

## The More Things Change? Delaware Supreme Court Applies Business Judgment Standard of Review in Going-Private Transaction

By Jaculin Aaron<sup>1</sup>

### *Kahn v. M&F Worldwide Corp.*

On March 14, 2014, the Delaware Supreme Court issued its decision in the widely followed case *Kahn v. M&F Worldwide Corp.* ("*M&F Worldwide*"), providing a blueprint for a controlling stockholder of a Delaware corporation to do a going-private transaction without subjecting the deal to "entire fairness" review by the courts, but instead the less exacting "business judgment" standard. The Supreme Court held that the business judgment standard will "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."<sup>2</sup>

The Supreme Court's ruling affirmed the May 2013 decision of the Delaware Court of Chancery granting summary judgment in *In re MFW Shareholders Litigation*.<sup>3</sup> The Court of Chancery's decision was rendered by then-Chancellor Leo E. Strine, Jr., who became the Chief Justice of the Delaware Supreme Court on February 28, 2014, just two weeks before the Supreme Court affirmed his decision. While Chief Justice Strine did not participate in the decision of the Supreme Court affirming his own decision below, his colleagues on the court adopted and quoted much of his reasoning. Nonetheless, the Supreme Court added observations and commentary indicating a more constrained view of the extent to which a controlling stockholder following the blueprint laid out by the court will be able to limit or cut short the litigation that going-private transactions invariably generate.

### Background of the Transaction

The case arose out of a dispute between the minority stockholders of M&F Worldwide Corporation ("MFW") and its controlling stockholder, MacAndrews & Forbes Holding Inc. ("MacAndrews"). MacAndrews, whose equity is owned by Ronald Perelman, owned 43% of MFW. In June 2011, MacAndrews offered to purchase the outstanding shares of MFW for \$24 per share. From the outset, MacAndrews maintained that it would not consider a going-private transaction unless it was approved by an independent special committee, and a vote of the majority-of-the-minority stockholders was a non-waivable condition to the transaction. In the months immediately following the initial proposal, the Board of Directors formed an independent special committee to negotiate with MacAndrews. The special committee selected its own legal and financial advisors, met several times over the course of three months, and negotiated extensively with MacAndrews. As a result of thorough negotiations, the special committee procured an offer of \$25 per share. Three months later, 65% of the shares unaffiliated with the controlling stockholder voted in favor of the transaction and the transaction was consummated.

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<sup>2</sup> *Kahn v. M&F Worldwide Corp.*, No. 334, 2013, slip op., 2014 WL 99270 (Del. Mar. 14, 2014), <http://courts.delaware.gov/opinions/download.aspx?ID=202790>.

<sup>3</sup> 67 A.3d 496 (Del. Ch. 2013).

## Proceedings and Decision in the Court of Chancery

Plaintiffs brought suit seeking a preliminary injunction in advance of the merger vote to prevent the buyout. They subsequently withdrew their injunction motion, but pursued their claim for damages based on breach of fiduciary duty after the merger closed. Following extensive discovery, the defendants moved for summary judgment, contending that the Court of Chancery should review the deal under the business judgment standard rather than the entire fairness test. Under the business judgment rule, the court does not inquire into the substantive fairness of the merger but instead will dismiss a challenge to the merger unless its terms were so disparate that no rational person acting in good faith could have thought the merger was fair to the minority. By contrast, the entire fairness test, which is “the highest standard of review in corporate law,”<sup>4</sup> requires that the court examine the entire fairness of the transaction to the minority stockholders with respect to both price and fair dealing, which includes “questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”<sup>5</sup>

Then-Chancellor Strine determined that the business judgment rule is the appropriate standard of review for a buyout transaction involving a controlling stockholder if two conditions are met: (i) a “properly empowered” independent special committee of the board of directors negotiates the transaction and, (ii) an “informed, uncoerced” majority-of-the-minority stockholders approve the merger.

The decision acknowledged that it was breaking new ground, observing that “the question has never been put directly to this court or, more important, to our Supreme Court.”<sup>6</sup> Delaware Supreme Court precedent had held that meeting either of these conditions would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff, but statements in the cases “could be, and were, read as suggesting that a controlling stockholder who consented to both procedural protections for the minority” would still be subject to the entire fairness standard.<sup>7</sup> In light of this precedent, controlling stockholders had little incentive to take the business risk of agreeing to both procedural protections, and so “the underlying question has never been squarely presented to our courts, and lawyers, investment bankers, managers, stockholders, and scholars have wondered what would be the effect on the standard of review of using both of these procedural devices.”<sup>8</sup>

## The Decision of the Delaware Supreme Court

Scholars and investment bankers need wonder no more — at least on that narrow question. On appeal of the Court of Chancery’s decision, the Delaware Supreme Court squarely answered the question implicitly raised by its previous decisions:

We hold 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.<sup>9</sup>

The Supreme Court then explained the legal reasoning upon which it based this conclusion.

