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The Illusion of Fairness Through Special Committees in Management Buyouts*

Shelby D. Green**

I. INTRODUCTION

Special committees of corporate directors are in vogue as the instruments to ensure fairness in management buyouts of their companies. Committees of directors, of course, are not new to corporate boards and most large publicly-held corporations maintain standing committees to handle a wide range of routine matters. Similarly, ad hoc or special committees have long-existed to address discrete, non-recurring questions. But the use of special committees on management buyout proposals as a response to questions of conflict of interest is excessive.

Consider the recent case of *Mills Acquisition Co. v. Macmillan, Inc.*¹ There, several members of the management of Macmillan proposed a leveraged buyout of the company; a deal bringing shareholders billions of dollars, but also bringing their elimination from the Macmillan enterprise.² To convince shareholders that this would be a fair deal, the board set up a special committee of directors.³ As a 'safeguard' (the end of which should be obvious) the chairman of the board handpicked the members.⁴ The chairman further offered the committee the able assistance and insight of the retained investment advisors that had crafted the management buyout proposal.⁵

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1. 559 A.2d 1261 (Del. 1989).

2. *Id.* at 1265-66. In a leveraged buyout, the purchaser acquires the company's outstanding stock from the shareholders. An investment banker arranges the transaction and the financing for the purchase. Management stays in control of the company and eventually repays the debt to the investors. The corporation's assets are normally used as collateral for the funds for the acquisition. See *Fradkin v. Ernst*, 571 F. Supp. 829, 833 (D. Ohio 1976). In *Macmillan*, certain members of management joined with the investment banking firm of Kohlberg, Kravis & Roberts in the buyout. *Macmillan*, 559 A.2d at 1264.

3. *Macmillan*, 559 A.2d at 1267.

4. *Id.* at 1267.

5. *Id.* at 1268.

For a while it seemed as though the chairman's strategy would work as the committee repeatedly rejected the bids of another suitor for the company.⁶ Even when the other suitor bid \$80 per share, all cash, and the management team bid \$64.15 (\$52.35 in cash with the balance in subordinated securities), the special committee was able to convince itself that the management bid was higher.⁷

In the shareholder suit that followed the special committee's decision was condemned.⁸ It must be clear that a committee so composed is unlikely to reach a decision that is fair to shareholders. However, it seems the issue is larger than the corruption of one committee. This case exposes the inherent deficiencies of the 'special committee' device as a treatment for conflict of interest problems.

This essay will explore these deficiencies and argue for real, and not illusory, safeguards against directors' self-dealing in management buyouts. Part II provides an overview of corporation law regarding the decisionmaking authority of the board. Part III discusses self-dealing transactions as exceptions to the normal judicial deference accorded board decisions. Part IV discusses the flaws in the use of the special committee to address conflict of interest problems. Part V provides an analysis of the case introducing this essay and Part VI offers conclusions and suggestions for reform.

II. THE PREROGATIVES OF MANAGEMENT

In considering the role played by special committees in management leveraged buyouts, some basic principles of corporate decisionmaking should be stated. The relevant Delaware statute expresses the concept well: "The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . ."⁹ In exercising this discretion directors must use reason and act as ordinarily prudent persons under similar circumstances, or be liable in damages to the corporation.¹⁰ It is not enough, though, that directors act without

6. *Id.* at 1270-71.

7. *Id.* at 1271.

8. *Id.* at 1278.

9. DEL. CODE ANN. tit. 8, § 141(a) (1988). The corporation statutes of other states contain similar wording. See REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1984): "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation." See also N.Y. BUS. CORP. LAW § 701 (McKinney 1989): "[T]he business of a corporation shall be managed under the direction of its board of directors . . ."

10. REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984) provides:

(a) A director shall discharge his duties as director, including his duties as a member of a committee:

(1) in good faith;

negligence as the discretion and duty to manage demands the good faith and honesty of directors. As Judge Cardozo once stated, "[n]ot honesty alone, but the punctilio of an honor the most sensitive is . . . the standard of behavior" required of corporate fiduciaries.¹¹ While these two fiduciary duties set the contours for management, the law nonetheless gives directors a large measure of discretion in decisionmaking.

This position finds its true expression in the "business judgment rule":

[A] court will not interfere with the judgment of the board of directors unless there is a showing of gross and palpable overreaching. A board of directors enjoys a presumption of sound business judgment and its decisions will not be disturbed if they can be attributed to any rational purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.¹²

The rule constitutes a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.¹³

The policies underlying the business judgment rule were well-stated in *Auerbach v. Bennett*:¹⁴

[T]he business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments. The authority and responsibilities vested in corporate directors both by statute and decisional law proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise.¹⁵

Since directors cannot be expected to make competent and dynamic decisions if confronted each time with the certainty of hindsight, the rule promotes efficiency in corporate decisionmaking.¹⁶

Given the broad grant of authority to manage and the great deference to the directors' considered business judgment, it follows that the board has the power to delegate specific authority to a committee of di-

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

11. *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928).

12. *Sinclair Oil v. Levien*, 280 A.2d 717, 720 (Del. 1971) (citation omitted). However, there is no protection for directors who have made an "unintelligent or unadvised judgment." *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

13. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

14. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

15. *Id.* at 625, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.

16. See Johnson & Osborne, *The Role of the Business Judgment Rule in a Litigation Society*, 15 VAL. U.L. REV. 49, 54 (1980).

rectors¹⁷ and that the business judgment rule should protect a decision of that committee.¹⁸

III. SELF-DEALING TRANSACTIONS

The business judgment rule indeed affords directors wide latitude in the operation of the enterprise, but it has only limited application in self-dealing transactions. At early common law transactions between corporate fiduciaries and the corporation were treated not with deference (as would be the case if the business judgment rule were applicable) but by great court scrutiny (as with the law of trusts).¹⁹

Under the trust analogy managers who proposed self-dealing contracts had dual interests — their own and their interests as fiduciaries of the corporation. Since both could not be served in the same decision it was idle to demand sublimation of this conflict. The common law thus demanded avoidance of these conflicts.²⁰

Since self-dealing transactions, the clearest example of a conflict between duty and self-interest, threaten the corporation,²¹ the rule of law

17. See DEL. CODE ANN. tit. 8, § 141(c) (1988):

The board . . . may, by resolution passed by a majority of the whole board, designate 1 or more committees . . . Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation

18. The decision by the board to delegate decisionmaking to a committee or to an outsider is unquestionably a matter of business judgment. See *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

19. See *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939). The court explained:

While technically not trustees, [corporate officers and directors] stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director . . . the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest If an officer or director of a corporation, in violation of his duty . . . acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election [This rule is] inveterate and uncompromising in its rigidity

See also *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 887 (6th Cir. 1986).

20. *Id.* See S. LORNE, *ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS*, § 1A.02[2][a] (1989).

