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CLIENT
MEMORANDUM

DELAWARE CHANCERY COURT HIGHLIGHTS PITFALLS OF A FLAWED SPECIAL COMMITTEE PROCESS IN INTERESTED MERGER TRANSACTION

Introduction

On December 21, 2005, the Delaware Chancery Court issued its decision in In re Tele-Communications, Inc. S'holders, Litig., Civ. A. No. 16470 (Del. Ch. Dec. 21, 2005) ("TCI"), which addressed the sale of TCI to AT&T in which the holders of the higher-voting Class B common stock ("TCOMB") received a 10% premium to the consideration received by the holders of the Class A common stock ("TCOMA"). TCI's board of directors had established a special committee of directors to review the transaction in light of the significant conflicts of certain board members, notably their control of the TCOMB shares. The Chancery Court denied summary judgment to TCI's board of directors, finding the entire special committee process to be flawed and certain public disclosures surrounding the special committee's work to be misleading.

The TCI opinion serves as a reminder that the Delaware courts will carefully scrutinize a special committee process to ensure that the committee is truly disinterested, understands its mandate, and performs its role with care. The TCI opinion also contains guidance for companies and their financial advisors when addressing the fairness of merger consideration paid in respect of multiple classes of stock.

The TCI opinion contains some valuable lessons, which are worth highlighting:

- If a board delegates matters to a special committee, the *committee members must be selected carefully.* Committee members cannot have interests that conflict with the interests of the constituency they represent.

- *Boards should consider carefully whether the compensation paid to special committee members may taint the special committee process, or otherwise give the appearance of impropriety or undue influence.* The form, timing, amount and disclosure of special committee compensation should be analyzed with great care; it is important to bear in mind the TCI court's observation that the "uncertain, contingent, and potentially large nature of the payments, without any objective benchmarks or other measures," could have affected the judgment of the special committee.

- *The mandate of the special committee must be clear.* The mandate should be in writing and in the form of a resolution adopted by the entire board. The class of shareholders, or other constituency on whose behalf the special committee is acting, must be clearly identified. A special committee must have the freedom to negotiate, and must actually negotiate, on behalf of the constituency it represents.

- Absent extraordinary circumstances, a special committee acting in an "interested" merger transaction, or a transaction involving a controlling shareholder, *should retain its own financial and legal advisors, separate from the advisors retained by the company or the controlling shareholder.* While separate advisors may lead to increased costs and delays, retention of such advisors may be critical in the event of a later challenge to the special committee's decisions and judgments. The most significant failures of the TCI special committee can be traced directly to the failure of the committee to retain independent legal and financial advisors.

- *A special committee must perform its role on an informed basis.* Outside counsel and financial advisors are a very important means by which a committee can inform itself, especially on an accelerated timetable. In addition, special committee members should meet as frequently as they desire, not act in a rushed or hurried time frame, make sure they follow up (with management or the advisors) on areas of uncertainty, and take all reasonable steps to make themselves comfortable with their decisions and judgments.

- Where fairness of the price being paid to a class of shares is at issue, a fairness opinion should address the impact upon that class of a preference being given to another class of shares. While it is common, and quite reasonable, for investment banks to delineate carefully those matters on which they are (and are not) opining, boards and their financial advisors should take heed of the TCI opinion: As part of an "entire fairness" inquiry, courts will review carefully a board's analysis, including its reliance upon a fairness opinion, that the consideration being paid to shareholders -- including preferences or premiums being paid to another class of shares -- is fair.

Background Facts

In mid-1998, TCI's board began discussions with AT&T about a merger between TCI and an AT&T subsidiary. TCI had six series of tracking stock representing its three divisions, with the "TCI Group" division represented by the TCOMA and TCOMB shares. Each share of TCOMB was entitled to 10 votes; each share of TCOMA was entitled to 1 vote. 84% of the TCOMB shares were held by five members of the nine-member TCI board. For all practical purposes, the TCOMA shares were the "public" shares and the TCOMB shares were shares held by TCI management and directors.

Through his TCOMB stock ownership and a voting agreement, TCI's Chairman and Chief Executive Officer, John Malone, controlled 47% of TCI's total voting power. From the outset, Malone made clear that he would not consent to any merger unless the TCOMB shares received a 10% premium over the TCOMA shares. Plainly, any premium exclusively granted to the TCOMB shares would primarily benefit the five members of the TCI board.

The board decided to appoint a special committee of "disinterested" directors because a number of directors had financial and other interests in a possible merger transaction. On June 15, 1998, two board members were appointed as a special committee to review any potential transaction.

