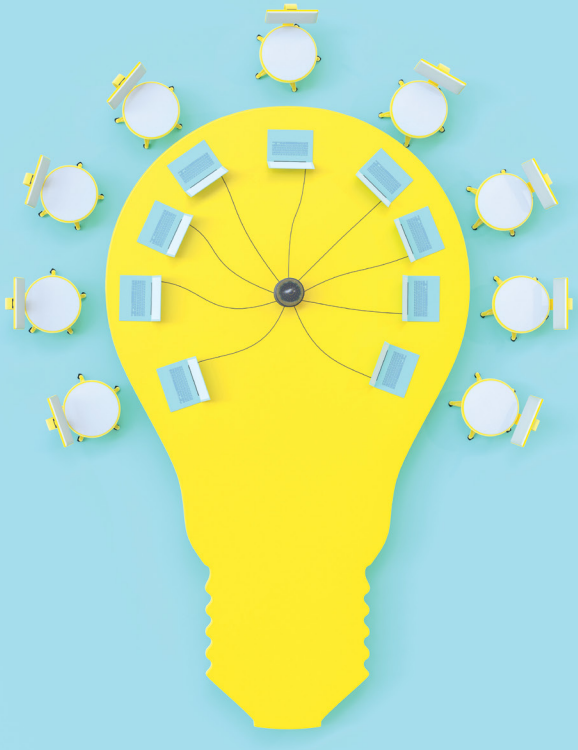

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# Forming a Special Committee to Evaluate a Controlling Shareholder Transaction

In his regular column, Frank Aquila drafts a memo to a board highlighting key considerations when forming a special committee to evaluate a potential transaction involving a company's controlling shareholder.

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**MEMORANDUM**

**TO:** The Board of Directors
**FROM:** Frank Aquila
**RE:** Considerations Regarding the Role of a Special Committee

As we have discussed, the Board has received a proposal regarding a potential going private transaction involving the Company's controlling shareholder. We have previously discussed that, under Delaware law, transactions with a controlling shareholder are subject to the heightened entire fairness standard, and not the more deferential business judgment rule, because the controlling shareholder may have a conflict of interest in relation to the company's public shareholders (whether because the controlling shareholder stands on both sides of the transaction such that they might act in their own self-interest instead of in the best interests of the company and its shareholders, or the controlling shareholder will receive different consideration from, or benefits to the detriment of, the other shareholders). The Board is now considering whether it should form a special committee to mitigate potential fiduciary duty concerns and minimize legal risks.

A board should establish a special committee if a majority of its directors have material conflicts of interest. However, in a going private transaction involving a controlling shareholder, even if a majority of directors are nominally independent and disinterested, the Board may wish to form a special committee to address the optics of any undue influence from the controlling shareholder. Having a special committee lead the process of evaluating and negotiating a controlling shareholder transaction can offer meaningful legal and practical benefits to a company and its shareholders, including ensuring that the interests of minority shareholders are protected.

When forming a special committee, it is essential for the Board to consider:

- The benefits of a special committee.
- Committee composition, including director independence.
- Advisors to the special committee.
- Guidelines for interactions between the special committee and potentially conflicted persons.

Search Making Good Use of Special Committees for more on the issues to consider when forming a special committee in connection with a transaction.

Search Going Private Transactions: Overview for more on going private transactions generally.

## 1. BENEFITS OF A SPECIAL COMMITTEE

Under the business judgment rule, directors are presumed to have acted in good faith, on an informed basis, and in the best interests of the company and its shareholders when making board decisions. This contrasts with the entire fairness standard, where defendants must prove the intrinsic fairness (with respect to both the process and price) of the transaction to shareholders. Delaware courts have traditionally applied the entire fairness standard to going private transactions with controlling shareholders, but the formation of a special committee may shift the standard of review to the more deferential business judgment rule. Specifically, Delaware courts have held that the business judgment rule applies in transactions with controlling shareholders if the transaction is conditioned on either:

- Approval by a special committee.
- A vote of the majority of the minority shareholders.

(*Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 642 (Del. 2014), overruled on other grounds by *Flood v. Synutra Int'l, Inc.*, 195 A.3d 754, 766 n.81 (Del. 2018)).

In addition to these two conditions, the Delaware Supreme Court held that in controlling shareholder transactions, the business judgment rule applies if:

- The special committee is entirely independent.
- The special committee has the power to freely select its own legal and financial advisors and to definitively reject the proposed transaction.
- The special committee fulfills its duty of care when negotiating a fair price.
- The minority's vote is informed.
- The minority's vote is not coerced.

