SQUIRE SANDERS

FIFTEEN TIPS FOR EFFECTIVELY CHAIRING A SPECIAL COMMITTEE

INTRODUCTION

Given the current regulatory environment and the prevalence of litigation challenging all manner of corporate activity, most public company directors will sooner or later find themselves staffing or chairing a Special Committee.

Work on a Special Committee is, in many regards, similar to board work, but there are some important differences. By their nature, Special Committees are task or project-oriented, have near-term purposes and goals, and frequently work under significant time constraints. In addition, unlike ordinary course Board matters, the decisions of a Special Committee are commonly scrutinized in a litigation or regulatory context, or both.

Thus, a director who chairs a Special Committee faces different challenges than a lead director or Board Chairman who presides over ordinary course board deliberations.

Much like a railroad conductor, a good Special Committee chair will be concerned with keeping the trains running on time. The Chair often ssumes primary responsibility for interfacing with various legal, financial and other professionals that have been retained by the Special Committee, as well as with company management. However, the Chair's responsibilities extend well beyond logistics, and include assuring that the Committee members fully understand and diligently work to fulfill the particular mandate that they are being asked to undertake.

Special Committees are created for varying reasons.

Common purposes include:

- Special Litigation Committees charged with responsibility for reviewing derivative litigation claims brought by shareholders and determining whether they should be sued on behalf of the corporation.
- Special Investigatory Committees are charged with the responsibility for overseeing internal investigations independently or, in tandem with governmental proceedings.
- Special Committees are frequently impaneled in connection with change of control or merger transactions, particularly where one or more Board members may have an interest in the transaction.
- Special Committees are often called upon to review related party transactions where management or Board members may have an interest in the transaction that could call their independence into question.

*This article concentrates primarily on the work of Special Committees in transactional and investigatory contexts. Service on Special Litigation Committees created to review derivative claims or on investigatory committees reviewing potentially illegal conduct presents important issues beyond the scope of this article.

Each of these Committee types presents its own slate of legal and practical considerations. Nevertheless, there are certain best practices that any Special Committee Chair can employ to assure the Committee's effectiveness.

About Frank M. Placenti

Frank Placenti serves as the chair of Squire Sanders' corporate finance and governance practice, and is nationally recognized for his work in corporate governance and mergers and acquisitions. Placenti has more than thirty years' experience in mergers and acquisitions, private equity, corporate governance, securities law, antitakeover and shareholder relations issues. He has represented public companies, private equity firms, portfolio companies and brokers/dealers in capital formation, securities and corporate law, regulatory compliance, recapitalizations, and mergers and acquisitions.

Placenti is listed in the 2006 to 2012 editions of Best Lawyers in America, the 2003 to 2012 editions of Chambers USA: America's Leading Lawyers for Business and is a multi-year member of the Lawdragon 500, an acknowledgment given to the top 500 lawyers in America. He was recommended in Arizona for corporate matters and mergers and acquisitions by PLC Which Lawyer? Yearbook 2009 and is listed in the PLC Cross-Border Mergers and Acquisitions Handbook 2008/2009. Each year since 2007, Placenti has been selected by his peers to appear in Southwest Super Lawyers, a distinction awarded to the top five percent of lawyers in the region. Frank also serves as vice chair of the Corporate Governance Committee of the American Bar Association and as the chair of its Shareholder and Investor Relations Subcommittee.

Placenti is a member of Greater Phoenix Leadership and serves as immediate past chair of the Phoenix Children's Hospital Foundation Board of Directors. He formerly served as the chair of the Board of Directors of the Boys and Girls Clubs of Metropolitan Phoenix, as chair of the Phoenix Chamber of Commerce, as a member of the Board of Directors of the Herberger Theater Company and as a member of the Board of Trustees of the Arizona Science Center.

"Increasing care needs to be given to the selection of the financial advisor."

I. Thoughtfully Select the Members of the Committee

Most Special Committees are established due to the need for independent review of a particular issue or transaction and must include only non-conflicted directors. These days, courts will look far more than just economic or business relationships to determine whether a director has the requisite independence. Social relationships with managers or directors who have an interest in the matter at hand (including those developed through community or charitable endeavors) or other key players in a transaction are considered by courts when determining whether an individual director should serve in connection with a given SpecialCommittee's work.

