

“. . . Skepticism But Not Cynicism”: Chancellor Allen’s Scrutiny of Special Committees

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As Chancellor William T. Allen retires from the Delaware Court of Chancery after 12 productive years as its presiding jurist, I want to pay special tribute to the beneficial influence he exerted on business lawyers like myself.

A word of background. In the decade of the eighties, I was practicing law in the mergers and acquisitions (M&A) area, enmeshed in the takeover activity that marked those frenetic years. I was not a litigator, but (like other business lawyers representing clients) was absorbed by what was happening concurrently in the courthouse—in particular, the one in Wilmington, Delaware. As I noted at the time, M&A practice in the 1980s had the following characteristics which, taken together, created a very unstable lawyering environment:

— The necessity for clients to take actions which had legal consequences in order to accomplish their business and financial goals—actions which placed a heavy premium on the lawyer’s counseling role.

— The knowledge that each step would likely be scrutinized by a court while under assault by an implacable, well-financed, intelligent adversary lawyer, poised to characterize one’s every move in apocalyptic terms as the ultimate depredation.

— The feeling of insecurity rooted in the fact that the “legal” issues tended to be broad ones, the considerations were highly fact-sensitive, and the facts were almost never the same in crucial respects from case to case. It was the edge of the law, with few “bright-lines” existing for appropriate conduct and new judicial

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decisions or regulatory positions being promulgated on a weekly basis.¹

All of this impacted directly on the lawyer's vital predictive function. The ability to tell a client how something is likely to come out—which is a large part of what separates the professional from the layman—furnishes the cornerstone on which considerations of strategy and approach are based. Those of us who counseled the demanding M&A clients of that turbulent decade had to live with the ever-present fear of not going far enough to accomplish our purpose, or conversely, going so far that we would live to regret it in the courthouse.

What we business lawyers needed was guidance, for which the prime source was the courts. Unfortunately, given the constant state of flux during those years, what guidance we received was often as likely to be puzzling as enlightening.

Chancellor Allen, perhaps more than any other jurist of his day, seemed to appreciate this constant quandary in which practicing lawyers found themselves. I like to think that he saw his function as not only to decide the numerous cases that came before him, but also to provide practitioners with explicit guidance as to what factors he considered acceptable and what he found troubling in the situations that recurred frequently during those years.² He spoke not only to the litigants, the litigators, and the law professors, but to those of us on the daily firing line—negotiating the next deal which was almost certain to be judicially reviewed.

This educational function was not an easy task for the Chancellor. After all, he wasn't drafting a statute or regulations, or writing a treatise—he was forced to deal with the cases that came before him, warts and all. He had the clarity of vision to realize that the world we inhabited was rarely black-and-white. More frequently, the situations were fact-specific and untidy, with some factors pointing one way, some another, and still others swathed in ambiguity. His approach was to embark on a painstaking journey through those facts, assessing and weighing each of them in turn. His principal goal, of course, was to arrive at a measured conclusion and thus be able to render an overall judgment on the matter, which subsumed all the facts. But, just as important to us, he also recognized that along the way—by expressing

1. James C. Freund, *Mergers and Acquisitions: The Quintessence of Change*, 36 CLEV. ST. L. REV. 495, 497 (1988).

2. See Stephen E. Jenkins, *The Once and Future Judge?*, THE J. DEL. ST. B. ASS'N, July/Aug. 1997, at 5 (noting Chancellor Allen's substantial influence on Delaware Corporation law).

candid (and often eminently quotable) reactions to the various patterns he encountered—he could educate practitioners who would be shepherding the next flock as to what was warranted and what missed the mark.

I am sure that the Chancellor must have realized that by doing this he eased our lawyering chores. Anyone who has practiced knows that when a lawyer is advising his or her client to do something that the client finds disagreeable (or to refrain from taking some action that the client wants to take), the advice is much more palatable (and the lawyer has a greater chance of convincing the client to so act or refrain) if the lawyer can point to a specific statement on the point by the Chancellor.

To show the reader how this worked in practice, I've chosen to focus on one specific area—the use of special committees of the board of directors in M&A transactions (such as, but not limited to, management- or parent-initiated buyouts). In doing so, I do not mean to imply that the Chancellor was the only jurist involved with special committees; in fact, Vice Chancellors Jacobs,³ Hartnett⁴ and Berger⁵ all dealt with special committee issues, as did the Delaware Supreme Court.⁶ The Chancellor also passed on the use of special committees in other contexts, such as in deciding on whether to institute derivative litigation.⁷ Nor do I intend to suggest any limitation on the Chancellor's judicial scope. He also dealt with the full range of thorny M&A issues passing through the Delaware courts (as well as many issues arising in other corporate⁸ and noncorporate⁹ contexts), such as board

3. See *Citron v. E.I. Dupont de Nemours & Co.*, 584 A.2d 490 (Del. 1990).

4. See *Aprahamian v. HBO*, 531 A.2d 1204 (Del. 1987); *American Gen. Corp. v. Texas Air Corp.*, CIV. A. Nos. 3890, 8406, 8650, 8805, 1987 WL 6337 (Del. Ch. Feb. 5, 1987) (Hartnett, V.C.). Vice-Chancellor Hartnett is now a justice of the Delaware Supreme Court.

