Client Alert

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Kahn v. MF Worldwide Corp.

The Delaware Supreme Court Affirms *In re MFW* Holding That a Going-Private Transaction May Gain the Benefit of Business Judgment Review

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On March 14, 2014, the Delaware Supreme Court decided *Kahn v. MF Worldwide Corp*.[2] and unanimously affirmed the Chancery Court's ruling in *In re MFW*.[3] As we discussed previously, in *In re MFW*, then-Chancellor (now Chief Justice) Strine[4] ruled that a going-private transaction with a controlling shareholder — typically subject to searching "entire fairness" review by the courts — may gain the benefit of the deferential business judgment rule if, at the outset of negotiations, the controller conditions any transaction on approval from both (1) an independent special committee of the board and (2) a majority of unaffiliated shareholders (a "majority-of-the-minority vote"). The rationale for the rulings is that, under those circumstances, the controller voluntarily relinquishes control over the transaction and it becomes akin to an arm's-length, third-party merger.

In *MF Worldwide*, the Supreme Court affirmed, but made clear that the courts must closely review controlling-party transactions to ensure that the requirements for business judgment review are met, including a truly independent special committee, empowered to negotiate (and ultimately to decline to consummate) a transaction and a fully informed and un-coerced minority shareholder vote. Thus, while *MF Worldwide* provides a predictable roadmap for a controlling shareholder to minimize the burden of litigating challenges to going-private transactions, a controller seeking the benefits of the business judgment rule must, in addition to undertaking the commitments required by *MF Worldwide,* take steps to establish a record demonstrating that the conditions for business judgment review under *MF Worldwide* are met and that the transaction replicates an arm's-length deal.

BACKGROUND

Prior Law. Under the business judgment rule, courts typically will not inquire into the substantive fairness or reasonableness of board action.[5] As a result, challenges to transactions considered under the business judgment rule will be dismissed on the pleadings unless a plaintiff can plead facts showing that no rational person in good faith could have thought that the transaction was fair.[6]

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[2] *Kahn v. M&F Worldwide Corp.*, No. 334, 2013, 2014 WL 996270 (Del. Mar. 14, 2014). Morrison & Foerster played no role in the litigation.

[3] *In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013).

[4] Chief Justice Strine recused himself from the Court's consideration of *Kahn v. M&F Worldwide*.

[5] *See Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys the presumption of sound business judgment, and its decision will not be disturbed if they can be attributed to any rational business purpose").

[6] *Stroud v. Grace*, 606 A.2d 75, 90 (Del. 1992); *see also Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) ("It is often of critical importance whether a particular decision is one to which the business judgment rule applies or the entire fairness rule applies."); Lyman Johnson, After

Under the Chancery Court's 1994 decision in *Kahn v. Lynch Commc'ns Syst.*, however, courts will assess the "entire fairness" of controlling-shareholder transactions by assessing whether the controller dealt fairly with the board and the transaction was completed at a fair price.[7] Practically speaking, in contrast to business judgment review, entire fairness review "normally will preclude dismissal of a complaint" on a motion to dismiss.[8] As a result, controlling-shareholder transactions have been particularly vulnerable to costly and burdensome litigation. As then-Vice-Chancellor Strine wrote in *In re Cox Communications*, "[u]nlike any other transaction one can imagine . . . it was impossible after *Lynch* to structure a merger with a controlling shareholder in a way that permitted the defendants to obtain a dismissal of the case on the pleadings."[9]

Chancery Court Decision. In *In re MFW*, the Chancery Court attempted to address this problem by providing a roadmap for a controlling shareholder to structure a transaction to gain the benefit of the business judgment rule. The decision considered a challenge to a transaction in which MacAndrews & Forbes purchased the 57% that it did not already own of M&F Worldwide ("MFW"). From the outset, MacAndrews conditioned the transaction on approval by both an independent special committee of MFW's board and a majority-of-the-minority vote. Shareholder plaintiffs sued, but dropped their request to enjoin the transaction and, after the special committee and a majority-of-the-minority approved the deal and the deal closed, sought damages.

The Chancery Court granted summary judgment in favor of MFW and MacAndrews. Most notably, the Chancery Court ruled that the transaction should be considered under the business judgment rule because conditioning a transaction on both approval by an independent special committee and a majority-of-the-minority vote both ensures "that there is a bargaining agent who can negotiate price and address the collective action problem facing shareholders" and "provides stockholders a chance to vote on a merger proposed by a controller-dominated board."[10]

The Chancery Court was clearly concerned about the litigation costs associated with entire fairness review. It reasoned that "by . . . 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."[11] And, the Chancery Court reasoned that minority shareholders would benefit because the decision provided a "strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection."[12]

THE SUPREME COURT'S DECISION

In *Kahn v. MF Worldwide Corp.*, the Delaware Supreme Court affirmed the decision in *In re MFW*, including the Chancery Court's application of the business judgment rule. The Court held that a controlling-shareholder transaction will be judged under the business judgment rule "*if and only if [:]*

Enron: Remembering Loyalty Discourse in Corporate Law, 28 Del. J. of Corp. L. 67-68 (2003) ("burdens and standards of review often are outcome determinative").

