

SPECIAL NEGOTIATING COMMITTEES: *If, When, Who and How—A Guide for the General Counsel*

Highlights

- Special negotiating committees are frequently appointed in corporate transactions in which directors or controlling stockholders have a conflict of interest. The authors review the law relating to the need for such committees and the role that corporate general counsel should play in their selection and operation.
- Delaware courts have continued to scrutinize board process in connection with conflict of interest transactions, including more recently going private transactions with private equity buyers, and a board that fails to adequately address independence and conflict issues, including in certain circumstances by forming a special negotiating committee, risks litigation and the prospect of personal liability.
- In our experience, the general counsel's participation and support is an essential element in managing the legal and business risks associated with conflict of interest transactions, and the general counsel is frequently the first legal decision-maker to be advised of and identify potential conflicts of interest.
- This M&A Commentary provides a general overview of the key issues the general counsel will face in connection with a conflict of interest transaction and suggests practice-oriented guidelines for addressing these concerns. Specifically, this M&A Commentary:
 - Summarizes the legal framework for analyzing and addressing conflicts of interest.
 - Describes when and how to form a special negotiating committee.
 - Discusses the composition and scope of authority required for a special negotiating committee to obtain judicial deference.
 - Offers practical guidance for the general counsel in connection with the special negotiating committee process.
 - Offers practical guidance for going private transactions with private equity buyers.

INTRODUCTION

The Sarbanes-Oxley Act of 2002 and contemporaneous SEC and stock exchange initiatives, together with recent decisions of the Delaware courts, have resulted in greater scrutiny of director independence and potential conflicts of interest. A board that fails to adequately address independence and conflicts issues, including, when appropriate, by forming a special negotiating committee,¹ risks litigation and the prospect of personal liability. For example, certain directors and the controlling stockholder were held jointly and severally liable for approximately \$77 million in connection with a going private transaction initiated by the controlling stockholder in the *Emerging Communications*² case. More recently, Delaware courts have scrutinized board process in connection with going private transactions with

private equity buyers.³ The tenor and substance of those decisions reflect deep concern in the Delaware courts over the incentives affecting and motives of all of the players in going private transactions, and the impact of such issues on the business outcomes of the transactions.

In our experience, the general counsel's participation and support is an essential element in managing the legal and business risks associated with conflict of interest transactions. The general counsel is frequently the first legal decision-maker to be advised of or identify the potential conflict transaction and, due to his or her familiarity with the business, social and other dynamics among directors and management of the corporation, is often in the best position, working with outside counsel, to facilitate a pragmatic and effective process to mitigate the conflict. At the same time, the general counsel will often be placed in a difficult position, balancing the demands of the board, independent directors – often constituted as a special negotiating committee – and management.

This paper seeks to guide the general counsel as he or she navigates the conflict of interest transaction. Our goal is to provide a general overview of the key issues the general counsel will face in this process and practice-oriented approaches to addressing these concerns. Because more than 50% of United States public corporations and 60% of Fortune 500 corporations are incorporated in Delaware,⁴ and Delaware is generally considered to have the most well developed law in this area, we look to Delaware law for purposes of this paper.

ESSENTIAL LEGAL BACKGROUND

The Business Judgment Rule

The traditional business judgment rule – the deferential standard known well to every general counsel⁵ – does not generally apply to the following conflict transactions:

- transactions in which a majority of the board has financial or other interests adverse to the corporation;⁶
- transactions in which an individual director or a minority of the board have financial or other interests adverse to the corporation, *if* the interested director or directors are viewed to control or dominate the board as a whole;⁷
- transactions in which a majority of the directors receive a special or personal benefit, if material, that may be incidental to an arms' length transaction;⁸ and
- transactions with a controlling stockholder.⁹

In these types of transactions, the predicate of the business judgment rule – that decisions made in good faith by informed, disinterested directors should not be second-guessed by Delaware courts – generally does not apply and Delaware courts will scrutinize the transaction to ensure it is fair to the corporation and its stockholders.¹⁰

Entire Fairness

In many circumstances, Delaware courts will review the board's actions with respect to conflict transactions under the "entire fairness" standard, which is the strictest standard for review of board action under Delaware law. Fundamentally, a transaction is "entirely fair" if it mimics a hypothetical arms' length negotiated transaction. The standard has two component parts – "fair dealing" and "fair price" – although the analysis is more fluid in practice and looks to all aspects of the transaction.¹¹

Although the general counsel must understand the entire fairness standard to advise the board and other constituents, the general counsel frequently has more opportunity to facilitate the process by which the parties reach a price – the fair dealing prong – than the price itself. This role is essential. A process that satisfies the fair dealing standard is itself strong evidence of the fairness of the transaction.¹² For these reasons, we focus heavily on process in this paper.

Fair Dealing

Fair dealing focuses upon the process by which the board considers, negotiates and approves the transaction. Delaware courts will scrutinize the following process points, among others:

- *Timing* – How and when the transaction was initiated, including whether the timing of the transaction was financially disadvantageous to the stockholders. Delaware courts will also scrutinize whether the board or special committee had adequate time to evaluate and respond to the transaction.¹³
- *Disclosure* – Whether the interested parties disclosed to the board or special committee all material information related to the transaction and the corporation, including up-to-date internal management projections, asset valuations and other information about the corporation's prospects.¹⁴ However, fair dealing does not typically require disclosure of the interested party's highest or "reservation" price or valuation analyses prepared for the interested party by its advisors.¹⁵
- *Structure* – Whether the transaction is viewed as coercive to the stockholders or is otherwise structured to unfairly favor the interested party. For instance, a two-step merger that offers cash in the first step and debt or other securities in the second step could be viewed as coercive and unfair.
- *Negotiations* – Whether the process served as a "surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary."¹⁶ Such analysis will often involve an evaluation of whether the board or special committee was reasonably informed, including by consultation with independent financial and legal advisors. Delaware courts also examine the behavior of the interested party in negotiations, and particularly whether the interested party acted in good faith. In this regard, threats by the interested party that are viewed as coercive will adversely affect a court's assessment of the credibility of the negotiating process.¹⁷
- *Approval* – How the board evaluated and approved the transaction, including scrutiny of the quality and depth of the board's deliberations.

Fair Price

Fair price relates to the economic and financial considerations relied upon when valuing the transaction, including the corporation's assets, market values, future prospects, earnings and other factors that affect the intrinsic value of the transaction.¹⁸ A fair price is not necessarily the highest price that the interested party would be willing to pay.¹⁹ However, a price within a range of reasonable prices may not be viewed as entirely fair, if a higher price could have been obtained in an arms' length transaction. As an evidentiary matter, a Delaware court is likely to consider a range of valuation metrics, including analyses based on comparable transactions, comparable companies, discounted cash flows, net asset value and stock price performance, among others.

In addition to the valuation metrics noted above, the structure of a transaction (including the existence of a pre- or post-signing "market-check"), while not directly related to the consideration offered, may be viewed as evidence of fairness.²⁰ In *Fort Howard Corp.*, for instance, the court viewed the availability of a permissive 30 trading day post-signing market check – and the fact that no competing offers were made during that period – as sufficient evidence of the fairness of the price to overcome a number of procedural defects in the special committee process.²¹

Impact of a Properly Functioning Special Negotiating Committee or Approval by a Majority of Disinterested Stockholders

It is important to note that in a transaction with a controlling stockholder, implementation of a special committee process in and of itself *does not* result in the application of the business judgment rule.²² In contrast, in a conflict transaction otherwise subject to entire fairness that does not involve a controlling stockholder, a special committee process likely permits a court to apply the more deferential business judgment rule.²³ The circumstances under which a Delaware court will apply this doctrine are not free from doubt, however. In *Krasner v. Moffitt*,²⁴ the Delaware Supreme Court suggested in a footnote that Section 144(a) of the Delaware

General Corporation Law provided guidance as to whether the business judgment rule would apply to a merger approved by a committee of disinterested directors, where five of the seven total directors were arguably conflicted. Even if the use of a special committee may result in the protection of the business judgment rule in some circumstances, the rules governing the use of such committees in those circumstances are the same as in the controlling stockholder context.²⁵

In litigation challenging a transaction subject to entire fairness review, the board initially has the burden to prove that the transaction is entirely fair. This burden shifts to the party challenging the transaction (that is, to prove that the transaction is *not* entirely fair) if the transaction is approved by an informed and properly functioning special committee of independent and disinterested directors.²⁶

Approval of a conflict transaction by an informed majority of disinterested stockholders may also shift the burden of proving “entire fairness” to the party challenging the transaction. Disinterested stockholder approval does not by itself cure defects in the underlying process or the price obtained, however, as Delaware courts still examine the fairness of the underlying transaction.²⁷ For this reason, practitioners do not typically rely on disinterested stockholder approval alone to protect a board seeking to navigate a conflict transaction successfully.