5. See *Iseman v. Liquid Air Corp.*, CIV. A. Nos. 9694, 9833, 1989 WL 125234 (Del. Ch. Oct. 23, 1989) (Berger, V.C.); *In re KDI Corp. Shareholders Litig.*, CIV. A. No. 1027, 1988 WL 116448 (Del. Ch. Nov. 1, 1988) (Berger, V.C.).

6. See *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (containing Justice Moore's characterization of MacMillan's efforts to establish an independent auction, free from the CEO's influence, as "torpid if not supine"); *In re RJR Nabisco, Inc. Shareholders Litig.*, 556 A.2d 1070 (Del. 1989) (referring to *Mills Acquisition Co.*, cited *supra*, for a discussion commending efforts of properly functioning special committees).

7. See *Spiegel v. Buntrock*, CIV. A. No. 8936, 1988 WL 124324 (Del. Ch. Nov. 17, 1988) (charging special committee with task of assessing and reporting on corporate accounting demanded by shareholders); *Thorpe v. CERBCO, Inc.*, 611 A.2d 5 (Del. 1991); *Thorpe v. CERBCO, Inc.*, CIV. A. No. 11713, 1995 WL 478954 (Del. Ch. Aug. 9, 1995) (employing special committee to deal with shareholder derivative litigation).

8. See *In re Caremark Int'l, Inc. Derivative Litig.*, CIV. A. No. 13670, 1996 WL 549894 (Del. Ch. Sept. 25, 1996) (approving proposed settlement of shareholder derivative litigation); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. 1988) (protecting the integrity of

determinations that effectively blocked shareholders from tendering shares to an unfriendly acquirer,¹⁰ including the issue of whether and when the board has a fiduciary duty to redeem a "poison pill,"¹¹ and the validity of the grant of lock-up options during the course of an acquisition.¹² It has been suggested, in fact, that of all the commercial law judges this century has witnessed, only Learned Hand produced a body of work which equals that turned out by Chancellor Allen.¹³ But our focus will be narrowed to just the Chancellor and to just this one issue, with the main emphasis on the five key years from 1986 through 1990.

First, here in brief is the backdrop against which this issue played out.¹⁴ An important tenet of Delaware corporation law is the business judgment rule, as a result of which courts will not substitute their judgment for the business judgment of boards of directors, provided that certain standards have been satisfied.¹⁵ When a corporate board confronts a decision on an issue such as selling the company, one such prerequisite is that the directors reviewing the transaction be disinterested.¹⁶ When directors stand on both sides of a deal, they cannot be

shareholder franchise).

9. See *Haft v. Dart Group Corp.*, CIV. A. No. 13736, 1994 WL 705194 (Del. Ch. Dec. 8, 1994) (granting equitable relief of specific performance in contract action); *Boush v. Hodges*, CIV. A. No. 12916, 1996 WL 652762 (Del. Ch. Nov. 6, 1996) (refusing to impose constructive trust on estate of decedent to fulfill contractual obligation).

10. See *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. 1986).

11. See *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787 (Del. 1988); *TW Services, Inc. v. SWT Acquisition Corp.*, CIV. A. Nos. 10427, 10298, 1989 WL 20290 (Del. Ch. March 2, 1989).

12. See *Cinerama, Inc. v. Technicolor, Inc.*, CIV. A. No. 8358, 1991 WL 111134 (Del. Ch. June 24, 1991); *Cottle v. Carr*, CIV. A. No. 9612, 1988 WL 10415 (Del. Ch. Feb. 9, 1988). See also Dennis J. Block et al., *Chancellor Allen, The Business Judgment Rule, and the Shareholders' Right to Decide*, 17 DEL. J. CORP. L. 785, 816 (1992).

13. See *Jenkins*, *supra* note 2, at 5 (comparing Chancellor Allen to Learned Hand).

14. There is a host of literature on this general subject. For four articles emphasizing special committees, see Jesse A. Finkelstein, *Independent Committees in Interested Transactions*, 12-FALL DEL. LAW 18 (1994); A. Gilchrist Sparks, III & Alan J. Stone, *The Important Role of the Special Committee Under Delaware Law*, 680 PLI/CORP 197 (Feb. 22, 1990); Meredith M. Brown & Michael W. Blair, *Representing a Special Committee of Directors in Connection with a Leveraged Buy-Out or Restructuring Transaction*, 636 PLI/CORP 153 (Apr. 6, 1989).

15. See generally Craig W. Palm & Mark A. Kearney, *A Primer on the Basics of Directors' Duties in Delaware: The Rule of the Game (Part I)*, 40 VILL. L. REV. 1297, 1300-04 (1995) (explaining operation and components of Delaware's business judgment rule); Block, *supra* note 12 (detailing the affect of Chancellor Allen's jurisprudence on Delaware's business judgment rule).

