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Delaware Chancery Court Ruling Provides for Business Judgment Review Where Transactions with Controlling Stockholders Are Conditioned on Special Committee Approval and Vote of a Majority of the Minority Stockholders

Delaware Chancellor Leo E. Strine, Jr. recently sent a message to large stockholders and corporate boards, offering them hope of a more tolerant standard of judicial review for certain transactions with controlling stockholders that are conditioned upon both approval by a functioning special committee of independent directors and the vote of a majority of minority stockholders.

The Chancellor's decision in *In re MFW Shareholders Litigation*, C.A. No. 6566-CC (Del. Ch. May 29, 2013) was a first. While Strine himself in an earlier case had expressed support for the standard finally applied in *MFW*, as his decision acknowledged, language in Delaware Supreme Court decisions could be read as supporting the belief that the more demanding "entire fairness" standard, rather than the more generous business judgment rule, would apply in *any* merger with a controlling stockholder.

In *MFW*, however, Strine noted that those decisions did not present the particular fact pattern raised by the transaction before him. There were two critical conditions met in *MFW*: from the time of the controlling stockholder's first overture, the transaction was subject to "(i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors."

Where both conditions are met, minority stockholders are sufficiently protected to permit application of the business judgment rule, Strine reasoned.

The Chancellor made clear that this rule is designed to reward controlling stockholders for employing an approach that maximizes protections for minority stockholders. The decision "will provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide the best protection…"

The benefit held out to corporate directors -- business judgment review -- is clear: if a transaction is subject to the business judgment standard, it will be harder for plaintiffs to get cases to trial, or even past a motion to dismiss, meaning a loss of settlement negotiation leverage for plaintiffs.

The Prior Understanding and Law

Controlling stockholder transactions have typically employed either a special committee of independent directors or a vote of a majority of the minority, but not both. This practice arose following the Delaware Supreme Court's decision in *Kahn v. Lynch Commc'n Sys.*, 638 A.2d 110, 117 (Del. 1994). There, the court held that if a transaction was either approved by a special committee or a majority of the minority stockholders, the burden of proof on the entire fairness standard would shift from the defendant to the plaintiff. But the standard of review would remain entire fairness, not business judgment.

Thus, many M&A lawyers understood that in a transaction with a controlling stockholder, the relevant standard was entire fairness, and defendants would have the burden of persuasion on fairness, but if the special committee or majority-of-the-minority condition was met, the burden of persuasion could shift to the plaintiff. Often this meant that only the special committee element was employed. As the Chancellor wrote, "Without any clear benefit to controllers for the clear costs of agreeing upfront to a majority-of-the minority condition…those conditions are now much less common than special committees, and when used are often done as part of a late stage deal-closing exercise in lieu of price moves."

Although there had been no decision holding that the defendants could be subject to business judgment review if both conditions were met, then-Vice Chancellor Strine had expressed the view that this should be the standard. He did so in what he described as a "coda" to his opinion approving an award of attorneys' fees for plaintiffs' counsel in a stockholder litigation settlement in *In re Cox Communications, Inc. Stockholder Litigation*, 879 A.2d 604 (Del. Ch. 2005). Vice Chancellor J. Travis Laster took a similar approach in *CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010), a case involving a merger by first-step tender offer to be followed by a second-step short-form merger.

The MFW Transaction Structure and the Court's Decision

In *MFW*, the parties structured their transaction in a manner consistent with the approach described in those decisions. MacAndrews & Forbes Holdings Inc. (owned by Ron Perelman) owned 43% of M&F Worldwide, and proposed to acquire the remaining shares from the non-controlling stockholders (referred to as the minority stockholders because they are separate from the controlling stockholder, although not actually a numerical minority). When it made its initial bid, MacAndrews stated that its proposal was subject to approval by both a majority of the minority and by a special committee.

In the litigation that followed challenging the fairness of the transaction, defendants moved for summary judgment, contending that business judgment should apply because both conditions were met. Chancellor Strine's analysis focused first on whether the "cleansing devices" were sufficient to qualify under Delaware law. He concluded that they did because there was no material dispute as to (i) the independence of the special committee, (ii) its ability to engage financial advisors and counsel and its having done so, and (iii) its "empowerment to negotiate the merger and definitively to say no to the transaction."

Elaborating on the meaning of ability to say no, the Chancellor stated that because MacAndrews & Forbes promised not to proceed with a buyout not supported by the special committee, the committee "did not have to fear that if it bargained too hard," the controller would make a tender offer directly to the minority stockholders. Thus, the committee could say no, "and make that decision stick."

As to the vote, "the plaintiffs admit that it was a fully informed vote, as they fail to point to any failure of disclosure."

Having found that these critical conditions were met, Chancellor Strine applied the business judgment rule. Under that rule, the complaint fails "unless no rational person could have believed that the merger was favorable to MFW's minority stockholders" – a standard the plaintiffs could not meet. He granted the defendants summary judgment.

Key Points for Consideration

Given the Chancellor's decision, stockholders and boards of companies faced with potential transactions with controlling stockholders should give serious consideration to employing both a special committee and a majority-of-the-minority vote. Other key points:

- The *MFW* decision is likely to be appealed to the Delaware Supreme Court, which will have the final word on the issue.
- Under *MFW*, courts will not simply accept at face value the professed adoption of the cleansing devices, but will scrutinize them and ask questions: Did the committee employ counsel and financial advisors? Did it negotiate with the controller? Did it truly have the ability to say no? Were there misleading disclosures in the proxy materials issued for the stockholder vote?
- Although *MFW* was decided on summary judgment, it may well enable future defendants to prevail at the motion-to-dismiss stage, since plaintiffs will have the burden of pleading facts supporting a rational conclusion that the key conditions did not apply (for example, the committee was not independent, or lacked the power to say no to the controller).
- The decision moves the law further in the direction of applying a uniform standard to judicial review of controlling stockholder freeze-out transactions effected either in the form of a negotiated single merger or a two-step tender offer and merger, as endorsed in both the *Cox* and *CNX* decisions.

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