(*M & F Worldwide*, 88 A.3d at 645.)

In a process where the company, the board, and the controlling shareholder have implemented these protections, Delaware courts have found that the controlling shareholder effectively relinquished control, allowing the negotiation and approval processes to more closely resemble those of an arm's length transaction where the interests of minority shareholders are protected (*M & F Worldwide*, 88 A.3d at 639, 644). The absence of any of these factors jeopardizes the applicability of the business judgment rule and increases legal risks for the Company, the Board, and the controlling shareholder. Therefore, when forming a special committee to evaluate a controlling shareholder transaction, the Board needs to be fully aware of the factors considered by Delaware courts to determine whether the business judgment rule or the entire fairness standard applies.

Search Fiduciary Duties of the Board of Directors for more on the standards of review that courts apply to directors' conduct.

Search Fiduciary Duties in M&A Transactions for more on the fiduciary duties of directors under Delaware law in the context of M&A transactions.

There are also practical benefits of forming a special committee that the Board should consider. Given the amount of work involved in negotiating a transaction, the special committee can increase efficiency and reduce demands on time and resources, allowing the rest of the board to focus on other matters. A special committee equipped with the right members and the mandate of obtaining the highest possible value for public shareholders can also create an effective negotiation dynamic that is geared towards a fair outcome.

At this stage, the Board should weigh the benefits of a special committee against the potential downsides (including delays related to committee formation and compensation expenses for committee members and their advisors). The decision to form a special committee in connection with the proposed transaction can also raise questions about the board's prior decisions. For example, formation of a special committee could signal to a court that a controlling shareholder was in fact conflicted, and that the resulting conflict had the capacity to taint the board's decision-making. Therefore, if the Board decides to form a special committee, it should determine whether it has approved any potentially conflicted transactions before the special committee's formation and, if so, consider whether to extend the special committee's mandate to reviewing and ratifying those prior approvals.

## 2. SPECIAL COMMITTEE COMPOSITION

Under Delaware law, a special committee provides a legal benefit when the special committee is properly formed and empowered to fulfill its duties. In particular, Delaware courts consider the composition of the special committee to be "of central importance" (*Gesoff v. IIC Industries, Inc.*, 902 A.2d 1130, 1145-46 (Del. Ch. 2006)).

As when vetting any potential director, a board appointing special committee members must determine whether a potential member will have the ability, time, and competency to fully engage with fellow committee members, negotiate with the controlling shareholder, and remain completely independent throughout the process. In the context of a controlling shareholder transaction, these assessments are even more critical because committee members will likely need to commit substantial time and effort to the evaluation and negotiation process, and any potential conflicts will be heavily scrutinized by the court.

### A. INDEPENDENT AND DISINTERESTED MEMBERS

Delaware courts closely examine special committee composition in controlling shareholder transactions. Key threshold issues in an analysis of committee composition are independence and disinterestedness. When selecting the members of the special committee, the Board should ensure that the committee members are independent from the controlling shareholder and disinterested with respect to the proposed controlling shareholder transaction.

A director who is dominated or controlled by an interested individual or entity will not be considered independent (see *In re MAXXAM, Inc.*, 659 A.2d 760, 773 (Del. Ch. 1995)). Directors are presumed to be independent, even when appointed by a controlling shareholder (*Aronson v. Lewis*, 473 A.2d at 816). To rebut this independence presumption, courts applying Delaware law require a party

to show that the director is so "beholden" to the controlling shareholder or other interested party or so under its influence that the director's "discretion would be sterilized" (*Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

The test for director independence in relation to a controlling shareholder is fact specific, and the Board should not automatically assume that a director who meets the general director independence tests under stock exchange rules would be independent in this context (for more information, search Director Independence Standards Chart on Practical Law). For example, a director may lack independence for purposes of a special committee analysis if they have sufficiently close relationships with the controlling shareholder. Courts look at a variety of relationships, from business relationships to personal and social interactions, in determining whether facts and circumstances exist that could make the candidate beholden to, or dominated and controlled by, the controlling shareholder so that the candidate cannot make an objective and impartial decision. Mere personal friendship or an outside business relationship, standing alone, is insufficient to raise a reasonable doubt about a director's independence, and Delaware courts have upheld the independence of directors in relation to a controlling shareholder where the directors and the controlling shareholder moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as friends (*Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1050-51 (Del. 2004)).

