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Delaware Court's Criticism of Special Committee in TCI Merger Provides Important Guidance But May Not Be Entirely Fair

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A recent Delaware Chancery Court decision relating to the merger of Tele-Communications, Inc. ("TCI") with a subsidiary of AT&T Corp. ("AT&T") contains important guidance regarding special committees — their mandate, compensation, composition and diligence responsibilities — as well as their use and compensation of legal and financial advisors.[1] However, the TCI court's view on some issues, particularly with respect to the appropriateness of contingent financial advisory fees, the relevance of historical trading premiums and certain precedent transactions and the need for a relative fairness opinion when the transaction consideration will be allocated among classes of capital stock, are controversial and raise significant issues for special committees and financial advisors. Finally, on a separate note, the TCI decision confirms that Delaware law does not generally require detailed disclosure to shareholders regarding a special committee's merger agreement deliberations. Often less is more.

The lessons of the TCI decision include:

- A special committee should have a clear and unambiguous mandate;
- Fees for serving on a special committee should be agreed upon at the beginning of the process and not be contingent on the outcome of the transaction;
- The interests of the members of a special committee should be aligned with the classes or groups of shareholders they are charged with protecting;
- Special committees should have their own legal and financial advisors and should be authorized to negotiate the terms of the transaction;
- Special committees should gather and consider all reasonably available information; and
- If the transaction consideration will be allocated among more than one class of capital stock, directors need to consider the specific impact of a premium paid to holders of one class of capital stock on other shareholders.

Factual Background

The case arose in connection with the 1999 merger of TCI with a subsidiary of AT&T. While on its face an arm's-length transaction, the board of TCI formed a special committee to evaluate the proposed merger because of the potential conflicts resulting from the ownership of different classes of TCI capital stock by members of the TCI board.

According to the TCI court's opinion, TCI had issued two classes of tracking stock — one high-vote, one low-vote — with respect to each of its three divisions, for a total of six classes of capital stock.[2] The terms of the proposed merger included a 10 percent premium payable to the holders of the high-vote stock of one division as compared to the consideration payable to the holders of the low-vote stock of that division.[3]

Disclosure claims and claims challenging the fairness of the transaction were brought against the directors of TCI on behalf of the holders of the low-vote stock of that division. The TCI decision was rendered on defendants' motion for summary judgment and was not a final determination on the merits of the plaintiffs' claims.

The Standard of Review and Burden of Proof

Since a majority of TCI's directors owned substantial amounts of high-vote stock and stood to receive a significant financial benefit as a result of the 10 percent premium, arguably at the expense of the holders of low-vote stock, the court applied an entire fairness test rather than the business judgment rule.[4] While shares of high-vote stock represented only 12 percent of the total number of outstanding shares of high- and low-vote stock, shares of high-vote stock represented nearly 70 percent of the total number of shares of high- and low-vote stock owned by TCI's directors.[5] As an alternative basis for applying the entire fairness test, the TCI court pointed to evidence in the record that a majority of TCI's directors were interested in the transaction. Five out of the nine TCI directors collectively owned 84 percent of the outstanding high-vote shares.[6]

In order to satisfy the entire fairness test, the transaction must be fair, both in process and in price.[7] The initial burden of proof regarding entire fairness rested with the TCI board, but the approval of the merger by either an independent, fully informed special committee with the freedom to negotiate the terms of the transaction or by an informed majority of disinterested shareholders would have shifted the burden of proof regarding entire fairness to the plaintiffs.[8] The TCI special committee and the TCI board approved the proposed merger on June 23, 1998, and on February 17, 1999, the merger was approved by TCI's shareholders, with 99.89 percent of the votes cast in favor of the merger.[9]

