haynesboone
Setting precedent.

THE INS AND OUTS OF PROPERLY ORGANIZING AND OPERATING SPECIAL INDEPENDENT BOARD COMMITTEES

Prepared by

Michael M. Boone

and

W. Scott Wallace

Haynes and Boone, LLP

February 8, 2008

29th Annual Conference on
Securities Regulation and Business Law Problems
Dallas, Texas

Sponsored by the University of Texas School of Law,
the Securities and Exchange Commission
and the Texas State Securities Commission

© 2008 Haynes and Boone, LLP

haynesboone
Setting precedent.

TABLE OF CONTENTS

Page

1. **INTRODUCTION** 1
  - 1.1 General Use Of Board Committees 1
  - 1.2 Use Of Standing Independent Board Committees In Complying With Post-Enron Regulatory Reforms 1
  - 1.3 Use Of Special Independent Board Committees In Addressing Conflicts Of Interest 1
  - 1.4 Purpose Of Outline 2
2. **SPECIAL NEGOTIATION COMMITTEES** 2
  - 2.1 Background 2
  - 2.2 Conflict Of Interest Transactions That Trigger The Use Of An SNC 2
    - A. Interested Transactions Involving A Majority Of The Directors 3
      - (1) Allocation Of Consideration Between Competing Classes Of Stock 3
      - (2) Squeeze Out Merger Of Minority Shareholders 3
      - (3) Repurchase of Stock 3
    - B. Interested Transactions Where A Conflicted Director Dominates A Majority Of The Directors 4
    - C. Interested Transactions Involving A Controlling Shareholder 4
      - (1) Sale of Assets Transactions 4
      - (2) Merger Transactions 4
      - (3) Recapitalization Transactions 4
  - 2.3 Judicial Standard Applied In Reviewing Interested Transactions 5
    - A. Deferential Business Judgment Rule 5
      - (1) Duty Of Care 5
      - (2) Process Rule 5
      - (3) Limited Applicability Of BJR To Conflict Of Interest Transactions 6
    - B. Stringent Entire Fairness Standard 6
      - (1) Duty Of Loyalty 6
      - (2) Application Of The Entire Fairness Standard To Interested Transactions6

2.4 Two Prongs Of Entire Fairness Standard 7
- A. Fair Price 7
  - (1) Fairness As Between Different Classes Of Stock 7
  - (2) Economic Factors Behind Fair Price 8
- B. Fair Dealing 8
  - (1) Timing Of Interested Transaction 8
  - (2) Initiation Of Transaction 9

2.5 Legal Reasons For Using an SNC 9
- A. SNCs Demonstrate Fair Dealing 9
- B. SNCs Shift The Burden Of Proof To The Plaintiff 9

2.6 Legitimate SNC Process 10
- A. Caveat 10
- B. Critical Evidentiary Factors In Determining Whether There Was A Legitimate SNC Process 10

2.7 What Is And What Is Not A Properly Organized SNC 10
- A. Committee Mandate 10
  - (1) Be Clear About The Mandate 10
  - (2) Be Clear That The SNC Has The Unbridled Power To Determine The Fate Of The Transaction 10
  - (3) Be Clear That The SNC Has The Full Authority To Select Its Own Advisors 11
  - (4) Be Clear About The SNC's Compensation 11
- B. Committee Composition 11
  - (1) Director-By-Director Analysis 11
  - (2) Independence 12
  - (3) Interested 12
  - (4) Materiality 12
  - (4) Delaware Decisions On The Meaning Of Independent And Interested 12
  - (5) Appointment Of Additional Directors 14
  - (6) Propriety Of A One-Person Committee 14

C. Committee Advisors 15
(1) Qualified And Knowledgeable 15
(2) Independent And Disinterested 15
(3) Selected By SNC 15
2.8 What Is And What Is Not A Properly Functioning SNC 16
A. Absence Of Undue Influence By Interested Parties 16
(1) Threats/Coercive Tactics 16
(2) Involvement In SNC Decision Making 17
B. Arms Length Negotiations Conducted By Committee 17
(1) Real Negotiations 17
(2) Real Bargaining Power 18
(3) Confidentiality Of Committee Meetings 19
C. Fully Informed Committee And Advisors 19
2.9 Advising Fiduciaries In Making The SNC Process Count 19
A. First Things First – Educate The Interested Parties 20
(1) Legal Aspects 20
(2) What To Expect 20
B. Start The SNC Process Right With A Clear Mandate From The Board 20
C. Start The First SNC Meeting By Educating The SNC Members 21
(1) Legal Aspects 21
(2) What To Expect 21
(3) Operating Protocol 21
(4) Selection Of Advisors 21
D. Maintain An Evidentiary Record That Reflects A Proper SNC Process 21
3. SPECIAL LITIGATION COMMITTEES 22
3.1 Shareholder Derivative Litigation 22
3.2 Use Of Special Litigation Committees 22
A. SLC Under Texas Law 22
(1) SLC Right To Dispose Of Derivative Claims 22
(2) Disinterested Director Definition 22
(3) Independent Director Definition 23

B. SLC Under Delaware Law 23
(1) SLC Right To Dispose Of Derivative Claims 23
(2) Zapata Case 24
4. SPECIAL INVESTIGATION COMMITTEES 24
4.1 Overview 24
4.2 Director's Fiduciary Duty To Prevent Corporate Wrongdoing 24
A. *Graham* Case (1963) – "Red Flag" Warning Standard 25
B. *Caremark* Case (1996) – Affirmative Duty To Monitor 25
C. *Stone* Case (2006) – Delaware Supreme Court Affirms *Caremark* 26
4.3 Making Special Internal Investigations Count 27
A. Establish The SIC 27
B. Build Credibility For The SIC 27
C. Address Sensitive Issues 27
D. Prepare The SIC Report 28
5. CONCLUSION 28

1. INTRODUCTION

1.1. <u>General Use Of Board Committees</u> Under state corporation law, the board of directors is given the responsibility of directing and overseeing the management of the corporation. In carrying out its responsibilities, a board will often work through committees especially with respect to ongoing tasks that need special board expertise and attention. Some board responsibilities are best overseen by an appropriate committee of directors rather than by the whole board. State corporation laws (e.g., Section 141(e) of the Delaware General Corporate Laws and Articles 2.36 and 2.41D of the Texas Business Corporation Act ("TBCA")) have long *enabled* directors to the use committees. Of course, the manner in which a board relies on a committee must comport with their fiduciary duties of care and loyalty.

1.2. <u>Use Of Standing Independent Board Committees In Complying With Post-Enron Federal Regulatory Reforms</u> While the internal affairs of corporations have historically been exclusively within the purview of state corporation laws, it is the Sarbanes-Oxley federal regulatory scheme (adopted in 2002 in the aftermath of major corporate scandals) that actually *requires* the use of standing board committees. After completing its investigations into the Enron and other corporate debacles, the United States Congress concluded that the blatant failure of many corporate boards to detect and deter corporate wrongdoing was attributable in large measure to major weaknesses in the American system of corporate governance. With the objective of rectifying these perceived weaknesses, the federal regulators adopted several reforms which prescribe specific governance oversight responsibilities to independent directors.

At the core of these regulatory reforms is the requirement of the New York Stock Exchange, the Nasdaq Stock Market Inc. and other exchanges that listed public companies maintain the following standing board committees: (1) the Audit Committee which is tasked with overseeing the financial reporting and disclosure functions of the company, (2) the Nominating and Governance Committee which is tasked with overseeing the corporate governance practices of the company (including the structure and operation of the board and the election of directors) and (3) the Compensation Committee which is tasked with overseeing the compensation practices of the company. Importantly, each such committee is required to be composed solely of independent directors. The use of such "standing" board committees of independent directors has now become a fundamental part of the corporate governance landscape in America.

Standing committees, like the three noted above, typically derive their duties and authority from a formal written charter approved by the board of directors. The duties stipulated in such charters can be significant as evidenced by the fact that many committees utilize a checklist to help make sure they comply with their charter responsibilities.

1.3. <u>Use Of Special Independent Board Committees In Addressing Conflicts Of Interest</u>. As contrasted to standing committees, corporate boards also establish, on an ad hoc basis, special independent board committees to address *conflicts of interest*

© 2008 Haynes and Boone, LLP

that arise between the corporation on the one hand and the board of directors, controlling shareholders, management and other fiduciaries on the other hand. As discussed more fully below, these special independent board committees generally fall into three separate categories:

(i) the special negotiation committee ("SNC") that is charged with the responsibility of considering and negotiating a proposed transaction involving a conflict of interest between (x) the company and (y) its directors, controlling shareholders or other fiduciaries,

(ii) the special litigation committee ("SLC") that is charged with the responsibility of deciding whether or not shareholder derivative litigation claims should be pursued, and

(iii) the special investigation committee ("SIC") that is charged with investigating and determining an appropriate response for alleged internal corporate wrongdoing.

