

# Pleading Bad Faith Against Special Committee Members: A New Trend?

October 12, 2021

Special committees, by design, are created to address conflicts and to insulate the board of directors from liability for the very conflicts that may invite judicial scrutiny of the fairness of the board's decision. A well-functioning special committee will also mitigate the risk of personal liability for a company's fiduciaries, reducing the likelihood of protracted post-closing litigation. Directors of Delaware public companies are typically exculpated for monetary liability for duty of care claims under their company's charter. In that case, the only hook for monetary liability against a director is a duty of loyalty breach, which requires the plaintiff to allege that the director was interested in the transaction, lacked independence in the transaction or acted in bad faith. A properly constituted special committee should eliminate the ability to allege both interest in the transaction or lack of independence, leaving only bad faith as a basis for breach of loyalty claims against directors serving on the committee. The Delaware Court of Chancery has acknowledged that a "finding of bad faith in the fiduciary duty context is rare" but despite that acknowledgment, in two separate decisions this year ([\*In Re Pattern Energy Group Inc. Stockholders Litigation\*](#) ("*Pattern Energy*") and [\*The MH Haberkorn 2006 Trust, et al. v. Empire Resorts, Inc., et al.\*](#) ("*Empire Resorts*")), the court allowed bad faith claims against special committee members to survive a motion to dismiss. These decisions, which are described in more detail below, highlight the importance of a committee's role in managing conflicts, particularly when it is made aware of potential wrongdoing by conflicted fiduciaries.

## Pleading Bad Faith in the Fiduciary Context

In both *Pattern Energy* and *Empire Resorts*, the special committee members were arguably disinterested and independent, so any duty of loyalty claim would need to allege that the serving directors acted in bad faith. Three types of bad faith are recognized in Delaware: "(i) subjective bad faith, in conduct motivated by an intent to do harm; (ii) intentional dereliction of duty or conscious disregard of duty; and (iii) "allow interests other than obtaining the best value reasonably available for stockholders to influence decisions during the sale process, given that they made decisions falling outside of the range of reasonableness." Because there was no direct evidence of an intent to do harm in either case, *Pattern Energy* and *Empire Resorts* focused on the latter two types of bad faith.

### ***Pattern Energy*: Allowing Interests Other Than Obtaining Best Value for Company's Stockholders to Influence Decisions**

**Background.** The dispute arose from the sale of Pattern Energy to Canada Pension Plan Investment Board ("CPPIB"). To contextualize the court's decision, it is important to understand Pattern Energy's relationship with Riverstone. Riverstone was, for some time (but not at the time of the challenged transaction), a large stockholder of Pattern Energy. At the time of the challenged transaction, Riverstone maintained a material business relationship with Pattern Energy through its controlling interest in Pattern Energy Group Holdings 2, LP ("Developer 2"). Pattern Energy and Developer 2 had a symbiotic relationship whereby Developer 2 would construct renewable energy projects and Pattern Energy would operate those projects. Riverstone was the controlling stockholder of Developer 2, and Pattern Energy, together with certain members of its management team, owned the remaining interest in Developer 2. Riverstone had a consent right (the "Consent Right") over any transfer of Pattern Energy's interest in Developer 2.

**Sales Process.** In 2018, the board launched a sales process with a special committee in place. Two of Pattern Energy's directors (Michael Garland and Edmund Browne), who also served as directors of certain Riverstone entities, were excluded from the committee because Riverstone was considered a potential acquirer. For over a year, the special committee conducted a robust sales process, actively engaging with multiple bidders, with CPPIB and Brookfield being the final two bidders. The complaint alleged that despite Brookfield offering a superior deal to Pattern Energy's stockholders, the special committee favored CPPIB throughout the process because CPPIB was Riverstone's preferred bidder. (And, according to the complaint, CPPIB had a history with Riverstone—it had invested over \$700 million in Riverstone funds—and CPPIB's bid (shaped with assistance from Riverstone) would allow Riverstone to take Pattern Energy private and consolidate it with Developer 2). Brookfield submitted multiple offers throughout the process, agreeing to price increases requested by the committee and otherwise amending its offer to accommodate requests from Riverstone. When it became clear to Brookfield that it would not receive Riverstone's cooperation, Brookfield withdrew

from the process. Two days later, upon recommendation of the special committee, the board approved CPPIB's all-cash offer of \$26.75 a share.

