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What the Kahn Decision Says About "Special Committees"

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The recent decision by the Delaware Supreme Court *in Kahn v. M&F Worldwide Corp.* has generated extensive commentary in the legal press because of its holding: that the relatively deferential "business judgment" standard of review, rather than the more exacting "entire fairness" standard, may now be applied in the context of controlling shareholder merger transactions if certain procedural protections are in place from the outset of the process.

Those protections are: the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of minority stockholders.

However, a close reading of the decision reveals that the shift in the nature of the judicial review may be less dramatic than suggested by the headlines that followed the decision. Under Kahn, a court will apply the business judgment standard in controlling shareholder merger transactions only if the Special Committee has actually performed its obligation to negotiate a fair price with due care and was effective in doing so, and if the court has scrutinized the factual record in sufficient detail so as to conclude that the due care and other conditions have demonstrably been satisfied.

The key will be the Special Committee's ability to demonstrate that it acted effectively in negotiating with the controlling stockholder in a manner that replicates genuine arm's-length negotiations with a third party.

Here are the main lessons we see in the decision:

• Don't expect that early dismissals of lawsuits challenging a controlled merger transaction will become routine. If a plaintiff can plead "a reasonably conceivable set of facts" showing that one of the requisite conditions was not satisfied, the plaintiff will be entitled to proceed with the case and conduct discovery. Accordingly, Special Committee members and their counsel should anticipate that a well-pleaded complaint will survive a motion to dismiss, and that discovery will occur.

• Pretrial discovery could be extensive. In order to prevail without a trial, the defendant must establish that there are no triable issues of fact as to the Special Committee's due care and effectiveness. Depending on the applicable facts, this is not a light burden for a defendant to carry. In Kahn, the court noted that the Court of Chancery had made its decision on the basis of "a highly extensive record" (during eight months of discovery, appellants had received more than 100,000 documents, had deposed all four Special Committee members as well as the Committee's financial advisers, and had also deposed senior executives of the relevant companies). On the basis of this record, the court found that compliance with the dual procedural protections "had both been undisputedly established prior to trial."

• The court's "procedural" standards embody substance as well as procedure. The court in Kahn characterizes the applicable legal standard using several different formulations that underscore the substantive requirements to be complied with by Special Committees:

• The business judgment standard will be applicable only where there is "an independent, adequately empowered Special Committee that fulfills its duty of care."

Special Committee members and their counsel should anticipate that a well-pleaded complaint will survive a motion to dismiss, and that discovery will occur.

• The court will undertake two price-related pre-trial determinations: "first, that a fair price was achieved by an empowered independent committee that acted with care and second, that a fully-informed uncoerced majority of the minority stockholders voted in favor of the price that was recommended by the independent committee."

Each member of a Special Committee should at all times maintain the mind-set of an independent third party without any predisposition to accommodate the controlling stockholder.

• Finally, the case will proceed to trial under the entire fairness standard of review if there are any triable issues of fact as to whether "the dual procedural protections were established, or if established were effective."

The court will assess whether the price is fair and whether the negotiations have been arm's-length. The court will examine whether, in its view, the Special Committee has been effective in negotiating an arm's-length price. The price that has been achieved will be the critical factor in the court's analysis, and the Special Committee must be shown to have exercised real bargaining power on an arm's-length basis in the negotiations.

The court will carefully examine and evaluate what the Special Committee actually did. In Kahn, the court carefully reviewed and recounted the care and sophistication with which the Special Committee obtained financial information from management, gave directions to its financial adviser to consider other strategic alternatives, and engaged in negotiations with the controlling stockholder. Significantly, the court referred to its previous Americas Mining decision, in which the Chancery Court had engaged in an extensive critique of the Special Committee's actions and concluded that the Special Committee "fell victim to a controlled mindset" that allowed the controlling stockholder to dictate the terms and structure of the transaction.

If the case proceeds to trial, the business judgment standard will not be applicable and the court will conduct the traditional entire fairness review. The less exacting business judgment standard is applicable only if the court decides that the undisputed facts establish both protections described above (the approval of the Special Committee, and the vote of a majority of the minority stockholders). If, after discovery, triable issues of fact remain as to either of these conditions, then the case will proceed to trial under an entire fairness standard.

In light of these lessons from the

decision, what is a Special Committee to do in order to try to qualify for business judgment review?

• Maintain an independent mind-set, and act accordingly. Each member of a Special Committee should at all times maintain the mind-set of an independent third party without any predisposition to accommodate the controlling stockholder. The Special Committee's objective is not to figure out how to accomplish the controlling stockholder's proposed transaction, but to decide whether and at what price such transaction or an alternative transaction would be in the best interests of the minority stockholders (or whether the Special Committee should just say "no" to the proposed transaction).

• Consider alternatives. The deal proposed by the controlling stockholder is not the only deal that the Special Committee should consider, and a careful consideration of alternative transactions can help the Special Committee assess the attractiveness (or not) of the controlling stockholder's proposed transaction. The court in Kahn was impressed that the Special Committee carefully considered alternative transactions even though it did not have the practical ability to accomplish such transactions because the controlling stockholder had stated its unwillingness to be a seller of its stake.

• Critically evaluate the financial analyses by the Committee's advisors. The Committee should be actively engaged with the work being done by the financial adviser, should provide direction to the financial adviser, and should not accept uncritically the financial adviser's work or analyses. In the Americas Mining decision, the court was highly critical of the financial adviser's valuation methodologies relied upon by the Special Committee and the Special Committee's "controlled mindset."

The Committee should be actively engaged with the work being done by the financial advisor and should not uncritically accept the financial adviser's work or analyses.

• Negotiate vigorously with the controlling stockholder. The Special Committee should engage in vigorous negotiations with the controlling stockholder, taking into realistic account the fair value of the target company and the parties' alternatives. In Kahn, the court rested its approval of the Special Committee's actions not just on the negotiating process (which resulted in only a $1 per share increase above the controlling stockholder's original proposal) but also on the court's consideration of the factual record that underlay the Special Committee's conclusion.

• Devote sufficient time and effort to the work of the Committee. The Special Committee members must devote substantial time and effort to their work. While they can and should delegate as appropriate to legal and financial advisers, they must remain engaged and involved in the process and must spend the necessary time in reviewing, understanding and critiquing the input from their advisers.

• Maintain good records of the Committee's work. The Special Committee should direct its counsel to ensure that adequate records are maintained of the work being done by the Committee. Such records will include minutes of each of the Committee's meetings, as well as copies of all materials presented to the Committee for its review.

The Kahn decision is a challenge by the Delaware Supreme Court to have Special Committees perform their roles with the kind of arm's-length and sophisticated vigor that will allow the reviewing court to conclude that the Special Committee has been demonstrably effective in negotiating a fair price. The Kahn court makes clear that it stands ready to review the work of Special Committees on the basis of the traditional "entire fairness" standard if the rigorous conditions laid out in the decision are not met. ■

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Friedman Kaplan Seiler & Adelman LLP was not involved in the Kahn case, but has represented affiliates of MacAndrews & Forbes in unrelated matters. MacAndrews & Forbes was a 43 percent stockholder in M&F Worldwide Corp., as discussed in the Kahn decision.