Fairness Opinions Guidelines and Issues:
Use of a Special Committee to the Board of Directors

"A committee is only as good as the most knowledgable, determined and vigorous person on it."
--Lady Bird Johnson, A White House Diary (1970)

"When confronted with a merger & acquisition, change of control, and/or other potential conflict-of-interestsituation, even sophisticated Board Members can be confused about their fiduciary role, duties, and responsibilities. This report is intended to provide practical and useful guidelines for Special Committees to the Board of Directors in dealing with these situations."
- Andrew D. Smith

Overview

Any corporate transaction involving an existing or potential conflict of interest may become the subject of litigation initiated by minority shareholders.[1] In such case, directors may be called upon to prove that all aspects of the transaction were fair to the corporation and its shareholders. Directors may, however, be able to shift this burden of proof away from themselves and to the minority shareholders/plaintiffs if they have taken certain steps to ensure the fairness of the transaction.[2] One important step is the establishment and use of a properly functioning Special Committee comprised of independent and disinterested Board members empowered to negotiate the transaction.[3]

The Entire Fairness Standard is Stricter than the Business Judgment Rule

A basic principle of corporate law is that the business and affairs of a corporation are managed by its Board of Directors. Courts have recognized that directors, in acting on behalf of a corporation, have certain fiduciary duties to the corporation and its shareholders, including a duty of care and a duty of loyalty. In fulfilling these duties, directors must act "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[4] Where directors have done so, a court will not question the business judgment of the directors or otherwise second- guess the transaction.[5] This is known as the business judgment rule, or the business judgment standard. One exception to this standard occurs where the interests of the directors or a controlling shareholder conflict with those of the corporation or its minority shareholders.[6] In that case, courts subject the transaction to a stricter standard. This stricter standard is known as the entire fairness standard and is best explained as follows:

1 These transactions may include mergers, acquisitions, management buyouts, recapitalizations, a sale of assets, or even a loan between a corporation and its controlling shareholder. See, e.g., Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997) [hereinafter Tremont] (involving the sale of a part interest in a corporation by an individual shareholder to a second corporation controlled by the same shareholder) and In re MAXXAM, Inc., Nos. 12,111 & 12,353, slip op. (Del. Ch. Apr. 4, 1997), 23 Del. J. Corp. L. 277 (1998) (involving the funding of a parent corporation's real estate development business by a subsidiary and eventual purchase by the subsidiary of the ailing development that secured the loan).
2 For an extensive discussion of director disinterestedness, see Grover C. Brown, et al., Director and Advisor Disinterestedness and Independence Under Delaware Law, 23 Del. J. Corp. L. 1157 (1998)
3 Brown, et al., supra note 2 at 1164.
4 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
5 Brown, et al., supra note 2 at 1161.
6 See Tremont, 694 A.2d at 428.

The concept of fairness has two basic aspects: fair dealing and fair price.

The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and fair price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. [Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (emphasis added).]

The reasoning behind this policy is the reality that controlling shareholders continue to dominate a corporation regardless of the outcome of a transaction. This creates a risk that those who evaluate the propriety of a transaction with a controlling shareholder might perceive that their disapproval of the transaction may cause the controlling shareholder to retaliate (by moving to reduce authorized dividends, for instance).[7]

Under the entire fairness standard, where a transaction involves a conflict of interest and has been contested by minority shareholders, directors bear the burden of proving the entire fairness of the transaction. Again, if directors have taken steps to ensure the fairness of the transaction, they may shift this burden of proof to the minority shareholders. Once the burden is shifted, minority shareholders must bear the burden of proving that the transaction was not entirely fair. As mentioned above, a Board may protect itself from the burden-shifting by creating and empowering a Special Committee of independent and disinterested Board members to negotiate the transaction.[8]

Establishing the Special Committee

Most corporate by-laws include provisions permitting the Board of Directors to create committees and specify their powers.[9] In such case, a Board of Directors need do little more than pass a resolution establishing the committee and describing its purpose, composition, powers, and duties.[10] Where a corporation's by-laws or articles of incorporation do not expressly include such powers, a Board should consider amending one or the other to include this provision.[11]

