DIRECTOR AND ADVISOR DISINTERESTEDNESS AND INDEPENDENCE UNDER DELAWARE LAW

BY GROVER C. BROWN, MICHAEL J. MAIMONE, AND JOSEPH C. SCHOELL*

TABLE OF CONTENTS

I. INTRODUCTION

Since the early 1980s, "enormous changes have occurred in the governance of public companies, including changes in the composition of boards of directors (resulting in more [disinterested and] independent boards) and the utilization of specialized board committees consisting of [disinterested and] independent directors to address conflict-of-interest transactions and related issues."[1] This trend towards utilizing disinterested and independent directors is based upon, among other things, the great deference courts give to decision makers who are capable of making an

---

*Messrs. Brown and Schoell are both members of the Delaware bar, and Mr. Maimone is a member of the Delaware bar and the New York bar. The authors practice law with Morris, James, Hitchens & Williams in Wilmington, Delaware. Portions of this article appeared in *Delaware Business Law Comments*, a newsletter published by Morris, James, Hitchens & Williams.

[1]Dennis J. Block et al., *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 BROOK. L. REV. 65, 65 (1993).

impartial business decision.[2] Indeed, where courts decide that such decision makers are incapable of making an impartial decision because of a disabling conflict of interest or lack of independence from a party suffering from such a conflict, judicial scrutiny is more demanding and courts review the merits of the business decision to determine whether it was fair to, and in the best interests of, the corporation.[3]

In addition to using disinterested and independent directors, directors have sought increasingly the advice of legal and financial advisors,[4] particularly when the directors are addressing a transaction or litigation involving a conflict of interest.[5] Directors may satisfy their obligation to inform themselves, "prior to making a business decision, of all material information reasonably available to them," by obtaining and relying upon the advice of professionals.[6] As noted by commentators, however, an important measure in determining whether directors may reasonably rely upon the advice provided by their advisors, and, thus, properly inform themselves prior to making a business decision, "is the independence of the advisors."[7] Instead, where a court questions the independence of a particular advisor, the court also may question the

---

[2]*See* Rales v. Blasband, 634 A.2d 927, 937 (Del. 1993).

[3]*See* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

[4]*See* Smith v. Van Gorkom, 488 A.2d 858, 880-81 (Del. 1985).

[5]*See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 938 (Del. 1985); Kahn v. Caporella, No. 13,248, 1994 Del. Ch. LEXIS 29, at *12 (Del. Ch. Mar. 10, 1994); Roberts v. General Instrument Corp., No. 11,639, slip op. at 27 (Del. Ch. Aug. 13, 1990), *reprinted in* 16 DEL. J. CORP. L. 1540, 1548 (1991); *In re* Formica Corp. Shareholders Litig., No. 10,598 (Cons.), 1989 Del. Ch. LEXIS 27, at *36 n.14 (Del. Ch. Mar. 22, 1989).

[6]Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* DEL. CODE ANN. tit. 8, § 141(e) (1991) (permitting directors to rely upon the advice provided by professionals). The statute provides in part:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of his duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Id.

[7]ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE § 3.03[A], at 3-82 (5th ed. 1997).

disinterestedness and independence of the directors that retained the advisor.[8]

Notwithstanding these developments in corporate governance, it is not always apparent whether a director or an advisor would be considered disinterested and independent by a court in connection with a transaction or litigation involving a potential conflict of interest.[9] Delaware courts most frequently confront the subjects of disinterestedness and independence in two distinct contexts.

First, in assessing a corporate transaction involving a potential conflict of interest, courts consider whether a majority of directors approving the transaction were disinterested and independent such that the transaction would be afforded the protection of the business judgment rule.[10] Similarly, where a majority of directors was not disinterested and independent and a special committee of directors was created to negotiate the transaction on behalf of the public stockholders of the corporation, courts would inquire into the disinterestedness and independence of the directors appointed to serve on the special committee.[11] Such an inquiry is a factor that courts consider in determining whether the fiduciaries have the burden of demonstrating the "entire fairness" of the transaction, or the stockholder challenging the transaction has the burden of demonstrating the "unfairness" of the transaction.[12]

Second, where a stockholder-plaintiff brings a derivative action on behalf of the corporation against an alleged wrongdoer, courts determine whether the directors were sufficiently disinterested and independent to decide whether an action should be brought to enforce the corporation's interest. In addition, where a majority of the directors was not sufficiently disinterested and independent and the directors created a special litigation committee to determine whether an action should be brought to enforce the corporation's interest, courts would examine (1) whether the members of the special litigation committee were sufficiently disinterested and independent to determine whether the derivative action should be pursued,[13] and (2) whether the advisors retained by the special litigation

---

[8]*See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1268-69, 1279 (Del. 1989); Iseman v. Liquid Air Corp., No. 9694, slip op. at 7 (Del. Ch. Oct. 23, 1989), *reprinted in* 15 DEL. J. CORP. L. 1041, 1047 (1990).

[9]*See infra* notes 56-89 & 117-52 and accompanying text.

[10]*See infra* notes 20-24 and accompanying text.

[11]*See* Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997); Kahn v. Lynch Communications Sys., 638 A.2d 1110, 1120 (Del. 1994).

[12]*See infra* notes 26-37 and accompanying text.

[13]*See infra* notes 117-52 and accompanying text.

committee could not assist the special litigation committee in satisfying its obligations because the advisors were not independent.[14]

This article sets forth issues that directors must address in connection with situations involving a potential conflict of interest.[15] Specifically, this article (1) surveys transactions involving interested fiduciaries and derivative litigations where a majority of the directors were not disinterested and independent in connection with the challenged actions, and (2) analyzes the rationale applied by courts in determining whether a director or an advisor was disinterested and independent in connection with such transactions or litigations. During such survey and analysis, this article attempts to offer guidance and suggestions to corporate fiduciaries and their advisors regarding the manner in which such fiduciaries and advisors should address situations where potential conflicts exist between the fiduciaries and the corporation.

II. TRANSACTIONS INVOLVING INTERESTED FIDUCIARIES

A. *Background*

Under Delaware corporate law, where directors make a business decision in the context of a conflict-of-interest transaction, the disinterestedness and independence of such directors are critical elements considered by courts in determining whether the challenged decision should be enjoined, or whether liability should be imposed upon the directors.[16] Such elements are based upon the fundamental principle of corporate law that the business and affairs of a corporation are managed by its board of directors,[17] and, in discharging their duties, directors have an unyielding fiduciary duty to protect and to act in the best interests of the corporation and its stockholders.[18] These fundamental principles form the foundation for the business judgment rule.[19]

Specifically, since 1984, the Delaware Supreme Court has described the business judgment rule as a "presumption" of regularity and has placed the burden of rebutting such presumption upon the stockholder challenging

---

[14]*See infra* notes 153-82 and accompanying text.

[15]*See infra* notes 104-16 and accompanying text.

[16]*See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1281 (Del. 1989).

[17]DEL. CODE ANN. tit. 8, § 141(a) (1991).

[18]*See Mills Acquisition Co.*, 559 A.2d at 1280; Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

[19]*See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993), *modified on reargument*, 636 A.2d 956 (Del. 1994).

the decision: "[I]t is 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."[20] The rationale underlying the business judgment rule is that corporate matters are "to be finally settled by the sound business judgment of the directors"[21] and not be exposed to second guessing by courts.[22]

Where directors are confronted with a situation in which their interests or the interests of a controlling stockholder conflict with those of the corporation or its public stockholders, the directors may be denied the protection of the business judgment rule because of the possibility that such directors would make self-interested business decisions to the detriment of the corporation and its stockholders.[23] Denial of such protection leaves the directors and the controlling stockholder to bear the burden of demonstrating the "entire fairness" of their business decision in litigation

---

[20]*Aronson*, 473 A.2d at 812. After its landmark decision in *Aronson*, the Delaware Supreme Court consistently and repeatedly described the business judgment rule as a "presumption" of regularity. *See* Scattered Corp. v. Chicago Stock Exch., Inc., 701 A.2d 70, 74 (Del. 1997); Brazen v. Bell Atl. Corp., 695 A.2d 43, 49 (Del. 1997); Kahn v. Roberts, 679 A.2d 460, 465 (Del. 1996); Grimes v. Donald, 673 A.2d 1207, 1219 (Del. 1996); Williams v. Geier, 671 A.2d 1368, 1377-78 (Del. 1996); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995); Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 (Del. 1993); Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993); *Cede & Co.*, 634 A.2d at 358; Stroud v. Grace, 606 A.2d 75, 83 (Del. 1992); Kahn v. Sullivan, 594 A.2d 48, 59 (Del. 1991); Levine v. Smith, 591 A.2d 194, 207 (Del. 1991); Gilbert v. El Paso Co., 575 A.2d 1131, 1145, 1147 (Del. 1990); Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990); *In re* Resorts Int'l Shareholders Litig. Appeals, 570 A.2d 259, 267 (Del. 1990); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989); *Mills Acquisition Co.*, 559 A.2d at 1288; Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987); Polk v. Good, 507 A.2d 531, 536 (Del. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986); Blosvern v. Fisher, 504 A.2d 571 (Del. 1985) (ORDER); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); *Van Gorkom*, 488 A.2d at 872; Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984).

[21]Gottlieb v. Heyden Chem. Corp., 90 A.2d 660, 663 (Del. 1952), *adhered to on reargument*, 91 A.2d 57 (Del. 1952).

[22]*See* Freedman v. Restaurant Assocs. Indus., No. 9212, slip op. at 23 (Del. Ch. Oct. 16, 1987), *reprinted in* 13 DEL. J. CORP. L. 651, 663-64 (1988); Karasik v. Pacific Elec. Corp., 180 A. 604, 611 (Del. Ch. 1935).

[23]Where a disinterested director, however, acts independently in considering and approving a transaction between the corporation and a controlling stockholder, such director may be afforded the protection of the business judgment rule, notwithstanding the fact that the controlling stockholder must demonstrate "entire fairness." *See* Citron v. E.I. DuPont de Nemours & Co., 584 A.2d 490, 499 (Del. Ch. 1990).

challenging the decision or seeking to impose liability on the fiduciaries.[24] As established by the Delaware Supreme Court, "entire fairness" entails a demonstration of both fair dealing and fair price:

> [Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. [Fair price] relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.[25]

The rationale underlying the "entire fairness" standard of judicial review is that some transactions involving interested fiduciaries "are not inherently detrimental to a corporation,"[26] and that corporate fiduciaries should have the opportunity to demonstrate the fairness of the transaction.[27] Indeed, in many situations, the corporation and its stockholders may secure major benefits from a transaction despite the presence of a director's

---

[24]*See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); *In re* MAXXAM Inc., 659 A.2d 760, 773-74 (Del. Ch. 1995); *see also* Summa Corp. v. Trans World Airlines, Inc., 540 A.2d 403, 407 (Del. 1988) (discussing the "entire fairness" test). The court noted that:

> Toolco was a 78% shareholder in TWA, and, exerting its control position, Toolco refused to allow TWA to purchase its own jets, delayed the production of jets which were ordered, unjustifiably rejected acceptable aircraft, forced TWA to enter into leases for aircraft, and sold airplanes to TWA at a profit — all to Toolco's benefit, but materially detrimental to the productivity and effectiveness of TWA.... Such conduct hardly comports with basic concepts of fair dealing under the fiduciary standards of Delaware corporation law.... Thus, for reasons clearly attributable to the eccentric and idiosyncratic business methods of Howard Hughes, TWA was unable to establish a jet fleet as quickly as competitors. Given this record, it is manifest that no independent board of directors could have taken such action in good faith and in the honest belief that it was in the best interests of TWA. That point becomes even more apparent when one considers the application of the intrinsic fairness test here, and Toolco's failure to meet its burden of proof in that regard.