Unlike a standing committee, the special independent board committees described above do not usually operate under a formal written charter since their assigned tasks are usually concerned with a single issue that is not on-going in nature. Instead, the committee's responsibilities and authority are established pursuant to board resolutions that lay out who will be the members and what the committee's resources, duties and powers will be.

1.4. Purpose Of Outline. The purpose of this outline is to examine the key legal issues (especially the legal dos and don'ts) concerning the use of the special independent committees described above. Because most large public companies are incorporated under Delaware corporation law and because the courts in other states typically look to Delaware case law as a guide in the development of their own corporate jurisprudence, this outline considers Delaware corporation law (and to a much lesser degree, Texas corporation law) with respect to how to properly organize and use of special independent board committees.

2. SPECIAL NEGOTIATION COMMITTEES.

2.1. Background. The function of a special negotiation committee is to independently consider and negotiate on behalf of the company, in a manner that satisfies the "entire fairness standard" discussed below, a transaction in which corporate fiduciaries have a conflict of interest. With a proper SNC, directors put themselves in the best position for defending their approval of a conflict of interest transaction if they are subsequently challenged by plaintiff-shareholders.

2.2. Conflict Of Interest Transactions That Trigger The Use Of An SNC. As discussed more fully below, the need for an SNC is triggered when, in connection with the approval of a company transaction, (i) a *majority of the board of directors* has a conflict of interest with respect to such transaction (e.g., *Paramount Communications, Inc. v. QVC Network, Inc*., 637 A 2d 34, 42 N.9 (Del. 1994), (ii) a *minority of the board of directors* (who has a conflict of interest with respect to such

transaction) *controls or dominates* a majority of the board (e.g., *Cinerama Inc. v. Technicolor Inc*., 663 A 2d 1156, 1168 (Del. 1995) or (iii) such transaction involves a *merger* of the company with *a controlling shareholder* (e.g., *Kahn v. Lynch Communications, Inc*., 638 A 2d 1110 (Del. 1994). These three categories of conflict of interest transactions are sometimes referred to in this outline as "*interested transactions*" and the persons who have the related conflicts of interest with the company are referred to as "*interested parties*." Below are specific examples of interested transactions that precipitate the use of an SNC.

A. Interested Transactions Where A Majority Of The Directors Are Conflicted. An interested transaction exists when a majority of the directors stand "on both sides of a transaction." *Weinberger v. UOP Inc.*, 457 A2d 701 (Del. 1983). See the additional discussion of director conflicts in Section 2.7B below.

(1) Allocation Of Consideration Between Competing Classes Of Stock

- A majority of the directors were conflicted in approving the allocation of merger consideration between two classes of stock since their ownership interests were primarily in one class. Their interests significantly diverged from the interests of other shareholders. *In re FLS Holdings Inc S'holders*, 1993 WL 104562 at 5 (Del. Ch. April 21, 1993).

- A majority of the directors were conflicted in approving the allocation of merger consideration between two classes of stock when they owned significantly more shares of one class of stock. That class received a 10% premium over what the other class of stock received. *In re Tele-Communications Inc. S'holders Litig.*, C.A. No 16470 Del. Ch. (January 10, 2006).

- Due to their substantial economic interest in one class of stock, a majority of the directors were conflicted in deciding the allocation of funds between two competing classes of stock pursuant to a plan of recapitalization. *Levco Alternative Fund Ltd. v. Readers Digest Ass'n., Inc.* 2002 WL 1859064, at 1 (Del. 2002).

(2) Squeeze Out Merger Of Minority Shareholders

- A majority of the directors (who approved a cash-out merger for the purpose of reconstituting the company as a sub-chapter S corporation through a reduction in the number of shareholders from 300 to 75) were deemed to be conflicted since, as continuing shareholders after the merger, they stood to personally benefit by approving a low cash-out price for the squeezed-out shareholders. *In re PNB Holding Co. S'holder. Litig.*, 2006 WL 2403999 (Del. Ch. August 18, 2006).

(3) Repurchases of Stock.

- Due to their ownership of 89% of the company's outstanding options and warrants, a majority of the directors were conflicted parties when they

decided to include options and warrants in the company's stock repurchase program. This decision enabled them "to claim a larger percentage of the repurchase proceeds." *Feldman v. Cuatia*, C.A. No. 1656, Del. Ch. (April 5, 2006).

B. Interested Transactions Where One Or More Conflicted Directors Dominates A Majority Of The Directors.

- A majority of the directors approved a consulting contract with an entity controlled by a fellow director, Mr. Edleman**.** On a motion to dismiss, the court concluded that there was evidence that such directors were dominated by Edleman through his control of certain business entities in which they were investors. *Heinman v. Datapoint Corp*., 611 A 2d 950, 955 (Del. 1992).

- A management group dominated the board of directors in connection with an auction of the company notwithstanding the fact that the members of the management group were participants with one of the bidders and thus, had a conflicting interest in handling the auction process. *Mills Acquisition Co. v. McMillian Inc*., 559 A 2d 1261, 1279 (Del. 1989).

C. Interested Transactions Involving A Controlling Shareholder. As interested transaction arises when a controlling shareholder (e.g., parent corporation), by virtue of its domination of a controlled corporation, causes the controlled entity to act in such a way that the controlling shareholder receives something to the exclusion of, and to the detriment of, the minority shareholders. *Sinclair Oil Corp v. Levien* 280 A2d 717, 720 (Del. Sup Ct. 1921). See *In re Cysive Inc.* 836 A 2d 531 (Del. Ch. 2003) for a thorough discussion of the key issues considered by courts in deciding whether a person is a controlling shareholder.

(1) Sale of Assets Transactions

- A controlling shareholder caused a controlled company to purchase assets (stock in an affiliated company) from one of his other controlled companies. *Kahn v. Tremont*, 694 A 2d 422 (Del. 1997).

(2) Merger Transactions

- A merger transaction with a controlling shareholder involves "inherent coercion." *Kahn v. Lynch Communications, Inc.,* 638 A 2d 1110 (Del. 1994).

(3) Recapitalization Transactions.

- Controlling shareholder used the company's redemption of the preferred stock owned by it at an excessive price when the company was not then obligated to redeem such stock. *In re Primedia Inc. Derivative Litig.*, C.A. No. 1808-N (Del. Ch. November 15, 2006).

Point to Remember: The entire fairness standard is not triggered simply by reason of the fact that a controlling shareholder has in some manner set the terms of a transaction. Instead, there must also be a showing that the controlling fiduciary has an interest in the transaction that conflicts with the interests of the company and its minority shareholders. *Jedwab v. MGM Grand Hotels, Inc.*, 509 A 2d 584, 594 (Del. Ch. 1986). By way of illustration, the court in *In re Orman v. Cullman*, 794 A 2d 5 (Del. Ch. 2002) held that a controlling shareholder who sold a portion of his equity ownership to a third party while maintaining a controlling interest in the resulting corporation was sufficiently unconflicted to permit the application of the business judgment rule rather than the entire fairness standard. On the other hand, in *In re LNR Property Corporation S'holder Litig.*, C.A. No. 674-N, Del. Ch. (November 4, 2005), the court concluded that the plaintiff's pleadings supported a reasonable inference that the controlling shareholder (who negotiated the merger) was sufficiently conflicted by reason of his arrangement with the purchaser to acquire a 20% stake in the resulting company.

Point to Remember: Not all large shareholders are deemed to be controlling shareholders. See *In re Cysive Inc. S'holder Litig.*, 836 A 2d 531 (Del. Ch. 2003).

2.3. Judicial Standard Applied In Reviewing Interested Transactions. A critical procedural question in litigation challenging a board's approval of an interested transaction is what judicial standard of review should be applied by the court in evaluating the conduct of the defendant-directors from a culpability standpoint. Below is a brief analysis of the two judicial standards of review that come into play in cases challenging interested transactions:

A. Deferential Business Judgment Rule.

(1) Duty Of Care. The duty of care requires that directors exercise due care as (i) in *making business decisions* (which would include approving an interested transaction) and (ii) in carrying out their *oversight responsibilities*. The judicial standard of review applied in cases alleging a breach of the duty of care in connection with a *board decision* is known as the business judgment rule ("BJR"). The BJR presumes that the directors' approval of an action was made in good faith, on a fully informed basis and with the honest belief that it was made in the best interests of the company. The BJR reflects the long-standing judicial policy that courts should defer to the business judgment of boards rather than substitute their own business judgment. *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984). This standard of review serves to *favorably* insulate directors against liability for duty of care claims arising out of their *decision making*.

