The Use of Special Committees in M&A Transactions

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Today’s Speakers

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Overview/Agenda

• Legal Standards in Change of Control Transactions
• Special Committees: Use and Purpose
• Special Committee Formation/Operating Requirements
• Special Committees in Action: Instructive Lessons to be learned from the special committees in the *Dole* and *J. Crew* "going private" transactions and the Southern Peru transaction
The Current Climate: “Merger Objection” Mania

• In 2014, 93% of all public company M&A transactions valued in excess of $100 million garnered so-called “merger objection” shareholder class actions seeking to block the deal
  • These numbers have been fairly consistent since 2009
  • Up from 44% as recently as 2007

• Dealing with these lawsuits, which pose varying degrees of risk depending on the nature of the deal, is simply a cost of doing business in public M&A these days

• Take-private transactions are particularly attractive to the plaintiffs’ lawyers, as they are often judged by a more exacting legal standard
Legal Standards in Change of Control Transactions

• Directors owe fiduciary duties to all stockholders, not to any one stockholder group.

• Duty of Care
  • Directors must act in an informed and deliberate manner in determining whether to approve a transaction.
  • The duty of care requires that directors: (i) inform themselves of all material information reasonably available, (ii) proceed with a critical eye in assessing information and (iii) develop a reasonable basis for their decisions.
  • Directors are entitled to rely reasonably on management, outside experts and financial and legal advisors who provide advice on appropriate issues.
Legal Standards in Change of Control Transactions

• Duty of Loyalty

• The duty of loyalty requires that a director not represent or take actions to promote interests other than the best interests of the corporation and its stockholders in making a business decision.

• Courts interpret the duty of loyalty as involving not only a duty to refrain from self-dealing, but also a duty to deal fairly with the company’s directors and stockholders.

• A director satisfies the duty of loyalty when he or she bases a decision on the merits of the issue rather than extraneous considerations or influences.

• A director may be deemed to be conflicted or lack independence if he or she has interests on both sides of a transaction, has a material personal financial interest in the decision that is separate from that of other stockholders, or is beholden to or affiliated with a controlling person having such an interest.
Legal Standards in Change of Control Transactions

• Standards of Judicial Review/Board Behavior
  • Business Judgment Rule
  • Revlon
  • Entire Fairness Standard

• Business Judgment Rule—Presumption that in making a business decision, the board of directors acted:
  • on an informed basis
  • in good faith and
  • in the honest belief that the action taken was in the best interests of the company

• Plaintiff attacking a board decision must rebut the business judgment rule presumption.
Legal Standards in Change of Control Transactions

• Revlon—Once it becomes “apparent to all that the break-up of the company [is] inevitable,” the board’s duty changes from “the preservation of [the company] as a corporate entity to maximization of the company’s value at a sale for the stockholders’ benefit” Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.

• If Revlon applicable, directors “have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders”

• Revlon applicable to sale of company for cash—usually not applicable in stock-for-stock merger of two public companies

• Under Revlon, use of special committee is almost universally used where the change of control transaction in which management has agreed to participate or where controlling shareholder is making bid
Legal Standards in Change of Control Transactions

• Entire Fairness Standard
  • Most exacting standard of review when change of control transactions are not entitled to presumption of business judgment
  • Much higher test than business judgment rule (loyalty and care)

• Areas of focus under Entire Fairness Standard
  • Fair Dealing
  • Fair Price
  • Courts apply high standard and typically review process and price together i.e. not separate inquiries.

• Entire fairness standard will apply in:
  • Going private transaction where majority of board is conflicted
  • Acquisitions by controlling shareholder
  • Change of control transactions in which plaintiffs establish that board is not entitled to presumption of business judgment rule
Effects on legal standards in "change of control" transactions

- Special committee not necessary if:
  - There is no board or management conflict
  - A minority of board may have conflict but such members can recuse themselves and remaining board members can run an effective sale process
- A special committee is strongly recommended under Revlon under change of control transaction in which management has agreed to participate
- The use of an effective special committee:
  - Under Revlon assists the board in establishing that it “acted reasonably to seek the transaction offering the best value reasonably available to the stockholders”
  - Under Entire Fairness scenario results in burden of proving fairness being shifted to plaintiffs challenging transaction (Kahn v. Lynch)
  - Delaware courts have repeatedly said that the use of a special committee is strong evidence of an effective sale process
Effects on legal standards in "change of control" transactions