Id. (citations omitted).

[25]*Weinberger*, 457 A.2d at 711 (citations omitted).

[26]Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991).

[27]*Id.*

conflicting interest. As the drafters of the Revised Model Business Corporation Law explained:

> [T]he essential character of interest conflict is often, unfortunately, misunderstood by the public and the media (and sometimes misunderstood, too, by lawyers and judges). Interest conflicts can and often do lead to baneful acts. The law regulates interest conflict transactions because experience shows that people do often yield to the temptation to advance their self-interests and, if they do, other people may be injured. That contingent fear is sufficient reason to warrant caution and to apply special standards and procedures to interest conflict transactions.
>
> Nonetheless, it is important to keep firmly in mind that it is a contingent risk we are dealing with — that an interest conflict is not in itself a crime or a tort or necessarily injurious to others. Contrary to much popular usage, having a "conflict of interest" is not something one is "guilty of"; it is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest.[28]

Placing the burden upon the corporate fiduciaries, therefore, "does not create *per se* liability on the part of the [fiduciaries] . . . [r]ather, it 'is a procedure by which Delaware courts of equity determine under what standard of review [fiduciary] liability is to be judged.'"[29]

In sum, where the plaintiff challenging a decision by directors rebuts the presumption of the business judgment rule, the directors must satisfy the burden of proving to the trier of fact the "entire fairness" of the decision to the corporation and its stockholders.[30] If the directors fail to satisfy their

---

[28]MODEL BUS. CORP. ACT § 8.60 (1991) (Intro. Cmt.).

[29]Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 371 (Del. 1993), *modified on reargument*, 636 A.2d 956 (Del. 1994)).

[30]*See, e.g.*, *Cede & Co.*, 634 A.2d at 361 (recognizing that the entire fairness standard requires the board of directors to prove "to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price").

burden, the challenged decision may be enjoined, and liability may be imposed upon the directors.[31]

B. *Satisfying the Burden of Proof*

Where a transaction is subject to the "entire fairness" standard of judicial review, corporate fiduciaries may avoid the burden of demonstrating the "entire fairness" of a transaction by creating and empowering a committee of disinterested and independent directors to negotiate the transaction on behalf of the public stockholders.[32] Where such a committee properly discharges its duties, Delaware courts impose upon the stockholder challenging the transaction the burden of demonstrating that the transaction is substantively "unfair."[33]

The Delaware Supreme Court has emphasized, however, that the mere formation of a special committee by the corporate fiduciaries is not enough to satisfy their burden:

> A condition precedent to finding that the burden of proving entire fairness has shifted in an interested merger transaction is a careful judicial analysis of the factual circumstances of each case. Particular consideration must be given to evidence of whether the special committee was *truly independent, fully informed, and had the freedom to negotiate at arm's length.* "Although perfection is not possible," unless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a

---

[31]*See Mills Acquisition Co.*, 559 A.2d at 1280-81; *Van Gorkom*, 488 A.2d at 893.

[32]*See, e.g., Weinberger*, 457 A.2d at 709 n.7 ("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 . . . ."); *see also, e.g., In re* Trans World Airlines, Inc. Shareholders Litig., No. 9844 (Cons.), slip op. at 22 (Del. Ch. Oct. 21, 1988), *reprinted in* 14 DEL. J. CORP. L. 870, 884 (1989) (noting that the committee's role is to "supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary").

[33]*See* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997):

> Ordinarily, in a challenged transaction involving self-dealing by a controlling shareholder, the substantive legal standard is that of entire fairness, with the burden of persuasion resting upon the defendants. The burden, however, may be shifted from the defendants to the plaintiff through the use of a well functioning committee of independent directors. Regardless of where the burden lies, when a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness as opposed to the more deferential business judgment standard.

> process "as though each of the contending parties had in fact exerted its bargaining power at arm's length," their burden of proving fairness will not shift.[34]

Similarly, in a more recent decision, the Delaware Supreme Court held that the special committee failed to satisfy its burden because, among other things, two members of the three person committee failed to involve themselves in the committee's functions with the requisite level of "'care, attention and sense of responsibility'" required of them.[35]

The Delaware Court of Chancery has recognized that corporate fiduciaries may satisfy their burden where a special committee comprised of disinterested and independent directors[36] supplies "an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary."[37] Simply stated, where a special committee emulates "that arm's length process," the interests of public stockholders are protected.[38] As the Delaware Court of Chancery noted, "Experience has shown that that procedure can work well."[39]

Numerous decisions of Delaware courts have described the duties of a special committee where such committee is created and empowered to conduct "arm's-length" negotiations with an interested party.[40] As explained by the Delaware Court of Chancery, it is the duty of a special committee of disinterested and independent directors to protect the interests of the public stockholders, assuring that if the conflict-of-interest transaction were "accomplished, it would be accomplished only on terms fair to the public shareholders and representing the best available terms

---

[34]Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1120-21 (Del. 1994) (quoting *Weinberger*, 457 A.2d at 709-10 n.7) (emphasis added) (citations omitted)).

[35]*Tremont Corp.*, 694 A.2d at 430 (quoting *Aronson*, 473 A.2d at 816).

[36]Courts have recognized that a committee comprised of one disinterested and independent director, although not fatal to the directors' position that such committee offered the public shareholders the "procedural protection" acknowledged in *Weinberger*, must undergo "careful judicial scrutiny." Kahn v. Dairy Mart Convenience Stores, Inc., No. 12,489, slip op. at 14 (Del. Ch. Mar. 29, 1996), *reprinted in* 21 DEL. J. CORP. L. 1143, 1157 (1996).

[37]*In re* Trans World Airlines, Inc. Shareholders Litig., No. 9844 (Cons.), slip op. at 18 (Del. Ch. Oct. 21, 1988), *reprinted in* 14 DEL. J. CORP. L. 870, 884 (1989).

[38]*Id.* (citing *Weinberger*, 457 A.2d at 701 n.7).

[39]*Id.* (citations omitted).

[40]*See* Mendel v. Carroll, 651 A.2d 297, 305 (Del. Ch. 1994); Kahn v. Lynch Communications Sys., 638 A.2d 1110, 1119 (Del. 1994), *aff'd*, 669 A.2d 79 (Del. 1995); *In re* First Boston, Inc. Shareholders Litig., No. 10,338, 1990 WL 78836, at *8 (Del. Ch. June 7, 1990).

from the shareholders' point of view."[41] Indeed, in protecting such interests, the members of the special committee cannot accept any offer from a controlling stockholder that they believe in good faith is inadequate.[42]

Chancellor Allen, in describing the duties of independent directors in the context of a "freeze-out" merger, recognized:

> The power to say no is a significant power. It is the duty of directors serving on . . . a [special] 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 [controlling shareholder] will pay if that price is not a fair price. Nor is sufficient to get a price that falls within a range of "fair values" somehow defined, if the [controlling shareholder] (or another) would pay more. The [controlling shareholder's] best price may not be fair and the [controlling shareholder's] position may preclude the emerge of alternative transactions at a higher price. The only leverage that a special committee may have where a [controlling shareholder's] position precludes alternatives . . . is the power to say no and, thus, to force the [controlling shareholder] 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 the transaction or abandon the transaction.[43]

In conclusion, the court held that the independent directors must

> agree only to a transaction that is in the best interests of the public shareholders; to say no unless they conclude that they have achieved a fair transaction that is the best transaction available — and where they pursue that goal independently,

---

[41]*Mendel*, 651 A.2d at 306 (citing *Lynch Communications Sys.*, 638 A.2d at 1119).

[42]*Lynch Communications Sys.*, 638 A.2d at 1118-19; *First Boston*, 1990 WL 78836, at *7.

[43]*First Boston*, 1990 WL 78836, at *7.

> in good faith and diligently, their decision . . . deserves the respect accorded by the business judgment rule.[44]

In addition to being comprised of disinterested and independent directors and having the freedom to negotiate at arm's length, a special committee must actively seek information concerning the transaction and make an informed decision.[45] For example, in *Kahn v. Tremont Corp.*,[46] the Delaware Supreme Court emphasized that each member of a special committee should be active and attentive in the special committee's affairs.[47] Specifically, the board of directors of Tremont Corporation (Tremont) had appointed a three person special committee to negotiate on behalf of the public stockholders a potential acquisition of the stock of N.L. Industries, Inc., which was affiliated with Tremont and Tremont's controlling stockholder.[48] Reversing the court of chancery's decision that the special committee was "fully informed, active and appropriately simulated an arms length transaction,"[49] the Delaware Supreme Court determined that two members of the special committee had "abdicated their responsibility as committee members" by failing to attend key meetings with the special committee's advisors and by delegating much of the work of the special committee to the special committee's chairman.[50] Accordingly, the Delaware Supreme Court rejected the chancery court's holding that the actions of the special committee justified shifting the burden of fairness to the stockholder challenging the acquisition, and

---

[44]*Id.* at *8. The reasoning adopted by Chancellor Allen in *First Boston* was embraced by the Delaware Supreme Court. *Lynch Communications Sys.*, 638 A.2d at 1119-21.

[45]*See* Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 274 (2d Cir. 1986); *Van Gorkom*, 488 A.2d at 873-74.

[46]694 A.2d at 422 (Del. 1997). In *Tremont*, Justices Walsh, Holland, and Berger, President Ridgely, and Judge Quillen, constituting the supreme court *en banc*, addressed the issues raised by plaintiff-appellant. In reversing and remanding the decision of the court of chancery, Justice Walsh (with Justice Holland joining and Judge Quillen concurring) stated that, among other things, "[a]fter careful review of the record, we conclude that under the circumstances the Special Committee did not operate in an independent or informed manner and therefore, the Court of Chancery erred in shifting the burden or persuasion to [plaintiff-appellant]." *Id.* at 424.

[47]*Id.* at 430.

[48]*Id.* at 426.

[49]*Id.* at 429.

[50]*Tremont Corp.*, 694 A.2d at 429-30.

remanded the case for a determination of entire fairness of the transaction with the burden of proof placed upon the corporate fiduciaries.[51]

The courts have viewed favorably the retention of disinterested and independent advisors by a special committee in determining whether the special committee properly performed its function and actively sought information concerning the transaction.[52] As stated by the Delaware Court of Chancery, consultation with and informed reliance upon legal and financial advisors by the disinterested and independent directors have become common components of a reviewing court's assessment of such directors' conduct.[53]

Accordingly, two important elements courts consider in determining "entire fairness" in the context of a conflict-of-interest transaction, are (1) whether the challenged transaction "had been negotiated by an independent committee representing" the public stockholders, and (2) if such committee exists, whether the committee retained a disinterested and independent "investment banker or other financial expert or legal counsel" to assist it in carrying out its responsibilities.[54] Where special committees were created and empowered (and properly discharged their function), courts have recognized that there was strong evidence of "entire fairness" and placed the burden of demonstrating the "unfairness" of the transaction upon the person or entity challenging the transaction or seeking to impose liability on the corporate fiduciaries.[55]

---

[51]*Id.* at 430, 432-33. Justice Berger and President Judge Ridgely dissented, saying that the decision of the court of chancery should have been accorded greater deference by the supreme court:

> The majority's thorough and well reasoned decision reverses the trial court's equally thorough and well reasoned decision. According to the majority, the Court of Chancery did not err in its legal analysis, but in its evaluation of the facts — particularly with respect to the Special Committee members' independence, level of knowledge and involvement in the negotiations. The trial court recognized these 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. I respectfully dissent.