Even if the procedural effect of a special committee process that merely shifts the burden of proof in litigation appears to be somewhat limited, the practical benefits are significant. A process that shifts the burden in litigation constitutes strong evidence that the transaction satisfies the fair dealing component of entire fairness. Indeed, the authors are not aware of any reported decision where the burden was effectively shifted as a result of a special committee process in which a Delaware court subsequently determined the transaction was not entirely fair. As a result, the settlement value of litigation – and the risk of personal liability for directors – falls dramatically if the burden of proof is shifted to the party challenging the transaction.

A “Siliconix”-Style Structure Permits a Controlling Stockholder to Avoid Entire Fairness Review in a Going Private Transaction

The entire fairness standard does not apply to a going private tender offer by a controlling stockholder, so long as (i) the offer is subject to a non-waivable condition that a majority of the disinterested stockholders tender their shares, (ii) the controlling stockholder commits to complete a “short form” merger at the same price if more than 90% of the outstanding shares are tendered in the offer and (iii) the controlling stockholder does not make “retributive threats” to the special committee or the minority stockholders.²⁸ This is commonly referred to as the *Siliconix* structure after one of the key cases in this area.²⁹ The *Siliconix* structure is available in a limited subset of the types of conflict transactions likely to come before the general counsel and, for this reason, we do not discuss the structure in detail here.³⁰ The structure is often considered by a controlling stockholder seeking to acquire the minority shares in a going private transaction, however, and the general counsel should be generally familiar with the implications of such a structure, particularly for board process.³¹

Further, in the *Cox Communications*³² case, Vice Chancellor Strine advocates for doctrinal reforms that would harmonize the rules applicable to going private transactions with a controlling stockholder, depending upon whether the transaction is structured as a merger or a *Siliconix*-style tender offer. Unlike a *Siliconix*-style tender offer, use of a special committee process in a merger with a controlling stockholder merely shifts the burden of proof on entire fairness and does not result in the application of the business judgment rule. Vice Chancellor Strine suggests that the business judgment rule could (and should) apply to a conflict transaction approved *both* by a special committee of disinterested directors *and* an informed majority of disinterested stockholders. Vice Chancellor Strine argues that the dual approval structure would most closely replicate the process by which an arms’ length merger is approved under Section 251 of the Delaware General Corporation Law. Vice Chancellor Strine also argues that special committee approval of a going private tender offer in the *Siliconix* structure could (and should) be a condition to the protection of the business judgment rule—a *Siliconix*-style tender offer that was not approved by a special committee should be subject to entire fairness review in his view. Because the Vice Chancellor’s discussion was ancillary to the holding of the case, which involved an objection to a request for attorneys’ fees by plaintiffs’ counsel, it must be considered *obiter dicta*, and the extent to which these views

become more broadly accepted remains to be seen. If these views were accepted, it would have a significant impact on the availability of business judgment rule protection in controlling stockholder transactions. The structure using both a special committee and an informed majority of disinterested stockholders has not been used with any frequency to date, no doubt in part due to the increased activism by hedge funds and the attendant leverage a majority of minority approval right would afford such players to “hold-up” the transaction.

Enhanced Scrutiny under Revlon and Unocal Standards

The board’s or special committee’s actions in going private transactions not involving a controlling stockholder, such as transactions with private equity buyers, will be subject to enhanced scrutiny under the *Revlon* and *Unocal* standards. In a transaction involving a sale of the company for cash or other sale of corporate control, as in the typical going private transaction with a private equity buyer, the *Revlon* standard requires the board to act reasonably to secure the best value reasonably available to shareholders.³³ This standard contemplates a judicial examination of the reasonableness of the board’s action, not the bare rationality standard under the business judgment rule.³⁴ It is often noted that “there is no single blueprint that a board must follow to fulfill its duties,”³⁵ and Delaware courts have historically supported the use of a post-signing “market check” as reasonable under the circumstances so long as the terms are consistent with the *Unocal* standard described below. As illustrated by the *Netsmart Technologies* case, however, in which a post-signing market check for a micro-cap public company was found not to be a reliable way to test the market for strategic buyers,³⁶ the *Revlon* standard is not susceptible to rote application and requires the board or special committee to design a tailored process, relying upon the advice of outside advisors, to secure the best value reasonably available.

Provisions in a merger agreement that are intended to protect the deal – “no-shops”, termination fees and the like – are also subject to enhanced scrutiny under the *Unocal* standard.³⁷ The *Unocal* standard requires that the board had reasonable grounds for believing that a third party bid would constitute a threat to corporate policy and that the deal protection provisions agreed to by the board or special committee were reasonable in response to the perceived threat and not otherwise preclusive of a third party bid or coercive to shareholders. As with the *Revlon* standard, there are no bright lines against which Delaware courts will measure deal protection provisions, or “safe harbors” for board action. As emphasized in a recent decision involving Caremark Rx, the Delaware court will consider a number of factors when evaluating the reasonableness of deal protection provisions, including, in that case, the termination fee: the overall size of the termination fee, as well as its percentage value, the benefit to shareholders, including the premium that directors seek to protect, the absolute size of the transaction, as well as the relative size of the parties to the transaction, the degree to which a counterparty found such protection to be crucial to the deal, and the preclusive or coercive power of all deal protections included in the transaction, taken as a whole.³⁸ The opinion in particular should caution those who indiscriminately apply “3%” as an acceptable termination fee without further analysis in the context of the transaction at hand and the likely interlopers.

WHEN TO FORM A SPECIAL NEGOTIATING COMMITTEE

The general counsel is frequently the first legal decision-maker to be advised of or identify potential conflicts in transactions and to respond to questions from directors and management about the process to mitigate the conflict. Because the analysis is fact intensive, gathering all of the information that may indicate the presence of a conflict is typically the first task. The fact gathering process may be uncomfortable for directors and, as a result, the general counsel may wish to enlist the help of the chairman or lead outside director. We describe below what constitutes a conflict of interest and give examples of transactions for which a special committee is often formed.

Identify and Analyze the Conflicts

A conflict generally exists in any circumstance in which a director has a material interest in or with respect to a transaction that is adverse to the corporation or not shared equally with the stockholders.³⁹ A conflict must be material to result in heightened scrutiny. The existence of

some immaterial self-interest, absent further evidence of disloyalty, is not alone sufficient to be viewed as a disabling conflict.⁴⁰ The most easily identifiable conflict exists in situations in which a director is on both sides of a transaction, as in a management buyout, or has a material financial interest adverse to the corporation, whether directly or indirectly via an entity that is doing business with the corporation. Examples of other possible conflicts of interest include:

- A director's family member or other close relative has a material interest in or with respect to a transaction.⁴¹
- The receipt of customary director's fees is not generally viewed as a material special benefit, but fees materially in excess of what is understood to be a usual and customary fee may constitute a conflict of interest.⁴² In *Emerging Communications*, a director was found to have a conflict of interest where the director's fees paid to him were material in relation to his income, from which the court inferred a financial incentive to agree to a going private transaction with the controlling stockholder, as opposed to a sale to a third party.⁴³
- Stock ownership by a director or his or her employer does not alone constitute a conflict of interest.⁴⁴ However, stock ownership may be viewed to result in a conflict of interest in circumstances in which differential consideration is paid with respect to multiple classes of stock, or if the corporation buys back stock from a director or his or her employer.⁴⁵
- Indemnification of directors is not typically viewed to create a conflict of interest. However, in a recent decision involving Caremark Rx,⁴⁶ the Delaware court noted that expanded indemnification provided by the buyer in a merger agreement could be important (and ostensibly constitute a conflict of interest) for directors subject to personal liability in connection with claims for backdating of executive stock options.
- A management director in an arms' length transaction receives substantial change in control payments under existing agreements, particularly when alternative transactions being considered may not trigger such payments, or substantial payments in the transaction in exchange for future consulting services or a non-competition covenant.⁴⁷

Determine Whether to Form a Special Negotiating Committee

If it is determined that a conflict exists, the next step is to evaluate whether a special committee should be formed with respect to the transaction. The board should make this decision after gathering all relevant information from management, the general counsel and outside counsel.