Unfortunately for the defendants, the TCI court (viewing disputed facts in the light most favorable to, and making all reasonable inferences in favor of, the plaintiffs as required when ruling on defendants' motion for summary judgment) found that there were serious issues of material fact as to whether the TCI special committee was truly independent and as to whether certain material facts required to be disclosed to TCI's shareholders in the proxy statement relating to the AT&T merger had been properly disclosed. As a consequence, the TCI court found that the defendants continued to bear the burden of proof regarding whether the proposed merger satisfied both the fair dealing and fair price prongs of the entire fairness test.[10] The TCI court ultimately concluded that the defendants had failed to adequately address certain alleged procedural flaws or demonstrate that the merger consideration was fair, and denied defendants' motion for summary judgment on the claims challenging the fairness of the merger as well as certain disclosure claims.[11]

Lessons for Boards and Special Committees

1. _Mandate._ The two members of the special committee established by the TCI board to consider and make a recommendation regarding the proposed AT&T merger had differing views as to the TCI special committee's mandate. Apparently, one member thought the special committee's assignment was to ensure that holders of the low-vote stock received fair consideration while the other member thought the special committee's assignment was to look after the interests of all shareholders, not just the holders of high-vote or low-vote stock.[12] In addition, only one member attempted to negotiate the terms of the proposed transaction, including the 10 percent premium, only to be rebuffed by John Malone, TCI's chairman and largest shareholder. [13] The other member of the TCI special committee thought that the special committee's role was merely to determine fairness, not to negotiate, and consequently didn't participate in any negotiations.[14] The TCI court viewed the TCI special committee members' disagreement over the special committee's mandate as "a structural flaw that fissured throughout the process that followed."[15]

Lesson: *When establishing a special committee, boards of directors should make sure that the members of the special committee clearly understand their mandate so that they can perform their duties in a fully informed, careful and consistent manner. Specifically, the members of a special committee should clearly understand whose interests the special committee has been established to protect, be granted authority and resources to engage separate legal and financial advisors on behalf of the special committee, insist upon the power to negotiate the terms of the proposed transaction and, in certain cases, seek additional authority.*[16]

2. _Compensation._ Although Mr. Malone recommended that the members of the TCI special committee be reasonably compensated, no specific action was taken by the TCI board when the special committee was formed (other than a decision that the TCI board would not recommend the proposed AT&T merger without the favorable recommendation of the TCI special committee)[17] and it was not until eight months later, when the merger was about to be approved by TCI's shareholders, that the TCI board approved a payment of $1 million to each member of the TCI special committee.[18] While not expressly criticizing the size of the payments, the TCI court cast doubt as to their reasonableness and found that the alleged facts provided a sufficient basis for concern that the members may have been improperly influenced by the "contingent, ambiguous, or otherwise uncertain" nature of their compensation.[19] The TCI court concluded that "non disclosure of the plan to reasonably compensate the members of the TCI special committee could be material to the reasonable shareholder: the uncertain, contingent and potentially large nature of the payments, without any objective benchmarks or other measures, could have given [the TCI special committee members] additional and undisclosed financial interests in the transaction that might have affected their judgments."[20] As a result, the TCI court refused to dismiss claims alleging inadequate disclosure regarding the compensation of the TCI special committee members. It was also a factor in the TCI court's conclusion that "the Special Committee process was flawed, providing an inhospitable clime for arm's length bargaining to blossom."[21]

Lesson: *Boards should ensure that the fees to be paid to members of a special committee are not vague, ambiguous or contingent upon the outcome of a transaction but are either fixed or determinable by objective benchmarks agreed at the beginning of the special committee process.*

3. _Composition._ One of the two members of the TCI special committee primarily held high-vote stock and stood to benefit financially from the premium to be paid for high-vote shares. In addition, a third director who would suffer a financial detriment as a result of the premium was not appointed to the TCI special committee.[22] Oddly, it was the member of the TCI special committee who owned a disproportionate amount of high-vote stock and stood to benefit from the premium that took the lead in attempting to negotiate a reduction in the size of the premium.[23] As a consequence, the TCI court expressed concern that the interests of the members of the TCI special committee were not ideally aligned with the interests of the holders of low-vote stock.

