

Considerations for Forming a Special Board Committee

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Hot Topics in Business Law

Hamline University School of Law

September 27, 2013

CONSIDERATIONS FOR FORMING A SPECIAL BOARD COMMITTEE¹

❖ WHAT IS A SPECIAL COMMITTEE AND WHEN IT IS APPROPRIATE?

- Not a regular standing committee of the board (e.g., audit, compensation, nominating).
- Typically formed if there is a need for independent review (e.g., controlling stockholder transaction or interested directors) or if there is a need for nimble action or a large time commitment because something big is happening
 - Potential significant transaction (merger, acquisition, sale of substantially all assets) with interested director or controlling shareholder²
 - Litigation - reviewing shareholder derivative claims or defending existing claims
 - External or internal investigations into alleged wrongdoing (e.g., internal whistleblower claim, audit by government agency)
 - CEO succession planning
 - Adoption of a new substantive law or large change in company's business
- If using special committees for potential significant transactions where there are not interested directors or related parties be sure that the full board remains fully informed and actively involved

❖ WHO SHOULD BE ON A SPECIAL COMMITTEE?

- Identify independent and disinterested directors and individuals
 - Directors with direct relationships or financial interests in the transaction, direct defendants in the lawsuit, those accused of wrongdoing in an investigation should not be on the special committee

¹ This outline is intended to introduce the reader to considerations for when and how to form a special committee of a board of directors. It is not intended to be an exclusive checklist and a board intending to establish a special committee should do so with appropriate guidance.

² Who is a controlling shareholder may not be always based on stock ownership alone. At a minimum, boards should also consider managerial power or board control. *See, e.g., In re PNB Holding Co. Stockholders Litigation*, C.A. No. 28-N, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006).

- In addition, consider social and family relationships or previous working relationships with interested directors and general optics³
- In certain circumstances who is disinterested or independent is governed by statute or other rule or regulation
 - Minn. Stat. § 302A.673 subd. 1(d)(3) (2012) (defining disinterested director in the case of an issuing public corporation entering into a business combination with an interested shareholder)
 - NYSE and NASDAQ Rules
- Don't stop once the committee is formed—review director independence periodically
- Some states allow nondirectors to be on a special committee
 - *See* Minn. Stat. § 302A.241 subd. 2 (2012) (“Unless the articles or bylaws provide for a different membership or manner of appointment, a committee shall consist of one or more persons, who need not be directors * * *.”)
 - *But* Del. Gen. Corp. L. § 141(c)(1) and (2) (“each committee to consist of 1 or more of the directors of the corporation”)
 - Typically when nondirectors are involved the committee is advisory only⁴
- Identify directors that have the time and are willing to serve
- Consider director's location in context of the scope (e.g., will site visits be necessary?)
- Identify the necessary expertise needed and director tenure, including what type and level of company knowledge might be helpful in overseeing advisers and evaluating their work product or recommendations
- Consider the optimal number for the committee
 - Single-member committees can receive strict scrutiny⁵ while large committees can slow down the resolution of the issue
 - The committees need to be nimble but also need to have proper breadth and expertise

³ *London v. Tyrrell*, C.A. No. 3321-CC, 2010 WL 877528 (Del. Ch. Mar. 11, 2010) (unpublished opinion).

⁴ One case mentions in a footnote that if a committee is advisory, even in Delaware nondirectors can serve on special committees. *See Scattered Corp. v. Chicago Stock Exchange, Inc.*, C.A. No. 14010, 1996 WL 417507, at *3 n.4 (Del. Ch. July 12, 1996) (unpublished opinion) (irrelevant subsequent history omitted).

⁵ *See Sutherland v. Sutherland*, C.A. No. 2399-VCL, 2008 WL 1932374, at *3 (Del. Ch. May 5, 2008) (unpublished opinion).

❖ HOW DO I FORM A SPECIAL COMMITTEE?