While a board that fails to form a special committee in a transaction subject to entire fairness review will face significant additional litigation risk and the possibility of personal liability,⁴⁸ formation of a special committee is costly and the board should not initiate the process without a complete understanding of the procedures and potential pitfalls. The costs are substantial. The directors serving on a special committee will expend untold hours to complete the process and will typically receive additional fees for their efforts, and the committee will retain separate financial, legal and possibly other advisors at the corporation's expense. Special committees may generate non-financial costs as well. For instance, arms' length bargaining often leads to separate factions within the board and can have a lasting impact on the relationships among directors or with management.

As a general rule, the board should form a special committee in any transaction in which a majority of the directors are conflicted. Also, the board should seriously consider forming a special committee even if a majority of the board is nominally independent and disinterested, if there is concern that the board will be viewed as "controlled" or "dominated" by the interested parties. Transactions with a controlling stockholder and management-led buyouts are the most frequent types of transactions in which special committees are formed.

Transactions with a Controlling Stockholder

Transactions involving a controlling stockholder involve conflicts in nearly every instance. The board should seriously consider forming a special committee in any significant transaction with a controlling stockholder or in which a controlling stockholder has a material interest adverse to the corporation or its minority stockholders.⁴⁹ This is prudent even if the board of the controlled corporation consists of a majority of nominally independent and disinterested directors, due to the concern that these directors will be viewed as “controlled” or “dominated” by the controlling stockholder and its directors. A going private transaction that results in the “freeze-out” of the minority stockholders is the classic case in which to form a special committee.⁵⁰ The board should also seriously consider forming a special committee in transactions that result in the controlling stockholder receiving differential consideration or material additional benefits that are not shared with the minority stockholders, which could include, for example, leveraged or other recapitalizations and stock buyback or exchange transactions.⁵¹ Lastly, the board may even consider forming a special committee in an arms’ length transaction in which a controlling stockholder directs the sale of the corporation, if the controlling stockholder’s interests with respect to the timing or form of consideration could be viewed to differ from the interests of the minority stockholders. In *McMullin v. Beran*, for instance, it was alleged that Atlantic Richfield Company had an interest not shared with the minority stockholders to sell ARCO Chemical Company quickly in a cash transaction (as opposed to a stock transaction) in order to obtain funding for another acquisition.⁵²

Management-Led Buyouts or Other Transactions with Private Equity Buyers

It is customary and prudent – though not required in all cases – to form a special committee to negotiate with management in connection with a management-led buyout, even if a majority of the board is independent and disinterested.⁵³ The concern is that, as a practical matter, the board will be viewed as “controlled” or “dominated” by management, in which case the entire fairness standard will apply.⁵⁴ There is also concern that the corporation’s financial and legal advisors may not be sufficiently independent of management. There may be circumstances in which a management-led buyout could be completed without a special committee, but only following careful consideration of the risks.

Although not as acute as in the traditional management-led buyout, similar concerns exist in any going private transaction with a private equity buyer. It is fair to observe that the trend is to form a special committee in the private equity buyer context, even if management maintains neutrality and is not formally aligned with any private equity buyer, and the full panoply of new outside independent advisors may not be retained. There is more flexibility in this context to complete the transaction without a special committee or, if a special committee is used, to more narrowly tailor the role and authority of the special committee.

WHEN NOT TO FORM A SPECIAL NEGOTIATING COMMITTEE

Absent special circumstances, the board need not – and arguably should not – form a special committee for a transaction in which a majority of the board is independent and disinterested. Action taken by a majority of independent and disinterested directors is subject to the business judgment rule, provided (i) the interested directors recuse themselves, (ii) the board has access to all material information and (iii) the board is not viewed as dominated or controlled by the interested director(s).⁵⁵ Examples of conflict transactions that do not typically merit formation of a special committee include:

- Transactions in which one director has a conflict of interest, if there is no concern the director dominates or controls the board. An audit committee of outside independent directors typically approves these transactions.⁵⁶
 - Employment agreements, stock option grants and other compensation arrangements. A compensation committee of outside independent directors typically approves these agreements.⁵⁷
 - Transactions resulting in an arms’ length sale to a third party, even if such transactions may result in change-in-control or other retention payments or accelerated vesting of options.⁵⁸
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The board should consider all the potential costs before forming a special committee in a circumstance in which one is not required. In addition to the costs (financial and social) incurred by an unnecessary special committee process, a decision to form a special committee may itself raise concerns about the board's independence, which could result in heightened scrutiny of the board's process. A board may nonetheless decide that the special committee process has independent value, even if formation of a special committee is not required, either out of an abundance of caution or to achieve administrative or resource allocation efficiencies. We do not generally recommend this approach, but believe it can be structured so as to avoid incremental risk if the purposes and authority of the special committee are clearly delineated, as discussed below.

SELECTING AND FORMING THE SPECIAL NEGOTIATING COMMITTEE

Disinterested Directors Should Select the Members

The disinterested directors should select the directors to serve on the special committee, not management or directors that have an interest in the transaction. The Delaware court cited the involvement of interested directors as a negative factor in evaluating the special committee process in *Fort Howard Corp.*, for instance, in which the chief executive officer leading a management buyout selected the chairman of the special committee and the other members.⁵⁹ That being said, the process of selecting special committee members will not be hermetic. The general counsel frequently will participate in vetting the independence of directors and identifying directors to potentially serve on the special committee and it would be unrealistic to expect otherwise, often assisting the chairman of the board (if independent and disinterested), lead outside director or chairman of the audit committee leading the process.

In connection with these initial discussions, we believe it is appropriate and helpful for the general counsel to:

- initially vet the independence of directors;
- initially advise directors of their fiduciary duties in light of the potential conflict of interest;
- consider recommendations of independent outside counsel; and
- work with the corporation's regular outside counsel or Delaware counsel to educate the board and management.

Establish the Size of the Special Negotiating Committee

We recommend the special committee consist of at least three and not more than five directors. This is based upon our practical experience, not any particular legal rule. Even a special committee made up of one independent director is permissible under Delaware law, although such a "committee of one" will be subject to special scrutiny and is not advisable⁶⁰ — "[I]f a single member committee is to be used, the member should, like Caesar's wife, be above reproach."⁶¹ Likewise, a special committee composed of two directors is less than ideal, because both directors will be required to approve any action and, if a court finds one director not independent, the remaining director will be subject to the special scrutiny reserved for single-member committees. Committees of more than three are workable, although we believe the administrative efficiency of the special committee is significantly hampered if the special committee exceeds five directors. We also note that attendance at special committee meetings may become challenging as the size of the committee increases. In *Emerging Communications*, the court noted that, due to the location of directors on different continents and in different time zones, the special committee never met in person and never met collectively — even by telephone — to consider the final negotiated offer.⁶²

Special Negotiating Committee Must be “Independent” (in Addition to Being “Disinterested”)

The directors selected to serve on the special committee must be “independent” under Delaware law.⁶³ It goes without saying, of course, that directors selected to serve on the special committee must also be disinterested from the particular transaction, as discussed above. Practitioners typically conduct in-person or telephonic interviews with directors to identify relationships that could be viewed as problematic. A director is generally considered independent and disinterested if he or she does not have a financial or other interest in the conflict transaction and does not have some other material interest or relationship that could influence his or her decision.

Definition of “Independent”

A director is “independent” if his or her action is “based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations.”⁶⁴ If the independence of a director serving on a special committee is challenged, the corporation will bear the burden of proving the independence of the director.⁶⁵ The court will analyze the facts and circumstances to determine if there is reasonable doubt whether the director in question is capable of objectively making a business judgment with only the best interests of the corporation in mind.⁶⁶ Directors are not viewed as independent if they have received “significant payments” for consulting or other services, including employment, from the corporation or an interested party.⁶⁷ “Significant payments” may include consulting or other fees received in the past.⁶⁸ In a case involving eBay, Inc., for example, unvested stock options potentially worth millions of dollars were found to create a financial incentive for directors to retain their positions as directors and make them beholden to the interested directors, and therefore not independent.⁶⁹ In that case, the interested directors had sufficient stock ownership to remove the other directors from the board.