21. See Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 759-60 (1978). The author states:

In a fiduciary relationship, the client or beneficiary depends on the fiduciary to an unusual degree to determine for the client what his best interests are. Given this disparity of experience, it would be extremely difficult and costly for the client to draft a detailed contract defining the duties of fiduciary.

Fiduciary duties economize on transaction costs by simply obliging the fiduciary to act in the best interests of his client or beneficiary and to refrain from self-interested behavior not specifically allowed by the employment contract. They codify the reasonable expecta-

that developed was that these transactions were disqualified not only from the protection of the business judgment rule, but also were voidable at the instance of the corporation or shareholders, without regard to the fairness or unfairness of the transaction or the disinterestedness of the directors who approved it.²² As one early case explains:

It is among the rudiments of the law that the same person cannot act for himself and at the same time, with respect to the same matter, as agent for another, whose interests are conflicting . . . The two positions impose different obligations, and their union would at once raise a conflict between interest and duty; and 'constituted as humanity is, in the majority of cases, duty would be overborne in the struggle'. . . .²³

Modern corporation statutes reflect a recognition of a need to fashion different rules for this kind of fiduciary relationship and generally permit such transactions. Statutes provide that self-dealing transactions are not void or voidable solely because of the conflict of interest if the transaction is: 1) disclosed and approved by a disinterested board; 2) disclosed and approved by the shareholders; or 3) is found to be fair to the corporation.²⁴ Despite their apparent breadth, conflict of interest stat-

tions of the client, by obliging the fiduciary to do what the client would tell him to do if the client had the same expertise as the fiduciary.

Id.

Ballantine points out that the early cases held, "[i]n fiduciary relationships, . . . the one upon whom the principal relies for representation and protection is not permitted to bargain with him at arm's length or to set up immunity for sharp practices under a claim of the bargaining privilege of *caveat emptor*." H. BALLANTINE, *BALLANTINE ON CORPORATIONS* 167 (1946).

22. Marsh, *Are Directors Trustees? — Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-43 (1966); see also Note, "Interested Director's" Contracts - Section 713 of the New York Business Corporation Law and the "Fairness" Test, 41 FORDHAM L. REV. 639, 640-41 (1973).

23. *Wardell v. Union Pac. R.R.*, 103 U.S. 651, 658 (1880). Therefore, in *Wardell*, the court held that it was improper for directors to make arrangements to secure an advantage for themselves by the formation of a new company as an auxiliary to the original one, with an understanding that they or some of them would take stock in it, and then that valuable contracts would be given to it.

Id.

This rigid prohibition against self-dealing seemed to have unquestionable validity in the trust relationship where conservatism in the application of the trust *res* is the controlling principle and trustee powers are in large measure derived from and limited by the trust instrument.

Corporate fiduciary relationships, however, seemed to require a more flexible approach. It was Ballantine's theory that while directors are fiduciaries, they possess great, even original, power. H. BALLANTINE, *supra* note 21, at 4-5, 133, 167-68; see also *People ex rel. Manice v. Powell*, 201 N.Y. 194, 200-01, 94 N.E. 634 (1911); *Hoyt v. Thompson's Executors*, 19 N.Y. 207, 216 (1859).

It has been argued that because the nature of the entity requires a certain dynamism in the application of corporate resources, the rules governing trustees (guardians, executors or administrators, agents, partners, promoters) and directors should not necessarily coincide. *Id.* Ballantine states further that although a high standard of loyalty must be demanded of directors, it might not be wise policy to restrict them to the same extent as trustees and agents. *Id.* Indeed, some have argued that self-dealing may be more beneficial than "comparable other-dealing, or market, transactions." R. CLARK, *CORPORATE LAW* 164 (1986). Others have suggested that conflicts of interest are the inevitable result of engaging in specialized exchange and since efficiency requires reliance on the specialized production of goods and services and on an extensive system of exchange to make goods and services available to those who need them, some conflicts of interest are unavoidable. See Anderson, *supra* note 21, at 739.

24. DEL. CODE ANN. tit. 8, § 144 (1988) provides in part:

(a) No contract or transaction between a corporation and 1 or more of its directors or

utes do not repudiate entirely the common law's aversion to self-dealing transactions.²⁵

Indeed, it would be absurd to argue that legislatures, in relaxing the rules on self-dealing, intended corporate fiduciaries to use these new rules to accomplish naked freeze-outs of shareholders from the corporation.²⁶ On the contrary, courts initially asserted continuing jurisdiction to evaluate the merits of self-dealing transactions with regard to fairness.²⁷ One court noted, "it would be a shocking concept of corporate morality to hold that because the majority directors or stockholders disclose their purposes and interest, they may strip the corporation of its assets to their own financial advantage"²⁸ This reaction seems to reflect the prevailing view that compliance with the disclosure and ratification provisions of these statutes merely "freshens the air" and removes the "interested director cloud,"²⁹ but the ultimate fairness of the transaction must still be proved to the satisfaction of the court.³⁰

officers, or between a corporation and any other corporation, . . . shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

See also REVISED MODEL BUSINESS CORP. ACT § 8.31 (1984). Thirty-eight corporate statutes have provisions relating to self-interest contracts.

25. See *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 67-68 (D.N.J. 1974); *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 418, 241 P.2d 66, 74 (1952).

26. See Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 730 (1985). The author states:

The first management buyouts appeared about ten years ago. Then called "going private," most of those transactions involved small firms that had gone public in the hot new issue market of the late 1960's and early 1970's

Though the supply of these small, "inadvertent" public companies has dried up since the early 1970's, management buyouts are still with us. But while the basic conflict of interest remains, management buyouts have in other respects changed considerably. . . .

Real economic and social gains from these buyouts are more difficult to find.

Id.

27. Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335, 335-36 (1948).

28. *Remillard Brick Co.*, 109 Cal. App. 2d at 418-19, 241 P.2d at 73-74.

29. *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976). Even with disclosure and approval it is still incumbent upon the self-dealing director to demonstrate the intrinsic fairness of the transaction. *Multi-Amp Corp.*, 386 F. Supp. at 68.

30. However, in a recent case decided by the Delaware Supreme Court, *Marciano v. Nakash*,

IV. ERADICATING THE THREAT THROUGH THE SPECIAL COMMITTEE

Even under continuing judicial scrutiny these rules relieve some corporate fiduciaries of rigid common law restraints and give them the means to redefine their relationship with shareholders and the corporation. Directors, top management and other fiduciaries can view themselves as co-venturers, entitled to share in the rewards of the enterprise.³¹ The recent conduct of managers in leveraged buyouts show, though, that these fiduciaries are not content with sharing, but would arrogate to themselves the whole enterprise.³²

A board or committee decision to accept a management buyout proposal should be tested under conflict of interest principles.³³ However, some have proposed that management leveraged buyout proposals approved by special committees of disinterested directors should be shielded from shareholder challenge by the business judgment rule.³⁴ This proposition seems to hold that a special committee, with its formal-

535 A.2d 400 (Del. 1987), some comments in dicta suggested that in certain cases a more preclusive effect may result from compliance with the statute.