Lesson: *If the mandate of a special committee is, in whole or in part, to protect the interests of a class or group of shareholders, the board should appoint members whose interests are aligned with the interests of the class or group to be protected.*

4. _Advisors._ The TCI special committee did not hire its own separate legal and financial advisors, but instead relied upon the advice of TCI's legal and financial advisors. The TCI court noted that "this alone raised questions regarding the quality and independence of the counsel and advice received."[24] With the benefit of its own advisors, the TCI special committee might have avoided many, if not all, of the deficiencies in disclosure and the special committee process that prevented the burden of proof regarding entire fairness from being shifted to the plaintiffs. In a controversial aspect of the decision, the TCI court also found that the contingent compensation of the financial advisor (here, approximately $40 million) created a serious issue of material fact as to whether the financial advisor could provide independent advice to the TCI special committee.[25]

Lesson: *Special committees should insist upon the authority to engage their own separate legal and financial advisors, with duties solely owing to the special committee. In addition, the structure of financial advisory fees should* *be carefully considered in order to align interests and avoid inappropriate incentives.*

5. Diligence Responsibilities. The TCI court criticized the TCI special committee for too easily dismissing and not adequately gathering and assessing information regarding the historical trading premium of TCI high-vote stock to TCI low-vote stock and premiums paid for high-vote stock in precedent transactions. In particular, the TCI court criticized the special committee for not informing itself more fully with respect to a number of similar transactions involving high-vote stock and low-vote stock in which the holders of high-vote stock did not receive a premium.[26] While the TCI court acknowledged that liquidity may play a part in trading premiums and, in another part of the opinion, that control premiums may often be foregone to, among other things, avoid entanglement in litigation or for other personal reasons,[27] the TCI court concluded that there were genuine issues of material fact relating to whether the TCI special committee was fully informed in considering the proposed premium to be paid for the high-vote shares.[28] As a consequence, the TCI court refused to grant summary judgment in favor of the defendants with respect to a claim that a statement in the proxy relating to the merger that the TCI special committee had "carefully considered" the premium payable to the high-vote shares was inaccurate.[29] It was also a factor in the TCI court's conclusion that the TCI special committee process was flawed from a procedural perspective under the entire fairness test.[30]

Lesson: Special committees should gather and carefully consider all reasonably available information likely to have a bearing on their deliberations even if they suspect some of that information will ultimately be deemed to have little relevance.

6. Specific Impact and Relative Fairness. The Delaware Supreme Court's decision rendered in connection with a proposed recapitalization of The Reader's Digest Association, Inc. required the TCI special committee to examine the specific impact on the holders of low-vote stock of the premium paid for the high-vote stock.[31] The TCI court interpreted that to mean the TCI special committee was required to examine the fairness of the premium paid for the high-vote stock relative to the value of the consideration received by the holders of low-vote stock, apparently by obtaining an opinion from a financial advisor as to the fairness of the high-vote premium to the holders of the low-vote stock.[32]

Lesson: Where the transaction consideration will be allocated among more than one class of capital stock, directors need to consider the specific impact of a premium paid to holders of one class of capital stock on other shareholders and, in particular, the impact of such a premium on the consideration received by other classes of shareholders. They should also try to obtain an opinion from their financial advisors with respect to the fairness of such premium to other classes of shareholders.

Significant Issues

1. Contingent Fees. While noting the defendants' arguments that, from TCI's perspective, it would not be advisable to incur a large financial advisory fee absent a successful transaction, the TCI court remained concerned that, from the special committee's perspective, the "potentially misguided recommendations [of a contingently paid and possibly interested financial advisor] could result in higher costs to the special committee's shareholder constituency in the event a deal was consummated."[33] Whether the mere existence of a contingent fee is sufficient, on its own, to create a serious issue of material fact as to whether a financial advisor can provide independent advice will be the subject of much debate. Prior to this decision, a number of courts had concluded that contingent fees actually aligned the interests of a financial advisor with its client's shareholders.[34] In TCI, where the controlling shareholder made it abundantly clear that he was not willing to negotiate the size of the premium and never budged from that stance, it may appear, in hindsight, that a non-contingent financial advisory fee would have been more appropriate. That may not always be the case. Often a controlling shareholder's initial position is not its final position and substantial value can be extracted by utilizing the strategy, tactics and negotiating skills of an appropriately incentivized financial advisor. Contingent fees better align the interests of a financial advisor with the interests of a special committee in attempting to negotiate a better deal on behalf of minority shareholders. Nevertheless, the TCI decision is likely to result in many corporate counsels advising special committees to engage financial advisors for substantially non-contingent fees absent a clear and convincing rationale for agreeing to even a partially contingent fee.