One committee member owned approximately 73,000 TCOMA shares; the other committee member owned approximately 88,000 TCOMA shares but *also* owned over 246,000 TCOMB shares. At that meeting, Malone suggested that the two committee members be reasonably compensated for their efforts, but no further decision was made as to the amount of such compensation.

By the time the special committee had been selected, merger negotiations were underway and TCI was in discussions with a nationally recognized investment banking firm which, in turn, had retained its own counsel. The special committee first met on June 19 and, after two intervening meetings, received and reviewed the final merger agreement on June 23. The special committee did not retain its own financial or legal advisors.

One important aspect of the transaction -- the 10% premium for the TCOMB shares that Malone had demanded -- was reflected in early proposals from AT&T. The special committee received advice from *TCI's* financial and legal advisors that there were precedents for higher-voting stock receiving a premium to lower-voting stock, but was also told that those transactions were "less common" than transactions in which all shares were compensated equally, regardless of voting power. The special committee also received presentations from TCI's investment bank, including a fairness opinion that the merger consideration being paid by AT&T for the TCOMA shares was fair to the TCOMA shareholders and that the consideration being paid for the TCOMB shares was fair to the TCOMB shareholders. The fairness opinion did not opine on the fairness to the TCOMA shareholders of the premium paid to the TCOMB shareholders. Four days after having first met, the special committee voted unanimously to recommend the merger to the full board, which approved the merger later the same day.

On the date the merger was announced, the merger consideration represented a premium of 37% over TCOMA's market price and a premium of 52% over TCOMB's market price. Ultimately, this translated into a 10% premium for the TCOMB shares over the price received by the TCOMA shares -- as Malone had demanded. As of the merger announcement, the different exchange ratios paid by AT&T for the TCOMA and TCOMB shares resulted in the directors -- who owned 84% of the TCOMB shares -- receiving $220 million more than if the TCOMB and TCOMA shares had received the same weighted exchange ratio of AT&T common stock.

On February 17, 1999, just prior to the shareholder vote, the board met and approved a payment of $1 million for each of the special committee members as compensation for their work.

TCI's shareholders overwhelmingly approved the merger. However, a class of TCOMA shareholders sued, claiming that the board breached its fiduciary duties by, inter alia, recommending a merger providing for the unequal treatment of TCOMA and TCOMB shares. The shareholders also claimed that the proxy statement disseminated in connection with the merger was misleading.

Highlights of the Opinion

The Evidentiary Burden

It is settled Delaware law that in interested-party transactions, where directors or controlling stockholders stand on both sides of the transaction, a higher standard of judicial scrutiny -- the "entire fairness test" -- is applied in lieu of the more common business judgment rule. In an interested transaction, the defendant directors initially bear the burden of demonstrating that the transaction is "entirely fair." However, in certain cases, such as where a properly functioning special committee of independent directors is involved, that burden can be shifted to the plaintiffs. Given the high level of scrutiny in the "entire fairness" test, it is often the case that the party that does not bear the evidentiary burden is the party that prevails.

In order to shift the burden, defendants "must establish that the special committee was truly independent, fully informed and had the freedom to negotiate at arm's length." The court could not shift the burden because one special committee member's ownership of 246,271 shares of TCOMB shares (which dwarfed his TCOMA shareholdings), together with the "suspiciously contingent" compensation arrangement, sufficiently impugned the independence of the special committee.

The Entire Fairness Test

With the evidentiary burden on the TCI directors, the Court turned to the dual prongs of the entire fairness test: fair dealing (the process leading to the consummation of the transaction) and fair price (the end result). The Court ultimately found that there were genuine issues of material fact as to whether the special committee was fully informed, truly disinterested and had the freedom to negotiate on behalf of the TCOMA shares. The Court raised the following significant issues:

<u>First</u>, the Court noted that the special committee appeared confused about its mandate. One committee member believed his role was to represent the TCOMA shareholders and to ensure they received fair consideration in relation to what the TCOMB shareholders received. But the other committee member believed his assignment was to look after <u>all</u> the shareholders' interests. One committee member did discuss the 10% premium with Malone, but acknowledged that not much time was spent discussing the issue; the other committee member believed his role was <u>not</u> to negotiate but to determine fairness. According to the Court, the disagreement and misunderstanding over the special committee mandate "initiat[ed] a structural flaw that fissured throughout the process that followed."

<u>Second</u>, the Court questioned the choice of directors on the special committee. The Court believed the confused mandate "probably foreordained a choice of directors not ideally aligned with those of the TCOMA holders." While one committee member owned no TCOMB shares and $5 million worth of TCOMA shares (and therefore adequately represented the financial interests of the TCOMA shares), the other committee member primarily held TCOMB shares and gained $1.4 million in value by virtue of the preferential treatment of the TCOMB shares. The Court questioned why another non-management director who owned only TCOMA shares, and "lost" over $13 million in value by virtue of the TCOMB premiums, was not selected to serve.

