

Delaware Court of Chancery Applies Business Judgment Rule to a Going-Private Merger

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Thomas J. Allingham II
Wilmington
302.651.3070
thomas.allingham@skadden.com

Franklin M. Gittes
New York
212.735.3780
franklin.gittes@skadden.com

Alan C. Myers
New York
212.735.3780
alan.myers@skadden.com

Joseph O. Larkin
Wilmington
302.651.3124
joseph.larkin@skadden.com

Christopher M. Foulds
Wilmington
302.651.3162
christopher.foulds@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

In a decision with important implications for structuring going-private transactions, Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery this week applied the business judgment rule — not the more rigorous entire fairness standard — to a going-private merger involving a controlled company and its controlling stockholder. The controlling stockholder conditioned its proposal on (i) approval by a special committee of independent directors and (ii) a nonwaivable, informed majority-of-the-minority stockholder vote.

The opinion issued in litigation arising from the 2011 going-private merger in which MacAndrews & Forbes Holdings acquired the 57 percent of M & F Worldwide (MFW) stock that it did not own. This decision is the first to apply the business judgment rule to a controlling stockholder merger. As the Court noted, prior cases had been read to require the application of the entire fairness standard of review to controller transactions, which made it effectively impossible to dismiss stockholder challenges before trial. The Court found that the dual, nonwaivable protections replicated the protections afforded stockholders in a third-party transaction, justifying application of the business judgment standard.

For a copy of the opinion, click [here](#).

Background

On June 13, 2011, MacAndrews & Forbes proposed to acquire the 57 percent of MFW shares it did not already own for \$24 per share in cash. The offer was expressly conditioned on approval by a special committee of MFW's independent directors and by a majority of the stockholders unaffiliated with MacAndrews & Forbes.

MFW formed a special committee. The special committee engaged independent legal and financial advisors. The special committee ultimately negotiated a \$1 increase to \$25 per share, a 47 percent premium to MFW's share price before the proposal was announced. More than 65 percent of unaffiliated MFW shares were voted in favor of the merger.

Stockholder class action lawsuits were filed in Delaware and New York. After the class was preliminarily certified in Delaware, the New York actions were dismissed. Following a flurry of discovery, plaintiffs withdrew their injunction application to concentrate on a post-closing claim for monetary damages. After the merger closed in December 2011, MacAndrews & Forbes and the other defendants moved for summary judgment on the post-closing damages claims, arguing that the dual protections of special committee approval and a majority-of-the-minority vote neutralized the controller's alleged influence over the process and price, and justified application of the business judgment rule. The plaintiffs insisted that the controller's presence on both sides of the transaction required entire fairness review, regardless of procedural protections, and that controlling precedent permitted only a shift in the burden of proof.

The Opinion

The Court noted at the outset of its 67-page opinion that the “case presents a novel question of law”: “The question of what standard of review should apply to a going

private merger conditioned upfront by the controlling stockholder on approval by *both* a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote has been a subject of debate for decades now.”

To answer that question, the Court first addressed whether the special committee and the majority-of-the-minority vote qualified as “cleansing devices” under Delaware law. The Court then considered whether or not the Delaware Supreme Court had already ruled on that question. After a thorough analysis of the underlying factual record, and the conceptual underpinnings of the business judgment rule and entire fairness standard, the Court concluded that “when a controlling stockholder merger has, from the time of the controller’s first overture, been 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, the business judgment rule standard of review applies.”

From a transactional planning perspective, the proper implementation of these procedural protections is critical. As the Court stated, “a transactional structure with both these protections is fundamentally different from one with only one protection. A special committee alone ensures only that there is a bargaining agent who can negotiate price and address the collective action problem facing stockholders, but it does not provide stockholders any chance to protect themselves. A majority-of-the-minority vote provides stockholders a chance to vote on a merger proposed by a controller-dominated board, but with no chance to have an independent bargaining agent work on their behalf to negotiate the merger price, and determine whether it is a favorable one that the bargaining agent commends to the minority stockholders for acceptance at a vote. These protections are therefore incomplete and not substitutes, but are complementary and effective in tandem.”