2. Historical Trading Premium. The TCI court criticized the TCI special committee for not being fully informed with respect to the historical trading premium of TCI high-vote stock to low-vote stock. But whether you trade one or 100 shares of high-vote stock, you don't transfer meaningfully more control than if you trade an equivalent number of shares of low-vote stock. It is only the prospect that *if* a change-of-control were to occur and *if* all holders of high-vote shares were permitted to share in any premium extracted by the holders of a controlling block of high-vote stock, that theoretically justifies a trading premium for high-vote shares as a class and, consequently, in most situations, a heavily discounted trading premium at that. In fact, a lack of liquidity can cause high-vote shares to trade at a discount to low-vote shares. High-vote shares will not typically trade at a premium reflecting their ability to affect a change-of-control unless and until a change-of-control is pending and they either convey control or it is clear that they are being permitted to share in a premium extracted by a control block. As a consequence, historical trading premium are likely to have little relevance in determining an appropriate allocation for a control premium.

3. Precedent Transactions with No Premium. The TCI court also criticized the TCI special committee for failing to ascertain how frequently high-vote stock was treated equally

with low-vote stock in precedent transactions. However, just because some holders of high-vote stock may voluntarily forego a premium to avoid becoming entangled in litigation or for other personal reasons does not mean it is fair or appropriate that other controlling shareholders should be required to forego or limit their demands for a premium to which they may be legally entitled. To the extent precedents are relevant (and it is not clear that they are), the most relevant precedents are the transactions in which controlling shareholders are willing to extract a premium. Even where a controlling shareholder is willing to extract a premium, the ultimate allocation of a control premium will depend on numerous factors including negotiating leverage and skill as well as efforts not to appear too greedy in order to reduce the likelihood of litigation, factors not normally associated with normative fairness. In assessing a premium, it is also important to note that it is not the nominal percentage premium that matters, but what it reflects in terms of the allocation of the overall control premium as between classes of capital stock. That will depend on the percentage of the outstanding capital stock comprised by each class.

4. Relative Fairness Opinions. The TCI court's interpretation of the Reader's Digest decision to apparently require the TCI special committee to obtain a fairness opinion was particularly surprising as no Delaware court had previously held that a board or special committee was required to obtain a fairness opinion, much less a so-called "relative fairness" opinion. In fact, many financial advisors believe that such normative judgments are beyond the scope of a professional opinion, particularly an opinion expressed "from a financial point of view," that typically focuses on the absolute or relative value of businesses and the consideration being paid or received in exchange therefor. Relative fairness opinions require normative judgments generally not susceptible to the types of valuation and other financial analyses performed by financial advisors. Financial advisors render fairness opinions based on analyses with respect to the value of a business taken as a whole and almost always avoid rendering judgments with respect to the appropriate allocation of the aggregate consideration among multiple equity constituencies with competing claims. They can (as TCI's financial advisors did), when pressed, separately analyze the intrinsic value of a class of capital stock and express an appropriately qualified opinion with respect to the fairness of the consideration to be received by holders of that class in exchange for their capital stock independent of the consideration to be received by holders of any other class of capital stock, but most opinion providers will include express language in their opinions to the effect that their opinions do not address the allocation of the aggregate consideration among competing equity classes. What financial advisors can and should do is provide special committees with all of the relevant financial analyses and information special committees need to make required normative determinations. After all, the views of financial advisors with respect to the financial aspects of transactions have never been viewed as a substitute for the judgment directors must apply in determining whether a transaction is advisable and in the best interests of shareholders.