16. See Palm & Kearney, *supra* note 15, at 1308-13 (explaining effect of interested director status on directors' decisions); Block, *supra* note 12, at 793-98 (explaining effects of disinterestedness and independence on corporate decisions).

said to be disinterested.¹⁷ If they're not, then they must affirmatively demonstrate the entire fairness of the transaction.¹⁸

That was the situation in the *Weinberger v. UOP, Inc.* case, involving a cash-out merger of a controlled subsidiary in which a majority of the subsidiary's board were designees of the parent.¹⁹ The Delaware Supreme Court considered the majority's failure to share pertinent information they possessed with the subsidiary's outside directors to be a breach of the fiduciary duty they owed to the subsidiary.²⁰ The court noted, however, in a footnote that the result could have been different if the subsidiary had appointed an independent negotiating committee of its outside directors to deal with the parent at arm's length, and suggested that use of such a committee would be considered strong evidence of fairness.²¹

In a subsequent decision, where arm's-length negotiations were conducted through a special committee, the Delaware Supreme Court deemed this to be "of considerable importance" and suggested that "it may give rise to the proposition that the directors' actions are more appropriately measured by business judgment standards."²² If so, this would be quite significant, since as a practical matter, in many cases the presumption afforded by the business judgment rule represents the crucial consideration for the court in deciding whether to validate or overturn the corporate action taken.²³

As a result, special committees came into vogue in the 1980s when conflicts existed, especially in management-led buyouts and where the minority shareholders of a controlled subsidiary were being squeezed out. The crucial question in those years was whether the court was satisfied that the formation and performance of the special committee was such that its actions were entitled to the benefits of the business

17. See *Palm & Kearney*, *supra* note 15, at 1309 (explaining Delaware's definition of interested director).

18. See *Palm & Kearney*, *supra* note 15, at 1349-50 (explaining shifting burden of proof and applicability of entire fairness standard under Delaware business judgment rule).

19. 457 A.2d 701, 704-8 (Del. 1983).

20. *Id.* at 703, 711-12.

21. *Id.* at 709-10 n.7.

22. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937-938 (Del. 1985).

23. Compare *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (upholding board action and explaining that absent self-interest, actions of board conducting corporate auction are protected by business judgment rule), with *MacAndrews & Forbes Holdings Inc. v. Revlon, Inc.*, 501 A.2d 1239 (Del. 1985) (voiding actions taken by directors approving lock-up arrangement, explaining that board's actions were not protected by business judgment rule). See also *AC Acquisitions Corp.*, 519 A.2d at 111 ("[The] effect of the proper invocation of the business judgment rule is so powerful [that it] . . . frequently is determinative of the outcome of derivative litigation").

judgment rule.²⁴ (Subsequent to this period, as we shall see, the Delaware Supreme Court ruled that the special committee's sole effect would be to shift the burden of proof on fairness from the defendant to the plaintiff.²⁵) And this is where Chancellor Allen and the Delaware Chancery Court came into the picture—to scrutinize particular transactions and lay down guidelines for practitioners.

At the outset, the Chancellor appeared to approach the subject a bit gingerly. In a case involving MGM Grand Hotels²⁶ in 1986, where no special committee participated in the key decision of how to apportion consideration received in the merger between the majority and minority stockholders, the Chancellor drily remarked that while having such a committee might typically constitute one of the "indicia of fairness," its absence "does not itself establish any breach of duty," and what's more "does not itself affect my assessment of [the] plaintiff's probability of success."²⁷

Then, in a case decided the next year²⁸ involving the combination of two companies controlled by the same individual, the Chancellor seemed impressed to find that there was a negotiating committee composed of two outside directors whose terms in office predated the controlling shareholder's appearance, who were experienced in evaluating mergers, and who were advised by independent experts.²⁹ He saw no basis to suspect that those directors were not negotiating "in a fully independent and duly aggressive way,"³⁰ and observed that "the apparent independence of the negotiating committee goes a long way in weakening"³¹ the plaintiff's claims about the fairness of the procedure employed. In the years to come, as we will see, the Chancellor would prove to be a lot less deferential to appearances.

Later in 1987, the Chancellor upheld the action of a special committee—"appropriately constituted, well advised and active" in attempting to maximize public shareholder values—in rejecting one

24. See generally Sparks and Stone, *supra* note 14 (explaining proper structure and functioning of effective special committees).

25. For a discussion of the Delaware Supreme Court's treatment of special committees, see notes 92-3 *infra* and accompanying text.

26. *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584 (Del. 1986).

27. *Id.* at 599-600.

28. *In re Maxxam Group, Inc. Stockholders Litig.*, CIV. A. No. 8636, 1987 WL 10016 (Del. Ch. Apr. 16, 1987).

29. *Id.* at *3.

30. *Id.* at *8.