(2) Process Rule. By reason of the BJR, in shareholder litigation against directors alleging a breach of the duty of care in *making a decision*, the question before the court is not about the wisdom of the challenged decision but rather it is about whether the board followed a reasonable process in reaching that decision. *Brazen v. Bell Atl. Corp.*, 695 A 2d 43, 49 (Del. 1997). Boiled down, this has come to mean that the protection afforded to

© 2008 Haynes and Boone, LLP

directors by the BJR can only be overcome by proof that the decision making process of the board was fatally flawed due to the gross negligence of the board. *Smith v. Van Gorkom*, 488 A 2d 858, 872 (Del. 1985). Thus, directors who give adequate time to their decision making process and who, before making their decision, exercise due care (i) in becoming fully informed of the material facts and (ii) in deliberating the issues can confidently face any subsequent legal challenges to their decision.

(3) **Non-Applicability Of BJR To Interested Transactions** The Delaware courts reject the BJR as the standard of review in the case of *interested transactions*. On the other hand, when a conflict of interest transaction does not involve a merger with a controlling shareholder and a majority of the directors are independent and disinterested parties, the courts will apply the BJR as the judicial standard of review.

B. Stringent Entire Fairness Standard.

(1) **Duty Of Loyalty**. The duty of loyalty requires that a corporate fiduciary give undivided loyalty to the company. It "mandates that the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling shareholder." *In re Walt Disney Company Derivative Litig.*, 2005 Del. Ch. LEXIS 113, 164 (August 9, 2005). The BJR presumption that a board acted loyally is rebutted by showing that the board was either interested in the outcome of the challenged transaction or lacked the independence to consider on an objective basis whether the transaction was in the best interest of the company and its shareholders. *Orman v. Cullman*, 794 A 2d 5 (Del. Ch. 2002).

(2) **Application Of The Entire Fairness Standard To Interested Transactions**. The duty of loyalty essentially requires that interested transactions be considered and approved by a "neutral decision making party." *Oberly v. Kirby*, 592 A 2d 445, 467 (Del. 1991). With that objective in mind, the courts apply the "entire fairness standard" of review rather than the BJR in determining whether the directors' conduct was culpable in connection with the approval of an interested transaction. This judicial standard is much more demanding than the BJR because it calls for the courts to examine the substantive merits of the challenged transaction in determining whether it was fair to the corporation and the disinterested shareholders. Additionally, the it is defendant-directors who initially bear the burden of proving that the transaction was entirely fair to the corporation and its shareholders. In sum, interested parties are held to a high degree of scrutiny when it comes to their approving an interested transaction.

Point to Remember: In merger transactions with controlling shareholders, the entire fairness standard applies notwithstanding the approval of the transaction by a majority of the directors who are independent and disinterested or the use of an SNC to approve the merger. *Kahn v. Lynch Communications Sys., Inc.,* 638 A 2d 1110 (Del. 1994)

2.4. Two Prongs Of Entire Fairness Standard. The entire fairness standard consists of a two-pronged test: (i) whether there was "fair dealing" between the interested parties and the company during the process that led to the consummation of the transaction and (ii) whether a "fair price" (fair economic result) was received by the company and its shareholders. In applying this test, the Delaware courts have made it clear that "… the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue *must be examined as one* since the question is one of entire fairness" (*Weinberger v. UOP Inc*., 457 A2d 701 (Del. 1983)) (emphasis added).

Broadly speaking, entire fairness turns on three factors: (i) the quality of the deal process (ii) the quality of the disclosures to the directors and shareholders who approved the transaction and (iii) the quality of the economic outcome to the corporation and the disinterested shareholders. In evaluating the presence of these factors in a case, the courts recognize that, "… perfection is not possible, or expected." *Weinberger*, 457 A 2d 709 No. 7 (Del. 1983).

A. "Fair Price". Fair price goes to an evaluation of the economic realities of the interested transaction for the purpose of determining whether the company and its disinterested shareholders received full value in the transaction. In making such determination, economic factors like comparable asset and market values, earnings, market conditions, future prospects and all other elements that affect the inherent value of the company are taken into account. See *Weinberger* 457 A 2d at 711-713; *Kahn v. Tremont Corp.*, 694 A2d 422, 430 (Del. 1997). For a discussion of the key economic factors that are considered by the courts in determining fair price, see *Moore, The "Interested" Director or Officer Transaction*, 4 Del. J. Corp. L. 674 (1979).

Point to Remember: "It is not sufficient … to achieve the best price that a fiduciary will pay if this price is not a fair price. Nor is it sufficient to get a price that falls within the range of 'fair value' if the fiduciary (or another) would pay more." *In re First Boston Inc. S'holders Litig.*, 1990 Del. Ch. LEXIS 74 (June 7, 1990).

(1) Fairness As Between Different Classes Of Stock.

- In a merger with an unaffiliated party, the price received by the Class A shareholders was unfair in light of the premium price received by the Class B shareholders. The investment advisor's fairness opinion did not address the fairness of the Class A premium to Class B. *In re Tele-Communications S'holders Litig*.

- The SNC obtained a fairness opinion as to whether a recapitalization plan was fair to the corporation but not as to whether the plan was fair to Class A shareholders when Class B shareholders were receiving a significant cash premium. *Levco Alternative Fund Ltd. v. The Readers Digest Assoc Inc.*, 803 A 2d 428, (Del. 2002).

© 2008 Haynes and Boone, LLP

- In a merger with an unaffiliated party, the controlling shareholder was not conflicted with respect to the allocation of the merger consideration between two separate classes of stock since his ownership of shares in each class of stock was substantially equal. *Jedwab v. MGM Grand Hotels, Inc.*, 509 A 2d 584, 594 (Del. Ch. 1986).

(2) <u>Economic Factors Behind Fair Price</u>.

- The value to the company of derivative claims deserved consideration in determining fair price. *Oliver v. Boston University*, 2006 W.L. 1064169 (Del. Ch. April 14, 2006).

B. <u>"Fair Dealing"</u>. Fair dealing goes to the question of whether the corporation and its disinterested shareholders were treated fairly in connection with the negotiations of the interested transaction. The concept of fair dealing is about the fairness of the process by which the transaction was initiated, negotiated and brought to completion. Below are noteworthy legal decisions that speak to the elements in what constitutes fair dealing.

(1) <u>Timing Of Interested Transaction</u>. Manipulating the timing of the negotiations of an interested transaction in order to suit the best interests of the conflicted parties but to the detriment of the company and its shareholders runs counter to the concept of fair dealing.

- A controlling shareholder breached its fiduciary duties when it manipulated the timing of a transaction to achieve the best economic results for itself to the detriment of the other shareholders. *Jedwab v. MGM Grand Hotels, Inc.*, 509 A 2d 584, 599 (Del. 1986).

- The court noted that the (i) "serious time constraints under which [the parties] acted were all set by the [controlling shareholder];" (i) "the entire transaction was presented to and approved by the [subsidiary's] board within four business days;" and (iii) "the rush imposed on the [investment bankers] by [the controlling shareholder's] timetable contributed to the difficulties under which the investment banking firm attempted to perform its responsibilities." *Weinberger*, 457 A 2d at 711-712.

- Controlling the timing of a transaction is not wrongful in itself. "The prototype instance in which the timing of a merger would itself likely constitute a breach of a controlling shareholder's duty is when it could be shown both (1) that the minority was financially injured by the timing (i.e., from their point of view it was an especially poor time to be required to liquidate their investment) and (2) that the controlling shareholder gained from the timing of the transaction what the minority lost." *Jedwab v. MGM Grand Hotels Inc.*, 509 A 2d 584, 599 (Del. Ch. 1986).

- The evidence of unfair timing was clear when the controlling shareholder abandoned a third-party proposal to acquire the company and then flipped

the deal "for his sole personal benefit to take advantage of the temporarily and artificially depressed stock price." *In re Emerging Communications Inc. S'holder Litig.*, C.A. NO. 16415 De. Ch. (June 4, 2004).

(2) <u>Initiation Of Transaction</u>

- In initiating his proposed acquisition of a company, the controlling shareholder immediately caused the then investment advisors to the SNC to become his advisors with respect to the transaction. *In re Emerging Communications Inc. S'holders Litig.*

2.5. <u>Legal Reasons For Using an SNC</u>. The purpose behind using an SNC is twofold:

A. <u>SNCs Demonstrate Fair Dealing</u>. The genesis of using SNCs to negotiate and consider interested party transactions is attributed to the *Weinberger* case. In reviewing the fairness of a merger transaction with a controlling shareholder, the Delaware Supreme Court commented in a footnote (457 A.2d at 706 n.7) that satisfying the requirement of showing fair dealing would have been helped if there had been "an independent negotiating committee of … outside directors to deal [with the controlling shareholder] at arms length." Clearly, the *Weinberger* court was of a mindset that without the procedural safeguard of having a "truly independent agency" negotiating on behalf of the disinterested shareholders, fair dealing was not obtainable. *In re Primedia Derivative Litig.*, C.A. 1808 Del. Ch. (November 15, 2006).