- Consult your governing documents and the applicable statutes first
 - Are special committees allowed?
 - What are the procedures and limitations in place for creating committees or for committee membership?
 - What are the limitations for the scope of work that special committees can perform?
 - For example: “[N]o such committee shall have the power or authority in reference to the following matter: (i) approving or adopting, or recommending to the stockholders, any action or matter (other than the election or removal of directors) expressly required by this chapter to be submitted to stockholders for approval or (ii) adopting, amending or repealing any bylaw of the corporation.” Del. Corp. Gen. L. § 141(c)(2) (governing corporations incorporated on or after July 1, 1996 or corporations that have adopted by resolution to be governed by this section).
- Within your limits, establish procedural guidelines for the committee:
 - Establish what a quorum will be and what votes are required to take action
 - Allow short notice to call meetings
 - Allow for action by written consent and by electronic transmission
 - Consider whether you want to limit this to actions approved by all members of the committee
 - Consider requiring committee minutes
 - Include a requirement to report to full board if appropriate and specify the method or format and frequency of such reporting
 - Set a timeline or end date for the committee if appropriate. If not clear when the committee will be finished with its duties, set a date for review by the full board
- Consider whether a committee shall have the power to create subcommittees
 - Minnesota and Delaware statutes both allow subcommittees unless otherwise provided
- Compensation Issues
 - Determine if the special committee members will be compensated
 - Do not base compensation on outcome or results (monthly stipend can be appropriate)

- To the extent possible, determine in advance, though leave open for adjustment
- Benchmark the amount and structure of the payments against other companies
- Assume the fees will be disclosed at some point

❖ ADDITIONAL CONSIDERATIONS FOR CRAFTING THE ENABLING RESOLUTION

- The scope and purpose of the committee should be as clear as possible, but leave the committee with flexibility to actively consider alternatives or the proper actions going forward⁶
 - The scope should carefully define the powers of the committee
 - Does it have the power to recommend only or to act? If negotiating a deal, can it turn down deals? Can it enter into exclusive negotiations? For litigation, can the committee settle a claim?
 - What is the desired final goal or output of the committee?
 - The scope must be considered reasonable by a court reviewing it after the fact
- Expressly allow the committee to hire its own independent advisers and experts at the expense of the Company if the committee determines it is necessary (e.g., financial, legal, forensic investigation, investment banking)
- Ensure that the committee and its advisers and experts have access to the appropriate resources to do their research (including direct access to management if applicable)
- Recite the source of the board’s legal power to create the committee (statute, charter, bylaws)
- Consider whether the board should have control over the members of the special committee and the ability to terminate it before it accomplishes its goals

⁶ Courts have criticized special committees where it appears the committee is formed to defend or rationalize a position or “attack” shareholder litigation. *See e.g., In re Southern Peru Copper Corp Shareholder Derivative Litigation*, 30 A.3d 60 (Del. Ch. Oct. 14, 2011) (subsequent history omitted); *London*, C.A. No. 3321-CC, 2010 WL 877528, at *16.

❖ PRACTICAL ROLES COUNSEL TO SPECIAL COMMITTEES CAN PLAY

- Keep the goal of the committee in the forefront of the discussion while staying within the mandate
- Ensure procedural guidelines and proper process are followed
- Prepare proper documentation of meetings and decisions of the committee
- Ensure that the special committee is communicating or not communicating, as necessary, with the full board
- Advise the special committee on its fiduciary duties
- Keep an eye to director, adviser and expert independence throughout⁷
- Review and advise on information from other experts, including fairness opinions
- Advise committee regarding internal and external “communication discipline”⁸
- Advise committee of likelihood of litigation
- Advise on the hiring of other experts
- Advise on attorney-client privilege – could it be waived if the special committee reports to the full board?⁹

⁷ Consider, for example, the conflicts of interests of the financial advisor discussed in *In re Del Monte Foods Co. Shareholder Litigation*, 25 A.3d 813, C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011) (financial advisor was also on the buy-side of the deal). An attorney advising the directors in such a situation should be advising the board on the conflict inherent in such an arrangement.