A Special Committee should consist of members of the corporation's Board of Directors[12] who are independent of the corporation and are disinterested vis-à-vis the contemplated transaction. In situations where no Board members are independent, a company should consider adding additional outside independent Board members who can also fill the role of Special Committee members. The size of a Special Committee may be dictated by state statute,[13] the corporation's by-laws or articles of incorporation, or by the common law. The Model Business Corporation Act suggests that "each committee must have two or more members."[14] Under existing Delaware case law, a Special Committee may consist of as few as one director.[15] The actions

7 Id.

8 Id.

9 Alternatively, these provisions may appear in a corporation's articles of incorporation. Model Bus. Corp. Act § 2.02 (Supp. 1998/99).

10 Section 8.25(b) of the Model Business Corporation Act requires the creation of a committee to be approved by either (1) a majority of all directors in office when the action is taken or (2) the number of directors required to approve such action under the by-laws or articles of incorporation, whichever is greater. Although most states have adopted the MBCA or an earlier version, practitioners are urged to review applicable state codes for additional restrictions or requirements.

11 Some state laws allow the creation of committees unless the articles of incorporation or by-laws provide otherwise. See, e.g., Colo. Rev. Stat. §7- 108-206(1) (2000). Other states permit the creation of committees only if authorized by the articles of incorporation or by-laws. See, e.g., N.M. Stat. Ann. §53-11-41(Michie 1978).

12 Non-directors may not serve on a committee of the Board of Directors. Steigerwald v. A.M. Steigerwald Co., 132 N.E.2d 373 (Ill. App. Ct. 1955).

13 See, e.g., Fla. Stat. Ch. 607.0825(e)(3) (2000) ("Each committee must have two or more members...") and Ala. Code § 10-2B-8.25 (1975) ("Each committee may have one or more members...").

14 Model Bus. Corp. Act § 8.25(a).

15 Practitioners should not construe this to mean that committees of one are an acceptable practice. In Lewis v. Fuqua the Delaware Court of Chancery denied a corporation's motion to dismiss a shareholder derivative action because, in part, the corporation's motion was based upon the recommendation of a one-director special litigation committee, where the sole committee member had material past and existing financial and other dealings with the controlling shareholder. Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985). The court noted, but did not object to, the size of the committee, stating "[i]f a single member committee is to be used, the member should, like Caesar's wife, be above reproach." Id. at 967.

of a single- member Special Committee, however, will be subject to extraordinary judicial scrutiny.

Advisors to the Special Committee

Once established, the Special Committee must focus on the task at hand – its job is not simply to complete the deal, rather, the Special Committee must ensure that the transaction will proceed only if it is favorable for the company and its shareholders.[16] In order to do this, Special Committees generally utilize the advice of professionals in making this determination, including outside counsel and independent financial advisors. A committee's first task, then, is to engage both legal and financial advisors.[17]

Engaging a Legal Advisor

When engaging a legal advisor, the Special Committee should consider whether counsel is generally qualified in matters of corporate governance and specifically experienced in the type of transaction being considered. Special Committee members should also review past and existing financial and business relationships between the proposed legal advisor and the controlling shareholder as well as the corporation and any interested Board members. The legal advisor should be expected to work with the Special Committee to set the committee's agenda and to guide the committee through legal issues that may arise. A legal advisor will also review and negotiate agreements governing the transaction. And to the extent the corporation or the transaction is subject to federal securities law, the legal advisor should draft or assist in the drafting of required disclosure documents and ensuring that all state, federal, and exchange-related filings or notices are made.[18] Under most circumstances, communications between the Special Committee and outside counsel will be covered by the attorney- client privilege.

Engaging a Financial Advisor

The Special Committee should also engage an independent financial advisor to assist it in negotiating the fairest price for the transaction. The financial advisor should be expected to analyze the proposed transaction, establish a value or a range of values for the transaction, and opine as to the financial fairness of the transaction. The Committee should require the financial advisor to do the same for competing offers or alternate transactions to the transaction(s) being considered. As with the outside counsel, the Special Committee should consider whether the financial advisor is truly independent and qualified to evaluate corporate transactions, and is specifically experienced in the type of transaction(s) being considered.

