(7) of the Delaware General Corporations Law (DGCL), which permits corporations to amend their charters to eliminate director liability in negligence cases. Accordingly, the same results would likely not be reached today, but the cases’ standards for director conduct clearly have continuing vitality in claims for injunctive or other relief, and, more important, in signaling to directors the proper standards for discharging their responsibilities.

In Van Gorkom, a distinguished group of directors was held personally liable to stockholders for approving an agreement to sell Trans Union Corporation, even though the sale price represented a premium of 48% over the market price and there was no evidence of misrepresentations or self-dealing. The directors approved the transaction during a relatively short board meeting, without advice from an investment banker, adequate understanding of the terms of the agreement, or other inquiry as to whether the price was truly reflective of the value of the corporation. The Delaware Supreme Court stated:

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves ‘prior to making a business decision, of all material information reasonably available to them.’

Under the business judgment rule there is no protection for directors who have made ‘an unintelligent or unadvised judgment.’ A director’s duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to

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(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

10 See Van Gorkom, 488 A.2d at 869.
proceed with a critical eye in assessing information of the type and under the circumstances present here.\textsuperscript{11}

Since \textit{Van Gorkom}, the procedures taken by directors to inform themselves and the thoroughness of their deliberations have been the principal focus of much stockholder litigation. In particular, the crux of these claims has been whether directors, in approving a business combination, have demonstrated diligence in seeking not just a \textit{fair} transaction but the \textit{best} transaction reasonably available to stockholders under the circumstances.\textsuperscript{12}

For example, the December 1993 ruling of the Delaware Supreme Court in \textit{Cede} found the directors personally liable for approving the sale of Technicolor in a fundamentally arm’s-length transaction at a premium of over 100\% above recent market prices for Technicolor’s stock. The court listed the following elements to support its ruling:

1. The definitive agreement was not preceded by a “prudent search for alternatives” to enable the directors to know whether a higher value might be obtainable from another party;
2. The terms of the definitive agreement and circumstances were such as to foreclose the possibility of a better offer once the agreement was entered into and announced;
3. Most of the directors had little or no knowledge of the transaction in advance of the board meeting at which the definitive agreement was approved; and
4. The board did not take reasonable steps to be adequately informed before it authorized the execution of the definitive agreement.\textsuperscript{13}

2. \textit{Duty of Loyalty}

In \textit{Cede}, the Delaware Supreme Court stated that “the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.”\textsuperscript{14} Clearly, if directors act to benefit their personal interests (e.g., to enrich themselves) at the expense of stockholder interests, the action is improper.\textsuperscript{15}

The Delaware Supreme Court in \textit{Revlon, Inc. v. MacAndrews \& Forbes Holdings, Inc.}\textsuperscript{16} underlined the legal risk of sacrificing the interests of stockholders to those of others (in that case, the interests of noteholders):

[T]he Revlon board could not make the requisite showing of good faith by preferring

\begin{itemize}
\item \textsuperscript{11} See \textit{Van Gorkom}, 488 A.2d at 872 (citations omitted).
\item \textsuperscript{12} See \textit{Revlon}, Inc. v. \textit{MacAndrews \& Forbes Holdings}, 506 A.2d 173, 182 (Del. 1986).
\item \textsuperscript{13} \textit{Cede}, 634 A.2d at 369.
\item \textsuperscript{14} Id. at 361.
\item \textsuperscript{15} Id. at 363.
\item \textsuperscript{16} See \textit{Revlon}, 506 A.2d at 182.
\end{itemize}
the noteholders and ignoring its duty of loyalty to the shareholders.

* * *

The Revlon board argued that it acted in good faith in protecting the noteholders because [Unocal Corporation v. Mesa Petroleum Company] permits consideration of other corporate constituencies. Although such considerations may be permissible, there are fundamental limitations upon that prerogative. *A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.* However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.\(^{17}\)

In the recent case of *Stone v. Ritter*, the Delaware Supreme Court emphasized that finding a violation of the duty of loyalty requires determining that the violator failed to act in good faith.\(^{18}\) The court labeled good faith as a “subsidiary element” of the duty of loyalty, and reiterated that good faith is lacking where a fiduciary either acts with a purpose other than that of advancing the best interests of the corporation, violates the law, or consciously disregards his or her duties.\(^{19}\)

3. Independence

A director is independent if his actions are “based entirely on the corporate merits of the transaction” and are not “influenced by personal or extraneous considerations.”\(^{20}\) Conversely, a director is considered interested where he or she stands to benefit personally from a transaction in a way that is not equally shared by the stockholders.\(^{21}\) All members of a special committee must be “independent” under applicable Delaware case law.\(^{22}\)