31. *Id.* at *9.

suitor's proposal.³² The committee had emphasized risks it saw with that proposal.³³ Chancellor Allen conceded that he had "no special expertise in making the judgment concerning whether it would be wise or foolish to incur the risks" that pursuit of the proposal entailed; to the contrary, the Chancellor noted,

one of the important reasons for the existence of the business judgment rule is the institutional incompetence of courts to pass upon the wisdom of business decisions.³⁴

In 1988, however, Chancellor Allen hit his stride with four major decisions involving special committees—*J.P. Stevens*,³⁵ *Fort Howard*,³⁶ *Amsted*³⁷ and *TWA*.³⁸ It should be noted that three of these cases (*J.P. Stevens*, *Fort Howard* and *TWA*) were decisions on motions to preliminarily enjoin the transaction, where one requisite of granting the motion is that the court has concluded that the plaintiff has established a reasonable probability of ultimate success on the claims asserted.³⁹ In each such case, the Chancellor was limited to perusing the discovery evidence before him (as contrasted with the evidence and testimony that would be available at a full trial).⁴⁰ As a result, the typical (and, to a corporate lawyer's ears, somewhat convoluted) formulation of his opinion on these issues was that the plaintiffs' claim is not "sufficiently supported by the evidence at this time to permit the conclusion that it is reasonably likely that at trial it would be found" that the claim had been proven.⁴¹ Those of us in the trenches were fully aware that in these M&A cases the granting or denial of a preliminary injunction was, as they say, the whole ball game—even though the Chancellor was generally forced (to mix the metaphor) to deal with less than a full deck.

32. *Freedman v. Restaurant Assocs.*, CIV. A. No. 9212, 1987 WL 14323, at *7 (Del. Ch. Oct. 16, 1987).

33. *Id.*

34. *Id.* at *8.

35. *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770 (Del. 1988).

36. *In re Fort Howard Corp. Shareholders Litig.*, CIV. A. No. 9991, 1988 WL 83147 (Del. Ch. Aug. 8, 1988).

37. *In re Amsted Indus. Litig.*, CIV. A. No. 8224, 1988 WL 92736 (Del. Ch. Aug. 24, 1988) (Allen, C.).

38. *In re Trans World Airlines Shareholders Litig.*, CIV. A. No. 9844, 1988 WL 111271 (Del. Ch. Oct. 21, 1988).

39. *See In re J.P. Stevens*, 542 A.2d at 778.

40. *See Freedman v. Restaurant Associates Indus. Inc.*, CIV. A. No. 9212, 1987 WL 14323 (Del. Ch. Oct. 16, 1987) (noting limited factual record available to Chancellor at preliminary injunction proceedings).

41. *In re J.P. Stevens*, 542 A.2d at 779.

In *J.P. Stevens*, the Chancellor's eye became a little more jaundiced, although he still ended up at the same ultimate point. My clue to his transformation was his use of a delicious phrase referring to the plaintiffs' scorn for a special committee "that vibrates sympathetically to management's desires."⁴² Here the plaintiffs' allegation was that the special committee had consistently acted to protect the interests of the company's management by pushing the transaction in the direction of the bidder that management wanted to see win the competition, by granting that bidder various contractual rights claimed to be preferential, and by ultimately making a deal with the favored bidder at a price lower than what was available elsewhere.⁴³

"Well," said the Chancellor as he appraised the allegations, "maybe that is true; it surely is plausible."⁴⁴ He then proceeded to list several actions of the committee that he considered suspicious—an unseemly haste in signing the merger agreement, the grant of a break-up fee (which arguably wasn't required), and the influence on the committee of a possibly hollow threat.⁴⁵ But when all was said and done, Chancellor Allen deemed the *evidence* of bad faith presented to him as insufficient to support the plaintiffs' plausible story.⁴⁶ "After all," he said,

the fact that the Special Committee meets all of the formal or structural characteristics of a board that is properly functioning—it is comprised of persons without a financial conflict of interest, it is well advised and appears diligent in carrying out its mission—means that something more than the suspicions upon which [the plaintiffs'] plausible account is based is necessary to conclude that bad faith is likely to be found here.⁴⁷

Those of us on the firing line were not about to overlook the significance of the Chancellor's suspicions, however. We heard what he was telling us: slow down when haste might imply favoritism; go easy on break-up fees when the leverage to demand them is not there; do not make flagrant threats to withdraw an offer that is not accepted immediately.

Now the Chancellor had the bit in his teeth, probing much more deeply into the makeup and activities of the special committees and

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* at 779-80

46. *Id.* at 780.

47. *Id.*

commenting pointedly on what he saw along the way. In two subsequent 1988 decisions (even though the Chancellor ultimately upheld the appropriateness of the special committee action), his words—to reverse the age-old axiom—spoke louder than his actions.

The first of these two decisions was the *Fort Howard* case, which involved a management-affiliated leveraged buyout of public shareholders.⁴⁸ In passing on the bona fides of the special committee that acted for the board in negotiating and approving the deal, Chancellor Allen noted that direct evidence of bad faith is rarely available.⁴⁹ Accordingly, one has to look to the inferences drawn from decisions made or actions taken by the committee.⁵⁰ This, he said, “requires the court . . . to be suspicious, to exercise such powers as it may possess to look imaginatively beneath the surface of events, which, in most instances, will itself be well-crafted and unobjectionable.”⁵¹

This was the eye-opener for me—the Chancellor letting us know that he felt the need to be suspicious. At this point, I began in earnest to let my clients know what lay in store for them in court. Especially, when the Chancellor, looking at the facts of the case before him, observed darkly that here were “aspects that supply a suspicious mind with fuel to feed its flame.”⁵² That became my favorite metaphor in counseling clients: “don’t do it,” I would say; “this only adds more fuel to feed the flame.”