From a deal litigation perspective, the Court added, “by also providing transactional planners with a basis to structure transactions from the beginning in a manner that, if properly implemented, qualifies for the business judgment rule, the benefit-to-cost ratio of litigation challenging controlling stockholders for investors in Delaware corporations will improve, as suits will not have settlement value simply because there is no feasible way for defendants to get them dismissed on the pleadings.”

Dual Procedural Protections

Independent, Fully-Functioning Special Committee

With respect to the special committee, the Court reaffirmed that under Delaware law directors are presumed to be independent. Thus, to show that a director was not independent, plaintiffs must meet a “materiality standard, under which the court must conclude that the director in question’s material ties to the person whose proposal or actions she is evaluating are sufficiently substantial that she cannot objectively fulfill her fiduciary duties.” The Chancellor found that the plaintiffs failed to raise a triable issue that any of the special committee members were self-interested or lacked independence.

The Court also found that the special committee satisfied its duty of care. The special committee (i) hired its own qualified legal and financial advisors; (ii) was empowered to “say no definitively” to MacAndrews & Forbes and could “make that decision stick”; (iii) negotiated the terms of MacAndrews & Forbes’s offer; and (iv) studied “a full range of financial information to inform itself.” Moreover, the Court held that, even though the special committee “did not have the practical authority to market MFW to other buyers,” the special committee had a reliable body of evidence concerning various strategic options available to the company.

Informed and Uncoerced Majority-of-the-Minority Approval

As for the second procedural protection, the Court found that an informed and uncoerced majority of the minority voted to approve the merger. The Court reaffirmed settled authority that the uncoerced, fully informed vote of disinterested stockholders is entitled to substantial weight under Delaware law: “Stockholders, especially institutional investors who dominate market holdings, regularly vote against management on many issues.” “Thus,” the Court continued, “when such stockholders are given a free opportunity to vote no on a merger negotiated by a special committee, and a majority of them choose to support the merger, it promises more cost than benefit to investors generally in terms of the impact on the overall cost of capital to have a standard of review other than the business judgment rule.”

Importantly, the Court held that these two procedural protections were incomplete when used separately, but were complementary and effective when used in tandem.

Issue Not Previously Addressed by Delaware Supreme Court

The Court rejected the plaintiffs’ argument that the Delaware Supreme Court had already answered the question presented in their favor, and instead agreed with the defendants’ argument that the standard of review for controlling stockholder going-private transactions had never been addressed in a case where both procedural protections were deployed effectively. The Court examined prior Delaware Supreme Court cases beginning with *Kahn v. Lynch*, and found that none of these decisions involved the dual procedural protections described above. As the Court noted, “[i]n this case, MacAndrews & Forbes made two promises that were not made in *Lynch*. MacAndrews & Forbes said it would not proceed with any transaction unless the special committee approved it, and that it would subject any merger to a majority-of-the-minority vote condition.”

Although the Court acknowledged broad statements in Delaware Supreme Court decisions suggesting that entire fairness applies to any merger with a controlling stockholder, the Chancellor noted that none of those cases involved deployment of the dual procedural protections present here, and held that “if an issue is not presented to a court with the benefit of full argument and record, any statement on that issue by that court is not a holding with binding force.”

Conclusion

The Court held that the business judgment rule is properly invoked in controlling stockholder going private transactions 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 advisers and to say no definitively; (iv) the special committee meets its duty of care; and (v) the approval of the minority is informed and uncoerced. The Court concluded that the rule that best protects minority investors is one that encourages controlling stockholders to accord the minority the protections of both procedural protections, and found that that application of business judgment rule review would accomplish that result.

If upheld on any appeal, the decision is a powerful clarifying step in the development of Delaware law on controlling stockholder going-private transactions.