*Legal Analysis of Bad Faith Claims.* The court acknowledged that—on the surface—the special committee appeared to have fulfilled its duties, noting that the committee conducted a robust sales process, engaged with multiple bidders, resisted calls for exclusivity, pursued a go-shop and negotiated multiple price increases from Brookfield. Given the active involvement of the special committee, it was “impossible to conceive of conscious disregard”, leaving plaintiffs to rely on the third type of bad faith: that defendants allowed interests other than obtaining the best value for Pattern Energy's stockholders to influence their decisions, given that the decisions they made fell outside the range of reasonableness. To support such a theory of bad faith, the complaint alleged that the special committee members valued Riverstone's interests over the interests of Pattern Energy's stockholders by: “(1) infecting the process with interested fiduciaries and conflicted advisors; (2) preferring Buyer throughout the process and at the moment of decision over Brookfield's premium bid; and (3) misusing the Consent Right to dissuade Brookfield.”

Although Browne and Garland were excluded from the special committee, Browne attended most committee meetings and Garland was actively involved in the sales process, often serving as the primary point of contact for bidders. Under Delaware law, there is nothing inherently wrong with delegating the negotiation of a transaction to a conflicted fiduciary, but the conflict must be appropriately managed. In this case, the complaint alleged that Garland set up an initial meeting between CPPIB and Riverstone regarding a potential sales transaction (in clear violation of the guidelines established by the special committee) after receiving Brookfield's initial offer. Plaintiffs alleged that Garland proactively reached out to CPPIB because Brookfield's initial offer was designed to avoid the Consent Right and did not otherwise align with Riverstone's objectives. Garland eventually disclosed the meeting to the committee, but that disclosure occurred more than a month after the meeting took place. The special committee seemingly acknowledged the materiality of that meeting but took no action to reduce Garland's participation or influence in the sales process. Additionally, the court questioned why Pattern Energy hired Goldman as a second financial advisor given Goldman's conflicts (Riverstone was formed by former Goldman employees; Goldman owned a 12% stake in Riverstone, received substantial fees from Riverstone in recent years, and was engaged by Riverstone in 2018 to advise on potential take-private of Pattern Energy). The timing of Goldman's engagement was also questionable: Goldman was hired shortly after receiving Brookfield's initial bid. Furthermore, unlike the committee's decision to hire Evercore, there was no discussion in the committee's minutes regarding its decision to hire Goldman (particularly given the belated engagement), nor were any of Goldman's conflicts disclosed in the proxy.

In addition to the inadequate management of conflicts, it was alleged that the committee acted in bad faith by favoring CPPIB throughout the process, despite their acknowledgement that Brookfield's offer was superior in value for Pattern Energy's stockholders. The special committee encouraged bidders to structure their offers to internalize Developer 2, despite knowing that any offer for Developer 2 “would require the Company's stockholders to compete for transaction consideration.” The court also took issue with the special committee's representation of the Consent Right to bidders. The committee's legal counsel had advised that the Consent Right was easily circumvented but the committee continued to advise bidders that Riverstone's consent was required for any transaction involving Pattern Energy, and that any transaction that did not receive Riverstone's consent would likely face litigation from Riverstone. The special committee argued that it preferred CPPIB's all cash-offer because it was less burdensome than Brookfield's stock-for-stock offer but the court found that argument unpersuasive, noting that: “in the *Revlon* context, it is dispositive that Buyer's offer took Merger consideration away from the Company's public stockholders in protecting Developer 2 and Riverstone.” The complaint did not detail any other rationales proffered by the director defendants for preferring CPPIB over Brookfield.

Given these allegations, the court found it reasonably conceivable that the special committee members breached their duty of loyalty by acting in bad faith, stating that: “the Complaint alleges facts from which it is reasonably conceivable that the Board's conduct with regard to the sales process and approval of the Merger can in no way be understood as in the corporate interest.”

#### ***Empire Resorts: Conscious Disregard of Duty***

*Background.* The dispute arose from the take-private of Empire Resorts, Inc. by its controlling stockholder, Kien Huat in 2019. Empire was in the gaming and hospitality business and its primary assets consisted of a horseracing facility and video lottery terminal, referred to as the Monticello Raceway, and a casino and resort, referred to as Resorts World. Important in the court's analysis was Empire's potential relocation of the Monticello Raceway to Orange County, NY. In May 2019, the controlling stockholder engaged Union Gaming to evaluate future revenue prospects for an Orange County facility. At the time of the challenged transaction, the relocation was not yet definitive, but the NY state legislature had approved the relocation on June 20, 2019 and Empire had entered into a non-binding term sheet for a 20-year lease at a facility in Orange County.