In contrast, Delaware courts have found that a director lacked independence where the director had a close, multi-decade friendship with an interested person, and the director's primary employment was as an executive of a company over which the interested person wielded substantial influence (*Delaware Cnty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015)). Courts have also focused on facts ranging from investment in a company founded by the interested person's spouse and the interested person's control of a director's largest client, to joint ownership of a private plane and charitable contributions to an organization in which a director has a significant role.

The assessment of whether a director is disinterested with respect to a potential transaction is also a fact and circumstances test. A director is interested if they have a material financial interest in the transaction that is not equally shared by the shareholders. The materiality of a financial benefit to a director is determined in the context of the director's personal financial circumstances. A director cannot be expected to impartially and objectively consider the transaction without being influenced by the personal consequences that may result from their decision. The fact that a potential committee member owns shares in a company or will remain on the board as a result of the potential transaction likely would not constitute an improper personal interest. However, the potential committee member may be unable to remain impartial or objective if there are significant personal consequences for them associated with the transaction (for example, where a director owns shares in a company and has a "compelling" or "idiosyncratic" need for liquidity or is given a long-term board seat guarantee (see *In re Crimson Exploration Inc. S'holder Litig.*, 2014 WL 5449419, at *19-20 (Del. Ch. Oct. 24, 2014); *C & J Energy Serv., Inc. v. City of Miami Gen. Emps' and Sanitation Emps' Ret. Trust*, 107 A.3d 1049, 1062 n.57 (Del. 2014))).

Given the importance of having an independent and disinterested special committee and the nuances involved in the analyses, a board should work together with legal advisors to develop a questionnaire for potential special committee members. The questions should screen for factors that courts have considered in their analyses, as well as any additional circumstances that are specific to the company, its business, the controlling shareholder, and the proposed transaction. Potential committee members should be encouraged to answer the questionnaires fully, and proactively consider whether their business, financial, and personal relationships could (actually or be perceived to) influence their decision-making. It is crucial for the Company to be aware of all of these facts before appointing committee members because even the perception of a conflict can be damaging to the controlling shareholder and special committee, the ultimate decision with respect to the proposed transaction, and potentially the reputation of the Board and the Company.

The Board should also consider the structure and amount of the committee members' compensation because compensation can impact director independence. Delaware courts generally have held that the receipt of customary directors' fees, standing alone, does not establish any disqualifying financial interest or jeopardize director independence. However, a director's independence may be questioned if their continued tenure as a director is determined by the interested person and the board compensation is material to that director. Legal or other advisors can help the Board understand the customary range of compensation for special committee members in the context of a controlling

shareholder transaction, and explore ways to structure payment (for example, a one-time lump sum payment or periodic payments that are capped or uncapped) to compensate directors for their time while minimizing the potential for actual or perceived conflicts.


Search Corporate Governance Practices: Commentary for more on director compensation generally.

### B. SIZE, CREDENTIALS, AND COMPETENCIES OF THE SPECIAL COMMITTEE

The Board must ensure that a special committee is able to fulfill its duty of care when negotiating a fair price in the controlling shareholder transaction. Therefore, the Board should consider certain other committee composition issues, such as committee size and director skills, in light of their legal and practical impact on the negotiation process.

In determining special committee size, the Board should balance the benefits of robust discussions among committee members with differing perspectives against the practical need to react quickly and nimbly to market conditions and negotiation dynamics. Delaware courts have held that a one-member special committee is problematic because the committee lacked competing viewpoints and was more likely to be susceptible to the controlling shareholder's influence (*Gesoff*, 902 A.2d at 1149).

It is typically a good idea to start with a special committee of at least three members, so that the special committee will have more than one member if a director subsequently is disqualified. There may be practical challenges with a committee larger than three members, such as a greater likelihood of scheduling conflicts and higher aggregate amount of committee compensation, as well as the up-front time investment needed to assess each director's independence and disinterestedness. In any case, the special committee's mandate should provide it with flexible quorum requirements and permit meetings by teleconference or video conference on short notice.

Delaware courts have not held that special committee members must possess certain educational or professional credentials to be able to fulfill the duty of care. However, because of the important role that the committee will play in guiding the Board and the Company, it is usually helpful to make sure that the committee, as a whole, has the relevant skill sets and experiences to quickly process key financial, legal, and other issues as they arise in the course of transaction negotiations.

## 3. SPECIAL COMMITTEE ADVISORS

A special committee must have adequate support from advisors so that it is well positioned to obtain the best deal for the company's shareholders, including minority shareholders. Under Delaware law, to maximize the legal benefits provided by a special committee, the committee must have the power to freely select its own legal and financial advisors and should have access to other types of support that a board would normally have in connection with an arm's length transaction.