Ever since *Weinberger*, the use of special negotiation committees of disinterested directors to negotiate interested party transactions has become an imperative. In the courtroom, evidence of a properly organized and functioning SNC supports the assertion that there was fair dealing between the parties. By the same token, the absence of such evidence makes for a prima facie case of unfair dealing. *Oliver v. Boston University*, 2006 W.L. 1064169 (Del. Ch. April 14, 2006).

B. <u>SNCs Shift The Burden Of Proof To The Plaintiff</u>. Under the entire fairness standard, defendant directors initially have the burden of proving the entire fairness of the challenged transaction to the company and its shareholders. *Emerald Partners v. Berlin*, 726 A 2d 1215, 1222 (Del. 1999). However, in *Kahn v. Lynch Communications Sys. Inc.*, 638 A 2d 1110, 1117 (Del. 1994), the Delaware Supreme Court announced that the burden of proof will shift to the plaintiff-shareholders to prove that the transaction was unfair if the challenged transaction has been approved by a *properly organized and fully functioning independent committee of independent directors*. (The burden can also be shifted if a challenged transaction is approved by an informed majority of the minority shareholders.) In sum, while the use of an SNC in negotiating an interested transaction will not invoke an application of the BJR rather than the entire fairness standard, it does afford an important procedural advantage to the directors.

2.6. Legitimate SNC Process.

A. Caveat. The existence of a special negotiation committee "does not in itself shift the burden of proof or establish that it is properly organized and fully functioning." *Rabkin v. Olin Corp.*, C.A. No. 7547 (Del. Ch. 1990) aff'd 586 A.2d 1202 (Del. 1990). Instead, the interested parties must prove that the committee's formation and operation were consistent with the concept of fair dealing. *Krasner v. Moffett*, 826 A2d 277, 284 (Del. 2003).

B. Critical Evidentiary Factors In Determining Whether There Was A Legitimate SNC Process. A "court's investigation of a special committee process for fairness is highly fact intensive." *Gesoff v. IIC Industries Inc.*, C.A. No. 19473 (Del. Ch. 2006). Discussed below in Sections 2.7 and 2.8 are the key factors that the Delaware courts normally consider in determining whether an SNC has been properly organized and has properly functioned for the purposes of satisfying the "fair dealing" requirements and in turn, shifting the burden of proof to the plaintiff.

2.7. What Is And What Is Not A Properly Organized SNC.

A. Sound Committee Mandate. From an evidentiary standpoint, board resolutions establishing an SNC are of fundamental importance since they set the tone for "fair dealing" and indicate to a trier of the facts as to whether or not the SNC was really structured to function with legitimacy. In that regard, directors should assume that the trier of facts will focus closely on the actual wording of their board resolutions that establish and empower the SNC.

(1) Be Clear About The Mandate. Board resolutions establishing an SNC should clearly grant the committee with the power and authority that is consistent with achieving the objective of fair dealing. In numerous cases, the absence of carefully prepared resolutions have raised doubts in the minds of courts about the committee's legitimacy. Undermining the credibility of the SNC process by soundly wording the mandate for the SNC can be a perilous mistake. An SNC's clear understanding of what it is charged to do is fundamental to the question of fair dealing.

- The "ambiguity" of the committee's mandate resulted in serious misunderstandings and disagreements among the SNC members as to their responsibilities. One member thought he was to just look after the interests of one particular class of stock while the second member thought that he was to look after all classes of stock. *In re Tele-Communications S'holders Litig*.

- The SNC process was structurally flawed because the committee members misunderstood its mandate. *Clements v. Rogers*, 790 A. 2d 1222 (Del. Ch. 2000).

(2) Be Clear That The SNC Has The Unbridled Power To Determine The Fate Of The Transaction. The SNC mandate should grant the committee

with full authority and power (i) to consider the proposed transaction, (ii) to negotiate the transaction on behalf of the company, (iii) to consider other alternatives and (iv) to reject the proposed transaction. The courts frown on situations where an SNC is restricted in protecting the best interests of the company and its disinterested shareholders in the context of a proposed interested transaction.

- The mandate was flawed because it did not set out a "clear range of authority" in terms of the SNC's power to accept or reject the proposed transaction. *Gesoff v. IIC Industries, Inc. C.A. 19473, Del. Ch. (May 18, 2006).*

- In connection with a proposed acquisition of the minority ownership through an exchange offer, the parent company limited the power of the SNC in considering and negotiating the terms of the transaction. When the SNC subsequently sought to clarify its authority including asking for the power to consider alternatives, the representatives of the parent "whittled down" the request. *In re Pure Resources Inc. S'holders Litig.* 808 A 2d 421, 430-432 (Del. Ch. 2002).

(3) **<u>Be Clear That The SNC Has The Full Authority To Select Its Own Advisors</u>**. The mandate should grant the SNC with all the resources and authority needed to independently select its own professional advisors. See Section 2.7C below.

(4) **<u>Be Clear About The SNC's Compensation</u>.** In the case of *In re Tele-Communications Inc. S'holders Litig.*, the mandate did not specify the compensation of the SNC members. The fee to the SNC's members was to be established at the end of the deal. The court viewed this approach to be some form of contingent compensation that placed in question the true independency of the SNC's members.

B. **<u>Committee Composition</u>.** A fundamental requirement of fair dealing is that the SNC be composed of directors who are independent and disinterested parties with respect to the matter at issue. Absent that, the work of the committee will be vulnerable to attack regarding its objectivity and impartiality in dealing with the conflicted parties**.** There have been numerous reported cases in which SNC process was rejected by the courts because the committee members were, from the start, not truly independent and disinterested. Accordingly, a board must take great care in selecting the members of an SNC.

(1) **<u>Director-By-Director Analysis</u>.** The question of "independence" and "disinterested" are fact intensive issues. *Cedo & Co. v. Technicolor Inc.*, 634 A 2d 345, 364 (Del. 1993). Unlike the New York Stock Exchange and the Nasdaq Stock Market corporate governance regulations, there are no bright line tests as to "independence" and "interested" under Delaware law. Each director is judged on an individual basis based on the total mix of facts and circumstances as to whether he or she is "disinterested" and "independent."

Cinerama Inc. v. Technicolor Inc., 663 A 2d 1156, 1167 (Del. 1995). This director-by-director approach is known as the "actual person standard." Importantly, the burden of proof with respect to the issue of whether a director is or is not independent and interested rests upon the party challenging the transaction. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1989).

(2) ***"Independence".*** Under Delaware case law, in context of a specific transaction, independence has come to mean that a person is "not dominated or otherwise controlled by an individual or entity interested in the subject transaction." *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988). See Section 3.2A(3) below for the definition of "independent" under the TBCA.

(3) ***"Interested".*** Generally speaking, under Delaware case law, a director is considered to be interested with respect to a matter when that director has divided loyalties in considering such matter or will receive a personal financial benefit that is not equally shared by the other shareholders or will be detrimentally impacted in a manner not shared by the corporation or the other shareholders. *Globis Partners, L.P. v. Plumtree Software Inc*., C.A. No. 1577 Del. Ch. (November 30, 2007) and *Jacobs v. Yang*, 2004 Del. Ch. LEXIS 1117 citing *Rales v. Blasband* 634 A 2d 927, 933-936 (Del. 1993). Stated somewhat differently, a director will not be deemed interested if such director "neither appear[s] on both sides of a transaction nor expect[s] to derive any benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all of its stockholders." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). See Section 3.2A(2) below for the definition of "disinterestedness" under the TBCA.

(4) ***Materiality.*** Since independent and disinterested directors are critical to the acceptability of a special independent board committee, selecting only the most pristine directors is the best practice to follow when a board establishes the committee. However, in some cases, all directors may have, in varying degrees, what might be considered to be disqualifying factors. In these cases, a director may still be deemed to be independent and disinterested because the disqualifying factor is not *material*. In *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), the Delaware Supreme Court observed that "a director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent." 634 A.2d at 36. In *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489 (Del. Ch. 1996), one member of a two-member committee had a consulting agreement with the corporation. The court observed that his independence must turn on whether the value of the consulting agreement was "so de minimus that it could not have influenced [his] ability to consider the [challenged transaction] impartially."

