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Delaware Supreme Court Confirms The Path to Business Judgment Review In Controlling Stockholder Transactions

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On March 14, 2014, the Delaware Supreme Court issued its eagerly-awaited decision in *Kahn v. M&F Worldwide Corp.*, No. 334, 2013 (Del. March 14, 2014). The Court affirmed the Chancery Court's holding (Strine, C.) that the deferential business judgment standard of judicial review – rather than the rigorous entire fairness standard – will apply to a controlling stockholder transaction if, from the outset, the transaction is (i) subject to negotiation and approval by an independent special committee empowered to say no, and (ii) conditioned on and approved by an uncoerced, fully informed majority of the minority stockholder vote. Although this framework has been endorsed by several Chancery Court decisions, the Delaware Supreme Court had not had the occasion to resolve the applicable standard of review when *both* of these minority stockholder procedural protections were employed at the outset. While the decision appears to provide a roadmap to minimize litigation risk in controlling stockholder transactions, the practical effect of the decision remains to be seen.

Case Summary

The lawsuit arose from a 2011 acquisition by MacAndrews & Forbes Holdings, Inc. ("M&F") of the remaining common stock of MFW Worldwide Corp. (the "Merger"). Slip Op. at 3. M&F held 43% of MFW's outstanding common stock. *Id.* From the outset, M&F required the Merger be contingent on approval by both an independent committee of MFW directors (the "Special Committee") and a majority of stockholders not affiliated with M&F. *Id.* The merger closed in 2011 following approval by 65.4% of MFW's minority stockholders. *Id.* Plaintiffs then brought suit, alleging that the Merger was unfair to minority stockholders. After finding that the Merger was conditioned on both stockholder protection mechanisms, the Court of Chancery reviewed the Merger under the business judgment rule and granted summary judgment for defendants. *Id.* at 4; see *In Re MFW S'holders Litig.*, 67 A.3d 496, 502 (Del. Ch. 2013). Former Chancellor Leo Strine Jr., who was sworn-in as Chief Justice of the Delaware Supreme Court on February 28, 2014, decided the 2013 Chancery Court case, and as a result did not participate in the Delaware Supreme Court's decision.

On appeal, plaintiffs primarily argued that (i) the record showed the Special Committee was not, *inter alia*, disinterested and independent, and the majority of the minority provision did not afford sufficient protection; and (ii) entire fairness should be the applicable standard of review even if both procedural protections were adopted. Slip Op. at 5. Defendants countered that the business judgment rule was the appropriate standard because the Merger was conditioned

ab initio on procedural protections that together replicated a third-party arm's length merger under Section 251 of the Delaware General Corporation Law. *Id.* at 6.

Under Delaware law, the entire fairness standard of review is applied where a transaction involving self-dealing by a controlling stockholder is challenged, and defendants have the burden of showing that the transaction was entirely fair to the minority stockholders. *See id.* at 11 (citing *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997)). However, defendants may shift the burden of persuasion to plaintiffs if they show that the transaction *either* was approved by (i) a well-functioning committee of independent directors; *or* (ii) an informed vote of a majority of the minority stockholders. *Id.* (citing *Kahn v. Lynch Comc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994)).

The Delaware Supreme Court's decision addressed a question of first impression: what is the appropriate standard of review in controlling stockholder transactions where *both* procedural protections are present. *Id.* at 11-12. In affirming the Chancery Court, the Delaware Supreme Court concluded that "business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." *Id.* at 15.

The Court's Reasoning

The Court enumerated four reasons for its decision to adopt the new standard. First, the entire fairness standard, the highest standard of review in corporate law, is applied as a substitute for the dual statutory protections of disinterested board and stockholder approval, because both are potentially undermined by the controlling stockholder. *Id.* at 15-16. However, this risk is eliminated where both procedural mechanisms are employed to effectively replicate a third-party arm's length transaction: "[t]he simultaneous deployment of the procedural protections employed here create a countervailing, offsetting influence of equal – if not greater – force." *Id.* at 16. Second, the dual procedural protections optimally protect minority stockholders in controller buyouts. *Id.* at 16. Third, applying the business judgment rule to the dual protection merger structure is consistent with Delaware law, which defers to informed, impartial directors, and will benefit minority stockholders; indeed, "[a] transactional structure subject to both conditions differs fundamentally from a merger having only one of those protections...." *Id.* at 13, 16-17. Lastly, "the underlying purposes of the dual protection merger structure and the entire fairness standard of review both converge and are fulfilled at the same critical point: price[.]" which may be the preponderant consideration in assessing the fairness of a merger. *Id.* at 17.

In sum, the Court held that "in controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) the controller conditions the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." *Id.* at 18 (emphasis in original). In agreeing with the Court of Chancery's conclusion – which was based on a "highly extensive record" – that the procedural protections had both been undisputedly established prior to trial, the court affirmed the use of the business judgment rule, finding that "it cannot be credibly argued (let alone concluded) that no rational person would find the

Merger favorable to MFW's minority stockholders." *Id.* at 38-39.

Takeaways

By outlining the steps to obtain review under the deferential business judgment rule standard, the Delaware Supreme Court has provided a blueprint for companies to minimize litigation risk in controlling stockholder transactions. If both minority protection mechanisms are employed at the outset of the transaction, and carefully followed, defendants will be in a stronger position to seek dismissal or negotiate a favorable settlement, and the specter of business judgment review may discourage frivolous stockholder suits in the first place.

That said, there are reasons to doubt that this decision will have a material impact on cases challenging controlling stockholder transactions. The Court of Chancery's decision in *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, 52 A.3d 761 (Del. Ch. 2011) (Strine), amply demonstrates that only a robust and well-executed special committee process will suffice. The special committee must, among other things, (i) be "well functioning;" (ii) operate without a "controlled mindset;" (ii) act like a third-party negotiator with a full range of options; and (iii) have a broad enough mandate to permit it to explore alternatives and effectively function as an arm's length negotiator. *See id.* at 774, 789, 804. Thus, the efficacy of the special committee process likely will be the principal battleground in cases challenging controlling stockholder transactions. In the future, plaintiffs will devote substantial portions of their complaints to attempting to discredit the special committee process in every way possible. As such, to the extent a company elects to follow the roadmap provided by the Delaware Supreme Court, it is well-advised to act scrupulously to ensure that its special committee is fully independent, active, informed, and has retained independent financial and legal advisors, lest it may lose the benefit it structured the transaction to achieve.

In any case, even where both minority protection devices are employed, a complaint raising fact issues regarding the special committee process remains likely to survive a motion to dismiss, particularly given Delaware's adherence to the low reasonable conceivability pleading standard. Indeed, the complaint here survived a motion to dismiss, and the case was resolved at summary judgment after discovery. In addition, disclosure challenges provide yet another route for plaintiffs to attempt to evade business judgment review. Plaintiffs will often allege that a majority of the minority stockholder vote was not adequately informed because of disclosure deficiencies. Accordingly, while this decision certainly provides defendants with additional ammunition, companies should not be misled to believe that it provides a get-out-of-stockholder-litigation-free card.