The court stated that disclosure and approval by the disinterested directors "permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction." *Id.* at 405 n.3. The case involved a challenge by a 50% shareholder to the corporation's repayment of loans made to the corporation by the other 50% shareholder. The board of directors was hopelessly deadlocked and as such there was no disclosure to the board nor approval of the loans by the disinterested members. Consequently, the burden of proving fairness rested upon the self-dealing directors. *Id.* at 404-05.

31. See Vagts, *The Leveraged Buyout and Management's Share*, 25 WAKE FOREST L. REV. 129, 132 (1990).

32. *Id.* See e.g., *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 885 (6th Cir. 1986): "[W]e conclude on the basis of strong evidence that . . . [the] Board of Directors unreasonably preferred incumbent management in the bidding process . . . [and] gave their colleagues on the Board, [as well as] . . . 'inside managers' preference in the negotiations, because of 'bias.'"

See also DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517, 517 (1988). The author states:

"In recent years the level of merger and acquisition activity in the United States has been strikingly high, staggeringly so to some observers. . . . In 1986, 4,024 transactions with a value of \$190,512.3 million were completed, topping the prior record set in 1985 of 3,397, valued at \$144,283.5 million. . . . [B]y June 1987, completed buyouts for the year totaled \$34.3 billion.

Id.

33. Simpson, *The Emerging Role of the Special Committee — Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665, 666 (1988):

[C]ommittees allow a board to engage in an objective, disinterested examination of corporate issues in which some or all non-committee board members are interested parties. . . . Membership in these committees is limited to so-called "independent or disinterested directors," who are free of any financial or other interests that would prevent them from exercising objective, unbiased judgment.

34. *Id.* at 667. The author argues that in management buyouts and other conflict of interest transactions "a special committee is helpful — if not invaluable — to ensure protection under the business judgment rule." *Id.*

ity and apparent detachment, removes from the transaction the odium of self-interest.

Judging from the number of recent cases involving special committees used for this purpose, this proposition has many adherents among the ranks of boards of directors.³⁵ In the last several years numerous corporate boards have taken comfort in apparent judicial approval of the practice by setting up special committees to evaluate leveraged buyout proposals.³⁶ However, the special committee fails to accomplish the hoped-for result — fairness. The deficiencies are as follows.

A. *Selection and Size of Committees*

The most fundamental flaw in the selection process for members of special committees is that there are no governing standards. While corporation statutes give the board authority to delegate authority to committees, the details of such delegation are left to the discretion of the board.³⁷ In the case of the usual standing committees, corporate boards

35. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), was one of the first cases to consider the role of the special committee in leveraged buyouts. The proposed purchaser was the controlling stockholder, Signal. Six of the thirteen UOP directors were elected by Signal and five of these were either directors or employees of Signal. *Id.* at 704.

UOP's president, a director of both companies, negotiated on behalf of UOP although the negotiations were half-hearted at best. He mentioned the price on only one occasion and failed to disclose a Signal study indicating a willingness to accept a price higher than that on the table. *Id.* at 707.

In the suit challenging the buyout, the court pointed to long-standing fiduciary principles that dictated that the Signal designated directors on UOP's board owed UOP and its shareholders an uncompromising duty of loyalty. The court stated:

When Directors of a . . . corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.

Id. at 710 (citations omitted).

That burden was not met in this case. There was no attempt to structure the transaction on an arm's length basis. In a footnote the court ventured a view on the significance of an independent committee in meeting the burden of proving fairness: "although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length." *Id.* at 709 n.7.

This single footnote has prompted much reliance and litigation. See, e.g., *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757, 762 (Del. Ch. 1986); but see *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 938 (Del. 1985).

36. See generally *In re Resorts Int'l Shareholders Litig.*, 570 A.2d 259 (Del. 1990); *Rabkin v. Phillip A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1985); *In re Envirodyne Indus. Shareholders Litig.*, No. 10702, slip. op. (Del. Ch. Apr. 20, 1989), *reprinted in* 15 DEL. J. CORP. L. 175 (1990); *In re Formica Corp. Shareholders Litig.*, No. 10598, slip. op. (Del. Ch. Mar. 22, 1989) (1989 WESTLAW 25812); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770 (Del. Ch. 1988); *In re Fort Howard Corp. Shareholders Litig.*, No. 9991, slip. op. (Del. Ch. Aug. 8, 1988), *reprinted in* 14 DEL. J. CORP. L. 699 (1989); *Rosman v. Shoe-Town*, No. 9483, slip. op. (Del. Ch. Jan. 18, 1988) (1988 WL 3638); *Freedman v. Restaurant Assoc. Indus.*, No. 9212, slip. op. (Del. Ch. Oct. 16, 1987), *reprinted in* 13 DEL. J. CORP. L. 651 (1988); *In re Maxxam Group, Inc.*, No. 8636, slip. op. (Del. Ch. Apr. 16, 1987), *reprinted in* 13 DEL. J. CORP. L. 324 (1988); *Joseph v. Shell Oil Co.*, 498 A.2d 1117 (Del. Ch. 1985); *Patents Management Corp. v. O'Connor*, No. 7110, slip. op. (Del. Ch. June 10, 1985), *reprinted in* 11 DEL. J. CORP. L. 693 (1986).

37. DEL. CODE ANN. tit. 8, § 141(c) (Supp. 1988).

can refer to history and industry practice for guidance in composing and staffing committees.³⁸ But the special committee in conflict of interest cases makes its own way.³⁹ Recent cases reveal no discernable patterns or standards for the composition of such committees. In terms of size there have been special committees of one,⁴⁰ two⁴¹ and three directors.⁴²

In other cases, directors become members of special committees by default — they are the only ones who are not financially interested in the matter before the committee.⁴³ Most often these are the outside directors. However, the benefits derived from the objective disinterest of outside directors may well be overshadowed by their limited knowledge of the corporation's day-to-day affairs. Outside directors are almost always executives of other companies which demand their attentions and leave little time to devote to the corporation's affairs.⁴⁴ In recent years it

38. Simpson, *supra* note 33. "A board will generally rely on standing committees, such as audit, compensation, and nominating committees, for recurring issues." *Id.* at 666. Indeed, the existence of such committees may be a matter of statute. *Id.* at 666 n.3.

39. It is apparent that, as an ad hoc response to exigency, these committees can have little in the way of tradition to aid them in setting their agenda. See generally Simpson, *supra* note 33.

40. Patents Management Corp. v. O'Connor, No. 7110, slip op. (Del. Ch. June 10, 1985), reprinted in 11 DEL. J. CORP. L. 830 (1986) (a special committee composed of one outside, disinterested director and one executive officer of the corporation was appointed to consider a management leveraged buyout).