Scenario in which business judgment rule could apply where otherwise entire fairness standard would be applicable

• If party proposing transaction commits at outset to proceed with the transaction, only if it is subject to both (1) negotiation and approval by effective special committee and (2) approval by uncoerced, fully informed "majority of the minority" vote, business judgment rule will apply (MFW Shareholders Litigation)
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• Legal Standards in Change of Control Transactions

• **Special Committees: Use and Purpose**

• Special Committee Formation/Operating Requirements

• Special Committees in Action: Instructive Lessons to be learned from the special committees in the *Dole* and *J. Crew* "going private" transactions and the Southern Peru transaction
What is a Special Committee

• A committee formed by the board of directors to evaluate and negotiate transactions proposed by other directors, members of management, or significant shareholders

• Special committees provide legal safety in case a proposed transaction presents conflicts of interest

• Whether the formation of a special committee is necessary or advisable is highly dependent on the particular facts and circumstances of the proposed transaction
Possible Transactions/Situations

• "Going private" transactions proposed by management
• Acquisitions proposed by a third party in which management has agreed to participate
• Certain other transactions proposed by a director, key member of management or significant shareholder
• Shareholder derivative litigation
Advantages of a special committee

• Delaware law--formation of special committee creates litigation advantages for the board
  • Revlon---Use of a special committee is strong evidence of an effective sale process
  • Entire Fairness--Shifts to plaintiffs the burden of proving that price and process are unfair
• Optics important to illustrate that negotiated transaction is fair to all stockholders
• Speed and efficiency of decision-making
Disadvantages of a special committee

• Mere formation of special committee could imply a conflict:
  • Potentially raise questions of independence where none need exist
  • Potentially make a transaction in question more likely to face litigation
• Cost of additional advisors
• Additional time/complexity
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What are the requirements of the formation/operation of a Special Committee

- Independence
- Experience and expertise
- Financial and legal advisors
- Mandate of committee
Independence

• Directors serving on special committee must be "independent" of directors/shareholder proposing transaction

• Rules defining an "independent director" under NYSE and NASDAQ rules don't apply

• Question is whether the director can base decision on merits of transaction rather than on connection with proposing director/shareholder

• Issues include:
  • Whether director is economically dependent on the proposing shareholder/director or is otherwise beholden to proposing director/shareholder because of material financial, personal or employment connections; and
  • Whether the director is willing to negotiate aggressively with proposing director/shareholder and whether the special committee as a whole has the right experience to evaluate and negotiate the best available transaction for shareholders

• Not all connections should disqualify an otherwise qualified director:
  • stock ownership
  • friendship
    • But "50 year" friendships (In re Sanchez Energy (Del. Sup. Ct. 2015)) may indicate a lack of independence while “thin social circle” friendships may not (Beam v. Stuart (Del. Sup. Ct. 2014))
  • fact that director proposing transaction picked director for board
    • But fact that director would serve on board of post-merger company for 5-year term could be a factor in determining independence (City of Miami v. C&J Energy Services, Inc., Del. Sup. Ct. 2014)

• Necessarily subjective nature of determination can augur in favor of formation of special committee formed entirely of directors whose independence is beyond reproach
Experience and expertise

• In addition to independence, criteria for the selection of directors for a special committee should also include the skills likely to be helpful in analyzing and negotiating the proposed transaction

• Examples of helpful experience include:
  • Past involvement in change of control transactions
  • Negotiating ability
  • Financial and accounting analysis
Financial and legal advisors

• Are they experienced in handling the matter at issue?

• Are the lawyers and bankers to be hired by the special committee independent of management or director proposing transaction?

• Has management hired them in the past to work for the company? A factor to be considered; not necessarily a disqualifier

• Do they have a financial connection (e.g., stock ownership) with the bidder?
  • Stock ownership of bidder by banking firm (19%) or by individual banker assigned to deal team ($340,000 worth) can give rise to argument that sale process is tainted (In re El Paso Corporation Litigation (Del. Chan. Ct. 2012))

• Have the advisors worked for the proposed bidder in the past?
  • Hiring advisor because of “fee tail”, when advisor received $56 million in fees from bidder over last four years and had $90 million position in credit facility created questions regarding independence of advisor, especially in view of failure of advisor to disclose facts until one day before fairness opinion issued. (In re PLX Technology Inc. (Del. Chan. Ct. 2015)(telephonic ruling))
Financial and legal advisors

- Investment banking presentation regarding transaction to bidder prior to engagement by committee may give rise to claims that the advisor has a conflict of interest (see Zale Corp. Securities Litigation (Del. Chan. Ct. 2014)).