Social or Personal Relationships

Directors may also not be considered independent if social or personal relationships render the director “beholden” to the interested party.⁷⁰ Cases in the context of special litigation committees have caused concerns among practitioners about the scope of this analysis as applied to special negotiating committees. In the case of *In re Oracle Corp. Derivative Litigation*,⁷¹ for instance, the court held that social, personal and (albeit indirect) financial ties among the directors serving on a special litigation committee and certain of the directors accused of insider trading and Stanford University were so substantial as to cause reasonable doubt regarding the special committee’s ability to render an impartial decision.⁷²

The case of *Beam v. Stewart* tempered these concerns somewhat. In *Stewart*, the Delaware Supreme Court held that a social or personal relationship “must be of a bias-producing nature” to result in a finding of non-independence.⁷³ The court clarified that the analysis relates to whether a social or personal relationship is “so close that the director’s independence may *reasonably* be doubted.” This doubt might arise either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis-à-vis an interested director.⁷⁴ The court indicated that allegations of mere personal friendship or outside business relationships, standing alone, are insufficient to raise a reasonable doubt about a director’s independence.⁷⁵

The Oracle case arises in the context of a special litigation committee, the independence of which is subject to the highest scrutiny – a special litigation committee permits a corporation to terminate a derivative suit if comprised of directors who can impartially consider a demand.⁷⁶ The Stewart case, on the other hand, considers the circumstances under which a plaintiff is excused from making a pre-suit demand in a derivative suit by raising a reasonable doubt about the independence of a majority of the board. A pre-suit demand would afford the board the opportunity to pursue the corporate claim that is the subject of a derivative suit. Directors in the context presented by the Stewart case enjoy a presumption of independence, which is not applicable in the context presented by the Oracle case. While it is unclear whether a Delaware court will apply the same relationship-based analysis of independence in the context of special negotiating committees as applied in Oracle and Stewart, we recommend the general counsel inquire about non-economic relationships and, if such relationships exist, fully disclose and document these relationships to the special committee and its counsel.

Think Strategically and Consider Intangibles

The general counsel should think strategically about the selection process, taking into account the intangibles that may significantly impact the success of the special committee. First and foremost, membership on a special committee requires a significant time commitment. Even the most competent, sophisticated director should not serve on a special committee if he or she does not have time. A successful process will typically involve frequent meetings, many of which are likely to be face-to-face, and additional time will be required to review materials, prepare for meetings and participate in negotiations. The general counsel should encourage the directors leading the formation process to consider directors' unique strengths and weaknesses, including personality, ability to work together in a difficult environment and the ability to act decisively, yet reasonably. For example, it is helpful, though not always possible, to have at least one director on the committee with financial, investment banking or deal expertise, as such director will have the experience and background to assist the committee in evaluating the consideration offered and may assume a lead role in negotiations. Lastly, it is important to consider how a director will perform in a deposition or at trial. The ability to communicate the special committee's mandate, deliberations and actions in a clear and convincing manner is invaluable in litigation. In *MAXXAM*, for instance, the court noted that a member of the special committee "could not recall any details of the negotiation process, including what his opening position was or how many times he met" with the controlling stockholder.⁷⁷

SCOPE OF SPECIAL NEGOTIATING COMMITTEE'S AUTHORITY

Delaware courts will not defer to a special committee vested with insufficient authority, no matter how pristine the process. The committee must have authority to act independently and exercise real bargaining power at arms' length with interested parties,⁷⁸ which is generally viewed as requiring both procedural and substantive authority.

Procedural Authority to Operate Independently

The special committee should have authority to operate independently as a procedural matter. First and foremost, the committee should have authority to engage independent legal, financial and other advisors at the corporation's expense. Independent advisors are viewed by Delaware courts as "critical with respect to protection of stockholder interests."⁷⁹ The committee should also have direct access to, and authority to obtain up-to-date information directly from management and the corporation's regular outside counsel and other advisors.

Substantive Authority to Walk Away

Delaware courts will scrutinize the substantive authority of the special committee – and particularly whether the special committee had the power to reject a proposed transaction – to determine whether the special committee had sufficient authority to engage in real arms' length bargaining. Delaware courts have consistently held that a special committee must have the power to say no to a proposed transaction. In *Lynch Communications*, for instance, the court stated: "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."⁸⁰ Authority to pass upon the fairness of the transaction, without more, is insufficient.⁸¹

Even if the special committee's authority to walk away from a transaction exists on paper (as documented in carefully drafted authorizing resolutions), Delaware courts will examine whether the special committee had such authority in practice. Actions by the committee that create doubt about whether the directors believed they could actually reject the proposed transaction, or threats by the interested party that are viewed as coercive of the committee, will significantly increase the likelihood that a court will find the process ineffective. In *Lynch Communications*, for instance, at an impasse in negotiations the controlling stockholder made a final offer and threatened to commence a hostile tender offer at a lower price if the special committee did not recommend the friendly acquisition to the full board.⁸²

In a transaction involving a controlling stockholder, Delaware courts will not require the special committee to undertake futile efforts pursuing alternatives that require the controlling stockholder's consent.⁸³ In those circumstances, the special committee need not have authority to pursue alternatives to the proposed transaction, the special committee should

consider available alternatives (even if on a hypothetical basis) to make an informed judgment about whether to approve the proposed transaction.

PROCESS AFTER FORMATION – THE ROLE OF THE GENERAL COUNSEL

After the board has formed a special committee with sufficient authority, the general counsel is likely to find that his or her role will be primarily to support the committee and its independent counsel. The committee's counsel will have responsibility for guiding and documenting the special committee's deliberations. The general counsel can be most effective during this period in educating management, a controlling stockholder (if applicable) and those directors not serving on the special committee about the process and, when necessary, acting as a buffer to protect the special committee's independence. We describe below practical advice gleaned from our experience and relevant case law related to process essentials.

Instruct the Special Negotiating Committee to Engage Independent Legal and Financial Advisors

After the board forms a special committee, the general counsel or the corporation's outside counsel should instruct the special committee to engage independent legal and financial advisors. An advisor is "independent" if it does not have any material relationships with the corporation or the interested parties that may impact the ability to offer full and frank advice to the committee. For example, in *Tremont Corp.*, the court questioned the independence of the special committee's financial advisors because an affiliate of the financial advisor previously earned "significant" fees from the controlling stockholder and his affiliated companies.⁸⁴

The special committee must select its advisors, not management or the interested parties. Although it is permissible – and may be quite helpful – for management or the general counsel to provide contacts to the special committee of experienced and well-known counsel or other advisory firms, there is a fine line between merely providing contacts and making affirmative recommendations, particularly if the recommendation relates to a firm that has previously performed services for the corporation or an interested party. In *Tremont Corp.*, for instance, the court questioned the independence of the legal advisors retained by the special committee that were recommended by the general counsel and had previously worked for the controlling stockholder.⁸⁵

We recommend that the special committee evaluate and interview more than one potential legal and financial advisor. The process of conducting actual interviews with multiple candidates demonstrates the seriousness with which the special committee views the engagement. In practice, the process of vetting potential advisors may occur concurrently with formation of the committee so long as the independent directors that constitute the committee lead the process.

The general counsel and the corporation's outside counsel also frequently participate in vetting legal advisors, at least in the narrow sense of assisting the special committee to verify that the potential candidates are independent and have sufficient expertise to discharge their task appropriately. The committee will establish the fees paid to independent advisors, which may be substantial.⁸⁶ The committee's counsel will typically guide the committee in verifying that potential financial advisors are independent and negotiating an appropriate engagement with the financial advisor. The committee's counsel may also revisit the issues discussed above related to formation of the committee, including verifying that each member is independent and that the committee has sufficient authority, and may seek to negotiate enhanced protection of the committee in terms of contractual indemnification rights.

