

# Managing Conflict Situations: Special Committees, Their Benefits and Challenges

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Transactions involving conflicts, including transactions involving controlling stockholders or interested directors, are one of the more challenging situations faced by in-house counsel. Conflict transactions present not only legal challenges (as they are the frequent subject of litigation alleging breach of directors' fiduciary duties), but also challenges in managing the competing interests of the company, on the one hand, and of the controlling stockholder or the interested director (who, in many situations, have long benefited the company), on the other hand. A special committee may offer important protection for the company and the board by ensuring the protection of the interests of minority stockholders in a conflict situation or sustaining a challenge to the validity of a board's action in litigation. However, the use of a special committee in a particular transaction will necessarily impose additional costs and may introduce significant deal execution risk or otherwise limit a company's flexibility to transact, all of which can impose significant strain on the in-house legal team and exert pressure on the transaction.

The calculus of whether to use a special committee will necessarily depend on the particular facts and circumstances of a conflict situation. Notably, only a properly constituted and empowered special committee will provide the full legal benefits in any challenged board action. This article sets forth key considerations in determining when and how to form a special committee in a transactional context. This article focuses on Delaware law considerations, as many jurisdictions (including Texas) look to Delaware law for guidance on corporate issues. Part I describes the judicial standard of review of board actions in conflict situations. Part II provides key considerations for using a special committee and Part III provides key considerations in establishing a special committee.

## **I. Judicial Standard of Review in Conflict Situations**

Directors of a Delaware corporation owe two core fiduciary duties to the corporation: the duty of care and the duty of loyalty. The duty of care requires directors to be fully and adequately informed and act with care when making decisions and acting for the corporation. The duty of loyalty requires that directors act and make decisions in the best interest of the corporation, disregarding their personal interests. The judicial standard of review refers to the test that courts will apply in litigation to evaluate whether a director has satisfied the standard of conduct required under applicable fiduciary duties.

### *A. Entire Fairness Applies in Conflict Situations*

The default standard for judicial review of board actions under Delaware law is the business judgment rule. The business judgment rule is a strong presumption in favor of the

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validity of a director's business decision, rebuttable only by a showing of gross negligence or waste. If the business judgment standard of review applies, a court will not second-guess the decision of a majority independent and disinterested board. The reviewing court will only interfere if the board's decision lacks any rationally conceivable basis.

However, in situations involving transactions with a controlling stockholder, or where a conflict exists and the decision is not made by a majority independent and disinterested board, Delaware courts apply the "entire fairness" standard of review. Entire fairness is Delaware's "most onerous" standard of review. Where entire fairness applies, the board must establish that the transaction was the product of both fair dealing and fair price. Entire fairness is "a unitary test, under which a reviewing court will scrutinize both the price and the process elements of the transaction as a whole." It is "nearly axiomatic" that, where entire fairness applies, a motion to dismiss is rarely granted, because review under entire fairness "requires a record to be meaningful." As a result, a breach of fiduciary duties claim to which entire fairness applies will almost assuredly result in prolonged discovery and costly litigation.

#### *B. Conflict Situations are Fact Specific*

Conflict situations typically arise in:

- conflicted board transactions, such as when the board of directors lacks independence from or is dominated or controlled by an interested party, has a material interest in the decision or transaction that differs from stockholders in general or stands on both sides of the transaction; or
- conflicted controlling-stockholder transactions, such as when a controlling stockholder stands on both sides of a transaction or receives additional non-ratable benefits in a transaction, to the detriment of the company's other stockholders.

Whether an individual director is independent and disinterested is necessarily a fact-specific inquiry. A director lacks independence if he or she has a material interest in the transaction or is "so beholden" to an interested party "that his or her discretion would be sterilized." Key considerations include whether the director "stands on both sides" of the transaction in question, has obtained some material benefit not ratably shared with the company's stockholders and/or is victim to a "controlled mindset" to an interested party. Potential conflicts can arise in many ways, including outsized director compensation from, or extensive personal or prior business relationships with, a party to the transaction, and other instances where a director will receive non-ratable benefits or suffer a detriment not aligned to the interests of the company's stockholders. Similarly, a board may be conflicted even if less than a majority of directors are conflicted, if the board is dominated or unduly influenced by an interested party.

Whether a stockholder is a "controlling stockholder" is also necessarily a fact-specific inquiry. A controlling stockholder includes a majority holder of voting power of the corporation, but also includes a minority holder that "exercises control" over the business affairs of the corporation. A minority holder may be deemed a controlling stockholder if facts support a

reasonable inference that such holder “exercised sufficient influence ‘that they, as a practical matter, are no differently situated than if they had majority voting control.’” The analysis of effective control looks to a stockholders’ ability to exert influence as a stockholder, in the boardroom and outside of the boardroom through managerial roles.