As “fuel” in that case, the Chancellor cited the fact that the CEO of Fort Howard, who was leading the leveraged buyout, chose an old school friend as chairman of the committee and then selected the other members in conjunction with that friend.⁵³ Remarked the Chancellor: “It cannot . . . be the best practice to have the interested CEO in effect handpick the members of the Special Committee.”⁵⁴ The CEO also chose special counsel for the committee, which elicited this judicial reaction that we all took very much to heart:

It is obvious that no role is more critical with respect to protection of shareholder interests in these matters than that of the expert lawyers who guide sometimes inexperienced directors through the process. A suspicious mind is made uneasy contemplating the

48. *In re Fort Howard*, 1988 WL 83147, at *2.

49. *Id.* at *8.

50. *Id.*

51. *Id.* at *12.

52. *Id.*

53. *Id.*

54. *Id.*

possibilities when the interested CEO is so active in choosing his adversary.⁵⁵

He was also bothered by a failure of the Special Committee to make prompt public disclosure of the proposal received from management—disclosure which management opposed since it might have led to a bidding war—on the basis that this “implies a bias . . . that is a source of concern to a suspicious mind.”⁵⁶

In the end, the Chancellor nevertheless upheld the transaction, because he believed that the special committee had effectively probed the market for alternative transactions, had not hobbled that market check with lock-ups and fees, and had responded quickly to the inquiries it received and provided full information promptly.⁵⁷ But what stuck in my mind was “a suspicious mind . . . made uneasy” contemplating nefarious possibilities, as well as the inference drawn through nondisclosure of “a bias . . . that is a source of concern to a suspicious mind.”⁵⁸ In a speech I gave to lawyers on the subject a short time later,⁵⁹ the consistent theme of my advice was not to supply fuel to feed the flame of the Chancellor’s suspicions.

Next came the *Amsted*⁶⁰ case, which gave the Chancellor even more trouble, although he ultimately approved the settlement of class action lawsuits arising out of the transaction.⁶¹ Here, after a takeover threat surfaced, the Board formed an ESOP; and the board’s independent special committee then proceeded to negotiate a deal with the ESOP (including an increase in price over what the ESOP originally offered).⁶² The Chancellor was bothered by the procedure used in selling the company, which “affords less confidence than one is entitled to expect that the available alternatives were fully developed.”⁶³ Here, the special committee had been specifically directed not to engage in a search for alternative transactions, and instead, right off the bat, they “chose to rely solely upon the theoretical advice of the investment banker” as to fairness.⁶⁴ The Chancellor considered this

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. Freund, *The Special Committee as an Integral Part of the Corporate Decision Making Process*, Address at the Practising Law Institute 21st Annual Institute on Securities Regulation New York, N.Y. (Nov. 4, 1989).

60. *In re Amsted*, 1988 WL 92736.

61. *Id.* at *16.

62. *Id.* at *2-5.

63. *Id.* at *1.

64. *Id.* at *7.

“a pale substitute” for a canvas of the relevant market,⁶⁵ and then asked this pointed question:

[W]hy did the independent committee of the board—if it was motivated in good faith to achieve the best transaction for the shareholders—not check that opinion by shopping the Company, or at least negotiating for a period in which it could publicly encourage any interested party to come forward?⁶⁶

Needless to say, the issue he thus raised—how much was enough in order to fulfill the committee’s fiduciary obligation—became the subject of much discussion in boardrooms and lawyers’ offices during subsequent transactions.

Case by case, one could observe the suspicions and adverse inferences building upon the Chancellor. Later in 1988, it all finally exploded in the TWA⁶⁷ case. This was a proposed buyout by the majority shareholder of the public’s minority interest in the company.⁶⁸ The members of the special committee had relied on their investment banker’s efforts to prod the majority holder to raise his bid to a point where the banker could render a favorable fairness opinion.⁶⁹ In the Chancellor’s view, however, minority shareholders have no obligation to accept a price simply because it falls within some range of fair prices.⁷⁰ The TWA special committee, said the Chancellor,

[d]id not seem to understand that their duty was to strive to negotiate the highest or best available transaction for the shareholders whom they undertook to represent.⁷¹

Accordingly, the Chancellor concluded that:

[T]he special committee did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm’s-length adversary [T]he burden-shifting effect will not occur where the special committee did not adequately understand its function—to aggressively seek to promote and protect minority interests—or was not adequately

65. *Id.*

66. *Id.*

67. *In re Trans World Airlines*, CIV. A. No. 9844, 1988 WL 111271, at *7 (Del. Ch. Oct. 21, 1988).

68. *Id.* at *1.

69. *Id.*

70. *Id.* at *5.