- Conflicts may arise after engagement, for example, is advisor pursuing a role in the bidder’s financing?
  - *Del Monte* and *Rural Metro* cases indicated that doing so could impair advisor’s independence.

- Analysis applies to legal as well as financial advisors, though courts have focused on financial advisors

- Special committee has an obligation to make these determinations, not to blindly rely on management references

  - “Buck stops with the board.” (*Del Monte*): exculpation provisions may save board from monetary liability for failing to detect and correct conflicts, but still pose risks to transation

- Specific questions better than general

- Questions should go to firm and individual members of deal team.

- Financial advisors can face “aiding and abetting” liability – and significant financial liability – for not revealing possible conflicts or for not advising board of them promptly
Compensation of advisors

• Do the compensation arrangements with the advisors create undue incentive for advisors to recommend the proposed transaction?
  • "All or nothing" fee based solely on whether deal occurs may be problematic
  • Contingent fees based on amount of price paid can align interests of advisor with shareholders
• Expense reimbursement customary
• Fee for issuing – or not issuing – a fairness opinion is typically acceptable
Mandate of special committee

- Does the special committee have the power to evaluate and negotiate the transaction in the same way that a disinterested third party would?

- Key questions:
  - Does the special committee have the authority to "just say no" and to pursue alternative transactions that would compete with the management proposal?
  - Does the special committee have the authority to adopt/redeem the company's rights plan?
  - Is the authority and mandate of the committee set forth in resolutions adopted by the board of directors and accepted by the special committee?
What are the requirements for effective operation of special committee

- Timing of formation
- Recordkeeping
- Information
- Management of process
- Interaction with directors not on committee
- "Attitude" toward negotiation
Timing of formation

• Committee ideally formed early in process, not after significant steps toward transaction

• Significant activity before formation can create issues for plaintiffs to attack
Recordkeeping

• Special committee must be prepared to prove what it did to protect shareholders

• Minutes of special committee meetings should be kept and documents submitted by advisors should be retained

• Record should set forth:
  • reliance on advice of financial advisors and legal counsel
  • active negotiation on behalf of shareholders
  • Informed and thoughtful deliberations

• Directors should be aware that any notes they keep may be subject to discovery by plaintiffs

• Any notes that are kept should be complete so as not to invite misinterpretation
Information

- Committee should have access to – and should gather – all necessary financial and operating information in order to fulfill mandate
- May rely on management, outside experts (accounting firm) and legal and financial advisors
- Committee should have access to members of management, including accounting, finance and operational personnel
  - Confidentiality paramount
Management of transaction process

• Important information should be shared with all committee members
• Committee and its advisors should oversee all key aspects of transaction
• Confidentiality agreements, due diligence, negotiation of merger agreements, etc.
• Management should be cooperative but should not be permitted to interfere with or preempt special committee
• Committee should inquire as to ongoing activities of financial advisors with respect to bidders
  • Efforts by financial advisors to participate in financing of bid may taint sale process. E.g., *In re Del Monte Foods Company Shareholders Litigation* (Del. Chan. Ct. 2011)
Interaction with directors not on special committee

• Directors not on special committee should be encouraged to share key information with members of committee

• Members of special committee should keep deliberations confidential and not share views, negotiating developments etc. with directors not on committee

• Non-committee directors and management should not communicate regarding transaction with proposing directors/shareholder without advance approval of special committee
“Attitude” toward negotiation

• Special committee must view itself as the bargaining agent for the other shareholders

• Should negotiate as vigorously as would a disinterested third party to get the best price available

• Should feel free to say “no” to the proposed deal and/or try to find a better deal from another party

• Should avoid any impression that the special committee is nothing more than a legal formality
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Special Committees in Action

- Most special committees run well and result in the intended benefits.
  - *MFW Shareholders Litigation*
- Adverse cases may be more instructive of the lessons we set forth above
Dole Food

• CEO and President, both directors, proposed buy-out but court found that they undermined and interfered with work of special committee.