Advisors Must be Truly Independent

Special Committee members should review past and existing financial and business relationships between the proposed financial advisor and the controlling shareholder as well as the corporation and any interested Board members. It is not unusual for some investment banking firms who stand ready to provide fairness and other opinions to a Special Committee to have had recent dealings with either one or both parties to the proposed transaction or to anticipate related (and lucrative) assignments as a result of the proposed transaction. In such cases, courts question whether a Special Committee has adequately represented minority shareholder interests.[19] In addition, the Special Committee should not engage the corporation's own auditor to provide a valuation or a fairness opinion. To do so may compromise the auditors' independence under the SEC's recently revised auditor independence rules.[20]

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16 For an extensive discussion of what courts currently expect from special committees, see Gregory V. Varallo, et al., From Kahn to Carlton: Recent Developments in Special Committee Practice, 53 Bus. Law. 397 (1998).

17 For guidance on engaging advisors, see Brown, et al., supra note 2 at 1175-79.

18 See, e.g., NASDAQ Marketplace Rule 4120, IM-4120-1(requiring prompt issuer disclosure to the NASDAQ of material news) and Item 8 of Schedule 13E-3 and Item 1014 of Regulation M-A under the Securities Exchange Act of 1934 (requiring details as to the fairness of a proposed going private transaction).

19 Tremont, 694 A.2d at 430; Ryan v. Tad's Enterprises, 709 A.2d 682 (Del. Ch. 1996).

20 Auditor Independence Requirements, 65 Fed. Reg. 76,007 (Dec. 5, 2000) (to be codified at 17 C.F.R. pts. 210 and 240) ("An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides...[a]ny appraisal service, valuation service, or any service involving a fairness opinion for an audit client, where it is reasonably likely that the results of t hese services, individually or in the aggregate, would be material to the financial statements, or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.").

Independent Fee Structure is Critical to Establish Advisor Independence

Finally, the Special Committee should consider the financial advisor's fee structure. For most transactions, a contingent, or success, fee is not appropriate, since such a fee depends upon the success of the proposed transaction. This may compromise a financial advisor's independence, giving the advisor and its client a mutual financial interest in the success of the transaction. The advisor may have incentive to opine that the proposed transaction is fair, and be reluctant or decline to criticize the transaction in any way. Given the SEC's willingness to disqualify an auditor's independence in the presence of contingent fee arrangements, it is not difficult to imagine that courts, the SEC or self-regulatory organizations would find a financial advisor's contingent fee structure or conflicting relationships to impair its independence when providing a fairness opinion.[21] In this respect, Special Committee members are cautioned to ensure that a financial advisor is absolutely independent, and has no interest in the success of the proposed transaction, through the fee structure or otherwise.

Where Problems Arise

When a minority shareholder challenges the fairness of a transaction, attacks generally take the form of a criticism of the committee itself, a criticism of the committee's advisors, and/or a criticism of the Special Committee's actions (or lack thereof).[22]

Challenging the Special Committee Itself

Courts generally have agreed with minority shareholders who dispute the fairness of a transaction for any one or all of the following reasons: there was no committee, the committee was too small; one or more of the committee members had an interest in the transaction not otherwise shared by the stockholders; at the time of the transaction, one or more of the committee members had a direct or indirect business or financial dealing with the controlling shareholder; or prior to the transaction, one or more of the committee members had a direct or indirect business or financial dealing with the controlling shareholder. Where any one of these factors is present, a court will strictly scrutinize the fairness of the transaction.

Challenge of the Special Committee's Advisors

The committee's selection of legal and financial advisors may also be exposed to challenge. Courts question the fairness of a transaction where the Special Committee has altogether failed to engage a financial advisor. The entire fairness of the transaction is also suspect where advisors have been selected prior to the formation of a Special Committee, by persons other than Special Committee members, or by a dominant committee member. Other factors that may compromise the fairness of a transaction are: an advisor had in interest in the transaction (by virtue of a contingent fee arrangement or the promise of future engagements); at the time of the transaction the advisor had a direct or indirect business or financial dealing with the controlling shareholder; or prior to the transaction, the advisor had a direct or indirect business or financial dealing with the controlling shareholder.

