MAKING GOOD USE OF SPECIAL COMMITTEES
Corporate boards evaluating potential transactions that are likely to attract scrutiny may want to consider forming a special committee of independent directors. Special committees provide objectivity in situations where a majority of directors of the company have an existing or potential conflict of interest in the transaction or matter.

So far in 2010 M&A activity has surged, in terms of both level and pace. Corporate boards have also had to consider a marked variety of transaction types this year, with numerous unsolicited bids, bidding wars and going private transactions hitting the headlines. Given the additional scrutiny and litigation that these situations attract, boards of directors need to understand when and how to form a special committee of independent directors.

A special committee is used to provide assurance that a corporate decision has not been coerced or unduly influenced by directors who have an existing or potential interest in a matter. A special committee is needed whenever the majority of the members of a board of directors has, or could appear to have, a conflict of interest in the transaction or matter at hand. An interested director is one who may appear to have a potential interest on both sides of the transaction or expects to derive a personal financial benefit from the transaction, as opposed to a benefit that exists for the company or all stockholders generally (see Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

This article, which focuses on special committees used in a transactional rather than a litigation context, explains:

- When to use a special committee.
- Considerations when forming a committee.
- Important criteria for the committee to properly conduct its functions.
- Issues relating to compensation of committee members.
**WHEN TO USE A SPECIAL COMMITTEE**

Special committees are often used in four categories of corporate situations:
- Going private or "freeze out" transactions where a controlling or significant stockholder wishes to eliminate the public minority.
- Leveraged buyouts in which management is participating with the group proposing the transaction and will have an interest in the surviving company.
- Certain other M&A transactions where an actual or potential conflict might exist.
- Stockholder derivative litigation.

In any of these situations, a special committee is not necessary if a majority of the board of directors is interested in the transaction and does not otherwise have a conflict of interest. In that case, the interested directors can simply recuse themselves from the deliberations and decisions regarding the proposed transaction. However, where a majority of directors on the board is interested, the board should delegate the power to review and negotiate the transaction to a special committee.

The need to establish a special committee is context specific and may change as the transaction evolves. Potential acquirers that start out as third-party bidders may become affiliated with management or management may respond to an unsolicited offer for the company by arranging a management buyout. Throughout the entire process, the board of directors must be alert to any potential conflicts and be prepared to establish a special committee when and if the circumstances require one.

**ADVANTAGES**

The formation of a special committee tends to reduce the criticism and litigation that naturally results from transactions in which the target’s entire board may not be viewed as disinterested and independent. By removing directors with an actual or perceived conflict of interest from the decision-making process, special committees provide comfort to the stockholders that the transaction that has been negotiated is fair.

In a transaction where a public minority is being squeezed out or senior management is interested in the transaction (an interested merger transaction), stockholder litigation and public scrutiny are likely. If an actual conflict of interest exists, Delaware courts will review the transaction under the exacting "entire fairness" standard (see Box, Entire Fairness Review). When confronting a transaction that would likely be subject to entire fairness review under Delaware law, a board of directors would be well advised to create a special committee of disinterested directors as early in the process as is feasible.

Special committees are also important in interested merger transactions because when they are properly formed and properly discharge their duties, the burden of proving that the transaction was entirely fair shifts to the plaintiffs. This means that instead of the majority stockholder and the board of directors being required to demonstrate the entire fairness of the negotiated transaction, the stockholder plaintiffs who are attacking the transaction must show that the transaction was not entirely fair (see Kahn v. Lynch Communications Systems, Inc., 638 A.2d 1110, 1117 (Del. 1994)). While not necessarily outcome determinative, shifting the burden back to the plaintiffs becomes important to successfully defending a judicial challenge.

**DISADVANTAGES**

While special committees are extremely useful in interested merger transactions, the creation of a special committee should still be approached with caution. The use of a special committee could potentially make a transaction more vulnerable to litigation. Because a court will generally review the actions of a disinterested board under the deferential standard of the business judgment rule, if a special committee is used in a transaction where the directors actually are truly independent, the existence of a special committee itself may cause the court to question the board’s independence and could expose the directors to a greater risk of litigation and liability.

