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POWER TO THE PEOPLE (AND RELIEF TO DIRECTORS): NEW CLARITY ON THE CLEANSING EFFECT OF STOCKHOLDER RATIFICATION

By Clare O'Brien and Aselle Kurmanova

Clare O'Brien is a partner, and Aselle Kurmanova is an associate, in the New York office of Shearman & Sterling LLP. Contact: cobrien@shearman.com or aselle.kurmanova@shearman.com.

***Editor's note**: This article is part of an occasional series that commemorates the 20th anniversary of **The M&A Lawyer** by examining how certain aspects of M&A law have changed over that period.*

It has long been a policy of corporate law[1] that the informed business decisions of independent and disinterested directors are protected by the presumption of the business judgment rule.[2] Courts are reluctant to second-guess decisions that are made by directors in good faith and with the requisite degree of care. This reluctance remains evident in the recent decisions of Delaware courts, holding, in two lines of cases, that the presumption of the business judgment rule should apply both to certain transactions involving conflicted controlling stockholders and to transactions not involving conflicted controlling stockholders, that would otherwise be subject to either the entire fairness or *Revlon* standard of review, as applicable, if those transactions are approved by a "fully informed, uncoerced majority of disinterested stockholders."[3]

Standard of Review of Transactions with Controlling Stockholder

Traditionally, the entire fairness standard of review, rather than the business judgment rule, has been applied by Delaware courts in reviewing transactions involving a company's controlling stockholder.[4] However, in 1994, in *Kahn v. Lynch Communications Systems, Inc.*,[5] the Delaware Supreme Court held that if a transaction with a controlling stockholder is approved by a board committee comprised of independent directors or an informed majority of minority stockholders, the burden of proof as to whether the transaction is fair to the minority stockholders shifts from the controlling stockholder to the plaintiff.[6] Regardless of whether or not the burden of proof has shifted, the appropriate standard of review would still be the entire fairness.[7]

Twenty years later, in 2014, the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.* was faced with a "novel question of law" regarding the appropriate standard of

IN THIS ISSUE:

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review in a going-private merger that, from the inception of the transaction, was conditioned on approval by both (i) an adequately empowered, independent committee and (ii) an informed, uncoerced majority-of-the-minority vote.[8] In affirming the decision of the Court of Chancery that the business judgment rule applies, the Supreme Court held that because the controlling stockholder irrevocably and publicly gave up its voting control to dictate the outcome of the transaction, which replicated the process that would apply in a third-party, arm's-length transaction, the business judgment standard of review should apply. There are six specific procedural requirements that a controlling stockholder must satisfy at the outset (collectively, the "MFW Standard") in order for the business judgment rule to apply: "(i) the controller conditions the procession of 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 definitely; (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."[9]

Similarly, in New York, transactions with controlling stockholders have generally been subject to entire fairness review. In *Alpert v. 28 Williams St. Corp.*, the Court of Appeals of the State of New York affirmed, in reviewing a freeze-out merger, that "the essence of the judicial inquiry is to determine whether the transaction, viewed as a whole, was "fair" as to all concerned."[10] Similarly to the entire fairness standard promulgated by Delaware courts,[11] the concept of fairness in New York involves two components: fair dealing toward minority holders and fair price offered for the minority's stock.[12] This standard of review continued to control in New York until *Kenneth Cole,*[13] when the Court of Appeals followed *Kahn v. M&F Worldwide* and applied the business judgment rule to a transaction with a controlling stockholder that complied with the MFW Standard.

M&F Worldwide and *Kenneth Cole* set forth a fairly clear standard in the context of take-private transactions involving a controlling stockholder. By ruling that the business judgment rule will apply if, at the outset, the transaction complies with the MFW Standard, the courts of both jurisdictions once again emphasized their preference not to evaluate independently the substance of a board's decision, but rather to only opine on the decision-making process itself. As a result, unlike 20 years ago, controlling stockhold-

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ers in New York and Delaware should be able to avoid the entire fairness standard of review by complying with the MFW Standard—assuming, of course, that they are prepared to relinquish the benefits of being able to control the outcome of the particular transaction, and, like any third party, assume the risk that the transaction will not be approved by an independent committee or the minority stockholders.[14]

Standard of Review of Transactions Not with Controlling Stockholders

Similarly, transactions involving the sale of a company for cash (or mostly cash) to someone other than a controlling stockholder were generally subject to the *Revlon* standard of review.[15] However, as made clear in several recent Delaware decisions, these transactions will be protected by the business judgment rule, even if a majority of the board was not disinterested or independent, if such transactions are approved by a fully informed, uncoerced vote of a majority of disinterested stockholders.