Challenge of the Special Committee's Actions

Finally, even where a Special Committee has been established without compromise, and its advisors are above reproach, it is possible that committee's actions may not survive court scrutiny. Courts are particularly troubled where committee actions are dominated by a single committee member or by the controlling shareholder, or where committee recommendations appear to "rubber stamp" the controlling shareholder or the Board of Directors. In addition, courts are alert where a committee has failed to aggressively negotiate on behalf of the corporation and its shareholders. Finally, if the committee does not appear to have been fully informed when making its recommendations, a court may find unfairness in the transaction. Courts have found

21 Auditor Independence Requirements, 65 Fed. Reg. 76,007 (Dec. 5, 2000) (to be codified at 17 C.F.R. pts. 210 and 240) ("An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.")

22 For practical guidance on how special committees can avoid most legal pitfalls, see Arthur M. Borden & Joel A. Yunis, Going Private, § 8.03[2] (2000) ("Seven Golden Rules for Independent Directors").

that committee recommendations were not fully informed where one or more committee members failed to attend meetings or otherwise participate in the evaluation or negotiation process, where the committee failed to thoroughly and critically review the advisor's reports, and where the review and negotiation process was compressed in time.

Recent Case Law

Under existing case law, courts have found that in the presence of a combination of some or all of the factors described above, a transaction does not survive the entire fairness evaluation. It does not, however, appear that the presence of a single factor will be fatal to a fairness determination. Recent case law shows that courts seek reassurance that the majority shareholder has not controlled the terms of the transaction, and that the Special Committee had real bargaining power that it could exercise with the majority shareholder on an arm's length basis.

In Kahn v. Lynch Communication Systems, Inc.[23] The Supreme Court of Delaware emphasized its expectation that a Special Committee actively negotiate on behalf of the corporation and its shareholders.[24] Further, should committee members determine a proposed transaction not to be in the corporation's and stockholders' best interests, it is the committee's duty to reject the proposed transaction.[25] The suit in Lynch was brought by minority shareholders who objected to the cash-out merger of a subsidiary by the controlling shareholder.[26] A Special Committee had been formed and utilized in connection with the transaction. The committee considered and rejected as inadequate three bids made by the controlling shareholder.[27] Under the threat of a hostile takeover, the committee accepted the fourth offer made by the controlling shareholder.[28] The committee ultimately obtained a better price than that originally proposed, but not necessarily the fairest possible price. The court noted that a Special Committee is not required to accept an unfair price, even if alternatives to the transaction are limited. The court noted:

The power to say no is a significant power.

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

In a later opinion on the same matter, the court maintained its stance, but provided that the domination of a Special Committee by a controlling shareholder would have to be material to cause a finding of fairness to fail.[29] "Where other economic forces are at work and more likely produced the decision to sell . . . the specter of coercion may not be deemed material with respect to the transaction as a whole, and will not prevent a finding of entire fairness."[30] In Kahn v. Tremont Corporation[31] the Supreme Court of Delaware reversed a Court of Chancery holding that the use of a Special Committee of disinterested directors alone was sufficient to shift the burden of proof of fairness to the plaintiffs.[32] Minority stakeholders had objected to the sale of a part interest in the corporation by an individual shareholder to a second corporation controlled by the same shareholder.[33]

Although a Special Committee had been formed and utilized in connection with the transaction, the Delaware Supreme Court

23 638 A.2d 1110 (Del. 1994).
24 Kahn v. Lynch Communication Systems, 638 A.2d 1110, 1118 (Del. 1994).
25 Id. at 1119-20.
26 Id. at 1111.
27 Id. at 1113. The special committee rejected offers of $14.00, $15.00 and $15.25 per share
28 Id. at 1113. The special committee recommended to the Board the fourth offer of $15.50 per share.
29 Kahn v. Lynch Communication Systems, 669 A.2d 79, 86 (Del. 1995).
30 Id. (emphasis added).
31 694 A.2d 422 (Del. 1997).
32 Kahn v. Tremont Corp., 694 A.2d 422, 433 (Del. 1997).
33 Id. at 423-24.