41. *In re Trans World Airlines Shareholders Litig.*, No. 9844, slip op. (Del. Ch. Oct. 21, 1988), reprinted in 14 DEL. J. CORP. L. 870 (1989) (a special committee composed of two board members was appointed to consider a leveraged buyout); *In re Maxxam Group, Inc.*, No. 8636, slip op. (Del. Ch. Apr. 16, 1987), reprinted in 13 DEL. J. CORP. L. 324 (1988) (special committee of two appointed to consider merger with company controlled by directors); *American General Corp. v. Texas Air Corp.*, No. 8390, slip op. (Del. Ch. Feb. 5, 1987), reprinted in 13 DEL. J. CORP. L. 173 (1988) (a special committee originally consisting of two outside directors was appointed to consider a merger proposal and a newly added outside director subsequently joined the committee).

42. *In re Resorts Int'l Shareholders Litig.*, 570 A.2d 259 (Del. 1990) (special committee consisted of three directors, half the board); *In re Formica Corp. Shareholders Litig.*, No. 10598, slip op. (Del. Ch. Mar. 22, 1989) (1989 WESTLAW 25812); *Shingala v. Becor Western, Inc.*, Nos. 8858, 8859, slip op. (Del. Ch. Feb. 3, 1988) (1988 WESTLAW 7390); *Freedman v. Restaurant Assocs. Indus.*, No. 9212, slip op. (Del. Ch. Oct. 16, 1987), reprinted in 13 DEL. J. CORP. L. 651 (1988) (special committee was composed of three of the eleven member board).

43. *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986) (special committee consisted of the outside directors); *Rabkin v. Phillip A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1985) (special committee consisted of the outside directors); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 773 (Del. Ch. 1988) (special committee consisted of all of the outside directors); but see *In re Maxxam Group, Inc.*, No. 8676, slip op. (Del. Ch. Apr. 16, 1987) (1987 WESTLAW 10016) (special committee of two where "[b]oth men had been directors of Maxxam from a date preceding [the merger proposal] and both appear[ed] to have experience and expertise in the field of mergers and acquisitions").

44. See M. MACE, DIRECTORS: MYTH AND REALITY 49, 107 (1971); see also Mace, *Directors: Myth and Reality—Ten Years Later*, 32 RUTGERS L. REV. 293 (1979). In his study of the boards of publicly-held corporations, Mace found:

[c]hief executives who serve other companies as directors are exceedingly busy men, and their carefully budgeted time schedules cannot allow substantial diversions. Devoting 12 to 18 hours a year to the board problems of other companies does not permit any perceptive and meaningful understanding of company problems. And to assume that company presidents — busy company presidents — will spend the time to do the homework essential to understanding company problems is asking more than should be reasonably expected. Their own stockholders would be short-changed if the president's time and energy were diverted to the problems of another company.

has become increasingly clear that it is not even the inside directors who manage the corporation, but senior executives.⁴⁵

In terms of member incompetence, the selection process is both arbitrary and biased. While members of the board are selected in part because of their expertise in the particular industry, staffing decisions for special committees ignore this relevant criteria and consider only the director's financial relationship to the matter to be decided.⁴⁶

B. Objective Disinterest

The cases reveal that some special committees are not even ostensibly disinterested. In *In re KDI Corp. Shareholders Litigation*,⁴⁷ a special committee was appointed to consider a management leveraged buyout.⁴⁸ The buyout contemplated the purchase of stock owned by Ariadne, which amounted to 49.5% of KDI.⁴⁹ Seven of nine KDI directors were appointed to the special committee.⁵⁰ Three of the committee members were also shareholders of Ariadne.⁵¹ After certain members of the special committee expressed concern about the presence of the Ariadne shareholding directors on the committee, the board reconstituted the special committee by making two of the three Ariadne shareholding directors alternates and retaining one as a regular member of the committee.⁵² The special committee then unanimously recommended approval of the buyout.⁵³

The plaintiffs, minority shareholders of KDI, claimed the special committee was tainted because its membership included a stockholder of Ariadne and Ariadne stood to benefit most from the transaction.⁵⁴ Despite what appeared to be an obvious conflict of interest the court dismissed the complaint on these grounds:

M. MACE, *supra*, at 107. See also M. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 146 (1971).

45. Mace reported that, contrary to myth, the role of directors is largely advisory and not of a decisionmaking nature, that management managed the company and board members served as sources of advice and counsel to management. In most large and medium sized companies the boards of directors did not establish objectives, strategies and policies. These roles were performed by management. CEO's and directors interviewed generally agreed that only management can and should have these responsibilities. M. MACE, *supra* note 44, at 47-49 & *passim*; see also M. EISENBERG, *supra* note 44, at 140. In fact, the language of the Delaware statute contemplates the delegation of executive functions: "The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors. . . ." DEL. CODE ANN. tit. 8, § 141(a) (1988).

46. R. CLARK, *supra* note 24, at 645.

47. No. 10,278, slip. op. (Del. Ch. Nov. 1, 1988), *reprinted in* 14 DEL. J. CORP. L. 759 (1989).

48. *Id.*, *reprinted in* 14 DEL. J. CORP. L. at 761.

49. *Id.*

50. *Id.*

51. *Id.*, *reprinted in* 14 DEL. J. CORP. L. at 762.

52. *Id.*

53. *Id.*, *reprinted in* 14 DEL. J. CORP. L. at 764.

54. *Id.*, *reprinted in* 14 DEL. J. CORP. L. at 769.

First, the record indicates that Ariadne was not willing to accept less than fair value for its KDI stock Second, Ariadne has no financial interest in the merger in the sense of standing on both sides of the transaction. Finally, Ariadne had only one representative on the Special Committee and there is no evidence that the Ariadne representative dominated or controlled the other disinterested members.⁵⁵

However, consider the decision in *Greenfield v. National Medical Care, Inc.*,⁵⁶ where a special committee was appointed to review and evaluate a management leveraged buyout proposal.⁵⁷ The committee was composed of four directors.⁵⁸ Three of these had no financial interest in the matter.⁵⁹ The fourth, Hager, was part of a group which would own 25% of the common stock of the resulting corporation.⁶⁰ Hager was initially paid as a consultant to the board and subsequently asked to join the board and allowed to purchase stock.⁶¹ Although Hager resigned, his resignation did not become effective until after the committee recommended acceptance of the merger proposal.⁶² The court rejected a defense motion to dismiss, ruling:

Although the complaint does not allege that there were any other bidders, it does allege that the merger price was unfair and that the lock-up prevented the stockholders from obtaining a higher offer. When combined with the allegations that the merger was approved by an interested board and that one of the members of the special committee was not independent, but did not resign until after the committee recommended the merger, I conclude that the complaint sufficiently states a claim for breach of fiduciary duty.⁶³

It is interesting that the same vice-chancellor decided both *In re KDI* and *Greenfield*, yet the decisions seem irreconcilable. In both cases, the same persons (the board of directors) proposing the buyout would also decide the matter.⁶⁴ *Greenfield* reflects the correct position that the offense of a self-dealing transaction cannot be treated by a special committee that is itself tainted.⁶⁵

55. *Id.*

56. Nos. 7720 & 7765 (consolidated), slip op. (Del. Ch. June 6, 1986), reprinted in 12 DEL. J. CORP. L. 737 (1987).

57. *Id.*, reprinted in 12 DEL. J. CORP. L. at 741.