5. The Reader's Digest Decision. The facts in the Reader's Digest case are distinguishable from the facts of TCI. While Reader's Digest involved a $100 million reduction in the equity value of Reader's Digest to the detriment of holders of Reader's Digest non-voting stock without their consent, TCI involved the allocation of a control premium being paid by a third party to which the holders of TCI low-vote stock were arguably not entitled. In the Reader's Digest decision, the Delaware Supreme Court took issue with the Reader's Digest special committee for its apparent failure to focus on the specific impact upon the holders of no-vote stock of a $100 million payment to holders of high-vote stock, particular given Reader's Digest's tenuous financial condition.[35] In the case of TCI, nothing was taken away from the holders of TCI low-vote stock. The only question was the extent to which they would be permitted to share in a control premium even though they had little or no ability to control the outcome of the transaction.[36] By voluntarily limiting the high-vote premium to 10 percent and not seeking the full amount of the premium to which a control block may legally be entitled, the holders of TCI high-vote stock permitted the holders of low-vote stock to receive a 37 percent premium upon a change-in-control, a premium that they could not reasonably have expected to receive when they bought shares of low-vote stock in a company controlled by one or a relatively small number of holders of high-vote stock.[37] That would appear pretty generous, particularly given that had the holders of TCI high-vote stock not voluntarily limited the size of their premium, it may have been difficult for the TCI board or special committee to have concluded that a mere 10 percent premium was fair to them.[38] The indirect impact of the high-vote premium on the value received by holders of low-vote stock was negligible. As noted by the TCI court, "the impact of the [high-vote stock] premium on the holders of [low-vote stock] was not large; effectively, the [high-vote stock] premium only lowered the price paid to the holders of [low-vote stock] by approximately 1.2%, from $67.19 to $66.37."[39] Given the foregoing, it is not surprising that the TCI special committee's principal negotiator viewed a 10 percent premium for shares of high-vote stock as a "pinhole part of the transaction" and worried that belaboring the point could threaten the deal.[40] Such analyses and information would appear much more relevant to a decision whether or not to recommend a transaction involving a premium for high-vote shares than historical trading premium and the number of precedent transactions not involving a premium.

Detailed Disclosure

On a separate note, the TCI court confirmed that Delaware law does not require merger proxies to contain a blow-by-blow description of a special committee's deliberative process: "No Delaware decision has ever held that a more detailed description of a committee's deliberations, either akin to the minutes of the committee, or a transcript of committee meetings, or some other description of the give and take and discussions of the committee must be disclosed in order to support a statement of "careful consideration." Instead, the courts of Delaware have repeatedly stated that, in the context of disclosures, less disclosure is often more appropriate than more in order to avoid burying shareholders beneath a tome of impenetrable complexity and length. [Citations omitted.]"[41]

Conclusion

While the defendants could still prevail at trial based on a balanced assessment of the evidence presented by both sides, the TCI decision provides important guidance for boards and special committees that, if followed, should increase their prospects of obtaining summary judgment in similar cases. Unfortunately, the TCI decision is not without controversy as it has raised a number of significant issues that, going forward, special committees and financial advisors may have difficulty addressing if they are not satisfactorily resolved by Delaware Chancery Court at trial or the Delaware Supreme Court upon appeal.