An interest in simply remaining a director does not preclude the independence necessary for application of the business judgment rule.\(^{23}\) In addition, ownership of stock in the corporation alone is not inconsistent with director independence.\(^{24}\)

On the other hand, a decision found that unvested stock options potentially worth millions of dollars created an incentive for the directors to retain their positions on the board and undermined their claim of independence from the controlling stockholder.\(^{25}\) A director who

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17 Revlon, 506 A.2d at 182 (emphasis added) (citation omitted).
19 Id.
20 Cede, 634 A.2d at 362.
22 See Kahn v. Lynch Comme’n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).
has a position as an officer or employee of the corporation, or is a member of a firm receiving substantial revenue from the corporation, may also be viewed as lacking independence. Similarly, a director who negotiates for an interest in connection with a transaction, such as a finder’s fee or a position with the surviving entity, may also lack independence.  

Under some circumstances, the presence of social or personal relationships between board members and controlling stockholders may be sufficient to jeopardize director independence. In Beam v. Stewart, the Delaware Supreme Court explained that the issue hinges on whether the relationship is “so close that the director’s independence may reasonably be doubted.” The court further indicated the mere presence of a personal friendship or business relationship does not by itself raise a reasonable doubt concerning director independence.

The presence of a majority of independent directors is critical in establishing the basis for applying the business judgment rule. When the majority of directors lack independence, the business combination will be reviewed under the entire fairness standard. However, as discussed in section II.D below, a special committee can be used to mitigate the harshness of this standard.

B. The “Entire Fairness” Standard

As established in the Van Gorkom and Cede cases, if the directors have violated their duty of care they will not be afforded the protection of the business judgment rule. Similarly, if the board of directors has violated its duty of loyalty to the corporation or lacks independence from the interested parties, a court will not apply the business judgment rule. Instead, it will subject the board’s decision to the “entire fairness” standard, the strictest standard of judicial review of board action under Delaware law.

In determining whether a transaction is entirely fair, the Delaware courts examine whether the process to achieve the transaction and the ultimate price paid reflect what would have been achieved and paid in an arm’s-length transaction. More specifically, the courts require the board to demonstrate that the transaction was a product of both fair dealing and fair price. The Delaware Supreme Court’s 1983 landmark decision in Weinberger v. UOP, Inc. summarized the showing of fairness as follows:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other

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26 See DEL. CODE ANN. tit. 8, § 144(a) (2008).
29 Id. at 1050.
elements that affect the intrinsic or inherent value of a company’s stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.  

1. Fair Dealing

Fair dealing, or “procedural fairness,” focuses on the process by which the board or special committee considers, negotiates, and approves the transaction.

a. Timing

The courts will examine when the transaction was initiated, including whether the transaction was timed to advantage the interested parties and disadvantage the other stockholders. The courts will also evaluate whether the board or special committee had adequate time to consider and respond to a proposal to complete a transaction.

b. Disclosure

All material information concerning the transaction and companies involved must be made available to both inside and outside directors, such as recent internal management projections, asset valuations and other forward-looking information. The courts do not, however, generally mandate disclosure of the interested party’s highest or “reservation” price or valuation analysis. This is consistent with the courts’ insistence that the transaction only mimic, but not go beyond, what would typically occur in an arm’s-length negotiated transaction.

c. Structure

If the structure of the transaction unfairly favors the interested party or is coercive to the other stockholders, the transaction will fail the entire fairness standard. A classic example of a coercive structure is a two-step acquisition with the interested party paying cash in a tender offer as the first step and issuing non-investment grade debt or preferred stock in a merger as the second step.

d. Negotiation

If the process does not serve as a “surrogate for the energetic, informed and aggressive

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33 See Weinberger, 457 A.2d at 711.
negotiation that one would reasonably expect from an arm’s-length adversary,” the transaction will likely not pass the entire fairness standard. To this end, it is important that the board remain reasonably informed concerning the terms of the agreement, including consulting with independent financial and legal advisors.

Courts will also examine the actions of the interested parties in the negotiation process and, in particular, will consider whether they acted in good faith. If the interested parties made coercive threats to the committee during negotiations, the courts will be less likely to approve the negotiating process.

e. Approval

The courts will carefully evaluate the quality of the board’s evaluation and approval of the transaction. Relevant factors might include, among other things, the number and duration of meetings, the presence and input of legal and financial advisers, and the depth of discussion (including the questioning of advisors).

2. Fair Price

Fair price is often the key factor in analyzing a transaction’s entire fairness. Indeed, “[p]rice may be the preponderant consideration outweighing other features of the merger.”