71. *Id.* at *4.

informed about the fair value of the firm and the minority shares in it.⁷²

I can remember vividly when the TWA decision came down. At the time, I was representing the special committee of a subsidiary, where the parent was intent on merging out the subsidiary's public shareholders. As with most such situations, the parent was not looking for an attitude of aggressiveness on the subsidiary's part. But the TWA opinion really strengthened the backbone of this—and every other—special committee. If a director had any doubt as to how forcefully he should be in fulfilling his responsibilities, all the committee's legal advisor had to do (and which I certainly did) was to read them the Chancellor's words. As a practical matter, given this opinion, it is hard to conceive of a situation—short of a truly preemptive offer—where the special committee's lawyer would feel comfortable advising the committee to accept management's initial proposal without attempting to negotiate for a higher price.⁷³

The Chancellor's outrage did not last too long however, and in the big case of the next year (1989)—in the course of passing on one of the most highly publicized M&A transactions of our time—he decided that RJR Nabisco's special committee deserved high marks.⁷⁴ This was in the face of allegations of bias and lack of care, and notwithstanding the committee's ultimate decision to accept what appeared to be the lower of two substantially equivalent bids and to close out the bidding without another round, much to the chagrin of the losing bidder (which, in a twist on the usual scenario, was the management-led group).⁷⁵

RJR Nabisco's committee was formed without input from management, and made prompt public disclosures, initiated an auction after receiving management's bid, and was actively involved in the negotiation process, meeting with all bidders.⁷⁶ The court found that it was reasonable for the committee to rely on the advice of its two financial advisors that the bids were essentially equivalent from a

72. *Id.* at *7.

73. Just in case anyone missed Chancellor Allen's point in TWA, he reiterated it the next year—once more finding that a special committee which did no more than pass upon the fairness of the price possessed too narrow a view of its role to take an otherwise interested transaction out of the class of cases governed by the entire fairness standard. *In re Republic American Corp. Litig.*, CIV. A. No. 10112, 1989 WL 31551 (Del. Ch. April 4, 1989) (Allen, C.).

74. *In re RJR Nabisco, Inc. Shareholders Litig.*, CIV. A. No. 10389, 1989 WL 7036, at *22 (Del. Ch. Jan. 31, 1989) (Allen, C.).

75. *Id.* at *15.

76. *Id.* at *1.

financial point of view.⁷⁷ There was no neglect of duty, "given the amount of attention the directors lavished upon this important transaction and the responsible steps they took to be competently advised concerning alternatives open to them."⁷⁸

The Chancellor's fullest exposition on the subject came the next year in the *First Boston*⁷⁹ case. This was a going private transaction where the public shareholders of the investment banking firm being merged with its parent were represented by a special committee of independent directors.⁸⁰ As in many cases of this type, the committee was unable to shop the buyout group's proposal with any likely effect, given the interrelated ownership.⁸¹ Moreover, it was forced to rely on management for information about the business and for the judgment that failure to complete a transaction would be harmful to the company.⁸²

The Chancellor recognized that, as a result, the special committee could see its options as limited.⁸³ But, he said, the special committee "retained . . . the critical power: the power to say no."⁸⁴ That power, and the responsibility it implies, is what gives utility to the special committee device in such transactions.⁸⁵ He then elaborated on the theme, touching on the interrelated issues of fairness and "best available transaction" in such lucid terms that this portion of his opinion should be read in its entirety:

The power to say no is a significant power. It is the duty of directors serving on such a committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price. Nor is it sufficient to get a price that falls within a range of "fair values" somehow defined, if the fiduciary (or another) would pay more. The fiduciary's best price may not be fair and a

77. *Id.* at *16.

78. *Id.* at *18. The Chancellor reached a similar conclusion regarding a special committee the next year in *Roberts v. General Instrument Corp.*, CIV. A. No. 11639, 1990 WL 118356 (Del. Ch. Aug. 13, 1990) (Allen, C.), which was significant because it validated a post-agreement market check procedure, building on the *Fort Howard* opinion.

79. *In re First Boston Inc. Shareholders Litig.*, CIV. A. No. 10338, 1990 WL 78836 (Del. Ch. June 7, 1990) (Allen, C.).

80. *Id.* at *1.

81. *Id.* at *2.

82. *Id.* at *4.

83. *Id.*

84. *Id.* at *7.

85. *Id.*

fiduciaries' [sic] position may preclude the emerge of alternative transactions at a higher price. The only leverage that a special committee may have where a fiduciary's position precludes alternatives (such as here or where a controlling shareholder owns a majority of voting power) is the power to say no and, thus, to force the fiduciary to choose among the options of implementing a frank self-dealing transaction at a price that knowledgeable directors have disapproved, to improve the terms of a transaction or abandon the transaction.⁸⁶

It is, he continued, only when independent directors understand their mission "to say no unless they conclude that they have achieved a fair transaction that is the best transaction available," and only "where they pursue that goal independently, in good faith and diligently," that their decision "deserves the respect accorded by the business judgment rule."⁸⁷ And as a final note—just in case we didn't get it—he reminded us that appearances are not conclusive.⁸⁸

The power to say no. The Chancellor had taken this sometimes complex area and boiled it down to its essence, while sending a forceful message to those serving on or advising special committees of directors charged with protecting the best interests of public shareholders. It was the last link in the chain of significant guidance that he furnished the bar in his numerous opinions on the subject. He shaped our views as to the composition, advice, and function of the special committee. And this, notwithstanding the fact that in the majority of cases, the Chancellor ended up either denying the plaintiffs' motions for a temporary injunction or otherwise validating the transactions.⁸⁹

As influential as Chancellor Allen was, however, his views were not always upheld by the Delaware Supreme Court, in this area as well as others.⁹⁰ In the years subsequent to those we have examined, the supreme court rejected the Chancellor's view that even where there was a controlling shareholder, the case could be afforded a business judgment type of judicial review through proper use of an independent

86. *Id.*

87. *Id.* at *8.

