# Success fees for special committee work

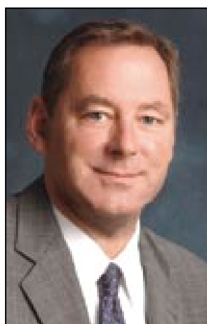
*Caution is required as contingent payments may create a potential conflict of interest.*

BY DOUG RAYMOND

PERHAPS THE most common route that boards take to protect against a conflict of interest challenge is to assign issues involving potential conflicts to a special committee comprised entirely of directors who are free of any conflict. However, the directors on the special committees need to be truly free of conflicts or the committee will not provide any protection.

The recent case, *In re MFW*, provided insights into how to assess conflicts of interest that arise from the financial and personal relationships directors and committee members share with conflicted parties. The alleged conflict of interest in *MFW* arose in a challenge to the acquisition of a company by its controlling stockholder and was premised on various "business and social ties" that special committee members shared with the controlling stockholder. In this case, Chancellor Leo Strine found that independence is not a hard and fast rule, but of necessity is a relative concept. It requires determining whether the financial compensation or the social relationships involved would be likely to influence the member's independent judgment. In *MFW*, the court found neither the financial compensation nor the social relationships were sufficiently material, in light of the facts about the members, to affect the committee's independence.

The recent case of *Southeastern Pennsylvania Transportation Authority v. Volgenau* builds on this analysis. In *SEPTA*, a third party acquired a publicly traded company with a majority stockholder. This case is significant in part because it applied the conflict of interest analysis to this "going private" transaction although the controlling stockholder was not initially part of the buying group. However, the controlling shareholder did in fact receive different consideration from the other stockholders in that he had agreed to roll over a substantial portion of his equity into the buying entity. A minority stockholder sued the former directors of the company, alleging among other things a breach of fiduciary duties by the directors for engaging in self-dealing during the sale process and failing to disclose material information. At the core of the discussion was whether the special committee that had approved the transaction was in fact disinterested and independent.



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After the merger agreement had been signed, the chairman of the special committee expressed dissatisfaction over the "meager compensation" offered him for his special committee work ($75,000 plus a $150,000 contribution to two charities supported by him) and requested a $1.3 million special bonus, payable to charities he supported. The plaintiffs alleged that this request for a bonus, contingent upon the successful sale of the company, revealed a conflict of interest on the part of the chairman that undermined the independence of the special committee. Furthermore, the plaintiffs asserted, this request revealed the chairman's expectation that he would receive a substantial bonus upon a successful transaction, an expectation that would motivate him to endorse the transaction even if not in the stockholders' interest. As the chairman had played a predominate role on the special committee, his independence was critical to its proper functioning. Vice Chancellor John Noble agreed that if the chairman expected to receive a significant bonus as a *quid pro quo* for delivering a deal, then this expectation may have led the special committee to negotiate less aggressively on behalf of the minority stockholders, removing the "cleansing effect" of the special committee and calling the fairness of the transaction into question.

The court eventually ruled that the bonus request did not tarnish the independence of the special committee. The court considered, but found no evidence to suggest, that a gift to the charities would have resulted in any "backdoor remuneration, measured in dollars or accolades, for a donation made because of him." However, in a strongly worded footnote, the court noted that the bonus request was far higher than customary for the transaction and raised serious doubts about the chairman's objectivity in negotiating the matter. The court also warned that such requests for contingent compensation can lead to abuse.

The important takeaway from *SEPTA* is that a significant bonus paid to a member of a special committee upon a successful deal — even if it arises after the fact — can destroy the independence of the special committee and call into question the fairness of the transaction. Going forward, while committee members are entitled to reasonable compensation for the work done, special committee members should exercise caution in dealing with conflicts of interest involving contingent payments or risk provoking a challenge on the issue of independence. In other words, the watchers need to watch themselves. ■

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