

# Court of Chancery Confirms *MFW* Applies to Controlled-Company Sale With Disparate Consideration

Contributors

**Paul J. Lockwood**, Partner

**Arthur R. Bookout**, Associate

**Matthew P. Majarian**, Associate

In 2014, the Delaware Supreme Court affirmed in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (*MFW II*), that the business judgment rule would apply to controlling stockholder “squeeze-out” mergers if the transaction is conditioned *ab initio* on the approval of both an empowered, independent special committee and a fully informed, uncoerced majority-of-the-minority vote. The decision, however, did not address whether the *MFW II* standard would operate to allow the business judgment rule to apply to the sale of a controlled company to an unaffiliated third party where the controller received disparate consideration or other “side deals.”

The Delaware Court of Chancery recently addressed this open issue in *In re Martha Stewart Living Omnimedia, Inc. Shareholder Litigation*, C.A. No. 11202-VCS (Del. Ch. Aug. 18, 2017). In that case, the court confirmed, in an alternative holding,<sup>1</sup> that the business judgment standard of review can apply at the pleadings stage to a litigation challenging a controlled-company sale to a third party if the transaction is subject to the protections proscribed in *MFW II*, even when the controller received disparate consideration for its shares.<sup>2</sup> The Court of Chancery analogized the “disparate consideration scenario” to a squeeze-out transaction, stating: “[t]he conflicts inherent in the disparate consideration scenario are no more or less present or worrisome than in the scenario where the controller stands on both sides of the transaction.”<sup>3</sup> Thus, it continued, “[t]he need to incentivize fiduciaries to act in the best interests of minority stockholders ... is equally important in one-sided and two-sided conflicted controller transactions,” and “[i]n both instances, the key is to ensure that all involved in the transaction, on both sides, appreciate from the outset that the terms of the deal will be negotiated and approved by a special committee free of the controller’s influence and that a majority of the minority stockholders will have the final say on whether the deal will go forward.”<sup>4</sup> However, the court cautioned that “strict compliance with the transactional road map laid out in [*MFW II*] is required for the controlling stockholder to earn pleadings-stage business judgment deference when it is well-pled that the controller, as seller, engaged in a conflicted transaction by wrongfully diverting to herself merger consideration that otherwise would have been paid to all stockholders.”<sup>5</sup>

The Court of Chancery highlighted one important distinction to the *MFW II* opinion — timing. It stated that the threshold date for implementing *MFW II*’s procedural protections derives from “the point where the controlling stockholder actually sits down with an acquirer to negotiate for additional consideration.”<sup>6</sup> In *MFW II*, which involved a controlling stockholder squeeze-out merger, the Delaware Supreme Court required the merger to be “conditioned *ab initio*” on the required structural protections.<sup>7</sup> In contrast, the *Martha Stewart* court

<sup>1</sup> In addition to applying *MFW II*, the Court of Chancery held that the controller’s alleged “side deals” did not siphon consideration from the minority stockholders; therefore, the controller did not “stand on both sides” of the transaction, and the transaction was not subject to entire fairness review on that basis. *Martha Stewart Living Omnimedia*, Slip op. at 31, 36-38.

<sup>2</sup> Slip op. at 50.

<sup>3</sup> *Id.* at 48.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 52.

<sup>7</sup> *MFW II*, 88 A.3d at 644.

held that, in controlled-company sales to third parties, the protections need not be in place until “the moment the controller and third party begin to negotiate the controller’s side deals.”<sup>8</sup>

In its opinion, the Court of Chancery acknowledged two pre-*MFW II* cases that arguably foreshadowed this decision.<sup>9</sup> In the first, *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, the court, while finding the requirements not met, held that the business judgment standard of review may apply to a controlled-company sale to a third party that was (1) recommended by a disinterested and independent special committee, and (2) approved by a majority in a nonwaivable vote of all minority shares.<sup>10</sup> The second, *Southeastern Pennsylvania Transportation Authority v. Volgenau*, applied the business judgment standard and granted summary judgment to all defendants in litigation challenging a controlled-company sale to a third party where the controller received disparate consideration because the transaction was

subject to the “robust procedural protections” identified in *John Q. Hammons*.<sup>11</sup> However, the *Martha Stewart Living Omnimedia* opinion noted that these pre-*MFW II* cases did not address when the protections needed to be in place and whether the business judgment standard of review could be conferred at the pleadings stage.<sup>12</sup>

Continuing the themes articulated by the Delaware Supreme Court in *MFW II* and *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), *Martha Stewart Living Omnimedia* extends the body of recent Delaware case law deferring to the decisions made by independent directors and informed stockholders, and incentivizing controlling stockholders and directors to insist on procedural protections that allow the parties to mimic arm’s-length bargaining. The decision also provides a road map for transactional attorneys seeking to comply with *MFW II*’s requirements outside of the traditional squeeze-out setting.

---

<sup>8</sup> *Id.* at 52-53.

<sup>9</sup> *Id.* at 45-46.

<sup>10</sup> C.A. No. 758-CC, slip op. at 3, 29 (Del. Ch. Oct. 2, 2009).

---

<sup>11</sup> C.A. No. 6354-VCN, slip op. at 2 (Del. Ch. Aug. 5, 2013), *aff’d*, 91 A.3d 562 (Del. 2014) (TABLE).

<sup>12</sup> *Martha Stewart Living Omnimedia*, slip op. at 46-47.