CORPORATE LITIGATION

Effective Special Committees: Lessons From Courts and Regulators

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Related-party transactions have long given rise to concerns about conflicts of interest and protection of minority shareholders.' Striking a special committee of directors to consider the transaction has become common practice as a way to address these concerns; it may be advisable under Canadian corporate law and, in some circumstances, it is mandatory under securities law. However, despite directors' best intentions, the involvement of a special committee may not necessarily insulate a transaction from scrutiny or directors from liability.

The recent Delaware Court of Chancery decision of *In re Dole Food Co. Inc. Stockholders Litigation*[2] highlights some of the challenges directors can face when a special committee attempts to navigate the conflicts of interest associated with a related-party transaction. In that case, the Court found that Dole's controlling shareholder and a director, David Murdock, and Dole's President, Chief Operating Officer and General Counsel, Michael Carter, had breached duties owed to Dole in the context of a merger. Vice Chancellor Laster awarded damages against them in the amount of $148,190,590.18.[3] This phenomenal damages award represented the amount Murdock and Carter owed to minority shareholders as a result of their conduct during the course of Murdock's acquisition of all outstanding Dole shares and was the difference between the amount minority shareholders received in the transaction, and the "fairer" price they should have received.[4]

Canadian corporate law imposes none of the specific procedural requirements that have developed through U.S. jurisprudence and are used by boards to defend themselves in litigation when their business decisions are challenged.[5] Instead, provided that a board has made a decision that falls within a range of reasonable alternatives, and the board members themselves are not in a conflict of interest, Canadian courts will not interfere with the business judgment of directors.[6] Under Ontario securities law, directors must have regard to the obligations imposed upon them by Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions?* This instrument applies to certain types of transactions — including related-party transactions such as the one at issue in *Dole* — and imposes additional procedural requirements on directors when these types of transactions are being considered. In certain circumstances, directors are obliged to constitute a special committee to consider a transaction.[8]

Regardless of whether it is mandatory, directors can benefit from an effective special committee. However, neither the Companion Policy nor MI 61-101 itself provide much in the way of concrete guidance for special committees considering a proposed related-party transaction. Flowing from recent court and regulatory decisions in the U.S. and Canada,

I See: C. Singer, "Going Private Transactions and other Related Party Transactions," *Critical Issues in Mergers and Acquisitions* (Queen's Annual Business Law Symposium, 1999).

[2] *In re Dole Food Co., Inc. S'holder Litig.,* C.A. No. 8703-VCL, 2015 WL 5052214 (Del. Ch. August 27, 2015) *("Dole").*

[3] Ibid. at 4.

[4] Ibid. at 3-4.

[5] See further discussion of *Dole,* below, for some examples of these procedural requirements.

[6] *BCE Inc. v. 1976 Debentureholders,* [2008] 3 S.C.R. 560.

[7] OSC MI 61-101, (2008) 31 O.S.C.B. 1321 (as amended) ("MI 61-101").

[8] Note, however, that the Companion Policy to Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions,* (2008) 31 O.S.C.B. 1357 (as amended), s. 6.1(6) (the "Companion Policy") states that in the regulators' view, it is generally appropriate to constitute a special committee for any transaction covered by that instrument.

this article offers some practical guidance to special committees.

Consider the Mandate

When constituting a special committee, a board should think critically about the scope of the special committee's mandate. When a company is faced with a potential transformative transaction in circumstances where it may not otherwise have been considering strategic alternatives, there may be a temptation to draw the committee's mandate narrowly, focusing only on the transaction before it. However, a weak mandate may cause courts and regulators to question the committee's efficacy. In *Magna*,[9] a special committee was appointed to assess only the management-developed proposal to collapse the company's dual share class structure. The Ontario Securities Commission was critical of the committee's mandate to "review and consider" only the proposal developed by managementlo as it did not empower the committee to negotiate terms directly with the related counterparty, did not allow it to consider other proposals, aside from that developed by management, and did not require it to do more than simply decide whether the transaction should be submitted to the shareholders for their vote.[11] In the Commission's view, this narrow mandate was "fundamentally flawed."[12]