In 2014, in *KKR Financial,*[16] the Delaware Court of Chancery reasoned that in transactions not involving a controlling stockholder, the business judgment rule presumption should apply if the board's decision is approved by a fully informed, uncoerced vote of a majority of disinterested stockholders, even if a majority of the directors approving the transaction are not independent or disinterested. This approach was later confirmed by the Delaware Supreme Court in *Corwin v. KKR Financial*,[17] when the court decided that the fully informed, uncoerced vote by disinterested stockholders restores the presumption of the business judgment rule even in a *Revlon* merger subject to enhanced scrutiny. In 2016, in *Larkin v. Shah*,[18] the Court of Chancery clarified that the only transactions subject to the entire fairness review that cannot be cleansed by proper stockholder approval are conflicted transactions with controlling stockholders.

The Court of Chancery reaffirmed *Corwin* in *Miami General Employees v. Comstock,*[19] as well as in its recent decision, *Solera Holdings, Inc.,*[20] holding that if a transaction that is subject to enhanced scrutiny under *Revlon* and its progeny is approved by a fully informed and uncoerced vote of a disinterested majority of stockholders, the business judgment rule presumption will apply.[21]

Similarly, in *Singh v. Attenborough*,[22] the Delaware Supreme Court affirmed the judgment of the Court of Chancery[23] that a fully informed, uncoerced vote of disinterested stockholders invoked the business judgment rule standard of review.[24] The court noted that the Chancery Court erred in considering post-closing whether the plaintiffs had stated a claim for the breach of the duty of care, stating that, absent a stockholder vote and an exculpatory charter provision, the damages liability standard for a disinterested director for breach of the duty of care is gross negligence. Therefore, "employing this same standard after an informed, uncoerced vote of the disinterested stockholders would give no standard-of-review-shifting effect to the vote. Where the business judgment rule standard of review is invoked because of a vote, dismissal is typically the result."[25]

In addition, the Delaware Court of Chancery recently provided clarity as to the cleansing effect of stockholder approval evidenced by stockholders' acceptance of a tender offer. In *Volcano*, the court concluded that the stockholder approval of a merger under Section 251(h) of the Delaware General Corporation Law by accepting a tender offer has the same cleansing effect as a vote in favor of that merger, rendering the business judgment rule presumption irrebuttable.[26] In a two-sentence opinion issued on February 9, 2017, the Delaware Supreme Court affirmed the judgment of the Court Of Chancery "for the reasons stated in its decision dated June 30, 2016."[27]

The result of this line of decisions is that, if the defendants establish the sufficiency of disclosure for

purposes of obtaining the cleansing effect of stockholder ratification, then, absent extraordinary circumstances, this will be outcome determinative, as such an approved transaction can be challenged only on the basis that it constituted waste—and, as noted in the *Volcano* decision, "it [is] logically difficult to conceptualize how a plaintiff can ultimately prove a waste or gift claim in the face of a decision by fully informed, uncoerced, independent stockholders to ratify the transaction," given that "the test for waste is whether any person of ordinary sound business judgment could view the transaction as fair."[28]

In affirming Chancellor Bouchard's opinion in *KKR Financial*, the Delaware Supreme Court in *Corwin* addressed the plaintiffs' argument that adhering to the proposition that a fully informed, uncoerced stockholder vote invokes the business judgment rule impairs the operation of *Unocal*[29] and *Revlon* and exposes stockholders to unfair action by directors without protection. The court held that, in advancing this argument, the plaintiffs ignored several factors, including that *Unocal* and *Revlon* were "not designed with post-closing money damages in mind, but rather to give stockholders and the Court of Chancery the tool of injunctive relief to address important M&A decisions in real time, before closing."[30] In addition, the court noted that "when the real parties in interest—the disinterested stockholders—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions in risk taking than it promises in terms of benefits to them."[31] Accordingly, and because judges are, by the court's admission, poorly positioned to evaluate the wisdom of business decisions, "there is little utility in having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders)."[32]

These recent cases, while generally consistent with long standing principles of corporate law, clarify and reinforce the notions that, absent a compelling reason for protection, stockholders should be masters of their own destiny when it comes to M&A transactions, while directors should be insulated from an intrusive standard of review when they give stockholders the information necessary to act on an informed basis. This clarity is welcome, as it gives directors the appropriate leeway to propose most transactions, and stockholders the appropriate discretion and responsibility in deciding whether to approve them. However, M&A practitioners should expect that, going forward, plaintiffs will attempt to reclaim a higher standard of review by alleging that stockholders have not been fully informed and/or have been coerced into approving a transaction. Accordingly, transaction participants (and their advisors) should ensure that stockholders are provided with full disclosure regarding all aspects of the transaction, particularly as to conflicts (the "warts and all" approach), and that plaintiffs have no credible basis to argue that stockholders were compelled to approve the transaction presented to them.

ENDNOTES:

[1] *See e.g.* Samuel Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 97.