[7] *Kahn v. Lynch Commc'ns Syst.*, 638 A.2d 1110, 1117 (Del. Ch. 1994).

[8] *Id.*

[9] In re Cox Communications Inc. S'holder Litig., 879 A.2d 604 (Del. Ch. 2005).

[10] *In re MFW,* 67 A.3d at 503.

[11] *Id.* at 504.

[12] *Id.* at 503.

(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."[13]

The Court noted, however, that "[i]f a plaintiff . . . can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist, that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery."[14] As a result, before ultimately determining that the business judgment rule applied, the Court conducted a detailed review of the record to determine whether each of the required conditions existed, including whether the Special Committee exercised real bargaining power and whether the majority-of-the-minority vote was fully informed and not coerced.

Both the Chancery Court and the Supreme Court emphasized the fact that majority-of-the-minority approval was non-waivable and that MacAndrews & Forbes agreed at the outset not to proceed with a tender offer in the event that the minority shareholders rejected a transaction.[15]

In addition, while the Court determined that the record in *In re MFW* supported application of the business judgment rule, it also made clear that, in other cases under the new standard, "[i]f, 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."[16]

DISCUSSION

M&F Worldwide is an important decision for dealmakers and their professional advisors because it offers a path to business judgment review of controlling-shareholder transactions. But its importance should not be overstated.

While then-Chancellor Strine hoped to provide a predictable basis for frivolous challenges to controlling-shareholder transactions to be dismissed on the pleadings, the Supreme Court left room for plaintiffs to proceed to discovery by alleging "reasonably conceivable" facts showing that that the Special Committee did not negotiate a fair price. Because the Supreme Court opened the door for plaintiffs to plead facts showing that the business judgment rule should not apply, it remains to be seen whether the decision will ultimately permit more cases to be dismissed on the pleadings. Indeed, the Court noted that the plaintiff in this case had made allegations regarding the "adequacy of the Special Committee's negotiations" sufficient to survive a motion to dismiss by noting, among other things, that some implied pricing multiples were "well below" those of other similar deals, that the deal price was lower than the company's trading price two months prior and that the company's share price at the time of the offer in any event

[13] *M&F Worldwide*, 2014 WL 996270, at *7 (emphasis in original) (formatting added).

[14] *Id*.

[15] *Id.* at *5 (noting that agreement to a non-waivable majority-of the-minority vote was "the vital distinction" between *M&F Worldwide* and other cases where the business judgment rule did not apply); *see also In re MFW*, 67 A.3d at 503 ("Not only that, a controller's promise that it will not proceed unless the special committee assents ensures that the committee will not be bypassed by the controller through the intrinsically more coercive setting of a tender offer.").

[16] *Id.* at *7.

was depressed due to "short-term" factors.[17] The Court also undertook a detailed review as to whether the Special Committee had demonstrated the care required by the new standard, and concluded that it had, noting that the Special Committee had, among other things, obtained updated information about the company's businesses and had explored other strategic alternatives for the company that might generate more value for minority stockholders, despite MacAndrew's unwillingness to sell its shares.

Even if plaintiffs survive motions to dismiss under the new standard, however, if the business judgment rule is applied, plaintiffs will face significant hurdles to prevail on the merits. Moreover, even if challenges proceed to discovery, the contested ground may be significantly narrowed to whether the special committee met its duties and the minority shareholders were properly informed. Under those circumstances, it may be possible for defendants to develop a factual record establishing that the business judgment rule applies and make an early summary judgment motion, precluding broader litigation of the transaction's entire fairness.

In short, *M&F Worldwide*'s ultimate impact will depend on how it is interpreted and applied in the Chancery Court.

CONCLUSION

Going forward, controlling shareholders initiating going-private transactions face a business decision whether to give up control at the outset of the transaction by irrevocably transferring veto power over any deal to minority shareholders (increasingly including event-driven holders who enter the stock after the initial announcement) in return for the still uncertain, but potentially meaningful, benefits of business judgment review under the Supreme Court's new standard in *MF Worldwide*. Controllers who decide to structure their transactions to gain business judgment review must carefully establish a record demonstrating both a truly independent and effective special committee process and complete and accurate disclosures to minority shareholders.

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[17] *Id* at *8, n. 14.