Educate the Board and Management about the Process

Once retained, the special committee's independent advisors will have responsibility for guiding the special committee's process and deliberations. Management, the directors not serving on the committee and the interested parties should respect the special committee's independence and deal with the committee at arms' length. We believe the general counsel can facilitate this process by educating the parties about certain important process points.

Engage in Real “Arms’ Length” Bargaining

To obtain judicial respect for the special committee process, it is essential that the committee engage in real arms’ length bargaining with the interested parties. Frequently, to the surprise of the transaction participants, this means the special committee *will* negotiate the price and other terms of the transaction *vigorously*, and there is invariably a moment in every special committee process in which the interested parties realize that the committee will in fact assert its independence and insist on favorable terms. The special committee process will often be lengthier, more process oriented and more expensive than the controlling stockholder or interested directors desire. Unless counseled to expect this from the special committee, interested parties often react negatively, to the detriment of the committee process. In our experience, an interested party’s perception of the special committee is often shaped by their counsel, who may not, due to the lack of a long relationship with the interested directors, be able to effectively manage expectations with respect to the special committee process. Given his or her relationships, the general counsel may be better positioned to shape the interested party’s perceptions, which can help avoid circumstances in which an interested party becomes frustrated to the detriment of the committee’s independence. In particular, the general counsel should consider:

- educating the controlling stockholder and interested directors about the special committee’s duties, the role process will play and the attendant “dance” and delays that are likely to occur;
- shaping expectations for costs of the process;
- shaping expectations for the tenor and level of negotiations, including apparent deadlocks that may periodically result; and
- staying in touch with the controlling stockholder and interested directors over the course of the transaction so as to be ahead of building tensions and disagreements.

Provide Most Recent and Best Information to the Special Negotiating Committee’s Financial Advisor

A common issue as to which the general counsel can be particularly helpful relates to the requirement to provide up-to-date financial information to the special committee’s financial advisor. The committee’s financial advisor is charged with assisting the committee in analyzing the financial aspects of the transaction and in assisting with negotiations. In addition, the financial advisor will deliver an opinion as to the fairness of the consideration offered in the transaction from a financial point of view. Historical and projected financial data provided by management will form the input for the financial advisor’s valuation models and the basis for the fairness opinion. Failure to provide the most recent and best information undermines these analyses and infects the entire committee process. In *Emerging Communications*, for instance, the special committee’s financial advisor was provided outdated financial projections prepared by the company, while the controlling stockholder had access to more recent projections which indicated substantially higher growth. Throughout the negotiation between the committee and the controlling stockholder, the committee and its advisors operated at a significant disadvantage as their financial models were premised on outdated projections, resulting in the committee undervaluing the company. The court determined that this imbalance of information rendered the special committee “ineffective as a bargaining agent for the minority stockholders.”⁸⁷

Respect the Confidentiality of the Committee’s Deliberations

The deliberations and strategy of the special committee should be confidential. Management and the interested directors should not discuss the special committee’s deliberations in “off-line” conversations with the members of the committee or its advisors. The special committee should use modes of communication separate from the corporation and the confidentiality of these communications should be respected. The court specifically noted the failure to maintain adequate safeguards in *Emerging Communications*, where the committee used the controlling

stockholder's secretary to transmit materials prepared for the committee by independent financial and legal advisors.⁸⁸

One additional point for the general counsel. We recommend that detailed time entries for the committee's counsel only be available to the committee, as they could reveal information concerning the strategies or other confidential deliberations of the special committee. The general counsel should only receive a simple invoice from the committee's counsel, which will be subject to the approval of the chairman of the special committee.

The Special Negotiating Committee Sets Its Agenda, Including Timing

The special committee should set its own agenda, including as to timing, number of meetings and method of response to the proposed transaction. This is an issue if the interested party seeks to impose unreasonable time deadlines on the special committee, which Delaware courts may find infringe upon the committee's ability to deliberate appropriately.

Otherwise Ordinary Course Actions by a Controlling Stockholder Receive Heightened Scrutiny in the Process

Directors serving on a special committee often feel at risk of heightened liability and public scrutiny. This is not simply a legal matter, but one of tone in what can be a tense special committee environment. As such, the committee will be sensitive to any action taken by a controlling stockholder or other interested party that could be viewed as coercive or otherwise impinging on its independence, even actions that would be viewed as ordinary course outside of the special committee process. Examples of actions that could be viewed as problematic include appointing new directors to the board, modifying the terms of change-in-control or retention agreements for management, and creating new arrangements or relationships with the controlling stockholder or its affiliates or family members.

The Special Negotiating Committee's Legal Advisor Will Document the Committee's Deliberations

The special committee's counsel will generally prepare minutes to document the committee's deliberations. The general counsel will not have access to, or an opportunity to review, these minutes prior to completion of the special committee process. However, the general counsel can frequently "set the bar" for minutes, by providing sample board minutes to the committee's counsel. We note that Delaware courts have expressed a preference for "long form" minutes, as opposed to the "short form" minutes that may be typical for ordinary course board actions. "Long form" minutes should describe the committee's meetings in significant detail, reflecting the advice from its independent advisors, deliberations and careful consideration of all relevant issues.

Consider the Possibility that Privilege will be Waived in Litigation

Advice rendered by the special committee's legal advisor to the committee is subject to the attorney-client privilege. In litigation it may be desirable to waive the privilege to permit Delaware courts unfettered access to the committee's deliberations. If the special committee ultimately determines to waive the privilege, the records of the special committee will be exposed. In light of this probable outcome, the general counsel and counsel to the committee should devote special care to the preparation of all written communications to and with the committee, because these documents may be judged in litigation with the benefit of hindsight.

There is No General Obligation to Disclose the Formation of a Special Negotiating Committee, Although the General Counsel Should be Mindful of Events that Trigger a Disclosure Obligation

Although the board or special committee may desire to announce the formation of the committee (for instance, as a follow-up to an announcement by the interested party of the proposed transaction or to initiate a competitive process in which the committee will consider alternative transactions), there is no general obligation to disclose the formation of a special committee *per se*, or that the board is evaluating a conflict transaction. The general counsel should be mindful, however, of events that may require disclosure under the federal securities

laws and applicable stock exchange rules. The filing of periodic reports with the SEC and the offer and sale of securities, including pursuant to a shelf registration statement, generally require disclosure of all material information. Similar disclosure may be required under Rule 10b-5, if a corporation is engaging in transactions in its stock, including pursuant to a stock repurchase program. Stock exchange rules generally require prompt disclosure of material information and the exchange may require immediate disclosure if rumors or unusual market activity indicate that information may have leaked to the public. Lastly, the new requirements for prompt disclosure of material agreements on Form 8-K, including change-in-control and retention agreements or new director indemnification agreement, may tip the market prematurely about a possible transaction.

Be a Resource for the Special Negotiating Committee

The general counsel should act throughout the process as a resource to the special committee and its advisors. This may be common sense, but the committee will be more effective and have a higher likelihood of success (both in terms of achieving an appropriate resolution of the proposed transaction and, if necessary, litigation) if it receives the highest level of cooperation and information from the corporation, including assistance in due diligence and preparation of disclosure schedules. Such assistance and support can also significantly reduce outside counsel's expense. The general counsel can greatly facilitate this process.

Bringing the Board Back Together – The Full Board Still Must Satisfy its Duty of Care

Delaware law requires that certain transactions be approved by the full board, not a special committee.⁸⁹ In these circumstances, the committee will make a recommendation to the full board, which will be required to act separately to approve the transaction. The full board still must satisfy its duty of care. At the full board meeting, we recommend the chairman of the committee describe in detail the committee's process and deliberations, including the alternatives evaluated by the committee. The board may ask that the committee's financial advisor briefly summarize its analyses and conclusions, including confirmation of the fairness opinion delivered to the committee. The committee should present its recommendation, which is frequently oral, but may also be delivered in written form, and should describe the reasons for its recommendation, with a view to the required disclosure of these reasons in SEC filings related to the transaction.

Going Private Transactions with Private Equity Buyers

Going private transactions with private equity buyers may result in enhanced scrutiny of board action due to the actual or perceived conflict relating to management's participation or expectation of future participation in the equity or other economics of the company after closing. Regardless of whether a special committee is formed,⁹⁰ we believe the general counsel can play a critical role in guiding management and the board in these transactions – particularly in the period before the board and outside counsel is fully engaged in the process – to avoid circumstances that may compel formation of a special committee, create “bad facts” for litigation or otherwise result in management's exclusion from the process. Like many matters in Delaware law, these are primarily process points, but these processes are most likely to result in transactions compliant with the principles outlined above and obtain judicial deference for the board's actions.