questioned its effectiveness.[34] The court noted:

- All three Special Committee members had past and ongoing business and/or financial relationships with the controlling shareholder, including a lucrative ongoing consulting relationship, past proxy contest fees, and banking and legal representation relationships.[35]
- These relationships effectively eliminated the disinterestedness of committee members.
- The negotiations were dominated by a single committee member.[36]
- In selecting legal counsel, the dominant member of the Special Committee relied upon the recommendation of the corporation's in-house counsel.[37] The Special Committee did not independently search for and select its legal advisor.
- One Special Committee member held senior management positions with sister subsidiaries of the financial advisor.[38]
- One Special Committee member failed to attend any meetings; another attended only sporadically.[39]
- Although the Special Committee requested an independent analysis of certain aspects of the financial advisor's evaluation, the committee did not receive or review the report prior to its final vote on the transaction.

The court emphasized that the committee members had an obligation to remain fully informed, acquire critical knowledge of essential aspects of the purchase, participate in an active exchange of ideas with each other, and otherwise actively participate in the process.

Because of committee member absences and failures to review meaningful advisor reports, the court concluded that the committee was not well informed. In addition, the court concluded that the committee was not disinterested due to the past or ongoing relationships described above. The court determined that the committee failed to discharge its duties. In holding for the minority shareholders, the court stated:

To obtain the benefit of burden shifting, the controlling shareholder must do more than establish a perfunctory Special Committee of outside directors. Rather, the Committee must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arm's length.' [Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997).]

In **Kahn v. Dairy Mart Convenience Stores, Inc.**[40] the Delaware Court of Chancery placed the burden of proving the entire fairness of a failed management leveraged buyout on management and the controlling shareholder. The LBO group, including Dairy Mart's chief executive officer and controlling shareholder, as well as senior management, sought reimbursement from Dairy Mart for expenses incurred in connection with the failed buyout.[41] Minority shareholders objected, claiming that the payment would result in a breach of the directors' fiduciary duty of loyalty.[42] The court denied the defendant's motion to dismiss,

34 Id. at 424.
35 Id. at 426.
36 Id. at 429.
37 Kahn v. Tremont Corp., 694 A.2d 422, 426-27, 429 (Del. 1997).
38 Id. at 426.
39 Id. at 427.
40 No. 12,489 slip op. (Del. Ch. Mar. 29, 1996), 21 Del. J. Corp. L. 1143 (1996).
41 Kahn v. Dairy Mart Convenience Stores, No. 12,489, slip op. (Del. Ch. Mar. 29, 1996), 21 Del. J. Corp. L. 1143, 1148-49 (1996). [Hereinafter, Dairy Mart.]
42 Dairy Mart, 21 Del. J. Corp. L. 1143, 1149 (1996).

requiring additional facts.[43] The court noted the factors contributing to its conclusion that the Special Committee's independence had been compromised:

- One of the two Special Committee members arguably was not disinterested due to an ongoing paid consulting relationship with the corporation.[44] The consulting relationship was dependent upon the continuing goodwill of the controlling shareholder.[45] This conflict effectively reduced the Special Committee to a single member.

- The Special Committee had relied upon the recommendations of a non-member in selecting its legal and financial advisors and considered no other candidates for the roles.[46] The non-member who made the recommendations had recently resigned from the Board of Directors because he was a partner in the law firm representing the buyout group.[47] The Special Committee did not independently search for and select its legal advisor.

- The same non-member recommended as financial advisor an individual who had significant prior dealings with Dairy Mart.[48]

- Under pressure from Dairy Mart's chief executive officer and controlling shareholder, the committee did not entertain other, better, offers presented to it, nor did it negotiate with the buyout group for a higher price.[49]

In **In re MAXXAM, Inc.**[50] the Delaware Court of Chancery considered the entire fairness of a subsidiary corporation's funding of its parent's real estate development business and the subsidiary's eventual purchase of the ailing development that secured the loan.[51] The court noted the need, where a controlling shareholder stands on both sides of a transaction, for a Special Committee of disinterested, informed, and truly independent directors to negotiate the transaction on behalf of minority stakeholders.[52] The court considered the loan transaction and the real estate purchase separately.