**Sales Process.** In February 2019, Empire engaged Moelis to advise on capital structure issues and long-term debt. The complaint alleged that Empire shifted to a take-private plan once it became clear that approval from NY state for the Orange County relocation was imminent. On June 21, 2019 (one day after receiving approval for the Orange County relocation), the Empire board decided to form a special committee to consider a related-party sales transaction. The committee hired separate legal counsel and engaged Moelis as its financial advisor. Meanwhile, in July 2019, the controlling stockholder engaged Union Gaming to evaluate a potential merger with Empire. On July 25, 2019, three days after receiving Union Gaming’s analysis, the controlling stockholder delivered a letter to Empire stating that it no longer believed Empire was viable as a stand-alone company. The special committee met for the first time later that day, with conflicted members of Empire management present. On August 5, 2019, the controlling stockholder (together with certain of its affiliates) submitted an offer to take Empire private for \$9.74/share, a 2% premium to its then current trading-price (and lower than any of the valuations prepared by Union Gaming). The special committee met the following day to discuss the controlling stockholder’s proposal and Moelis reviewed management’s projections that were prepared for the merger. Those projections specifically excluded the expected impact on revenue from the contemplated relocation to Orange County, despite the the full board having met earlier that day to receive an update on the Orange County relocation, including the receipt of state approval and the execution of non-binding term sheet for the facility lease. On August 14, 2019, the chairman of the board (who was affiliated with the controlling stockholder) learned of a third party’s interest in providing financing to Empire, which could enable it to continue as a standalone public company. On August 16, 2019, the controlling stockholder delivered a letter to the special committee indicating that it may back away from the deal if an agreement was not signed by Sunday, August 18, 2019. The full board then met on August 18, 2019 and, upon recommendation of the special committee, approved the merger with the controlling stockholder.

**Legal Analysis of Bad Faith Claims.** The court’s decision in *Empire Resorts* focused on the second type of bad faith: conscious disregard of duty. Finding it reasonably conceivable that the committee members acted with a conscious disregard of their duties, the opinion focused on the committee’s failure to manage conflicts, with particular emphasis on how that failure tainted Empire’s projections. Like *Pattern Energy*, where the committee was criticized for allowing conflicted fiduciaries to participate in the process once it became clear that those individuals had violated the committee’s guidelines, the court in *Empire Resorts* questioned why the committee continued to allow conflicted fiduciaries at their meetings even **after** it became clear that the committee’s deliberations were being leaked to the controlling stockholder. The court further criticized the committee for not taking a more active role in the review and preparation of projections that were used to evaluate the merger and support the fairness opinion provided by Moelis. In particular, the court questioned why the special committee never received or asked for projections that included the impact that the relocation to Orange County could have on the projections and Empire’s valuation. The committee argued that it was justifiable to exclude Orange County from the projections given its uncertainty, but the court dismissed that argument—at least at the pleading stage—noting that nothing in the minutes suggest that the committee even sought such an analysis. The uncertainty argument was even less persuasive because some of the projections assumed that online sports gambling would be legalized, and the likelihood of such legalization was less probable than the Orange County relocation. Per the opinion: “The complaint alleges that the special committee approved a deal it knew undervalued Empire’s minority shares, based on management projections that excluded the impact of plans and issues that were allegedly lucrative, discussed by the board in prior meetings. These allegations support a conclusion that the special committee acted consciously with disregard for its duties and allowed management to taint the process so that the proposal was not adequate consideration for Empire’s shares.”