88. *Id.*

89. See Karen Donovan, *End of an Era Nears for Delaware Courts*, NAT'L L.J., Dec. 23, 1996, at A1 (chronicling Chancellor Allen's key opinions).

90. See *Kahn v. Tremont, Corp.*, CIV. A. No. 12339, 1996 WL 145452 (Del. Ch. Mar. 21, revised Mar. 27, 1996) (Allen, C.), *rev'd*, 694 A.2d 422 (Del. 1997) (reversing Chancellor Allen in special committee case); *Cede & Co. v. Technicolor, Inc.*, CIV. A. Nos. 7129, 8358, 1987 WL 4768 (Del. Ch. Jan. 13, revised Jan. 20, 1987) (Allen, C.), *rev'd*, 542 A.2d 1182 (Del. 1988) (reversing Chancellor Allen).

effective special committee.⁹¹ The substantive legal standard in these cases, according to the supreme court, remains one of fairness; and a well-functioning special committee of disinterested directors will only have the effect of shifting the burden of proof on fairness from the defendant to the plaintiff.⁹²

Then, in 1997 the Delaware Supreme Court pointedly disagreed with the Chancellor as to whether the burden of proof should shift under the facts of the particular case.⁹³ This may be where the Chancellor's willingness to concede that he was bothered by certain facts (although ultimately supporting the committee's action) finally got him in trouble.⁹⁴ He expressed his concern over the fact that the independent director most closely connected to management was the one who took a leading role in the committee's deliberations.⁹⁵ He was openly troubled about the selection of professional advisors—lawyers recommended by company counsel and a financial advisor which had done prior business with entities related to the controlling shareholder.⁹⁶ Nonetheless, because the process appeared “informed, active and loyal to the interests” of the company, he overrode his reservations and shifted the burden of proving fairness to the plaintiff.⁹⁷ The Supreme Court, referring at length to the very reservations expressed by the Chancellor, concluded that his ultimate determination was not supported by the record.⁹⁸ Speaking personally, I wouldn't have needed the formality of the Supreme Court reversal to steer clear of those troublesome fact patterns in future advisory situations—the Chancellor's having singled them out as matters of concern had always been enough for me.

91. Kahn v. Tremont Corp., CIV. A. No. 12339, 1996 WL 145452 (Del. Ch. March 21, revised March 27, 1996) (Allen, C.), *rev'd*, 694 A.2d 422 (Del. 1997).

92. Kahn v. Lynch Communication Sys., 638 A.2d 1110 (Del. 1994).

93. Kahn v. Tremont Corp., 694 A.2d at 428.

94. *Id.*; Kahn v. Tremont Corp., CIV. A. No. 12339, 1996 WL 145452 (Del. Ch. March 21, revised March 27, 1996) (Allen, C.) (explaining Chancellor Allen's reservations regarding effectiveness of Tremont's special committee).

95. Kahn v. Tremont Corp., 1996 WL 145452, at *8.

96. *Id.*

97. *Id.* at *8.

98. Two of the five judges dissented in a brief opinion by Justice Berger. “The majority's thorough and well reasoned decision reverses the trial court's equally thorough and well reasoned decision.” The issue here, Justice Berger noted, wasn't legal analysis but evaluation of certain facts. The trial court recognized the issues “and was satisfied, after six days of trial, that the Special Committee members were ‘informed, active and loyal to the interests of Tremont.’ That finding is supported by the record and should be accorded deference.” *Tremont Corp.*, 694 A.2d at 434 (Berger, J., dissenting).

In January 1990, Chancellor Allen gave an address on this subject to practicing lawyers, which provides some interesting insights into his thinking.⁹⁹ First, he posed what he considered the crucial question in deciding whether courts should afford respect to the special committees: can outside directors be expected to exercise independent judgment on matters (such as a management-affiliated leveraged buyout) in which the corporation's CEO has a conflicting interest?¹⁰⁰ There is, he said, a dichotomy of views on this.¹⁰¹ One school of thought is that directors are largely ornamental, rubber-stamping management to mollify outside stockholders.¹⁰² At the other extreme, however, is the emphasis in the recent development of corporate law on bringing more outside directors onto boards and the creation of significant outside director committees (such as those overseeing audits, compensation, and nomination of directors).¹⁰³