Partnering with legal counsel, the Chair should lead the effort to determine whether any of the directors who might initially have been considered to be qualified for committee service should be asked to stand down. While delicate, these conversations are crucial. A single conflicted director can taint months of otherwise solid effort by a Special Committee, resulting in a rejection of its conclusions by a court or a regulator.

Beyond the issue of independence, committee size itself is an important issue. A Special Committee charged with reviewing a transaction (or developing alternatives to a proposed transaction) will likely have several dozen meetings in a series of weeks, frequently on short notice, making large committees unwieldy. By the same token, a committee that is too small can exclude valuable contributors. On balance, the "Goldilocks" rule applies--the committee should be neither too small nor toolarge to do its work.

II. Hire the Right Law Firm and Financial Advisors

Special Committees will, in many cases, need to hire a law firm and a financial advisor. It is sometimes acceptable for the Special Committee to rely upon the Company's regular corporate counsel to assist. In an increasing number of cases, however, the Special Committees will want to secure its own legal counsel with no prior or ongoing relationship with the corporation or its management. This is true in not only investigatory and litigation matters, but in transactional matters as well where courts will examine the independence of the advice being received by the Special Committee. Special Committee members will often have contacts that enable them to assemble a list of qualified firms to be evaluated. In other cases, they can rely upon the Company's general counsel to make suggestions so long as that counsel has no personal interest in the matter.

It is generally a good idea to interview several law firms to determine not only their qualifications for dealing with the relevant subject matter, but also to assure that there is appropriate chemistry with the Committee members. Legal counsel and Committee members will be working very closely on highly sensitive matters, and a comfortable working relationship built on confidence and trust will be important. Thought should also be given as to the ability of counsel to effectively interface with other transaction participants, regulators or others involved in the matter. Arrogance and abrasiveness are rarely advantageous traits.

The process by which counsel is selected should be documented and should include a finding by the Committee that the law firm has appropriate skills, and that it is independent. In investigatory and litigation matters in particular, selecting a firm that is (and will readily be perceived by courts and regulators to be) independent is critical. In circumstances where senior management or members of the Board have an interest, it will rarely (if ever) be advisable to select a firm with pre-existing ties to the Company.

Similar considerations apply to the retention of financial advisors. Where a financial advisor will be assisting a Special Committee in analyzing or developing alternatives to a proposed transaction, the Committee might naturally turn to a financial advisory firm that has a prior relationship with the company. Indeed, it was traditionally believed that this prior relationship and knowledge of the company was an advantage.

More recently, however, the Delaware courts have been scrutinizing the independence of the financial advisory firms. Where a firm has had a long history with the Company and ties to the management team, the courts have questioned whether they are in a position to render independent advice to the Company. Similarly, where the firm has had a prior relationship with a party on the opposite side of the table, or hopes to provide financing services to that party in connection with the transaction, the courts have questioned the firm's independence.

In this environment, increasing care needs to be given to the selection of the financial advisor. It is generally a good idea to interview several to evaluate their qualifications, knowledge in the industry and the Company, available team resources and other substantive factors.

While independence should also be considered in certain circumstances, the Committee may believe that it is nevertheless appropriate to select a given firm with a prior relationship to the Company. When this occurs, it is particularly important to document the Committee's rationale with minutes that reflect the Committee's determination that the benefits of retaining the firm outweigh whatever issues are present relating to its independence.

For this reason, it is often helpful to retain legal counsel prior to selecting the financial advisor so that legal counsel can assist with the documentation of the process relating to the financial advisor's engagement. Counsel will also be very helpful in negotiating the terms of the advisor's engagement letter. Engagement letters presented by financial advisory firms frequently include an ever-evolving set of non-standard terms that legal counsel can help identify and negotiate.

III. Understand the Importance of Process

As successful business persons, Board members will be instinctively focused on making the "right decision" on the issues at hand. In most business contexts, the ability to "short cut" a lengthy process to quickly reach an insightful business decision is a trait that is highly rewarded. When undertaking Special Committee work, the opposite is often true.

When called upon to review the decision makingof a Special Committee, courts will be most keenly focused on the adequacy of its processes and less on the brilliance of its achievement. Care should be taken to assure that the process utilized by the Special Committee is well-designed, thoughtful, and well-documented.