There is no single test for determining whether a price is “fair.” A court will take all relevant factors into account during its analysis, including asset values, market values, comparable transactions, historical earnings, discounted cash flows and future prospects.

The Chancery Court stated:

A fair price does not mean the highest price financeable or the highest price that [a] fiduciary could afford to pay. At least in the non-self-dealing context, it means a price that is one that a reasonable seller, under all the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept.

Although there is no clear judicial pronouncement regarding what information a special committee must possess in order to determine fair price, the following measures may assist special committees in becoming sufficiently informed:

38 See supra section III.A.
40 See Kahn v. Lynch Commc’n Sys., Inc., 638 A.2d 1110, 1121 (Del. 1994).
43 Weinberger, 457 A.2d at 711.
44 See Cinerama, 663 A.2d at 1143.
1. The special committee may request that an independent investment banking firm opine as to the fairness, from the public stockholders’ point of view, of a proposed transaction.

2. The special committee may direct its investment banking firm to conduct a “market check” or other market survey in order to ascertain whether a better transaction might be available.

3. The special committee may direct its investment banking firm to seek alternative transactions with other potentially interested parties and may rely on the investment banking firm’s conclusions respecting the availability of any better alternative transaction.

4. Extended publicity of an impending sale may provide the special committee with a basis for inferring that no better alternative transaction will be forthcoming.

It is also advisable for the special committee to analyze the current projected results of the company’s business and the projected future share price if no transaction was undertaken.

C. Applicability of the “Entire Fairness” Standard in Conflict Transactions

Directors will always prefer to operate under the deferential business judgment rule rather than the exacting entire fairness standard. Except as described below, a properly appointed and functioning special committee should bring the transaction within the scope of the business judgment rule.45

However, the Delaware courts will scrutinize the M&A transaction to ensure its entire fairness to stockholders if: (1) a majority of directors have interests adverse to the corporation, (2) an investor or group of investors with interests in the transaction controls or dominates the board, (3) a majority of directors receive material, special or personal benefits, or (4) the transaction is with a controlling stockholder.

1. Majority of Directors Have Interests Adverse to the Corporation

If a majority of directors have material interests adverse to the corporation or not shared equally with the stockholders, the court will not presume the board’s actions should be upheld.46

The most easily identifiable conflict exists in situations in which a director is on both sides of a transaction, as in a management buyout, or when a director has a material financial interest adverse to the corporation, such as receipt of an advisory fee payable upon completion of the transaction.

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2. **Individual Director or Minority of Directors Have Adverse Interests and He or They Control or Dominate the Board**

Even if a majority of the directors are nominally independent and disinterested, courts will likely not presume the board acted in the company’s best interests if there is concern that the board is “controlled” or “dominated” by the interested parties. If the directors conclude it is possible that the court will determine them to be controlled or dominated by an interested party, they should consider forming a special committee to handle the transaction.

3. **Majority of Directors Receive Material, Special or Personal Benefits**

If a majority of the directors receive some material, special, or personal benefit from a transaction that is not available to the stockholders generally, their decision concerning the acceptance or rejection of that transaction will not be presumed to be for the corporation’s benefit.

For example, in *In re Tele-Communications, Inc.* (TCI), the Delaware Court of Chancery subjected the decision of TCI’s board to accept AT&T’s acquisition bid to the entire fairness standard because a majority of TCI’s directors held high-vote shares that received a premium relative to the low vote-shares. The court found this incentive, held by a majority of TCI’s board but not all of its stockholders, was sufficient to potentially taint the board’s decision.

4. **Transaction is With a Controlling Stockholder**

If the transaction is with a controlling stockholder rather than a third-party buyer unaffiliated with the company, a decision of the board of directors to “go private” will be subjected to the entire fairness standard. Recent Delaware decisions, however, have questioned whether this is necessarily the case when a merger transaction is negotiated and approved by a special committee of independent directors as well as conditioned on an affirmative vote of a majority of the minority stockholders. Those decisions state that if both of these requirements are met, the business judgment standard will be used.

Indeed, special committees are typically formed in any M&A transaction with a controlling stockholder. It is also customary to form a special committee in a management buyout, regardless of whether a majority of the board is independent, and for the special committee to engage legal and financial advisors that are not beholden to management.