Although the Chancellor recognized that cases like *TWA* might support the cynical view of director conduct, he flatly disagreed.¹⁰⁴ "I remain unconvinced," he said.¹⁰⁵ "I confess to skepticism but not cynicism."¹⁰⁶ Citing cases such as *RJR Nabisco*, he concluded that it is possible for outside directors to function independently (while noting that not every decision by a special committee deserves such respect) and characterized the distinction as follows:

The factor that distinguishes those circumstances in which the decision of a committee of outside directors has been accorded respect and those in which its decision has not, is not mysterious. The court's own implicit evaluation of the integrity of the special committee's process marks that process as deserving respect or condemns it to be ignored. When a special committee's process is perceived as reflecting a good faith, informed attempt to approximate aggressive, arm's-length bargaining, it will be accorded substantial importance by the court. When, on the other hand, it appears as artifice, ruse or charade, or when the board unduly limits the committee or when the committee fails to correctly perceive its

99. William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 *BUS. LAW* 2055 (1990). Chancellor Allen delivered this address at the University of California San Diego's 17th Annual Securities Regulation seminar. It was reprinted in a slightly revised form.

100. *Id.* at 2055-56 (questioning whether "special committees of outside directors . . . can or do function adequately to protect appropriate interests" when the corporation is being sold).

101. *Id.* at 2056.

102. *Id.*

103. *Id.*

104. *Id.* at 2056-59.

105. *Id.* at 2059.

106. *Id.*

mission—then one can expect that its decision will be accorded no respect.¹⁰⁷

The Chancellor well understood the pressures on directors and could see that some committees appear “as no more than, in T.S. Eliot’s phrase, ‘an easy tool, deferential, glad to be of use.’”¹⁰⁸ But the factor that stands against the pressures toward accommodation with the CEO is a sense of duty on the part of directors—a realization that they “stand in a new and different relationship to the firm’s management or its controlling shareholder.”¹⁰⁹ When a special committee performs its assignment badly, “it is probably because its members have been ill-served by their advisors and, as a result, have failed to understand or to accept the radical change in that relationship that had occurred.”¹¹⁰

This led the Chancellor to comment on one of his favorite subjects—the lawyers on whom the often inexperienced committee members rely—and to the crucial role counsel must play in establishing the trustworthiness of the process.¹¹¹

[I]n my opinion, if the special committee process is to have integrity, it falls in the first instance to the lawyers to unwrap the bindings that have joined the directors into a single board; to install in the committee a clear understanding of the radically altered state in which it finds itself and to lead the committee to a full understanding of its new duty.¹¹²

This means that lawyers have “to implement the substance of an arm’s-length process.”¹¹³ Their client is the committee, so they must be independent of management, holding the CEO and his associates at arm’s-length—a posture which, he recognized, may mean that the lawyers have to be prepared to forego future business.¹¹⁴ If the process is to “offer to shareholders protections that are consistent with justice, it will in large measure be because lawyers have been true to their professional responsibilities and have used their talent and power to see that outside directors understand and strive to satisfy their

107. *Id.* at 2060.

108. *Id.* at 2061 (quoting T.S. Eliot, *The Love Song of J. Alfred Prufrock*, in COLLECTED POEMS 1909-1962 (Harcourt, Brace & World 1970)).

109. *Id.*

110. *Id.*

111. *Id.* at 2061-62.

112. *Id.*

113. *Id.* at 2062.

114. *Id.*

duty.”¹¹⁵ This is a “special role” we lawyers have to play, said the Chancellor, reminding us finally that we were “not engaged in a strictly commercial enterprise” but rather “have accepted an obligation . . . to . . . the pursuit of systematic justice.”¹¹⁶

I never appeared before Chancellor Allen (although a number of my partners did), but all through those years—and especially when I was representing a special committee—I could hear him talking to me and my colleagues. Amid the legalistic parlance addressing the procedural niceties of chancery court, what the Chancellor really wanted us to absorb came through to the practitioners, loud and clear—and occasionally in colorful terms and memorable metaphors. *Suspicious minds made uneasy; fuel to feed flames; committees vibrating sympathetically; pale substitutes; directors who don't understand their duty; the power to say 'no'*. We may not always have agreed with him, but is it any wonder we listened so closely?¹¹⁷

The able lawyers who practiced in the M&A area during those turbulent times implicitly understood the special role they occupied, as they looked to the Chancellor for leadership. The guidance he furnished, in this and numerous other areas, has done much to raise standards of acceptable conduct to new and improved heights—all of which should stand as a monument to the intelligence, depth, and integrity of Chancellor Allen.

115. *Id.* at 2063.

116. *Id.*

117. As an example of one of the Chancellor's observations with which I did not agree, he was bothered in the *Fort Howard* case, discussed *supra*, by a meeting of the investment bankers for the two sides which took place at a point before the banker for the special committee had arrived at a preliminary view on fair value. I expressed the view at the time (in the speech cited *supra* at note 60) that, as a practical matter, it was often important for the investment advisors to have a preliminary exchange of views on valuation, as well as to make sure they were relying on the same financial information and relevant factors. Moreover, having personally witnessed the kind of blatant posturing that goes on between investment bankers at such affairs, I didn't see how any whiff of bias could be inferred from the mere fact that they had held a meeting.