• Delaware chancery court did not find fault with the special committee but imposed personal liability in the amount of $148 million on CEO and President
  • Financial advisor to special committee found agreed upon price was fair
  • But court said that CEO and President should pay personally shareholders the difference between agreed upon price and “fairer” price--$148 million

• Illustrates recent inclination of Delaware courts to impose financial liability for M&A process problems
  • Not just “deal tax” settlements as in past
  • Typical exculpation provisions not effective to prevent liability in *Dole*
  • E.g., *Del Monte Foods Co.* ($89 million paid by financial advisor); *Rural Metro* ($76 million paid by advisor; $6 million by directors)
Court in *Dole* found that CEO and President:

- Tried to limit the committee’s authority to just negotiating with CEO, rather than considering third parties that might offer more
- Controlled the terms of confidentiality agreements with competing bidders, giving the CEO and President insight into information about other bidders
- Pushed the special committee to hire a financial advisor with long-standing relationship with CEO
- Before making bid, tried to depress stock price to make bid less expensive
- Held up data room access for committee’s financial advisor
- Arranged due diligence session for directors’ financial advisors without telling the committee
- Pre-bid transactions to depress stock price affect “entire fairness” analysis
- Biggest problem was that they gave special committee one set of projections and more optimistic set of projections to the banks financing their bid
Board escaped liability in *Dole*

- Board and special committee, and financial advisor to CEO and President, all escaped liability
  - But actions of directors management prevented other directors from benefitting from business judgment rule under *MFW*, “entire fairness” standard used instead
- Court praised the special committee’s financial advisor for “acting with integrity” and providing a “thorough and balanced work product” in trying to counteract problems raised by CEO/President
- Court noted that financial advisor worked with committee to develop projections of their own after spotting the flaws in the projections from the CEO/President
- Receipt of “fairness opinion” doesn’t end necessarily end inquiry. Misconduct can cause courts to impose “fairer” price
- Highlights special risks of “domineering” management personalities
J. Crew Group Inc.

- CEO and private equity firm made bid for J. Crew Group Inc.
- As in *Dole*, CEO made mistakes that undermined the process, but unlike *Dole*, the resulting problems resulted in the payment of a settlement by the company
- Two directors proposed bid to CEO; didn’t tell fellow directors until weeks later
- CEO didn’t report other bids to board of directors
- CEO arranged management meetings with PE firm without notifying the board
- CEO shared confidential information with PE firm before NDA was signed
- While CEO was arranging its bid, two other bidders contacted board to express interest in acquisition; special committee didn’t follow up at all with one of them and contacted second one only after bidder reached out a second time
- Special committee negotiated price before giving bidder all negative information available, resulting in a reduction of the bid price
- Special committee relied on “go shop” provision to remedy these issues, but “matching” rights discouraged competition
- Case settled for $16 million payment, plus $6.5 million in attorneys’ fees, plus numerous procedural measures, including (1) extending go-shop period, (2) stripping buy-out group of right to be informed of results of go-shop until period over; (3) requiring 2 year non-compete for CEO if he declined to work for “topping” bidder; (4) reducing break-up fee to less than 1%; and (5) eliminating “matching” rights.
Southern Peru Copper Corp.

- Grupo Mexico owned 63% of Southern Peru and 99% of stock of Minera Mexico. Southern Peru agreed to buy Grupo’s position in Minera for $3.05 billion.

- Shareholders sued and Delaware chancery court awarded $2 billion in damages and interest.

- Court noted an “attitude” issue with special committee:
  - Took “strenuous effort to justify a transaction at the level originally demanded” by Grupo
  - Special committee failed to reconsider its recommendation prior to shareholder vote, even though it had negotiated the ability to do so
  - Did not ask for updated fairness opinion from financial advisors even though it had right to do so.
Southern Peru: Problems with mandate and attitudes

- Court also noted that the committee’s mandate was too narrow as its “duty and sole purpose” was to evaluate the proposed transaction and did not give the special committee the power to negotiate with Grupo.
  - Court noted that efforts to negotiate were stilted and “influenced by its uncertainty about whether it was actually empowered to negotiate.”
- At no point did special committee consider alternative transactions; it allowed Grupo to “dictate the terms of the transaction.”
Cases should not discourage going private transactions but underscore key principles

• Members of committee must be independent of bidder
• Committee must investigate and assess advisors’ conflicts
• Beware of efforts to dominate by director/shareholder proposing bid
• Preliminary discussions by insiders before formation of special committee
• Special committees are not a legal formality; should negotiate as a true third party
• Special committees must take independent efforts to gather reliable information and resist efforts to influence
  • Be able to prove what committee did
• “Rushing” the transaction
• Fairness opinions are not a legal firewall
  • Work as a team to monitor and drive process for shareholders
Questions?

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Thank You