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**DELAWARE SPECIAL
COMMITTEES --
Worth Another Look**

*By Jon E. Abramczyk and
Thomas W. Briggs, Jr.¹*

Experienced practitioners of corporation law are undoubtedly familiar with the important benefits of using independent "special committees" of boards of directors of Delaware corporations to evaluate interested transactions or to respond to demands that the board commence litigation on behalf of the corporation.²

In view of the alarming events in corporate America discovered during 2002, which arguably created a "crisis of investor confidence,"³ the need for careful independent review of transactions involving majority stockholders or corporate insiders is now more apparent than ever before. To be sure, the regulatory reforms proposed in response to those events -- particularly the NYSE Governance Reforms and the proposed SEC rules requiring that a majority of directors serving on boards of listed companies be independent -- could obviate the need for special committees in some situations. Nevertheless, given the wide variety of conflict transactions that are effectively addressed by special committees and the likelihood that boards comprised of a majority of independent directors will continue to face transactions in which a majority may not be considered independent, a fundamental understanding of when and how to use such committees remains an important part of the corporate practitioner's kit.

The purpose of this article is to provide a short primer on the various

purposes for which special committees may be used, and to provide some guidance on handling the important threshold issue of when to use such committees.

**A. The Role And Composition Of
Special Committees**

Broadly stated, Delaware law has recognized two situations in which special committees of directors may be used. Special committees may be used to protect minority interests in structuring interested transactions ("Special Negotiating Committees"), as well as to respond to stockholder demands to bring derivative claims or to respond to such claims once they have been made ("Special Litigation Committees").

Regardless of the role that a special committee will serve, the committee must be composed of disinterested and independent directors.⁴ Although a wide variety of fact-specific issues often arise in examining whether a particular director may qualify for service on a special committee, the reported decisions on director independence and disinterestedness counsel for a conservative approach in making such determinations. On balance, although the independence of directors chosen to serve need not be above reproach,⁵ if there is any serious question concerning a director's independence or disinterestedness, he or she should not be pressed into service on a special committee.

**1. Special Negotiating
Committees**

By far, the most common use of special committees of directors of

Delaware corporations is in the context of transactions involving potential or actual conflicts of interest between the corporation and its directors, officers, and/or majority stockholders. The recognized advantage of using such committees is to obtain a more favorable standard of review for interested transactions should they face stockholder challenge and judicial scrutiny.

Although informed decisions of the board in matters in which the directors have no personal interest ordinarily enjoy the protection of the business judgment rule,⁶ transactions involving an interested board or controlling stockholder are likely to be subject to the more rigorous “entire fairness” standard of review.⁷ In certain transactions in which there is no controlling stockholder but a conflicted board, Delaware courts have allowed appropriately constituted and fully functioning special committees to confer the full benefits of the business judgment rule on the committees’ actions.⁸ In situations involving controlling stockholders (one notably not addressed by NYSE and SEC reforms), special committees have the effect of shifting the burden of proving the “entire fairness” of such interested transactions to the party challenging the transaction.⁹ In any case, because the standard of review and burden of meeting the applicable standard in such transactions is often outcome determinative,¹⁰ special committees should be used whenever a board is considering an interested transaction.

To obtain the benefits gained by using a Special Negotiating Committee (i.e., an opportunity to obtain a more favorable standard of review or to shift the burden of proving entire fairness to

the party challenging the transaction), the committee ordinarily must hire its own independent advisors and must follow a process that replicates the rigorous negotiation that would occur in transactions involving unaffiliated third parties.¹¹ Most importantly, the Special Negotiating Committee must have the power to reject the proposed transaction.

2. Special Litigation Committees

Delaware law has also recognized two roles for special committees in the context of litigation involving derivative claims made on behalf of the corporation. One role for special litigation committees is to investigate and recommend a response to a demand by a stockholder to institute derivative litigation on behalf of the corporation. The second, and more common, use of special litigation committees is to exercise the power of the full board in determining whether to pursue derivative litigation on behalf of the corporation when such litigation may be against the interest of certain board members. Each of these roles is briefly outlined below.

a. Demand Investigation Committees

After receiving a stockholder demand to commence litigation on behalf of the corporation,¹² the directors of a Delaware corporation have a number of options, including: prosecuting the claim on behalf of the corporation; allowing the stockholders making the demand to pursue the claim; resolving the claim without litigation; or refusing the demand, thereby refusing to pursue the litigation. To make its determination, the board may choose to

establish a special committee of disinterested and independent directors that would hire independent advisors, investigate the demand, and recommend the appropriate action to be taken to the full board of directors.¹³