The board of directors must also weigh the time and cost involved in using a special committee. If the board otherwise employs a proper process, a special committee will add a layer of complexity and could slow down the transaction. The board not only needs to consider the compensation of the committee itself, but also the cost of engaging independent financial and legal advisors in addition to the company’s own advisors (see below Independent Advisors). If the majority of a company’s board is independent, it is often better to allow the independent members of the board to act for the entire board rather than undertake the time and expense of creating a special committee.

**CONSIDERATIONS WHEN FORMING A COMMITTEE**

A properly formed and fully functioning special committee must be independent from the majority or
controlling stockholder (or the party that otherwise creates the potential conflict) and have a meaningful mandate. Not only must the special committee members be independent, but its legal and financial advisors must also be independent. The special committee should be formed with a clear understanding of its role as an independent, arms-length negotiator.

**INDEPENDENCE OF COMMITTEE MEMBERS**

The independence of the members of the special committee is of paramount importance because it is often the first thing that courts will scrutinize. To the extent possible, the special committee should be chosen by directors who are not personally interested in the transaction under consideration and each member of the committee should have no direct or indirect interest in the proponents of the transaction.

An independent director is one whose decision “is based on the corporate merits of the subject before the board rather than extraneous considerations or influence” (see *Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 733 A.2d 386, 407 (Del. Ch. 1999), citing *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984)). 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)). Factors that will generally disqualify a member of a special committee from being considered independent include:

- A current material financial or employment relationship with a controlling stockholder or its subsidiaries.
- Significant prior business dealings with a controlling stockholder.
- Personal or other relationships with a controlling stockholder that would demonstrate that the member is beholden to that stockholder.

Stock ownership in the company and the election of a director by a majority stockholder are not disqualifying factors. A director will also not be disqualified if he or she has a financial interest solely because he or she will be a director in the surviving corporation.

The Delaware courts have provided broad guidelines for the meaning of independence, but it often remains unclear whether a director’s relationship with an interested party rises to the level of a conflict. Beyond clear-cut cases of obviously interested or disinterested directors lies a gray area that has yet to be clarified by the Delaware courts. The New York Stock Exchange (NYSE) and NASDAQ Stock Market (NASDAQ) standards of director independence may provide additional guidance, but they do not correlate with the standard of independence under Delaware law. Therefore it is important to recognize that a director who is otherwise independent under the NYSE and NASDAQ standards may still not be considered independent for purposes of serving on a special committee.

Courts may regard the independence of a special committee differently depending on the purpose for which the special committee was formed. Delaware cases show that the independence requirements for special litigation committees, which have the authority to decide whether stockholder derivative claims should be pursued, settled or dismissed, are more stringent than the requirements for special committees created in the transactional context. This is because, in the context of stockholder derivative

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**ENTIRE FAIRNESS REVIEW**

Delaware case law holds that merger transactions (such as freeze-outs, management-led buyouts and other change-of-control transactions) where an actual conflict of interest exists are not entitled to the protections of the business judgment rule. Instead, the relevant actions will be reviewed under the “entire fairness” standard (see *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1115 (Del. 1994)).

The entire fairness standard applies when a majority of the board is personally interested in the transaction or lacks independence from the interested party (see *GPC XLI L.L.C. v. Loral Space & Communications Inc.*, 2008 WL 4293781 at *21 (Del. Ch. Sept. 19, 2008)). Entire fairness review requires a judicial determination on whether the transaction was entirely fair to stockholders (see *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)).

In analyzing the entire fairness of a transaction, Delaware courts will consider the two basic aspects of the transaction:

- **Fair dealing.** This focuses on process and “the actual conduct of corporate fiduciaries in effecting a transaction, such as its initiation, structure and negotiation.”

- **Fair price.** This requires that directors commit to obtaining the highest price reasonably available to the company’s stockholders under all the circumstances. (See *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989)).

The inquiry is not bifurcated; rather a court conducting an entire fairness review will examine the process aspect and the price aspect as a whole.

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litigation, a majority of the board of directors is always interested as defendants in the litigation.

However, even in the area of stockholder derivative litigation, the question of independence is not always clear cut. For example, in *In re Oracle Corp. Deriv. Litig.*, the Delaware Chancery Court found that the members of a special litigation committee lacked independence because of a variety of connections that both the special committee members and the directors under investigation had with the same university, emphasizing “the extraordinary importance and difficulty of such a committee’s responsibility” (see *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003) at 940). However, in *Beam v. Stewart*, the Delaware Supreme Court held that allegations of personal friendship or an outside business relationship with the directors under investigation, standing alone, did not raise reasonable doubt about the independence of members of the special litigation committee. As was emphasized in *Beam*, “independence is a fact-specific determination made in the context of a particular case” (see *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004)).