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<sup>4</sup> *M&F Worldwide*, slip op. at 15, 2014 WL 99270, at \*6.

<sup>5</sup> *Emerald Partners v. Berlin*, 787 A.2d 85, 97 (Del. 2001) (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983)).

<sup>6</sup> 67 A.3d at 500.

<sup>7</sup> *Id.* (discussing *Kahn v. Lynch Commc’n Sys.*, 638 A.2d 1110, 1117 (Del. 1994)).

<sup>8</sup> *Id.* at 501.

<sup>9</sup> *M&F Worldwide*, slip op. at 15, 2014 WL 99270, at \*6.

First, as the Court of Chancery observed, “entire fairness is the highest standard of review in corporate law” and “is applied in the controller merger context as a substitute for the dual statutory protections of disinterested board and stockholder approval, because both protections are potentially undermined by the influence of the controller.” As established by the facts of the case before it, however, “that undermining influence does not exist in every controlled merger setting, regardless of the circumstances.” The simultaneous use of the two procedural protections “create a countervailing, offsetting influence of equal — if not greater — force.” Accordingly, “where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm’s-length mergers, which are reviewed under the business judgment standard.”<sup>10</sup>

Second, “the dual procedural protection merger structure optimally protects the minority stockholders in controller buyouts” because the controlling stockholder will know from the outset that it will not be able to bypass the special committee’s ability to reject the controlling shareholder’s proposal and that it will not be able to “dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move.”<sup>11</sup>

Third, the application of the business judgment rule in these circumstances “is consistent with the central tradition of Delaware law, which defers to the informed decisions of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion.”<sup>12</sup>

Fourth, the dual protection merger structure and the entire fairness standard “converge and are fulfilled at the same critical point: **price**.”<sup>13</sup> The Supreme Court observed that it had consistently held that “although entire fairness review comprises the dual components of fair dealing and fair price, in a non-fraudulent transaction “price may be the preponderant consideration outweighing other features of the merger.”<sup>14</sup>

The part of the Supreme Court’s decision expounding on Delaware corporate law doctrine is logical and accessible and, on its face, encouraging for controlling stockholders and those advising them in going-private transactions. But there can be a large gap between the logic of the legal principles and their not always orderly application in practice. On that score, lawyers, investment bankers, managers and stockholders, and maybe even scholars, will still wonder how the legal doctrine will be applied in practice.

The Court of Chancery’s decision seemed to suggest that the new framework would enable a controlling stockholder to dispose of litigation at the pleading stage, or at least summary judgment — thereby avoiding trial and possibly time-consuming discovery. The Supreme Court’s opinion provides considerably less comfort that litigation might be readily disposed of, even if the controlling stockholder follows the blueprint laid out by the court.

First, the Supreme Court was precise and emphatic in its delineation of the facts that must be established in order to merit business judgment review:

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<sup>10</sup> *Id.* at 16, 2014 WL 99270, at \*6.

<sup>11</sup> *Id.* (citation omitted).

<sup>12</sup> *Id.* at 16-17, 2014 WL 99270, at \*6-7 (citation omitted).

<sup>13</sup> *Id.* at 17, 2014 WL 99270, at \*7 (emphasis in original).

<sup>14</sup> *Id.* at 17, 2014 WL 99270, at \*7 (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983)).

To summarize our holding, in controller buyouts, the business judgment standard of review will be *applied if and only if*: (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 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.<sup>15</sup>

While a controlling stockholder may have a blueprint for a means to obtain a less onerous standard of review for a going-private deal, the Supreme Court's decision thus provides plaintiffs with a how-to manual for attacking the transaction in litigation, both at the pleading stage and on summary judgment.

Second, the Supreme Court emphasized that the decision in the Court of Chancery had been "[b]ased on a highly extensive record" which "undisputedly established *prior to trial*" that there had been approval by an independent and empowered special committee and by an uncoerced informed majority of the minority stockholders.<sup>16</sup> Highly extensive factual records are generally not established quickly or inexpensively, or in a fashion that does not entail considerable risk that the court will ultimately find that the requisite facts have not been "undisputedly established prior to trial."

