PHOENIX
MANAGEMENT SERVICES

Board Best Practice Series: Managing Conflict Transactions

By Marc Sullivan

Directors would be forgiven for believing that this is the most challenging period for corporate governance in our lifetimes. Boards face an increasingly disruptive competitive market; for public company directors, the threat of activists is ever present; a pandemic has complicated any attempt to plan; skilled leadership talent is shockingly scarce; and the list goes on. It should come as no surprise that a growing number of companies have found themselves either in the zone of insolvency or insolvent. Contrary to what some may believe, distress is not an indication of board or individual director misbehavior. This principle was reaffirmed in the *In re Citigroup Inc. Shareholder Derivative Litigation Case*. "It is well established that the mere fact that a company takes on business risk and suffers losses – even catastrophic losses – does not evidence misconduct, and without more, is not a basis for personal director liability."[1] Although bad business decisions do not result in personal director liability, in many situations conflicts may. One such situation is in regard to decisions made by conflicted directors in merger and acquisition transactions.

Although there are many roads to turnaround success, a sale of the business remains a common way to return the maximum value to stakeholders. In some situations, insiders, controlling shareholders, or related entities may see the inherent value of the enterprise and seek to give the company a second chance by way of acquisition, merger, or going private transaction. Those types of transactions are called conflict transactions. Conflict transactions are somewhat common in distressed situations. But, in order for them to be successful, they must be properly managed and structured as it is likely that there will be litigation. One of the keys to achieving success is the creation of a properly formed special committee of the board of directors. Why does the special committee increase the likelihood of success in litigation for directors? Who should sit on the special committee? What convinces courts that the committee is functioning properly?

The Business Judgement Rule vs The Entire Fairness Standard

Members of boards of directors routinely rely on the business judgment rule to protect themselves from claims that they have breached their fiduciary duties as it generally protects their decisions from second guessing by a judge. But the business judgement rule has its limits. It is "a rule of law that insulates an officer or director of a corporation from liability for a business decision made in good faith if he is not interested in the subject of the business judgement, is informed with respect to the subject of the business judgment to the extent he reasonably believes to be appropriate under the circumstance, and rationally believes that the business judgment is in the best interests of the corporation"[2]. Simply put, when the majority of directors are not independent and disinterested, then courts will not apply the business judgement rule but a more exacting standard of review. The authors of the Harvard Law School Forum on

[1] 964 A. 2d 106, 130 (Del. Ch. 2009).
[2] Am. Soc'y for Testing & Materials v. Corrpro Cos., 478 F. 3d 557, 572 (3d Cir. 2007) (internal quotations omitted).

Corporate Governance's report titled "Determining the Likely Standard of Review in Delaware M&A Transactions" identified eleven fact patterns common to Delaware M&A transactions and provides a preliminary assessment of the likely standard of review applicable to transactions fitting those fact patterns.[3] The more exacting standard (than the business judgement rule) applied in cases in which the majority of directors are conflicted or interested is called the Entire Fairness Standard.

The entire fairness standard is the most exacting and onerous standard that the Delaware courts can apply to a merger or acquisition transaction. Although not the focus of this article, it is worth noting that an entire fairness review can also be required in other situations involving conflicted directors, for example, in regard to discretionary director compensation. When the entire fairness standard is applied to a transaction, the defendant (the board of the company) bears the burden of proving that the transaction is fair in regard to both price and process. Fairness of price involves all questions surrounding the inherent or intrinsic value of the company. As the Court of Chancery has put it, "A fair price does not mean the highest price financeable or the highest price that fiduciary could afford to pay. At least in the non-self-dealing context, it means a price that is one that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept."[4] Fair process refers to fair dealing. The authors of the "Use of Special Committees in Conflict Transactions" described fair dealing this way: "Fair dealing involves 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 the stockholders were obtained".[5]

Because of both the difficulty of bearing the burden of proof and the possible consequences of losing in litigation, boards would generally seek to shift the burden from the defendant to the plaintiff. A properly formed special committee of the board empowered to independently decide if the transaction is approved can do exactly that. In effect, the special committee takes the place of conflicted and/or interested directors weakening or eliminating the argument that the transaction in question is not in the best interest of the company. The remainder of this article will focus on who should sit on the special committee and how the committee should function.