In considering the loan transaction, the court noted that no independent committee negotiated or approved the loan.[53] In fact, the decision to approve the loan was made by the entire Board. In this respect, the court placed the burden of proving the fairness of the transaction on the defendants.[54] The court reviewed the initiation and timing of the transaction, the negotiation structure, disclosures made to the Board, the bargaining process, and the Board's final approval of the loan.[55] **The court ultimately concluded that the loans were not entirely fair, specifically citing the lack of an independent negotiating committee, as well as the Board's failure to engage a disinterested financial advisor (or any advisor at all) to produce a fairness opinion.[56]**

The Board then considered the real estate transaction. Although a Special Committee had been formed and utilized in connection with the transaction, the court questioned its effectiveness. The court noted:

- All of the five Special Committee members had existing or past significant business and/or financial relationships with

43 Id. at 1158-59.
44 Id. at 1157.
45 Id.
46 Dairy Mart, No. 12,489, slip op. (Del. Ch. Mar. 29, 1996), 21 Del. J. Corp. L. 1143, 1151 (1996) (while at another investment banking firm, the advisor represented a corporation in its sale of a subsidiary to Dairy Mart).
47 Dairy Mart, 21 Del. J. Corp. L. 1143, 1151 (1996).
48 Id.
49 Id. at 1158
50 Nos. 12,111 & 12,353, slip op. (Del. Ch. Apr. 4, 1997), 23 Del. J. Corp. L. 277 (1998).
51 In re MAXXAM, Nos. 12,111 & 12,353, slip op. (Del. Ch. Apr. 4, 1997), 23 Del. J. Corp. L. 277, 289 (1998).
52 MAXXAM, 23 Del. J. Corp. L. 277, 307 (1998).
53 Id.
54 Id. at 308.
55 Id. at 307-13.
56 Id. at 309-10, 313, 330.

the corporation and/or the controlling shareholder, among other things, a lucrative ongoing consulting relationships and lucrative employment contracts with affiliated corporations.[57]

- The committee was dominated by a single member, who unilaterally selected at least one of the Special Committee's appraisers.[58] In fact, the dominant member had engaged one appraiser prior to the formation of the Special Committee.[59]
- The two Committee members with the most significant ties to the controlling shareholder conducted the negotiations.[60]
- The committee did not negotiate for a better price, or aggressively negotiate at all.[61]
- The committee was not fully informed because it relied on a flawed advisor's report and disregarded the reports of other financial advisors that disagreed with or were critical of the first advisor's recommendations. In fact, Special Committee minutes did not reflect any critical evaluation of the first advisor's reports.[62]
- The committee had essentially determined to agree to the transaction before it had received all requested evaluations from its advisors.[63]

The court was particularly critical of one committee member's dominant role in the selection of the committee's advisors, noting its suspicions that committee minutes had been drafted to downplay or obscure the dominant Committee member's role.[64] The court referred back to its opinions in Tremont and Dairy Mart, ultimately concluding that the real estate transaction did not meet the entire fairness standard.

What are the Implications of Recent Rulings?

The recent opinions above share several unifying themes. First, courts will not permit the beneficial shifting at trial of the burden of proving fairness absent the existence of a Special Committee, comprised of rigorously independent directors and lacking in any entanglement or conflicting interest. Courts are now clear that they will carefully scrutinize the independence of Special Committee members. Recall that in Tremont, all three Special Committee members had past and ongoing business and/or financial relationships with the controlling shareholder, including a lucrative ongoing consulting relationship, past proxy contest fees, and banking and legal representation relationships.[65] In Dairy Mart, one of the two Special Committee members arguably was not disinterested due to an ongoing paid consulting with the corporation.[66] And in MAXXAM, all of the five Special Committee members had existing or past significant business and/or financial relationships with the corporation and/or the controlling shareholder, among other things, a lucrative ongoing consulting relationships and lucrative employment contracts with affiliated corporations.[67] Additionally, the Committee failed to engage a disinterested and independent advisor to provide a fairness opinion. Second, the court will expect the Special Committee to be an active and well-informed bargainer. In Tremont, the court found that the Special Committee was not well informed because of the Committee members' spotty attendance records.[68] In addition, the court noted that although the Special Committee requested an independent analysis of