Consider All Strategic Alternatives, including Strategic and Private Equity Buyers

We recommend that the board be apprised of and consider strategic alternatives annually, including receiving presentations from management and outside financial advisors. We believe this provides an important foundation from which the board can quickly evaluate strategic opportunities that present themselves to the board, whether received from a private equity buyer or otherwise, and avoid judicial characterization of such presentations made in connection with a proposed going private transaction as intended solely to justify the outcome rather than seriously evaluate the alternatives. These more general presentations will not, of course, substitute for more detailed evaluations at the time a specific transaction is tabled, at which time the board must carefully consider the *then available* strategic alternatives, including with strategic and private equity buyers. The recent decision in the *Netsmart Technologies* case, for instance, counsels that the board should consider strategic buyers in its strategic

alternatives review or, if strategic buyers are not considered, present a current and carefully tailored basis for not doing so. In that case, the court suggests that neither stale analyses or historic canvassing of possible buyers, nor “boilerplate” rationales for excluding strategic buyers – risk of disclosure of confidential information or disruption to customer or other relationships – will be sufficient justification for excluding strategic buyers, absent unique circumstances and substantiation by outside advisors.⁹¹

Management Should Advise the Board of Private Equity Buyer Interest When Contact is Made and Should Not Engage Substantively Without Board Consent

Practitioners debate the stage in a transaction at which to advise the board of private equity interest, ranging from the early stage at which initial contact is made, prior to execution of a confidentiality agreement, prior to engaging in substantive discussions, or at the point that the company has received a written indication of interest. Although there is no absolute rule in this area, and failure to advise the board at the earliest stages is not likely to be fatal from a Delaware process perspective, the best practice and clearly preferred approach is to advise the board of private equity buyer interest when initial contact is made. Management likewise should not engage substantively with the private equity buyer, including by entering into a confidentiality and/or standstill agreement, without board consent. This mitigates the appearance of impropriety, often couched as a claim that management misappropriated corporate assets to further their own interests,⁹² and avoids the uncomfortable position of being perceived as “getting ahead of the board.” The consequences for management can be draconian. With increasing frequency management that is perceived as having engaged private equity without board knowledge will be excluded from the sale process entirely, or, in some cases, the process will be terminated—and so will management.

Demand Management Neutrality

To secure the best posture from a Delaware process perspective, the board or special committee should direct that management remain neutral during the process, at least until the parties have agreed to the principal business terms of the transaction. We suggest that formal guidelines be established for management’s conduct, and that management agree not to enter into any discussions, arrangements or understandings with a private equity buyer related to management participation in the transaction without board consent. In circumstances in which management is unable or unwilling to remain neutral, it is likely that management will be marginalized, and in certain circumstances excluded, from the strategic alternatives review process.

Outside Advisors as “Hall Monitors”

The board or special committee should ensure that independent advisors are actively involved in, and monitor management’s neutrality with respect to, the diligence process and other substantive discussions, so as to maintain a level playing field among bidders. As one influential court has noted: “If management had an incentive to favor a particular bidder (or type of bidder), it could use the due diligence process to its advantage, by using different body language and verbal emphasis with different bidders.”⁹³ There are circumstances in which it may be necessary and appropriate for management to have discussions with potential bidders on an unmonitored basis, but we would suggest these discussions be disclosed and approved by the board or special committee in advance.

Process to Maximize Value Should Be Custom Tailored to Unique Facts and Circumstances

As noted above, rote application of market practice and custom – whether relating to the relative efficacy of pre- and post-signing processes to maximize shareholder value, the appropriate quantum of deal protection or otherwise – is not a substitute for a thoughtful process designed to maximize shareholder value, custom-tailored to the company’s unique facts and circumstances. In the private equity context these deal protection devices are viewed with an additional measure of suspicion, and thus the lessons noted above take on particular importance.

Evaluate and Understand Incentives and Conflicts of Advisors

The board or special committee should be fully informed, evaluate and understand the incentives and conflicts of outside financial, legal and other advisors. Incentives created by fees paid to financial advisors are of particular importance. In the case involving Caremark Rx, for instance, the court required disclosure to shareholders that a significant portion of the financial advisor's fee was contingent upon initial approval of the transaction, stating that knowledge of such financial incentives was material to shareholders.⁹⁴ Disclosure of financial advisor fees and incentive structures – first to the board or special committee and ultimately the shareholders – likely mitigates any concerns and, absent egregious circumstances, these incentives should not substantively impact the record from a Delaware process perspective.

A recent preliminary ruling in a case involving an auction process in which only private equity bid in a meaningful way suggests that “stapled financing” offered by a financial advisor could result in heightened scrutiny of the sale process by a Delaware court.⁹⁵ In that ruling, the court recited plaintiff's allegation that the financial advisor's interest in obtaining fees from “stapled financing” actually affected the sales process when the financial advisor allegedly advised the company not to pursue an indication of interest from a strategic buyer that might not utilize the “stapled financing.” This allegation, if true, would not necessarily be mitigated by disclosure, as it runs to the integrity of the board's actions as a substantive matter. Notwithstanding this concern, we believe that “stapled financing” may be permissible, and in many circumstances advisable from the perspective of maximizing value. The board record must reflect receipt of current and specific information to substantiate the business rationale for “stapled financing” and a fair presentation of the benefits and risks of offering such a package (including potential conflicts), followed by board or special committee action taken in consultation with legal advisors.

Depending upon the facts and circumstances, and unlike the situation involving a controlling stockholder, the company's legacy advisors may be eligible to represent the board or special committee in evaluating a transaction with a private equity buyer. This is particularly the case if management is committed to remain neutral in the process. If management is not neutral in the process, the company's legacy advisors could be viewed as beholden to management and, therefore, not eligible to serve.

Anticipate Disclosure of Company Projections

The parties should anticipate that management's projections will ultimately be disclosed to shareholders. In the context of “cash-out” transactions, Delaware courts have found that the duty of disclosure extends to “reliable” management projections, with reliability turning on the staleness and circumstances of preparation of the projections, among other factors.⁹⁶ The court in *Netsmart Technologies* expanded the duty of disclosure in this context, however, finding that in a cash-out transaction management projections underlying a financial advisor's fairness opinion are material and, due to the weight placed by the board or special committee on the fairness opinion, presumptively – if not conclusively – reliable.⁹⁷ Chancellor Strine in particular noted that management's projections in this context are “the best estimate of the company's future returns” and “probably among the most highly-prized disclosures by investors.”⁹⁸

Concluding Thoughts

A board that fails to adequately address conflicts of interest, including in appropriate circumstances by forming a special negotiating committee, risks litigation and personal liability. An effective special negotiating committee process requires nuanced analysis, strategic planning and careful execution, all things in which, in our experience, general counsels excel. The general counsel's participation and support is an essential element to effectively manage the legal and business risks associated with conflict of interest transactions and establish processes that will result in the maximum deference allowed by law from a reviewing court.

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¹ Although more frequently referred to as a "special committee," we use the term special negotiating committee from time to time to distinguish from a special litigation committee, which is established in connection with shareholder derivative actions.

² *In re Emerging Communications, Inc. S'holders Litig.*, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004).

³ See, e.g., *In re Netsmart Technologies, Inc. S'holders Litig.*, 2007 Del. Ch. LEXIS 35 (Mar. 14, 2007) and *In re SS&C Technologies, Inc. S'holders Litig.*, 2006 Del. Ch. LEXIS 201 (Nov. 29, 2006).

⁴ State of Delaware, Department of State: Division of Corporations, *Why Choose Delaware as Your Corporate Home?*, at <http://www.delaware.gov/default.shtml> (last modified Mar. 23, 2007).

⁵ The business judgment rule is the presumption under Delaware law that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

⁶ See *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 42 n.9 (Del. 1994).

⁷ See *Cinerama, Inc. v. Technicolor ("Technicolor II")*, 663 A.2d 1156, 1168 (Del. 1995).