Id. at 434 (Berger, J., dissenting and Ridgely, P.J., joining).

[52]*See* Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1121 (Del. 1995).

[53]See *Tremont Corp.*, 694 A.2d at 429-30.

[54]Sealy Mattress Co. of N.J. v. Sealy, Inc., 532 A.2d 1324, 1336-37 (Del. Ch. 1987) (citing Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985); *see also* Wiegand v. Berry Petroleum Co., No. 9316, slip op. at 4 (Del. Ch. Mar. 27, 1991) (recognizing the importance of an independent committee and independent advisors in a conflict-of-interest transaction).

[55]*See Lynch Communications Sys.*, 638 A.2d at 1121; Citron v. E.I. DuPont de Nemours & Co., 584 A.2d 490, 500-02 (Del. Ch. 1990).

C. *Composition of the Special Committee*

Where a special committee is used to represent the interests of the public stockholders in the context of a conflict-of-interest transaction, one fundamental concern is the composition of the committee.[56] Specifically, a committee should be comprised solely of directors that (1) have no interest in the transaction at issue that is not shared by the stockholders generally, and (2) are independent, not "dominated" or "controlled," by persons or entities with a conflicting interest.[57]

In order to demonstrate director "interest," plaintiffs must allege that the director's decision was not "based entirely on the corporate merits of the transaction," but was "influenced by personal or extraneous considerations."[58] The party challenging the transaction or seeking to impose liability on the fiduciaries, also must establish that such "interest" was "material."[59] The Delaware Supreme Court defined "material" as a "subjective actual person" standard.[60] In adopting the language of the Delaware Court of Chancery, the Delaware Supreme Court held:

> "Under such a test of materiality [it] would be required to determine *not* how or whether a reasonable person in the same or similar circumstances . . . would be affected by a financial interest of the same sort as present in the case, but whether *this* director in fact was or would likely be affected." Thus, the "actual person" test requires an independent judicial determination regarding the materiality of the "*given*" director's self-interest.[61]

---

[56]*See Tremont Corp.*, 694 A.2d at 429.; *In re* RJR Nabisco, Inc. Shareholders Litig., No. 10,389 (Cons.), slip op. at 2 (Del. Ch. Jan. 31, 1989), *reprinted in* 14 DEL. J. CORP. L. 1132, 1142 (1989).

[57]*See* Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983).

[58]*Cede & Co.*, 634 A.2d at 362.

[59]*See, e.g.*, Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 595 n.7 (Del. Ch. 1986); *see also Cede & Co.*, 634 A.2d at 364 (stating that a "court must have flexibility in determining whether an officer's or director's interest in a challenged board-approved transaction is sufficiently material to find the director to have breached his duty of loyalty and to have infected the board's decision").

[60]Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995).

[61]*Id.* (quoting Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1151 (Del. Ch. 1994)).

For example, in *Cinerama, Inc. v. Technicolor, Inc.*,[62] the Delaware Court of Chancery held that a nonemployee director received a material benefit with respect to a merger that was not shared by the stockholders of the corporation (and, thus, was "interested" in the merger) because the director received a "finders fee of $150,000" upon the consummation of the merger.[63] Specifically, the Delaware Court of Chancery stated:

> Mr. Sullivan made money on the transaction . . . and apparently engaged in or instituted some trades in Technicolor stock while in possession of non-public information. The fee was fully disclosed to the board. That fact does not render him disinterested in the transaction. Plainly, a $150,000 cash payment contingent upon the closing of the deal is a circumstance that has a substantial probability of affecting the independence of Mr. Sullivan's judgment to the detriment of the company's shareholders, given all of the circumstances (*i.e.*, his very modest stock holding in the company).[64]

Where a court, applying the "actual person" test, determines that one or more directors, but less than a majority of directors, were interested in a transaction, the court must then determine whether the interested directors "controlled" or "dominated" the remaining disinterested directors.[65] As stated by the Delaware Court of Chancery:

> [A] financial interest in a transaction that is material to one or more directors less than a majority of those voting is "significant" for burden shifting purposes . . . when the interested director *controls* or *dominates* the board as a whole or when the interested director *fails to disclose his interest* in the transaction to the board *and* a reasonable board member would have regarded the existence of the material interest as

---

[62]No. 8358 (Del. Ch. June 21, 1991) (revised June 24, 1991), *reprinted in* 17 DEL. J. CORP. L. 551 (1992), *rev'd on other grounds*, 634 A.2d 345 (Del. 1993), *modified on reargument*, 636 A.2d 956 (Del. 1994).

[63]*Id.*, slip op. at *35, *reprinted in* 17 DEL. J. CORP. L. at 578.

[64]*Id.* *See also* Ryan v. Tad's Enters., 709 A.2d 682, 689-90 (Del. Ch. 1996) (concluding that a material conflicting personal interest existed where two of three directors negotiated consulting and noncompetition agreements in the context of an asset sale and merger that resulted in the two directors obtaining an additional $500,000 above their pro rata share of the proceeds from the transactions).

[65]*Cinerama*, 663 A.2d at 1153.

> a significant fact in the evaluation of the proposed transaction. In such circumstances the interested director cannot plausibly claim that the appropriate board processes upon which investors are required to place their trust, functioned and thus he cannot plausibly claim the benefits of the normal presumptions. Such a director would be required to prove the entire fairness of the transaction and face the risks of equitable remedies should he fail to do so.[66]

"Control" and "domination," however, are difficult terms to define with precision. As one court explained, such terms require that the interested director or controlling stockholder exercise "actual" control over the disinterested directors or, if a special committee has been created, the members of such committee.[67] In determining the existence of "actual" control, courts have suggested that directors who are employees of the corporation should be excluded from serving on special committees because such employment could make the directors "beholden" to the interested directors or the controlling stockholders.[68] Indeed, where a director, "personally or through his firm, was employed by" the corporation, such director is "potentially" under the control of the interested directors or the controlling stockholders, and, hence, lacks the necessary independence to serve on a committee.[69]

As explained by the Delaware Court of Chancery, in the context of a "parent-subsidiary" merger, where the members of the subsidiary's board were employees of the parent, such directors were deemed to be "beholden" to the parent:

---

[66]*Id.*; *see also* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 n.9 (Del. 1993) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair . . . .") (citing Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).

[67]Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1267 (Del. 1989).

[68]*See* Iseman v. Liquid Air Corp., No. 9694, slip op. at 7 (Del. Ch. Oct. 23, 1989), *reprinted in* 15 DEL. J. CORP. L. 1041, 1047 (1990); *In re* Formica Corp. Shareholders Litig., No. 10,598 (Cons.), 1989 Del. Ch. LEXIS 27, at *35-36 (Del. Ch. Mar. 22, 1989); *see also, e.g.*, Freedman v. Restaurant Assocs. Indus., No. 9212, slip op. at 21 (Del. Ch. Oct. 16, 1987), *reprinted in* 13 DEL. J. CORP. L. 651, 663 (1988).

[69]*Iseman*, No. 9694, slip op. at 7, *reprinted in* 15 DEL. J. CORP. L. at 1047; *see also In re* MAXXAM Inc., 659 A.2d 760, 774 (Del. Ch. 1995) (holding that three members of a five-member committee lacked independence because they "were receiving significant payments from [the controlling shareholder] as compensation for their services" as employees). *But see* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 938 n.7 (Del. 1985) (stating that an employee may serve on a special committee and still maintain independence).

> As key employees of Ohio-Sealy and Ohio Mattress, the individual defendants were entitled, indeed obligated, to demonstrate their loyalty to their employer whose directions they were bound to follow. But once having assumed the position of directors of Sealy, Inc., a corporation that had stockholders other than Ohio-Sealy, those defendants became fiduciaries for the minority shareholders, with a concomitant affirmative duty to protect the interests of the minority, as well as the majority, stockholders.[70]

Judicial decisions have also recognized that directors may be "beholden" to a controlling stockholder where the directors of the subsidiary are employees of the subsidiary, rather than the parent.[71] Accordingly, where directors of a subsidiary corporation also served as employees of either the subsidiary or the parent corporation, "[t]he fiduciary obligation they assumed was not unlike that of persons holding dual directorships in both a parent and subsidiary corporation."[72] With regard to such persons, the Delaware Supreme Court stated:

> There is no dilution of this [fiduciary] obligation where one holds dual or multiple directorships, as in a parent-subsidiary context. Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure . . . or the directors' total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies.[73]

Although courts have suggested that a special committee formed to negotiate with an interested fiduciary should be comprised of nonemployee directors,[74] the failure to comply with this suggestion may not "cause the transaction to be invalidated, provided that there are adequate

---

[70]Sealy Mattress Co. of N.J. v. Sealy, Inc., 532 A.2d 1324, 1337-38 (Del. Ch. 1987).

[71]*In re MAXXAM, Inc.*, 659 A.2d at 774.

[72]*Sealy Mattress Co.*, 532 A.2d at 1338.

[73]*Id.* (citing Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983)) (citations omitted).

[74]*See In re MAXXAM, Inc.*, 659 A.2d at 774; *Iseman*, No. 9694, slip op. at 7, *reprinted in* 15 DEL. J. CORP. L. at 1047; *In re* Formica Corp. Shareholders Litig., No. 10,598 (Cons.), 1989 Del. Ch. LEXIS 27, at *30 (Del. Ch. Mar. 22, 1989).

countervailing procedural safeguards, calculated to protect the shareholders' interests."[75] In *Rosenblatt v. Getty Oil Co.*,[76] for example, the Delaware Supreme Court recognized as independent a special committee where two members of the three-member negotiating committee of Skelly Oil Company (Skelly), a corporation controlled by Getty Oil Company (Getty), were employees of Skelly.[77] Notwithstanding the presence of employees of the subsidiary corporation on the special committee, the Delaware Supreme Court held:

> As to the negotiations themselves, it is obvious that the divergence in objectives insured the arm's length quality of the bargaining between the Getty and Skelly teams on asset value. In fact, Skelly's attempt to obtain the highest possible value . . . nearly caused the collapse of negotiations on at least two occasions . . . . Moreover, Skelly's persistent efforts to obtain a high price forced the parties to turn to [an independent appraiser] to render, alone, the final subsurface asset value.[78]

Apparently, in *Rosenblatt*, notwithstanding the presence of employee directors on the special committee, the court recognized that there were adequate countervailing procedural safeguards calculated to protect the interests of the public stockholders of Skelly, including:

- the "arm's length" and "adversarial" negotiations between the special committee and Getty;
- the substantial economic resources and manpower Skelly and Getty devoted to evaluate separately their respective assets and then negotiate of those values;
- the "asset-by-asset bargaining" between the special committee and Getty;
- the absence of "credible evidence" indicating that Getty dictated the terms of the transaction;

---

[75] *In re Formica Corp.*, 1998 Del. Ch. LEXIS 27, at *36 n.14.
[76] 493 A.2d 929 (Del. 1985).
[77] *Id.* at 938 n.7.
[78] *Id.* at 938.