#### **Key Takeaways**

- **Managing Conflicts.** In both *Pattern Energy* and *Empire Resorts*, the overarching theory was that the special committee acted in bad faith by failing to adequately oversee and manage conflicts. In *Pattern Energy*, the court acknowledged that there is nothing inherently wrong with allowing conflicted members of management to negotiate a sales transaction but admonished the committee for not taking any action to reduce CEO Garland’s role in the sales transaction once the committee became aware that he had taken several actions in violation of the committee’s guidelines (“Garland was afforded the opportunity to tip the scales in Riverstone’s favor and did so”). In *Empire Resorts*, the court questioned why the committee allowed conflicted fiduciaries to attend committee meetings after it became clear that their deliberations were being leaked to the potential buyer. These decisions should not be read to prohibit conflicted fiduciaries from all participation in a sales process or in the special committee’s process, but they do reinforce a committee’s ongoing obligation to manage those conflicts and the risks that come with allowing such participation. The committee must be sensitive to the risk that conflicted fiduciaries may attempt to tip a deal in favor of a conflicted buyer and should limit their ability to do so. Committees can allow conflicted management or other fiduciaries to make presentations and answer questions but should excuse conflicted persons from committee deliberations. Furthermore, conflicted management should not control the messaging to bidders or make material negotiating decisions and the committee should be proactive in questioning information that it receives from conflicted management as part of its deliberative process (and ensure that such questioning is reflected in the committee’s minutes). For example—and as these decisions

demonstrate—the committee should not just accept at face value assertions by conflicted management or directors that the company cannot remain a separate public company and refinance its debt or that the company’s plans should not be considered when determining a company’s valuation as a standalone entity.

- *Participation in Financial Projections.* In *Empire Resorts*, the court also found it conceivable that the committee’s failure to manage conflicts resulted in compromised financial projections and an undervaluation of the company. Of course, the committee members themselves were not in the position to prepare projections. The complaint alleged, however, that the committee allowed conflicted management to work with Moelis to create projections that depressed the company’s value by excluding the impact of the proposed relocation to Orange County and making other last-minute changes to the projections to enable approval of a transaction that undervalued Empire’s shares. The decision serves as a reminder that a special committee should take an active role in reviewing any projections used to evaluate a transaction, particularly those that are prepared by conflicted management. The committee needs to understand the key assumptions in the projections and can request that the financial advisor prepare sensitivity analyses that show the impact of changes to these assumptions as well as the probability of achieving the projected or alternative outcomes. If the projections exclude certain known developments that could impact future revenue or cash flow, the special committee should inquire as to the rationale for the exclusions and should document that rationale in the committee’s minutes.
- *Minutes / Records Reflecting Deliberations.* Both decisions highlight the need to take careful meeting minutes, particularly given the scrutiny facing conflicted transaction involving a public company. Committee members should be prepared to defend material actions (or inaction), which is decidedly more difficult when that action (or inaction) is not supported by the committee’s minutes. In *Empire Resorts*, the committee members argued that excluding the impact of the relocation to Orange County from the projections was justifiable given the uncertainty of the relocation, but nothing in the minutes indicated that the committee ever discussed the possible impact of the relocation or whether it should be included in any of the projections. In *Pattern Energy*, the court highlighted multiple instances in which Garland’s contact with CPPIB, as described in the proxy, was inconsistent with the committee’s minutes and also questioned why the committee’s minutes documented the decision to retain Evercore, but no discussion was made of its decision to engage Goldman, despite Goldman’s conflicts.
- *Impact on Willingness to Serve on a Special Committee.* Recognizing the value that a special committee can add for minority stockholders, the Delaware judiciary has been circumspect of any “approach that would create incentives for independent directors to avoid serving as special committee members.” The concern with these decisions (particularly *Empire Records*) is where to draw the line between a bad faith claim and a duty of care claim. The primary focus of the court in *Empire Records* was the special committee’s failure to be more involved in the review of the financial analyses based on financial projections prepared by conflicted management without adequate oversight from the committee. That claim could have been cast as a duty of care claim, but to survive a motion to dismiss, the plaintiffs were required to plead bad faith. If an increasing number of these cases survive a motion to dismiss, special committee members will face increased litigation risks, including potential personal liability.

## Conclusion

The plaintiffs’ bar is continually testing new ways to hold corporate fiduciaries personally liable for damages. We have already witnessed a growing trend of bringing duty of care claims against officers (only corporate directors can be exculpated for duty of care claims under Delaware corporate law), and suspect that these two decisions will be followed by more bad faith claims against special committee members. These cases, and the risks attendant to bad faith claims, demonstrate that it is not sufficient to establish a special committee of independent directors in conflicted transactions. The directors serving on the committee must manage the transaction process in a manner that does not allow the conflicts to result in an unfair outcome for minority stockholders.

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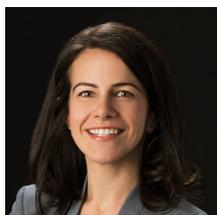
See *In reCornerstone Therapeutics Inc. Stockholder Litigation*.

Also appearing on Cooley’s M&A blog

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