Similarly, in *Dole*, the board of directors was faced with an offer from Murdock, a director and Dole's controlling shareholder, to take the company private. When the special committee was struck, it intended its mandate to include considering not only the Murdock transaction, but to also consider alternatives. Carter (Murdock's "right-hand man"[13]) objected to this mandate, insisting that the special committee had been created solely to consider Murdock's proposal." Vice Chancellor Laster found that Carter "interfered with the Committee's operations" by seeking to limit its mandate in this way. By contrast, in an earlier Delaware decision, Chancellor Strine had commented favourably on the special committee of M&F Worldwide's mandate to negotiate terms of the proposed going-private merger with its controlling shareholder, rather than to simply "evaluate" the transaction "like some special committees with weak mandates."[15]

Ensure Independence

A fundamental criterion for a special committee is that its membership should be made up of directors who are "independent" — not conflicted in respect of the proposed transaction.[16] Courts have recognized that in complex transactions, it may not be possible to eliminate conflicts of interest, but directors should seek to minimize them to the greatest extent possible." MI 61-101 sets out certain circumstances in which a director will be determined not to be independent, such as where a director has an interest in the transaction at issue or acts as adviser to an interested party to the transaction. However, beyond these prescribed circumstances, whether a director is truly independent is a question of fact for the regulator or the court to assess.[18]

The independence of directors generally, and members of a special committee in particular, has been a focus for decision-makers who are asked to review transactions. A special committee must be able to protect the interests of minority shareholders without being affected by conflicts of interest.

In *Dole*, the issue of independence was raised squarely before Vice Chancellor Laster. The plaintiffs alleged the members of the special committee were conflicted, on the basis of their various personal connections to Murdock and the businesses he controlled. Vice Chancellor Laster acknowledged that prior to the trial, the connections between the Chair of the special committee and Murdock might have suggested that the Chair would be

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[9] *Magna (Re)* (June 24, 2010), OSC Decision, online: https://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20110131_magna.pdf *("Magna").*

I° Ibid. at paragraph 30.

"Ibid. at paragraphs 221-223.

[12] Ibid. at paragraph 224.

[13] *Dole*, supra note 2 at 1.

[14] Ibid. at 36.

[15] *1n re MFW S'holder Litig.*, C.A. No. 6566-CS, (2013) 67 A.3d 496 (Del. Ch. May 29, 2013) *("MFW") at 17.*

[16] In circumstances where the use of a special committee is mandated by MI 61-101, the committee must be comprised solely of members who are independent. Where a special committee is not required by law, boards may have more latitude.

[12] *Gazit (1997) Inc. v. Centrefund Realty Corp.*, [2000] O.J. No. 3070 (Sup. Ct.) at paragraph 68.

[18] MI 61-101, s. 7.1(1).

"cooperative, if not malleable" when dealing with Murdock.i° However, rather than simply basing his assessment of independence on the connections between the Chair and Murdock, the Vice Chancellor considered the Chair's testimony and demeanour at trial, together with the performance of the special committee as a whole. Taking these facts together, Vice Chancellor Laster found no basis to the plaintiffs' allegations that the special committee lacked independence 2[0]

Chancellor Strine engaged in a similar assessment in *MFW.* After first setting out the law of Delaware, that "mere allegations that directors are friendly with, travel in the same social circles, or have past business relationships with the proponent of a transaction... are not enough to rebut the presumption of independence,"[21] he proceeded to assess whether any ties between Ron Perelman (principal of MacAndrews & Forbes, the company seeking to acquire the outstanding shares of M&F Worldwide) and members of the special committee were sufficiently material as to call their independence into question.[22]

The question of a director's independence was addressed again recently by the Delaware Supreme Court in the case of *Delaware County Employees Retirement Fund et al. v. Sanchez et* a/.[23] In that case, the plaintiffs had brought a derivative action on behalf of Sanchez Energy Corp., a public company, alleging that a transaction it had entered into with Sanchez Resources, LLC (a private corporation owned by the Sanchez family that provided management services to Sanchez Energy) involved a gross overpayment by the public company that unfairly benefitted the private company.