- the delegation by Skelly and Getty of the valuation of subsurface assets to an appraiser that had "the requisite reputation and experience to assist" the parties and was not "beholden" to either party; and

- the questioning by the Skelly board of directors of representatives of Getty, two investment banking firms (one representing Getty and one representing Skelly), Skelly's counsel and counsel for a stockholder threatening legal action.[79]

In addition to employment, Delaware courts have also addressed the issue of "actual" control where directors have consultation agreements with the corporation.[80] Specifically, in *Kahn v. Dairy Mart Convenience Stores, Inc.*,[81] the Delaware Court of Chancery recognized that a consulting agreement between a corporation and a nonemployee director appointed to a special committee created and empowered to consider a leveraged-buyout merger (LBO) proposed by senior management raised a factual issue regarding the director's independence.[82] In denying defendants' motion for summary judgment, the Delaware Court of Chancery stated:

> It must be inferred, at least on this record, that the arrangement was beneficial to [the director] and that he had an interest in its continuation. However, continuation of those benefits would depend upon the ongoing good will of [management], who would control Dairy Mart regardless of the outcome of the special committee's deliberations. It may be that the value of the consulting arrangement was so *de minimis* that it could not have influenced [the director's] ability to consider the LBO proposal impartially. But that conclusion cannot be drawn as a matter of law on this record. There is at the very least a material fact question regarding [the director's] ability to act independently, since it may be inferred that he was beholden to . . . senior management for the continuation of his consulting agreement.[83]

---

[79] *Id.* at 937-43.

[80] *See* Kahn v. Dairy Mart Convenience Stores, Inc., No. 12,489 (Del. Ch. Mar. 29, 1996), *reprinted in* 21 DEL. J. CORP. L. 1143 (1996).

[81] *Id.*

[82] *Id.*, slip op. at 14, *reprinted in* 21 DEL. J. CORP. L. at 1157.

[83] *Id.*

The value of employment and consultation agreements between the director and the corporation, however, may be outweighed by other interests that the director shares with the stockholders of the corporation generally.[84] In *Kidsco Inc. v. Dinsmore*,[85] the court of chancery denied plaintiff's motion to enjoin a merger, holding that, although a director was "to receive monies under an agreement to consult with" the potential acquiror, the director's "financial interest under that agreement was far outweighed by his interest in maximizing the value of his 15.7% stock interest in" the corporation.[86] The court, therefore, concluded that the director "had no material conflicting self interest that would cause him to act other than in the best interests of" the corporation's stockholders.[87]

Simply stated, the existence of an employment or consultation agreement between a director and the corporation is not a dispositive fact in determining whether a disinterested director was controlled or dominated by an interested fiduciary. The existence of such an agreement, however, creates the "potential" for dependence and such potential (where coupled with additional facts) could result in a court deciding that a disinterested director was controlled or dominated by the interested fiduciaries.

Although less frequently encountered as the basis for an asserted lack of independence, nonmonetary relationships with an interested fiduciary or the corporation also could defeat claimed independence.[88] For example, courts have determined that, under certain circumstances, individuals with a personal relationship with an interested director or controlling stockholder could not be sufficiently independent to act on behalf of public stockholders.[89]

D. *The Advisors to the Special Committee*

Financial and legal advisors to a special committee, like directors serving on such committee, should be free of any conflict of interest.[90]

---

[84]Kidsco Inc. v. Dinsmore, 674 A.2d 483 (Del. Ch. 1995), *aff'd mem.*, 670 A.2d 1338 (Del. 1995).

[85]*Id.*

[86]*Id.* at 494.

[87]*Id.*

[88]*See* Packer v. Yampol, No. 8432, slip op. at 35-36 (Del. Ch. Apr. 18, 1986) (revised Apr. 22, 1986), *reprinted in* 12 DEL. J. CORP. L. 332, 354 (1987).

[89]*See, e.g.*, *id.* (noting that directors who were having a personal relationship with an interested director were determined not to be independent in the context of a proxy contest).

[90]Although the majority of cases addressing the "independence" of advisors to a committee involve financial advisors, courts have recognized "that no role is more critical with respect to protection of shareholder interest in these matters than that of the expert lawyers who

Although advisors that have "no previous business relationship with" the corporation are preferable because such advisors would be "able to function as independently and in as conflict-free a manner as possible,"[91] courts have sustained directors' decisions to retain advisors notwithstanding allegations made by stockholders that such advisors lacked independence because the advisors had a prior or current relationship with the corporation.[92] In fact, courts have recognized that the prior or current employment by the corporation of the advisors to the special committee is not a dispositive factor—a court must consider such factor in light of a "multitude of factors" in reviewing the transaction.[93] The presence of a relationship, however, may cause a court to more closely scrutinize the judgment of advisors where such judgment is challenged. As the Delaware Court of Chancery has stated:

> The committee's own financial advisors . . . informed the committee that based upon management's earnings projections, the $15 price fell outside the range of fairness. Rather than attempt to negotiate a higher price within the range developed by [the financial advisors], the committee permitted [the financial advisors] to adjust the projections (and, hence, the fairness range) downward. That was done in

---

guide sometimes inexperienced directors through the process." *In re* Fort Howard Corp. Shareholders Litig., No. 9991 (Cons.), slip op. at 30 (Del. Ch. Aug. 8. 1988), *reprinted in* 14 DEL. J. CORP. L. 699, 720 (1989); *see also* Berlin v. Emerald Partners, 552 A.2d 482, 485 n.2 (Del. 1989) (noting with approval that the legal advisors retained by the outside directors had never represented either the controlling stockholder or the corporation).

[91]*In re* Formica Corp. Shareholders Litig., No. 10,598 (Cons.), 1989 Del. Ch. LEXIS 27, at *36 (Del. Ch. Mar. 22, 1989); *see also* Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997) (holding that a special committee was not sufficiently independent to shift burden of proof to plaintiffs under an "entire fairness" standard of judicial review because, among other things, an affiliate of the financial advisor to the special committee and the controlling stockholder had a previous relationship).

[92]*See, e.g.*, Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) (noting that notwithstanding an appraiser's past relationship with both a parent corporation and its subsidiary, in the context of a parent-subsidiary merger, there was "no proof that [the appraiser] lacked independence or was in any way beholden to either party"); Kahn v. Caporella, No. 13,248, 1994 Del. Ch. LEXIS 29, at *20 (Del. Ch. Mar. 10, 1994) ("[T]here is no evidence that those prior engagements were extensive or in any way affected the advisors' loyalties in the current matter."); *see also, e.g.*, Roberts v. General Instrument Corp., No. 11,639, slip op. at 26 (Del. Ch. Aug. 13, 1990), *reprinted in* 16 DEL. J. CORP. L. 1540, 1560 (1991) (committee retained corporation's investment banker); *In re* RJR Nabisco, Inc. Shareholders Litig., No. 10,389 (Cons.), slip op. at 11 (Del. Ch. Jan. 31, 1989), *reprinted in* 14 DEL. J. CORP. L. 1132, 1142 (1989) (committee retained the corporation's and one other investment banker).

[93]*In re* Formica Corp. Shareholders Litig., No. (Cons.), 1989 Del. Ch. LEXIS 27, at 36 n.14 (Del. Ch. Mar. 22, 1989).

> response to [a director's] suggestion that the projections were "aggressive." The defendants portray that decision as one of pure valuation judgment, and so it may have been. But, the record also permits the inference, arising from [a financial advisor's] prior involvements with the [corporation's] management group, of a possible motivation for her firm to secure future professional business from the . . . management group, which would remain in control of [the corporation] whether or not the [leveraged buyout transaction] went forward. That inference may ultimately prove incorrect, but given the present procedural posture and state of the record, it cannot be disregarded at this stage.[94]

Courts particularly have questioned the judgment of special committees where such committees have retained advisors that performed services for interested parties (i.e., the interested directors or the controlling stockholders) in connection with the transactions that the special committees were created and empowered to address.[95] In *Tremont*, for example, a majority of the Delaware Supreme Court criticized a special committee's advisors in determining whether the actions of the special committee would shift the burden of demonstrating "unfairness" to the stockholder challenging the transaction.[96] Specifically, the special committee was advised by financial and legal advisors, and the court noted that (1) an affiliate bank of the financial advisor previously had earned significant fees from companies affiliated with Tremont's controlling stockholder, and (2) the special committee's legal advisor previously had been retained by a company affiliated with the controlling stockholder.[97] The court held that such prior relationships between the advisors and the controlling stockholder of Tremont raised issues concerning the independence of the advisors.[98] In addition, the manner in which the advisors were retained troubled the court—the financial advisor was recommended by the special committee's chairman and "quickly retained" by the committee, and the legal advisor had been recommended by the

---

[94]Kahn v. Dairy Mart Convenience Stores, Inc., No. 12,489, slip op. at 20-21 (Del. Ch. Mar. 29, 1996), *reprinted in* 21 DEL. J. CORP. L. 1143, 1160-61 (1996).

[95]*See* Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997); Ryan v. Tad's Enters., 709 A.2d 682 (Del. Ch. 1996).

[96]*Tremont Corp.*, 694 A.2d at 429-30.

[97]*Id.* at 430.

[98]*Id.*

general counsel of Tremont.[99] Accordingly, the court concluded that the advisors "did little to bolster the independence" of the committee itself.[100]

Similarly, in *Ryan v. Tad's Enterprises*,[101] the Delaware Court of Chancery questioned the disinterestedness and independence of the directors' financial and legal advisors because such advisors were advising both the interested directors and the public stockholders in connection with a merger. The court there explained that:

> [t]he defendants were required to, but did not, demonstrate that they took measures that would have offset or neutralized the [interested directors'] inherent conflict of interest. Neither Bressler, as legal counsel, nor Muller, as financial advisor, were shown to have independently or adequately represented the distinctive interests of the minority shareholders . . . . Bressler, who was acting for both the [corporation's] shareholders and the [interested directors] personally, and who owned no significant stock interest in his own right, could hardly have been counted on to vigorously advocate the interests of the minority shareholders. To do so would compromise the individual interests of his clients, the [interested directors]. For its part, Muller had been retained by the majority-interested board, and it was not asked . . . to assist in negotiating against the conflicted directors on behalf of the minority stockholders.[102]

In sum, where a special committee retains an advisor that "performed services for [an affiliate of the controlling stockholder] and apparently continued to represent both the special committee (the seller) and [the affiliate] (one of the buyers)," a court must question both "[t]he conduct of the special committee" and the disinterestedness and independence of the members of the special committee and the advisor.[103] At a minimum, therefore, a special committee should avoid retaining

---

[99] *Id.*

[100] *Tremont Corp.*, 694 A.2d at 430.

[101] 709 A.2d 682 (Del. Ch. 1996).

[102] *Id.* at 691-92.

[103] Iseman v. Liquid Air Corp., No. 9694, slip op. at 7 (Del. Ch. Oct. 23, 1989), *reprinted in* 15 DEL. J. CORP. L. 1041, 1047 (1990). *See also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1268-69, 1281 (Del. 1989) (questioning the independence of advisors to a committee in a management leveraged buyout transaction, where such advisors had previously performed services for management in connection with the buyout); Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1233-34 (Del. Ch. 1988) (same).

advisors that performed services for the interested fiduciaries in connection with the conflict-of-interest transaction being addressed by the committee, and, preferably, should retain advisors with no previous or current business relationship with those fiduciaries or the corporation. Moreover, the special committee should carefully and independently determine the advisors that are retained to assist the special committee in discharging its duties.