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It is not uncommon for Special Committee members to grow weary of hearing from counsel about the importance of process, and the Special Committee Chair can play a very important role in assuring that adequate process is honored even when it seems less than efficient.

IV. Understand the Importance of Reliance Upon Experts

Any Special Committee will need to establish that it has acted with due care based upon reliable information. Most Board members are not substantive experts in litigation, forensic investigation, investment banking, or other relevant disciplines, and do not have either sufficient time to analyze or even access to relevant data. It is important for the Committee to rely upon experts chosen with due care. Indeed, the laws of the State of Delaware (in which many public companies are organized) expressly protect a board member who undertakes action in reasonable reliance upon experts chosen carefully.

Boards are accustomed to relying upon presentations made by the Company's management team, which in many ordinary situations is entirely appropriate. However, when the management team's conduct has been called into question, or when management is involved in a transaction, exclusive reliance upon information provided by management is problematic. Here, reliance on independent, third party experts becomes acutely important.

V. Know How a Fairness Opinion Works

When reviewing a proposed transaction (including a change of control or related party transaction), it has become standard practice for Special Committees to secure a "fairness opinion" from a financial advisor. In a fairness opinion, the advisor expresses an opinion, "from a financial point of view," that the terms of a proposed transaction are fair to the Company and/or to its shareholders.

In many senses, a fairness opinion is not a financial document, but is instead a legal document in that it evidences the Committee's effort to assure that it has acted with due care in reliance upon experts. It is important thatthe Chair (in particular) and the Committee members (in general) understand what a fairness opinion is, and what it is not. Specifically, a fairness opinion is not a recommendation to undertake a transaction nor is it a form of valuation.

The process by which a financial advisor renders a fairness opinion must also be well-understood by the Chair. Financial advisors have an internal fairness committee process in which the team working on the transaction must present the draft opinion to an independent group within the investment banking firm. All of this takes time, and that schedule must be considered in the context of a transaction that is time-sensitive.

It is not uncommon for a financial advisory firm to charge substantial fees for rendering a fairness opinion. The amount and timing of when those fees become due and payable is an item for negotiation in preparing the advisory's engagement letter. Financial advisory firm's practices vary in terms of whether they will require separate fees for so called "bring down" opinions. In the absence of an express provision to the contrary in the engagement letter, the advisor may take the position that any "bring down" or update of the opinion is a separate opinion generating a separate fairness opinion fee, which can become quite costly. The Chair will want to work closely with legal counsel to understand the optimal time for delivery of the opinion to assure that the opinion is not delivered too early (and thus subject to attack based upon intervening events).

The Chair will also want to discuss with counsel the factors that are considered by courts in determining whether a fairness opinion is worthy of reliance. The valuation methodologies utilized by the firm are important, but the Chair and the Committee also need to understand any common valuation methodology that was not utilized, and why. A fairness opinion that utilizes too broad a range of values is particularly vulnerable. The Chair might consider requesting that legal counsel provide a short presentation highlighting the key factors to be considered by the Committee in connection with evaluating a fairness opinion.

VI. Thoughtfully Document the Process

Because of the strong judicial emphasis on process and the public disclosures that frequently accompany Special Committee decisions, it is important that the Special Committee document the hard work that is undertaken. While the Committee members may be accustomed to short form minutes in connection with ordinary Board activities, counsel for a Special Committee should be instructed to prepare thoughtfullycrafted minutes that reflect the diligent effort of the Committee. Those minutes should be drafted with the prospect of both public disclosure and litigation in mind. While they do not need to contain a blow-by-blow description of who said what and when, they should reflect that the primary factors considered by the Committee in connection with each of its significant decisions. The minutes taken as a whole should combine to provide a narrative that speaks to how the Committee viewed its tasks, how it diligently executed those tasks, and why its decisions and actions were justified. In a transactional context, well-prepared Committee minutes provide a good road map for preparation of public proxy or tender offer disclosure documents.

Minutes of Committee meetings should be the only official documentation of the Committee's deliberations and processes. Committee members should be instructed by counsel concerning the thoughtful management (and avoidance) of notes, e-mail communications and other items that could complicate litigation or regulatory processes. Similarly, care must be taken to protect the attorneyclient privilege to assure that communications with counsel not be inadvertently disclosed, jeopardizing their confidentiality.