Under U.S. law, a shareholder is required to provide notice to a corporation of its complaint, and demand the board take action. This step is only unnecessary if the demand would be futile.[24] In this case, the plaintiffs alleged that the demand would be futile because a majority of the board's directors were not disinterested and independent of the transaction. The parties agreed that of the five-member board, A.R. Sanchez and his son were not disinterested, but the question before the Court was whether director Alan Jackson was independent.

The Delaware Supreme Court overturned the Court of Chancery's decision that Mr. Jackson was independent, on the basis that the Court of Chancery had wrongly considered his personal ties to Sanchez separate and distinct form his business relationship.[25] Jackson and Sanchez had been friends for fifty years; Jackson's full-time job was as an executive at an insurance brokerage that provides insurance services to Sanchez Energy and its affiliates and that is owned by a parent corporation for which Sanchez was the largest stockholder. The Delaware Supreme Court considered the full context of the personal and professional relationship between Jackson and Sanchez, and found that a reasonable doubt had been raised as to the independence of Jackson.[26]

Canadian courts and regulators will perform a similar review of committee members' independence.[27] This means that when striking a special committee, directors should consider that any relationships between individual directors and officers or directors of the entity proposing to engage in the transaction will come under scrutiny, whether by a regulator or in the public eye.

Insist on Access to Information

In order to properly discharge its duty, a special committee may require information from management or from the related party to the transaction. A special committee may need information such as forecasts or projections for the purpose of supporting a valuation or

[19] *Dole,* supra note 2 at 35.
[20] Ibid.
[21] *MFW,* supra note 15 at 19.
[22] Ibid. at 23. Chancellor Strine described this as an allegation of friendliness that is of the immaterial and insubstantial kind the Delaware Supreme Court has determined to be not material to the issue of a director's independence.
[23] 2015 WL 5766264 (Del. Supr.) *("Sanchez").*
[24] *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984).
[25] *Sanchez,* supra note 23 at 7.
[26] Ibid. at 10. The Supreme Court noted: "Close friendships of that duration are likely considered precious by many people, and are rare. People drift apart for many reasons, and when a close relationship endures for that long, a pleading stage inference arises that it is important to the parties."
[27] *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* (1998), 39 O.R. (3D) 755 (Gen. Div.).

information as to the nature of arrangements as between the related party and certain shareholders of the company. Decisions in Canada and the United States support the propositions that special committees are entitled to information necessary to them in discharging their duties, and where such information is refused or obstructed, the transaction process may be tainted.

In *Re. Sears Canada Inc.*,[28] the Ontario Securities Commission considered whether Sears Holdings Corp. engaged in conduct that was abusive and coercive, and contrary to the public interest, in its bid to purchase all outstanding shares of Sears Canada Inc. and take the company private. The Commission considered Sears Holdings' refusal to provide the special committee of directors of Sears Canada with information as to the terms of support agreements between Sears Holdings and certain minority shareholders as conduct that "fell far short of the conduct we would expect of even the most determined offeror in the pursuit of its insider bid."[29] In reaching this conclusion, the Commission rejected Sears Holdings' argument that it had no statutory obligation to provide information to the Sears Canada special committee, finding that insiders bidding for a public company assume an obligation to cooperate with the special committee as it discharges its function 30