### D. Effect of Special Committee on Fiduciary Framework

When the entire fairness standard applies to a transaction, it is more difficult for the board’s decision to withstand a plaintiff’s challenge than if the standard of the business

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47 See *Cinerama*, 663 A.2d at 1168.
48 See *Cede*, 634 A.2d at 362.
50 See *Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).
judgment rule were used for two reasons. First, as previously noted, the standard for review under the entire fairness standard is significantly more exacting and subjects the board’s decision to a much higher level of scrutiny. Indeed, many board decisions that pass muster under the business judgment rule would not satisfy the entire fairness standard. Second, whereas under the business judgment rule the burden of proof rests upon the plaintiff to establish that the business judgment rule is not applicable, under the entire fairness test the burden of proof is on the board of directors to establish entire fairness. In other words, except as discussed below, under the entire fairness standard the court will presume that the decision of the board was not in the best interest of the corporation unless the board can convince it otherwise.

For boards of directors operating under the entire fairness standard in a business combination, the Delaware courts have established the use of “special committees” as a defensive mechanism. If a board establishes a special committee composed entirely of disinterested directors, it may mitigate the entire fairness standard’s harsh application. Though the proper formation of a special committee will not necessarily result in the application of the business judgment rule, it may shift the burden of proof to the shareholder-plaintiff and provide evidence that the transaction is fair.

1. Does Not Result in Application of Business Judgment Rule

When the target company’s board is conflicted in one of the manners described in section II.C. above, even a properly appointed and functioning special committee will not subject the board’s decision to the lower standard of review of the business judgment rule. When such conflicts are present, courts will still require the board’s decision to be entirely fair in both dealing and price even if a special committee has been properly utilized.

2. May Shift “Fairness” Burden to the Plaintiff

Forming a special committee of disinterested directors to review a transaction may shift the burden of proof from the board of directors to the challenging party. The Delaware Chancery Court stated that “when independent directors understand the nature of their mission . . . and where they pursue that goal independently, in good faith and diligently,” their decision will shift the burden of proving or disproving entire fairness to the challenging party.

The shifting of the burden, while appearing technical, has significant practical—and often case-changing—implications. In particular, the shifting of the burden from the directors to the plaintiff often dramatically decreases the amount required to settle litigation challenging the transaction.

52 See Paramount Comm’ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994); Cinerama, 663 A.2d at 1168; Cede, 634 A.2d at 362; Lynch, 638 A.2d at 1115.


3. **Persuasive Evidence that the Transaction is Fair**

In addition to shifting the burden of proof from the board to the challenging stockholders, the use of a special committee may also make the stockholders’ case more difficult to prove. If the transaction was rigorously analyzed and negotiated by a group of disinterested directors, it will typically be more difficult for the plaintiff to attack the entire fairness of the deal.

III. **POWERS AND DUTIES OF SPECIAL COMMITTEE**

Special committees are created by boards of directors and thus rely on grants of authority by the board for all of their actions. If the board fails to give the special committee sufficient power and authority to fulfill its duties, or if the committee fails to fulfill those duties, the burden of proof regarding the entire fairness of a transaction will not shift from the directors to the plaintiffs.

A. **Acting as Surrogate for Energetic, Informed and Aggressive Arm’s-Length Negotiations**

The fundamental duty of a special committee is to represent the corporation during the negotiation of a transaction. This responsibility is normally reserved for the entire board but is passed to the special committee in order to shift the burden of proof when the loyalty or independence of the board is in doubt.

The court in *Revlon Inc. v. MacAndrews & Forbes Holdings* held that when contemplating a change of control transaction, “obtaining the highest price for the benefit of the stockholders should [be] the central theme guiding director action.”\(^{55}\) The special committee is thus responsible for actively negotiating with proposed buyers as auctioneers to secure the best price for the corporation and its stockholders. In short, the committee must take all actions that a reasonable and independent seller would take in obtaining the best acceptable price from a sale. If the committee fails to fulfill this duty by passively accepting an offer without attempting to obtain the best price available, it will retain the burden of proof in demonstrating the entire fairness of the transaction.\(^{56}\)

In order to fulfill its duty to negotiate on the corporation’s behalf, a special committee must have the power to say “no” to a transaction. The Delaware Chancery Court has referred to the power to say no as “critical,” emphasizing that “[i]t is that power and the recognition of the responsibility it implies by committees of disinterested directors . . . that gives utility to the device of special board committees in cha[n]ge of control transactions.”\(^{57}\)

If the committee has only nominal authority to walk away from the transaction or if the actions of the interested parties make the eventual result of the negotiations inevitable, then the presence of the special committee will fail to shift the burden of proof. For example, if a takeover threat is presented as a “take it or leave it” ultimatum that, if rejected, will be

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\(^{56}\) See *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

\(^{57}\) *In re First Boston*, 1990 Del. Ch. LEXIS 74 at *20.
followed by a hostile takeover, the usefulness of the committee process will be undermined.\(^{58}\) However, the threat of a potential purchaser withdrawing its bid should not jeopardize the committee’s authority to walk away.