VII. Remember Where Your Loyalties Are Owed

In transactions involving related parties or in litigation where the conduct of management or other Directors is under scrutiny, personal relationships can make the Committee's job difficult. Special Committee members must be prepared to objectively review the conduct of their peers and, if for any reason they are not prepared to do so, should decline to serve. Members of the Special Committee owe important fiduciary duties to the corporation and its shareholders, that these duties must trump any other considerations of personal loyalty.

"The Chair must understand the right balance between effective leadership and unhelpful authoritarian behavior."

VIII. Manage Corporate Disclosures & Public Communications with Care

Most Board members are involved in corporate disclosure only infrequently and generally in connection with regular earnings releases. When working on a Special Committee, especially one relating to a transaction or an internal investigation, Committee members are more likely to find themselves embroiled in the process of formulating and authorizing corporate disclosures.

In connection with an investigation of financial or other improprieties, there is a natural tendency to "minimize" the severity of a potential problem in an effort to calm the market, customers, employees and other constituencies. This inclination must be resisted. Premature assurances can backfire and result in a requirement for continuous updating of incorrect or incomplete statements that is damaging to corporate credibility and legally problematic.

Corporate constituencies should be assured that the Company and the Committee are taking the matter seriously, that appropriate investigatory efforts are being undertaken, and that required actions and remedial measures will be implemented. In some cases, assurance of appropriate cooperation with governmental agencies is indicated. Beyond that, providing assurance of size, scope or by nature of the underly ing conduct or any resulting financial impact is inadvisable until all of the facts are known and the investigation is complete.

In transactional matters, there may be a need to update the market as to events throughout the transaction process. Here, advice from counsel as well as financial advisors will be very helpful in assuring that the market remains informed, while the process does not suffer from publication of sensitive information on a premature basis.

Communication discipline will also be important. The Committee must speak exclusively through its Chair and its counsel in discussing sensitive matters with a full Board, management or regulators. Any "side conversations" with members of management or transaction parties in the transactional context must be carefully managed and all Committee members should be aware of these events. Committee members must "stay on the reservation" and they should not be discussing Committee matters outside of the Committee until the project is complete. This will be particularly important with respect to matters that may be subject to a claim of attorney-client privilege, where inadvertent disclosures can result in a waiver of that privilege, potentially subjecting all communications with counsel to discovery.

IX. Know That the Committee Work Will Be Intrusive; Manage the Expectations of Committee Members Accordingly

Board service can be a very enjoyable experience. Serving on a Special Committee called upon to investigate alleged improprieties or to manage intense merger negotiations in a compressed time frame is often intellectually stimulating, but would seldom be characterized as "fun." In addition, Board members who are accustomed to a few quarterly Board and Committee meetings held with significant advance notice might find the intensity and frequency of the activity necessary to properly staff a Special Committee to be intrusive. Particularly when committees function over a duration of many months, members can become frustrated with the volume of materials they are asked to review, the short notice provided in connection with frequent meetings, the late hours, early mornings and interrupted evenings and weekends that characterize Special Committee work.

It will be helpful for the Special Committee Chair to set the expectations up front to assure that all Committee members understand that their service on the Committee will most likely be more rigorous than traditional Board service.

X. Effective Management of the Committee Will RequireSubstantial Time and Effort Outside Committee Meetings

The work of a Special Committee will go more smoothly if the Chair undertakes appropriate leadership activity apart from simply presiding over the Committee's meetings. Efforts to keep Committee members informed, to identify concerns in advance of meetings so they can be addressed, and other common business leadership activities are equally important in Special Committee work. An effective Special Committee Chair will be on alert for signals that Committee members may have concerns that would require differential examination and data development that might otherwise derail or delay the process.

XI. Lead, But Don't Get Too Far Out Front

Effective Special Committee Chairs understand and employ the concept of "servant leadership." They act to understand the needs of the Committee as a whole, and work to provide logistical and other support so that the Committee can perform its work effectively. However, particularly where a pecial Committee Chair may be a CEO or other corporate executive accustomed to unilaterally directing behavior, the Chair must understand the right balance between effective leadership and unhelpful authoritarian behavior. A Special Committee Chair that gets "too far out front" of his or her Committee can find results that are both unpleasant and damaging to the process.