(5) ***Delaware Decisions On The Meaning Of "Independent" And "Interested".*** Below are illustrative legal decisions on the issue of "independence" and "interested."

Personal Economic Conflicts

- The allegations that the two directors on the SNC had compensation arrangements with companies affiliated with the corporation on the other side of the merger raised legitimate fact issues as to whether these directors were independent. *Krasner v. Moffett*, 826 A 2d 277 (Del. 2003).

- The fact that one director expected to have a consulting agreement with the surviving company after the merger and another director was entitled to receive a significant fee if the merger closed was sufficient evidence that they were both interested parties. *Orman v. Cullman*, 794 A 2d 5 (Del. Ch. 2002).

- SNC members who negotiated the allocation of merger consideration between two classes of stock were interested parties since they owned significantly more shares of one class. *In re Telecommunications*, C.A. No. 16470, 2005 Del. Ch. LEXIS 206 (Del. Ch. Dec. 12, 2005).

- Majority of members of the SNC had "disabling effects because they were economically beholden to [the controlling shareholder]." One director was his lawyer, another was paid consulting fees by him and the others received extremely generous director fees for only meeting three or four times a year. *In re Emerging Communications Inc. S'holder. Litig*., C.A. 16415 Del. Ch. (June 4, 2006).

Non-Disqualifying Benefits

- The receipt of customary director fees and pension benefits, standing alone, do not constitute disqualifying financial interests for directors *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) and *Parnes v. Bally Entertainment Corp*., C.A. No. 15192, slip op. (Del. Ch. 1997).

- Director fees and other benefits can constitute a disqualifying financial interest under circumstances when they are "shown to exceed materially what is commonly understood and accepted to be a usual and customary director's fee." *In re Auto Credit, Inc. Shareholder's Litigation*, C.A. No. 19028 – NC (Del. Ch. January 10, 2003).

- A director's right to indemnification from the corporation does not constitute a disqualifying interest *In Re Sea Land Corp. Shareholders Litig*., 642 A.2d 792, 804 (Del. Ch. 1993).

- The acceleration of vesting rights of stock options in a merger transaction is not disabling when the interests of the shareholders and directors are aligned in obtaining the highest price. *Krim v. ProNet, Inc*. 744 A 2d 523, 528 (Del. Ch. 1999).

© 2008 Haynes and Boone, LLP

- A one time profits to each director of $187,000 was not considered material since the directors were "persons of means." *In re Staples, Inc. S'holders Litig.*, 792 A 2d 934, 951 (Del. Ch. 2001)

Personal Relationship Conflicts

- Director lacked independence because his son benefited economically from the consummation of the challenged transaction. *Chaffin v. GNI Group Inc.*, C.A., 16211, 1999 Del. Ch. LEXIS 182 (Del. Ch. September 3, 1999).

- SNC process was flawed since certain committee members were not independent by reason of prior business relationships with the controlling shareholder. *Kahn v. Tremont Corp.*, 694 A 2d 422, 426 (Del. 1997).

- "The naked assertion of a previous business relationship is not enough to overcome the presumption of a director's independence … a long-standing 15-year professional and personal relationship … [were] insufficient to support a finding of control." *Orman v. Cullman*, 794 A 2d 5, 27 (Del. Ch. 2002).

- Two SNC members (both tenured faculty members of Stanford University) were deemed not to be independent due to the fact that a defendant-director in the derivative litigation was very a significant donor to the university. In re *Oracle Corporation Derivative Litig.*, 824 A 2d 917 (Del. Ch. 2003).

- Without more, directors are not deemed to lose their independence by reason of running in the same social circles or sitting on the same boards. *Beam v. Stewart*, 845 A 2d 1040, 1051-52 (Del. 2004).

(5) ***Appointment Of Additional Directors***. In the case where there are no "independent" directors, one alternative is to appoint additional directors to the board who are independent and disinterested for the purpose of establishing an SNC. See *Carlton Investments v. TLC Beatrice International Holdings, Inc.*, C.A. No. 17950 (Del. Ch. 1997) (two independent directors added to a board of directors to act as special committee).

(6) ***Propriety Of A One-Person Committee***. While appearance-wise it's not desirable, a one person committee has generally found acceptance with the Delaware Courts with this caveat: "If a single member committee is to be used, the member should, like Caesar's wife, be above reproach." *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985). Without doubt, one-person committees are looked on with disfavor and thus, will be subjected to greater scrutiny by the courts.

- The lack of independence of one member of a two-person committee was deemed not to be fatal in itself. *Kahn v. Dairy Mart Convenience Stores, Inc.* C.A. No. 12489, N. 6 (Del. Ch. 1996).

© 2008 Haynes and Boone, LLP

- The appointment of a one-member committee was held to be a fundamental flaw in the SNC process notwithstanding the fact that he was the only independent and disinterested director available to serve. The court appropriately noted that: "… the facts of this case serve to illustrate exactly why a single-member special committee has been thought such a worrisome portent of unfair dealing." *Gesoff v. IIC Industries, Inc.*, Del. Ch. C.A. No. 19473 (May 18, 2006).

C. <u>Committee Advisors</u>.

(1) <u>Qualified And Knowledgeable</u>. Fair dealing requires that an SNC have qualified, knowledgeable independent advisors (e.g., legal counsel and investment bankers).

- SNC process was flawed by the fact that the committee's advisors were inexperienced and otherwise not qualified to advise the SNC. *Gesoff v. IIC Industries, Inc.*

- Reliance by the SNC on experienced legal counsel is evidence of fair dealing. *Cinerama Inc. v. Technicolor Inc*. 663 A 2d 1196, 1175 (Del. 1993).

(2) <u>Independent And Disinterested</u>. A lack of independence and disinterestedness on the part of the advisors to the committee will taint the acceptability of the work of an SNC. Prior relationships between an investment banking firm or legal counsel and the conflicted parties are looked upon with much disfavor by the courts in deciding if there was "fair dealing." The thought being that only truly independent advisors are able to act aggressively toward the conflicted parties.

- The court strongly criticized the retention of a financial advisor which had lucrative past dealings with the controlling shareholder and his affiliates. Likewise, legal counsel to the committee had previously represented an affiliate of the controlling shareholder. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997).

- The contingent compensation payable to the financial advisors upon consummation of the transaction, created "a serious issue of material fact as to whether the advisor could provide independent advice" to the SNC. *In re Tele-Communications*.

(3) <u>Selected By SNC</u>. The SNC should independently select its own advisors. To do otherwise will place the independence of the advisors in question. Selections based on the directives or influences of the interested parties are ill advised. The record should reflect the SNC's due diligence in satisfying itself as to the independence and disinterestedness and the experience and qualifications of their advisors in handling the kind of matters before the SNC. See *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489, n.

6 (Del. Ch. 1996); *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997); *Fort Howard Corp. Shareholders Litig.* C.A. No. 9991, slip op. at 30 (Del. Ch. 1988).

- The Delaware Supreme Court observed that the SNC's selection of legal counsel suggested by the general counsel of the company was a clear indicator that the SNC process was not trustworthy. *Kahn v. Tremont*, 694 A 2d 422, 429 (Del. 1997).

- The court noted that conflicted parties should not participate in the selection of the advisors to the committee. *Mills Acquisition Co. v. MacMillan*, 559 A.2d 1261, 1279-80 (Del. 1989).

- The record showed that the SNC had no independent legal and financial advice because it had no real authority to select its own legal counsel and financial advisors and in fact, it was the conflicted party who effectively selected the advisors. As a result, the court viewed the structure of the SNC to be fatal to an assertion of fair dealing. *Gesoff v. IIC Industries, Inc.*, Del. Ch. No. 19473 (May 18, 2006).

- The court viewed the selection of advisors as being flawed when rather than retain its own separate legal and financial advisors, the SNC used the legal and financial advisors who were already advising the company. *In re Tele-Communications*. However, based on the particular facts, the court in *In re Cysive, S'holders. Litig*. 836 A 2d 531, 541 (Del. Ch. 2003) concluded that the investment advisor's prior representation of the company did not disqualify it from serving as advisor to the SNC.

2.8. <u>What Is And What Is Not A Properly Functioning SNC</u>.

A. <u>Absence Of Undue Influence By Interested Parties</u>. To demonstrate that it functioned properly, an SNC must act independently. This means that it must be free of the influence of the interested parties. Most assuredly, a conflicted party cannot dictate the terms of a proposed transaction. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985). This means that interested parties must not engage in any conduct that would effectively undermine the ability of the SNC to negotiate freely or to walk away from the proposed transaction.

(1) <u>Threats/Coercive Tactics</u>.