The Delaware courts have also ruled that the mere authority to pass upon the fairness of a transaction, without more, is insufficient to shift the burden.\(^{59}\) A special committee must control its own agenda in evaluating a transaction. Any timelines or other pressures imposed upon the special committee by the board are generally inconsistent with the special committee’s role as an independent negotiator. Of course, the proposed buyers may impose deadlines to the negotiating process without undermining the arm’s-length nature of the transaction, and the special committee should be free to enter into such time restrictions if it deems doing so to be in the best interests of the corporation and its stockholders.

When a special committee is properly formed and vested with the power to negotiate effectively on the company’s behalf, courts will give great deference to the decisions of that committee. Committees may even take proactive steps, such as delaying a vote for shareholder approval, to ensure the completion of transactions the committees have actively negotiated and believe to be in the company’s best interest.\(^{60}\)

**B. Remaining Independent**

The special committee must maintain its independence from the influence of interested board members and the transaction as a whole. The legitimacy of the board’s decision to a very large extent relies upon the special committee’s independence, and it is because of their independence that members of the board are eligible to sit on special committees.

It is obvious that directors who have a material and conflicting interest in the transaction under review should not be appointed to a special committee. Such instances include management members of a parent corporation in a freeze-out of a subsidiary or an advisor who will receive a fee contingent on the consummation of the transaction.

There are also a number of other less obvious situations that courts have deemed to compromise a director’s independence. As a general matter, the Delaware Supreme Court has held that there need be no “direct nexus” between a conflict and a transaction for a director to lose his or her independence.\(^ {61}\) More specifically, the Delaware courts have found that prior financial relationships with the controlling stockholder may extinguish independence.\(^ {62}\) They have also found that extensive social interaction with the controlling party may be relevant in determining independence.\(^ {63}\) However, the receipt of directors’ fees or the existence of some immaterial “self-interest, standing alone and without evidence of disloyalty,” does not

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\(^{58}\) See Kahn v. Lynch Commc’n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).


\(^{60}\) See Mercier v. Inter-Tel, Inc., 929 A.2d 786, 813–14 (Del. Ch. 2007).


\(^{62}\) See Kahn v. Tremont Corp., 694 A.2d 422, 426 (Del. 1997).

Throughout the entire sale process, the board of directors and its advisors must monitor the development or discovery of conflicts that arise after the formation of the special committee. Should such conflicts arise, the committee and the board should work together to remove the newly-conflicted director from the committee and ensure that his or her influence will not taint the committee’s decision. If committee members lose their independence during the process, the court may be unwilling to shift the burden to the plaintiffs under the entire fairness standard.

Under current Delaware case law, the presumption is against director independence and, therefore, directors carry the burden of rebutting that presumption. If they are unable to convince the court of their independence, the special committee’s presence will not effectively shift the burden of proof from the directors to the plaintiffs.

The committee as a whole must also maintain its independence from management and interested directors. A recent court decision refused the defendant-company’s request for summary judgment against suing stockholders because the special committee’s independence had been compromised when a director who was not on the committee forwarded a committee memorandum to outside parties after he had been permitted to attend committee meetings.

C. Being Adequately Informed

A special committee must exercise real diligence to acquire all information that may be necessary or useful in evaluating the fairness of a proposed transaction. The committee must seek and analyze all material information concerning the transaction from all relevant sources, including conflicted board members. Special committees should take an active role in seeking out all pertinent information and should not delegate the due diligence process to management or any other potentially-conflicted parties.

In general, interested parties must disclose to the special committee: (1) all material terms of the transaction, (2) all material facts relating to the use or value of the asset in question by or to the interested party, and (3) all material facts relating to the market value of the subject matter of the transaction.

D. Retaining Independent Financial and Legal Advisors

Special committees should employ independent financial and legal advisors to assist in the valuation and bargaining process. The Delaware courts regard independent advisors as critical

64 Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988).
68 See In re Netsmart Techs, Inc. S’holder Litig., 924 A.2d 171, 195 (Del. Ch. 2007).
in protecting stockholder interests.\textsuperscript{70} When special committees fail to use experts, the courts may view this as an absence of fair dealing and fair price and will likely refuse to shift the burden of proof from the board to the plaintiffs.

The special committee, and not the interested party or directors, should select the independent advisors. If the interested party selects the committee’s advisors, it may taint the independence of their advice and the special committee. Further, except to the extent that sharing such information will enhance the special committee’s process, the deliberations of the special committee and the advice it receives from its independent financial and legal advisors should be kept confidential from the interested parties and their negotiators.\textsuperscript{71}

IV. PROBLEMS TO AVOID

Boards and special committees should be aware of actions and inactions that would likely cause the courts to disregard the special committee and require the board to demonstrate entire fairness.