III. DERIVATIVE LITIGATION INVOLVING INTERESTED DIRECTORS

A. *Background*

All jurisdictions require that, prior to filing a derivative action, a stockholder generally must demand that the corporation's board of directors cause the corporation to pursue the alleged claim.[104] Delaware Court of Chancery Rule 23.1, for example, mandates that, in a derivative action, "[t]he complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."[105] The rationale underlying the demand requirement is that, unlike a claim that a plaintiff brings to enforce a right the plaintiff possesses personally, a derivative claim is brought on behalf of a corporation to remedy an injury purportedly suffered by the corporation.[106] The corporation, therefore, and not the individual stockholder, is the real plaintiff.[107]

Consistent with its underlying rationale, the demand requirement mandates that stockholders "seek redress of their grievances through the corporation's board of directors, or, alternatively, . . . justify their entitlement to act on the corporation's behalf independently of the board."[108] Indeed, the demand requirement is designed to effectuate "the

---

[104]*See, e.g.*, FED. R. CIV. P. 23.1 (requiring that a stockholder must make a demand upon the directors of a corporation or plead that demand was futile prior to commencing a derivative action); CAL. CORP. CODE § 800(b)(2) (West 1990) (same); DEL. CH. CT. R. 23.1 (same); N.Y. BUS. CORP. LAW § 626(c) (McKinney 1986) (same).

[105]DEL. CH. CT. R. 23.1.

[106]*See, e.g.*, Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) (stating that in a derivative suit, "a shareholder asserts on behalf of a corporation a claim belonging not to the shareholder, but to the corporation").

[107]*See* Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993); *Levine*, 591 A.2d at 200; Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

[108]Levine v. Smith, No. 8833, slip op. at 10 (Del. Ch. Nov. 27, 1989), *reprinted in* 16 DEL. J. CORP. L. 333, 343 (1991), *aff'd*, 591 A.2d 194 (Del. 1991).

fundamental principle that the board of directors normally controls the corporation's actions and policies."[109] Accordingly, as recently stated by the Delaware Supreme Court:

> The demand requirement serves a salutary purpose. First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether. Second, if litigation is beneficial, the corporation can control the proceedings. Third, if demand is excused or wrongfully refused, the stockholder will normally control the proceedings.[110]

Under Delaware Court of Chancery Rule 23.1, for example, where a plaintiff files a derivative action without first making a demand upon the board of directors to rectify the matters about which the plaintiff complains the derivative action will only be allowed to proceed where a court is satisfied that the particularized facts in the complaint create a "reasonable doubt" as to either (1) the disinterestedness or independence of a majority of the directors, or (2) whether a majority of the directors exercised proper

---

[109]*Id.* (citing *Aronson*, 473 A.2d at 811-12; *see also Rales*, 634 A.2d at 932 (holding that Chancery Court Rule 23.1 "constitutes the procedural embodiment of [the] substantive principle of corporation law" that directors, not shareholders, manage the corporation); Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) ("The decision to bring a law suit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation."). Federal law under Rule 23.1 of the Federal Rules of Civil Procedure is identical. As stated by the Seventh Circuit, the demand requirement

> allows directors to make a business decision about a business question: whether to invest the time and resources of the corporation in litigation . . . . Choosing between litigation and some other response may be difficult, depending on information unavailable to courts and a sense of the situation in which business executives are trained. . . . If principles such as the "business judgment rule" preserve room for managers to err in making an operational decision, so too they preserve room to err in deciding what remedies to pursue.

Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1342-43 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991) (citations omitted). Similarly, as the Second Circuit explained: "Whether a corporation should bring a lawsuit is a business decision, and the directors are, under the laws of every state, responsible for the conduct of the corporation's business, including the decision to litigate." RCM Sec. Fund, Inc. v. Stanton, 928 F.2d 1318, 1326 (2d Cir. 1991) (citations omitted).

[110]Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996).

business judgment in connection with the challenged transaction.[111] The purpose of this test is to allow a court "to determine who is entitled, as between the corporation and its shareholders, to assert the plaintiff's underlying substantive claim on the corporation's behalf."[112] In sum, where demand upon directors is not made, as explained by the Delaware Supreme Court, "[t]he jurisprudence of *Aronson* and its progeny is designed to create a balanced environment,"[113] empowering a court either to "deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms," or to "permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt" that a majority of the directors (1) was disinterested and independent, or (2) exercised proper business judgment in connection with the challenged transaction.[114]

---

[111]*See Aronson*, 473 A.2d at 814; *see also, e.g., Levine*, 591 A.2d at 205 (applying the standard adopted by the Delaware Supreme Court in *Aronson*); Grobow v. Perot, 539 A.2d 180, 186, 188 (Del. 1988) (same).

[112]*Levine*, No. 8833, slip op. at 14, *reprinted in* 14 DEL. J. CORP. L. at 345. Federal law is in accord. As recognized by the Seventh Circuit, demand would be considered "futile" where the directors have a disabling conflict-of-interest, not where the directors disagree with the contentions of the shareholder that made the demand:

> A demand is "futile" only if the directors' minds are closed to argument. That the directors disagreed with an argument could show their unwillingness to listen, but also could show that the argument was feeble. Demand enables the directors to take the leading role in managing the corporation. Conscientious managers may conclude that legal action is unjustified because [it is] not meritorious, or because it would subject the firm to injury. This is why courts assess futility *ex ante* rather than *ex post*. To say that a demand would have been futile because the directors proved unsympathetic to the lawsuit is like saying that sending Mickey Mantle to the plate with the bases loaded was futile because he struck out.

Kamen v. Kemper Fin. Servs., Inc., 939 F.2d 458, 462 (7th Cir. 1991) (citations omitted).

[113]*Grimes*, 673 A.2d at 1217.

[114]*Id.*; *see also* Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute*, 48 BUS. LAW. 1443, 1454 (1993) (discussing that some lawsuits may not be cost efficient).

> The rationale underlying the demand requirement is in no way diminished by the fact that causes of action having merit may exist that the corporation has not pursued or may not be inclined to pursue. A board of directors may decide against bringing an action, for example, where "the litigation costs and the adverse effect on the business relationship between the corporation and the potential defendant might outweigh any potential recovery in the lawsuit." Even where "something must be done," acts short of litigation can have net benefits exceeding those of litigation. Indeed, even where a lawsuit "seems to have good prospects and a positive value," the lawsuit "still may be an unwise business decision because of the value of managerial time that would have to be invested, time unavailable to pursue the principal business of the corporation." In short, a board must be given an opportunity in such a case to determine "whether the chances for

Where a stockholder makes a demand upon the directors, however, and the directors refuse to pursue the action set forth in the demand, the directors' decision is protected by the presumption of the business judgment rule unless a stockholder challenging such decision demonstrates that the decision was wrongful.[115] To demonstrate "wrongful refusal" of a demand, a stockholder challenging the decision of the directors must demonstrate with the same degree of particularity required to establish that demand should be excused under Chancery Court Rule 23.1 that the directors acted in bad faith or failed to undertake a reasonable investigation of the claim.[116]

B. *Director Disinterestedness and Independence*

To show that demand was excused or wrongfully refused under Delaware law, a plaintiff must allege particularized facts which, if true, demonstrate that a majority of a board of directors was personally interested in the transaction underlying the complaint.[117] "Personal interest" in connection with the demand requirement has been described as "either a financial interest or entrenchment on the part of the . . . directors."[118] Further, "[d]irectorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders."[119] Indeed, "[i]n such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision."[120]

> a successful suit, the costs of maintaining a suit, and other factors militate in favor of instituting such an action."

Id. (quoting Zauber v. Murray Sav. Ass'n, 591 S.W.2d 932, 936 (Tex. Civ. App. 1979))(footnotes omitted).

[115]*See Levine*, 591 A.2d at 209-10; Spiegel v. Buntrock, 571 A.2d 767, 777-78 (Del. 1990); Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).

[116]*See Levine*, 591 A.2d at 212. In undertaking the investigation of the derivative claim underlying the demand, commentators have emphasized:

> There is no rule, statute, or decision which mandates a particular methodology to be followed by a board.... The board may be advised by a disinterested committee of the board, it may act on its own knowledge of the facts, or it may base its decision on a report of the general counsel or some other officer or agent. The matter is one of good faith, objectivity, due care, common sense, and good counseling.

Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 508 (1989).

[117]*See* Grobow v. Perot, 539 A.2d 180, 188-89 (Del. 1988); *Aronson*, 473 A.2d at 812.

[118]*Grobow*, 539 A.2d at 188.

[119]Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993).

[120]*Id.*

Not every personal benefit or detriment realized by a director resulting from a challenged board action raises a reasonable doubt that the director was disinterested.[121] To create a reasonable doubt as to director disinterestedness, "the conflicting self-interest must be material."[122] As explained by the Delaware Court of Chancery:

> [I]n assessing whether there is a reasonable doubt that a board decision was tainted by a conflicting self-interest, the court must consider facts bearing on the significance or magnitude of the alleged conflicting financial interests at stake. Where no particularized facts on that subject are pleaded, the court may conclude that no reasonable doubt as to the directors' disinterest has been established.[123]

The rationale for such a pleading requirement is that directors cannot act as objective decision makers where they "appear on both sides of the transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[124] In sum, to be objective decision makers, directors "must be able to act free of personal financial interest and improper extraneous influences."[125]

If a plaintiff fails to demonstrate that a majority of the board of directors is "interested," a derivative complaint must otherwise "raise a reasonable doubt of director independence."[126] This requires stockholders to allege with particularity that a majority of the "directors were dominated or otherwise controlled by an individual or entity interested in the

---

[121]*See, e.g.*, *Grobow*, 539 A.2d at 188 (stating that allegations that directors receive fees for their services are insufficient, without more, to demonstrate a material financial interest); *Aronson*, 473 A.2d at 815 ("[T]he mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors . . . .").

[122]Rothenberg v. Santa Fe Pac. Corp., No. 11,749, slip op. at 9 (Del. Ch. Sept. 5, 1995), *reprinted in* 21 DEL. J. CORP. L. 309, 317 (1996); *see also* Bodkin v. Mercantile Stores Co., No. 13,770, slip op. at 6-7 (Del. Ch. Nov. 1, 1996), *reprinted in* 22 DEL. J. CORP. L. 1156 (1997) (holding that the alleged conflicting interest must be material).

[123]*Rothenberg*, No. 11,749, slip op. at 9, *reprinted in* 21 DEL. J. CORP. L. at 317.

[124]*Aronson*, 473 A.2d at 812.

[125]Rales v. Blasband, 634 A.2d 927, 935 (Del. 1993); *see also Bodkin*, No. 13,770, slip op. at 6 , *reprinted in* 22 DEL. J. CORP. L. at 1160 (holding that the alleged interest must be an interest not shared by the stockholders of the corporation generally).