In a controlling shareholder transaction, it is crucial to have an independent financial advisor assess whether the proposed transaction is fair to the company and its minority shareholders. To navigate the potential conflicts and other legal issues involved, the special committee should also have access to legal advisors who are free of material conflicts with the company and who will help the special committee implement proper protections around the deal process (including keeping records of committee deliberations). Both financial and legal advisors, especially those who have experience with special committee representation, will aid the special committee in anticipating the particular issues that tend to arise in a controlling shareholder transaction.

It may also be helpful for a special committee to engage its own public relations advisors to monitor market reactions and make sure that the committee speaks with a unified voice that is distinct from that of the company. Public relations advisors can assist the committee in managing its messaging and crafting a media and investor relations strategy as negotiations develop. If the company is in a specialized industry (for example, if there are regulatory or governmental implications or unique assets involved in the potential transaction), the special committee may also consider hiring experts to supplement the expertise of the special committee members and its other advisors.

Often, in the same resolutions that establish the special committee, boards include a relatively broad authorization for special committees to determine the selection process, engagement, and

compensation of their advisors. The special committee, and not company management, should screen and interview prospective advisors to determine their independence. It is important for a committee to thoroughly review all potential advisor proposals and conflicts disclosures before engaging an advisor. The fact that an advisor has provided some services to a company over which the controlling shareholder exerts meaningful influence may not jeopardize the advisor's independence or disinterestedness, but significant prior or ongoing commercial or financial connections may raise red flags.

Once a special committee has chosen a legal advisor, the legal advisor will typically assist the special committee in negotiating with the other advisors and screening potential advisors for conflicts. The committee should work with its legal advisor to develop questionnaires for assessing the independence and disinterestedness of the committee advisors. In addition, the special committee should update its conflicts analysis on an ongoing basis. For example, it is standard practice for a special committee to request financial advisors to provide a conflicts disclosure around the time that a fairness opinion is rendered, even if the committee has previously screened the financial advisor for conflicts. In some cases, it may make sense for the special committee to hire more than one financial advisor so that the special committee does not have to start over should a conflict arise later on with its original financial advisor.

## 4. GUIDELINES FOR INTERACTIONS WITH THE SPECIAL COMMITTEE

It is helpful to develop clear rules for interactions among the special committee and its advisors, on the one hand, and other parties, such as the controlling shareholder, company management, the board, other potentially conflicted persons, and advisors of those persons, on the other. To make sure that all relevant stakeholders are aware of rules regarding communications and contact to protect the special committee process, these rules should address interactions during the committee formation and advisor selection process, as well as afterwards as the committee and its advisors move forward with their work. For example, in a recent Delaware court decision, a special committee did not meet the requirements for business judgment deference where the committee's financial advisor spoke to the controlling shareholder prior to the official formation of the special committee and before the official hiring of the financial advisor by the special committee (see *Brown v. Empire Resorts, Inc.*, C.A. No. 2019-0908-KSJM (Del. Ch. Feb. 20, 2020)).

After the formation of a special committee, company management should refrain from discussing the proposed transaction with the public. As a general rule, all communications regarding the transaction should come from the special committee members, who should speak with one voice and only through coordinated communications with the media or the company's shareholders. Although it may be difficult, special committee members should also limit their communications with other directors (and vice versa), especially to the extent related to the proposed transaction, to reduce the risk of inadvertent disclosures, leaks, and perceived conflicts. Directors who are not on the special committee should not expect to receive notice of special committee meetings or any materials that are provided specifically to the special committee, and special committee members and their advisors should avoid including other board members in these communications.

The interactions between the special committee and company management also should be carefully managed and subject to clear guidelines. The committee and its advisors will need to rely on management for assistance with completing their financial analysis and any requisite due diligence. However, management should not develop any valuation analyses or financial projections without the special committee's prior approval. Management should also consult with the special committee before providing any confidential information to the controlling shareholder because there may be existing service arrangements between the controlling shareholder and the company that need to be preserved throughout the negotiations. Management must also keep confidential the information that is shared with the special committee about the company or the controlling shareholder and any knowledge of the special committee discussions to which management may be privy. Taking the time to set out clear rules at the outset, and revising these rules as negotiations advance, will ensure that expectations regarding the nuanced process of negotiating a controlling shareholder transaction are aligned throughout the Company.

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I look forward to discussing this at your convenience.

F.J.A. PL