The committee need not follow any particular predetermined "blueprint" in conducting its investigation.¹⁴ The committee must, however, fully inform itself of relevant information by conducting a thorough investigation before making its decision.¹⁵ That process usually involves examining documents, conducting interviews of witnesses, and assembling a formal report of the investigation. If the committee determines, after its review, to refuse the demand, the Court will review its determination, as well as the board's ultimate decision, for good faith and reasonableness.

b. Special Litigation Committees

In the context of derivative litigation, a special committee of independent directors may also be formed to exercise the full power of the board to make the decision whether to terminate derivative litigation in cases where plaintiff has pleaded that making demand on the board would be futile because a majority of the board has a disabling conflict of interest with respect to the litigation.¹⁶ Of course, in the context of derivative claims made against certain directors, or claims challenging decisions made by the entire board, it is critical that the committee be comprised of directors who are disinterested and independent. In some situations, that requirement may call for establishing a committee of directors who were not on the board at the time of

the alleged wrongdoing to make the determination as to whether derivative claims should proceed, although the board's approval of a particular transaction does not, in and of itself, necessarily disqualify those board members from determining whether a derivative claim should proceed.¹⁷ At the very least, however, the directors selected for service must not have divided loyalties with respect to the alleged wrongs.¹⁸

In this context, unlike the demand review context, the committee must be given full authority with respect to decisions concerning the litigation. A mere advisory role will not be given deference by a court reviewing the decision of the committee.¹⁹ The committee's decisions do not enjoy the presumption of the business judgment rule. Instead, Delaware courts review the independence and good faith of the committee and the bases supporting its conclusions,²⁰ and may analyze the reasonableness of the committee's business judgment to determine whether the derivative claim was properly handled.²¹

B. When Should A Special Committee Be Used?

1. Special Negotiating Committees

Without question, Special Negotiating Committees formed under the guidelines set forth in Delaware jurisprudence have long served the purposes now being recognized by the NYSE and SEC as fundamental instruments of good corporate governance. As such, there is little question that Special Negotiating Committees should be used whenever a

board is presented with any transaction involving a potential or actual conflict of interest of the board members considering the transaction.

Where a majority of the board is independent and disinterested with respect to a proposed transaction, the decision of the board will be given the benefit of the business judgment rule, and there is no need for a Special Negotiating Committee. Thus, a corporation may sometimes be able to avoid using a special committee by maintaining a majority of truly independent directors on its board. Given the variety of conflict transactions in which special committees should be used (including transactions involving controlling stockholders), however, it is unlikely that such board composition will ever supplant the need for careful evaluation for the need for such committees even though for many purposes a majority of the board could properly be considered independent.

Because Special Negotiating Committees provide the company with an opportunity for judicial review of an interested transaction under the business judgment rule, and at least provide favorable burden shifting and evidence of fairness in any litigation challenging the transaction, they have become an expected feature of any conflict transaction. Therefore, like it or not, any interested transaction pursued without an independent committee is almost certainly doomed to fail,²² or succeed only after considerable litigation expense.

2. Special Litigation Committees

Special Litigation Committees are an equally necessary instrument of good corporate governance, albeit for somewhat different reasons. Like Special Negotiating Committees, they are necessary to avoid the problems presented when conflicts of interest are present. In addition, however, Special Litigation Committees offer the benefit of removing the distraction of demands and derivative litigation from boards that must devote increasing amounts of time to oversight of the business of the corporation. Therefore, Special Litigation Committees should find increasing popularity as regulators and markets respond to the crisis in investor confidence created by the corporate scandals reported in 2002 that were frequently attributed to failure of directors to exercise fully informed, independent judgment -- principles of corporate governance at the core of functioning special committees.

CONCLUSION

In sum, although proposed regulatory changes may increase the number of independent directors serving on boards of Delaware corporations, given the variety of conflict transactions that special committees are required to address for such transactions to receive favorable treatment under Delaware law, those regulatory reforms will certainly not eliminate the need for such committees. Instead, the proposed reforms should prompt careful practitioners to take another look at using such committees in appropriate circumstances to enhance the proper functioning of the board and to ensure a

more favorable review of interested transactions.

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² Section 141(c) of the Delaware General Corporation Law authorizes a board to delegate such powers to committees of directors.