58. *Id.*

59. *Id.*, reprinted in 12 DEL. J. CORP. L. at 742.

60. *Id.*

61. *Id.*

62. *Id.*, reprinted in 12 DEL. J. CORP. L. at 743.

63. *Id.*

64. *In re KDI Corp. Shareholders Litig.*, No. 10,278, slip op. (Del. Ch. Nov. 1, 1988), reprinted in 14 DEL. J. CORP. L. 759 (1989); *Greenfield*, Nos. 7720 & 7765 (consolidated), slip op., reprinted in 12 DEL. J. CORP. L. 737.

65. Moreover, "when the persons . . . who control the making of a transaction and the fixing of its terms . . . are on both sides, then the presumption [of] and deference to sound business judgment are no longer present." *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427, 430-31 (Del. Ch. 1969).

C. Structural Bias

The appointment of directors with no identifiable stake in a transaction before the committee is no guarantee of objective decisionmaking. Even board members recognize the existence of more subtle forces that may compromise a director's objectivity.⁶⁶ In the selection of directors generally, one scholar, Mace, found that chief executive officers specifically seek board members who are aligned philosophically and politically with management.⁶⁷ Among the desirable qualifications of candidates, position, and title as leaders in their field are essential.⁶⁸ In the special committee cases chief executive officers assure a favorable outcome by choosing friendly directors and by excluding those who may be adverse or represent minority interests.⁶⁹

66. *In re KDI Corp. Shareholders Litig.*, No. 10,278, slip op. (Del. Ch. Nov. 1, 1988), *reprinted in* 14 DEL. J. CORP. L. 759 (Del. Ch. 1989).

67. M. MACE, *supra* note 44, at 98-99, 196.

68. *Id.* Mace found that a director must "not be a controversial figure, and not be inclined to stimulate controversy with the management or with the other outside directors." *Id.* at 98. Rather, the director must be sympathetic to the management. *Id.* at 196.

Other studies have reached similar conclusions. See Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS., Summer, 1985, at 83, 85. The authors studied the special litigation committee and examined "several social-psychological mechanisms that can generate bias in the directors' assessment of the suit, including biases established by appointment of members to the board or a special litigation committee, control of pecuniary or nonpecuniary rewards made available to the independent directors by the defendant members of the board of directors, the independent directors' prior associations with the defendants, and their cultural and social heritages." *Id.* at 84-85. The authors concluded that "these several psychological mechanisms can be expected to generate subtle, but powerful, biases which result in the independent directors' reaching a decision insulating colleagues on the board from legal sanctions." *Id.* at 85.

Eisenberg has suggested that these biases arise from various compositional elements. The most striking is the degree to which the typical board includes persons who are economically or psychologically dependent upon or tied to the corporation's executives, particularly its chief executive:

Recent surveys suggest, for example, that approximately one-fifth to one-fourth of the outside directors in large American corporations are lawyers or investment bankers. Probably most of these are suppliers of services to the corporations on whose boards they sit, and are therefore highly interested in retaining the good graces of the chief executive, who normally has control over the purchase of such services. These surveys also indicate that approximately 12 to 15 percent of outside directors are commercial bankers, who are also often intent on retaining the corporation's business. Many if not most of the remaining directors are psychologically tied to the chief executive by friendship, former colleagueship, or both.

M. EISENBERG, *supra* note 44, at 144-46. Eisenberg's treatment of the subject was based in part upon Conference Board Surveys and two studies: HEIDRICK & STRUGGLES, *PROFILE OF THE BOARD OF DIRECTORS* (1971) and KORN/FERRY INTERNATIONAL, *BOARD OF DIRECTORS ANNUAL STUDY* 18 (1975).

69. Two examples illustrate the point. In *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989), the chairman and chief executive officer who proposed a restructuring plan in which senior management would end up with absolute majority control handpicked the committee members and included a college classmate of his father as a member. In *In re Ft. Howard Corp. Shareholders Litig.*, No. 9991, slip op. (Del. Ch. Aug. 8, 1988), *reprinted in* 14 DEL. J. CORP. L. 699 (1989), the chairman of the board, who proposed the buyout, selected the special committee. He met with another director at an airport to ask the latter to serve as chairman and the two of them agreed upon two others who "were best suited for the job." While the court declined to rule that such a selection process amounted to bad faith, it did venture that "[i]t cannot . . . be the best practice to

D. Deliberate Control Mechanisms

Structural biases are not the only corrupting elements at work in the special committee. The integrity of the special committee's decision making may be compromised by the deployment of deliberate control mechanisms. A special committee, a creature of the board, has only the authority the board has delegated.⁷⁰ Limitations on the sphere of author-

have the interested CEO in effect handpick the members of the Special Committee" *Id.*, reprinted in 14 DEL. J. CORP. L. at 720.

Whether such structural biases should impeach a board decision has been debated (at least in the shareholder litigation context and most often has been resolved in favor of the directors). See *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981); see also Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27 (1981); Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and ALI Project*, 1982 DUKE L.J. 959; Elfin, *An Evaluation of a New Trend in Corporate Law: Dismissal of Derivative Suits by Minority Board Committees*, 20 AM. BUS. L.J. 179 (1982); Note, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CALIF. L.REV. 885 (1981); Note, *Zapata Corp. v. Maldonado: Delaware's Judicial Business Judgment Rule — A Ship without a Rudder?*, 19 CAL. W.L. REV. 189 (1982); Note, *The Misapplication of the Business Judgment Rule to Dismiss Shareholder Derivative Suits Against Directors*, 33 U. FLA. L. REV. 589 (1981); Note, *Special Litigation Committees: An Unwelcome Solution to Shareholders Demands*, 1981 U. ILL. L. REV. 485.

However, there appears a trend away from automatic deference to these committees' decisions on the basis that such structural bias is a significant factor affecting the integrity of a committee's decision. The case of *Alford v. Shaw*, 320 N.C. 465, 358 S.E.2d 323 (1987), followed this movement. The shareholders commenced a derivative suit alleging fraud, self-dealing and mismanagement by certain directors. In response, the board appointed a special committee to investigate the allegations and make recommendations on the proper course to follow. It recommended that two claims be settled and all others dismissed. Acting in accordance with the recommendations, the board approved a settlement covering the two claims and moved for summary judgment on the others.

The North Carolina Supreme Court held that the North Carolina Business Corporation Act reflected a policy adopted by the legislature favoring minority shareholders and shareholders' derivative actions. As such, the statute precluded the termination of shareholder derivative actions without court approval. In this regard, the court would conduct an independent inquiry into the merits of the recommendation to determine whether the directors by their special litigation committees had met their burden of proof.

Further, the court noted:

[a] growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose institutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interests of plaintiffs forced to bring suit on behalf of the corporation.

