

Linchpins Of A Successful Special Committee

Law360, New York (October 22, 2012, 1:59 PM ET) -- Special committees are being used today more than ever before. In the corporate transaction context, this is largely due to the increased number of transactions involving significant conflicts such as take-privates and controlling stockholder and management buyouts resulting, in part, from the growing prominence of private equity firms in the mergers and acquisition market.

Special committees are also playing an increasingly important role in investigating and addressing allegations of illegal or otherwise improper conduct within a company. This is largely attributable to the corporate scandals of the early 2000s and the resulting emphasis on the obligations of boards of directors to oversee management and assume control over major issues in their organizations.

There are substantial benefits to employing a properly authorized and functioning special committee. Correspondingly, defects in the authorization and functioning of a special committee will invite criticism and even attack from those scrutinizing the committee's work, such as stockholders threatening suit or enforcement agencies interested in the subject of the committee's work.

An essential element of a properly functioning special committee is that its members be independent and disinterested. This article explores the critical concepts of "independence" and "disinterestedness" as they relate to special committees, and the standards applied by the Delaware courts to determine the suitability of directors to serve on special committees.

Conflict Transactions

Special committees are used to objectively evaluate proposed transactions involving a material conflict between the interests of the company and all of its stockholders on the one hand, and the interests of members of the board of directors or a controlling stockholder on the other.

While conflict transactions come in many forms, a classic example is a controlling stockholder seeking to effect either a cash-out merger of the minority stockholders, or a sale to a third party in which the controlling stockholder receives consideration different in form or per share amount than that which other stockholders receive.

Conflict transactions also include transactions in which a majority (or significant number) of the directors have a conflict of interest with the company, such as a management buyout in which members of senior management also sit on the board, or a sale of assets or a financing transaction with an entity affiliated with one or more directors.

In these situations, the role of the special committee is to ensure that the unaffiliated stockholders are treated fairly. In practice, this requires the committee to actively and aggressively protect those interests, including where appropriate, to engage in arm's-length, independent and sometimes adversarial negotiations with the controlling stockholders or management team, to seek competing offers, or to walk away from the deal completely.

A properly authorized and functioning special committee in the context of a conflict transaction can provide valuable protection against potential legal challenges to the transaction in three ways. First, it may confer the protections of the business judgment rule upon a transaction otherwise subject to the more exacting entire fairness standard of review.

Secondly, it may shift the burden of proof in litigation challenging a transaction subject to entire fairness review from defendant to plaintiff. Finally, it may assist in demonstrating that a challenged transaction satisfies Delaware's entire fairness standard. Conflict transactions are often subject to legal challenge, particularly those involving the sale of a public company, and obtaining these protections is often outcome-determinative.

Investigating and Addressing Misconduct

In the post-Enron, Sarbanes-Oxley era, special committees have become an important and commonly used governance tool to investigate and address allegations or evidence of serious misconduct within a company. As with conflict transactions, the primary purpose of special committees in this context is to insert an objective investigative and decision-making process into the governance structure where the usual "decider," either the full board or one of its regular committees, is conflicted.

While investigative special committees can be (and are) utilized to address virtually any significant matter arising within a company that warrants board attention, such matters typically involve allegations of accounting or financial statement irregularities, or violations of law such as the Foreign Corrupt Practices Act.

The triggering event for forming an investigative special committee varies widely. It may result from the internal identification of a potential problem by an employee whistleblower or the internal audit function or from an external inquiry from the U.S. Securities and Exchange Commission, Financial Industry Regulatory Authority or the U.S. Department of Justice.

Special committee investigations may also arise from stockholder claims against the company, management and/or board. In many jurisdictions, stockholders seeking to bring derivative litigation on behalf of the company must first demand that the board take action to address the alleged wrongdoing. Often, in the face of such demand, a special committee will conduct an internal investigation into the stockholders' claims.

If the special committee's findings are such that the board determines that it is not in the company's interest to pursue the stockholders' claims, the stockholders can file a derivative action. The court's assessment of the composition of the special committee and the manner in which it performs the investigation will determine whether or not it allows the stockholders' action to proceed.

The primary benefit of investigating alleged wrongdoing through a special committee is that, under most circumstances, it enhances the company's ability to control a potentially problematic situation. In the case of a purely internal matter, it allows the company to gain an understanding of the nature and breadth of the problem, develop a remediation plan, and prepare and plan for any potential legal, public relations or political fallout. In cases where the potential mistake or misconduct has become public or has been reported to the government, an internal investigation — if deemed objective and thorough — may avoid or mitigate the obtrusiveness of an investigation conducted by the government.