³ See, e.g., Speech by former SEC Chairman Harvey L. Pitt, made at the September Symposium on Corporate Governance and Accounting Reform, September 20, 2002, available at <http://www.sec.gov/news/speech/spch584.htm>.

⁴ The question of whether a director appointed to a special committee is independent and disinterested is a question of fact. Under Delaware law, the Court will consider a director to be disinterested if the Court finds that the director neither has a personal financial stake in the transaction (*Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)) nor would otherwise be affected (positively or negatively) by the proposed transaction in a way different than the corporation or its stockholders. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993). A director is independent so long as his or her decision is “based on the corporate merits of the subject before the board rather than extraneous influences.” *Aronson*, 473 A.2d at 816.

⁵ Delaware courts have noted, however, that the independence of one person committees may be

reviewed under a more rigorous standard than committees comprised of more than one person. See, e.g., *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985).

⁶ See generally DAVID A. DREXLER, LEWIS S. BLACK, JR., AND A. GILCHRIST SPARKS, III, *DELAWARE CORPORATION LAW AND PRACTICE* § 15.03 (2002).

⁷ See generally, *id.* § 15.05; see also *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (the concept of fairness has two basic aspects -- fair dealing and fair price).

⁸ See, e.g., *Kohls v. Duthie*, C.A. No. 17762 (Del. Ch. Dec. 11, 2000); *In re: W. Nat'l Corp. S'holders Litig.*, Consol. C.A. No. 15927 (Del. Ch. May 22, 2000).

⁹ See, e.g., *Kahn v. Lynch Communications Systems*, 638 A.2d 1110, 1113-14 (Del. 1994) (in controlling stockholder transactions a burden shift in entire fairness analysis, rather than business judgment review, is appropriate because “even where no coercion is intended, shareholders ... might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder.”) (quoting *Citron v. E.I. du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990)).

¹⁰ See, e.g., *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) (“[B]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate

standard of judicial review frequently is determinative of the outcome of derivative litigation.”) (citations omitted).

¹¹ See e.g., *Weinberger*, 457 A.2d at 709 n.7 (noting that, in interested transactions, the role of the committee is to simulate the arms-length negotiation that would occur in a transaction in which there is no conflict of interest).

¹² By making a demand, the stockholder plaintiff concedes that a majority of the board is disinterested and independent. *Rales*, 634 A.2d at 936 n.12. The consequence of making a demand and requirements of standing to make such demands are beyond the scope of this article but are addressed in detail in the BNA portfolio addressing special committees. See ANDREW M. JOHNSTON & S. MARK HURD, SPECIAL COMMITTEES OF INDEPENDENT DIRECTORS (The Bureau of Nat’l Affairs, Inc., Corp. Practice Series No. 79, 2002).

¹³ Because the demand itself acknowledges the independence and disinterestedness of a majority of the board, there is no need to give the committee authority to act for the board in deciding how to respond to the demand.

¹⁴ See, e.g., *Levine v. Smith*, 591 A.2d 194, 210 (Del. 1991).

¹⁵ *Boeing Co. v. Shrontz*, 1994 WL 30542, at *2 (Del. Ch. Jan. 19, 1994).

¹⁶ Of course, if no demand is made and there are no allegations that demand is futile, there is generally no need

for a committee because the defendants will move to dismiss under Court of Chancery Rule 23.1 based on plaintiff’s failure to adequately plead a derivative claim.

¹⁷ See *Katell v. Morgan Stanley Group, Inc.*, 1995 WL 376952, at *7-8 (Del. Ch., June 15, 1995); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785 (Del. 1981).

¹⁸ See, e.g., *Carlton Investments v. TLC Beatrice Int’l Holdings*, 1997 WL 305829, at *10 (Del. Ch. May 30, 1992); *Katell*, 1995 WL 376952, at *8.

¹⁹ See *In re Par Pharmaceutical, Inc. Derivative Litig.*, 750 F. Supp. 641, 647 (S.D.N.Y. 1990); see also, e.g., *Kaplan v. Wyatt*, 484 A.2d 501, 519-20 (Del. Ch. 1984).

²⁰ *Zapata*, 430 A.2d at 788.

²¹ *Carlton*, 1997 WL 305829, at *1-2.

²² The Court of Chancery has observed that the failure to use a special negotiating committee in a cash-out merger by a majority stockholder indicates the “absence of fair dealing.” See, e.g., *Nebel v. Southwest Bancorp*, C.A. No. 13618 (Del. Ch. Mar. 9, 1999).