⁸ Fifteen Tips for Effectively Chairing a Special Committee, Frank M. Placenti, Squire Sanders at 5 (February 2013).

⁹ See *Ryan v. Gifford*, C.A. No. 2213-CC, 2007 WL 4259557 (Nov. 30, 2007) (unpublished opinion) (finding the attorney-client privilege waived in a stockholder lawsuit when counsel for special committee reported to the entire board and directors that were individually named in the lawsuit were present as was their separate outside counsel, and the court determined that the directors were there in their individual, as opposed to fiduciary, capacity).

❖ CONSIDERATIONS AFTER FORMATION OF THE SPECIAL COMMITTEE

- Hiring advisers
 - Interview several possible candidates
 - Ask potential advisers explicitly if they have any conflict of interest or prior dealings with the Company and follow up to explore details
 - Choose a firm or individual with the proper skills but without a prior connection to the Company, or if a prior connection is desired or appropriate, document why and disclose this relationship in communications with the full board and shareholders
 - Document your choice and the reasons for your choice
- Insurance and Indemnification
 - Especially important if you have a nondirector on a committee
 - Indemnification might be automatically extended by statute¹⁰ but insurance may not cover that individual without a special rider
 - At least one insurance company tried to argue that the insurance did not cover attorneys' fees when the client was the special committee, as opposed to the company¹¹
- Guard who attends the meetings
 - Again, part of the communication discipline, but keep attendance at committee meetings to those who need to be there. Even if having interested members present for a vote might not make that determination void or voidable, if you don't need them there don't push your luck
- Don't disband too soon
 - Even after a transaction is signed, there may be significant remaining diligence for a special committee to perform¹²

¹⁰ See e.g., Minn. Stat. § 302A.241 subd. 7 (2012) (committee members deemed directors for purposes of Minn. Stat. § 302A.521 (2012) relating to indemnification).

¹¹ *MBIA, Inc. v. Federal Ins. Co.*, No. 08 CIV. 4313, 2009 WL 6635307 (S.D.N.Y. Dec. 30, 2009), *aff'd in part and rev'd in part* by 652 F.3d 152 (2d Cir. 2011).

¹² *In re Southern Peru*, 30 A.3d at 112 (criticizing the special committee for failing to renegotiate and calling the committee's failure to obtain an updated fairness opinion "a regrettable and important lapse").

❖ OTHER USEFUL SOURCES

- Fifteen Tips for Effectively Chairing a Special Committee, Frank M. Placenti, Squire Sanders (Feb. 2013), *available at* <http://www.squiresanders.com/publications/detail.aspx?pub=6380>.
- Speed Reading: Top 10 Issues to Consider When Advising a Special Committee in a Going Private Transaction, Frank Aquila, Melissa Sawyer & Keerthika Subramanian, LexisNexis Emerging Issues Analysis (Feb. 2012), *available at* <http://www.sullcrom.com/publications>.
- Appointing and Managing the Special Committee of the Board of Directors, Peter C. Buck and Kelly A. Koeninger, Robinson, Bradshaw & Hinson, P.A., 2011 Business Law Institute, *available at* <http://www.rbh.com/pubs> (focusing on North Carolina and Delaware law).
- *In re Trados Incorporated Shareholder Litigation*, C.A. No. 1512-VCL (Del. Ch. Aug. 16, 2013) (reviewing conflicts that arose from directors' ownership of preferred stock).
- *In re MFW Shareholder Litigation*, C.A. No. 6566-CS (Del. Ch. May 29, 2013) (finding that the business judgment rule can apply even to a freeze-out merger when a controlling stockholder consents to the use of a well-functioning special committee and obtains a fully-informed majority-of-the-minority vote).
- *In re John Q. Hammons Hotels, Inc. Shareholder Litigation*, C.A. No. 758-CC, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009) (unpublished opinion) (a useful discussion of standards of review).