To obtain the foregoing benefits of employing a special committee, both the composition and functioning of the committee are critical. Members of the committee must be willing to act independently and in an informed and diligent manner. The special committee must be empowered to veto the transaction proposed by a controlling stockholder or the interested directors or to take remedial action against those it finds have engaged in misconduct. The committee also should be given the resources necessary to retain independent financial and legal advisors. Most importantly, members of the special committee must be independent and disinterested.

Assessing the Independence and Disinterestedness of a Special Committee Member

The legal requirement of “independence” appears in various places and is defined in multiple ways. For example, the SEC, the New York Stock Exchange and the Nasdaq Stock Market provide standards of director independence. These standards may provide some guidance in assessing the independence of a special committee member, but they do not necessarily correlate with the standards of independence under Delaware law.

The general principles are easily stated and have their genesis in the business judgment rule. To benefit from the business judgment rule in court, a director serving on a special committee must be both independent and disinterested. *Maldonado v. Flynn*, 413 A.2d 1251, 1255–56 (Del. Ch. 1980).

Whether a director is independent and disinterested “turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind.” In re *Oracle Corp. Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003). “Independence is a fact-specific determination made in the context of a particular case.” *Beam v. Stewart*, 845 A.2d 1040, 1049 (Del. 2004).

While some courts have analyzed these elements separately, with “disinterested” referring to a personal stake in the matter and “independence” referring to other relationships or factors that could cloud objectivity, for most analyses these elements do not require separate treatment and can be conflated into the singular concept of “independence.”

So how do you determine whether a proposed special committee member will qualify as “independent” and “disinterested”? While the assessment is fact-based and case specific, certain principles have emerged from Delaware case law.

Conflicting Fiduciary Duties

An individual owing a fiduciary duty to more than one party to a transaction — such as a director sitting on the board of both parties or a person who is a member of the board of one party and an executive of the other party — is unable to act in the best interests of both parties, and thus is neither independent nor disinterested.

Personal Financial Stake

A director should not be disqualified from serving on a special committee simply because he has a significant equity interest in the company, because such interest aligns the interests of the director with those of its stockholders. However, a director with a significant personal financial stake in the subject of the special committee's work (beyond the stake that any stockholder has) should not serve on the special committee.

For example, a director of company A who is a significant stockholder of company B proposed to be acquired by company A should not serve on the special committee assessing the transaction. Likewise, a director who is also an officer of the company may not be independent for purposes of a special committee charged with considering a transaction that may result in the termination of such person's employment by the company.

Similarly, a director with a consulting relationship with the company may not be independent for purposes of a special committee charged with considering a transaction that may result in the termination of the consulting relationship, depending on the significance of the consulting fees and the relationship of those fees to the director's net worth and income.

Role in the Subject Matter

A personal role in the subject matter of the special committee's assignment disqualifies the candidate. For example, a special committee investigating corporate misconduct in connection with the payment of questionable fees should not include a director whose firm received some of the fees in question. Likewise, CEOs and CFOs who are also directors typically should not serve on special committees investigating financial statement irregularities.

Personal Relationships

It is common for board members to have personal relationships with other directors and members of management and courts do not disqualify directors from serving on special committees just because they are a colleague, social acquaintance or even personal friend of someone who is the subject of the special committee assignment. However, significant or extensive personal relationships with potential targets of the special committee's work often are a disqualifying factor.

For example, courts have found that a director was not sufficiently independent when (1) a cousin of his wife was a likely target of the special committee's investigation; (2) the committee was investigating the conduct of a fellow professor who was a substantial benefactor of the university at which the director taught; or (3) he had a close personal friendship of long standing with an individual under investigation.

Multiple Financial, Business and/or Personal Ties

The eligibility of a director to serve on a special committee generally is not determined by any one of the above factors but rather is based on a combination of those factors. A director with several financial, business or personal ties to the subject of the special committee's review likely will not pass a court's independence scrutiny.

For example, the Delaware courts have questioned a special committee's objectivity because members not only stood to gain financially by approving the transaction at issue, but were also business school classmates, close friends and/or had business ties to the counterparty's founder. Similarly, a director was deemed to lack independence due to the combination of a lifelong friendship with the subject of the investigation (the CEO), employment by the company of the director's son, and a financial interest in some of the CEO's alleged wrongdoing (option repricing).

It is important to note that the application of the independence factors will vary by the context of the special committee's assignment. When the special committee is charged with investigating the conduct of individuals, courts tend to place more emphasis on the relationships between individuals, examining business entanglements and social relationships closely. Likewise, when the task is to address a stockholder's demand, a decision to dismiss the litigation will often prompt the judge to consider even casual social and business relationships of the special committee members.

Regardless of context, questions of committee membership and independence ultimately must focus on the ability of the director to act objectively and in the best interest of the company and all its stockholders in carrying out the special committee's assignment.

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