Conflict situations where entire fairness would apply can arise in any corporate transaction, and most commonly arise within the acquisition context. For example, conflict situations may arise in:

- going-private transactions involving a controlling or significant stockholder, such as a freeze-out or squeeze-out merger;
- going-private transactions involving a private equity sponsor, with “management on the buy side,” such as when a private equity sponsor teams up with management to buy a public target; or
- other corporate transactions involving a controlling stockholder where the controlling stockholder receives additional non-ratable benefits not received by other stockholders or where a majority of directors on the board are not independent and disinterested. For example, Delaware courts have recently found improper benefit in the context of a reverse spin-off transaction and a performance-based executive compensation package of a controlling stockholder, as well as denied a motion to dismiss where improper benefit was alleged in the context of a redomestication of a Delaware corporation, finding that entire fairness was the appropriate standard for review in such circumstance.

## **II. Key Considerations for Using a Special Committee**

The purpose of a special committee is to simulate the decision-making process of an independent and disinterested board, and thereby replicate as much as possible the conditions of arm’s length negotiations in situations where the board may be conflicted or otherwise controlled by a controlling stockholder. A properly established and well-functioning special committee can provide assurance that the board’s decision has not been coerced or unduly influenced by conflicted directors or a controlling stockholder, and offer meaningful protection in the likely event of litigation. However, the potential costs associated with special committees may mean that alternative procedural protections, such as recusal of conflicted directors, are preferable. A board must weigh the potential benefits against potential costs, prior to determining whether to delegate its power to negotiate and evaluate a transaction to a special committee.

### *A. Special Committees Can Lower the Standard of Review or Shift the Burden of Proof*

Once the entire fairness standard of review is implicated, the directors or the controlling stockholder—as defendants—have the burden of proving the “entire fairness” of the transaction, as to both price and process. However, the business judgment rule may apply where entire fairness would otherwise apply if the “MFW Safeguards” are implemented before any “substantive economic negotiations” regarding a transaction occur, because the MFW

Safeguards provide “the shareholder-protective characteristics [of disinterested board and stockholder approval that would exist in a] . . . third-party, arm’s-length” transaction. Restoring the favorable presumption of the business judgment rule can increase the chances of a successful motion to dismiss, thereby avoiding burdensome discovery and related litigation expenses.

The “MFW Safeguards” refer to both:

- a special committee wholly comprised of independent, disinterested directors to establish the process for the transaction and consider the transaction on behalf of the company, including the power to reject any transaction and select its own legal and financial advisors; and
- a requirement that the transaction be approved by a majority-of-the-minority vote (i.e. approval by holders of a majority of the outstanding shares unaffiliated with the controller) in an informed and uncoerced vote.

There are other benefits in litigation to using a special committee, even when not paired with a majority-of-the minority vote. Use of only one of the MFW Safeguards (e.g., use of a properly constituted and empowered special committee without a majority-of-the-minority vote) can shift the burden of proof to the plaintiffs to prove that the transaction was not entirely fair. Further, the mere existence of a special committee may also mitigate the perception of undue influence on the board, and mitigate the risk that a transaction is successfully challenged in litigation.

#### *B. However, Special Committees Can Introduce Deal Execution Risk*

Not every potential conflict situation necessitates a special committee. In fact, potential substantial associated costs may render a special committee inadvisable. The special committee must retain separate financial, legal and other advisors at the expense of the company. The additional process associated with proper use of a special committee will add a layer of complexity and will necessarily slow down a transaction. Empowering a special committee with ultimate decision-making authority for a transaction may ultimately jeopardize the transaction if the committee over-zealously scrutinizes—and kills—a transaction that could be in the best interests of a company’s stockholders.

Special committees may impose other externalities by adding time to negotiations, distracting directors or putting pressure on relationships among directors or with management. The mere existence of a special committee could also create an inference of a conflict where none was otherwise apparent, and increase the risk of litigation challenging the potential transaction.

### **III. Key Considerations in Establishing a Special Committee**

A properly constituted and well-functioning special committee should, in the context where the board is not independent and disinterested, replicate a fully independent and disinterested board and, in the context of a controlling stockholder, function “in a manner which indicates that the controlling stockholder did not dictate the terms of the transaction and that the

committee exercised real bargaining power at an arm’s length”. A properly constituted special committee should be:

- wholly comprised of independent, disinterested directors;
- empowered to establish the process for the transaction and consider the transaction on behalf of the company, including the power to reject any transaction; and
- empowered to select its own legal and financial advisors.

The board action forming the special committee should be documented in board minutes through a formal resolution describing the specific powers and purpose of the committee and appointing the members of the committee.