**INDEPENDENT ADVISORS**

A special committee will need independent financial and legal advisors to assist in evaluating the transaction at issue. The special committee should take an active role in choosing its advisors. It may receive suggestions from management on which advisors have sufficient expertise, but the special committee must make the final decision.

In choosing its advisors, the special committee should independently interview the advisors and determine whether or not the advisors have any interest that would cast doubt on their advice. Advisors who have previously acted for the company do not necessarily need to be excluded. However, if there has been a previous relationship with the company, the special committee should carefully consider that issue and document the decision to be in a position to refute any future claim that the advisor was not independent and disinterested.

In general, the special committee should retain advisors who have not had any significant previous relationship with a controlling stockholder or other party to the transaction. If the advisors who are chosen have a relationship with the interested party, the purpose of the special committee will be undermined and the special committee will not be effective in shifting the burden of proving entire fairness.

**THE COMMITTEE’S MANDATE**

A special committee should be empowered to act on behalf of the corporation independently of the interested directors or any controlling stockholder. The special committee should have a clear understanding of its role and should not be constrained by a narrow mandate. The critical attributes of a special committee, in addition to independent legal and financial advice, are:

- Access to all the information required to make an informed decision.
- Ability to forcefully and diligently negotiate on behalf of the company’s stockholders.
- Power to enforce a decision to reject the proposed transaction.

The action of the directors in forming the special committee should be reflected in the minutes, with a formal resolution describing the specific powers and purpose of the committee. While not necessary, in some situations the resolution constitutes a charter describing the powers, duties and procedures of the special committee. The record should demonstrate that the special committee is aware of its responsibilities and can meet them without being limited or constrained by the board of directors or management.

**SIZE OF THE COMMITTEE**

Under Delaware law, a committee of the board of directors may be composed of one or more directors, but as a practical matter a special committee should have at least three members. Courts have expressed significant skepticism about the ability of a special committee with fewer than three members (and especially a one-member special committee) to remain objective and properly exercise its responsibilities. In general, the fewer the members of a special committee there are, the greater the scrutiny. As the Delaware Supreme Court stated in *Kahn v. Tremont Corp.*, “[i]f a single member committee is to be used, the member should, like Caesar’s wife, be above reproach” (see *Kahn v. Tremont Corp.*, 694 A.2d 422, 430 (Del. 1997), citing *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985)).

Under certain circumstances, companies have added directors solely for the purpose of populating a
special committee. When a director is added for the purpose of serving as a special committee member, the new director should not be brought on for a limited term. The expectation should be that the new director will remain on the board beyond the term of the special committee.

**PROPER CONDUCT**

The special committee essentially has the same role as that of the board as a whole: to act with due care and loyalty to protect the interests of the company’s stockholders. Basically, the special committee functions as a proxy for a disinterested board in negotiations with a third party. In this regard, the special committee has the obligation not to merely pass judgment on the price and terms proposed by the other party to the transaction, but also to actively negotiate to achieve the highest price and the best possible terms for the company’s stockholders. In other words, the special committee must have real bargaining power sufficient to simulate an arms-length transaction.

To conduct its functions properly, committees should:

- Have access to all material information.
- Take an active role in negotiating the transaction.
- Have the ability to do a market check.
- Have the power to say no to the transaction.
- Obtain an independent fairness opinion.
- Consider obtaining approval by a majority-of-the-minority stockholders in a “freeze-out” transaction.
- Preserve a proper record of the proceedings.

**ACCESS TO INFORMATION**

To properly fulfill its responsibilities, the special committee must have access to all material information about the company and the transaction. The board resolutions creating the special committee and establishing its mandate should specifically state that the committee will have full access to all reasonably available information (see above The Committee’s Mandate).

**ACTIVE ROLE IN NEGOTIATION**

The special committee must also have the ability to negotiate the transaction when necessary. If management is actively involved in the transaction, such as a leveraged buyout in which management is participating, its role should be limited to providing information and general assistance to the special committee and the committee’s advisors.