Id. at 469, 358 S.E.2d at 326.

In light of these deficiencies, the court refused a slavish application of the business judgment rule. Instead, while the board may appoint a special litigation committee to decide whether to terminate a shareholder derivative suit, such a determination would not be binding upon the court. Instead, the court would make a fair assessment of the report of the special committee, along with all the facts and circumstances in the case, in order to determine whether the directors will be able to show that the transaction complained of was just and reasonable for the corporation. Accordingly, the case was remanded in order for plaintiffs to

develop and present evidence on th[e] issue . . . that, in fact, false and/or incomplete information was supplied to the committee because of the nonadversarial way in which it gathered and evaluated information, and therefore . . . in light of these and other problems which arise from the structural bias inherent in the use of board-appointed special litigation committees, that the committee's decision with respect to the litigation eviscerates plaintiffs' opportunities as minority shareholders to vindicate their rights under North Carolina Law.

Id. at 473, 358 S.E.2d at 328.

70. DEL. CODE ANN. tit. 8, § 141(c) (1988).

ity delegated, the scope of the assignment and the flow of information to the committee are devices that have successfully circumscribed the decision making of special committees.⁷¹

E. Delegation to Outside Advisors

While the common law limits on the power of the board to delegate authority to executive committees of directors are not settled, the limits of delegable duties are most clearly defined in cases involving outsiders.⁷² In order for such a delegation to be legally enforceable the delegation must not involve surrender or abdication by the board of its statutory duty to manage.⁷³ Where the duties left to the board after delegation are only unimportant, ministerial acts, the delegation is improper.⁷⁴

Many committees studied here relied upon financial advisors to determine the fairness of an offering price.⁷⁵ In several cases the special

71. In *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986), the special committee, composed of outside directors appointed to consider a management buyout proposal, failed to request any comparative analysis of the management's proposal, read the pertinent document, or order fairness opinions and communicate with the principal of the proposing group. Nevertheless, the committee recommended the proposal. See *id.* at 885-86.

In *Barkan v. Amsted Indus. Litig.*, 567 A.2d 1279, 1282 (Del. 1989), the special committee was specifically directed not to engage in a search for alternative transactions to a management buyout proposal.

In *In re Trans World Airlines*, No. 9844, slip op. (Del. Ch. Oct. 21, 1988), reprinted in 14 DEL. J. CORP. L. 870 (1989), the members of the two person special committee understood their responsibility to be very limited; that it did not include any negotiation with the merger offeror, that negotiation was the function of investment advisors and that it was not their intent to get the highest price possible. The court stated:

[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 [of the business judgment rule] 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 informed about the fair value of the firm and the minority shares in it.

Id., reprinted in 14 DEL. J. CORP. L. at 884.

In *Rosman v. Shoe-Town*, No. 9483, slip op. (Del. Ch. Jan. 18, 1988) (1988 WESTLAW 3638), the special committee was asked to decide a management leveraged buyout proposal of a company which had a history of going private, then public, then private again with little benefit to the investors. It appeared that several directors had been active participants in these maneuvers. The special committee was instructed not to be concerned with price and the investment advisors hired by the board never expressed an opinion on the price expected. In the court's view, the formality of setting up a committee was only the beginning of the director's burden in such cases.

72. H. BALLANTINE, *supra* note 21, at 134-35.

73. *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588 (7th Cir.), cert. denied, 282 U.S. 893 (1930).

74. *Id.* at 592. See also *Fournier v. Fournier*, 479 A.2d 708, 712 (R.I. 1984) (too broad a delegation, express or implied, may be interpreted as an unlawful abdication by the board of its management functions); *Lane v. Bogert*, 116 N.J. Eq. 454, 174 A. 217 (1934) (while directors may delegate they may not abdicate authority); *Kenneron v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 173, 260 P.2d 823, 832-33 (1953) (while the board may grant authority to act it cannot delegate its function to govern).

75. See, e.g., *in re Envirodyne Indus. Shareholders Litig.*, No. 10702, slip op. (Del. Ch. Apr. 20, 1989), reprinted in 15 DEL. J. CORP. L. 175 (1990); *In re Trans World Airline Shareholders Litig.*, No. 9844, slip op. (Del. Ch. Oct. 21, 1988), reprinted in 14 DEL. J. CORP. L. 870 (Del. Ch. 1989). See also DeMott, *supra* note 32, at 545. The author states:

committee directed the advisors to negotiate the terms of the buyout.⁷⁶ This complete reliance upon outside advisors to negotiate the terms of the proposal, to determine the fairness of the offer and even to determine whether to sell the corporation, seems a complete delegation of board powers.

To be sure, the referral of some decisionmaking tasks to outsiders is necessary in the evaluation of a transaction.⁷⁷ However, the ostensible impartiality and detachment of outsiders meets neither the obligations of directors nor the corporation's ends. Directors must be advocates, promoting the corporation, protecting its interests and refraining from conduct injurious to the corporation.⁷⁸ As agents or employees of the board or committee, outside advisors serve and are accountable to their employers — the management that hired them.⁷⁹ Their perspectives and orientation are necessarily limited and skewed.⁸⁰

In a rough sense, the [fairness] opinion, if it is based upon a thoughtful assessment of relevant non-public information about the company, is a surrogate for full disclosure to both the shareholders and the market generally, as a basis on which to assess the adequacy of the price being offered. Although fairness opinions appear more rather than less credible if the investment banker giving the opinion is not compensated on an outcome-contingent basis, generally investment bankers' fees in this connection are larger if the opinion asserts that the transaction is fair and smaller if the opinion asserts that the price offered is financially inadequate. "Inadequacy" or unfairness opinions cost less than "fairness" or adequacy opinions because part of the fee is in effect an insurance premium against the risk of litigation against the investment bank. If the banker concludes that the proposed price is inadequate, it is likely that either the transaction will not occur, or if it occurs, a higher price will be offered. Non-transactions are inherently less conducive to litigation than transactions, and thus require less of an insurance premium.

Id.

76. For example, in *In re Trans World Airlines Shareholders Litig.*, No. 9844, slip op. (Del. Ch. Oct. 21, 1988), *reprinted in* 14 DEL. J. CORP. L. 870 (1989), the two members of the special committee believed that negotiation was the task of the financial advisor.

In *Macmillan*, 559 A.2d 1261 (Del. 1989), only the financial advisors had direct contact with the bidders. In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986), the board accepted without question the advice of its financial advisor that the prices offered were "within the range of fair value," although the financial advisor had not in fact calculated a range of fairness. *Id.* at 271.

77. *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886 (6th Cir. 1986).

78. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1955). The court stated:

[F]ulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes upon a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.

Id. at 872.

79. See RESTATEMENT (SECOND) OF AGENCY § 387 (1958): "Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."

80. See *In re Fort Howard Corp. Shareholders Litig.*, No. 9991, slip op. (Del. Ch. Aug. 8, 1988), *reprinted in* 14 DEL. J. CORP. L. 699 (1989). Out of fear that a temporarily depressed stock price might render the company particularly vulnerable to a takeover attempt, senior management met with the investment banking firm of Morgan Stanley for advice concerning possible steps to protect shareholders from the perceived threat. *Id.*, *reprinted in* 14 DEL. J. CORP. L. at 705-06.