- A controlling shareholder's threat to a special committee that it would veto any proposal other than its own was viewed as effectively taking away the bargaining power of the committee. The committee had no ability to "shop" the deal for a better offer. *Kahn v. Dairy Mart Convenience Stores, Inc.*, C. A. No. 12489 (Del. Ch. 1996).

- A controlling shareholder's threat to a special committee to launch a hostile tender offer at a price less than what was then being offered by the controlling shareholder in a proposed merger was viewed as depriving the

© 2008 Haynes and Boone, LLP

special committee of the "power to say no." "Blackmailing" a committee can be fatal to the claim of "fair dealing." *Kahn v. Lynch Communication Systems, Inc.* 638 A.2d at 1120.

- A controlling shareholder used an ultimatum to a special committee that it would proceed with a transaction without the committee's input if the committee did not accept the offer that was then being offered by the controlling shareholder in merger negotiations. The court viewed this as having caused the committee to lose its ability to negotiate on an arms length basis since it had in effect no other choices to pursue. See *American General Corp. v. Texas Air Corp.* C.A. No. 8390 (Del. Ch. 1988).

- Committee selected the same legal counsel and investment advisor that the company had been utilizing. *In re Tele-Communications Inc. S'holders Litig*.

- The SNC was not subjected to threats but instead the controlling shareholder gave the SNC the leeway to fulfill its responsibilities. *In re Cysive Inc. S'holders. Litig.*, 836 A 2d 531 (Del. Ch. 2003).

(2) <u>Involvement In SNC Decision Making</u>.

- While not fatal, the court noted that the controlling shareholder dominated the SNC process. SNC members and its advisors involvement in the due diligence process was not vigorous because they deferred to management which put them in a position to favor the bidders that they desired to work for. *In re Netsmart Technologies*, 924 A 2d 171, 193 (Del. Ch. 2007).

B. <u>Arms Length Negotiations Conducted By Committee</u>. For an SNC to be properly functioning, the committee must have total freedom to negotiate on an arms length basis. Accordingly, a committee should be under no compulsion to reach any agreement with the conflicted parties. The SNC must be granted real bargaining power to freely negotiate with the conflicted parties. *Rabkin v. Olin Corp.*, C.A. No. 7547 (Del. Ch. 1990). Negotiations that simulate the negotiations of an arm's length transaction are strong evidence of fairness. *Rosenblatt v. Getty Oil Co.*, 493 A 2d 929, 937-38. Delaware courts will reject an SNC process that has the earmarks of a charade (e.g., when there is a lack of real substance and integrity in the way the SNC negotiations are conducted).

(1) <u>Real Negotiations</u>.

- "It is the duty of directors serving on [an SNC] to approve only a transaction that is in the best interest of the public shareholders and to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such direction to achieve the best price that a fiduciary will pay if that price is not a fair price. Nor is it sufficient to get a price that falls within a range of 'fair value'

somehow defined, if the fiduciary [or someone else] would pay more." *First Boston, Inc. Shareholders Litig.* C.A. No. 10338, slip op. 68 (Del. Ch. 1990).

- In finding that the SNC had conducted a thorough and reasonable SNC process, the court observed that the SNC had held twenty-one meetings and that the two committee members had devoted a great deal of personal time and energy in fulfilling their duties with the aid of their legal and financial advisors. The court was favorably impressed that the negotiations were "adversarial, spirited and conducted in good faith" even to the point of frustrating the controlling shareholder. *In re Cysive Inc. S'holders. Litig.* 836 A 2d 351.

- The record indicated that the SNCs chief negotiator believed that the SNC's assignment was not to negotiate the terms of the deal but instead to solely determine the "fairness" of the proposed merger transaction. *In re Tele-Communications Inc. S'holders. Litig*.

- The SNC process in negotiating a sale of the company was tainted because the conflicting interests of the chief negotiator made him an "unreliable negotiator." *In re SS&C Technologies, Inc. S'holders Litig.*, Del. Ch. C.A. No 8525 _ N (November 29, 2006).

- The court observed that the SNC made a mistake by permitting the "CEO to negotiate the merger outside the presence of special committee supervision" especially when the CEO had economic motivations that were different from those of the shareholders. *In re Lear Corporation S'holders. Litig.*, 926 A 2d 94, 97-98 (Del. lCh. 2007).

- "… the adversarial nature of the negotiations completely support a conclusion that they were conducted at arms length." *Rosenblatt v. Getty Oil Co.*, 493 A 2d 929, 937 (Del. 1985).

- From the record, the court concluded that the negotiations were flawed since the SNC was unwilling to confront the controlling shareholder "as aggressively as it would have a third-party bidder." *In re Pure Resources, Inc. S'holders. Litig.*, 808 A 2d 421, 431 (Del. Ch. 2002).

(2) <u>Real Bargaining Power</u>.

- "The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price." 638 A.2d *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1119 (Del. 1994).

- Negotiation process is flawed when SNC's only power is to pass upon the fairness of the price. *In re Republic American Corporation Litig.*, 586 A 2d 1202 (Del. 1990).

(3) Confidentiality Of Committee Meetings.

- SNC process flawed because it gave controlling shareholder access to the SNC's deliberations. *In re Netsmart Technologies*, 924 A 2d 171, 192 (Del. Ch. 2007).

- The SNC was "careless if not reckless by routing all" committee communications through the controlling shareholder's secretary. *In re Emerging Communications Inc. S'holder. Litig*., C.A. 16415 Del. Ch. (June 4, 2006).

C. **Fully Informed Committee And Advisors**. Suffice it to say, adequate disclosure of all material facts to the SNC and its advisors is fundamental to the notion of fair dealing.

- The SNC process was flawed by the fact that the SNC lacked complete information about whether the premium received by one class of shares was fair to another class of shares not receiving such premium. Moreover, the committee members could not demonstrate that they had a real basis for their conclusions about fair price other than to point to the presentation of the financial advisor. *In re Tele-Communications Inc. S'holders Litig*.

- Controlling shareholder negotiated a squeeze-out merger with the company at a merger price of $21 per share. Two directors of the company who were designees of the controlling shareholder violated their duty of loyalty to the company by failing to disclose to their fellow directors a report indicating the controlling shareholder believed that the merger would be a good investment at $24 per share. *Weinberger v. UOP, Inc.*, 457 A 2d 701, 708-710 (Del. 1983).

- A squeeze-out merger was proposed by a controlling shareholder three months after its cash tender had been completed. The SNC had obtained a fairness opinion in connection with the tender offer. While the merger price was the same as the tender offer price, the court viewed the SNC's failure to obtain an updated fairness opinion for the merger as being evidence of a lack of fair dealing. *Gesoff v. IIC Industries, Inc.*, Del. Ch. No. 99473 (May 18, 2006).

2.9. Advising Fiduciaries In Making The SNC Process Count. In advising on the legal aspects for handling an interested transaction, the general counsel and outside law firm for the company, the legal counsel for the conflicted parties and the legal counsel to the SNC all play very important roles in assuring that the SNC process will pass muster on judicial review. Below are four important legal counsel can be of help in assuring the legitimacy of an SNC process.

A. **First Things First – Educate The Interested Parties**. Legal counsel to the interested parties will be the first to advise on the legal ramifications of effecting the proposed interested transaction.

(1) **Legal Aspects**. Law books are full of cases in which the SNC process was fatally flawed because of ill advised conduct of an interested party. Many of these missteps often occur during the very earliest stages of planning and initiating a proposed interested transaction. For that reason, it is imperative that, before a proposed transaction is ever broached by the interested parties, legal counsel should fully brief them about the legal aspects of interested transactions. Gaining a clear understanding of the legal dos and don'ts in an SNC process is lesson number one for interested parties.

(2) **What To Expect**. The next thing that legal counsel can do is to instruct the interested parties on what to expect as the SNC process proceeds. Being able to react to likely issues that are encountered along the way can be important. Below are some of the things that interested parties should be alerted to before the SNC process begins.

- **"Cold Shoulder" Treatment By SNC**. Notwithstanding their long, close relationships with members of the SNC, interested parties should expect them to be tight-lipped and certainly unwilling to discuss any issue regarding the proposed transaction, except through their spokesperson.

- **Adversarial Negotiations With SNC**. If the SNC does its job correctly it will be looking out solely for the best interests of the company and its shareholders and not the interest of the interested parties. So, just as in a real arms-length negotiation with a third party, heated negotiations can surface. An SNC cannot afford to take a laid back approach.

- **Temptation To Influence The SNC**. Interested parties are often tempted to pry into the SNC's thinking and negotiating strategies. The SNC should be left alone to do its job.