However, if management does not have a meaningful interest in the transaction, such as in a merger with a non-controlling third party, management may take the lead in the negotiations. In any case, management’s involvement in the negotiations should be in close cooperation with, and under the supervision of, the special committee.

**ABILITY TO DO A MARKET CHECK**

A post-signing market check, or a go-shop provision, is useful in transactions that are likely to attract conflict of interest allegations. A go-shop allows the target company to actively seek other buyers for a period of time after the transaction has been announced. Under certain circumstances a go-shop is more indicative of a fair transaction than a fiduciary out. A fiduciary out would only enable a target company to accept a competing offer if, in the opinion of the target’s board, the competing offer was superior.

Frequently, in M&A transactions, a third party will propose entering into the acquisition agreement before the board of directors of the target company has had the opportunity to reasonably determine that the transaction is at the best price obtainable for the stockholders. In that situation, to enable the board of directors of the target company to properly discharge its duty (whether it is the full board or a special committee) the agreement should provide for the target to do a meaningful post-signing market check.

In deals where concerns about procedural fairness outweigh the benefits of locking up the deal, unless a company has done a full market check before entering into an agreement, a go-shop provision would support the argument that the transaction was entirely fair.

**POWER TO SAY NO**

The special committee should also have a real ability to “just say no” to a transaction if the committee determines that it is not in the best interest of the company’s stockholders. Where a special committee has been formed to consider a takeover bid, the resolution that establishes the special committee should give the committee the power to say no to the transaction and adopt takeover defenses to protect the company from an unsolicited bid (see above The Committee’s Mandate). Otherwise, the special committee cannot properly meet its obligation to achieve the best possible result for the stockholders of the company.

If the special committee, after careful consideration and with advice from advisors, determines that the
company should reject a hostile takeover bid, the special committee should have the power to:

- Adopt a stockholder rights plan (poison pill).
- Refuse to redeem a poison pill.
- Take other measures within the limits of its fiduciary duties.

INDEPENDENT FAIRNESS OPINION
As part of the process of evaluating the proposed transaction, the special committee should obtain a fairness opinion from its independent financial advisor if it is approving a transaction. The committee should be satisfied by the scope of the financial advisor’s investigation and the procedures followed by the financial advisor in reaching the fairness opinion.

MAJORITY-OF-THE-MINORITY APPROVAL
In a “freeze-out” transaction (for example, a going private transaction), the special committee often proposes, in addition to the fairness opinion, that the transaction be approved by a majority-of-the-minority stockholders to support the fair process prong of entire fairness review. A majority-of-the-minority condition may also be used in lieu of a special committee to shift the burden of proving entire fairness to the plaintiffs under Delaware law. However, it is still advantageous for the board to have a special committee because, if there is no special committee, the court will be more likely to carefully examine whether full disclosure has been made in obtaining the vote of the minority stockholders.

As a practical matter, it is useful to have a special committee with an independent financial advisor to assure that the disclosure obligation has been satisfied. In addition, many buyers will argue against including a majority-of-the-minority condition in the purchase agreement because of the risk that activist hedge funds will then have the ability to block approval of the transaction and thereby have the power to negotiate a higher price.

PREVENT A PROPER RECORD
In reviewing the actions of a special committee, a court will thoroughly examine the record of the proceedings of the special committee. It is critical to keep careful minutes of meetings and to preserve the documents submitted by advisors. As with any action by a board of directors, the special committee should be meticulous in creating a record that demonstrates active participation by all the members in the special committee’s activities and informed, deliberate and careful review of the issues. It is particularly helpful if the record created by the special committee reflects price increases and improvements in other material terms of the transaction.

Delaware courts are cognizant of the fact that no process, no matter how well thought out, is perfect. If the overall process is carried out in good faith by independent directors with an understanding of their duties and who are properly advised by independent advisors, individual flaws in the process should not impact the outcome.

COMPENSATION
Deciding how to compensate the members of the special committee can be complicated. The members of a special committee can be compensated under a flat fee arrangement, a per-meeting fee arrangement or a combination of both. It is important that the fee be fixed in advance and not be dependent on the outcome of the proposed transaction. Compensation of special committee members that is contingent, ambiguous or otherwise uncertain may call into question the committee members’ independence.

Further, financial advisors should not receive compensation that is contingent on the outcome of a particular transaction. Excessive compensation (of either the special committee members or the independent financial advisors) that would cast doubt on independence should be avoided.

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