The facts were even more egregious in *Dole.* Beyond simply refusing to provide access to information, Carter actively misrepresented information as to cost savings that could be realized as a result of the sale of certain portions of Dole's business, and income to be earned from the purchase of some farms.[31] These misrepresentations prevented the Dole special committee from providing accurate information to its financial adviser, or obtaining an accurate assessment of the company's value with which to consider Murdock's offer. While Vice Chancellor Laster found the Dole special committee to have conducted itself with integrity, he held that Carter's failure to provide the committee with accurate information rendered the committee ineffective as a bargaining agent on behalf of the minority stockholders.[32]

Members of a special committee must have access to information that enables them to meet their duties as directors to ensure informed decision-making on a course of conduct that is in the best interests of the company. Particularly where a counterparty to a potential transaction is related, special committee members should insist upon — and management should ensure it provides — access to any information committee members reasonably conclude is necessary for them to fulfill their mandate. Management should be particularly mindful of the fact that related parties who control access to information will be subject to criticism if they frustrate the special committee's efforts.

Be Wary of Coercion

Unsurprisingly, related parties can be self-interested in seeking to complete their proposed transaction at the lowest price possible. This self-interest can cause them to employ tactics to encourage a special committee to recommend a proposed transaction either before the special committee has had the opportunity to fully consider the transaction, or worse, to recommend it to the board of directors when it is not in the best interests of the corporation to proceed. Recent cases involving special committees provide some examples of potentially coercive tactics that special committee members may face:

- *Arbitrary deadlines.* A potential acquiror may set an arbitrary deadline for consideration of the proposed transaction, simply to apply pressure to the special committee.[33]
- *Circumscribing Options.* Where a potential acquiror is a controlling shareholder, the acquiror may make public statements that it has no intention to sell its shares, thus limiting or eliminating the possibility of alternative transactions. While there is no requirement on a controlling shareholder to sell its shares,[34] or to refrain from making statements about its intentions,

[28] *Sears (Re)* (August 8, 2006), OSC Decision, online: https://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20060808_searscanada.pdf *("Sears").*
[29] Ibid. at paragraph 295.
[30] Ibid.
[31] *Dole*, supra note 2 at 70-71.
[32] Ibid. at 72.
[33] *Dole*, supra note 2 at 32.
[34] *Magna*, supra note 9 at paragraph 194.

the timing of such statements can be designed to lead a special committee to a particular conclusion.

- *Tightening Mandate.* As noted above, a special committee will want to consider its mandate, to ensure it has the scope to consider all options in the best interests of the corporation; however, a potential acquiror may wish to ensure that key controlling shareholder views are taken into account in framing the mandate, which may lead to a tension between an expansive mandate and a more narrow one.
- *Public Pressure.* A potential acquiror may use the media or press releases to apply pressure to the special committee, for example:
  - making statements about dividend or other practices that it will seek to change should a special committee not support a proposed transaction;[35]
  - making statements about the length of time certain steps are taking in order to suggest the special committee is delaying or taking too long;[36]
  - making statements about members of the special committee's ownership of shares of the corporation, and historic purchase or sale practices;[37] or
  - making statements about the ongoing business prospects of the corporation in the absence of a transaction, whether officially or by way of "leaks."[38]

Conclusion

Not every transaction that a board of directors is faced with requires the striking of a special committee, but as case law develops in the United States and securities regulators continue their focus on related-party and other special transactions where protection of minority shareholders is warranted, directors' use of special committees is likely to become more and more commonplace. In order to protect themselves, and to guard their decisions against challenge, directors should consider the practical guidance that is provided by court and regulatory decisions in establishing special committees and fulfilling their roles.

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[35] *Sears*, supra note 28 at paragraphs 275-277.

[36] Ibid. at paragraphs 27 and 284-285.

[37] Ibid. at paragraph 286.

[38] Ibid. at paragraphs 287, 291 and 295. In its decision, the OSC found the conduct of Sears Holdings to fall "far short of the conduct we would expect of even the most determined offeror in the pursuit of its insider bid."