Delaware Supreme Court Enhances Protections for Controlling Stockholder Buyouts

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The Delaware Supreme Court's affirmance in *Swomley* should encourage transaction planners to follow the *MFW* requirements in structuring buyouts by controlling stockholders, recognizing that litigation challenging such transactions can be resolved on a motion to dismiss if the *MFW* pathway is followed. In doing so, however, there should be no ambiguity with respect to whether the initial proposal is conditioned on a majority-of-the-minority vote to avoid raising any unnecessary confusion on that point at the pleading stage.

In November 2015, the Delaware Supreme Court bolstered the protection afforded to majority or controlling stockholders seeking to buy out the minority, provided that the transaction is structured in accordance with the requirements it had earlier set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*). In a summary order, the court affirmed Vice Chancellor J. Travis Laster's transcript ruling in *Swomley v. Schlecht*, C.A. No. 9355-VCL (Del. Ch. Aug. 27, 2014) (TRANSCRIPT), which held that it is appropriate to determine at the pleading stage whether a controlling stockholder transaction complies with *MFW*'s requirements and is, therefore, within the protective ambit of the business judgment rule. *Swomley v. Schlecht*, No. 180, 2015 (Del. Nov. 19, 2015) (ORDER).

The court's affirmance is significant because it resolves the issue raised by *MFW*'s Footnote 14 — which noted that the pleading in that action would have survived a motion to dismiss — that led at least some commentators to believe that whether a transaction complied with *MFW*'s structural requirements could only be decided on a motion for summary judgment or after a full trial on the merits. The *Swomley* affirmance confirms that the benefit of disposing with litigation challenging the transaction at the pleading stage is available to a controlling stockholder who chooses to comply with *MFW* by providing minority stockholders with the protections afforded by the combination of an independent special committee and a "majority-of-the-minority" vote.

The '*MFW* Standard' for Reviewing Controlling Stockholder Transactions

Although it had been nibbling at the question since 2005's *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005), in its 2013 opinion in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013), *aff'd*, *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), the Delaware Court of Chancery squarely addressed the issue 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.

In that opinion, then-Chancellor Leo E. Strine, Jr. concluded that the business judgment rule would apply to controlling stockholder transactions if the following six conditions were satisfied: "(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; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." *In re MFW*, 67 A.3d at 535.

As explained by Chancellor Strine, such a rule would "provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection." *In re MFW*, 67 A.3d at 502-03. The court reasoned that those two protections in tandem are more valuable to stockholders than the more abstract benefits derived from a higher standard of review, because there is a "strong incentive [ ] created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests …" and which "replicates the arm's-length merger steps of the DGCL by 'requir[ing] two independent approvals.'" *Id.* at 528 (quoting *Cox Commc'ns*, 879 A.2d at 618).

Moreover, for transactional planners, the rule provides "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." *In re MFW*, 67 A.3d at 504.

On appeal, the Delaware Supreme Court affirmed Chancellor Strine's decision and approved the new standard. However, it modified the duty-of-care condition to require that the special committee meet its duty "in negotiating a fair price," signaling that perhaps a more fact-intensive inquiry would be required to apply the business judgment standard to a controlling stockholder transaction. *MFW*, 88 A.3d at 645. That modification, and the much discussed Footnote 14 of the court's opinion, led some commentators to suggest that the court intended for the *MFW* standard to be applied only after discovery. *Id.* at 645 n.14.