⁸ See *Cede & Co. v. Technicolor ("Technicolor I")*, 634 A.2d 345, 362 (Del. 1993).

⁹ See *Kahn v. Lynch Communication Sys., Inc. ("Lynch I")*, 638 A.2d 1110, 1115 (Del. 1994). Note that a stockholder may be viewed as "controlling" at less than 50% ownership if the stockholder exercises control over the business affairs of the corporation. See *id.* at 1113-14 (citing *Ivanhoe Partners v. Newmont Min. Corp.*, 535 A.2d 1334, 1344 (Del. 1987)). See also *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 551-53 (Del. Ch. 2003) (chairman and CEO with approximately 40% of outstanding voting stock held to be a controlling stockholder).

¹⁰ We also discuss below circumstances in which the business judgment rule may still apply to a conflict transaction. See "When to Form a Special Committee—When Not to Form a Special Committee" below. In addition, a controlling stockholder may utilize a tender offer structure, which we refer to as the *Siliconix* structure, to complete a going private transaction without being subject to entire fairness review. See "A '*Siliconix*'-Style Structure Permits a Controlling Stockholder to Avoid Entire Fairness Review in a Going Private Transaction" below.

¹¹ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) ("The test of fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.").

¹² See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 928 n.7 (Del. 1985) (An "independent bargaining structure, while not conclusive, is strong evidence of the fairness of the merger ratio."). See also *Seagraves v. Urstadt Property Co.*, 1996 Del. Ch. LEXIS 36, at *15 (Apr. 1, 1996) ("A board is not legally required to utilize an independent negotiating committee or obtaining [sic] an investment banker fairness opinion. However, where a board does employ one or more of those procedural safeguards, that will be viewed as persuasive evidence that the minority stockholders were treated fairly." (citations omitted)).

¹³ See *Weinberger*, 457 A.2d at 711.

¹⁴ See *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *129 (failure to provide most-recent financial projections, "without more, was enough to render the Special Committee ineffective as a bargaining agent for the minority stockholders").

¹⁵ See *Kahn v. Tremont Corp.*, 1996 Del. Ch. LEXIS 40, *51-56 (Mar. 21, 1996), *rev'd on other grounds*, 694 A.2d 422 (Del. 1997), for a discussion of the duty of disclosure in negotiations with a special committee. Although the Delaware Supreme Court disagreed with the Court of Chancery's characterization of the basis for not disclosing certain information as a form of "privilege," the court recognized that the duty of disclosure could be limited by the "normal standards of arms-length bargaining."

¹⁶ *In re Trans World Airlines, Inc. S'holders Litig.*, 1988 Del. Ch. LEXIS 139, at *21 (Oct. 21, 1988). See also *Weinberger*, 457 A.2d at 709 n.7 ("[A] showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.").

¹⁷ See, e.g., *Lynch I*, 638 A.2d at 1121.

¹⁸ See *Tremont Corp.*, 694 A.2d at 431.

¹⁹ See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1143 (Del. Ch. 1994), *aff'd* *Technicolor II*, 663 A.2d 1156.

²⁰ Sole reliance on an investment banking firm's fairness opinion is "a pale substitute for the dependable information that a canvas of the relevant market can provide." *In re Amsted Indus. Inc. Litig., Cons.*, 1988 Del. Ch. LEXIS 116, at *21 (Aug. 24, 1988).

21 See *In re Fort Howard Corp. S'holders Litig.*, 1988 Del. Ch. LEXIS 110 (Aug. 8, 1988). See also *In re Pennaco Energy, Inc. S'holders Litig.*, 787 A.2d 691, 706-7 (Del. Ch. 2001) (fact that no higher bid comes forward during post-agreement market check period is evidence that the directors obtained the highest and best transaction reasonably available). In a transaction involving the sale of corporate control, the special committee and the board are obligated to seek the best value reasonably available to the stockholders. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

22 See *Lynch I*, 638 A.2d at 1117 (“[T]he exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness . . . [A]n approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.” (citations omitted).)

23 See *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991) (“Section 144 [of the Delaware General Corporation Law] allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule.”); *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987) (same). See also *In re W. Nat’l Corp. S’holders Litig.*, 2000 Del. Ch. LEXIS 82, at *85-92 (May 22, 2000) (holding business judgment rule applies to board’s decision to approve a merger with a 46% non-controlling stockholder following use of special committee of three independent and disinterested directors from an eight member board) and *In re PNB Holding Co. S’holders Litig.*, 2006 Del. Ch. LEXIS 158, at *3-4 (Aug. 18, 2006) (suggesting that, in conflict situation not involving a controlling stockholder, approval of a transaction by a special negotiating committee or an informed majority-of-the-minority vote could justify review under the business judgment rule).

24 826 A.2d 277, 288 n.43 (Del. 2003).

25 See *Bombarko, Inc. v. Int’l Telecharge, Inc.*, 794 A.2d 1161, 1177-79 (Del. Ch. 1999).

26 See *Lynch I*, 638 A.2d at 1117.

27 See *Lynch I*, 638 A.2d at 1117.

28 See *In re Pure Resources, Inc.*, S’holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002).

29 See *In re Siliconix Inc.*, S’holders Litig., 2001 Del. Ch. LEXIS 83 (June 19, 2001).

30 The policy implications of the *Siliconix* structure have been frequently discussed in the academic literature. For an excellent discussion of the academic literature, presented in the context of a policy proposal, see Guhan Subramanian, *Fixing Freezeouts* (Harvard Law School Olin Series Discussion Paper # 501, December 2004), at 16-23.

31 The *Siliconix* structure is subject to the federal tender offer rules under Section 14(d) of the Securities Exchange Act of 1934, as amended. Among other things, these rules require the controlling stockholder to pay the highest and best price to all holders tendering in the offer.

32 *In re Cox Communications, Inc. S’holders Litig.*, 2005 Del. Ch. LEXIS 79 (June 6, 2005).

33 See *Revlon, Inc.*, 506 A.2d. See also *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1994) (“In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end.”)

34 See *Netsmart Technologies*, 2007 Del. Ch. 35, at *58-59.

35 See *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

36 See *Netsmart Technologies*, 2007 Del. Ch. LEXIS 35, at *73.

37 See *Omicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), applying *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) standard of review for defensive devices to deal protection devices generally.

38 See *La. Mun. Police Emples. Ret. Sys. v. Crawford*, 2007 Del. Ch. LEXIS 27 (Feb. 23, 2007).

39 See *Aronson*, 473 A.2d at 812.

40 See, e.g., *Technicolor I*, 634 A.2d at 363.

41 See *Chaffin v. GNI Group, Inc.*, 1999 Del. Ch. LEXIS 182, at *17-18 (Sept. 3, 1999) (finding conflict of interest where approval of merger would result in substantial economic and career benefits to director’s son).

42 See *In re National Auto Credit, Inc. S’holders Litig.*, 2003 Del. Ch. LEXIS 5, at *38-39 (Jan. 10, 2003). Fees paid to a director who is a financial advisor in connection with a transaction have been held not to constitute a conflict of interest, but rather to align the interests of the director with the stockholders in attempting to maximize the value of the corporation. See *Crescent/Mach I Partners, L.P. v. Turner*, 2000 Del. Ch. LEXIS 145, at *39 (Sept. 29, 2000).

43 See *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *123.

44 See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985).

45 See *Levco Alternative Fund Ltd. v. Reader’s Digest Ass’n*, 2002 Del. LEXIS 488, at *5-6 (2002). See also *In re FLS Holdings, Inc. S’holders Litig.*, 19 Del. J. Corp. L. 270, 278 (Del. Ch. Apr. 2, 1993) .

46 See *Crawford*, 2007 Del. Ch. LEXIS 27.

47 See *Ryan v. Tad’s Enterprises, Inc.*, 709 A.2d 682 (Del. Ch. 1996).

48 See, e.g., *Emerging Communications* 2004 Del. Ch. LEXIS 70, at *155.

49 We note that it is customary that the audit committee – which is required to be composed of independent directors pursuant to Rule 10A-3(b)(1) under the Securities Exchange Act of 1934, as amended, and relevant stock exchange rules – or some other committee of independent directors separately approve even insignificant transactions with a controlling stockholder. The controlling stockholder is required to deal fairly with the corporation in every transaction, including insignificant matters, but insignificant transactions are much less likely to result in litigation or personal liability.