#### A. *Disinterested and Independent Directors*

Members of the special committee should be selected by directors who are not personally interested in the transaction. All members of the special committee should be independent and disinterested with respect to the particular transaction. Notably, the Delaware Supreme Court recently held that a committee with only a majority of independent and disinterested directors will not suffice to secure the protection of the MFW Safeguards in the context of a controlling stockholder transaction.

Delaware courts will presume directors to be independent. Plaintiffs seeking to challenge director independence must show that the director is “so beholden” to an interested party “that his or her discretion would be sterilized.” The inquiry is “highly fact specific” and there is “no magic formula to find control.” The test of director independence for stock exchange purposes is not equivalent—although may be informative—to that of independence for Delaware purposes. Financial and business relationships, social and personal relationships and compensation, including compensation for serving on the special committee, must be examined in their totality. While certain individual director relationships may not, in isolation, be sufficient to call into question a director’s independence, those factors in the aggregate may be disabling.

Directors selected to serve on a special committee must also be free from any disabling interest in a conflict situation. A disabling interest can arise if directors have a direct or indirect material financial interest in the transaction that is not ratably shared by the company’s stockholders or the transaction involves any self-dealing on the part of the director, regardless of materiality. The materiality of a financial benefit to a director is determined in reference to all relevant facts and circumstances.

A special committee may be comprised of one or more directors. However, Delaware courts have expressed significant skepticism about the ability of a special committee with fewer than three members (and especially, a one-member committee) to remain objective and properly exercise their fiduciary duties. A special committee comprised of a sole director will likely face heightened scrutiny regarding the sole member’s disinterestedness and independence, and a sole director who operates without the oversight provided by a multimember committee must

adequately document its process. “[I]f a single member committee is to be used, the member should, like Caesar’s wife, be above reproach.” It is therefore advisable for a special committee to be comprised of least three members at the outset in the event a director is subsequently disqualified, and it may even be advisable in certain circumstances to add new director seats solely for the purpose of populating a special committee.

### *B. Special Committee Mandates*

A special committee should be empowered to act on behalf of the board independently of the interested directors or any controlling stockholder. Board resolutions establishing a special committee should empower the special committee with a sufficiently broad mandate to:

- access all the information required to make an informed decision, including the power to retain independent legal and financial advisors;
- forcefully and diligently negotiate on behalf of the company’s stockholders, including the ability to control the pace of negotiations, the timing and content of special committee meetings; and
- enforce a decision to reject the proposed transaction.

Special committee members must be aware of the breadth of their mandate and exercise the powers granted under the special committee mandate. A sufficiently broad mandate alone will not cure a conflicted transaction if special committee members fail to exercise the powers granted under the committee’s mandate.

### *C. Independent Legal and Financial Advisors*

A special committee must select its own financial, legal and other advisors, as well as implement a process to identify and consider potential conflicts of advisors. Advisors to the special committee should be free from conflicts with respect to the counterparty, and should be qualified and experienced in the type of transaction under consideration. The special committee may receive suggestions from management on which advisors could have sufficient expertise, but the special committee must make the final decision.

Advisors to the special committee with close prior connections to the company may raise independence concerns and undermine the purpose of the special committee. However, advisors who are familiar with the company or have access to information through prior dealings with the company may be better positioned to advise a special committee on a transaction. In practice, it may be the case that all potential advisors with relevant expertise to advise in a conflict transaction have prior dealings the company, and therefore unavoidable that a special committee engages an advisor that has an existing relationship with the company. Where a special committee engages an advisor with a potential conflict with the company, the special committee should document the consideration of such conflicts, consider and implement appropriate protections to mitigate the impact of any such conflicts (including through appropriately structured fee or confidentiality arrangements), as well as the specific reasons for engaging the advisor in spite of such conflicts.

*D. Special Committee Compensation*

The structure of compensation for special committee members should be determined at the outset of the establishment of a special committee. The fee can be structured in a number of ways, but flat-fee arrangements (without contingencies) are preferable, as a contingent or otherwise ambiguous fee could undermine the independence and disinterested nature of the special committee. Furthermore, excessive compensation and the payment of, or a special committee member's request for, a success fee after the approval of the transaction may call into question the special committee's independence.

**IV. Conclusion**

The establishment of a special committee, while highly beneficial if properly implemented, can be subject to rigorous review in litigation, including through scrutiny of its membership, mandate, advisors and compensation. Proper execution requires thorough consideration of the facts and circumstances of a particular situation, including how such facts and circumstances may be interpreted in hindsight, as well as careful planning in the establishment and implementation of a special committee. While the use of special committees in conflict transactions can create deal execution risk and increase transaction costs, the benefit of utilizing them in such transactions can often protect the transaction and mitigate the time and cost of subsequent litigation.

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