XII. Control the Advisors

Assuming the Committee has done its job, it will have selected legal and financial advisors that have travelled the road the Committee is embarking upon many times before. These advisors will provide very valuable guidance. But, however experienced, advisors are just that—advisors. It is important that the process ultimately be controlled by the Committee and that the formal record demonstrates that the Committee, and not the advisors, made the ultimate decisions on key issues.

By the same token, in matters involving an independent investigation of alleged misconduct or financial irregularities, the Committee needs to understand that the independence of legal counsel conducting an investigation is imperative if the investigation is to have credibility with regulators. Undue interference with, or limitations upon, the conduct of the investigation are unwise and can, in extreme cases, result in the resignation of counsel with potentially disastrous consequences for the company.

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XIII. Understand the Constraints & Factors Relating to the Special Committee Compensation

Special Committees often requires significant time and effort. It is common that members of a Special Committee will receive compensation separate and apart from that which they receive for ordinary Board service. In years past, it was common that Special Committee members would receive compensation based upon meeting attendance, with in-person meetings generating a larger meeting fee than telephonic meetings.

Basing compensation on meeting participation has sometimes proven problematic and can generate awkward issues including whether a five-minute telephone call should generate the same fee as a two hour review of materials presented by counsel or financial advisors.

To avoid these issues, many Special Committees opt for receipt of a monthly stipend for Committee service. The amount of that stipend can be set at the initiation of the Committee's efforts and adjusted later, if appropriate. The Chair of the Special Committee frequently receives a greater monthly fee than those of the other Committee members, recognizing the additional effort required of the Committee Chair. Legal counsel can be called upon to review recent public filings by peer corporations to provide guidelines and benchmarks.

The Special Committee should not normally receive a success fee in connection with a transactional review. The Committee should remain independent, and there should be no appearance that the Committee had a bias in favor of a transaction.

The amount paid to Special Committee members will be subject to public disclosure either in connection with the transaction, or in the Company's regular proxy materials. Thus, while Committee members will want to be appropriately remunerated, they will wish to assure that the fees that they are being paid appear to be reasonable under the circumstances.

XIV. Begin with the End in Mind

The Chair needs to understand the desired "output" of the Special Committee's work. In a transaction, the desired output is a record that demonstrates a thoughtful consideration of a proposed transaction as well as an effort to develop and consider alternatives, a clear effort by the Committee to negotiate advantageous terms for the transaction, and other matters that demonstrate that the Committee acted with the shareholders' interests clearly in mind, even if it means not pursuing a deal.

When the Committee is called upon to oversee any investigation, it will want to carefully consult with legal counsel as to the purposes to which the investigatory effort will be put. The Committee will want to know whether a written report is advisable, whether the results of the investigation will be utilized in a regulatory context, and how the investigative report may be treated in a litigation context.

The Committee reviewing derivative litigation to determine whether the corporation should proceed, will want to take pains to understand how the derivative demand process works, and how its determination will be reviewed in a litigation context.

XV. Know That Litigation Challenging the Committee's Actions is Likely

Notwithstanding all of the hard work that a Special Committee undertakes, members need to understand that litigation is likely, particularly in a change of control or merger context. A recent survey of public company merger transactions found that, notwithstanding the fact that the vast majority of shareholders supported those transactions as beneficial from a financial point of view, nearly all of them resulted in shareholder litigation challenging either the fairness of the transaction or the adequacy of the disclosure made in the Company's proxy statement.

This type of seemingly groundless litigation can be extremely frustrating and unsettling for Committee members, many of them may not have been party to a high-profile lawsuit in any of their business activities. Care should be taken to brief the Committee as to the potential and likelihood of litigation in order to steel them against the prospect and underscore the need for good process. The prospect of litigation also suggests that empanelment of the Special Committee is a good opportunity to review the company's Director's Indemnification and D&O insurance arrangements to make sure that the Committee members will feel adequately protected.

Conclusion

While Special Committee work can be rigorous, it is also one of the most important contributions that a Director can make to a company in the current regulatory and litigation environment. A thoughtful, hardworking and well-prepared Special Committee Chairman is crucial to the Committee's success.

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