A. Appointing Too Few Members to Committee

A special committee should have a sufficient number of members, and typically will have at least three. Appointing only two members could be problematic in that it gives either a veto power, and single-member committees are disfavored by the courts, especially when negotiations with a controlling stockholder are required.\textsuperscript{72} When there is only a single member on a special committee, courts will particularly scrutinize the independence of and the procedures employed by that individual. In such a case, both the director and the process employed must be “above reproach for the director defendants to receive the procedural benefits of using an independent committee.”\textsuperscript{73}

A further risk in appointing too few committee members arises should any of the members later be found to be conflicted. In \textit{Kahn v. Dairy Mart},\textsuperscript{74} the actions of the single independent committee member were scrutinized closely after the other committee member was found to have a conflict of interest.

B. Interested Directors Appointing Committee Members

Only disinterested directors should appoint members of the special committee. If the composition of the committee is decided by board members with an interest in the transaction, the interested directors may be tempted to appoint directors whom they feel will favor the transaction favored by the interested directors.

Directors should divulge any interests they may have in the transaction immediately to all

\textsuperscript{70} See \textit{In re Fort Howard Corp. S’holders Litig.}, No. 9991, 1988 Del. Ch. LEXIS 110, at *36 (Del. Ch. Aug. 8, 1988).
\textsuperscript{72} Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1146 (Del. Ch. 2006).
\textsuperscript{73} Kahn v. Dairy Mart, 1996 Del. Ch. LEXIS 38, at *20 (Del. Ch. 1996).
\textsuperscript{74} Id. at *19.
other board members. Failure to do so may result in their appointment to the committee by unsuspecting disinterested directors and jeopardize the independence of the committee. Moreover, should a director wait too long to reveal a conflict, the corporation may make the wrong decision in its original determination of the need to use a special committee.

C. Forming the Special Committee Too Late in the Deal

A special committee should be formed early in the M&A process so that it may participate in the entire process. If boards wait until important decisions regarding the transaction have already been made, the power of the special committee may be questioned.75

D. Failing to Create a Clear Committee Mandate

Generally speaking, the function of a special committee is “to aggressively seek to promote and protect minority interests.”76 More specifically, special negotiating committees should have a clear and specific mandate at the beginning of the committee’s work.77 This mandate should be clearly stated in the board resolutions creating and empowering the committee and may, among other things, direct the committee to consider a variety of strategic options, empower the committee to hire independent advisors, and grant the committee the exclusive responsibility for approving public disclosures concerning the committee’s and the board’s activities and deliberations. Special committee members must be aware of their legal roles and specific responsibilities as committee members. Recently, in In re Tele-Communications Inc. Shareholders Litigation, the Court of Chancery confirmed the importance of special committees’ maintaining a written record of their mandate, including applicable legal standards and the directors’ understanding of these standards.78

E. Acting Too Quickly

Special committees should avoid accepting or rejecting a proposal too quickly. If the committee has not taken adequate time to consider and study the transaction sufficiently, bargain for the best price, or consider potential alternative offers, the court may question the true independence or negotiating power of the committee.79 If the court has doubts concerning these important elements, it will likely decline to shift the burden of proof from the board of directors to the plaintiffs.

F. Failing to Negotiate Aggressively

The key function of the special committee is to seek aggressively to protect the interests of minority stockholders, and it is typically impossible to fulfill this function without aggressively negotiating. If the committee is overly passive in negotiating the transaction or fails to endeavor to obtain a reasonably high price for minority stockholders, the court will likely

75 See In re Netsmart Techs, Inc. S’holder Litig., 924 A.2d 171, 199 (Del. Ch. 2007).
78 Id.
question the independence and authority of the committee and decline to shift the burden of proof from the board to the plaintiffs. 80

G. Passive Relying on Outside Advisors

Though special committees should seek the advice of independent financial and legal advisors, they can not rely solely upon the opinions of such advisors in making their recommendations to the board. The court in *In re Trans World Airlines* held the committee’s passive reliance on the efforts of its investment banker to be indicative that “the directors did not seem to understand that their duty was to strive to negotiate the highest or best available transaction for the stockholders whom they undertook to represent.” 81 The committee members should engage in rigorous discussion, exchange views, and as appropriate, debate; their inquiry and dialogue should include questioning and even challenging, where appropriate, their experts. Unless the committee applies the independent advisors’ recommendations to the specific needs of the corporation in the negotiating process, the court might not shift the burden of proof to the plaintiffs.