- **SNC Process Can Take A Life Of Its Own.** Interested parties need to recognize at the start that once an SNC is put in place, the negotiations can take a life of their own. Even so, the interested parties can ill afford to step in and try to direct the SNC process. Thus, they must be prepared to accept the freedom of the SNC to depart from the route that the interested parties had expected them to take.

B. **Start The SNC Process Right With A Clear Mandate From The Board**. As discussed under Section 2.7A above, a board is well advised to carefully consider how the SNC's mandate is crafted. Board resolutions that implement the mandate should be carefully prepared so that all the important issues are adequately covered. The whole board including the conflicted directors and the independent/disinterested directors have to be on the same page as to what the SNC is charged to do and how it is to operate that is in keeping with the entire

fairness standard. The task of properly orienting the board about a proper mandate usually falls on the shoulders of the company's general counsel and outside corporate counsel.

C. <u>Start The First SNC Meeting By Educating The SNC Members</u>. The legal counsel selected by the SNC will be the guide for the SNC in navigating through the legal hurdles of satisfying the entire fairness standard.

(1) <u>Legal Aspects</u>. As the case in Section 2.9A(1) above for interested parties, the SNC members need to be briefed at their first meeting on the legal ramifications of an SNC. This should be done by the SNC's legal advisor again even if it was covered at the board meeting at which the SNC was established. Importantly, the members of the SNC need to understand the dos and don'ts in carrying out their responsibilities. Practically speaking, they need to have an unwavering mindset that they are to essentially deal with the interested parties as if they were an unknown third-party.

(2) <u>What To Expect</u>. The SNC members should be prepared for the demands that are likely to be placed on them in carrying out their responsibilities. Additionally, they need to be alerted upfront to issues that may likely result in a difficult confrontation with the interested parties.

(3) <u>Operating Protocol</u>. The SNC should establish its protocol for carrying out its responsibilities. It is usually best that one member be designated exclusive spokesperson (negotiator) in dealing with the interested parties in negotiations. The importance of not discussing the SNC thinking or its positions with others except through the spokesperson should be emphasized over and over again.

(4) <u>Selection Of Advisors</u>. As indicated in Section 2.7C above, the SNC should exercise great care in selecting its advisors. The past experiences of the advisors can make a difference.

D. <u>Maintain An Evidentiary Record That Reflects A Proper SNC Process</u>. Without question, the courts will examine the minutes of SNC meetings in determining fair dealing and fair price. Accordingly, their minutes need to be sufficiently detailed to demonstrate that the SNC operated properly. Well crafted minutes can carry the day in the courtroom. The responsibility for making SNC minutes count will largely rest with the legal counsel to the SNC.

- "The minutes do not describe how the directors might be interested or the Special Committee's exact assignment." *In re Tele-Communications.*

- Board minutes are strong evidence of whether material information was provided to the independent directors can "The minutes of the … board meeting do not identify the … report as having been delivered to the [independent] directors. This is particularly significant since the minutes describe in considerable detail the materials that actually were distributed." *Weinberger, 457 A 2d at 709.*

© 2008 Haynes and Boone, LLP

3. SPECIAL LITIGATION COMMITTEES

3.1. Shareholder Derivative Litigation. Shareholder derivative litigation (i.e., a lawsuit brought by shareholders on behalf of the corporation against directors for alleged breaches of their fiduciary duties resulting in damages to the corporation) also usually precipitate the use of special independent board committees. Derivative claims belong to the corporation and thus, the decision as to whether it is in the best interests of the corporation to pursue such claims rests with the directors as overseers of the corporation's affairs. See *Wise, Demand Futility in Shareholder-Derivative Litigation Under Texas Law*, 28 Tex. Tech L. Rev. 59, 66 (1997). For that reason, state corporation law (e.g., Delaware Chancery Court Rule 23.1 and Texas Business Corporation Act ("TBCA") Article 5.14) typically requires that plaintiff-shareholders make demand on the board of directors before filing a derivative suit unless they can show that such a demand would be futile due to a lack of independence of the board. Shareholders have the right to initiate a derivative action without board approval only when conflicts of interest prevent a board from deciding what is in the best interests of the corporation.

3.2. Use Of Special Litigation Committees. When a shareholder makes a demand on a corporation with respect to a derivative claim against directors, often some or even all of the directors are made defendants and thus, they may be deemed to have a conflict of interest in considering whether the pursuit of the claims would be in the best interests of the company. In such event, it is common practice for a board to appoint a special litigation committee consisting of independent and disinterested directors who are charged with the authority to investigate the claims and to determine if their pursuit would be in the best interests of the corporation. Discussed below are the corporate laws of Texas and Delaware pertaining to the use of SLCs.

A. SLC Under Texas Law. Article 5.14 of the TBCA establishes specific procedures for the disposition of shareholder derivative litigation through the use of SLCs and other means.

(1) SLC Right To Dispose Of Derivative Claims. Article 5.14H requires a court to dismiss a shareholder derivative lawsuit if an independent/disinterested group (as prescribed by Article 5.14F of the TBCA) determines: (i) in good faith, (ii) after conducting a reasonable inquiry, and (iii) based on the factors that the group deems appropriate under the circumstances that continuation of such derivative proceeding would not be in the best interests of the corporation. An Article 5.14F determination must be made by (i) a majority vote of the independent and disinterested directors, (ii) a committee consisting of two or more independent and disinterested directors (an SLC), or (iii) a panel of one or more independent and disinterested persons appointed by a court.

(2) "Disinterested" Director Definition. Article 1.02A(12) of the TBCA provides that a person is "disinterested" if he or she (i) is not a party to the contract or transaction that is the subject of the claim or challenge, (ii) was "not materially involved in the conduct that is subject to the claim or

challenge" and (iii) "does not otherwise have a material financial interest in the outcome of … the disposition of the claim or challenge." Most importantly, article 1.02A(12) provides that a director is not considered to be materially involved in the challenged conduct or to have a material financial interest in the outcome of the disposition of the subject claim or challenge … solely by reason of the fact (1) that such director is named as "a defendant" in the subject derivative proceeding or is alleged to be "a person who engaged in the alleged misconduct" that is the basis for the subject derivative claims or (2) that such director approved or acquiesced in the alleged misconduct without receiving any personal benefit as a result thereof and the challenging person "fails to allege with particularity facts that if true, raise a significant prospect that the director would be adjudged liable by reason of such conduct" (emphasis added).

(3) "Independent" Director Definition. Under Article 1.02A(15) of the TBCA, a person is deemed "independent" if he or she: (i) is disinterested; (ii) is not an associate (other than by reason of being a director of the corporation or one or more of its subsidiaries or associates) or member of the immediate family of a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in the conduct that is subject to the claim or challenge; (iii) does not have (and an associate or member of the immediate family of such person must not have) a business, financial, or familial relationship with a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in conduct that is subject to the claim or challenge, which, in each case, could reasonably be expected to materially and adversely affect the director's or other person's judgment with respect to the consideration of the disposition of the matter subject to the claim or challenge in the interests of the corporation; and (iv) is not otherwise shown, by a preponderance of the evidence by the person challenging the independence of the director or other person, to be under the controlling influence of a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in conduct that is subject to the claim or challenge. Article 1.02A(15) also identifies six circumstances that would not by themselves alone cause a director to be considered to have a relationship that would materially affect such person's judgment thereby making him non-independent.

B. SLC Under Delaware Law.

(1) SLC Right To Dispose Of Derivative Claims. Unlike Texas, Delaware corporate statutes do not spell out specific definitions and procedures for the disposition of shareholder derivative claims. Instead, Delaware Court of Chancery Rule 23.1 provides for shareholder derivative litigation. In that regard, a shareholder is required to make demand on the directors before filing a derivative lawsuit. Only where such a demand would be futile due to the conflicted status of directors can plaintiff-shareholders be excused from making such demand. See *Aranson v. Lewis*, 473 A 2d 805 (Del. 1984) and

Rales v. Blasband, 634 A 2d 927 (Del. 1993). If a majority of the directors are not sufficiently disinterested and independent to decide the proper disposition of shareholder derivative litigation, the board can still establish a special litigation committee for that purpose of maintaining control of the disposition of such litigation.

(2) **Zapata Case**. The Delaware Supreme Court in *Zapata Corp. v. Maldonado* 430 A 2d announced a procedure that enables an SLC of independent and disinterested directors to take control of shareholder derivative litigation and if appropriate, to cause its dismissal. The judicial mandate of an SLC is twofold: (1) review the merits of the litigation and determine in good faith whether it is in the best interests of the corporation that the claims be pursued and (2) terminate the litigation if the SLC determines that such litigation is not in the best interests of the company.