[126]*Grobow*, 539 A.2d at 189.

transaction."[127] As the Delaware Court of Chancery explained, "[A]t a minimum" such terms imply that stockholders allege that the directors adopt "a direction of corporate conduct comport[ing] with the wishes or interests of the" controlling person or entity rather than the interests of the corporation that the directors serve.[128]

Specifically, to properly allege domination or control of the board, especially where the dominating entity owns less than a majority of the corporation's stock,[129] a plaintiff must allege facts with particularity evidencing that the board could not have exercised its independent business judgment.[130] As stated by the Delaware Supreme Court in its landmark decision in *Aronson*: "[A] plaintiff charging domination or control of one or more directors must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.'"[131]

In applying this standard, conclusory allegations asserting that disinterested directors are dominated or controlled by the "interested" party because of their current or former status as formerly officers or consultants to the corporation are insufficient to demonstrate that the disinterested directors lacked independence.[132] Similarly, it is insufficient to allege that disinterested directors lack independence based upon conclusory allegations that such directors have financial dealings with the "interested" party or the corporation that are unrelated to the conduct set forth in the complaint:

---

[127]*Id.* (citing *Aronson*, 473 A.2d at 815-16); *see also Bodkin*, No. 13,770, slip op. at 9, *reprinted in* 22 DEL. J. CORP. L. at 1164 (holding that in order to demonstrate that certain directors lacked independence, plaintiff initially must allege particularized facts which demonstrate that the dominating and controlling fiduciary had a disabling conflict of interest).

[128]Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971); *see also* Pogostin v. Rice, 480 A.2d 619, 626 (Del. 1984) (finding that a "material" interest must afflict a majority of the corporation's directors).

[129]The Delaware Court of Chancery, however, held that "[s]tock ownership alone, even a majority interest, is insufficient proof of 'domination or control' over the board of directors." Katz v. Halperin, No. 13,811, slip op. at 24 (Del. Ch. Feb. 5, 1996) (revised Feb. 8, 1996), *reprinted in* 21 DEL. J. CORP. L. 690, 704 (1996) (quoting *Aronson*, 473 A.2d at 815).

[130]*See Rales*, 634 A.2d at 936 ("To establish lack of independence, [plaintiff] must show that the directors are 'beholden' to [the interested parties] or so under their influence that their discretion would be sterilized."); Levine v. Smith, 591 A.2d 194, 205 (Del. 1991) ("[P]laintiff must show that the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is 'sterilize[d].'") (quoting Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981)).

[131]473 A.2d at 816 (quoting *Centex Corp.*, 284 A.2d at 123).

[132]*See id.* at 815-16; Lewis v. Aronson, No. 6919, slip op. at 10-11 (Del. Ch. May 1, 1985), *reprinted in* 11 DEL. J. CORP. L. 243, 249-50 (1986).

> The complaint also contains allegations of extensive business relationships between the various directors and [an interested director]. The existence of these relationships, absent more, is also insufficient to excuse the failure to make a pre-suit demand. No facts are alleged which suggest that the directors would not have retained their other positions unless they acted in accordance with [the interested shareholder's] wishes.[133]

At a minimum, a plaintiff must allege particularized facts which demonstrate that such financial dealings relate to the challenged conduct and are "material."[134]

In *Aronson*, for example, the Delaware Supreme Court held that pre-litigation demand was not excused,[135] notwithstanding the following allegations asserted by plaintiff:

- The board of directors was "dominated and controlled" by an interested director by virtue of his 47% stock ownership in the corporation;[136]
- Five members of a ten-member board of directors were officers or employees of the corporation or had financial dealings with the corporation;[137]
- Collectively, five members of a ten-member board of directors owned "a clear majority interest of 57.5% of the stock" of the corporation;[138] and
- The interested director "personally selected each" member of the board of directors.[139]

---

[133]Stein v. Orloff, No. 7276, slip op. at 11 (Del. Ch. May 30, 1985), *reprinted in* 11 DEL. J. CORP. L. 312, 318 (1986).

[134]*See Rales*, 634 A.2d at 936; *see also* Rothenberg v. Santa Fe Pac. Corp., No. 11,749, slip op. at 9 (Del. Ch. Sept. 5, 1995), *reprinted in* 21 DEL. J. CORP. L. 309, 317 (1996) (finding that to excuse demand, "the conflicting self-interest must be material").

[135]*See Aronson*, 473 A.2d at 815-18, *rev'g* Lewis v. Aronson, 466 A.2d 375 (Del. Ch. 1983).

[136]*Lewis*, 466 A.2d at 379, 381.

[137]*Id.* at 381.

[138]*Id.* at 381-82.

[139]*Id.* at 382.

Thus, under the holding in *Aronson*, "the fact that [directors] hold positions with the company," or have other financial dealings with the company, does not sufficiently support an allegation that such directors lacked independence.[140]

Consistent with the decision in *Aronson*, the Delaware Supreme Court in *Rales v. Blasband*,[141] in determining that demand should be excused, based its holding primarily upon a related decision of the Third Circuit and two facts (each pleaded with particularity) that, when viewed as a whole, created a reasonable doubt that the directors were disinterested and independent in connection with the challenged transaction.[142] Specifically, in *Rales*, plaintiff demonstrated that five members of an eight-member board of directors were either interested in the challenged transaction or lacked independence.[143] In connection with the "interestedness" of three of the directors, the Delaware Supreme Court turned to a previous decision of the Third Circuit, and held:

> We conclude that [three directors, including defendants Steven M. Rales and Mitchell P. Rales] the Rales Brothers . . . must be considered interested in a decision of the Board in response to a demand addressing the alleged wrongdoing described in Blasband's amended complaint. Normally, "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors. . . ." Nevertheless, the Third Circuit has already concluded that "Blasband has pleaded facts raising at least a reasonable doubt that the . . . use of proceeds from the [transaction] was a valid exercise of business judgment." This determination is part of the law of the case, and is therefore binding upon this Court. Such determination indicates that the potential for liability is not "a mere threat" but instead may rise to "a substantial likelihood."[144]

---

[140]Lewis v. Aronson, No. 6919, slip op. at 10-11 (Del. Ch. May 1, 1985), *reprinted in* 11 DEL. J. CORP. L. 243, 250 (1986).

[141]634 A.2d 927 (Del. 1993).

[142]*Id.* at 937.

[143]*Id.* at 936-37.

[144]*Id.* at 936 (citations omitted).

After adopting the holding of the Third Circuit regarding the "interestedness" of the directors, the Delaware Supreme Court addressed the "independence" of two of the directors, and held:

- At all relevant times (including the period of time following the filing of the complaint) defendant Steven M. Rales was Chairman of the board of directors and defendant Mitchell P. Rales was Chairman of the Executive Committee of the board of directors of Danaher Corporation (Danaher), placing "them in a position to exert considerable influence over" a director of Danaher who was also the President and Chief Executive Officer of Danaher and received a salary of approximately $1 million per year from Danaher;[145] and

- The Rales Brothers were directors and controlling stockholders of Wabash National Bank, placing them in a position to influence a director of Danaher who was also the President of Wabash.[146]

In applying the rationale set forth in *Aronson* and *Rales*, the Delaware courts have recognized that (where considered in the context of other facts alleged with particularity in the complaint that demonstrated a lack of independence) being an employee of the corporation,[147] receiving a consulting fee from the corporation,[148] or being a legal (or financial) advisor to the corporation[149] may create a reasonable doubt as to the independence of a director where a director interested in the challenged transaction possesses the authority to exert considerable influence over

---

[145]*Rales*, 634 A.2d at 936.

[146]*Id.* at 937.

[147]*See, e.g.*, Steiner v. Meyerson, No. 13,139, slip op. at 23 (Del. Ch. July 18, 1995), *reprinted in* 21 DEL. J. CORP. L. 320, 336 (1996) (indicating that the facts created a reasonable doubt that a corporation's president, chief operating officer and chief financial officer would have responded to a demand based upon "extraneous considerations or influences" rather than the corporate merits of the demand letter) (quoting *Rales*, 634 A.2d at 936).

[148]*See, e.g.*, Friedman v. Beningson, No. 12,232, slip op. at 12 (Del. Ch. Dec. 4, 1995), *reprinted in* 21 DEL. J. CORP. L. 659, 667 (1996) (holding that the receipt of a consulting fee, which was approximately $48,000 per year, when considered in the context of other facts alleged, created a reasonable doubt of a director's independence).

[149]*See, e.g.*, *Steiner*, No. 13,139, slip op. at 24-25, *reprinted in* 21 DEL. J. CORP. L. at 336 (discussing that the fact that a director's law firm received nearly $1 million for services provided to a corporation, when considered with other facts alleged, raised a reasonable doubt concerning the director's independence in assessing the merits of a demand letter).

such financial arrangement.[150] As explained by the Delaware Court of Chancery, a court considers such factors, in light of many, in determining whether directors possess the requisite independence to assess the merits of a demand letter:

> There is inescapably a question of judgment to be made by the trial court in [applying the standard established in *Aronson*]; what is required is the sound exercise of discretion. Terms like reasonable doubt, for example, help guide judgment but, are not scientific. In making the required judgment no single factor — such as receipt of directorial compensation; family or social relationships; approval of the transaction attacked; or other relationships with the corporation (*e.g.*, attorney or banker) — may itself be dispositive in any particular case.[151]

Simply stated, "[T]he question is whether the accumulation of all factors creates the reasonable doubt to which *Aronson* refers."[152]

C. *Special Litigation Committees*

Although a stockholder may have a right to commence a derivative action against directors where it is demonstrated that demand is not required, such stockholder does not have a right to control the action after it has been filed. In *Zapata Corp. v. Maldonado*,[153] for example, the Delaware Supreme Court created a procedure that permits directors to take control of an action properly filed by a stockholder and to cause its dismissal.[154] Specifically, the Delaware Supreme Court acknowledged that the directors could (1) designate a special litigation committee to review the merits of the action demanded and to determine whether the action is in the best interests of the corporation;[155] and (2) empower such committee

---

[150]*See id.*; *see also In re* NVF Co. Litig., No. 9050 (Cons.), slip op. at 12 (Del. Ch. Nov. 21, 1989), *reprinted in* 16 DEL. J. CORP. L. 361, 374 (1991) (noting that directors having a "family relationship" with controlling stockholders were determined not to be independent under the standard established in *Aronson*).

[151]Harris v. Carter, 582 A.2d 222, 229 (Del. Ch. 1990) (citations omitted).

[152]*Id.*

[153]430 A.2d 779, 785 (Del. 1981).

[154]*Id.* at 785.

[155]The Delaware Supreme Court has recognized "that in demand-excused cases the board of directors may sometimes reassert its authority over a derivative claim in certain instances through the device of the [s]pecial [l]itigation [c]ommittee." Grimes v. Donald, 673

to terminate the action where it is determined that the action lacks merit or, if meritorious, is detrimental to the best interests of the corporation.[156] A decision to terminate the action, however, would be accepted and approved by a court only after the court, applying a standard "akin to [the standard for a Rule 56 motion for] summary judgment," makes determinations with respect to the two-step standard established in *Zapata*.[157]

Under the first step, the court must determine whether the members of the committee have demonstrated that they were in fact independent and disinterested and had conducted a reasonable investigation with respect to the action.[158] Unlike judicial review under the business judgment rule,[159] there is no "presumption" of regularity, and the corporation has the burden of demonstrating disinterestedness and independence, and the reasonableness of the investigation.[160] Where a corporation satisfies its burden, the court may "in its discretion" (1) accept and approve the decision of the committee, and grant the motion to dismiss the action, or

---

A.2d 1207, 1216 n.13 (Del. 1996). The supreme court emphasized that where demand is not excused, however, "[t]he use of a committee of the board formed to respond to a demand or to advise the board on its duty in responding to a demand is not the same as the [special litigation committee] process contemplated by *Zapata* .... It is important that these discrete and quite different processes not be confused." *Id.*; *see also* Boeing Co. v. Shrontz, No. 11,273, 1994 Del. Ch. LEXIS 14, at *5 (Del. Ch. Jan. 19, 1994) (noting that the board of directors refused a demand based upon a recommendation of a committee of the board).