Third, a footnote in the Supreme Court's decision (footnote 14) indicates that the Delaware courts may be reluctant to grant motions to dismiss complaints challenging a going-private transaction even if it utilizes both procedural protections.<sup>17</sup> Footnote 14 may end up being cited more than the text of the decision itself, by plaintiffs seeking to avoid dismissal of their complaints and by practitioners explaining to their clients the risks involved in making an attempt to secure business judgment review:

The Verified Consolidated Class Action Complaint would have survived a motion to dismiss under this new standard. First, the complaint alleged that Perelman's offer 'value[d] the company at just four times' MFW's profits per share and 'five times 2010 pre-tax cash flow,' and that these ratios were 'well below' those calculated for recent similar transactions. Second, the complaint alleged that the final Merger price was two dollars per share *lower* than the trading price only about two months earlier. Third, the complaint alleged particularized facts indicating that MFW's share price was depressed at the times of Perelman's offer and the Merger announcement due to short-term factors such as MFW's acquisition of other entities and Standard & Poor's downgrading of the United States' creditworthiness. Fourth, the complaint alleged that commentators viewed both Perelman's initial \$24 per share offer and the final \$25 per share Merger price as being surprisingly low. These allegations about the sufficiency of the price call into question the adequacy of the Special Committee's negotiations, thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule.<sup>18</sup>

Footnote 14 does not cite any allegations of the complaint that specifically challenged the care with which the special committee proceeded, or the independence or disinterestedness of the committee. Instead, the allegations cited by the Supreme Court raised issues — that were not particularly compelling — concerning the adequacy of the price. The Supreme Court nonetheless considered these issues sufficient to plead a challenge to the adequacy of the special committee process.

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<sup>15</sup> *Id.* (emphasis in original).

<sup>16</sup> *Id.* at 38-39, 2014 WL 99270, at \*15 (emphasis in original).

<sup>17</sup> *Id.* at 18-19 n.14, 2014 WL 99270, at \*7 n.14.

<sup>18</sup> *Id.* (emphasis in original).

Fourth, the language of the decision indicates that if the factual record prior to trial (that is, on summary judgment) does not establish that the transaction has met all six of the factors listed above, then the case will go to trial and the transaction will be reviewed under the entire fairness standard.<sup>19</sup> That is, even if there is a question of fact concerning any of the six factors, the proponents of the transaction may not have the ability to prove them at trial and thus receive business judgment review, but instead will be relegated to the entire fairness standard.

#### Is It Worth It?

If nothing else, the blueprint established by the Delaware Supreme Court in *M&F Worldwide* for business judgment review of a going-private transaction makes clear that Delaware corporate law does not always and in all circumstances require that such transactions be reviewed by the courts under the stringent entire fairness standard. It appears, however, that the Delaware courts may police very closely a controlling stockholder's attempt to invoke business judgment review by utilizing the dual protections set forth in *M&F Worldwide*, and a controlling stockholder could face substantial expense, time and difficulty in proving its case in court before trial — while retaining the risk that the attempt will be deemed inadequate and the transaction subjected to entire fairness review.

Moreover, there are significant business risks for a controlling stockholder in agreeing to the dual protections required for business judgment review. A majority-of-the-minority vote entails risk, particularly taking into account the altered composition of the minority stockholder body after the transaction is announced. Likewise, an upfront agreement to abide by the decision of the special committee carries with it execution risk, as well as a risk that the controlling stockholder will remain bound for an undefined period to its agreement not to proceed with a transaction in the absence of special committee approval. A controlling shareholder applying a cost/benefit analysis might determine that it would be better off maintaining its optionality in the transaction structure and seeking an early settlement of the litigation — in other words, generally following past practice in such transactions regardless of the *M&F Worldwide* decision.

Despite its restrictions and caveats, the Delaware Supreme Court's decision does provide a controlling stockholder with a means to reduce the scope and impact of the lawsuits a going-private deal will inevitably attract. In each case, however, the controlling stockholder and its advisers will need to consider the particular circumstances of their deal, as well as the precedents from the Delaware courts as they develop, in determining whether to take advantage of the potentially twisting and rocky path to business judgment review provided by *M&F Worldwide*.

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<sup>19</sup> *M&F Worldwide*, slip op. at 19, 2014 WL 99270, at \*7 (“If, after discovery, triable issues of fact remain about whether either or both of the dual procedural protections were established, or if established were effective, the case will proceed to a trial in which the court will conduct an entire fairness review. . . . Stated differently, unless *both* procedural protections for the minority stockholders are established *prior to trial*, the ultimate judicial scrutiny of controller buyouts will continue to be the entire fairness standard of review.”) (emphasis in original).