[2] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re Kenneth Cole Prod., Inc., S'holder Litig.*, 2016 WL 2350133 (2016) citing *Chelrob, Inc. v. Barrett*, 293 NY 442, 459-460 (1944) and *Auerbach v. Bennett*, 47 NY2d 619, 630-631 (1979).

[3] *Corwin v. KKR Fin. Hldgs. LLC*, 125 A.3d 304, 312 (Del. 2015).

[4] *Kahn v. Lynch Commc'n Sys., Inc.,* 638 A.2d 1110, 1115 (Del. 1994) citing Weinberger v. UOP, Inc., 457 A.2d 701, 710 (1983); *Alpert v. 28 Williams St. Corp.,* 63 NY2d 557, 569 (1984).

[5] *Kahn,* 638 A.2d 1110, 1117 (Del. 1994).

[6] *Id.*

[7] *Id.*

[8] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 642

(Del. 2014).

[9]*In re Books-a-Million, Inc.*, 2016 WL 5874974, at *8.

[10]*Alpert v. 28 Williams St. Corp.,* 63 NY2d 557, 569 (1984).

[11]*Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

[12]*Alpert*, at 569.

[13]*In re Kenneth Cole*, 2016 WL 2350133, at *12 (2016).

[14]A transaction may still be subject to an entire fairness review if the plaintiff can plead a reasonably conceivable set of facts that any of the conditions of the MFW Standard are not satisfied. *M&F Worldwide Corp*., at 645. See also *In re Kenneth Cole*, at *14. The Court of Chancery confirmed in *In re Books-a-Million, Inc.,* referring to *Swomley v. Schlecht*, 2014 WL 4470947 (Del. Ch. Aug. 27, 2014)*, aff'd,*128 A.3d 992 (Del. 2015),that the court will apply the business judgment rule at the motion to dismiss stage if the defendants show their adherence to the MFW Standard "in a public way suitable for judicial notice, such as board resolutions and a proxy statement," unless the plaintiff pleads sufficiently that any conditions of the MFW Standard were not satisfied. *In re Books-a-Million, Inc.*, at *8. Chief Justice Strine in a footnote to the Supreme Court's December 19, 2016 decision in *Employees Retirement System of the City of St. Louis v. TC Pipelines GP, Inc.*, 2016 WL 7338592 (Del. 2016) confirmed, citing *Swomley*, that the pleading stage is an appropriate point to determine if a transaction complied with the MFW Standard.

[15]Transactions involving the sale of control or break-up of a company are subject to *Revlon* enhanced scrutiny review, which requires the directors' decisions to be reasonable under the circumstances, but not perfect. *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173 (Del. 1986).

[16]*In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980, 1003 (Del. Ch. 2014).

[17]*Corwin*, at 308.

[18]*Larkin v. Shah*, 2016 WL 448 5447, at *13 (Del. Ch. Aug. 25, 2016).

[19]*City of Miami Gen. Employees' and Sanitation Employees' Ret. Trust v. Comstock*, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016), at *22; the decision is currently under review by the Delaware Supreme Court.

[20]*In re Solera Holdings, Inc. S'holder Litig.*, 2017 WL 57839 (Del. Ch. Jan 5, 2017).

[21]*Comstock,* at *22; *In re Solera*, at *13.

[22]*Singh v. Attenborough (Zale III)*, 137 A.3d 151 (Del. 2016).

[23]*In re Zale Corp. S'holders Litig.*, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015).

[24]*Id.*

[25]*Id.*

[26]*In re Volcano Corp. S'holder Litig.*, 143 A.3d 727, 738 (Del. Ch. 2016).

[27]*In re Volcano Corp. S'holder Litig.*, C.A. No. 10485-VCM (Del. Feb 9, 2017).

[28]*In re Volcano Corp.*, 143 A.3d 727, at *750.

[29]In cases involving defensive actions by a target board of directors, the burden of proof shifts to the defendant to show both (1) that the directors reasonably perceived a threat to the corporation, and (2) that the directors' defensive responses were proportional to that threat. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[30]*Corwin*, at 312.

[31]*Id.*

[32]*Id.*

ACCOUNTING TRUE-UP VS. VALUATION DISPUTE

By Michael P. Conway, Bryan E. Davis, Elizabeth Clough Kitslaar and James A. White

Michael Conway, Elizabeth Clough Kitslaar and James White are partners in the Chicago office of Jones Day. Bryan Davis is a partner in Jones Day's Atlanta office.
Contact: mconway@jonesday.com or bedavis@jonesday.com or ekitslaar@jonesday.com or jawhite@jonesday.com. The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

On December 2, 2016, a Delaware Chancery Court held that the courts had no role in considering a purchase price adjustment dispute based on "plain language of the purchase agreement" that made arbitration by an independent accounting firm the "mandatory path" for resolving disputes over a closing date