50 We also note that, even though the business judgment rule applies in the *Siliconix* structure, the board should form a special committee to review and make the recommendation to the minority stockholders with respect to the consideration offered in the transaction, as required by Rule 14e-2(a) promulgated under the Securities Exchange Act of 1934, as amended.

51 See, e.g., *Reader’s Digest Ass’n*, 2002 Del. LEXIS 488, at *5-6 (special committee formed in connection with recapitalization in which controlling stockholder received cash premium).

52 See *McMullin v. Beran*, 765 A.2d 910, 921 (Del. 2000).

53 See, e.g., *In re RJR Nabisco, Inc. S’holders Litig.*, 1989 Del. Ch. LEXIS 9 (Feb. 14, 1989) (in which the board formed a special committee to conduct an auction process in response to a management buyout proposal).

54 See, e.g., *Cysive, Inc.*, 836 A.2d at 551-53.

55 See *Technicolor II*, 663 A.2d at 1168. “Examples of techniques which can restrict the influence an interested director may exert include: recusal of the interested director(s) from participation in board meetings, resignation from the board by the interested director(s), or establishment of a committee of disinterested, independent directors to review the proposal.” *Technicolor I*, 634 A.2d at 366 n.35 (citations omitted).

56 The Nasdaq Marketplace Rules require approval of conflict transactions by the audit committee or other independent body of the board. See Rule 4350(h), *The Nasdaq Stock Market, Inc.*, NASDAQ Manual Online, Marketplace Rules, at http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=13 (2007). The New York Stock Exchange requires the board to review and oversee related party transactions on an on-going basis, but does not mandate any particular

approval mechanism. See Rule 307, NYSE Euronext, Listed Company Manual, at http://www.nyse.com/Frameset.html?nyseref=http%3A/www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html (last modified Sept. 1, 1984).

57 Except for controlled companies, which may be exempt from the rule, the Nasdaq Marketplace Rules require that a compensation committee of independent directors approve or recommend to the board the compensation of the CEO and other executive officers. See Rule 4350(c)(3), The Nasdaq Stock Market, Inc., NASDAQ Manual Online, Marketplace Rules, at http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=13 (2007). A similar requirement exists for companies listed on the New York Stock Exchange. See Rule 303A.05, NYSE Euronext, Listed Company Manual, at http://www.nyse.com/Frameset.html?nyseref=http%3A/www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html (last modified Nov. 3, 2004).

58 See, e.g., *Parnes v. Bally Entertainment Corp.*, 2001 Del. Ch. LEXIS 34 (Feb. 20, 2001).

59 See *Fort Howard Corp.*, 1988 Del. Ch. LEXIS 110, at *36 ("It cannot, for example, be the best practice to have the interested CEO in effect handpick the members of the Special Committee as was, I am satisfied, done here.").

60 See *Kahn v. Dairy Mart Convenience Stores, Inc.*, 1996 Del. Ch. LEXIS 38, at *19-20 (Mar. 29, 1996). See also *Strassburger v. Earley*, 752 A.2d 557, 571 (Del. Ch. 2000) (special committee of one director not effective to shift the burden of proof in case where the special committee did not negotiate the terms of the transaction or engage outside legal or financial advisors).

61 *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985).

62 See *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *23.

63 See *Lynch I*, 638 A.2d at 1117.

64 *Technicolor I*, 634 A.2d at 362.

65 See *Krasner*, 826 A.2d at 284-5.

66 See *Beam v. Stewart*, 845 A.2d 1040, 1049-51 (Del. 2004).

67 See, e.g., *In re MAXXAM, Inc./Federated Dev. S'holders Litig.*, 23 Del. J. Corp. L. 277, 318-19 (Del. Ch. Apr. 4, 1997) (directors acting as consultants to corporation not independent). See also *Rales v. Blasband*, 634 A.2d 927, 936-7 (Del. 1993) (director who is chief executive officer of company controlled by other interested directors is not independent).

68 See *Tremont Corp.*, 694 A.2d at 426 (directors with prior business relationships not independent).

69 See *In re eBay, Inc. S'holders Litig.*, 2004 Del. Ch. LEXIS 4, at *9-11 (Feb. 11, 2004).

70 See *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938-39 (Del. Ch. 2003).

71 *Id.*

72 See *id.* at 942. Factors noted by the court included: (i) both of the special litigation committee members were tenured professors at Stanford University; (ii) one of the interested directors had taught one of the special committee members while he was a graduate student at Stanford – they also served on the same steering committee for the Stanford Institute for Economic Policy Research (SIEPR); (iii) another interested director was an alumnus of Stanford, who chaired the SIEPR advisory board and had contributed millions to Stanford; and (iv) a third interested director had made substantial donations to Stanford and, at the time the special committee was formed, was reportedly considering another substantial donation. It should be noted, however, that the court took great effort to distinguish the standard applicable to special litigation committees from that applicable to special negotiating committees.

73 *Stewart*, 845 A.2d at 1050.

74 *Id.* at 1051 (emphasis in original).

75 *Id.* at 1050.

76 *Id.* at 1050.

77 23 Del. J. Corp. L. at 320.

78 See *Tremont Corp.*, 694 A.2d at 429.

79 *Fort Howard Corp.*, 1988 Del. Ch. LEXIS 110, at *36.

80 *Lynch I*, 638 A.2d at 1119 (*quoting In re First Boston, Inc. S'holders Litig.*, 1990 Del. Ch. LEXIS 74, at *20-21 (June 7, 1990)).

81 See *Rabkin v. Olin Corp.*, 1990 Del. Ch. LEXIS 50, at *21 (Apr. 17, 1990).

82 See *Lynch I*, 638 A.2d at 1113. In this case the special committee was constrained from seeking alternative transactions because the controlling stockholder's ownership of the company permitted it to block any potential third party transactions. See *id.* at 1119.

83 See *Beran*, 765 A.2d at 919 ("When the entire sale to a third-party is proposed, negotiated and timed by a majority shareholder, however, the board cannot realistically seek any alternative because the majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board's consideration.").

84 See *Tremont Corp.*, 694 A.2d at 429 ("[T]he circumstances surrounding the retaining of the Special Committee's advisors, as well as the advice given, cast serious doubt on the effectiveness of the Special Committee.").

85 See *id.*

86 The committee's counsel may wish to consider the timing and structure of the fees paid to the special committee's independent financial advisor. In the case of *In re The MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 22 and n.28 (Del. Ch. 2004), for example, the court noted that a fee set at 1% of transaction value incentivized the financial advisor to obtain the best available price. It is unclear how a transaction value-based fee would be construed in the special committee context. Although a fee based upon transaction value may provide an incentive to obtain the best available price, an engagement in which all fees are contingent solely upon completion of a transaction, particularly in a transaction with a controlling stockholder, could be viewed as compromising the independence of the financial advisor by providing an incentive to complete the transaction regardless of price.

87 See *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *129.

88 See *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *131.

89 See, e.g., Del. Code Ann. tit. 8, §§151 (mergers), 271 (asset sales), and 242 (charter amendments) (2005).

90 See, e.g., Del. Code Ann. tit. 8, §§151 (mergers), 271 (asset sales), and 242 (charter amendments) (2005).

91 See *Netsmart Technologies*, 2007 Del. Ch. LEXIS 35, at *68-78.

92 See, e.g., *Prime Hospitality, Inc. S'holders Litig.*, 2005 Del. Ch. LEXIS 61, at *16 (May 4, 2005) (describing circumstance in which the chairman and chief executive officer first presented a going private transaction to the board after negotiations had occurred and the final price had been agreed upon).

93 *Netsmart Technologies*, 2007 Del. Ch. LEXIS 35, at *64.

94 See *Crawford*, 2007 Del. Ch. LEXIS 27, at *41-44.

95 See *Ortsman v. Green*, 2007 Del. Ch. LEXIS 29 (Feb. 28, 2007).

96 See *In re PNB Holding Co. S'holders Litig.*, 2006 Del. Ch. LEXIS 158, at *58-61.

97 See *Netsmart Technologies*, 2007 Del. Ch. LEXIS 35, at *86-94.