57 MAXXAM, 23 Del. J. Corp. L. 277, 318 (1998).
58 Id. at 319.
59 Id.
60 Id. at 318.
61 Id. at 320, 330.
62 MAXXAM, 23 Del. J. Corp. L. 277, 328 (1998).
63 Id. at 328.
64 Id. at 319.
65 Tremont, 694 A.2d 422, 426 (Del. 1997).
66 Dairy Mart, 21 Del. J. Corp. L. 1143, 1157 (1996).
67 MAXXAM, 23 Del. J. Corp. L. 277, 318 (1998).
68 Tremont, 694 A.2d 422, 427 (Del. 1997).

certain aspects of the financial advisor's evaluation, the Committee did not receive or review the report prior to its final vote on the transaction.[69]In MAXXAM, the Special Committee relied on a flawed advisor's report and disregarded the reports of other financial advisors that disagreed with or were critical of the first advisor's recommendations.[70]

Finally, the court will expect the Special Committee to act vigorously in the interest of the corporation and its shareholders. The Special Committee should not seek to simply get the deal done, but should objectively determine whether the transaction is the most favorable option for the corporation and its shareholders, and only then should permit the transaction to proceed. Recall that in Lynch, the court chided the Special Committee for failing to walk away from the deal.[71] In Dairy Mart, the corporation's chief executive officer and controlling shareholder pressured the committee into disregarding other offers and accepting without negotiation the price offered by the buyout group.[72] And in MAXXAM, the court found no evidence of meaningful negotiation.

Other Special Committee Considerations

Special Committee members should also be cognizant of the potential for liability under the federal securities laws. Unlike under the common law, use of a well-functioning Special Committee does little to relieve committee members of liability under the federal securities laws. Although federal securities laws do not directly address the roles of corporate directors and committees of the Board, Special Committee members may be exposed under the anti-fraud provisions of Section 10(b)75 of the Securities Exchange Act of 1934 and Rule 10b-576 thereunder or the controlling person provisions of Section 20(a)77 of the Exchange Act. In this respect, Special Committee members are cautioned to be circumspect in their handling of material, nonpublic information about their corporation. Special Committee members (and their advisors) likewise should caution all corporation staff with knowledge of the proposed transaction and its details. In addition, Special Committee members should avoid making any misleading statements about the corporation or the proposed transaction, particularly in connection with the preparation of proxy materials, if required.

Houlihan Capital's Practical Guidelines for Special Committee Members

- The establishment of an independent and disinterested Special Committee is an essential tool to protect a Board of Directors from attack by minority shareholders in corporate finance situations that involve potential conflicts of interest. Think backwards – from the viewpoint of a dissenting minority shareholder – and be certain that the Special Committee is properly formed.
- Where existing Board members are not sufficiently independent and qualified to negotiate a transaction, consider adding additional outside Board members who can serve as Special Committee members. Make sure that Special Committee members are truly empowered to negotiate a transaction.
- The proper selection and use of independent and qualified legal and financial advisors is a critical responsibility of Special Committees. Recent case law supports the need for the Special Committee to independently search for and select its legal and financial advisors. Always be sure to speak with and obtain engagement proposals from more than one legal and financial advisor.
- A Fairness Opinion from an independent and qualified financial advisor is an essential part of satisfying that the standard of entire fairness has been met in any situation involving a potential conflict of interest.
- A Fairness Opinion obtained from a financial advisor that will earn a contingent fee-based on the completion of the

69 Id.
70 MAXXAM, 23 Del. J. Corp. L. 277, 328 (1998).
71 Kahn v. Lynch Communication Systems, 638 A.2d 1110, 1119 (Del. 1994).
72 Dairy Mart, 21 Del. J. Corp. L. 1143, 1158 (1996).

transaction will generally be viewed as lacking sufficient independence. This is especially true due to the recent SEC amendments to the Securities Act of 1934 regarding auditor independence.

- The Special Committee should formally meet with its legal and financial advisors (and scrupulously document such meeting) to review all major points where possible conflict of interest assertions may be made.

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