Further, the creation of a committee in response to a derivative action does not operate as a concession by directors that demand would be futile. As the Delaware Supreme Court noted, "a board of directors concedes demand futility when it is *both* interested *and* establishes a special litigation committee to resolve the derivative plaintiff's suit." Levine v. Smith, 591 A.2d 194, 209 (Del. 1991) (emphasis added); *see also* Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990) (upholding procedure); Seminaris v. Landa, 662 A.2d 1350, 1353 (Del. Ch. 1995) (holding same). In sum, "a disinterested board of directors does not waive its right to control derivative litigation merely by delegating that control to a special committee." *Id. Compare* Abbey v. Computer & Communications Tech. Corp., 457 A.2d 368, 373-74 (Del. Ch. 1983) (holding that the board of directors' decision to refer a demand to a special litigation committee and delegate the power to determine the corporation's position to such committee "in effect" conceded that the board of directors, acting as a body, was not capable to act upon the demand; thus, such decision by the board of directors demonstrated that demand was excused) *with* Richardson v. Graves, No. 6617, 1983 Del. Ch. LEXIS 466, at *11 (Del. Ch. June 17, 1983) (distinguishing *Abbey* on the ground that the board of directors in *Richardson* filed a motion to dismiss based upon plaintiff's failure to satisfy the demand requirement, pursuant to Court of Chancery Rule 23.1, before the board of directors "by resolution decide[d] to appoint a special litigation committee to investigate and make a determination"; by moving to dismiss before appointing such committee, the board of directors did not concede that demand was excused).

[156] *See Zapata Corp.*, 430 A.2d at 788-89.

[157] *Id.* at 788-89.

[158] *Id.* at 788.

[159] *See supra* notes 20-24 and accompanying text.

[160] *See Zapata Corp.*, 430 A.2d at 788-89.

(2) proceed to the second step. Where a court determines to proceed to the second step:

> The Court should determine, applying its own independent business judgment, whether the motion should be granted . . . . The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.
>
> If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms and conditions the Court finds necessary or desirable.[161]

In sum, under the procedures established in *Zapata*, a court has the discretion to apply its own "business judgment" to the special litigation committee's decision, and thus, may "second guess" a decision made by disinterested and independent directors.[162]

Application of "[t]he procedure created in *Zapata* is very fact specific" and "cannot be cabined into all purpose rules."[163] In *Kaplan v.*

---

[161]*Id.* at 789. Although, as previously noted, the law in all jurisdictions is that prior to filing a derivative action a stockholder generally must make a demand, see *supra* notes 106-20 and accompanying text, where demand is excused, some jurisdictions have created procedures that differ from the procedures applicable to Delaware corporations. For example, the New York Court of Appeals held that judicial review of a decision of a special litigation committee of a New York corporation to terminate an action that has been properly filed by a stockholder is limited to the issues of the disinterestedness and independence of the members of the committee, and the sufficiency of the committee's investigation. *See* Auerbach v. Bennett, 393 N.E.2d 994, 996 (N.Y. 1979).

[162]*Zapata Corp.*, 430 A.2d at 787-88. For an analysis of the two-step test established in *Zapata* deemed "excellent" and "accurate" by the Delaware Supreme Court, see Kaplan v. Wyatt, 484 A.2d 501, 506-09 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184, 1188 (Del. 1985).

[163]Katell v. Morgan Stanley Leveraged Capital Fund, Inc., No. 12,343, slip op. at 17 (Del. Ch. June 15, 1995) (revised June 28, 1995), *reprinted in* 20 DEL. J. CORP. L. 1059 (1995).

Wyatt,[164] for example, the Delaware Court of Chancery stated that a determination regarding whether the composition and conduct of a two-member special litigation committee satisfied the corporation's burden under the first step of *Zapata* must be based upon a review of "the undisputed material facts" as set forth in the record.[165] Based upon such review, the court held that "as a matter of law . . . the Special Litigation Committee acted independently in making its investigation and report" concerning the claims alleged by the plaintiff in the derivative action.[166] Further, in reviewing the facts underlying the investigation and report of the special litigation committee, the court determined:

> [A]s a matter of law the Special Litigation Committee acted in good faith and that the investigation made by it was adequate to support the conclusions and recommendation reached. The report of the Committee appears to be comprehensive and well documented and gives indication of a reasonable and thorough investigation of the plaintiff's allegations. The broadside fired against it by the plaintiff based upon additional things which he feels the Committee should have done and the conclusions that he would have the Court draw by innuendo from the manner in which certain things were done is not sufficient to overcome the showing made by the Committee in my opinion.[167]

In sum, the court concluded:

> [P]ursuant to the first-step analysis required by *Zapata*, . . . the Special Litigation Committee, on behalf of the corporation, has carried its burden and has demonstrated that there is a reasonable basis for its recommendation that it is in the best interests of the corporation to have the derivative suit of the plaintiff dismissed.[168]

After so concluding, the court addressed the second step of the *Zapata* standard:

---

[164]484 A.2d at 501.
[165]*Id.* at 519.
[166]*Id.*
[167]*Id.* at 519-20.
[168]*Wyatt*, 484 A.2d at 520.

> Having reached the foregoing conclusion, I find it unnecessary to proceed to the discretionary, second-step analysis authorized by *Zapata*. As stated in the lengthy quotation from *Zapata* set forth at the outset, the discretionary second step "is intended to thwart instances where corporate actions meet the criterion of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest." The dismissal of this suit does not run counter to the spirit of *Zapata* as I comprehend it, and based upon the record made on a motion to dismiss when weighed against the allegations of the complaint, I do not find that the termination of this suit will prematurely end a stockholder grievance which, in the interest of the corporation, deserves further consideration through the device of derivative litigation.[169]

The procedure of a special litigation committee was also tested by the Delaware Court of Chancery in *Lewis v. Fuqua*.[170] In determining whether to grant a motion to dismiss brought by a corporation based upon an investigation and report of a one-member special litigation committee, the court held that the corporation failed to satisfy its burden under the first step of the *Zapata* standard.[171] Specifically, based upon the material facts presented, the court concluded:

> Unlike in *Kaplan v. Wyatt*, where the Special Litigation Committee consisted of two members, the Committee here consisted of but one person — Terry Sanford. Although Mr. Sanford is well renowned, there are circumstances which must lead the Court to have questions as to his independence. He was a member of the Board of Directors of Fuqua Industries at the time the challenged actions took place; he is one of the defendants in the suit; he has had numerous

---

[169] *Id.* (quoting *Zapata Corp.*, 430 A.2d at 789); *see also Katell*, No. 12,343, slip op. at 26-27, *reprinted in* 20 DEL. J. CORP. L. at 1078 (noting that in the context of a limited partnership, the court declined to "undertake its own independent review of the merits of the derivative claim" because the court determined that the decision of the special litigation committee to dismiss the derivative action was "the product of the procedure envisioned by the Supreme Court in *Zapata*").

[170] 502 A.2d 962 (Del. Ch. 1985).

[171] *See id.* at 966-67.

> political and financial dealings with J.B. Fuqua who is the chief executive officer of Fuqua Industries and who allegedly controls the Board; he is President of Duke University which is a recent recipient of a $10 million pledge from Fuqua Industries and J.B. Fuqua; and J.B. Fuqua has, in the past, made several contributions to Duke University and is a Trustee of that University.
>
> These potential conflicts of interest or divided loyalties, when considered as a whole, raise a question of fact as to whether Terry Sanford could act independently. This is not to say that he actually acted improperly, but I find that the moving party has not borne its burden of showing the absence of any possible issue of fact material to the issue of the independence of Mr. Sanford.[172]

The court reasoned that, based upon the high level of scrutiny applied, its conclusion was required because the procedure created in *Zapata* represented:

> The only instance in American Jurisprudence where a defendant can free itself from a suit by merely appointing a committee to review the allegations of the complaint is in the context of a stockholder derivative suit. A defendant who desires to avail itself of this unique power to self destruct a suit brought against it ought to make certain that the Special Litigation Committee is truly independent. If a single member committee is to be used, the member should, like Caesar's wife, be above reproach.
>
> Terry Sanford is, unfortunately, the sole member of the Committee. His past and present associations raise a question of fact as to his independence. This alone is grounds to deny the motion to dismiss under the first test set forth in *Zapata*.[173]

---

[172] *Id.* at 966-67 (citation omitted).

[173] *Id.* at 967. In *Fuqua*, the court further held that the corporation had not satisfied its burden of establishing a reasonable bases for the conclusions of the special litigation committee. *Id.* at 967.

More recently, in *Carlton Investments v. TLC Beatrice International Holdings, Inc.*,[174] the Delaware Court of Chancery applied and commented upon the *Zapata* standard. Specifically, in *Carlton Investments*, a special litigation committee (SLC) of the board of directors of TLC Beatrice International Holdings, Inc. and defendants filed a motion, pursuant to Chancery Court Rule 23.1, requesting that the court of chancery approve as fair and reasonable a proposed settlement of a derivative action brought on behalf of Beatrice.[175] The proposed settlement was resisted by the representative party that brought and prosecuted the derivative claims.[176] Before addressing and approving the proposed settlement, the court of chancery reviewed "the role of the court under Delaware law" in determining whether the settlement was "fair and reasonable in light of the factual support for the alleged claims and defenses in the discovery record before it."[177] During such review, the court stated:

> Since this proposed settlement was negotiated by [a] SLC, the parties have agreed that under Delaware law, it is to be reviewed under the two step approach set forth in *Zapata Corp. v. Maldonado*. First, the court must analyze the "independence and good faith of the committee and the bases supporting its conclusions." Second, the court is directed to exercise its own business judgment to determine whether the settlement should be approved, considering both the corporation's best interests and matters of law and policy.[178]

After "carefully reviewing the investigation and negotiation process of the SLC, the evidentiary basis for the conclusions reached by the SLC, and the terms of the proposed settlement," the court held that (1) "the SLC and its counsel proceeded in good faith throughout the investigation and negotiation of the proposed settlement," (2) "the conclusions reached by the SLC . . . were well informed by the existing record," and (3) "the proposed settlement falls within a range of reasonable solutions to the problem presented."[179]

In addition, the court held:

---

[174]No. 13,950 (Del. Ch. May 30, 1997), *reprinted in* 23 DEL. J. CORP. L. 712 (1998).

[175]*Id.*, slip op. at 2-3, *reprinted in* 23 DEL. J. CORP. L. at 718-19.

[176]*Id.*

[177]*Id.*, *reprinted in* 23 DEL. J. CORP. L. at 719.

[178]*Carlton Investments*, No. 13,950, slip op. at 3, *reprinted in* 23 DEL. J. CORP. L. at 719-20 (quoting *Zapata*, 430 A.2d at 788-89) (citation omitted)

[179]*Id.*, slip op. at 3-4, *reprinted in* 23 DEL. J. CORP. L. at 720.