A subsequent Court of Chancery decision in *ACP Master Ltd. v. Sprint Corp.*, lent further support to this theory when Vice Chancellor Laster indicated that Sprint had put forth the "strongest possible" case that it met *MFW*'s requirements by conditioning its transaction *ab initio* on special committee approval and a majority-of-the-minority vote, yet still denied Sprint's motion to dismiss. C.A. No. 8508-VCL, trans. at 101 (Del. Ch. June 18, 2014). In denying Sprint's motion, the court determined that, per the pleadings and making all inferences in the plaintiff's favor, the majority-of-the-minority vote (which passed by a large margin) was a "mixed bag" that could have been coerced, thus negating the objectives of *MFW*. *Id.* at 102-04. Specifically, among other things, the plaintiff alleged or the court inferred that the transaction at issue did not offer a large premium because the preannouncement value of the transferred assets was depressed; that certain investors' incentives were misaligned prior to the vote; and that the majority tainted the vote by threatening "significant dilution to the minority stockholders if they rejected the merger." *Id.* at 103-04. Nonetheless, the court noted that the parties could revisit the *MFW* analysis on summary judgment, and that if the facts indicated that no coercion existed with regard to the vote, *MFW* would apply. *Id.* at 109.

Swomley Clarifies MFW Standard as Applied at the Pleading Stage

In upholding *Swomley*, the Delaware Supreme Court resolved the issue as to whether a lower court could evaluate the *MFW* six-factor test at the pleading stage. *Swomley* involved a challenge to a merger by which SynQor, Inc. was acquired by a management group that owned approximately 46 percent of the company. Following the road map set forth in *MFW*, the merger was conditioned on (i) the approval of an independent and fully empowered special committee and (ii) a majority vote of the unaffiliated stockholders who owned 54 percent of the company prior to the merger. The special committee recommended in favor of the transaction, which was then approved by 61 percent of the unaffiliated stockholders.

In dismissing the plaintiffs' complaint after the transaction closed, Vice Chancellor Laster held that the *MFW* standard could be applied at the pleadings stage. The court cited the decade-old *In re Cox Communications* decision, stating that "*the whole point* of encouraging this structure was to create a situation where defendants ... could obtain a *pleading-stage dismissal* against breach of fiduciary duty claims." *Swomley*, C.A. No. 9355-VCL, trans. at 66 (emphasis added). The court went on to point out that the *MFW* standard "was born with the goal of establishing a technique, a practice, a structure, where, at the pleading stage, defendants could show that they were not subject to a breach of fiduciary duty challenge." *Id.* at 67 (emphasis added).

In applying *MFW*'s six-factor test at the pleading stage, Vice Chancellor Laster stated that the court's role is "to consider whether the plaintiffs have pled facts sufficient to call into question the existence of [the six elements of the MFW test], at least when those elements have been described in a public way suitable for judicial notice, such as board resolutions and a proxy statement ..." *Swomley*, C.A. No. 9355-VCL, trans. at 69-70. While noting there was some ambiguity as to whether the offer was conditioned at the outset on a nonwaivable "majority-of-the-minority" vote, the court was satisfied that, to the extent there was any ambiguity, it was resolved at the board meeting where the transaction was first raised, before any negotiations took place. *Id.* at 70-71. The court found no issue regarding any of the

remaining *MFW* elements, noting that it was not enough for plaintiffs to claim unfair price as a means of showing that the committee did not satisfy its duty of care. *Id.* at 71-73. Rather, the plaintiffs had to allege facts showing gross negligence, a showing "that really requires recklessness ... a very tough standard to satisfy." *Id.* at 73.

Noting the increase in price negotiated by the special committee, as well as other improvements to the proposed transaction, the court found that the plaintiffs' allegations attacking the methodology underlying the fairness opinion were insufficient to state a claim that the committee failed to meet its duty of care in negotiating a fair price. *Swomley*, C.A. No. 9355-VCL, trans. at 73-74. The court also rejected plaintiffs' allegations that the vote was coercive because the alternative to the merger was the maintenance of an unattractive status quo as opposed to pursuing other potential options, noting that "the question for coercion is whether you can return to the status quo," not whether there might be some more favorable alternative. *Id.* at 76. Finally, the court answered in the negative its own question as to whether SynQor's status as a private company meant that the *MFW* factors did not apply, pointing out that "[h]istorically, we haven't made any distinctions between public companies and private companies." *Id.* at 66.