Notes

1. *In re: Tele-Communications, Inc. S'holders Litig.*, No. 16470, 2005 Del. Ch. LEXIS 206, (Del. Ch. Dec. 21, 2005).
2. *Id.* at *3.
3. *Id.* at *4.
4. *Id.* at *30-31.
5. *Id.* at *29.
6. *Id.* at *30.
7. *Id.* at *35.
8. *Id.* at *33-35.
9. *Id.* at *7 and *11.
10. One member of the TCI special committee owned 246,271 shares of high-vote stock as compared to the 161,244 shares of low-vote stock owned by both members of the TCI special committee combined. *Id.* at 24.
11. *Id.* at *57.
12. *Id.* at *37.
13. Mr. Malone, the chairman of TCI and its largest shareholder (with the right to vote approximately 47 percent of the total voting power of TCI's outstanding shares), made it clear from the outset that in order to obtain his approval for the merger a 10 percent premium would have to be paid for the high-vote shares, stating "[a]nd I didn't care if the special committee came back and said it's grossly unfair. I would have just said, that's how life is. You want the deal, you pay the 10 percent. You don't want the deal, don't pay the 10 percent." *Id.* at *9, n.26 and *48. n.133.
14. *Id.* at *47.
15. *Id.* at *39.
16. For example, where a controlling shareholder seeks to buy out a minority, special committees are often well advised to seek the authority to solicit, evaluate and negotiate alternative proposals. Even if rebuffed, in whole or in part, by seeking such authority the special committee demonstrates its independence and can firmly establish whether the controlling shareholder is a seller or only a buyer.
17. *Id.* at *5.
18. *Id.* at *11.
19. *Id.* at *19 and n.52.
20. *Id.* at *19.
21. *Id.* at *49.
22. *Id.* at *40.
23. *Id.* at *48-49
24. *Id.* at *41. The opinion does not actually describe any legal advice provided to the TCI special committee by TCI's counsel. Interestingly, the only legal advice provided to the TCI special committee that is described in the opinion is legal advice provided by counsel to TCI's financial advisor. *Id.* at *6-7 and *46.
25. *Id.* at *41.
26. *Id.* at *46-47.
27. *Id.* at *49.
28. *Id.* at *47.
29. *Id.* at *23-25.
30. *Id.* at *49.
31. *Levco Alternative Fund Ltd.* v. *Reader's Digest Ass'n, Inc.*, Nos. 466,2002, 467,2002, 2002 WL 1859064, *2 (Del. Aug. 13, 2002).
32. *TCI* at *54-55.
33. *Id.* at *41-42.
34. *See e.g., In re Toys "R" Us, Inc. Shareholder Litigation*, 877 A.2d 975, 1005 (Del. Ch. 2005). ("This feature of the contract was designed to provide an incentive for First Boston to seek higher value, and has been recognized as proper by our courts.") and *In re The MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 22 (Del. Ch. 2004) ("This financially sophisticated Board engaged CSFB for advice in maximizing stockholder value. It obtained a fairness opinion from CSFB, itself incentivized to obtain the best available price due to a fee that was set at 1% of transaction value;…"). *See also*, Andrew L. Bab, William D. Regner and Jeffrey J. Rosen, *Faulty Assumptions*, The Daily Deal, September 6, 2004 ("Certainly the banker's fee structure may enhance the pressure that all service providers feel to render advice that their clients want to hear. But ethics, responsibility, reputation and potential liability all work hard to counter those pressures. Moreover, the basis of the banker's compensation is fully disclosed to both the board of directors and to shareholders who may read the opinion.").
35. *Levco* at *2.
36. There is no discussion in the opinion as to whether AT&T insisted on an immediate one-step merger (presumably requiring prior board approval for purposes of Section 203 of the Delaware General Corporation Law) or whether AT&T would have been prepared to purchase a controlling block of high-vote stock from Mr. Malone and others (permitting them to extract the entire control premium if they so desired) in the event the TCI special committee had refused to recommend a merger in which holders of TCI high-vote stock would have received a 10 percent premium.
37. *TCI* at *8 and *49-50.
38. In an earlier decision relating to the same transaction, the TCI court acknowledged that "[i]n at least one case, this Court approved a settlement in which a single controlling block of [super-voting shares] would be purchased for $135 per share whereas [other shareholders] would receive only $36 per share." *In re Tele-Communications, Inc. S'holders Litig.*, No. 16470, 2003 Del. Ch. LEXIS 78, *13, n.18 (Del. Ch. July 7, 2003).
39. *TCI* at *55.
40. *Id.* at *48.
41. *Id.* at *22.

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