As in the case of a proper SNC process discussed in Section 3 above, the members of the SLC are required to be independent and disinterested. (The guidance provided in Section 2.7 above of the qualifications of committee members is instructive in this area as well.) Additionally, the SLC is required to (i) conduct a reasonable investigation and (ii) in good faith exercise its business judgment in deciding the disposition of the litigation. *Zapata*, 430 A 2d at 788-89. Importantly, the burden of proof rests with the SLC to show that it satisfied these judicial requirements. But, as a final protection against potential abuse by an SLC, the Delaware courts have retained the discretion to substitute their own business judgment for that of the SLC rather than accept the SLC's decision. In sum, a court may exercise its own business judgment when it is not satisfied with the composition or work of the SLC. See *Lewis v. Fuqua*, 502 A 2d 962 (Del. Ch. 1985).

4. SPECIAL INVESTIGATION COMMITTEES.

4.1. **Overview.** Due to the increased number of whistle-blower complaints by employees, the increased activity of government regulators in investigating corporate wrongdoing, the expanded responsibilities of independent directors (especially the audit committee) in monitoring corporate conduct and the heightened sensitivity to accounting irregularities, boards of directors are more frequently encountering internal issues that raise the need for independent internal investigations.

4.2. **Director's Fiduciary Duty To Prevent Corporate Wrongdoing.** As already noted in Section 2.3A above, the directors' oversight responsibilities include the duty to exercise care in preventing corporate wrongdoing. Through judicial interpretation, it is generally recognized that this duty requires of directors that:

(i) They keep themselves informed about the affairs of the corporation;

(ii) They, in good faith, satisfy themselves that the corporation has in place effective internal systems for detecting and preventing corporate wrongdoing; and

(iii) They appropriately monitor the effectiveness of internal reporting and compliance systems.

Below is a brief overview of the three leading Delaware decisions that speak to what is legally required of directors in carrying out their oversight duties in preventing corporate wrongdoing.

A. ***Graham* Case (1963) – "Red Flag" Warning Standard**. The first noteworthy Delaware case on the responsibility of directors in detecting and preventing corporate wrongdoing was *Graham v. Allis Chalmers Mfg. Co*., 188 A2d 125 (Del. 1963). The defendant directors were alleged to have breached their oversight duties by having failed to prevent antitrust violations perpetrated by the company. The directors had no knowledge that company employees were engaged in such wrongdoings. In finding the directors not liable, the Delaware Supreme Court essentially held that in the normal course of things, directors do not have an affirmative duty to search out wrongful conduct by the corporation. The court explained that "*Absent a cause for suspicion*, there is no duty upon directors to install and operate a corporate system of espionage to ferret out wrong doing which they have no reason to suspect exists." In sum, the *Graham* case stands for the proposition that in the absence of an obvious "red flag" warning of a problem, directors have no obligation to be out searching for wrongful corporate conduct. *Thus, if directors receive notice of possible corporate wrongdoing (e.g., an employee whistle-blower complaint), the board will be expected to diligently investigate the matter in order to determine the validity of the complaint and whether any remedial action needs to be taken.*

B. ***Caremark* Case (1996) – Affirmative Duty To Monitor**. In the *Caremark* case, the directors were alleged to have breached their duty to monitor the affairs of the corporation because they had failed to detect and deter wrongful conduct of employees who had been illegally making payments for referrals of Medicare and Medicaid patients. The directors had no knowledge or reason to know of this wrongful conduct so there was no evidence that the directors were guilty of violating the "red flag" warning standard announced in the *Graham* case. However, the Delaware Chancery Court pointed out that director oversight duties also require that directors have reasonable grounds for believing that the company has in place effective internal systems for detecting and preventing company wrongdoing. The *Caremark* court explained that:

> "*[I]t would . . . be a mistake to conclude that our Supreme Court's statement in Graham concerning "espionage" means that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance*."

Since the decision, the *Caremark* case has been cited many times for the proposition that in fulfilling their oversight duties, directors are expected to have in place reasonable systems for detecting and preventing wrongful conduct by the company. The *Caremark* court held that with respect to a board's failure to deter wrongdoing, liability attaches only when there is "*a sustained or systematic failure to exercise oversight*" or there has been "*an utter legal failure to attempt to ensure a reporting and information system.*"

C. ***Stone*** **Case (2006) – Delaware Supreme Court Affirms *Caremark*.** In *Stone v. Ritter*, 911 A2d 362 (Del. 2006), the Delaware Supreme Court affirmed the *Caremark* standards with respect to director responsibilities for corporate legal compliance.

In *Stone*, a Tennessee bank branch of AmSouth Corporation was used by some customers in carrying out their unlawful Ponzi scheme to defraud investors. In its aftermath, government investigators found that AmSouth had violated certain federal anti-money-laundering laws by failing to file Suspicious Activity Reports with the regulators. Moreover, they concluded that AmSouth's systems for detecting and preventing violations of anti-money-laundering statutes were "materially deficient" and lacked "adequate board and management oversight." In settling resulting civil and criminal charges, AmSouth paid $50 million in fines and penalties. Subsequently, a stockholder derivative lawsuit was brought against AmSouth's directors for damages resulting from their failure to prevent such wrongdoing.

Like the directors in *Caremark*, the AmSouth directors also had no "red flag" warnings of the corporate wrongdoings so the *Graham* duty to pursue obvious signs of wrongdoing was not applicable. The derivative suit alleged that the AmSouth directors had breached their fiduciary duties by failing to properly satisfy themselves that the company had in place effective systems for detecting and preventing illegal activity. In affirming the dismissal of the lawsuit against the directors, the Delaware Supreme Court said:

> "*We hold that Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls, or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.*"

The court then explained that director "oversight liability" draws directly from the concept of director bad faith as discussed in its *In re Walt Disney Derivative Litigation*, 906 A2d 27 (Del. 2006), decision. In that connection, the court announced that the duty to act in good faith to prevent corporate wrongdoing is not a stand alone fiduciary duty, but instead is a "subsidiary element" of the directors' duty of loyalty.

While the *Caremark* decision had previously been viewed as holding that an alleged violation of the duty to monitor falls under the duty of care, the Delaware Supreme Court made it clear that a *Caremark* claim is in fact a duty of loyalty claim. That being the case, it is important to recognize that a *Caremark* claim asserted against directors *does not fall within the protection of an exculpation clause in a corporate charter nor are directors afforded protection from liability under the business judgment rule against such a claim.* In sum, a *Caremark/Stone* claim goes to intent (state of mind) of the defendant-directors as opposed to whether they exercised proper care in gathering information about their company's activities. So, to prove a breach of the duty to prevent corporate wrongdoing "*requires a showing that the directors knew that they were not discharging their fiduciary duties*."

4.3. Making Special Internal Investigations Count.

A. Establish The SIC. Whenever corporate wrongdoing is suspected, the immediate decisions are twofold: (1) should an investigation be conducted, and (2) should it be handled by staff or by an independent board committee Some internal investigations may be readily handled by a company's general counsel staff. But when there are credible allegations of serious corporate wrongdoing (e.g. issuance of fraudulent financial statements or wrongdoing by corporate executives), it is usually prudent to appoint an SIC to conduct an independent investigation with the assistance of independent legal counsel, forensic accountants and other independent third-party advisors.

B. Build Credibility For The SIC. The proper composition and conduct of an SIC is extremely important in establishing credibility with third parties who may likely have an interest in the suspected wrongdoing especially the Securities Exchange Commission, the Department of Justice and other government regulators. A properly conducted investigation and an appropriate response by the company to any wrongdoing can make a positive difference in how regulatory inquiries or legal enforcement issues are administered.

The credibility of the findings and conclusions of a special internal investigation will depend on how thorough, impartial and fair the investigation was conducted and how impartial and fair the SIC and its advisors were. To start with, a clear board mandate as to the responsibilities, authority and resources of the SIC as well as the scope of its investigation is an imperative. Of course, the independency and disinterestedness of the directors serving on the SIC is a must. Additionally, it is important to establish an appropriate record of the activities of the SIC and its advisors and to preserve pertinent evidence developed in the investigation.

C. Address Sensitive Issues. Special internal investigation committees often face very sensitive and difficult issues ranging from questions about wrongdoing by key executives to the issues of whether to cooperate with government investigations or how to handle disclosure to outside auditors. Most importantly,

© 2008 Haynes and Boone, LLP

where wrongdoing is found, the committee has to decide what is the appropriate action for the company to take.

D. **Prepare The SIC Report**. Finally, the manner in which the SIC reports its findings and recommendations to the board is an important decision. There are plusses and minuses in giving a written report. The circumstances will dictate the manner of preparing a report.

5. CONCLUSION.