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The segregation of companies' management from independent committees may harm shareholders

Client Updates

The independent committees in companies, are designed to protect the interests of public shareholders. The segregation of companies' management, which is intended to protect the shareholders, may in fact lead to the exact opposite, and negatively affect the terms of the transaction, as companies' management are knowledgeable and experienced in their company's businesses. Therefore, it is appropriate to develop guiding principles whereby the independent committee can use the input of management without calling into question its own independence.

A recent ruling by District Court Judge Michal Agmon-Gonen, once again turned the spotlight on to the activities of board of director's independent committees. Such committees, are established by companies' board of directors in order to discuss and approve significant "controlling shareholder transactions" in which the controlling shareholder has a conflict of interest. The role of the committee is to ensure the company enters into an optimal and fair transaction, which is not biased in favor of the controlling shareholder and its business, at the expense of the company. As such, the role of the committee is to "represent" the interests of the minority shareholders and ensure they are not at a disadvantage.

In her ruling, Judge Agmon-Gonen deliberated the roles of the independent committees that were established in Bezeq, for the purpose of approving transactions with companies that were under the control of the controlling shareholder of Bezeq at the time, Shaul Elovitch. The judge determined that the applicable law does not obligate the committees to keep their deliberations confidential, and the issue is now before the Supreme Court.

In addition to the question of confidentiality, the role of the company's management in the independent committee also comes into question. Given that a company's management is appointed by the board of directors, and that the controlling shareholder, in practice, appoints a majority of the board's members, there is a common perception that the management, in effect, is in the same conflict of interest as the controlling shareholder.

Confidential Procedure

According to the guidelines outlined in Israeli case law, as well as the accepted norms (prior to the Agmon-Gonen ruling), the committee must conduct the transaction analysis procedure in complete confidentiality. The committee is expected to lead the negotiations while "excluding" the controlling shareholder and those

related to the controlling shareholder, from the discussions and decisions. The goal is to ensure that the committee makes a decision that is independent of the interest of the controlling shareholder.

However, the expansion of the "segregation" and its application to management may in fact be problematic and harmful to public shareholders. When it comes to an asset purchase transaction or a merger with another company, the professional opinion of the CEO regarding the acquired company and the viability of the purchase is highly important, in light of their experience as a CEO and the fact that they are due to manage the target company in future.

The members of the independent committees are external or independent directors. Although they participate in board meetings and are familiar with the company's business, their level of knowledge of its business and challenges does not come close to that of the management who "live" the company's business and industry. Therefore, the members of the committee are often at a disadvantage and are unable to conduct negotiations as effectively as would a more experienced member of management. The result is that the segregation of the management, which is intended to protect public shareholders, may in fact bring about the exact opposite and in effect harm the ability of the committee to negotiate optimally with the controlling shareholder regarding the terms of the transaction.

In order to avoid such an outcome, independent committees sometimes seek assistance from the company's management, in the hope to benefit from their expertise when conducting the negotiations. However, the committee members are then exposed to a claim that they did not sufficiently maintain the independence of the committee and the confidentiality required.

Therefore, it is recommended to establish guiding principles for the manner in which an independent committee may be assisted by their company's management, without the committee's independence being called into question. Until the courts address this issue, and the Supreme Court clarifies the standard of confidentiality that is applicable to the committee, it is prudent for independent committees, with the guidance of their legal advisors, to adopt an "operating procedures" from the outset, that will balance the opposing considerations.

Full Transparency

In accordance with the guidelines of the Israel Securities Authority, the committee's procedures should be made public, enabling full transparency in order to preserve the shareholders trust in the work of the committee. Given that the development of these guiding principles is in the interest of public shareholders, it is reasonable to assume that the institutional investors that manage public funds will also support their development. As such, along with the strict corporate governance rules – including the rules of confidentiality derived from the nature of the committee's work, the professional expertise and input of management, which would be unfortunate to forego, can be leveraged.

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