Third, the Court criticized the special committee's decision to use the legal and financial advisors already advising TCI instead of retaining its own advisors. In addition, because TCI's investment bank was compensated on a contingent basis (it received approximately $40 million upon consummation of the merger), the Court questioned whether the investment bank could provide independent advice to the special committee.

Fourth, the Court found that the special committee was inadequately informed because it failed to investigate the historical premiums at which the TCOMB shares had traded and was not sufficiently informed about precedent transactions involving higher-voting stock premiums. The special committee had relied on the investment bank's presentation, which identified four precedent transactions in which premiums were paid for higher-voting stock, even though the investment bank's lawyer had indicated that such premiums were less common than equal treatment. The Court particularly faulted the special committee for failing to ask "the lingering question . . . how less common are such high vote premiums than equal treatment?"

Fifth, the Court determined that, given the muddled special committee mandate, one committee member's $1.4 million premium windfall, the unspecified special committee compensation, and the special committee's lack of information regarding historical TCOMB trading prices and precedent transactions involving premiums for higher-voting stock, there was "an inhospitable clime for arm's length bargaining to blossom." (Because genuine questions were raised over the level of care applied by the special committee, the Court also denied summary judgment on the disclosure claim that the merger proxy was false and misleading because of its statement that the special committee "carefully considered" the TCOMB premium.)

Finally, the Court questioned whether the price paid to the TCOMA shareholders was fair. It was undisputed that the price obtained by the TCOMA shareholders was significantly higher than TCOMA's market price, and within the range of the investment bank's valuations. But the Court concluded that the price was arguably unfair in light of the premium received by the TCOMB holders. The Court examined the investment bank's fairness opinion and noted that the investment bank made parallel but separate analyses with respect to the fairness to each class of stock. However, the fairness opinion "[did] not discuss the effect of the TCOMB premium upon the TCOMA holders, *i.e.*, whether the TCOMB premium was fair to the TCOMA holders." The Court held that an earlier Delaware Supreme Court opinion, Levco Alternative Fund Ltd. v. Reader's Digest Assoc., Inc., No. 466, 2002, 2002 WL 1859064 (Del. Aug. 13, 2002), "mandated more than separate analyses that blindly ignore the preferences another class might be receiving." According to the Court, if the investment bank's separate analyses were determinative, the TCOMB holders theoretically could have received a *110%* premium, and the transaction still could have been "fair" to the TCOMA shareholders because those shareholders had received a 37% premium over the TCOMA market price. According to the Court, "entire fairness requires an examination of the fairness of such exorbitant premiums to the prices received by the TCOMA holders." Even though the TCOMB premium lowered the price paid to the TCOMA shareholders by just 1.2%, the Court still held that there was a triable issue of fact on the fairness of price paid to the TCOMA shareholders.

Failure to Disclose Special Committee Compensation

The merger proxy statement did not disclose the plan to compensate the special committee members, nor did it disclose the eventual payment of $1 million to each of the two committee members. The Court stated that the failure to disclose a plan to compensate the special committee could be material to a shareholder voting on the merger: "The uncertain, contingent, and potentially large nature of the payments, without any objective benchmarks or other measures, could have given [the special committee members] additional and undisclosed financial interests in the transaction that might have affected their judgments. Compensation of Special Committee members that is contingent, ambiguous, or otherwise uncertain, raises a triable issue of material fact as to what each member anticipated in the event the Special Committee approved the transaction, and whether such anticipated reward was significant to the reasonable shareholder."

In addition, the Court made some pointed remarks about the reasonableness of the committee's compensation and the potential influence it might have had over the deliberations: "I pass over . . . how one might rationally consider a $1 million payment for four meetings over a one-week period to be reasonable compensation. I also pass over . . . the rather obvious question of how a Special Committee member might act when he suspected that potential compensation might hinge on the answer he were to give."

Conclusion

The <u>TCI</u> opinion reaffirms that a special committee process must be carefully designed and implemented if a board wishes to satisfy the high standard required under the entire fairness test. <u>TCI</u> was issued after discovery on a full record and, unless settled, will now proceed to trial. Ultimately there may be an appeal to the Delaware Supreme Court.

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Clients wishing to obtain a copy of the TCI opinion or having further questions about it, or the special committee process generally, should contact Tariq Mundiya (212-728-8565 or tmundiya@willkie.com), Michael Schwartz (212-728-8267 or mschwartz@willkie.com), Steven Gartner (212-728-8222 or sgartner@willkie.com), Steven Seidman (212-728-8763 or sseidman@willkie.com), or the partner with whom you regularly work.

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