Morgan Stanley had been engaged on a number of occasions in recent years to give investment banking advice or services to the company. The investment banker prepared a written report of alternatives available including recapitalization, share repurchase, spin-off and a leveraged buy-out.

V. ABUSE OF THE SPECIAL COMMITTEE DEVICE

In *Mills Acquisition Co. v. Macmillan, Inc.*,⁸¹ the forces of self-interest proved irresistible and revealed the pretensions of the special committee.

In May 1987, certain members of senior management,⁸² concluding that Macmillan was a likely target of unsolicited takeover bids, "began exploring various defensive measures, including a [complete] corporate restructuring of the company."⁸³ In all measures it was a central concept that these same members of management would emerge with absolute control of the company.⁸⁴ Management's prediction of unsolicited bids came true as they were confronted with a takeover proposal by Robert M. Bass [Bass].⁸⁵

Management began meetings with the investment banking firm of Lazard, Freres & Co. [Lazard], which was later retained by the special committee as *its* advisor.⁸⁶ Previously, Lazard had advised senior management on other matters for over 500 hours. The special committee was not told of Lazard's previous contractual relationship with management.⁸⁷ The committee was further advised by the financial advisors, Wasserstein, Perella [Wasserstein].⁸⁸

Lazard valued the Macmillan stock at \$72.57 per share on a pre-tax basis, but advised the special committee directors that it found the restructuring price of \$64.15 to be fair. Lazard also recommended rejection of the \$64 Bass offer as "inadequate."⁸⁹ "On the Special Committee's recommendation, the Macmillan board adopted the management restructuring [plan] and rejected the Bass offer. The committee, however, had not negotiated any aspect of the transaction with

Morgan Stanley indicated that it would be interested in participating with management in a leveraged buy-out. *Id.*, reprinted in 14 DEL. J. CORP. L. at 706. Their self-interest revealed, the report might have been rejected or at least viewed with a measure of skepticism. Instead, management teamed up with the corporation's long-time associate to pursue their mutual self-interest. Although the court criticized the manner in which the special committee was selected, it nevertheless denied relief. *Id.* at 718-27.

81. 559 A.2d 1261 (Del. 1989).

82. This group included the chairman, chief executive officer, president, chief operating officer, and the chief financial officer. *Id.* at 1265.

83. *Id.*

84. *Id.*

85. Management decided in February or March to establish a special committee to consider management's restructuring plan to fend off Bass. *Id.* at 1267.

86. *Id.* at 1268.

87. *Id.* at 1267-68. In addition, Evans invited a law firm to attend and the committee retained the firm. *Id.*

88. *Id.* at 1270.

89. *Id.* at 1270. Wasserstein valued Macmillan between \$63 and \$68 per share and also recommended rejecting the Bass offer. *Id.*

management.”⁹⁰

Bass raised its bid to \$73.⁹¹ Lazard advised the board that it could furnish an “adequacy” opinion that would enable the special committee to reject the Bass offer.⁹² Accordingly, Lazard concluded that the Bass offer was inadequate, given Lazard’s earlier opinion that the “pre-tax” value of the company was between \$72 and \$80 per share.⁹³ Wasserstein concurred.⁹⁴

Once again, on the special committee’s recommendation, the board rejected the revised Bass offer and reaffirmed its approval of the management restructuring plan.⁹⁵ Management was unable to consummate the transaction only because of a successful motion for a preliminary injunction filed by Bass.⁹⁶

Undaunted, senior management then began extensive discussions with Kohlberg, Kravis & Roberts [KKR], investment bankers, in an attempt to develop defensive measures to thwart the Bass offer, including discussions on a management-sponsored buyout of the company.⁹⁷ Robert Maxwell [Maxwell] then entered the fray and proposed to the chairman a consensual merger between Macmillan and Maxwell at an all-cash bid of \$80 per share, which was \$5 higher than any other outstanding offer for the company.⁹⁸

Although on May 30, both Wasserstein and Lazard had given opinions that the management restructuring plan, with a price of \$64.15 per share, was fair and on June 7, had advised the board that the company had a maximum breakup value of \$80 per share, they both issued revised opinions on August 25, that an \$80 per share offer was unfair and inadequate.⁹⁹

90. *Id.*

91. *Id.* at 1271.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* The vice-chancellor held both revised Bass offers “were clearly superior to the restructuring” and the only real threat posed by the Bass offers was to the incumbency of the board or to the “management group’s expectations of garnering a 39% ownership interest [in the company] on extremely favorable terms.” *Id.*

97. *Id.* at 1272.

98. *Id.* After more than three weeks of silence from the board, Maxwell made an \$80 per share, all-cash tender offer for Macmillan. *Id.*

99. *Id.* at 1272-73. Accordingly, the Maxwell bid was rejected. Macmillan and KKR met to negotiate and finalize the management-sponsored buyout. At the same time Macmillan’s financial advisors were instructed by management to notify the remaining potential bidders to submit their best and final bids within 2 days. Thereafter, in a meeting with Maxwell the chairman of Macmillan announced that the company’s management planned to recommend a management-KKR leveraged buyout to the directors of Macmillan and that he would not consider Maxwell’s outstanding offer despite Maxwell’s stated claim that he would pay “top dollar” for the entire company. The chairman stated further that he would only discuss the possible sale of up to \$750 million worth of assets

Several rounds of bidding followed.¹⁰⁰ When the Maxwell all-cash bid reached \$89 and the KKR mixed bid \$89.50 (\$82 in cash and the balance in subordinated securities), the two financial advisors concluded that the offers were too close to call.¹⁰¹ On the last evening of bidding, KKR submitted a final revised bid with a face value of \$90 per share (higher than the last Maxwell bid).¹⁰² Both financial advisors agreed that the KKR bid was higher and the special committee recommended acceptance of the KKR offer.¹⁰³ The board adopted the resolution.¹⁰⁴

The result of this case was stated in the beginning of this essay. It was clear from the record that the board's conduct failed all basic standards of fairness. The court held that although the board was aware of its ultimate responsibility for ensuring the integrity of the auction, the directors wholly delegated the creation and administration of the auction to an array of the chairman's handpicked investment advisors.¹⁰⁵ The decisionmaking process was "clandestinely and impermissibly skewed" in favor of the management-sponsored bid, which received significant material advantages to the exclusion and detriment of other bidders in order to "stymie, rather than enhance, the bidding process."¹⁰⁶ The

to Maxwell in order to facilitate the management-sponsored buyout and that senior management would leave the company if any other bidder prevailed over the management sponsored buyout offer. During the bidding process and despite its repeated requests Maxwell was not given complete information until almost two months after such data had been furnished to KKR. *Id.* at 1273.