H. Failing to Understand Key Documents

The special committee must understand the specific terms and implications of the key documents in the transaction. If the court concludes that members of the special committee did not understand the terms of the transaction, it may question the committee’s ability to fulfill its key functions. Under these circumstances, it is unlikely that the court would shift the burden of proof from the directors.

I. Failing to Ask Questions

The special committee should ask questions of the interested parties, the conflicted members of the board, and the committee’s independent advisors. Failing to ask appropriate questions may cause the court to question whether the special committee members truly comprehended their duties and the proposed transaction. 82

Failing to inquire about potentially questionable terms of the agreement or other actions of the interested parties may also evidence that the committee failed to take its job seriously, was conflicted, or was incompetent; accordingly, the court may refuse to shift the burden of proof. 83

J. Failing to Consider Alternatives

If the special committee believes that its only option is to agree to the transaction, then it does not possess sufficient authority to deal in an arm’s-length nature. 84 At a minimum, the

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81 Id. at *12.
82 See id. at *11–13.
83 See id. at *12–13, *21–22.
84 Id. at *21.
special committee must consider the option of refusing to accept the offer, even if it does not consider any other offers at the time of rejection.

Though a special committee must have the authority to “just say no” and must be cognizant of that power during negotiations, the committee need not be empowered to “shop the company.” If a parent company or controlling stockholder is not interested in selling the company to anyone other than itself, it does not have to. As the Delaware Supreme Court has stated, “a stockholder is under no duty to sell its holdings . . . merely because the sale would profit the minority.”

K. Failing to Document the Process

The special committee should carefully document deliberations and investigations so as to convince the court that the committee was careful and informed in its deliberations. In trial, such documentation could prove invaluable in demonstrating to the court that the committee fulfilled its duties without compromising its independence.

In addition, many going private transactions require extensive public disclosures of the approval process under Rule 13e-3 of the Securities Exchange Act of 1934, including the public filing—with the Securities and Exchange Commission—of documents relating to the privatization process as exhibits to Schedule 13e-3.

L. Favoring One Party without a Good Reason Related to the Best Interests of the Stockholders and the Corporation

When a special committee is forced to choose among several competing offers, the committee cannot give preferential treatment to a bidder unless it has a good financial reason to do so. Because its main duty is to protect the interests of minority stockholders, the financial reason put forth by the committee in selecting one potential purchaser over another must be sufficiently related to the best interests of the stockholders and the corporation. If the committee selects a proposal that is not the best proposal available to the stockholders, the courts will question the independence and competency of the committee and likely require the board to establish entire fairness. Further, choosing a lower value without an adequate reason will likely fail both the fair dealing and fair price elements of the entire fairness test, leaving the entire board susceptible to personal liability.

86 See discussion infra Part V.G (discussing document preparation and retention).
90 See Paramount Comm’ns, Inc. v. QVC Network, Inc, 637 A.2d 34, 46 (Del., 1994).
V. MISCELLANEOUS ISSUES

A. Special Fees for Service by Committee Members

It is appropriate for special committee members to be compensated for their service on the committee. The board determines such compensation, and its determination is typically protected by the business judgment rule. However, “[c]ompensation of [s]pecial [c]ommittee members that is contingent, ambiguous or otherwise uncertain raises a triable issue of material fact as to what each member anticipated in the event the special committee approved the transaction and whether such anticipated reward was significant to the reasonable shareholder.”91 It is possible that a disproportionately large fee will compromise the independence of special committee members.

If the compensation of committee members is contingent upon the transaction being approved by the special committee, the court may rule that the committee’s independence has been compromised and the burden of proof under the entire fairness standard will not shift to the plaintiffs.92

B. Terms of Financial Advisory Agreement

The TCI court held that when the fairness opinion of the special committee’s financial advisor is given pursuant to a contingent fee arrangement, it “creates a serious issue of material fact, as to whether [that advisor] could provide independent advice to the special committee.”93 However, the Court of Chancery recently observed in In re Toys “R” Us Inc. Shareholder Litigation that contingent fee arrangements for advisers “ha[ve] been recognized as proper by [the] courts.”94

Contingency fees that positively correlate with the consideration payable in a transaction are an important way to align the incentives of advisors with those of the minority stockholders. In fact, a large majority of engagement letters contemplate payment of a high percentage of the aggregate fees upon the closing of a transaction and are structured to increase in amount as the consideration increases in amount. However, the courts may view an agreement in which all advisor compensation is contingent upon the completion of a transaction as compromising the independence of the financial advisor.