> [T]o the extent I am required by the second step of *Zapata*, uncomfortably, to exercise some form of independent judgment concerning the merits of the settlement, I cannot conclude that it is badly off the mark. It is true that in some respects the claims that Carlton asserts on behalf of TLC Beatrice appear strong. But the settlement proposed offers substantial consideration for [the] release. As to the conceptually difficult second step of the *Zapata* technique, it is difficult to rationalize in principle; but it must have been designed to offer protection for cases in which, while the court could not consciously determine on the first leg of the analysis that there was no want of independence and good faith, it nevertheless "felt" that the result reached was "irrational" or "egregious" or some other such extreme word. My opinion is that courts should not make such judgments but for reasons of legitimacy and for reasons of shareholder welfare. But if I am directed to exercise my own "business judgment" by the second step of *Zapata*, I must conclude that this settlement represents one reasonable comprise of the claims asserted.[180]

In so holding, however, the court questioned the rationale underlying the "second step" of the *Zapata* standard:

> The idea suggested in *Zapata* that the court may—for reasons of public policy—require the board to continue a litigation even though an independent committee determines in good faith and on appropriate information that a proposed settlement is advantageous to the corporation, is difficult to understand. It is fair to ask, on what basis may a court legitimately impose the cost and risk of litigation on a party in order to achieve *only a perceived public benefit*? In other contexts the constitution explicitly protects against such exactions (*i.e.*, takings clause of U.S. constitution).[181]

In sum, decisions of the Delaware Court of Chancery illustrate both the factors that a court would consider in connection with the first step of the *Zapata* standard, and the level of scrutiny that a court would apply in

---

[180] *Id.*, slip op. at 4, *reprinted in* 23 DEL. J. CORP. L. at 720.

[181] *Id.*, slip op. at 4 n.4, *reprinted in* 23 DEL. J. CORP. L. at 720 n.4.

reviewing such factors. Such court of chancery decisions also reflect the reluctance of the court to "undertake its own independent review of the merits of the derivative claim" where a special litigation committee comprised of disinterested and independent directors, conducted a thorough evaluation of the derivative claims and reasonably concluded that the corporation should not pursue such claims.[182]

D. *Advisors and Derivative Litigation*

Consistent with other areas of Delaware law,[183] where advisors are retained by a special litigation committee to assist in reviewing the merits of derivative claims and determining whether the pursuit or settlement of such claims would be in the best interests of the corporation, such advisors should be free of any conflict of interest. Specifically, Delaware courts have examined the independence of the advisors retained by a special litigation committee in connection with derivative litigation in two contexts, where demand is excused and where a corporation is considering whether to settle a derivative action.

Where a demand upon the directors is excused and a derivative action is brought by a stockholder, the Delaware Court of Chancery has emphasized that the independence of the advisors retained by a special litigation committee to assist in discharging its function is a factor that a court would examine in determining the independence and good faith of the committee under *Zapata*.[184] In *Kaplan*, for example, the court initially recognized that where demand is excused, "the board, if it so desires, may appoint an independent committee to investigate the allegations of wrongdoing against the corporation contained in the complaint,"[185] and may empower the special litigation committee to retain advisors "to assist in its investigation."[186] The court then noted that where directors appoint a special litigation committee and empower such committee to retain advisors, the independence of the advisors retained by such committee should be considered by a court in determining the independence and good

---

[182]*See* Katell v. Morgan Stanley Leveraged Capital Fund, Inc., No. 12,343, slip op. at 26-27 (Del. Ch. June 15, 1995), *reprinted in* 20 DEL. J. CORP. L. 1059, 1078 (1995); Kaplan v. Wyatt, 484 A.2d 501, 520-21 (Del. Ch. 1984).

[183]*See supra* notes 90-103.

[184]*See, e.g.*, *Wyatt*, 484 A.2d at 514, 519; *see also Katell*, No. 12,343, slip op. at 20, *reprinted in* 20 DEL. J. CORP. L. at 1074 (noting that a committee selected and relied heavily upon the advice of capable counsel).

[185]*Wyatt*, 484 A.2d at 506.

[186]*Id.* at 511.

faith of the committee under the first step of the *Zapata* standard.[187] As stated by the court in *Kaplan*:

> Concerning the good faith of the Committee, plaintiff points to the fact that the New York law firm of Brown, Wood, Ivey, Mitchell & Petty ("Brown, Wood") was retained by the Special Litigation Committee as its counsel and to assist it in making its investigation of the plaintiff's allegations. The problem with this, plaintiff says, is that in an earlier and unrelated class action in the Federal courts in California, the Brown, Wood firm was named as a defendant along with others, and in that action a $50 million recovery was achieved on behalf of the class, with Brown, Wood being responsible for a portion thereof. The successful plaintiff's attorneys in that action were Mr. Weiss and Mr. Morris and their associates, the same attorneys who are representing the plaintiff here. Of all the law firms available in the country to assist it, how can the Committee be said to be acting in good faith, plaintiffs ask, by selecting as its counsel a law firm which might conceivably have a personal axe to grind with the attorneys for the plaintiffs here?
>
> . . . .
>
> As noted previously, the Brown, Wood firm has expended several thousand hours of lawyer time in assisting the Committee in its investigation and has received some $500,000 in fees and expenses for its efforts. By contrast, the two members of the Special Litigation Committee are said to have spent a total of all or part of 35 days on the project for which they received some $17,500 in compensation. In view of this plaintiff suggests that the report is primarily the product of Brown, Wood's efforts and that the taint attributable to the involvement and conduct of Brown, Wood is chargeable to the Committee itself, thus casting doubt as to the good faith of the entire enterprise.[188]

---

[187] *Id.* at 514-15.

[188] *Id.*

In rejecting the plaintiff's assertions concerning the good faith of the special litigation committee and its advisors, the court stated:

> I am satisfied from the undisputed material facts thus made applicable to the motion that the Special litigation Committee . . . together with Brown, Wood, their counsel operated independently of the defendants . . . as well as independently of [the] board [of directors] and management, and this despite the undisputed charge that house counsel for [the corporation] assisted the Committee in scheduling its numerous interviews and sat in on interviews in which personnel of [the corporation] were involved. While it seems to me that it would be better if such a practice was avoided, I cannot find from the bare circumstance relied on by plaintiff, without more . . . warrants a finding that the Special Litigation Committee was not independent of those in charge of the corporation during the conduct of its investigation. Thus, I find as a matter of law that the Special Litigation Committee acted independently in making its investigation and report.[189]

Similarly, where the corporation is considering whether to settle a derivative claim brought by a stockholder, a court would likely review, among other things, whether a committee of the board of directors was appointed to investigate the acts underlying the derivative action, and whether such committee retained and consulted with its own advisors to assist in the investigation and settlement. In *Kahn v. Occidental Petroleum Corp.*,[190] a plaintiff in a stockholder derivative action filed a motion to preliminarily enjoin a settlement in the progress of being negotiated in a related action.[191] Although denying the motion because plaintiff would "suffer no irreparable harm if a proposed settlement is subsequently finalized and submitted to the Court for approval,"[192] the court, among other things, noted:

> The proposed settlement, in its present form, is certainly subject to criticism although whether, on balance, a settlement should be approved, is not now before me. Among

---

[189]*Wyatt*, 484 A.2d at 519.

[190]No. 10,808 (Del. Ch. July 19, 1989), *reprinted in* 15 DEL. J. CORP. L. 654 (1990).

[191]*See id.*, slip op. at 5, *reprinted in* 15 DEL. J. CORP. L. at 657.

[192]*Id.*, slip op. at 11, *reprinted in* 15 DEL. J. CORP. L. at 661.

> the troublesome issues which will have to be addressed at any settlement hearing are . . . the failure of the Special Committee appointed by the directors of Occidental to hire its own counsel and advisors or even to formally approve the challenged acts . . . . The time to consider these deficiencies and to also consider the arguments in favor of the settlement, however, is after a proposed Settlement Agreement is submitted and notice is given to the entire class so that all may be heard.[193]

In response to the concern expressed by the Delaware Court of Chancery, the committee retained "independent Delaware counsel with no prior connection to Occidental or its officers."[194] "Thereafter, this independent counsel . . . advise[d] the Special Committee with respect to the [challenged transaction] and the terms of any settlement of the shareholder litigation."[195] Specifically, the committee

> retained former Chancellor Grover C. Brown of the law firm of Morris, James, Hitchens & Williams as its independent counsel to review the merits of the actions taken by the Board of Occidental . . . . [Additionally,] Occidental's Board of Directors delegated to the Special Committee the additional authority to approve or disapprove the proposed settlement agreement in this action after consulting with and considering the advice of its independent counsel.[196]

Based in part upon these factors, the Delaware Court of Chancery approved the settlement, emphasizing that the committee (1) "formally approved the challenged charitable contributions" only after it retained independent counsel and examined the challenged actions with the assistance of its counsel,[197] and (2) "determined that, in its opinion, it was in the best interest of Occidental to agree to the proposed settlement presented in this action" only after it was advised by its special counsel regarding the various litigations.[193] The Delaware Supreme Court affirmed

---

[193] *Id.*, slip op. at 13, *reprinted in* 15 DEL. J. CORP. L. at 662.

[194] Kahn v. Sullivan, 594 A.2d 48, 56 (Del. 1991), *aff'g* Sullivan v. Hammer, No. 10,823, 1990 Del. Ch. LEXIS 119 (Del. Ch. Aug. 14, 1990).

[195] *Id.*

[196] *Sullivan*, 1990 Del. Ch. LEXIS 119, at *7.

[197] *Id.*

[153] *Id.*

the decision of the court of chancery approving the settlement,[199] noting that the court of chancery properly considered (among other things) that the committee retained and consulted with independent counsel before making any determination regarding the challenged actions or the various litigations.[200]

In sum, where a committee of the board of directors is delegated the authority to determine the merits of a derivative action (generally where demand is excused or refused, or in the context of a settlement) a factor that a court considers in evaluating the decision is whether the committee retained and consulted with independent advisors prior to making its decisions.[201] Where the committee retained and consulted with such advisors, this factor, among others, would support a judicial determination that (1) the corporation satisfied its burden under the *Zapata* standard by demonstrating "that there is a reasonable basis for [the committee's] recommendation that it is in the best interests of the corporation to have the derivative suit of the plaintiff dismissed,"[202] and (2) the decision of the committee to settle or dismiss the derivative action should "be protected by the presumption of propriety afforded by the business judgment rule."[203]

IV. CONCLUSION

Although a variety of factors are considered in determining whether corporate decision makers are capable of making impartial decisions, Delaware courts consistently have scrutinized the composition of special committees of directors created and empowered to negotiate conflict-of-interest transactions with interested corporate fiduciaries or to determine whether a derivative action is in the best interests of a corporation. Further, where such committees are created, Delaware courts frequently have examined whether the advisors that are retained by special committees could act independently of, and would not be influenced by, any interested party to the transaction or the litigation. These factors offer directors guidance in the context of a conflict-of-interest transaction or a derivative litigation by establishing procedures with respect to the decision-making process that, if adopted by directors, should demonstrate that the decision

---

[199] *See Kahn*, 594 A.2d at 63.

[200] *See id.* at 60-61.

[201] *See id.*

[202] Kaplan v. Wyatt, 484 A.2d 501, 520 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

[203] *Kahn*, 594 A.2d at 61.

maker was capable of making an impartial decision, and that such decision should survive judicial review if challenged by stockholders.