The Members of the Special Committee

Independence and Disinterestedness are Key

The special committee should consist solely of independent and disinterested directors. This is not an easy standard to meet and boards should understand each potential director's compensatory, financial, business, social, and personal ties before appointing anyone to the committee.[6] It is important to note that the Delaware Supreme Court held in Delaware City Employees Retirement Fund v. Sanchez that factors that may disqualify a director must be considered "in their totality and not in isolation from each

[3] Little et al. (2017). Determining the Likely Standard of Review in Delaware M&A Transactions. Harvard Law Forum on Corporate Governance. Retrieved from https://corpgov.law.harvard.edu/2017/04/28/determining-the-likely-standard-of-review-in-delaware-ma-transactions-2/

[4] Cinerama, inc. v Technicolor, Inc., 663 A.2d 1143 (Del. Ch. 1994)

[5] Brownstein et al. (2019). Use of Special Committees in Conflict Transactions. The M&A Journal. https://corpgov.law.harvard.edu/wp-content/uploads/2019/09/Use-of-Special-Committees-in-Conflict-Transactions.pdf

[6] Sullivan, M. C. (2020). Steps in managing Conflict Transactions. Phoenix Management Services. https://www.phoenixmanagement.com/steps-in-managing-conflict-transactions/

other."[7] Disclosure of all of the previously mentioned information to both the board and advisors is critical to making a decision in regard to prospective independence and disinterestedness. As many boards may not know qualified independent, disinterested directors, it may be appropriate to get recommendations for prospective special committee members from advisors. Many board members favor appointing people that they know, like, and trust instead of people who are knowledgeable about governance, willing to engage in difficult discussions, and fill a specific knowledge gap. That is always bad board practice, but it is especially bad in the context of a special committee. Furthermore, while industry knowledge is often favored by those choosing new board members, it is not of paramount importance for those sitting on a special committee of the board although having at least one member who has experience in the industry (or a similar industry) may be advisable.

Expertise in the Kind of Transaction Under Consideration

In addition to independence and disinterestedness, it is critical to select special committee members with knowledge relevant to the situation that resulted in the creation of the special committee. In the context of distressed situations, turnaround management experience and expertise are critical to understanding the issues that will arise. It is even more important to have relevant experience and expertise if the company is involved in a court supervised process (e.g. chapter 11). In addition, as the special committee in a conflict transaction situation will be considering a transaction, it is important for the members of the committee to have relevant merger and acquisition experience. Lastly, any member of the special committee should have demonstrated knowledge of and training in governance.

Best Practice on the Committee

It is the purpose of a special committee to create an arm's length bargaining process between the company and potential buyers. As the board should understand that conflicted and/or interested directors are not able to bargain at arm's length, the special committee takes the place of the full board in making independent and disinterested decisions when the full board cannot. While it is important to understand the specifics of best practice on the special committee, boards will generally be well served to focus on doing what is necessary to increase the value of the company or in the bankruptcy context, the estate. That said, the resolution creating the committee should clearly outline the committee's powers and the members of the special committee should wield those powers to ensure the best possible outcome for the company.

Keys to a Sound Special Committee Resolution

i. The Special Committee Must Have the Power to Negotiate Independently

As it is the role of the special committee to negotiate on behalf of the company or estate at arm's length, enshrining the power to negotiate independently in the board resolution that creates the committee is one of the keys to ensuring that courts will support the decisions made by the committee. It is important, for example, that there be no obligation for the committee to report to any dependent or interested person or to any stakeholder before making a decision on matters that come before the committee.

ii. The Special Committee Must Have the Power to Hire Its Own Advisors

[7] Delaware City Employees Retirement Fund v. Sanchez, 124 A.3d 1017, 1019 (Del. 2015).

The resolution creating the special committee should also give the committee the power to hire its own legal and financial advisors in addition to any other advisor that it may need to fully understand the company's operations, value, and options. It is critically important that the committee hire a legal advisor with expertise in corporate governance law and that the legal advisor to the committee be independent from the advisor to the company or the full board. It is often appropriate for the special committee of a solvent company to hire an independent investment bank to render a fairness opinion on the fairness of the transaction from a financial point of view to the company and any minority shareholders. In the context of section 363 sale, this is usually not necessary because there is typically an auction and the investment banker testifies to the commercial reasonableness of the process.

iii. The Special Committee Must Have the Power to Reject Any Offer

The special committee must be able to accept or reject any offer without having to get approval from any interested or dependent party and without an interested or dependent party participating in the discussion in regard to the decision.

iv. The Special Committee Must Use Sound Board Process

There is a high probability that the announcement of a conflict transaction will result in litigation against the board. As a result, the special committee should take care to ensure that they are using best practice in all board deliberations. A professional, preferably an attorney, should be hired to take or review minutes. In addition, a resolution should be used to formalize any significant decision. Sound board process can be critical to getting better outcomes in litigation.[6]

Other Keys to Best Practice on the Committee

I cannot stress enough how important it is that the special committee understand the full financial and operational picture at the company. Without a full understanding of the company's operational and financial situation, it is virtually impossible for the special committee to understand the value of the company, when an offer should be accepted, and which of the offers is fair.

Finally, some may believe that the special committee should work against insider or affiliated company bids; but that is certainly not the case. There is nothing inherently wrong with an insider or affiliated entity bid and there is nothing wrong if the special committee choses an insider or affiliated entity as the winning bidder assuming that their bid offers the best value.