C. Interaction with Management

The deliberations of the special committee typically should remain confidential and committee members should avoid discussing those deliberations with interested parties. In order to ensure the confidentiality of its deliberations and strategies, the committee should use modes of communication separate from the corporation. For example, the Chancery Court

92 See id.
93 Id. at *41.
criticized the special committee’s use of the controlling stockholder’s secretary to transmit materials prepared for the committee by independent financial and legal advisors.  

It is also typically advisable that the notes kept by the committee’s counsel only be made available to the committee and even be kept from the corporation’s general counsel. Such notes may contain information concerning the strategies or deliberations of the committee, which, if revealed, could jeopardize the committee’s independence.

D. Waiver of Privilege

Communications between the special committee and its legal advisor are subject to the attorney-client privilege, and that privilege belongs to the committee as a group. In a stockholder suit involving an M&A transaction, the special committee may waive the privilege for these communications to provide the courts and, in turn, the plaintiffs complete access to the committee’s dealings. For example, the court may conclude that the special committee waived its privilege for discussions with its legal advisors by sharing the content of such discussions with the full board. Considering this possibility of a waiver, the committee’s counsel should exercise great care in preparing a record of its communications with the committee, remembering the risk of the court engaging in hindsight when analyzing the record.

E. Compliance by Full Board with Duty of Care

Delaware law requires that the full board approve many business combinations and related matters. When this is the case, the special committee will make its recommendation to the full board and the board as a body, even though a majority of its member may not be independent, must act to approve or disapprove the transaction. In order for the full board to fulfill its duty of care, it is advisable that the chairman of the committee describe to the board the committee’s analysis of the transaction and deliberations. The committee may present its recommendation either orally or in writing and should highlight the committee’s reasons supporting its conclusion.

F. Liability of Committee Members

Section 102(b)(7) of the DGCL provides that corporations may limit the personal liability of directors in certain circumstances. When the entire fairness standard is applied to a challenged conflict transaction, a director relying on section 102(b)(7) to avoid personal liability must show that any finding of liability against him is attributable solely to a violation of the duty of care, not a breach of the duty of loyalty or a failure to act in good faith.

Because members of a special committee should be independent of all parties interested in the transaction, they will generally be free of duty of loyalty and good faith concerns and thus

97 See, e.g., DEL. CODE ANN. tit. 8, §§ 151(mergers), 271 (asset sales), and 242 (charter amendments) (2005).
98 See Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1164 (Del. Ch. 2006).
avoid being personally liable to suing stockholders. However, like all directors, they still must take care not to violate those duties that might move them outside of the protections permitted by section 102(b)(7).

G. Applicability to Private Companies.

Although most of the case law involving special committees involves public corporations, the fiduciary framework governing change in control transactions and the appointment and conduct of special committees applies with equal force to privately held Delaware corporations.

H. Document Preparation and Retention

The frequency of litigation concerning M&A transactions justifies particular attention to the directors’ preparation and retention of memoranda, notes, emails, and other documents. Directors and special committee members occasionally communicate their ideas to one another through written memoranda and emails distributed before or after meetings. Many directors and committee members also find it necessary or desirable to use notes in their work. Further, in reviewing documents and drafts, most people make marginal notations. All such memoranda, emails, notes, and documents are subject to subpoena in litigation. Used as evidence months or even years after the fact, they may attain an unwarranted significance and can be extremely difficult (and, when used in depositions, time consuming) to address. As for notes, the problem is compounded because they are, by their very nature, brief and incomplete and may create a completely misleading impression of the writer’s thoughts.

Under certain circumstances, it is possible to protect written communications and notations from disclosure based on the attorney-client privilege, although, as discussed in section V.D. above, the special committee possesses the attorney-client privilege and often waives it. In any event, it is useful to consult with counsel before a memorandum is prepared and sent and to identify in handwritten notations those matters that are reflective of questions of, and the advice from, counsel.

With these considerations in mind, the following principles merit attention:

1. Directors should be careful about what they put in notes. Notes should be written with recognition that they may become litigation evidence. Glib or casual remarks should always be avoided.

2. Notes and documents containing notes should not normally be retained beyond the period of usefulness. If, for example, members of special committees use notes as reminders of issues to be raised in a meeting, the notes should normally be destroyed once the issues have been resolved. Notes and documents relating to the subject of a reasonably foreseeable lawsuit will be discoverable in that lawsuit and should not be destroyed. Of course, once documents have been subpoenaed, or subpoena of documents is imminent, those documents become potential evidence and may not be destroyed.
3. If the directors desire to retain a record of a particular matter, they or counsel should prepare an appropriate memorandum that it is complete and not misleading or confusing. Counsel should be contacted in advance to consider whether the memo may be prepared so as to protect it from disclosure on the basis of the attorney-client privilege.