100. *Id.* at 1273-74.

101. At this point, the chairman called KKR and tipped Maxwell's bid. *Id.* at 1275. The committee set up procedures for a final round of bidding. Wasserstein prepared a "script" to be read over the telephone to both bidders. While the prepared script was read to Maxwell, in the call to KKR Wasserstein and other financial advisors impressed upon KKR "the need to go as high as [KKR] could go" in terms of price. *Id.* at 1276.

102. *Id.* at 1276. While Macmillan continued to negotiate with both parties over different matters it never suggested to Maxwell that KKR had topped Maxwell's last bid. *Id.*

In turn for raising its bid to \$90.05 KKR succeeded in winning other important concessions from Macmillan including the sale to KKR of certain assets which would immediately result in a \$250 million current tax liability for Macmillan. This liability could have been avoided through an installment basis sale of the assets, but as structured it operated as a de facto poison pill. *Id.* at 1277.

103. *Id.* at 1277.

104. *Id.* at 1277-78. On the same day Robert Maxwell delivered a letter to Evans announcing that he had amended his cash tender offer to \$90.25 per share, conditioned upon invalidation of the KKR lockup agreement. In his letter Maxwell emphasized that he had previously stated his willingness to top any offer higher than his earlier \$89 offer. *Id.*

On October 4, the Macmillan board met to consider both the revised Maxwell bid and Evans' "tip" to KKR. After some discussion and deliberation the board rejected Maxwell's increased offer because it was conditioned on invalidating the KKR lockup. Furthermore, the board considered that the "tip" to KKR was immaterial in light of the second round of bidding that occurred. In addition, after consultation with counsel, the board concluded that their ignorance of this "tip" at the time they approved the merger with KKR was insufficient grounds for repudiating the lockup agreement. *Id.* at 1278.

105. *Id.* at 1281.

106. *Id.* In particular, the "negotiations" with Maxwell were noteworthy only for the peremptory and curt attitude of Macmillan through its chairman. Maxwell was deliberately misled by the advisors and subjected to a series of short bidding deadlines in a seeming effort to prevent the submission of a meaningful bid. *Id.* at 1281-82.

court concluded:

Normally decisions of a board based upon [opinions or reports of officers and other experts selected with reasonable care] will not be disturbed when made in the proper exercise of business judgment. However, when a board is deceived by those who will gain from such misconduct, the protections girding the decision itself vanish. Decisions made on such a basis are voidable at the behest of innocent parties to whom a fiduciary duty was owed and breached, and whose interests were thereby materially and adversely affected.¹⁰⁷ This rule is based on the unyielding principle that corporate fiduciaries shall abjure every temptation for personal profit at the expense of those they serve.¹⁰⁸

This ruling seems to answer the central inquiry of this paper — constituted as humanity is, the special committee fails as a device to ensure a proper resolution of a conflict between duty and self-interest.

VI. CONCLUSION

In *Macmillan*, the court found that because the proponents of the management buyout had failed to disclose all relevant information and had engaged in other acts in a deliberate attempt to thwart the board's duty to enhance shareholder wealth, the decision was disqualified from the normal standards of deference due under the business judgment rule.¹⁰⁹ It seems that the result in this case was correct, but the stated issue too narrow. The real issue needing resolution was whether, as a general proposition, special committees are fit to treat transactions tainted with self-interest. The cases reveal inherent deficiencies in the selection and composition of members such that honest, dispassionate decisionmaking is impossible. Even when committee members are otherwise well-meaning, the cases show they can be hoodwinked by a determined group of self-dealing managers. It is little comfort that some courts, such as the *Macmillan* court, eventually vindicate the rights of

107. The court explained:

In this context, we speak only of the traditional concept of protecting the decision itself, sometimes referred to as the business judgment doctrine. The question of the independent directors' personal liability for these challenged decisions, reached under circumstances born of the board's lack of oversight, is not the issue here. However, we entertain no doubt that this board's virtual abandonment of its oversight function in the face of [the management bidders'] patent self-interest was a breach of its fundamental duties of loyalty and care in the conduct of this auction"

Id. at 1284 n.32 (citation omitted).

108. *Id.* at 1284. The court went on to discuss whether the directors' had met their "enhanced duty" of loyalty in responding to a potential shift in control and whether the lockup agreement was valid. The duty was not met and the decision of the directors granting the lockup option was neither informed nor disinterested. As such, it was not protected by the business judgment rule. *Id.* (footnote omitted).

109. *Id.* at 1287-88.

shareholders because interim costs (corporate resources used to plan, effectuate and defend the appropriation) are great and irretrievable. Moreover, there is a more fundamental cost in the loss of shareholder control. In these schemes, the power to decide on actions which will bring about irrevocable consequences is removed from persons loyal to the enterprise and given to those who have subordinated themselves to their own self-interest or to outsiders who have never pledged any loyalty to the corporation or the shareholders. The locus of corporate decisionmaking thus shifts. In that shift, shareholders are wholly excluded from the corporate process.

In normal business decisions directors have discretion and their honest and informed judgments require deference. Self-dealing transactions, however, warrant greater court scrutiny. While a standard method for evaluating such transactions may facilitate intelligent adjudications, a set of procedures which ensures only a cursory review of self-dealing transactions as to procedural fairness only encourages management compromise. As long as the use of the special committee can be set up as conclusive (or even rebuttable) evidence of fairness, a director need not avoid plans which conflict with the interests of the corporation. Instead, he will find it profitable to curb his ideas, energies and commitment until shareholders have been eliminated and the corporation is his alone. Indeed, his office as a fiduciary affords him the means — information, financial resources and business relationships — by which to accomplish his coup (not only in practical aspects, but in sustaining his burden during a challenge in court).¹¹⁰ To accord business judgment rule protection to a decision by a corporation's fiduciaries in these situations seems perverse.

It is necessary to import substantive considerations into the evaluation of conflict of interest questions. This can be accomplished by allowing directors no choice between self-interest and duty. An absolute rule prohibiting directors from proposing self-interested buyouts is required.¹¹¹

110. See generally Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978).

111. This writer is not the first to call for an absolute prohibition on management buyouts. See Brudney & Chirelstein, *supra* note 110, at 1367-68, 1376 (advocating prohibition on all going private transactions).

See also Demott, *supra* note 32. The author considers the various policy alternatives for addressing management buyouts including absolute prohibition. She argues that while a categorical ban presents serious problems of definition, "[i]f the principle interest to be served by the directors is that of the company's shareholders, directors should not be free to ensure that the transaction sponsored by management and its allies will trump competing bids." *Id.* at 554. DeMott proposes permitting management groups to bid, but restricted from structuring any such transaction so that public equity is entirely eliminated. *Id.* at 555. In addition, she proposes that there be a requirement

that the fact of the management proposal be publicly announced coupled with a requirement that non-public information equivalent to that given the management group be made available to other prospective bidders, who could in turn be required to agree to treat the information received as confidential. *Id.* at 556.